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ISSUES IN ISLAMIC BANKING AND FINANCE: ISLAMIC BANKS, SHARI'AH-COMPLIANT INVESTMENT AND SUKUK

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Abstract

This introductory article of the special issue "Islamic Banking and Finance II" highlights various studies on fast-growing Islamic finance industry. It focuses specifically on Islamic banking and Islamic capital market research. To date, scholarly research on Islamic finance is mainly confined to empirical verification of its performance on the argument that the Islamic finance is distinct from conventional finance. While more works need to be done to soundly and concretely justify the viability of Islamic finance, future works should aim at placing the Islamic foundations of the industry in proper theoretical settings beyond the statement that it is different. In addition, theoretically and empirically, demonstration of its bearings on economic well-beings and policies such as economic stability, financial inclusion, economic development and stabilization policies is needed.

1. Introduction

The recent interest in Islamic banking and finance is not only driven by its rapid growth but also by recurring financial crises over the past decade with the recent global financial crisis of 2007 – 2009 to be the most severe. By the end of 2014, the total assets of the Islamic financial industry is estimated to surpass $ 2 trillion and, with this estimate, the compounded average growth rate of the total Islamic assets would be 17.3% over 2010-2014 (Malaysia International Islamic Financial Centre, 2014). A more spectacular development of the Islamic finance industry, in addition to its rapid growth in Southeast Asia and the Middle East, is its penetration into non-Muslim countries primarily in Europe and North America (Pollard and Samers, 2007). At present, the Islamic financial sector is no longer a business entity operated only to fulfil the religious obligations of the Muslim community but to cater the needs and demands of new customers as well. The recent global financial crisis has added further to the attraction of Islamic finance to practitioners, monetary authorities and academic scholars in their search for a viable and resilient alternative financial system.

This special issue comprises academic articles addressing two essential sectors of the Islamic finance industry, the Islamic banking sector and the Islamic capital markets, the latter making up of mainly Islamic stock and *Sukuk* (Islamic Bond) markets. Papers on Islamic banking address on-going discussion and debate on the Islamic banks being "*Islamic*" according to a basic tenet of profit-and-loss sharing and on the performance of Islamic banks during the sub-prime crisis. Whether shari'ah-compliant financial assets can serve as a distinct asset with hedging or diversifying property continues to capture much interest especially from financial investors. Embedded in this interest is the relative return and risk performance of Shari'ah-compliant or Islamic stocks and their interactions with the conventional stock markets or among themselves, on which there are several papers in this special issue. Finally, although there is relatively fewer studies on *Sukuk*, its encouraging development in recent years has captured increasing attention and the list of research on the *Sukuk* market keeps expanding, to which the present special issue contributes two interesting articles.

The purposes of this introductory article to the special issue, *Islamic Banking and Finance II*, are: (i) to place these articles in proper perspectives in the expanding literature on Islamic banking and finance; and (ii) to suggest future research areas. The article is organized as follows. The next section discusses research on Islamic banking. Section 3 reviews literature on the shari'ah-compliant stocks as well as other shari'ah-compliant assets. Section 4 elaborates on research on Islamic bonds or *Sukuk*. Finally, Section 5 highlights potential research agenda in Islamic banking and finance.

2. Islamic Banking

While the "the *Islamicity*" issue of Islamic banking products or Islamic banks and their efficiency performance remain the predominant focuses of Islamic banking research, the recent literature has widened its scope to cover broad ranges of performance measures. The eruption of the global financial crisis has also added "resiliency" and "stability" of the Islamic banking system as a part of the assessment as to whether the Islamic banking system can be a viable alternative banking system to the fragile conventional system.

The question "are Islamic banks Islamic?" continues to intrigue many fronts, despite the Islamic banking business is based on the principles of Islamic laws and hence is distinct from the conventional banking. Indeed, it has been argued that, in practice, there is no principal difference between Islamic banks and conventional banks. As noted by Chong and Liu (2009) in their scrutiny of Malaysia's Islamic banks, the profit-and-loss-sharing (PLS)-based assets of Islamic banks make up only a small portion of Islamic banks' assets. In addition, the return on Islamic deposits is closely pegged to deposit rates paid by conventional banks. Khan (2010) further confirms these features of Islamic banks in several other countries. While these observed features of Islamic banks may have not made Islamic banks to be distinct from convention banks, it is worth noting that Islamic banks' assets and liabilities are governed by contractual arrangements in conformance with the Islamic principles. Hence, we believe that the main issue is not "are Islamic banks Islamic?" or "how 'Islamic' are Islamic banks?" Instead, it is "what has kept Islamic banks away from the PLS contracts?"

Abdul-Rahman et al. (2014) question the ability of Islamic banks to widen their business activities based on the PLS contracts. They argue on the basis of the New Institutional Economics that, as long as Islamic banks are financial intermediaries having no part in the management of projects and hence are exposed to business risks, there would be no opportunity for the PLS contracts to prosper. This means that the PLS contracts being highlighted as a distinct feature of the Islamic banks are likely to fail. In this special issue, Azmat et al. (2015) advance the analysis further by building a theoretical model to explain the inability of Islamic banks to move towards their ideal financing mode, i.e. PLS-type or Islamic joint venture contracts. Being theoretical, the paper provides a solid foundation in explaining the predominantly trade and debt styled contracts of Islamic banks, as previously documented by Chong and Liu (2009) and Khan (2010). According to them, asymmetric information alone cannot fully explain the absence of the PLS-styled contracts in Islamic banks. Instead, in the presence of asymmetric information, risk averse bank depositors, long-term contracts and legal punishment, the lack of demand for the PLS contracts from borrowing firms has kept away the Islamic banks from offering such a contract. In line with Abdul-Rahman et al. (2014), they believe that the Islamic banks may not be in the best position to offer Islamic joint-venture contracts. Instead, they suggest the development of separate venture capital and private equity corporate structures as a solution.

When it comes to Islamic banking research, it is undoubtedly the performance of Islamic banks is at the forefront of the research agenda. The literature on Islamic banks' efficiency performance and its determinants is rather extensive. While it is not our intention to provide a review of this body of literature here, it suffices to state that, comparatively, the evidence tends to paint mixed picture on the relative efficiency of Islamic banks vis-à-vis conventional banks (see, for instances, Hassan et al., 2009; Srairi, 2010; Ahmad and Abdul-Rahman, 2012). In the banking literature in general, various factors have been identified to explain variations in efficiency across banks. These include such factors as bank size, liquidity, profitability, market competition and market power, bank ownership, product diversity or loan activity, regulation and crisis (Hou et al., 2014; Pasiouras, 2008; Das and Ghosh, 2009; Pasiouras et al., 2009; Moradi-Motlagh and Babacan, 2015).

In a recent study, Rosman et al. (2014) examine the overall efficiency, pure technical efficiency and scale efficiency of 79 Islamic banks from 19 countries. In addition to noting the Islamic banks to be operating at the region of decreasing return to scale, they identify profitability and capitalization to be two major determinants of Islamic bank efficiency in their sample. A paper by Belanes et al. (2015), which is contained in this special issue, contributes further to the literature on Islamic banking literature by analysing the influence of the global financial crisis on Islamic banking efficiency. Employing a sample of 30 Islamic banks over 2005 – 2011 from the GCC region, they estimate the overall technical efficiency, pure technical efficiency, and scale efficiency using the Data Envelopment Analysis (DEA) methodology and examine their evolving patterns during the subprime crisis. They note that, during the crisis, most Islamic banks in their sample remained efficient. A reduction in the efficiency is also noted for several banks; however, it is only marginal. Hence, Islamic banks can remain efficient in the face of adverse global shocks, a finding that strengthens the view and empirical evidence that the Islamic banks are resilient or less susceptible to financial crises (Cihak and Hesse, 2010; Hasan and Dridi, 2010).

Some recent studies have extended the analysis of Islamic banks to cover wider ranges of performance measures. These include such measures as lending/financing, loan loss provisions, capital buffers, profitability, cost effectiveness, capitalization, asset quality and intermediation ratio (Abedifar et al., 2013; Beck et al., 2013; Abdul Karim et al., 2014; Khediri et al., 2014; Farook et al., 2014; Daher et al., 2015). We believe that, for the argument in favour of the Islamic banking system to be sound and concrete, these various dimensions of Islamic banking performance must be further investigated. For instance, the findings that Islamic banks have higher intermediation ratios, have better asset quality and are better capitalized by Beck et al. (2013) may reflect the stability of Islamic banks in serving their intermediation roles. However, the findings that Islamic banks tend to be less cost effective (Beck et al., 2013) and have higher capital buffers (Daher et al., 2015) may raise doubt on whether Islamic banks can remain competitive in an ever increasingly integrated financial market. These later findings, moreover, tend to contradict the findings that Islamic banks are more profitable by Abedifar et al., (2013) and Khediri et al. (2014). In short, more evidence needs to be uncovered.

3. Shari'ah-Compliant Financial Investment

Another fast growing area of research in Islamic finance relates to examination of Shari'ah-compliant financial assets particularly shari'ah-compliant stocks. In this strand of research, two aspects have been prominently emphasized, namely, the performance of Shari'ah-compliant stocks vis-à-vis the conventional stocks and dynamic interactions and contagion between them. Apart from these two aspects, few studies have also evaluated other Islamic assets such Islamic mutual funds and Islamic gold. The primary objectives of this strand of the literature are generally to assess (i) whether Islamic financial assets can serve as alternative assets for investment, (ii) whether Islamic financial assets provide a diversification benefit and (iii) whether they can provide protection during turbulent times.

While the Islamic stocks may not register superior performance in all periods, various studies have offered evidence supporting their better performance during financial turbulences. These include Al-Khazali et al. (2014), Ashraf and Mohammad (2014), Jawadi et al. (2014), and Ho et al., (2014). Despite applying different empirical methodologies to different sets of Shari'ah-compliant stock indexes and conventional indexes, they are in conformity in noting the better performance of the Islamic stock indices during crisis periods. This finding suggests that investors stand to benefit by allocating their financial resources to Islamic stocks. Dewandaru et al. (2015) elaborate further on the potential of Islamic equity investors to outperform the market. In their paper, they construct active Islamic portfolios using multi-style rotation strategy on the basis of momentum, value and quality investment strategies and apply Black-Litterman factor model for the analysis. The finding they uncover based on the out-of-sample performance of the portfolios over 2001-2012 suggests promising rewards for active investors. According to them, Islamic investors need to actively employ multi-style rotation strategies in combination with market view and macroeconomic factors in order to outperform the market.

Another line of research inquiry in Islamic finance deals with the pricing of risk factors in the Islamic stocks. As interest rate is prohibited in the transactions of Shari'ah-compliant firms, a natural inquiry that arises is whether the interest rate is priced by the Islamic stocks. Shamsuddin (2014) deals with this issue by evaluating the exposure of the Dow Jones Islamic equity indexes to the interest rate risk. While he finds that at the sectoral level some Islamic equity portfolios are affected by interest rate variations, the overall evidence tends to suggest lower interest rate risk exposure of the Islamic portfolios as compared to conventional portfolios. Moreover, the insulation of the aggregate portfolio of Islamic stocks from the interest rate risk is supported. In this special issue, Merdad et al. (2015) introduces a novel risk factor in expected stock returns, which they term as the Islamic risk factor. Being Shari'ah-compliant entails the application of Islamic principles to firm operations. Accordingly, it is fundamentally tied to the firm's business activities, riskiness, financing sources, performance and leverage. These, in turns, are expected to be encapsulated in the firm's value. The question is: Is adherence to the Islamic principles priced? From their analysis, the answer is affirmative. Indeed, they demonstrate the presence of negative Islamic effect using Saudi Arabia as a case study. Namely, the Islamic firms tend to have lower average returns. Further, they note that this "negative Islamic effect" is a common, systematic and undiversifiable risk factor in the Islamic stock pricing. According to them, the Islamic effect should be further investigated for other countries or regions for robustness and added insights in the Islamic asset pricing.

With Shari'ah principles shaping Islamic financial assets and making them distinct from conventional counterparts, a view that the Islamic markets should be segmented or only weakly linked to conventional markets emerges. Thus, being decoupled from the conventional counterpart, the Islamic financial markets can provide a diversification benefit and serve as a cushion against potential losses from the crises. In recent years, this so-called "decoupling hypothesis" has been the subject of increasing scrutiny. However, available evidence for the hypothesis is rather weak. Indeed, the preponderance of evidence tends to suggest that the Islamic stock markets have been increasingly integrated and thus are vulnerable to adverse shocks and "contagion" in the manner as the conventional markets are.

Among the various recent studies, Rizvi and Arshad (2014) and Majdoub and Mansour (2014) offer evidence that the Islamic indexes are only weakly correlated with conventional indexes. In contrast, recent studies by Hammoudeh et al. (2014), Dewandaru et al. (2014), Ajmi et al. (2014), Yilmaz et al. (2015) and Rizvi et al. (2015) negate the decoupling hypothesis. Using a copula approach, Hammoudeh et al. (2014) demonstrate the significant dependence of the global Islamic equity market index on major global conventional equity indexes and various global factors, highlighting no distinct differences of the Islamic indexes from the conventional indexes. In a similar vein, Ajmi et al. (2014) find significant causality between the Islamic stock indexes on one hand and conventional stock indexes and other markets (interest rate and interest-bearing securities) on the other hand using linear and nonlinear Granger causality tests. Dewandaru et al. (2014) further note the presence of contagion and interdependence between the Islamic markets and conventional markets, the finding substantiated by a paper in this issue by Rizvi et al. (2015). Both Rizvi et al. (2015) and Yilmaz et al. (2015) further note increasing integration of the Islamic equity sectors to the global market. The increasingly noted interdependence of Islamic equity markets with global markets as well as the presence of contagion tend to weaken the diversification benefit of the Islamic equity markets as well as cast doubt on whether they can play a hedging role or safe haven role during times of stress.

Apart from the stock indexes, various studies have also evaluated the performance of Islamic mutual funds. In a critical analysis of Islamic mutual funds in Malaysia, Kamil et al. (2014) discover that the Malaysian Islamic equity funds (IEFs) do not outperform market benchmarks. When their performance is superior, only 1.95% of the funds are genuinely skilled while 47% are due to luck. Their findings conform to the early works by Hayat and Kraessui (2011) and Abdullah et al. (2007). Hayat and Kraessui (2011) analyse 145 IEFs over the period 2000 to 2009 and document the underperformance of the IEFs as compared to both Islamic and conventional equity benchmarks, which become more apparent during the global financial crisis. Earlier, relying on the Sharp and Treynor ratios, Jensen's alpha, the Modigliani measure and information ratio, Abdullah et al. (2007) conclude that Islamic funds tend to fare better during bearish market phases but underperform during the bullish periods. In short, these studies echo the findings that Islamic fund managers are not very competent at stock selection and at market timing.

In this special issue, Ghazali et al. (2015) assess the hedging and safe haven property of different Islamic assets, namely official gold and Islamic gold accounts, and hence add to the literature on the role of gold as a diversifying, hedging and safe haven investment asset. In the analysis, they examine the constant and time-varying correlations between gold returns and stock market returns using Malaysia as a case study. While they find the official gold to be a better hedging asset as compared to the Islamic gold account, both are not safe haven during episodes of market declines.

In a summary, whether Islamic financial assets (Islamic stocks, Islamic mutual funds or Islamic gold) form a distinct asset class for investment remains elusive. The observations that the Islamic financial assets are tied closely to interest-bearing assets, are increasingly integrated to global factors and risks and are subject to "contagious" effect make them to behave in a similar manner as the conventional financial assets. However, the findings that they tend to perform relatively better during crisis periods provide a promising avenue for them to play a hedging role. Since the returns on financial investments can be driven by investors' sentiments and herding behaviour over the short run and by firms' fundamentals over the long run, the latter is reflected by their balance sheet and statement of income positions, future works may attempt to demarcate these short-run and long-run determinants of Islamic asset pricing. What makes the Islamic assets to be different from the conventional assets is the underlying fundamentals of the firms particularly their leverages and activities delimited by the Shari'ah and hence, the long run behaviour of the Islamic assets should be more relevant.

4. Sukuk (Islamic Bonds)

The development of the sukuk market has been most encouraging in recent years. According to the Malaysia International Islamic Financial Centre (2014), there was sizeable increase in sukuk issuances during January – November 2014 as compared to the same period in 2013, i.e. an increase of 8.6% from USD105.6 billion to USD114.7 billion. The more exciting development is the acceptance of sukuk outside the Muslim world as manifested by its issuance in non-OIC nations, namely, UK, Senegal, Hong Kong, South Africa and Luxembourg.

Despite this encouraging development, as compared to research on Islamic banking and Shari'ah-compliant stocks, the scholarly research on sukuk is relatively limited and thinly scattered over various issues. Contrary to the increasing acceptance of sukuk by finance industry, the empirical and theoretical assessments of sukuk do not seem to be promising. According to Miller et al. (2007) and Wilson (2008), sukuk does not represent a financial innovation since it is generally structured according to western rules of securitization. In other words, there should be no distinct difference between sukuk and conventional bonds. In their evaluation of the issuer's choice of Islamic bonds, Azmat et al. (2014a) corroborate this view by noting insignificant difference between Secured-against-Real Asset (SARA) bonds, Ijarah sukuk and conventional secured bonds. Hanifa et al. (2015) further explicate firms' motivation for sukuk issuances from the lenses of various capital structure theories and find evidence supportive of the trade-off view and the pecking order theory in their analysis of 120 conventional bond and 80 sukuk issuers. A less promising or even damaging finding from recent studies by Alam et al. (2014) and Godlewski et al. (2014) is the negative wealth effect of sukuk issuance. Azmat et al. (2014b) further provide a theoretical basis of the Shari'ah-compliant risk of the sukuk. According to them, this risk is inherent stemming from high costs of being Shari'ah-compliant.

These issues aside, the fast growth and increasing acceptance of sukuk necessitates investigation of its risk to aid policymakers in monitoring potential and impending risk and investors in forming their asset portfolios. In this issue, Arundina et al. (2015) apply the multinomial logit and neural network models to predict sukuk rating using a sample of 317 sukuk. The results from their analysis indicate the better performance of the neural network in predicting sukuk rating. More specifically, while the multinomial logistic model has the prediction rate with 91.7% accuracy rate, the predictive accuracy of the neural network is 96.2%. Further, they note the significance of firms' underlying share prices, structures of sukuk, industry, and guarantee status in predicting the sukuk rating. Interestingly, among these variables, share prices and structures of sukuk are found to have the most predictive ability.

5. Looking Forward

The fast-growing Islamic finance amidst the global financial uncertainties has captivated much interest especially as to whether it can serve as a viable alternative system. Facilitated by increasing data availability, Islamic banking and Islamic capital markets become subjects of increasing empirical inquiries. Over the years, many scholarly works have emerged to assess various dimensions of Islamic banking and finance. However, they are predominantly confined to empirical verifications of the performance of Islamic banks and Islamic capital markets. While there is much to be done due to contradictory findings from existing empirical studies, there are two critical avenues of research that need to be undertaken such that the viability of the Islamic financial system can be based on a sound and concrete ground. The first avenue relates to the micro-foundations of Islamic finance while the second is the extension of empirical studies on the bearings Islamic finance has on socio-economic aspects as embedded in the *Maqasid al Shari'ah* (Objectives of Shari'ah) of its establishment.

With few exceptions, existing Islamic finance studies can be viewed as empirical extensions of prevailing mainstream works on banking and finance, backed mainly by an argument that Islamic finance is different. Little attempt, however, has been made to place Islamic-specific characteristics in theoretical settings. Theoretically, it would be insightful to explicitly derive the implications of banks' or firms' adherence to Islamic principles. Empirical analyses using existing data can be deceptive in demonstrating the distinct nature of Islamic finance since it has been well noted that, in practice, Islamic finance particularly Islamic banking has yet reached its ideal business model or has not departed substantially from conventional practices. Moreover, in the case of Islamic stocks, taking firms that pass Shari'ah screening to be Islamic may not be fully accurate since the *Maqasid al Shari'ah* goes beyond the used screening criteria. As such, Shari'ah-compliant firms as classified may share a similar bottom line as any other firm, i.e. profit maximization, and hence no difference in their behaviour. Meanwhile, Islamic firms have *Maqasid al Shari'ah* governing their behaviour and, thus, they have more than profit maximization to achieve. Accordingly, the theoretical behaviour of the latter would be more relevant for understanding Islamic banking and finance.

Despite the need of theoretical foundations, we also believe that a fruitful avenue to pursue is to assess the bearings the present Islamic banking and finance have on the economy at large. The key question is: has Islamic finance fulfilled the objectives of Shari'ah? These questions mean that assessments need to be made on the roles played by Islamic finance in, for examples, poverty alleviation, income distribution, equal and widened access to finance, and economic productivity and efficiency. Moreover, how the significant presence of Islamic finance would affect monetary policy instruments and the conduct of monetary policy or even whether monetary policy has any role would be important especially to monetary authorities in countries spearheading the development of Islamic finance. At present, our understanding on the relations between Islamic finance on one hand and socio-economic outcomes and macroeconomic policies on the other hand remains limited.

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HIGHLIGHTS

- An introductory article to the special issue: Islamic Banking and Finance II
- Place the papers in the issue in the perspectives of existing literature
- Highlight future directions of research