

Abstract

Depositors' contribution to financial stability does not only stem from the funding they provide to the system, but their disciplining power on overall financial system. The theory of depositor discipline predicts that when excessive risk taking occurs, depositors exert higher disciplining by asking higher returns on their deposits or withdraw their funds. Although it has been intensively claimed that depositor (market) discipline is at least accommodative in banking regulation, the empirical literature is surprisingly mute on the factors that affect depositor discipline. This paper examines the role of religiosity on the disciplining power of depositors in a dual banking system. By segregating the deposits across cities in Turkey, we examine how city-level religiosity affects the depositor discipline. We also identify whether this effect is running differently for Islamic and conventional banks. We find that religiosity has a weakening power on depositor discipline. We also find that Islamic banks are exposed to less depositor discipline, however the weaker disciplining on Islamic banks is found to be unrelated to the degree of religiosity. These results imply that religiosity is an integral part of depositor discipline which might raise the importance of financial inclusion as religious commitments hinder some potential depositors from the financial system due to limited product diversity.