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Political systems and the financial soundness of Islamic banks☆

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ABSTRACT

We investigate whether and how political systems affect the financial soundness of conventional and Islamic banks. Using factors extracted from principal component analysis, we find that Islamic banks underperform their conventional counterparts in more democratic political systems but outperform them in hybrid and *Sharia'a*-based legal systems. The findings reflect the challenges Islamic banks face in Western countries in terms of perception, financial infrastructure, and regulatory constraints while mirroring the recognition of their specificities and their cultural and religious compliance with *Sharia'a* law in Muslim countries. The findings are robust to a battery of alternative estimation techniques and methods of correcting standard errors.

1. Introduction

More than five years after the beginning of the Arab Spring in 2010 (Ghosh, 2016), many Arab countries are still facing serious social and political tensions (as well as financial and economic instability), despite democratic elections that have led to new political regimes. Besides the Arab Spring, other episodes of political change have marked recent history, e.g., the transition from autocratic and communist regimes to democratic regimes in Europe and Latin America in the 1970s, 1980s, and early 1990s (Faria and McAdam, 2015). Yet, in contrast to most of these political changes, an important feature of the Arab revolts is that religion is recognized as a major force in politics and can play a key role in motivating and governing people's decisions. An important manifestation of this phenomenon is the choice between a democratic political system and a *Sharia'a*-based legal system. The outcome of this decision may have a direct influence on the country's economic and financial conditions.

Recently, several empirical studies have investigated the impact of the Arab Spring on the performance and stability of the banking sector. For instance, Bitar et al. (2016) find that the Arab Spring had a different effect on the performance and risk of conventional banks in Gulf Cooperation Council (GCC) countries than in countries in the rest of the Middle East and North Africa (MENA). Ghosh (2016) finds that the Arab Spring negatively affected the profitability and stability of both conventional and Islamic banks. In earlier contributions, Mahboub and Abdou (2012) and Khandelwa and Roitman (2013) show that the Arab Spring led to a sharp decrease in macroeconomic outputs, especially in the short- and medium-term. Finally, Awadallah (2013) finds that the economies of the Arab Spring countries lack a strong private sector due to fragmented markets and weak competition.

Another set of empirical studies examines the influence of political connections and autocratic political systems on bank performance and economic growth. For example, Nys et al. (2015) find that politically connected banks in Indonesia are more capa-

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ble of attracting deposits while Abdelsalama et al. (2017) find that politically connected banks in the MENA region are less efficient. As for economic growth, Khafagy (2017) and Commander (2017) report that autocratic governments exhibit opportunistic behavior and often badge themselves as reformers only to gain popularity, thus leading to a deterioration of countries' economic situation.

Our paper differs from these previous studies in three major respects; firstly, we use factors extracted from principal component analysis (PCA), instead of financial ratios, to examine bank financial soundness. Secondly, we examine the effect of political systems in general (not just during times of upheaval) on the financial soundness of banks. Thirdly, we not only consider conventional banks but extend our analysis so that it also covers Islamic banks. In addition, our study covers a longer time period than most of the existing literature, beginning a decade before the Arab Spring, and thus considers the circumstances that led to these political changes. Our goal is to investigate the effect of various political systems on the financial soundness of the two bank types; specifically, we explore whether a Western democratic political system and a *Sharia'a*-based legal system have different effects on the financial soundness of conventional versus Islamic banks and investigate the potential reasons for these differences.

Our study employs a three-stage approach. In the first stage, we apply PCA on twenty-nine measures of bank financial soundness. We use an initial sample of 729 banks (including 139 Islamic banks) in 33 developing countries for the period between 1999 and 2013. The results of the extracted components indicate that capital, efficiency, the volatility of returns, liquidity, the charging of rents for offering *Sharia'a* compliant products, profitability, and credit risk are the most informative indicators of Islamic banks' financial soundness.

In the second stage of our analysis, we follow a difference-in difference research design and use random-effect Generalized Least Squares (GLS) regressions to compare the financial soundness of conventional and Islamic banks. In contrast to Abedifar et al. (2013), Beck et al. (2013), and Alqahtani et al. (2016), our findings suggest that Islamic banks are more efficient, more profitable, slightly more capitalized and have more volatile earnings (are less stable) than their conventional counterparts. We also examine whether the political environment has the same effect on the financial soundness of Islamic banks compared to conventional banks, taking into consideration bank and country-level control variables. Our findings suggest that Islamic banks underperform their conventional counterparts in Western democratic nations but outperform them in countries that employ *Sharia'a* or hybrid legal systems. We argue that recognizing the *Sharia'a* law in a country's political or legal system could be a valuable resource for Islamic banks, especially in highly religious countries. First, recognizing Islamic law may translate into regulatory authorities better understanding the specificities of Islamic banks, leading to better adapted regulatory guidelines and avoidance of potential double regulatory standards. Second, recognizing *Sharia'a* law may enhance people's confidence, the public trust, and the reputation of Islamic banking institutions thus enabling them to more easily obtain resources in the form of deposits and sell their products to customers. Finally, in countries that have *Sharia'a* or hybrid legal systems, Islamic banks may benefit from the goodwill of religious depositors who believe that they preserve the Muslim culture and identity. Other than political systems, our results also indicate that bank age, economic cycles, market discipline, and ownership dispersion are important determinants of Islamic banks' financial soundness as well.

In the third stage of our analysis, we use several additional tests to check the robustness of our results. First, we employ a propensity score matching (PSM) technique by matching observations of banks based on their probability of being Islamic. We continue to find evidence that Islamic banks are more capitalized, more efficient and profitable, and have lower credit risk than their conventional counterparts, while also having more volatile earnings. Second, we employ difference-in-difference (DID) estimation to compare changes in the financial soundness of both types of bank due to the Arab Spring. Our findings suggest that Islamic banks are less profitable and have more volatile earnings during the Arab Spring than conventional banks. Third, we use an instrumental variables (IV) approach to address endogeneity and correct for potential adverse selection problems. We also use a Heckman (1979) selection approach to correct for a potential self-selection bias. Our results confirm the previous findings and thus are not driven by endogeneity. Finally, we use truncated regressions with a Newey-West procedure to correct for autocorrelation among the residuals and again report very similar results.

Our study contributes to the literature in two ways. First, previous empirical studies that compare the financial characteristics of Islamic and conventional banks are based on ratio analyses and often report mixed results. Banking institutions are complex organizations and the financial soundness of their investment portfolio depends on many factors. These factors can be internal ones such as bank age and experience or external ones such as economic conditions and political systems. Thus, simple ratio analyses cannot capture the complete picture of a bank's financial soundness (Klomp and de Haan, 2012, 2014). Furthermore, in the context of Islamic banks, Johnes et al. (2014) argue that "the most severe drawback is the assumption underlying financial ratios of cost minimization or profit maximization" (pg. S96). In other words, the assumption that Islamic banks are excessive risk-taking and profit-maximizing organizations is unlikely to be wholly valid. Note that we do not completely dismiss the assumption; this is because there remain substantial divergences between what *Sharia'a* law ideally expects from Islamic banks and what has been applied in practice, where Islamic banks' practices are often criticized for being indistinguishable from those of conventional banks (Khan, 2010). Nevertheless, a few studies – including the present one – consider a multi-faceted concept for bank financial soundness instead of one-dimensional measures (Canbas et al., 2005; Shih et al., 2008; Klomp and de Haan, 2012, 2014).[1] While a few empirical studies use principal component analysis (PCA) to examine the conventional banking sector's financial soundness, no study has used PCA to evaluate the financial soundness of Islamic banks.

Our second contribution relates to the newly emerging literature on the political environment (Bove et al., 2016; Boubakri and Saffar, 2016; Klomp and de Haan, 2016) and the literature on the effect of the Arab Spring (Mahboub and Abdou, 2012; Awadallah, 2013; Khandelwa and Roitman, 2013; Bitar et al., 2016; Ghosh, 2016). We also focus on a set of countries of particular importance in areas that are characterized by a high concentration of political instability (Ghosh, 2016) and high corruption levels (Belkhir et al., 2016), in addition to a mix of weak democracies, monarchies and authoritarian regimes (Abdelsalama et al., 2017). Finally, we complement the literature on the important role played by religion in affecting the financial characteristics of Islamic banks (Beck et al., 2013; Abedifar et al., 2013; Mollah and Zaman, 2015). By comparing banks that operate in democratic political systems with those that operate in *Sharia'a* and hybrid legal systems, we show that Islamic banks appear to be less financially sound in more

[1] Multidimensional measures of bank performance such as Data Envelopment Analysis (DEA) have been extensively used in the Islamic banking literature (cf., Sufian, 2007; Viverita and Skully, 2007; Belans and Hassiki, 2012; Johnes et al., 2014; Saeed and Izzeldin, 2016). In this study, we use principal component analysis and extend the analysis by creating several dimensional measures that aim to cover all aspects of bank financial soundness such as capital, liquidity, and risk, and not only bank performance (e.g. profitability and efficiency).