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RESEARCH ARTICLE

Private credit in dual banking countries: Does bank ownership type matter?

Nazrul Hazizi Noordin[1] | Mohamed Eskandar Shah Mohd Rasid[2] | Mansor H. Ibrahim[3]

[1]IIUM Institute of Islamic Banking and Finance, International Islamic University Malaysia, Kuala Lumpur, Malaysia

[2]College of Islamic Studies, Hamad Bin Khalifa University, Doha, Qatar

[3]INCEIF University, Kuala Lumpur, Malaysia

Correspondence
Nazrul Hazizi Noordin, IIUM Institute of Islamic Banking and Finance, International Islamic University Malaysia, Block D, Level 2, KICT Building, Jalan Gombak, Kuala Lumpur 53100, Malaysia.
Email: hazizi@iium.edu.my

Abstract

This study investigates how the effects of government and foreign bank ownership on private credit vary in the cases of Islamic and conventional banks using data extended from Claessens and van Horen (2014) of 29 dual banking countries from 1995 to 2017. In support of the political view of financial development, we find that the presence of state-owned Islamic banks seem to be slightly less harmful to private credit flows than their conventional peers, particularly in the period after the global financial crisis. We also document evidence showing that countries with a larger foreign Islamic bank presence tend to have deeper credit markets postcrisis. However, such advantages may often be outweighed by the costs associated with increased penetration by foreign conventional banks.

KEYWORDS
foreign banks, Islamic banking, private credit, state-owned banks

1 | INTRODUCTION

The financial liberalization since the 1980s has led to the privatization of state-owned banks and the removal of barriers to foreign bank entry in many countries. The bank ownership reform has given rise to policy concerns about the consequences it has for economic and financial development. One such concern pertains to whether the reform would result in banks extending less financial resources to the private sector (henceforth referred to as "private credit"). This study adds to this line of inquiry by providing evidence from countries where Islamic banks operate alongside their conventional counterparts. These so-called dual banking countries are often described as "bank-based" economies because firms in the countries, especially small and medium-sized ones, heavily rely on bank loans to finance their business operations. As shown in Figure 1, the ratio of private credit to gross domestic product (GDP) of the countries grew by more than half between 1995 and 2017, exceeding the world average in 2014.

The proposition that bank-lending decisions are largely driven by the nature and incentives of bank owners themselves is intuitively appealing, yet the existing evidence on this is at best inconclusive. On one hand, the *social* view of state banking asserts that insufficiently developed economic institutions and weak contracting environment make lending to small, riskier borrowers nearly impossible for private banks. In such markets, it is necessary for the governments through the banks they own to step in to compensate for market failures and extend credit to underserved borrowers (Andrianova, Demetriades, & Shortland, 2008; Gerschenkron, 1962). On the other hand, the alternative *political* view suggests that state-owned banks are often used by politicians to direct credit to their affiliates and supporters, who later return the favor by giving them votes, campaign donations, and bribes. This sort of political meddling is linked to economic inefficiency and consequently put a damper on credit depth (Sapienza, 2004; Shleifer & Vishny, 1994). Another plausible explanation would be that government bank managers tend to look less aggressively for lending opportunities due to lack of incentives to maximize profits, instead lump public savings into government borrowings (Micco & Panizza, 2006). As a result, private sector financing would be displaced or crowded out by huge government debts (Aschauer, 1989).

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