Islamic Banking and Finance: Beyond Comparison and Investment Opportunities

Mansor H. Ibrahim
International Centre for Education in Islamic Finance (INCEIF)
Lorong Universiti A
59100 Kuala Lumpur MALAYSIA
mansorhi@inceif.org

M. Shahid Ebrahim
Durham University Business School
Durham UNITED KINGDOM
m.s.ebrahim@durham.ac.uk

1. INTRODUCTION

Islamic finance as a field of research continues to be exciting and has been evolving with coverage that goes beyond mere comparison with conventional finance. With rapid development in Islamic banking to reach the status of being systematically important in many jurisdictions, the following questions seem pertinent: Should Islamic banking diversify to non-intermediation activities such that it can rival and become a truly alternative to conventional banking in the provision of banking services? How should Islamic banks structure their financing? And what are the financial and real impacts of Islamic banking? As for the Islamic stock markets, in light of on-going research and still inconclusive findings, investment opportunities provided by Shari'ah compliant stocks remain a central issue. The question is: what is the role of Islamic stocks in investment strategies especially from the lens of price discovery? Apart from these traditionally-focused Islamic finance areas, Islamic finance research starts to emphasize other equivalently important areas, among which include Islamic corporate finance and Islamic microfinance.

This special issue, Islamic Finance and Banking IV, contains articles that address some of the above questions on Islamic banking and Islamic stock markets as well as few articles on other areas of Islamic finance. This editorial note provides an overview of these articles. We first overview the articles on Islamic banking and then proceed to those on Islamic stock markets. The few articles on other areas of Islamic finance are next highlighted before we conclude with some thoughts on potential avenue for future research.

2. ISLAMIC BANKING: BEYOND COMPARISON

Since especially the 2007/2008 Global Financial crisis, studies on Islamic banking has been growing. Motivated by the observed resilience of Islamic banking during the crisis and its rapid development in recent years, numerous studies have focused on comparative analyses of Islamic and conventional banks in terms of, among others, efficiency, risk/stability, profitability and financing/deposit behavior (Abdul Majid et al., 2017; Alqahtani et al., 2017; Kabir and Worthington, 2017; Alqahtani and Mayes, 2018; Yanikkaya et al., 2018; and Ibrahim and Rizvi, 2018). Few studies, however, have performed assessments of Islamic banking that go beyond mere comparison with conventional banking (Gheeraert and Weill, 2016; Imam and Kpodar, 2016; Abedifar et al., 2016; and Meslier et al., 2017), a direction strongly suggested by Ibrahim (2015). This special issue contributes to the research in this direction with 4 articles on Islamic banking. These are Naqvi et al. (2018), Abdul-Rahman et al. (2018), Chen et al. (2018), and Leon and Weill (2018).

The rise of Islamic banking to prominence in many countries raises a pertinent question whether it has picked up the slack in global financial intermediation. Naqvi et al. (2018) provide evidence for the contribution of Islamic banks to global financial reintermediation. Utilizing bank-level data of 486 conventional banks and 154 Islamic banks from 21 countries, they demonstrate higher intermediation ratios of Islamic banks. More specifically, over the period 2004-2015, the asset growth, loan-deposit ratio, loan to earning assets and gross loan growth are higher for Islamic banks. Indeed, they remain higher even after the global financial crisis (2010-2015) despite increasing intermediation activities of conventional banks. This intermediation trend of Islamic banks means that they play a key role in reintermediated financial markets. In their analysis, they identify better capitalization, improved liquidity and better service quality as enablers of financial reintermediation of Islamic banks. However, they further note that the reintermediation role of Islamic banks tends to be confined to only high-income countries.

Abdul-Rahman et al. (2018) address the effects of financing structure on liquidity risk of Islamic and conventional banks, an issue that has potential policy implications especially on the liquidity risk management. In the dual-banking system, Islamic banks are normally subject to regulatory requirements similar to those for conventional banks in addition to their own Islamic or Shari'ah requirements. In the context of liquidity risk management, Abdul-Rahman et al. (2018) recommend that the regulatory bodies and market players develop separate framework for Islamic and conventional banks. This recommendation is drawn from their analysis of financing structure and its effects on liquidity risk using a panel sample of Islamic and conventional banks operating in Malaysia. According to them, real estate financing exerts significant bearings on the liquidity risk of only Islamic banks while financing specialization tends to increase the liquidity risk of only conventional banks. Given different drivers of liquidity risk, it is thus recommended that the liquidity risk management framework be different for both types of banks.

As Islamic banking grows in importance, another pertinent inquiry is whether Islamic banks should relook at its business orientation by diversifying into non-intermediation activities, which is still low in comparison to the non-intermediation activities of conventional banks. Theoretically, the issue of "focus" versus "diversification" in banking is debatable. According to the classical finance theory, banks should benefit from diversification in terms of risk-return profile. By contrast, the corporate finance theory posits that "focus" would allow banks to concentrate in sectors or activities that they have expertise in and hence result in better performance. While the prevailing empirical evidence tends to favor the "focus" strategy in banking (Rossi et al., 2009), a safer conclusion from existing literature is not to lean toward a one-size-fits-all recommendation especially for banks with different business principles such as Islamic banks. Molineux and Yip (2013), perhaps the only notable study on the issue on Islamic banking, document evidence supporting diversification strategy for Islamic banks. In this special issue, Chen et al. (2018) echo this finding especially for large Islamic banks. More specifically, evaluating three dual-banking countries in Asia (Indonesia, Malaysia and Pakistan), they find evidence that the profitability effect of asset diversification tends to be pronounced for large Islamic banks in these countries.

Finally, Leon and and Weill (2018) focus directly on the contribution of Islamic banking development on access to credit. They assess empirically obstacles to financing based on a unique dataset that covers 15,302 firms from 52 developing and emerging economies over the period 2006 - 2009. Interestingly, deviating from the findings by Gheeraert and Weill, 2016; Imam and Kpodar, 2016 that Islamic banking development does contribute to economic efficiency and growth, they uncover evidence that it in general does not alleviate obstacles to financing. The contribution of Islamic banking development on access to credit, however, is evident only for countries that have low conventional banking development. These findings not only challenge a general view on the importance of Islamic banking on financial inclusion and hence access but also raise an important inquiry as to why Islamic banking in a developed conventional banking market fails to have impacts on credit constraints.

3. ISLAMIC STOCK MARKETS: INVESTMENT STRATEGIES

"What are the roles of Islamic stocks in investment strategies?" remains an important question in Islamic market research. In this special issue, two articles respectively by Karabiyik et al. (2018) and Narayan et al. (2018) focus on price discovery, the process by which new information is impounded into asset prices and consequently results in leading and lagging stocks (markets), and its investment implications. Meanwhile, Hutchinson et al. (2018) cautions that existing findings on comparative performance of Islamic and conventional stocks have not properly considered the cost of Islamic purification. Finally, Narayan (2018) assesses whether technology bears any implication on profitability of Islamic and non-Islamic stocks. These studies, overall, bring new perspectives on Islamic stock markets and hence contribute to the on-going research in the area.

Using data from 19 countries, Karabiyik et al. (2018) assess interactions between Islamic spot and index futures markets by means of a panel vector error correction model to obtain the estimates of price discovery. Interestingly, in 12 out of the 19 markets, the price discovery is dominated by the spot market, which is in consonant with the trading volume hypothesis. In these markets, the trading volumes in the spot market are relatively high as compared to the futures market, which should be expected given the fact that investment in futures and derivatives remains controversial from an Islamic point of view. They further demonstrate that information on price discovery that they obtain has economic significance in that it can be used to forecast and devise economically meaningful strategies. They show that the information can increase investment returns by roughly 62.35% (i.e. annualized average profit of 4.91%) from the buy-and-hold strategy, which is 2.97% per year.

Narayan et al. (2018) confine their analysis of price discovery to Islamic banking stocks from eight countries (Bahrain, Egypt, Jordan, Kuwait, Oman, Qatar, Saudi Arabia and UAE) and suggest investment strategies around the price discovery process to maximize profit or minimize loss. They find that, in each of these countries, there seems to be one bank that dominates the price discovery process. According to them, utilizing this information would help investors to cushion against risk. More specifically, in order to maximize profit or minimize loss, they suggest that investors should buy portfolios of price discovery dominant Islamic banks and sell other country portfolios or a portfolio of highly volatile stock. This finding is however still preliminary as the title of the article suggests and hence more research is still needed.

While Karabiyik et al. (2018) and Narayan et al. (2018) hint on profit opportunities from investing is Islamic stocks by utilizing information on price discovery, Hutchinson et al. (2018) and Narayan (2010) seem to place caution on Islamic stock investments. Hutchinson et al. (2018) in particular note that "conclusions about the performance of *Shari'ah* portfolios do so in errors" since they do not factor in the cost of Islamic purification. In their paper, Hutchinson et al. (2018) compute this so-called cost of faith and arrive at the figure to be as high as 0.89% per annum. According to them, the cost of faith is non-trivial and hence should be considered for proper assessments of Islamic portfolio returns. From another perspective, Narayan (2019) notes that technology does have profitability bearing on stock returns but only for non-Islamic countries. In other words, Islamic stock markets do not seem to gain from investment in technology.

4. OTHER ISLAMIC FINANCE

Apart from the above research on Islamic banking and Islamic stock markets, three articles are devoted to Islamic mutual funds, Islamic microfinance, and financing policy. These are contributed respectively by Naqvi et al. (2018), Fianto et al. (2018), and Zaman et al. (2018).

Adding to the earlier caution on proper assessment of investments in Islamic stocks to give due recognition to purification, Naqvi et al. (2018) raise further concern on documented findings supporting superior performance of Islamic mutual funds as manifested by higher Islamic alpha and lower Islamic beta. According to them, the performance differential between Islamic and conventional mutual funds could be an illusion. They provide evidence to support their contention using sample mutual funds from Pakistan and Malaysia. That is, the differences in performance between those two types of funds are mostly attributed to country differences or to a particular investment style. Hence, Islamic mutual funds per se would not offer any incremental benefit. In their words, "positive *Islamic Alpha* and negative *Islamic Beta*, on incremental basis, does not exist".

The study by Fianto et al. (2018) is interesting in its own way. It examines whether modes of Islamic microfinancing, equity versus debt-based financing, has differential welfare implications on recipients of microfinance (rural households in Indonesia). Their findings suggest that clients of equity-based Islamic microfinance received higher income than non-clients by roughly 8.1%. Meanwhile, the corresponding figure for debt-based Islamic microfinance is roughly 6.8%. These findings lead them to infer the superiority of equity financing as compared to debt-based financing of microfinance institutions in Indonesia. This supportive evidence for welfare-improving Islamic microfinancing notwithstanding, they remain skeptical as to whether Islamic microfinance will really benefit the poorest in Indonesia due to collateral constraints.

The work by Zaman et al. (2018) is distinct from the rest not only in its focus on corporate tax policy but also its use of simulation technique to gauge the impacts of corporate tax incentives to debt and to equity on firms' value. As they demonstrate, the dividend tax shield would align well to the Islamic financial principle of profit and loss sharing and would reduce firms' indebtedness. Based on simulation exercises, firms would be more stable and face lower costs of financing and become value oriented. On the basis of these findings, their recommendation is simple and direct – abolish corporate tax incentives to debt and institute tax incentives to equity.

5. CONCLUSION

Islamic finance is and will be a vibrant research area. Taking the articles in this special issue as a point of departure, we resonate the view by Ibrahim (2015) that future research should cover the bearings Islamic finance has on the economy at large. At the early stage of Islamic finance, a comparative analysis of Islamic and conventional finance is justifiable to provide a basis for its existence. Currently, Islamic finance has been systematically important in many countries and have been a fast-growing financial segment in other countries including the poverty-ridden African countries. In other words, Islamic finance is here to stay. Accordingly, Islamic finance research should move beyond mere comparison with conventional finance. The articles in this special issue take an important step to this direction. Based on these articles, I foresee several promising avenues for future research especially given the increasing emphasis on sustainable and inclusive growth and the challenges brought by Industry 4.0.

The economic roles of Islamic finance particularly Islamic banking should be assessed against a more comprehensive yardstick as encapsulated in the United Nations' Sustainable Development Goals (SDGs). Abedifar et al. (2016) point out that Islamic finance can play a role. However, Leon and Weill (2018) seem to paint a negative picture whether Islamic finance can widen financial access. Likewise, Islamic microfinance may not benefit the poorest due to collateral requirements in securing microfinancing (Fianto et al., 2018). In other words, access remains an obstacle to the poor. These limited and yet contradicting findings means that further assessments of Islamic finance contribution to SDGs are needed. Moreover, if the findings by Leon and Weill (2018) is right, further assessments of what contributes to the lack of impacts of Islamic finance on access to credit would be important. We believe that examining the implications of Islamic finance on intermediation costs or costs of capital would provide further insight that would bring far-reaching implications on the attainment of SDGs, particularly those related to inclusive and sustainable growth.

Recently, in its effort to embed SDGs in the Islamic banking business models, Bank Negara Malaysia (i.e. Malaysia's Central Bank) issued guidance documents for the implementation of Valued-Based Intermediation (VBI), which refers to financing decisions by Islamic banks that take into consideration their potential environmental and social risk and impact. To facilitate the adoption of the VBI, Bank Negara Malaysia in collaboration with the World Bank and the International Centre for Education in Islamic Finance (INCEIF) has developed the VBI Financing and Investment Impact Assessment Framework for Islamic Finance. Indeed, as Islamic finance is distinct from conventional finance, we acknowledge the importance of separate regulatory frameworks for Islamic banking and finance as aptly pointed out by Abdul-Rahman et al. (2018) for the liquidity risk framework and Zaman et al. (2018) for tax incentives. Further developments and assessments of the guidance and regulatory frameworks for Islamic banks especially those that have direct implications on SDGs should take a spotlight in Islamic finance research.

Apart from moving away from mere comparison with conventional finance, Islamic finance should extend its coverage to other segments of Islamic finance particularly Islamic social finance. Despite their financial and economic contributions as documented in several studies, Islamic banking and Islamic capital markets have their own plateau or limitations in their contributions to sustainable and inclusive growth. As Fianto et al. (2018) precisely put it, there is a cost to financial access. Accordingly, the developments of Islamic social finance particularly Zakat and Awqaf, which should cover both operational and regulatory frameworks, deserve research attention. Perhaps, Islamic social finance, which remains underdeveloped in many countries, should leverage on financial technology to maximize its impacts on society. Indeed, the future research, there is a need to focus on the challenges brought by the so-called technological disruption in widening of the roles that can be played by Islamic finance in general.

REFERENCES

Abdul-Majid, M., Falahaty, M., Jusoh, M., 2017. Performance of Islamic and conventional banks: A meta-frontier approach. Research in International Business and Finance 42, 1327-1335.

Abdul-Rahman, A., Sulaiman, A.A., Mohd Said, N.L.H., 2018. Does financing structure affect bank liquidity risk? Pacific-Basin Finance Journal, this issue.

Abedifar, P., Hasan, I., Tarazi, A., 2016. Finance-growth nexus and dual-banking systems: Relative importance of Islamic banks. Journal of Economic Behavior & Organization 132, 198-215.

Alqahtani, F., Mayes, D.G., 2018. Financial stability of Islamic banking and the global financial crisis: Evidence from the Gulf Cooperation Council. Economic Systems 42(2), 346-360.

Alqahtani, F., Mayes, D.G., Brown, K., 2017. Islamic bank efficiency compared to conventional banks during the global crisis in the GCC region. Journal of International Financial Markets, Institutions and Money 51, 58-74.

Chen, N., Liang, H.-Y., Yu, M.-T., 2018. Asset diversification and bank performance: Evidence from three Asian countries with a dual banking system. Pacific-Basin Finance Journal, this issue.

Fianto, B.A., Gan, C., Hu, B., Roudaki, J., 2018. Equity financing and debt-based financing: evidence from Islamic microfinance institutions in Indonesia. Pacific-Basin Finance Journal, this issue.

Gheeraert, L.., Weill, L., 2016. Does Islamic banking development favour macroeconomic efficiency? Evidence on the Islamic finance-growth nexus. Economic Modelling 47, 32-39.

Hutchinson, M.C., Mulcahy, M., O'Brien, J., 2018. What is the cost of faith? An empirical investigation of Islamic purification. Pacific-Basin Finance Journal, this issue.

Ibrahim, M. H., 2015. Issues in Islamic banking and finance: Islamic banks, Shari'ah-compliant investment and sukuk. Pacific-Basin Finance Journal 34, 185-191.

Ibrahim, M.H., Rizvi, S.A.R., 2018. Bank lending, deposits and risk-taking in times of crisis: A panel analysis of Islamic and conventional banks. Emerging Markets Review 35, 31-47.

Imam, P., Kpodar, K., 2016. Islamic banking: Good for growth? Economic Modelling 56: 387-401.

Kabir, M. N., Worthington, A. C., 2017. The 'competition-stability/fragility' nexus: A comparative analysis of Islamic and conventional banks. International Review of Financial Analysis 50, 111-128.

Karabiyik, H., Narayan, P.K., Phan, D.H.B., Westerlund, J., 2018. Islamic spot and index futures markets: Where is the price discovery? Pacific-Basin Finance Journal, this issue.

Leon, F., Weill, L., 2018. Islamic banking development and access to credit. Pacific-Basin Finance Journal, this issue.

Meslier, C., Risfandy, T., Tarazi, A., 2017. Dual market competition and deposit rate setting in Islamic and conventional banks. Economic Modelling 63, 318-333.

Molineux, P., Yip, J., 2013. Income diversification and performance of Islamic banks. Journal of Financial Management Markets and Institutions, 1(1): 47-66.

Naqvi, B., Rizvi, S.K.A., Mirza, N., Reddy, K., 2018. Religion based investing and illusion of Islamic Alpha and Beta. Pacific-Basin Finance Journal, this issue.

Naqvi, B., Rizvi, S.K.A., Uqaili, H.A., Chaudhry, S.M., 2018. What enables Islamic banks to contribute in financial reintermediation? Pacific-Basin Finance Journal, this issue.

Narayan, P.K., 2018. Profitability of technology-investing Islamic and non-Islamic stock markets. Pacific-Basin Finance Journal, this issue.

Narayan, P.K., Sharma, S. S., Thuraisamy, K. S., 2018. Some preliminary evidence of price discovery in Islamic banks. Pacific-Basin Finance Journal, this issue.

Rossi, S.P.S., Schwaiger, M.S., Winkler, G., 2009. How loan portfolio diversification affects risk, efficiency and capitalization: A managerial behavior model for Austrian banks. Journal of Banking & Finance 33(12), 2218-2226.

Yanikkaya, H., Gumus, N., Pabuccu, Y.S., 2018. How profitability differs between conventional and Islamic banks: A dynamic panel data approach. Pacific-Basin Finance Journal 48, 99-111.

Zaman, Q.U., Hassan, M.K., Akhter, W., Meraj, M.A., 2018. From interest tax shield to dividend tax shield: A corporate financing policy for equitable and sustainable wealth creation. Pacific-Basin Finance Journal, this issue.