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DO WE NEED BIGGER ISLAMIC BANKS? AN ASSESSMENT OF BANK STABILITY

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HIGHLIGHTS

- Investigate the size – stability relations for a panel sample of Islamic banks
- Document evidence that Islamic banks need to be larger for scale economies to be realized
- Regulation particularly capital stringency is important in firming the positive size – stability relation of larger Islamic banks
- Private monitoring and supervisory power may not be effective for large Islamic banks.

ABSTRACT

In this paper, we evaluate from the stability point of view whether Islamic banks should stay small or should be bigger. More specifically, in relating bank stability to bank size, we examine potential non-linear effects of size on bank soundness and the roles regulation plays in strengthening or weakening the size – stability relations using a panel sample of 45 Islamic banks from 13 countries. Our results suggest that larger Islamic banks are more stable, at least when they surpass a certain threshold size. As regards regulation, activity restrictions and capital stringency play the role in strengthening the stability – size relations. By contrast, the positive stability – size relation is weakened with more private monitoring and supervisory power. Hence, our results point to the benefits of having bigger Islamic banks. They also suggest that, to further enhance the stability implications of larger Islamic banks, policymakers should focus on improving regulation in the forms of activity restrictions and capital stringency.