

# Chapter 9

## Risk Behavior, Country Governance, and Bank Stability in Pakistan

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### **ABSTRACT**

*Keeping risk behavior and country governance in observation, this study has investigated the trends in financial stability for a sample of 22 commercial banks in Pakistan while controlling the effect of economic growth. Over the period of 2007 to 2016, the authors have applied OLS, FE, and RE regression methods to investigate which risk and governance factors are influencing the stability measures of the banks. It is found that financial stability in overall banks is affected by credit risk, operational risk, country risk, and financial crisis risk while control of corruption is also affecting ZROA in an adverse way.*

### **1. INTRODUCTION**

From the context of financial markets, banking firms are playing their significant role through provision of credit and cash flows facility. However, since global financial crisis (GFC) of 2007-2009, question of financial stability (FS) for the banks is under the focus of policy makers, researchers, and financial analysts (Acharya & Richardson, 2009; Allen & Gale, 2004). The issue of FS is significantly identified in both developed and emerging economies in recent literature through series of determinants. However, various risk factors as core determinants of FS in both conventional and Islamic banks are under observation. Both types of these banking system are facing various risk factors, affecting their stability. It means that risk and FS are highly associated to each other. The most significant risk factors in banking system are known under the title of liquidity and credit risk, indicating their adverse influence on the banks as specified by (Hassan, Khan, & Paltrinieri, 2019). They further believe that liquidity and credit

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risk are negatively associated to each other and during the time of financial crisis, both risk factors has affected FS of banks.

In addition, financial institutions are vulnerable towards the operational failures which are in the form of procedural and operational lapses (Allen & Saunders, 2004). Banking system fragility is also affected by operational risk (Barakat & Hussainey, 2013). The reason is that operational hazards reflects the reputational risk for financial firms like banks (Eckert & Gatzert, 2017). The factors of market and country risk are also under significant attention of the reserachers. Increasing volatility in the interest rate is a well-known measure for the market risk (Jorion, 2000). Central banks also use the interest rate to analyze the stability in the economy (Di Giorgio & Rotondi, 2008). At international level, GFC is a well-known category of risk faced by the banks, hampering FS in various financial systems (Avgouleas & Cullen, 2014; Diamond & Kashyap, 2016; Johnson, 2011).

It is believed that the factor of country governance, bank performance and stability measures have their significant association to each other (Ho, Lin, & Tsai, 2016). The objective of this research is to investigate the risk behaviors and country governance as determinants of FS of banks in Pakistan. For a detailed analysis, we have divided overall empirical results into four major categories. The first step is to examine the impact of risk and country governance on two stability measures (ZROA, ZROE). The second phase is to analyze the risk and governance indicators for examining the stability trends in public sector banks. For the third case, only private banks were selected to analyze the impact of risk and governance on their stability profile. In analyzing these relationships, we controlled the effect of bank size (measured through total assets) and overall domestic economic growth (GDP growth rate) due to their consistent and significant effect on FS as specified in previous literature. Furthermore, panel models are applied through robust technique while controlling the issue of biasness in the coefficients. The rest of the paper is structured as follows. Section two defines the literature context of the study. Section three shows the description of the variables. Section four explains methodological context. Section five covers empirical findings and comprehensive discussion. Last section deals with conclusions of the study.

## **2. LITERATURE REVIEW**

Risk behavior and bank stability are closely associated to each other. Literature context has significantly addressed the issue of banking sector fragility and performance under the situation of various risk factors. However, one of the key issue as found in the existing literature is to examine the trends in the banking sector stability through set of the risk factors. The reason is that literature is missing with compiling both bank related, regional economic, and international risk factors in a one setting to examine their effect on the stability of the banks specifically in the developing economies. For example, Shen, Chen, Kao, and Yeh (2009) primarily focuses on the liquidity risk (LR) for twelve advance economies during 1994 to 2006 through two-stage least square (2SLS) regression estimate. They have found that LR is an endogenous indicator for the performance of banking sector in the targeted economies under market bases-financial system. However, in the presence of bank-based financial system, behavior of LR for banking sector performance is insignificant. Such findings has provided a limited context for the generalization as most of the developing economies are missing with either market based or bank-based financial system.

Research work conducted by Hassan et al. (2019) provide a comprehensive assessment for both conventional and Islamic banking as observed through liquidity, credit, and stability measures. It is observed that both Islamic and conventional banks are negatively associated to liquidity and credit risk

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