UNIVERSITI TEKNOLOGI MARA

SCRUTINIZING DUAL BANKING FRAGILITY: EVIDENCE FROM HIGH-INCOME AND MIDDLE-INCOME COUNTRIES

NUR HAZIMAH BINTI AMRAN

Thesis submitted in fulfilment
of the requirements for the degree of
Doctor of Philosophy
(Business Management)

Faculty of Business and Management

August 2022

ABSTRACT

The fragility of an individual bank impacts significantly on other banks given, the nature of the banking system in which various banks are interconnected, especially in terms of inter-financing activities. This creates a domino effect that could possibly jeopardize the whole banking system in the country, and to a large extent, might affect other countries. This could be attributed to the significance of the banking industry in a country. The stability of the banks empowers sustainability and growth in the industry. Banks become more fragile if excessive risks persist, especially liquidity risk and capital risk. This study aims (i) to investigate the possible factors influencing dual banks fragility; (ii) to assess the interaction effects of a) financing growth, b) banks size, c) credit risk, and d) income diversification on the relationship between the potential driver(s) and banks fragility; (iii) to distinguish the intensity of banks fragility between Islamic and conventional banks for high-income and middle-income countries; and (iv) to compare the level of banks fragility between high-income and middle-income countries for Islamic and conventional banks. This study involves panel data analysis of banks in high-income and middle-income countries (Bahrain, Bangladesh, Kuwait, Malaysia, Qatar, Saudi Arabia and United Arab Emirates) with 645 observations that spans from 2009 to 2018. Specifically, this study employs a Random Effect Model with cluster standard errors, which is appropriate for heteroscedasticity and autocorrelation issues. The findings reveal cost efficiency primarily determines the funding fragility for all banks regardless of type and country income level. Meanwhile, bank size is evidently the main determinant for capital fragility for Islamic and conventional banks in high-income and middle-income countries. In line with the too-big-to-fail theory, bigger banks are exposed to greater capital fragility. Hence, the large banks have to be caution on capital fragility while enlarging their size. Another prominent finding, the banks are proposed to pile up profitability in order to reduce the dual banks fragility, applied to both funding and capital fragility. Interestingly, the study discovers Islamic banks are significantly exposed to greater funding and capital fragility relative to their conventional counterparts. Whilst, banks in high-income countries are found to be less exposed to funding and capital fragility as compared to the middle-income countries. The interaction effect discloses conventional banks with high financing growth are exposed to greater funding fragility given higher credit risk. The study also discovers different effect of size on the relationship between capital level and funding fragility. Islamic banks in middle-income countries with high credit risk are more fragile when the banks are more cost efficient. Therefore, while being cost-efficient banks, the Islamic banks in middle-income countries are proposed to pay more attention to their credit risk level in avoidance of greater capital fragility exposure. Conventional banks, particularly in middle-income countries with high intensity of income diversification are less vulnerable to capital fragility when the increase in liquidity. On the contrary, Islamic banks with greater income diversification are more fragile when the banks add up more liquidity. Therefore, the policy makers should consider the differences between Islamic and conventional banks as well as the income level of the countries in mitigating banks fragility. This is because, the way that the banks behave are different. Additionally, bank strategies should be different by taking into account type and size of the banks.

ACKNOWLEDGEMENT

In the name of Allah, the Most Gracious, the Most Merciful.

To begin, I would like to express my gratitude and praise to Allah for providing me with the courage, strength, guidance, and patience I needed to embark on this PhD journey. Again, I thank Allah for providing me with the opportunity to complete this difficult journey smoothly and successfully. I would like to express my heartfelt gratitude to my main supervisor, Associate Professor Dr Wahida Ahmad, for her words of wisdom, guidance, invaluable time, critical assessment, unending support, and inspiration in helping me work on and complete this thesis. Her willingness to review all of my work, answer all of my questions, and her weekly commitment motivated and inspired me to work very hard in completing my PhD journey. I am truly grateful for her professional supervision and constructive comments, which assisted me in learning and improving my thesis. Throughout the ups and downs of completing my PhD thesis, especially during the Covid-19 pandemic, I learned a lot. I believe in her words saying that “a calm sea does not make a skilled sailor and smooth research does not make a proficient researcher”. I would also like to thank my co-supervisor, Dr Faridah Najuna Misman.

I am eternally grateful to both of my beloved parents, *Mak (Patimah)* and *Abah (Amran)*, for their never-ending support throughout this PhD journey. I will be eternally grateful to them for their eternal love, prayers, and courage. I am grateful to my beloved brothers and sisters, *Abang Ngah, Kak Ngah, Adik Eti, Adik Add, Adik Edd, Adik Eshyia,* and *Dik Ya*, for their never-ending love and humour that has accompanied me throughout my PhD journey. Not to forget my niece, *Eliya* our little happy pill in the family. Also, to my late Tok, who encouraged me to continue my studies after I received my MSc. I would also like to thank my dearest friends, especially *Aliaa, Zun, Aten, Anip, Aina, Zayana, Memen, Ecah, Liyana, Adidi, Syahmi, Fahmi, Amirul, Safwan, Izz,* and *Samsuri* for their sincere and heartfelt support. My PhD journey might not be as interesting if they were not there. I would also like to thank my mindy rings Professor Dr Catherine Soke Fun Ho, Associate Professor Dr Mazila Md Yusoff, Dr Sarina Mohamad Noor, Ms Rozihanim Shekh Zain, and Madam Noor Azillah Mohamad Ali for their encouragement and support. Last but not least, I would like to thank everyone else who has assisted me, directly or indirectly to complete this PhD journey.

Alhamdulillah, finally I reached the final state.

Adios!

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