


Measuring the Determining Factors of Financial Development of Commercial Banks in Selected SAARC Countries

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ABSTRACT

Traditional banks face the issue of risk diversification, and it is dealt with when they evolve into financial institutions. So, the present study aims to investigate banking and off-balance sheet (OBS)-based risks and regulatory changes in certain age-old South Asian (SA) banks and finds the tenacity of the OBS in the long run. For these research goals, two estimates are applied: fixed effects (FE) and generalized method of moments (GMM). Using FE, the researchers estimate the realm and time for finding financial shocks and other time-related factors affecting the SA countries. The majority of findings reveal a constant market theory stating the performance of SA in assessing OBS-related risks. Banks in SA also seem to follow the market regulatory and TT in capital needs that will incentivize banks to take too much risk in off-balance sheet activities (OBSA). The research findings are practically applied to bank-related risks, pressure from regulatory restructuring, and dangers from the systematic factors beneficial to policymakers and practitioners.

KEYWORDS

Bank-Specific Risk, GMM, Off-Balance Sheet Activities, Regulatory Pressure, Systematic Risk, South Asian

1. INTRODUCTION

As time has progressed, rapid high-tech innovations are shifting the market's subtleties; Commercial Banks (CB) have transitioned from financial intermediaries to Financial Institutions (FI), which can provide market-based lending. CB now engages in risk transfers and trading to a greater extent.

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The development of fintech causes CB to take on more risk (Hu et al., 2022). Restructured banking and financial systems are transforming how CB operates. According to (Beyer et al., 2018), the primary sources of income for banks are interest (conventional) income, which comes from lending activities as well as holding and selling securities, and non-interest income, which comes from the sale of financial product' fees such as servicing and loan origination. Together, these two types of income make up the majority of banks' revenues. Non-Interest income like Off-Balance Sheet (OBS) indicators that can be useful for evaluating the quality of accounting information. Off-Balance Sheet Activities (OBSA) have been identified as a solution to declining conventional activities because they improve banks' financial performance by yielding higher returns with lower risks. However, several empirical inquiries, such as that of (F. Wang et al., 2020), highlighted the enterprise Credit Risk (CR) assessment using big data analytics on an e-business platform and emphasized the effect of non-interest income in increasing variance, *i.e.*, the risks on earnings. Still, other recent studies have proven that OBSA can improve the financial performance of CB with no adverse consequences.

According to the literature, Machine Learning (ML) has been used to manage banking risks like CR, market risk, operational risk, and Liquidity Risk (LR). It's not commensurate with the industry's focus on Risk Management (RM) and ML. Incorrect incentive mechanisms have led bankers to prioritize investment returns over risk. With that in mind, this activity could jeopardize the financial stability of CB and depositors' money. It is evident that in the post-crisis period, the banking industry faces many challenges, one of which is the development of OBSA (L. Sun et al., 2017). As bank policies on traditional banking exercises influence the evolution of OBSA, OBS information is receiving more attention. Meanwhile, Systematic Risks (SR) also significantly impact OBSA (Ashraf et al., 2015).

Academics, policymakers, and bankers have debated risk diversification, operational scope expansion, and regulatory pressure to justify banks' OBSA. The developing SA banking industry engages less in OBS than other developing and developed nations. OBSA are used to reduce risks, but both the data selection process and data description are risky when considering bank efficiency (Sengupta & De, 2020). The highly concentrated SA banking market makes banks strive greatly to earn expected returns; OBSA facilitates them in doing so, but at the expense of facing continuous risks. Reforming how information is managed is becoming increasingly necessary as a result of incidents involving the leaking, alteration, and loss of information, and progress has been made in this area.

According to (Parthasarathy & Daneva (2021); D'avino et al. (2022)), there is an entirely new global dataset that is geared toward developing and emerging nations as well as engineering frameworks and the ability of banks to generate liquidity. There is a rapid increase in OBSA in commercial Banking Sectors (BS) worldwide. This raises the question of why CB engages in OBSA. The main reason identified is that OBSA can generate extra cash inflows. (Rahman & Iverson, 2015) suggest that OBSA facilitate banks in enhancing their scope of operations and, in turn, increasing their income, which is not achievable by engaging in OBS kinds of stuff or conventional banking actions. The following emerging query entails why banks today demonstrate extreme aggressiveness towards their scope of operations. (Dvorski Lacković et al., 2020) suggested the application of selected aspects of big data in the RM of banks. It is because of increased financial market competition, increased CR and LR, and the pressure for banks to find new earning avenues due to the related risks. Hence, from the banker's perspective, OBSA provides a means for improving returns and bringing value to shareholders.

Another reason for engaging in OBSA is to manage banking risks and solutions to avert the next financial crisis in South Asia (Melecky, 2021). (Sabir & Khan, 2018) sustained this notion and indicated that banks that engage in more non-conventional activities are less risky. However, other scholars (Fischer & Baskerville, 2020) highlighted that for the 21st century, the socio-technical perspective needs to be revised, and there are new mechanisms at play. Increased Fee-Based Income (F-BI) could increase volatility in bank income and thus pose higher risks. In short, it is critical to understand the role of Information and Communication Technology in the development of banking ecosystems (Tunio, 2020). OBSA are extremely risky, and the risks they pose can either be a prospect or a hazard. For instance, despite being a basis of extra revenue, guarantees jeopardize imminent

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