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The relationship between risk, capital and efficiency in South African banks

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2016
http://hdl.handle.net/10539/22223

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ABSTRACT

This research project analyzed the relationship between bank risk taking, capital and operating efficiency in South African banks. The relationship between bank risk taking, capital and operating efficiency is one of the central topics in banking studies because of regulators' and researchers' quest to understand the determinants of bank risk taking. The research used a panel data set of top 4 South African banks for the period 2004 to 2013. The period under study includes the credit crisis which therefore introduces parameter instability with a known structural break or change point into the regression parameters. The research data was collected from financial statements of the sampled the banks to construct standard accounting measures of bank risk taking, capital adequacy and operating efficiency all of which were regressed using simultaneous equations in EViews. The regression results do not provide evidence of any relationship between risk taking and capital. The only statistically significant relationship is the inverse relationship between risk taking and efficiency. The finding that efficiency is negatively related to bank risk taking supports earlier research findings that bank risk taking is more pronounced in inefficient banks compared to efficient ones. It also supports the moral hazard hypothesis which posits that banks undertake more risk taking when faced with greater inefficiencies; and the "bad management" hypothesis which states declines in efficiency lead to increased risk taking. The regression results also do not provide evidence of a relationship between capital and efficiency: implying that capital and efficiency are not simultaneously determined. The results in this study oblige management and regulators to pay much attention to operating efficiency as a driver of bank risk taking.

Keywords: Bank risk taking, operating efficiency, capital adequacy, credit risk, credit loss ratio, cost to income, capital adequacy ratio