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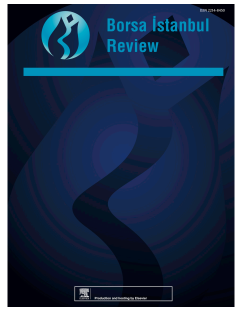

Capital adequacy implications on Islamic and non-Islamic bank's behavior: Does market power matter?

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Abstract

After each crisis, reforms are carried out to prevent a new episode of financial crises. In this context, our objective in this study is to examine and simultaneously compare the behavior of Islamic and conventional banks in relation to the ratio of the capital adequacy in different competitive circumstances. We used data from 12 MENA and South East Asian countries characterized by the coexistence of Islamic and conventional banks. We concluded that the funding ratio has a significant impact on the behavior of 70 conventional banks and 47 Islamic banks. However, competitive conditions have no significant effect on the relationship between the weighted assets ratio and Islamic bank behavior, which means that this type of banks is applying theoretical models based on the prohibition of the interest.

1. Introduction

Since the early 80s, the number, frequency and size of financial crises have continued to rise. A large number of developed, developing and in transition countries have experienced severe banking crises during the eighties and nineties and recently the 2007/2008 global financial crisis. The interest in the bank failure is caused by the bankruptcy substantial costs. Actually, the consequences of a bank failure are usually very expensive; financial losses for the fund suppliers (shareholders, depositors, and insurers), loss of competitiveness of the banking industry and a destabilization of the financial system as a whole if several individual failures escalate into a banking crisis through contagion mechanisms. The resolution of this type of failure implies a waste of resources, which are particularly scarce in the emerging economies [Honohan (1997)].

The excess risk is the major cause of bank failure. It is the result of inefficient management and control of the bank lending activity. The information asymmetry is the cause of two issues that can affect the level of the credit risk. The first is an ex-ante problem called adverse selection which occurs before the financial transaction takes place. Adverse selection is when the lender is subject to risk from the borrower because of the information he keeps for his own interest. The second is an ex-post problem and also known as moral hazard. This type of problem arises after the granting of the credit. Such problem arises after the credit is granted as a result of the lender's failure to observe the borrower's actions (shares) so as to ensure the proper use of the distributed funds, which, therefore, affects the probability of repayment. Obviously, the level of the information asymmetry,