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THE IMPACT OF OWNERS BEHAVIOUR TOWARDS RISK TAKING BY PAKISTANI BANKS: MEDIATING ROLE OF PROFITABILITY

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Abstract

This study determines the mediating impact of profitability on owners' behaviour and risk-taking by Pakistani banks. Many of the previous studies mentioned that as far as ownership structure is going to be private, the risk-taking activities are going to reduce because less agency issues but this situation does not exist in case of Pakistani banks. Pakistani banks show different scenario which clearly highlights the issue of relationship interruption and also creates the need of mediator to explain this phenomenon. This study concluded that profitability/financial performance mediate the relationship between owner's behavior and risk taking activities of the banks because profits have the characteristics to change owner's behavior regarding regulations implementation and risk taking activities of financial institutions.

Keywords: Profitability, Ownership Structure, Regulation, Risk taking, Banks of Pakistan.

JEL classification codes: G21, G22, G32.

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1. INTRODUCTION

Financial institutions' role in the solution of financial issues and economic development intensely increase over the past years which forced regulatory authorities to work-out on its soundness. World Bank Report (2016) highlighted the increasing contribution of banking institutions in the economic betterment of the world. World Bank also supports developing countries for the solution of different financial problems in the country such as it helps below average formers that they grow more food and sell them in the markets and earn more income so that poverty can be waived off. These efforts can create links between farmers and markets to create jobs for other peoples through agro-processing and other agricultural associated businesses. Moreover, World Bank provides strong support to developing countries and their partner countries over past years and also provides the financial aids to all sectors that they stand up and contribute in the economic development of the country and their organizations are focused on delivering quick results and bringing a global solution for local challenges.

2. LITERATURE REVIEW

A strong connection is observed between risk and financial institutions because risk is considered as "exposure to danger" for financial system of the world. Many factors exist in the financial environment that boosts up risks in the institutions such as high risk-taking behaviours, agency relationship issues and uncertainty of future events. Jaffee and Russell (1976) and Jensen and Meckling (1976) argued in their study on "ownership structure and agency cost" that risk can originate from the conflicts of interest between managers and owners of the institution. Similarly, Eisenhardt (1989) also found in his study that conflicts of desire goals of principal and agent are also imperative causes of risk. Moreover, Saunders and Cornett (2003) analyzed the US banks by collecting data from financial statements from 1995 to 2000 and investigated that agents of the banks always behave opportunistically while making decisions but when their decisions are not appropriate according to the situation then risk can take place. Additionally, Drew and Kendrick (2005) analyzed the firms of US in their study on "challenges of risk management". They defined the risk as probability of variation in the actual results from expected results". "The volatility in the business value and variability in the cash flows are the causes of risks (Tandelilin, Kaaro, & Mahadwartha, 2007). Moreover, Gourieroux and Jasiak (2010) and Duffie and Singleton (2012) conducted the studies on risk management and analyzed that profits and risk are highly associated with each other which shows that risk is very crucial part of the business and needs to investigate after short intervals because nature of the risk change with the passage of time. Similarly, Rahman (2012) analyzed the Malaysian commercial banks by collecting data from the financial statement and found that banks are high risk exposure by the nature and suggested that risk-taking is ongoing debate due to financial crisis and needs to explore frequently. In addition, Neves and Eisenberger (2014) conducted the study on Portugal's organizations and ignored financial sector because risk-taking is a core activity of financial system and analyzed that uncertain outcome are the results of risk taking. Furthermore, (Vona, 2016; Wang, Wang, Wu, & Wu, 2017) investigated in their study that incomplete knowledge regarding future events generates the risk in the institution. This lack of information regarding future events creates misjudgment of situation, less perfection in decisions and lack of confidence which tend to move the business into risky environment. Furthermore, they concluded that "asymmetric information problem" also the major cause of risk and this problem exists when the managers have more information than shareholders about the institution.

According to the previous studies there is significant negative relationship observed between private ownership structure and risk taking activities of the banks such as (Bhojraj & Sengupta, 2003; Laeven & Levine, 2009; Paligorova, 2010; Zhong, 2017) and significant positive relationship observed between government ownership structure and risk taking by the previous studies such as (Chou & Lin, 2011; Grassa, 2016; Haw, Ho, Hu, & Wu, 2010; Iannotta, Nocera, & Sironi, 2007; Khwaja & Mian, 2005) and also significant negative relationship observed between foreign ownership structure and risk taking by the previous studies such as (Agoraki, Delis, & Pasiouras, 2011; Angkinand & Wihlborg, 2010; Micco, Panizza, & Yanez, 2007; Zhong, 2017) but all of these studies ignored the mediating role of profitability or financial performance that recent studies (Lun, Shang, Lai & Cheng, 2016; Purnomosidi, Suhadak & Dzulkirom, 2014; Wahba & Elsayed, 2015) clearly highlighted that mediating role of profitability is totally ignored by previous studies. On the basis of all provided gaps by previous literature, this study has proposed a conceptual framework (See Figure 1) and also suggested that it will be emerging area for future studies and also can empirically be tested.

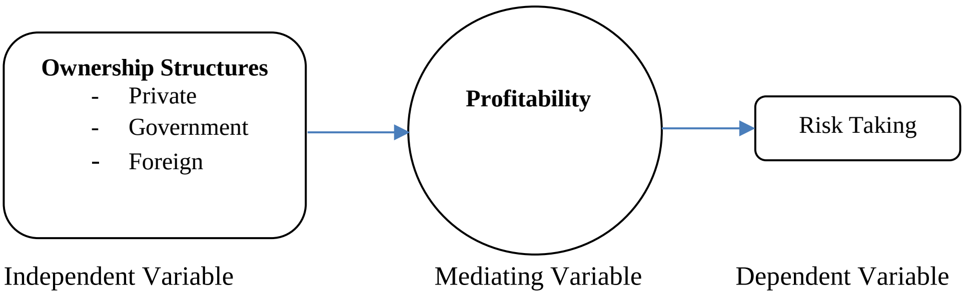

Figure 1. *Shows the conceptual framework of the study*

Source: The authors

3. OWNERSHIP STRUCTURES AND RISK TAKING

As far as agency theory is a concern, risk-taking activities are varied in different types of ownership structures of financial institutions because different owners have various behaviour regarding risk-taking. Shleifer and Vishny (1997), conducted the study on government ownership structure and found that political interference, weak supervisory control and gap in communication between managers and owners are the basic reasons of the significant negative impact of government ownership and risk-taking of the financial institutions. Moreover, government ownership is not expert enough in the management of risk. Furthermore, Wiwattanakantang (2001) analyzed non-financial system of Thailand through secondary methods and completely ignored financial sector. He analyzed that state ownership has significant positive impact on NPLs and also observed that politics influences the decisions of state-owned banks. Additionally, Dinç (2005) analyzed the state ownership of 43 countries through secondary methods by collecting data from 1994 to 2004. He found that lending of financial institutions increased during election years in state-owned financial institutions because loans are provided to fulfil the objectives of politics not for the institutions. In addition, Khwaja and Mian (2005) conducted the study on state-owned banks of Pakistan and analyzed that most of the lending of banks used for political benefits, not for institutional benefits. These lending produced a high level of NPLs, and that is the major cause of state-owned banks are riskier than others. Similarly, Iannotta et al. (2007) conducted the study on European countries and found that government-owned institutions have poor loan quality and high risk exposure that led towards the risky environment.

Furthermore, Micco et al. (2007) found that government owned institutions are less profitable and more riskier than other institutions in developing countries. These difference of risk and profitability between state-owned institutions and others are more prominent in the period of elections due to heavy supply of loan for fulfil the political objectives. Similarly, Haw et al. (2010) analyzed that agency issues are very high in government owned banks due to lack of contact between owners & managers and also weak regulatory environment in the institution. In addition, Angkinand and Wihlborg (2010) found in their study that "higher credit risks situation" exist in Eastern European and Asian government banks. Major reason of this situation is to provide loans to politically related projects that produced a high level of NPLs. According to the Chou and Lin (2011), public banks of Taiwan face the situation of lower capital adequacy ratio and higher overdue loans. Similarly, Grassa (2016) conducted the study on Islamic banks by collecting data from financial statement 2005-2012 and ignored conventional banks which represent a major part of the banking system. He found that lack of contact between principal and agents creates agency issues and these agency issues are the major problem of government-owned banks which increase the probability of failure. All above studies found a significant positive relationship between state-owned banks and risk-taking activities of the banks.

Lack of agency issues, strong supervision and less political interference, are the factors exist in private ownership structure that controls risk-taking activities of the institution. Insider ownership, institutional ownership and family ownership jointly called private ownership of the institution. Smith and Stulz (1985), argued that risk-averse behaviour has been observed in insider ownership and because of not having well diversified portfolio, the insider ownership always pursuing risk reduction strategies. Furthermore, Morck, Shleifer, and Vishny (1988) analyzed 500 firms by cross-section analysis for the year 1980 and found that when the insider ownership control up to 5 percent the risk-taking activities increase and when this control reached at 25 percent or more risk-taking activities decrease. Moreover, McConnell and Servaes (1990) found in their comparative study that significant negative relationship exists between insider ownership and banks' risk-taking and also reported that risk-taking activities are going to control when insider ownership reached up to 40 percent or more. In addition, Gorton and Rosen (1995) conducted the study on US banks and analyzed that limited risk-taking activities have been observed due to lack of agency issues in case of insider ownership. They also investigated that the quantity of risky loans increases until insider ownership grown enough that they control the decisions of management and avoid them to take unnecessary risks. However, Knopf and Teall (1996) found a positive relationship between insider ownership and risk-taking by banks. They also argued that the banks whose managers hold a large portion of shares are a relatively high-risk taker. Moreover, Bhojraj and Sengupta (2003) conducted the study on industry sector and found that institutional ownership has significant negative effect on risk-taking because institutional owners are more expert in order to take risk and control over the risk-taking activities. In addition, Laeven and Levine (2009) also found a negative relationship between institutional owners and risk-taking because experience institutional ownership structure always invests in less risky and more profitable assets. Similarly, Paligorova (2010) analyzed the corporate sector of 38 countries for the period of 2003 to 2006 and found that significant negative relationship between institutional owned financial institutions and risk-taking. Srivastav and Hagendorff (2016), argued the behaviour of insider ownership is risk-averse and also likely to pursuing risk reduction strategies in the institution because insider ownership probably not hold a well-diversified portfolio. Additionally, Zhong (2017) examined the banks of China through secondary data analysis of 2006 to 2015 and found that private ownership structure has less agency issues which reduce the chances of failure in the banks. All of above studies found a significant negative relationship between private ownership and risk-taking by banks. Moreover, Zheng, Huq, Rahman, and Ashraf (2017) analyzed the developing countries in their study for the year 2006-2014. They indicated that significant negative relationship between insider ownership and risk-taking activities of banks and also reported that risk-taking activities of banking institutions rise until insider ownership reaches up to 40 percent or more.

Risk-taking of financial institutions also influenced by foreign ownership structure of the institution. Laeven (1999), analyzed the banking sector of South Korea, Thailand, Philippines, Malaysia and Indonesia for the year 1992 to 1996. He found the risk-averse behaviour of foreign-owned banks because they invest in less risky assets. Similarly, Pinteris (2002) found in his study that foreign ownership is less risky than state ownership and family ownership due to lower NPLs ratio. In addition, Beck (2004) conducted the study on banking system of Kenya about structural issues and analyzed that profitability and risk-taking influenced by ownership structure such as foreign banks are less risky and more profitable than local banks in developing countries while foreign banks are more risky and less profitable than local banks in industrial countries due to tax breaks benefits, technological efficiency and other preferential treatments. Moreover, Cosset, and Guedhami (2005) analyzed the corporate sector and found that less agency cost and issues observed in foreign ownership structure. Additionally, Choi and Hasan (2005) conducted the study on Korean commercial banks for the period of 1998 to 2002 and reported that significant positive relationship between foreign-owned banks and return on assets and significant negative relationship between foreign ownership and risk-taking by banks. They also point out that combination of strong governance and high expertise in foreign ownership decrease risk and increase the performance of the institution.

In addition, Micco et al. (2007) indicated in their study that due to lower overhead cost the foreign banks of developing countries are less risky and more profitable than other banks. Similarly, Angkinand and Wihlborg (2010) indicated that low NPLs situation observed in foreign ownership structure of the banks. Furthermore, Agoraki et al. (2011) analyzed banks of Eastern Europe for the period of 1998 to 2005 and found a significant negative relationship between foreign ownership and risk-taking in emerging economies. Furthermore, Lassoued, Sassi, and Attia (2016) analyzed the 171commercial banks of 13 MENA countries and panel data collected for the period of 2006 to 2012. They conducted the study on risk-taking by foreign-owned banks and found that foreign-owned banks are reducing the risk-taking activities. Similarly, Zhong (2017), analyzed 25 listed banks of China and found that lack of agency cost and issues reduce the chances of losses in foreign-owned banks. All of the above studies indicated a significant negative relationship between foreign ownership and risk-taking by banks. Moreover, Zheng et al. (2017), conducted the study on developing country such as Bangladesh about ownership structures and their risk-taking activities. They investigated the 28 private, 4 government and 4 foreign owned banks and collected data from 2006 to 2014. They found that significant negative relationship between foreign ownership and their risk-taking activities. They also observed that foreign owners are risk-averse in nature and avoid themselves from risky activities.

4. MEDIATING IMPACT OF PROFITABILITY

Basic goal and motivational objective of every organization regardless of its nature and size is the financial performance or profitability. Profitability has a characteristic of changing the owners' behaviour about risk-taking and other decisions (Yılmaz, 2013). As far as previous studies are a concern, significant negative relationship observed between private ownership & risk-taking and foreign ownership and risk-taking while positive relationship observed between government ownership and risk taking but this situation not observed in Pakistani banks. As mentioned above in Table (2) and (3) that most of the Pakistani banks under private ownership but instead of decreasing, NPLs ratio increases from 6.9 percent to 12.4 percent from 2006 to 2015 which shows that private ownership structure not suitable enough to manage the risk-taking activities of the banks and there is something that may interrupt the relationship between the variables such as profitability. The profit motive of the banks forces them to take extensive risk that is the reason the banks maintain CAR by increasing their equity but not reducing their risk-taking activities. This situation is the major cause of increasing level of NPLs in Pakistani banks. Financial performance has ability to change the behaviour of owners about risk-taking and can be used as a mediator as clearly mentioned by (Musibah & Alfattani, 2014; Purnomosidi et al., 2014) in their study on profitability as mediator. Similarly, Wahba and Elsayed (2015) conducted the study titled as "The Mediating Effect of Financial Performance on the Relationship between Social Responsibility and Ownership Structure" and used profitability as a mediator and also suggested that it can be used as a mediator with other variables. In addition, Lun et al. (2016) also used profitability as a mediator and suggested that less attention has been paid on profitability as mediator. On the basis of all given gaps, this study is going to use profitability as a mediator in the relationship of different ownership structures and risk-taking activities of the banks.

5. GENERAL DISCUSSION

Strong and experienced ownership structure is necessary to manage the risk-taking activities for every financial institution because risk-taking decisions depend upon the owner's behaviour regarding the risk of the financial institutions. Similarly, (Laeven and Levine (2009); Paligorova (2010); Pinteris (2002); Zhong (2017)) found in their studies that private ownership structure is more expert than other ownership structure to manage the risk-taking activities of the banks. Most of the banks in Pakistan under private control but fail to manage the risk due to fulfil high profitability goals of the owners. Extensive risk associated with high return assets and banks in Pakistan purchase high risky assets to get more returns. Similarly, (Musibah and Alfattani (2014); Purnomosidi et al. (2014); Wahba and Elsayed (2015)) also concluded that high profitability goal of owners has characteristics to change owners' attitude about risk-taking. Same in case of Pakistani banks, although most of the banks under private ownership but fail to handle NPLs of the Banks. There are two ways of increasing the CAR, by increasing the equity and by decreasing risky activities. The focus of regulators is only on increasing the CAR but not on how it is increasing. Banks of Pakistan increase the CAR by increasing their equity through new investment in return risk-taking activities also increase with the passage of time, and that is a reason on high NPLs situation in the Pakistani banks. At the end, it is summarized that strong and experienced ownership structure is necessary to manage the risky environment of the banks, but owners' behaviour also modifies the risk-taking activities thus most importantly must keep watch on risky investment of the banks to increase the profits of the banks.

6. CONCLUSION

This study concluded that significant negative relationship both private ownership and risk-taking and foreign ownership and risk-taking while positive relationship between government ownership and risk taking. However, this situation is not observed in Pakistani banks because Tables (2 & 3) showed an interruption of relationship. Most of the Pakistani banks under private control but NPLs increasing with the passage of time that shows the focus of Pakistani banks and owners is to increase the profitability, and this motive changes the owners' behaviour in terms of risk-taking. The focus of risk management team and regulatory authorities only on increasing level of CAR not on the investment activities of the banks. Banks are increasing the CAR by increasing the equity but not reducing the risk-taking activities. Regulators must be put a check on risky investment activities of the banks for generating more profits and avoid the management to take unnecessary risks. In addition, less attention has been paid on profitability as mediator especially in this relationship, and this study suggests that future studies should empirically evaluate the conceptual framework (See Figure 1) given in this study.

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