UNIVERSITI TEKNOLOGI MARA

THE EFFECT OF MACROECONOMIC FACTORS AND MACROPRUDENTIAL POLICY ELEMENTS ON MACROPRUDENTIAL POLICY INDICATORS AND BANKS' STABILITY: EMPIRICAL EVIDENCE FROM ISLAMIC BANKING SYSTEM

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ABSTRACT

The 2008-2009 Global Financial Crisis (GFC) had redirected the focus on the relationship between Islamic banking and financial stability particularly, the resilience of the Islamic banking industry during a crisis. Effective macroprudential policy are necessary and desirable in Islamic banking to mitigate systemic risks. The objectives of applying this policy on Islamic banking activities are to pursue and maintain financial stability by ensuring the safety and stability of banks, thereby preventing the systemic effects of emerging problems. There are three key elements of an effective macroprudential policy framework namely a system of early warning indicators that signal increased vulnerabilities to financial stability, a set of policy instruments that can help contain risks, address the increased vulnerabilities at an early stage, as well as help build buffers and an effective institutional framework. Therefore, this study is conducted to extend the investigation on how macroprudential policies may affect the Islamic banking system. The objectives of this study are to analyze the trend of main macroprudential policy indicators in Islamic banks, to investigate the influence of macroeconomic factors and macroprudential policy elements on the main macroprudential policy indicators in Islamic banks in order to strengthen the links between the different financial components of the financial system and the macroeconomic environment and finally to study the impact of macroprudential policy indicators on Islamic banks'stability. This study employed the two- stage least square estimator and Hausman Taylor estimator to establish the second research objective and panel data analysis for the third research objective. The annual data was collected from Islamic banks in twenty (20) selected countries during the post crisis period from 2008 to 2017. The empirical result proved that, GDP growth rate, the balance of payment, money supply, domestic credit growth, unemployment rate, loan-to-value ratio, debt-to-income ratio, reserve requirement, mandate and transparency have a significant influence on the macroprudential policy indicators in Islamic banks. Meanwhile, these macroprudential policy indicators have a strong relationship with Islamic banks' stability. Therefore, the result provides significant contributions to the existing body of knowledge on the macroprudential policy framework. The results of this study can help policy-makers especially those in countries that practice the Islamic banking system in strengthening their macroprudential policy toolkit and clarifying the mandate for financial stability, developing a more formal institutional framework of macroprudential policy and expanding the range of macroprudential instruments.

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CHAPTER ONE
INTRODUCTION

1.1 Introduction

Starting in the United States (U.S.) and later spread around the world, the Global Financial Crisis (GFC) of 2008 to 2009 had left a huge impact on the world economy. It led to an asset bubble caused by a wide array of financial derivatives that led to the sub prime mortgage boom, exploding into housing and banking crisis with a cascading effect on consumer and investment demand (Zainal Abidin & Rasiah, 2009). Krugman (2009) stated that from a housing crisis, it quickly grew into a global banking crisis with investment and merchant banks first absorbing the impact before it spread to commercial banks. Islamic banks were also affected by the 2008 global financial crisis in a different way (Hasan & Dridi, 2010). In other words, this crisis played a significant role in the collapse of financial institutions, failure of key businesses, decline in consumer wealth and downturn in economic activities not only in the U S. but also in almost every country worldwide.

According to Arvai, Prasad and Katayama (2014), the global financial crisis did not only trigger major changes in the approach taken by countries in financial regulation, but also led to the recognition of financial stability for achieving macroeconomic stability. The main lesson from this crisis is the revelation of the importance of mitigating systemic risks and the need to strengthen the macroprudential approach towards supervision and regulation which can identify risks throughout the system and enable appropriate actions to maintain financial stability (Kawai & Morgan, 2012).

Financial stability can be defined as “a condition in which the financial system comprising of financial intermediaries, markets, and market infrastructures is capable of withstanding shocks, thereby reducing the probability of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities" (ECB, 2012). As financial intermediaries, banks are important suppliers of funds and their stability represent a central and relevant concern for the financial system. This crisis has proven that a sound banking system is a necessity for some fundamental aspects of the economy and for its