Editorial

Islamic Finance: An Introduction*

This special issue of JEBO is motivated by the desire to advance research, especially empirical research, in the field of Islamic finance. The Islamic finance industry, albeit relatively small, is growing at a very rapid rate, almost 20%, which is believed to be double the growth rate of the conventional finance industry. The number of financial institutions reporting *shariah*-compliant[1] assets and the number of *shariah*-compliant mutual funds reached 349 and 800, respectively, in 2013 (The Banker, 2013). Islamic finance assets are predicted to exceed the $2 trillion in 2014 (Ernst and Young, 2013). However, research in this field is still lagging behind, which is reflected by the limited number of papers published on Islamic finance in the top ranking journals. This creates a serious motivational problem for pursuing research in this nascent field, which should be guided, developed and criticized by pioneering research. Driven by such desire, we organized a conference in the fall of 2012, entitled "JEBO Islamic Finance Conference" that was sponsored by El Shaarani Centre for Islamic Business and Finance, at Aston Business School, UK and Durham Business School, UK. The objective of the conference was to offer a venue for analytical and empirical research in Islamic finance. This special issue, which is the first to be entirely dedicated to Islamic finance, crowns such efforts. The papers selected for this issue include a number of empirical and theoretical techniques illustrating the broad range of research questions that can be addressed by these methods.

These research questions can be categorized into three groups. The first one deals with the current practices in Islamic finance, to what extent they impact the economy and how they can be developed to benefit the economy. Gheeraert (2014) provides empirical evidence on the impact of Islamic banking on banking sector development (in dual banking systems, where Islamic banks and conventional banks are operating side by side). He finds a positive impact of the development of Islamic banking on the overall banking sector development in Muslim countries, as measured by the amount of private credit or bank deposits scaled to GDP. This empirical finding is reached through utilizing a newly constructed and comprehensive database, "IFIRST", which covers Islamic commercial banks worldwide over the period 2000–2005.

The social outreach of Islamic financial institutions measures their impact on society. In line with the theoretical ideals of Islamic finance, promotion of social welfare and justice should be the hallmark of corporate social responsibility (CSR) policies formulated by Islamic financial institutions. However, in reality, ethical reporting has received limited attention from these institutions and their reporting of CSR performance has remained modest (Belal et al., 2014). In this issue, Mallin et al. (2014) point out the mission-drift in Islamic banking, which favors financial performance while neglecting the environment dimension. They also provide evidence on the positive relationship between financial performance and CSR disclosure. Using a sample of 90 Islamic Banks operating in 13 countries, they employ a CSR index with 10 dimensions defined through 84 items to distinguish between mandatory and voluntary disclosure. They find that Islamic Banks are more compliant to mandatory disclosure than voluntary disclosure.

Shaban et al. (2014) look at corporate social outreach from a different perspective. They look at banks' willingness to provide loans to small businesses as a proxy for their CSR. They use 114 commercial banks in Indonesia during 2002–2010 to show that Islamic banks benefit more from lending to small businesses. However, due to the limited capital available to them, Islamic banks should depend on cyclic expansion policies, but in practice countercyclical policies are operational, in line with a 'profitability smoothing approach'.

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[1] *Shariah* is Islamic jurisprudence.

Islamic finance innovations can also benefit the society when used as a developmental tool to include those who are typically financially excluded. The only experimental paper on this issue, by El-Gamal et al. (2014), performs a framed-field experiment to test for a new microfinance model that is based on RoSCAs (Rotating Savings and Credit Associations). Random RoSCAs are *shariah* compliant since they involve no interest. However, poor people may not be able to use them as a means of finance because of coordination failure (the availability of close ties who are ready to engage in a RoSCA can be limited at this poverty level, while people will avoid engaging with strangers in a RoSCA). The model's main essence lies in guaranteeing the ordinary RoSCA by a financial institution. Thus, there is a higher incentive for people to exchange savings and loans through a guaranteed-RoSCA when compared to the ordinary non-guaranteed one. The experiment was implemented using typical microfinance clients in rural Egypt. The researchers found higher take-up rates for the guaranteed-RoSCA when compared to a model that mimics conventional microfinance (Grameen-style). Their findings provide proof-of-evidence in support of non-interest bearing modes of microfinance, while solving for coordination failure.

RoSCA was also used by Salleh et al. (2014) in this issue in a theoretical model that offered a *shariah*-compliant and less costly alternative to payday loans. They investigated the question of whether an interest-free credit facility can be more efficient than a usurious payday loan. The authors made their case by comparing the negative outcomes of tradi- tional payday lending, such as over-indebtedness leading to distress and criminality, with micro-lending facilities helping to create debt-free communities by removing income, loan, pre-commitment, collateral and financial constraints, as well as fostering social cohesiveness and high moral values. Salleh et al. (2014) tested for various possible scenarios as well as the resulting Pareto-neutral, superior and inferior outcomes. A mechanism for avoiding strategic default has also been proposed.

The second group of research questions in this issue deals with the performance of Islamic financial institutions under the presence of different constraints than they typically face (not faced by their conventional counterparts). In this issue Johnes et al. (2014) cover matters pertaining to the efficiency of both Islamic and conventional banks and the ways in which efficiency is related to its type. A second study (Abdelsalam et al., 2014) in this issue also examines the impact of different portfolio restrictions, expenses and value added criteria on the performance of both SRI (Socially Responsible Investments) and Islamic mutual funds. The third study, by Azmat et al. (2014), examines whether conventional structural credit risk models truly capture the underlying risk of Islamic bonds.

In the study by Johnes et al. (2014), meta-frontier data envelopment analysis is used to decompose the overall technical efficiency measure into two components: one which reflects managerial efficiency and another which measures the impact of the operational context of the bank. Studies which compare conventional and Islamic banks have not, to date, distin- guished between these two types of efficiency. This research utilizes one of the largest data sets used to compare Islamic and conventional banks. The study finds that *overall* technical efficiency is similar in both bank types. The meta-frontier analysis reveals, however, that *operational* efficiency is lower in Islamic banks than conventional banks, whereas *managerial* efficiency is higher in Islamic banks. The latter result is plausibly attributed to differences between the two types of banks in remuneration packages, while the former may be a consequence of the bespoke nature of Islamic banks' products. Using a comprehensive data set for 138 Islamic mutual funds and 636 SRI mutual funds from 2001 to 2011, in this issue Abdelsalam et al. (2014) compare the performance of both Islamic mutual funds and SRI funds. The study compares the performances of SRI and Islamic mutual funds by innovatively combining the Free Disposal Hull methods (order-*m* and order-α) in the first stage and quantile regression in the second stage, to allow analysis of covariates across methods and quantiles. Despite the stated differences in the screening criteria and portfolio management of both Islamic and SRI funds, variation in performance was limited to certain quantiles of the conditional distribution of mutual fund performance. In the case of inefficient funds, the performance of SRI funds was superior and statistically significant; whereas, in the case of best mutual funds, Islamic funds outperformed SRI funds.

Islamic Joint Venture (IJV) bonds, also known as '*Musharkah Sukuk*', present a new area in terms of both practice and research related to Islamic finance. In this issue, Azmat et al. (2014) test the adequacy of conventional Structural Credit Risk Models and their modified Islamic extensions in appraising IJV bonds using simulated data and real information acquired from 52 companies in Malaysia. The main finding and concern drawn from this research is the unsuitability of conventional models and its derivatives to ascertain the credit risk associated with IJV bonds, resulting in misevaluations and lower ratings. While the conventional structural models have been in use since the 1970s, they have their strengths and weaknesses, which require substantial upgrading to keep abreast of the developments in the industry. In the particular case of IJV bonds, the failure of conventional methods and their modified versions is mainly rooted in the focus of the instruments on the principal's repayment abilities, whereas the IJV bonds are inherently based on equity, resulting in lower credit ratings.

Despite these constraints and the higher premium, in this issue Berg and Kim (2014) explain why current Islamic finance products are still popular with some clients, while Elnahass et al. (2014) explain why investors value the possible earnings management practices of Islamic financial institutions differently from their conventional counterparts. Hence, the third group of research questions of this special issue deals with the valuation of Islamic finance products. Berg and Kim (2014) provide a theoretical insight of why Islamic banks' clients benefit, despite of choosing financial services from a relatively restricted menu of higher-cost cash flows. Many would argue that by providing more expensive services, Islamic banks are disadvantaged and will not be able to compete with their conventional counterparts. However, the researchers argue that by charging a higher premium and imposing substantial restrictions on the available options to clients, Islamic banks are creating a signaling technology. This signaling technology induces clients to reveal information (that would be otherwise unrevealed) about their piety, and thus, selecting the higher quality clients and reducing free-riding. Therefore, they predict that the need for piety signaling will be more intense where the proportion of highly pious Muslims is small. This will result in higher premiums and restrictions by Islamic banks.

Bank managers may exercise earnings management/manipulation in their estimates of loan loss reserves and provisions to smooth out earnings from good periods to bad periods. Elnahass et al. (2014) investigate the use of reported loan loss provisions (LLP) by investors in their valuations of banks within the Middle East and North Africa from 2006 to 2011. A price-level valuation model is estimated using two-stage analyses. The study shows that LLP has positive value relevance to investors in both banking sectors. Investors in Islamic banks price the discretionary component relatively lower than their conventional counterparts. The authors attribute this result to differences in product and governance structures as well as to the religious perception of Islamic banking. This study is the first to empirically examine investors' valuations of Islamic banks, compared to their conventional counterparts, through the use of LLP.

These papers reflect part of the wide spectrum of issues related to Islamic finance and the rich variety of methods to address them. Researchers on this issue have spared no effort in criticizing, developing and analyzing Islamic finance. Their analysis covered the use of theory, observational data and experimental data. All of this was done to offer the reader a taste of the challenges, innovations and critiques in this rapidly growing field that require more attention from the research community.

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