DO PROFIT-SHARING INVESTMENT ACCOUNT HOLDERS PROVIDE MARKET DISCIPLINE

IN AN ISLAMIC BANKING SYSTEM?

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***This is a summary of an article published in the Journal of Financial Regulation (2017)*

> In tandem with conventional banking system, Islamic banking also emphasize on market discipline, signified by the global standard number 4 issued by Islamic Financial Services Board in 2007.

Market discipline is one of the main pillars for stability and resiliency in banking system (Basel II, 2004). The mechanism of market discipline primarily relies on the role of depositors who receive timely information and act accordingly through their respective accounts. Empirical evidence shows the presence of market discipline, whereby non-insured depositors react to risk factors of the bank accordingly by either withdrawing their deposit (quantity mechanism) or demanding higher return (price mechanism). In tandem with conventional banking system, Islamic banking also emphasize on market discipline, signified by the global standard number 4 issued by Islamic Financial Services Board in 2007. However, unlike conventional banking, market discipline in Islamic Banking is conjectured to work via profit-loss sharing system. That is, the role of Profit Sharing Investment Account (PSIA) holders who are exposed to the variability of profit generated from their investment. The intriguing question of whether PSIA would be more effective and efficient in implementing market discipline remains an on-going debate. Even there is no empirical study attempts to address this issue. Therefore, we perform empirical research to discover it.

In this study, we use panel data of 44 Islamic banks across different regions to research the presence of market discipline in the global Islamic banking system focussing on the behaviour of the PSIA holders and their rule on governance of the Islamic banks. This study applies GMM panel technique and finds weak relationships between the behaviour of PSIA holders and the risk variables of the Islamic banks (measured by: Capital adequacy, Asset quality, Management, Earnings or Liquidity). This implies negligible effect of the current profit sharing system in exercising market discipline. This might indicates that PSIA holders remain unaware of bank's risks as well as low quality of disclosure process from Islamic banks. Nevertheless, our empirical results for Malaysia indicate different conclusions, suggesting that PSIAH observe and correspond to the changes in the asset quality risk as well as to the changes in liquidity risk by quantity mechanism.

Our findings confirm a weak market discipline a cross Islamic banks. PSIAH behaviours in general indicate weak respond to the different types of risks facing the banks throw the quantity mechanism as well as throw price mechanism. This might be a result of lack in transparency of the Islamic banks or it might be also a result of the deposit insurance scheme. Nevertheless, this would need further inspection and construct an interesting area for more research. However, our empirical results for Malaysia indicate different conclusions, suggesting that PSIAH observe and correspond to the changes in the asset quality risk as well as to the changes in liquidity risk by quantity mechanism. This is to say that PSIAH in Malaysia would withdraw their deposits from the bank facing an increasing liquidity risk or credit risk in terms of non-performing loans. At the same time, the results suggest that PSIAH would ask for higher return when they observe an increase in the credit risk of the bank rather than withdrawing the deposits. Nevertheless, the results regarding the price mechanism can't be taken as definitive finding as the ROD is an average rate rather than a market rate for PSIAH deposits. Furthermore, although our result confirm a market discipline in Malaysia where PSIAH correspond to the credit risk and liquidity risk, such concrete conclusion would need to apply some advance technique to account for the interactive relationship between ROD and PSIAG. This is to say that withdrawals by depositors due to greater risk taking by banks may trigger movements in the supply and demand curve of deposits. These two processes (i.e. movements in the supply and demand curve of deposits) need to be unravelled by controlling for the possible price effect of worsening fundamentals (shift in supply curve) and analysing whether an increase in the interest rate can influence the quantity, which would be an interesting area for future research.

****Notes:***

Alaeddin, O., Archer, S., Karim, R. A. A., Rasid, M., & Shah, M. E. (2017). Do Profit-sharing Investment Account Holders Provide Market Discipline in an Islamic Banking System?. Journal of Financial Regulation, 3(2), 210-232."