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Behavioral explanation for risk taking in Islamic and conventional banks

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A B S T R A C T

The objective of this paper is to provide a behavioral explanation for risk taking in Islamic and conventional banks. Within the prospect theory framework; we consider the bias of loss aversion and mental accounting to explain the risk behavior in Islamic and conventional banks in the MENA region. We use the Fishburn's (1977) risk measure and the Kendall's *t* to test the prospect theory predictions. Several measures of performance and risk are used as target level. The results for the two types of banks are too similar and provided evidence for Fishburn's (1977) risk measure and Tversky and Kahneman's (1992) cumulative prospect theory. Banks above the target level tend to show risk aversion behavior, while the banks listed below tend to be risk-oriented. This finding provides evidence for the loss aversion bias and mental accounting.

1. Introduction

The Islamic financial system is growing widely over the last thirty years. Islamic finance has become one of the segments of the financial industry and has occupied a very important place in many countries (Hasan and Dridi 2010). As part of this Islamic sphere, Islamic banks are becoming increasingly important. They constitute new players whose activity is governed by the principles of the Islamic Shari'ah, which requires ethical rules in harmony with financial practices and banking products.

While the traditional bank relies on the concept of the interest rate to take advantage of its operations, the Islamic bank has no access to this mechanism. These Islamic banks have adopted techniques that replace interest income with cash flows from productive sources (Hassoune, 2009; Tayebi, 2008).

However, Islamic financing, which is motivated by the desire to ensure a justified distribution of wealth and income, does not appear to be safe from risk. Moreover, this type of banks might to be induced to take on more risk in order to compete with their conventional counterparts. This subject of risk has always been explained by the traditional finance paradigm, which is based on the rationality of agents. This rationality is based on perfect information and coherent beliefs. However, classical explanations based on rationality prove insufficient to explain the risk which is of major importance in the banking activity especially with the recurrence of the crises of the banking system. The emergence of an innovative research stream called behavioral finance has given rise to a new explanatory approach based on the cognitive and emotional biases inherent in the behavior of managers within banking institutions. Indeed, it is only recently that particular attention is given to the study of behavioral biases of managers for the explanation of bank's risks. These biases, which are cognitive and emotional, have the power, to influence significantly the decisions of managers.

Behavioral finance models based on cognitive psychology suggest specific features of agent's behavior, relaxing the rationality hypothesis (Barberis and Thaler, 2003). In this same context of behavioral finance, another essential assumption is made about the preferences of investors and how to evaluate risky choices.The prospect theory, introduced by Kahneman and Tversky (1979), is the

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most famous of these theories.This theory is essentially based on the criticism of the expected utility theory as a descriptive model for decision-making under risk.The prospect theory suggests several important features. First, utility is defined on the gains and losses, and not in the final wealth (mental accounting). Second, institutions are rather more averse to losses than they are attracted to gains (lossaversion). Third, institutions are risk seekers in the area of losses, and risk aversion in the area of earnings (asymmetric risk preference). finally, this theory suggests the feature of non-linear transformation of probabilities, where institutions evaluate extreme events in the manner that they overestimate low probabilities and underestimate high probabilities (probability weight function) (Kahneman and Tversky, 1979).

In this paper, we focus on the banking industry, but in a specific framework, conventional and Islamic banks, where risk taking behavior can become adverse, generating excessive risks for Islamic banks. The specificities of these banks, in the sense that they are guided by the principles of Shari'a (prohibition of interest, profit and loss sharing, etc.), may foster excessive risk taking, affecting the perception of risk by the bankers. Therefore, an investigation of this risk perception in a behavioral finance framework is suitable.

In this context, we examine the relevance of the prospect theory as well as the risk measure of Fishburn (1977) to explain risk taking behavior in the Islamic and conventional banking system. Admitting that risk-taking decisions are influenced by human subjective judgment as well as perception of risk, then it seems relevant to engage in the behavioral perspective in order to better study and understand this process. We empirically study risk taking in the banking sector within the framework of the cumulative prospect theory.

As there are relatively few studies on the risk behavior of Islamic banks, this study contributes to widening the scope of the literature by providing empirical results on the behavioral biases affecting risk taking of Islamic banks. To our knowledge, this is the first study that considers the loss aversion bias and mental accounting to explain the risk behavior of Islamic and conventional banks in a comparative framework.

This paper is organized in the as follow: Section 2 present a literature review, section describes data and methodology, the empirical results based on the prospect theory are presented in Section 4 and finally Section 5 concludes the paper.

2. Literature review

Fishburn (1977) suggests a portfolio allocation model, alternative to “mean-variance”, where risk is defined as the dispersion of returns below the target. The model is motivated by the idea that portfolio managers generally associate a risk with the failure to achieve a certain benchmark level of performance.

In the same way, Kahneman and Tversky (1979) propose the prospect theory as an alternative to the theory of expected utility in decision making. They show that when individuals are confronted with events involving a set of choices, the real response of these individuals does not necessarily follow the rational calculation of expected utility on the basis of the objective notion of risk-return (Kahneman and Tversky, 2000). The main contribution of Kahneman and Tversky, focuses on a set of choices presented to individuals as well as on the events underlying this set of choices. Their findings largely resultfrom laboratory experiments, in which participants were generally asked to choose a preferred alternative (with particular risk-return characteristics) from a set of choices.

First, prospect theory was developed to explain individual choices based on predefined losses or gains and fixed probabilities associated with other alternatives (Kahneman and Tversky, 1979, 2000). As the probability of outcomes for true organizational choices can’t be clearly determined (March and Shapira, 1987) and external factors are likely to be present in organizations (Bromiley et al., 2001), the question Therefore, is whether the principles of prospect theory can be applied to organizational parameters?

Bowman (1980) introduce the risk-return paradox in strategic management (in the context of underperforming firms that also have higher risks). Then, some testable hypothSesis is suggested by Kahneman and Tversky (1979) framework: the decision makers are risk-seeking in a below target level and risk-averse above given target level. Payne and al. (1980 and 1981) confirm the Kahneman and Tversky results and show that basing on prospect theory, an individual can exhibit different level of risk aversion.

The prospect theory’s feature requires that risk attitude is determined by the outcome relation to a reference point of a grouping of other perspectives, among which a choice must be made. This framework acts as a mental filter to organize preferences for other modes of action (eg a strategic choice to invest or not to invest).

Barberis (2013) findings are of particular interest showing an important insight into the prospect theory in firms. The first idea stipulates that choices often occurs in relation to the status quo as a point of reference. The status quo may not only reflect a situation at some point in time but may also include a trajectory as an income stream or an expected trend of market share in the case of unchanged behavior. The second idea states that, with the status quo, defined as a reference point, the perception of choices will be associated with safe gains (following a particular framework) and will generally be favored independently of the expected values. Safe gains, even if they are low, are systematically preferred to probabilistic results where losses are a possibility of realization (even with a low probability), reflecting risk aversion (losses are more “threatening” than earnings). In the context of managerial management, the concept of certainty is different from that which prevails in the context of a laboratory experiment. Here, managers have a propensity to think that they can at least partially control the future of their business in the face of a difficult strategic event, such as a threat from the environment (March and Shapira, 1987). More precisely, if the expected result of a particular reaction at the firm level to a difficult strategic event is perceived as a secure gain (compared to other responses, losses are a possibility), then risk aversion will be selected. However, if the perceived result of a particular reaction could be the avoidance of safe losses, even if the likelihood of such a success would be low (compared to alternative responses, losses are a certainty) then the behavior of risk research prevail.

This proposition was empirically tested by Fiegenbaum (1990) using a sample of 85 US industries composed of about 3300 firms. The results show that companies below the industry target are looking for risk, while those above are risk averse.

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