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ISLAMIC BANKING STRUCTURES: IMPLICATIONS FOR RISK AND FINANCIAL STABILITY

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The recent persistence of global economic imbalances has further highlighted the importance of financial stability. This research tested the implication of Islamic banks' structure on risk and financial stability using bank-level data from 39 full-fledged Islamic banks in 17 selected countries. The tested model used pooled least squares with white cross-section standard errors and fixed effects. After allowing for non-linear relationship between financial stability and market structure, three regression equations were estimated for three dependent variables used as proxies for the Islamic banks' financing portfolio risk, overall risk and capitalization level. The ratio of non-performing financing, Z-index, and capitalization ratio respectively were used. In all regressions, the Lerner Index, HHI-deposit Index and HHI-financing Index were used as measures of competition and concentration. Across these regressions, the higher value of these indexes implied a degree of market power and therefore, a less competitive environment. In addition, the paper also included the log value of the GDP per capita, inflation and Exchange rate in all regressions to control for the variations in business and economic development.

The first estimated equation relates to the ratio of non-performing financings (NPFs). The results of this equation shows that there was a positive relationship between bank market power (LI, LIs) and financing risk portfolio in the investigated banks. These results were consistent with the competitive-stability view which claims more bank market power is associated with riskier loan portfolio. The negative sign in HHI-Financing suggested that concentration in these Islamic banks brings about a decline in credit risk, which supported the franchise value paradigm. This means the charter value which is associated with market power reduces competition and promotes banking stability in the investigated Islamic banks.

The paper also examined the impact of the Islamic banks market structure on the overall bank risk, using Z-index. The results showed high overall Islamic bank stability. Consistent with the NPFs, the Z-index results indicated that Islamic banks enjoy higher franchise value and greater stability. Hence, results of Z-index imply that the investigated Islamic banks might use their market power to increase their financing rates which in turn increases their credit risk, but at the same time protects their charter value by rule of risk sharing and high capitalization level.

Thirdly, the study investigated whether the Islamic banks' higher market power as it appeared in the above results also means such banks hold more equity capital as a prudential behavior to meet any unexpected losses resulting from their financing portfolio. The results showed that the equity capital in these Islamic banks was positively related to their stability. This implies that, although Islamic banks are associated with higher credit risk, the lower overall risk most likely resulted from their higher level of charter value as implied in their higher equity level. The estimated contemporaneous GDP per capita, inflation and Exchange rate indicated that the business cycle did influence the investigated Islamic banks and hence Islamic banks might take more risks in connection with the more variations in economic development.

To sum up, one can conclude that the Islamic banks are found financially stable in this research as indicated by the result of their concentration structure, which is supported by their built-in prudential regulations extracted from Sharīʿah. This makes them more conservative in lending and selecting their investment portfolio.

Lessons learned:

1. Islamic banks are not immune to the financial crisis if their market discipline does not coincide with the Sharīʿah based values. That is to say although Islamic banks are found to be stable based on structure, they could be affected by the indirect causes of the financial crisis

related to the real sectors such as stocks and real estate prices unless care is taken.

2. The nature and practice of Islamic banking that is based on "no pain, no gain" might help more in averaging the high risk as reflected in the results of the research.
3. Equity finance (asset side) plays a major role in Islamic banking stability as shown in this study.
4. To curb down unfavorable competition, banking regulators are advised not to allow Islamic banking windows and encourage the growth of full-fledged banks.
5. Islamic banks should not imitate the conventional banks blindly in new banking innovations such as financial derivatives.
6. The role of Sharīʿah advisors should be strengthened to detect any deviation from the Islamic values.
7. New research is encouraged to investigate the impact of the credit risk transfer on the behavior of Islamic banks' financing in a connection with the current financial crisis.

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Islamic Economics and Finance are the two fields that are very promising for attaining economic growth with equity and for sound development of financial sector globally. Muslim societies that believe in the teachings of Islam and hence in the capacity of such system have the added responsibility to create and offer this to the world. However, multi-dimensional efforts and fulfilling of some pre-requisites are required in achieving the paradigm shift from the entrenched economic and financial system to an Islamic one.

Meeting these challenges require development of basic theory of Islamic economics and finance as well as active efforts for its practical implementation, such that both the theory and the practice feed into each other for their mutual development.

The volume-2 of the book *Advances in Islamic Economics and Finance* has been edited with the above consideration.[1] It comprises of selected papers and comments from the Sixth International Conference on Islamic Economics and Finance. The introductory chapter specially written for the volume brings out the key issues facing the development of Islamic economics and finance and also places the selected papers in the context of those issues.

The present volume is divided into six themes each presented in a separate part covering: (i) fundamental issues, (ii) legal development and contractual forms, (iii) *ṣukūk* products, (iv) regulation and supervision, (v) consumer behaviour, and (vi) financial stability and institutions.

Fundamental Issues:

The collection of papers opens with the paper by Waleed El-Ansary entitled "The Qunatum Enigma and Islamic Sciences of Nature: Implications for Islamic Economic Theory". El-Ansary discusses a methodological question on the nature of Islamic economics. The question is whether the neoclassical framework is sufficient and hence appropriate for Islamic sciences.

Legal Development and Contractual Forms:

Legal system plays a vital role in economic and financial development of a society in multiple ways. Firstly, a legal system has important role in delineation of contractual rights, and most often also in enforcement of these contracts. Ex-ante, this decreases legal uncertainty, and ex-post, it helps in conflict resolution. It may be noted that the prohibition of '*gharar*' in Islam aims exactly at that. Secondly, in this way, a legal system also has bearing on types of financial (and other) contracts that will evolve in the system. A large literature has emerged explaining how a legal system that adapts efficiently to the contractual needs of the economy can foster financial sector development. This ability, however, depends on the nature of the particular legal system. This nature is defined by many factors such as the relative importance of life, property, progeny, intellect, and faith and other human

[1] Volume-1 of *Advances in Islamic Economics and Finance* has been published in 2010 by IRTI.

rights in a legal system; the centralized versus decentralized nature of law and its procedure of interpretation and judgment; and the extent of its unchanging core and the evolving periphery, etc. Similarly, a large literature has emerged on security design and financial innovation stemming from the risk appetite of investors, the information asymmetry between the contracting parties, and the legal system's ability to define and enforce property rights. Islamic literature on *gharar* can play an important role in this respect.

Depending on the nature and enforceability of the legal system, the financial innovations can be evolutionary and beneficial to the society or such innovations can also be in negative direction leading to social degradation and adaptation of law in the wrong direction, i.e., undermining the rights of some for the sake of some more influential segments.

Three papers in Part-II of this volume address these important issues of adaptability of Islamic law, examination of the legal nature of shares or stocks, and role of risk aversion in determination of sharing ratio in sharing contracts.

Habib Ahmed "Islamic Law, Adaptability and Financial Development".

Faizal Manjoo "Reviewing the Concept of Shares: Towards a Dynamic Legal Perspective".

Sief el Din Tag el Din "Income Ratio and the Risk-Sharing Structure of Optimal Contracts: The Breakeven Theory of *Muḍārabah*".

Ṣukūk Products:

Ṣukūk products are relatively new among Islamic financial products. They are a class of structured finance products that can be used for financing projects as well as meeting the needs of the corporate and government sectors. Most of them can be structured to allow their tradability in the secondary market and can generate fixed or variable rates for their holders. Hence *ṣukūk* can contribute to the development of a market for fixed income instruments within Islamic framework. Like any other instrument, Sharīʿah non-compliant features can creep into legitimate *ṣukūk* structures if proper safeguards are not observed. Two papers in this Part-III provide a very good survey of the issues, existing and possible structures, as well as the economic and financial opportunities afforded by *ṣukūk* for Islamic finance.

Muhammad Ayub "Securitization, *Ṣukūk* and Fund Management Potential to be Realized by Islamic Financial Institutions".

Nathif Jama Adam "*Ṣukūk*: A Panacea for Convergence and Capital Market Development in OIC Countries".

Regulation and Supervision:

In the wake of various episodes of financial instabilities and banking crises, which the world has experienced over the years, a number of efforts have been made at the international level to streamline and standardize the regulation and supervision methods for the banking industry. The principles and standards developed by the Basel Committee are one example. Although major differences exist between Islamic and conventional banks in regard to the banking theory, practices and the contracts used for raising funds and their investments, however being a small part of the international financial system, Islamic banks are likely to be judged and regulated by the same rules. This is likely to create problems for the workings of Islamic banks and may create regulatory and supervisory hurdles for them.

A set of three papers and comments by three discussants on this set of papers constitute the contents of Part-IV of this collection. These evaluate the implications of Basel-II for Islamic banks and try to suggest alternate requirements of capital adequacy.

Kabir Hassan and Mehmet F. Dicle, "Basel-II and Capital Requirements of Islamic Banks".

Abdul Ghaffar Ismail and Ahmed Azam Sulaiman, "Cyclical Patterns in Profit, Provisioning and Lending of Islamic Banks and Procyclicality of the New Basel Requirements".

Monzer Kahf, "Basel-II: Implications for Islamic Banking".

Customer Behaviour:

Part-V of this collection deals with customer behaviour. The importance of customer behaviour for Islamic economics as well as for Islamic finance cannot be over emphasised. Firstly, this knowledge is important for individual Islamic banks in their marketing strategies. Secondly, it is also of high significance for various governments in deciding about their policy stance towards acceptance of Islamic finance. Thirdly, customer behaviour and their Islamic financial literacy also have implications for the sound growth of Islamic financial industry in the correct direction.

Although, a large number of studies on customer and client behaviour may have been done internally by various Islamic banks for their marketing purposes they are either not available to public or not of academic nature.

Academic studies in this area exist but are few and mostly country and time specific. The three papers collected in this volume on customer behaviour are also not exception to this limitation. However, they are value adding in the sense that one of them deals with Indonesia using qualitative approach, the other deals with Malaysia using quantitative approach, and another deals with the demand for Islamic finance in China. To the best of our knowledge this may be the first such study focusing on China.

Adiwarman A. Karim and Adi Zakaria Affif, "Islamic Banking Consumer Behaviour in Indonesia: A Qualitative Approach".

Sudin Haron and Wan Nursofiza Wan Azmi, "Measuring Depositors' Behaviour of Malaysian Islamic Banking System: A Co-integration Approach".

Tianming Liu, "Islamic Financial Thought and Chinese Muslims' Financial Behaviour".

Financial Stability and Institutions:

Success of a financial system lies in provision of its services in a manner relevant to the broader society and in most stable way. The first criterion calls for a very inclusive financial sector that would contribute to broad-based economic growth, while the second criterion calls for avoidance of breakdown of its services and avoidance of abrupt fluctuations in valuation of assets. An Islamic financial system can achieve both these objectives. Firstly, by providing finance free from interest, it aligns the finance with the religious and moral values of the society which helps in increasing the participation of the broader society in formal financial system. Secondly, by tying finance to real economic activity it ensures stability. This is achieved through Islam's complete system of beliefs, rules, and moral ethics that help in internalization of appropriate behaviour as well as through external regulation. In this context two papers are included here in Part-VI: the first one addressing ways to improve stability through reduced speculative trade, the second one proposing the use of already existing mosque institution to increase the outreach of Islamic finance and hence enhance its inclusiveness.

Yousef Khalifa Al-Yousef, "Speculative Capital: An Islamic View".

Asry Yusoff and Abdullah Sudin Ab. Rahman, "A Study on the Possibility of Mosque Institution Running a Micro-Credit Programme Based on the Grameen Bank Group Lending Model: The Case of Mosque Institution in Kelantan, Malaysia".

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