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A CONCEPTUAL THOUGHT: HOW DOES THE PERFORMANCE OF FOREIGN ISLAMIC AND CONVENTIONAL BANKS DIFFER BY BANK SIZE?

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Abstract: *This conceptual paper aims to highlight the importance of examining the influence of bank size on Islamic and conventional banks' performance differently due to the fundamental differences in both types of banks. Aside from this, this paper also aims to call attention to the influence of bank size on foreign Islamic and foreign conventional banks. Unlike domestic banks, foreign banks can be subjected to diseconomies when operating or monitoring an institution from a distance. Hence, an increase in foreign bank size may result in even greater complexity for foreign banks, which may negatively affect their performance. Due to the relatively lack of experience in foreign expansion of foreign Islamic banks in comparison to foreign conventional banks, increasing a foreign Islamic bank's size may have a significant negative influence on its performance. On the other hand, as many foreign conventional banks started expanding into foreign territory much earlier than foreign Islamic banks, they may be less affected by agency costs associated with being a foreign entity and can have significantly higher performance with the increase of bank size due to economies of scale. Due to the differences in foreign Islamic and foreign conventional banks, this study calls upon researchers to examine the influence of bank size on foreign Islamic and conventional banks.*

Keywords: Ownership, Islamic Banks, Bank Size, Performance, Foreign banks

1. Introduction

Following the outbreak of the Global Financial Crisis (GFC), many scholars are motivated to investigate the influence of bank size on various performance indicators of banks. These include Laeve et al. (2016), Biswas et al. (2017), and Sapci and Miles (2019). According to Laeve et al. (2016), the increased discussion on bank size influencing the performance of banks in recent years can be attributed to a few factors. This includes the argument that large banks tend to have less stable funding and are more exposed to potentially risky market-based activities and a substantial increase in the size of large banks. Theoretically, we can relate two theories, namely Too Big to Fail and Too Big to Save, to the influence of bank size on the performance of banks. According to Too Big to Fail, large banks achieve economies of scale when they become large, which results in higher performance. However, in Too Big to Save, it was theorised that when banks become too big, it is difficult for the government to step in and save the bank.

While there have been a lot of empirical studies looking at the influence of bank size on the performance of commercial banks, such as Laeven et al. (2016), Biswas et al. (2017), and Spaci and Miles (2019), and a few that looked into its influence on Islamic banks, not much is known about how bank size influences foreign Islamic and foreign conventional banks. Fundamentally, the influence of bank size on Islamic and conventional banks can be different. According to Beck et al. (2013), although Islamic banks may have lower agency costs due to the presence of Profit and Loss Sharing (PLS) products, the lack of experience and relatively higher complexity than conventional counterparts can potentially affect the overall performance of Islamic banks. Due to the lack of experience and higher complexity of Islamic banks in comparison to their conventional counterparts, the increasing size of Islamic banks may result in even higher complexity for Islamic banks and may result in lower efficiency and performance. Hence, empirical results from previous studies using conventional banks' samples cannot be generalised to Islamic banks. Therefore, there is a need to empirically study the influence of bank size on Islamic and conventional banks separately.

Aside from the lack of empirical study on the influence of bank size on Islamic banks, not much is known about how being a foreign entity—both Islamic and conventional—can be influenced by bank size. Foreign banks faced different challenges than domestic banks, such as those mentioned in the Home-field Advantages and Global Advantages hypotheses (Berger et al., 2000). In the Home-field Advantages hypothesis, domestic banks should be more efficient since they do not suffer from the organisational diseconomies associated with international banks that must oversee operations from afar. However, according to Saw et al. (2022), some foreign banks can overcome the disadvantages of being a foreign bank due to superior managerial skills, which may derive from favourable home country conditions, such as access to an educated labour force. At such, the increase of foreign Islamic and conventional bank's size can be beneficial due to superior managerial skills in home country. However, due to the lack of empirical work on understanding the influence of bank size on foreign Islamic and conventional banks, there is no statistical support that foreign Islamic and conventional banks would be more profitable if the bank size was increased. This is where this conceptual paper comes from, to expose the importance of understanding how bank size influences the performance of foreign Islamic and conventional banks. This is also a much needed analysis because in recent years, many foreign Islamic banks that entered Malaysia, such as Kuwait Finance House, suffered losses in the years 2010-2011 and 2015-2016 (Saw et al., 2022). This motivates and creates urgency to further understand what can influence the performance of foreign banks.

This conceptual paper aims to come up with a few hypotheses related to bank size and its influence on foreign Islamic and conventional banking. The outcome of this study implies that there is a potential difference in the influence of bank size on foreign and domestic banks, in the context of Islamic and conventional banks. The rest of the paper is as follows: The next session will provide literature reviews, which are used to create hypotheses linking ownership, bank size, and performance of banks. Next, we will discuss a methodology suitable to carry out the analysis, and it is followed by the conclusion of the study.

2. Literature Reviews

2.1 Bank Size

There are several hypotheses related to bank size. These include "Too Big to Fail," which explains that an increase in bank size benefits a bank by increasing its bargaining power and economic scale (Kozubovska, 2017). On the other hand, "Too Big to Save" suggests that large banks are subjected to high market discipline and this leads to the government's having difficulty in saving these large banks from failing (Bertay et al., 2013). Another hypothesis proposed by Laeven et al. (2016) is the Unstable Banking hypothesis, which contends that large banks are more likely to participate in risky projects such as trading and thus are more vulnerable because large banks tend to finance with short-term debt. Laeven et al. (2016) associate large banks with the agency cost hypothesis, where large and complex banks are thought to suffer high systemic risk caused by issues related to corporate governance and increased agency problems.

Some studies such as Othman et al. (2013), Bitar et al. (2017), Biswas et al. (2017), Khan et al. (2018) support the theory of Too Big to Fail, while some studies such as Pasiouras and Kosmidou (2007), Bertay et al. (2013), found results against it. The varied results of these studies can be associated with different samples, duration, and the state of the host country. In a handful of studies that looked into Islamic banks, Alqahtani et al. (2017) and Chen et al. (2018) found a positive association between bank size and the performance of Islamic banks, while Ibrahim and Rizvi (2017) found a negative association between bank size and the performance of Islamic banks. These complications provided by literature and the conflicting theories on bank size, as well as the limited number of studies carried out on bank size and the efficiency of Islamic and conventional banks, motivate examination of the influence of bank size on the efficiency of Islamic and conventional banks.

2.2 Ownership

In relation to ownership, there are several hypotheses that must be addressed. These include the Home-field Advantages and Global Advantages hypotheses. According to Berger et al. (2000) in their discussion on the Home-field Advantages hypothesis, foreign institutions are generally less efficient than domestic counterparts due to diseconomies in operating or monitoring an institution from a distance. Monitoring problems may make it difficult to evaluate the behaviour and effort of managers in a distant market or make it difficult to determine how well they are performing relative to other institutions in that market. Other than distance, home-field advantages could occur as a result of differences in language, culture, currency, regulatory and supervisory structures, other country-specific market features, biases against foreign institutions, or other explicit or implicit barriers. In other words, the agency costs of foreign banks can be different in comparison to domestic banks. On the other hand, under the Global Advantages hypothesis, some efficiently managed foreign institutions are able to overcome these cross-border disadvantages and operate more efficiently than the domestic institutions in other nations. These organisations may have higher efficiency when operating in other nations by spreading their superior managerial skills or best-practice policies and procedures over more resources, lowering costs. They may also raise revenues through superior investment or risk management skills by providing a superior quality or variety of services that some customers prefer or by obtaining diversification of risks that allows them to undertake investments with higher risk and higher expected returns. As suggested by the Home-field Advantages hypothesis and the Global Advantages hypothesis, foreign banks can perform differently than domestic banks due to differences in agency costs and managerial skills. This can affect how increasing bank size affects the performance of foreign banks.

3. Discussion and Conclusion

Bank size influence on Islamic and Conventional banks

As suggested by empirical results and hypotheses mentioned in the literature review, there has been a mix of results and opinions on how bank size can influence the performance of banks. Considering the presence of PLS in Islamic banks, which can reduce the agency problem of Islamic banks, an increase in Islamic banks' size may drive higher performance of Islamic banks. However, due to the complexity and relatively lack of experience of Islamic banks, an increase in Islamic banks' size may result in poorer performance of large Islamic banks as suggested in the Unstable Banking hypothesis. Due to these differences as well as mixed empirical results, it is rational to expect that certain studies on the bank size of Islamic and conventional banks may have been significant and positive, significant and negative, or insignificant. However, due to the overwhelming number of empirical results that found a positive and significant influence of bank size on bank performance in comparison to studies that found a negative influence on bank performance, the hypothesis suggested by this study is as follows:

$H1_0$: Bank size has no significantly different influence on Islamic banks' performance

$H1_1$: Bank size has significant positive influence on Islamic banks' performance

$H2_0$: Bank size has no significantly different influence on conventional banks' performance

$H2_1$: Bank size has significant positive influence on conventional banks' performance

Bank size influence on foreign Islamic and foreign conventional banks

According to the Home-field Advantages hypothesis, foreign banks may be at a disadvantage in comparison to domestic banks because of the higher agency costs of foreign banks in comparison to domestic banks. However, in the Global Advantages hypothesis, foreign banks can overcome the issue with agency costs by bringing in superior managerial talent from their home country. While it is possible for foreign conventional banks to bring over superior managerial skills they have in their home country, it is unlikely to be the case for foreign Islamic banks. Foreign Islamic banks only started to expand into other markets in the 2000s.[1] n comparison, many conventional banks, such as Standard Chartered Bank and HSBC Bank, started foreign expansion much earlier.[2] Hence, foreign Islamic banks may not have the managerial skills that foreign conventional banks have. Due to the disadvantages of being a foreign bank, lack of experience in foreign expansion, and potential increase in complexity when foreign Islamic bank size increases, we suggest the following hypothesis on how bank size can influence foreign Islamic banks:

$H3_0$: Bank size has no significantly different influence on foreign Islamic banks' performance

$H3_1$: Bank size has a significant negative influence on foreign Islamic banks' performance

[1] Based on Fitch Connect description of Kuwait finance House (Malaysia) Berhad and Al rajhi Banking & Investment Corporate (Malaysia) Bhd, both foreign banks in Malaysia were incorporated in Malaysia in year 2005 and 2006 respectively.

[2] Based on Fitch Connect description of Standard Chartered Bank Malaysia Berhad and HSBC Bank Malaysia Berhad, both foreign banks in Malaysia were incorporated in Malaysia in year 1984.

As for foreign conventional banks, we suggest bank size can have a positive influence on foreign conventional banks' performance because many foreign conventional banks have experience in foreign expansion, which can lower agency costs associated with expansion, and these banks can bring their superior managerial skills consistent with the Global Advantages hypothesis to increase performance. Therefore, we suggest the following hypothesis for foreign conventional banks:

$H4_0$: Bank size has no significantly different influence on foreign conventional banks' performance

$H4_1$: Bank size has significant positive influence on foreign conventional banks' performance

4. Acknowledgments

This paper aims to highlight the importance of examining bank size in Islamic and conventional banks separately as well as how bank size can influence foreign counterparts of both types of banks. This paper's argument is based on available theories and hypotheses such as Too Big to Fail, Too Big to Save, Unstable Banking, Home-Field Advantages, and Global Advantages hypotheses. Due to mixed theories and empirical results from previous studies, bank size can potentially have a positive or negative influence on the performance of both types of banks. However, as empirical results from previous studies are heavily skewed towards a positive influence of bank size on the performance of banks, we hypothesise that bank size can have a significant influence on the performance of Islamic and conventional banks. This paper also suggests that foreign Islamic banks may be at a disadvantage more than foreign conventional banks because of the lack of experience in expansion. As such, the agency problem that is associated with foreign Islamic banks can be higher than that of foreign conventional banks. Due to the disadvantages such as lack of experience in foreign expansion, higher agency costs, and complexity, we suggest that bank size can have a negative influence on the performance of foreign Islamic banks. As for foreign conventional banks, many, such as HSBC bank and Standard Chartered Bank, have extensive experience in foreign expansion, and these banks can potentially bring over their superior managerial skills in home markets to host markets and achieve economies of scale when bank size is increased. As many foreign banks have suffered in recent years, it is important for researchers to continue to observe and empirically examine foreign Islamic and conventional banks.

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