ECONOMICS OF RISK-TAKING, RISK-BASED CAPITAL, AND PROFITABILITY: EMPIRICAL EVIDENCE OF ISLAMIC BANKS

Faisal Abbas[1], Shoaib Ali[2], Imran Yousaf[2] and Wing-Keung Wong[3, 4, 5]*

[1]UCP Business School, University of Central Punjab, 1- Khayaban-e-Jinnah Road, Johar Town, Lahore, Pakistan
[2]Air University School of Management, Air University, Islamabad
[3]Department of Finance, Fintech & Blockchain Research Center, and Big Data Research Center, Asia University, Taiwan
[4]Department of Medical Research, China Medical University Hospital, Taiwan
[5]Department of Economics and Finance, The Hang Seng University of Hong Kong, Hong Kong

*Corresponding author: wong@asia.edu.tw

ABSTRACT

This study aims to explore the interrelationship between risk-based capital, risk-taking, and profitability. This study employs two-stage least square (2SLS) methods on the annual data of 217 Islamic banks from 35 countries ranging from 2010 to 2019. We find that the relationship between risk-based capital and risk-taking behaviour is negative, and the results are heterogeneous across different regions concerning both signs and significance. Consistent with the theory of moral hazard, we find the negative relationship between risk-based capital and Islamic banks' risk-taking behaviour, implying that managers in Islamic banks could increase their investment in risky assets and keep only smaller amounts of capital. The concept of profit and loss sharing motivates them to take a higher risk and aim to get a higher yield. This relationship is also in line with the agency theory, inferring that bank managers could take excessive risk to get higher compensation to align with higher profitability. The results also reveal a positive relationship between risk-taking and profitability, which is in line with the portfolio theory in finance. The findings in our paper would be useful for decision-makers and bank managers in understanding the interrelationship between risk, capital, and profitability and no factor alone could be good enough to ensure bank soundness. Furthermore, our findings imply that regulators and bank managers should not only focus on bank capital for increasing banks' stability. They should also look into both profitability and capital ratios in addition to bank capital because all three factors could increase banks' stability simultaneously.

Keywords: Islamic banks, risk-taking, risk-based capital, profitability