Pacific-Basin Finance Journal 34 (2015) 253–272

Contents lists available at ScienceDirect

Pacific-Basin Finance Journal

journal homepage: www.elsevier.com/locate/pacfin

Can Islamic banking ever become Islamic?

Saad Azmat [a,1], Michael Skully [b,2], Kym Brown [b,*]

[a] Suleman Dawood School of Business, Lahore University of Management Sciences, D.H.A., Lahore Cantt, 54792, Pakistan
[b] Department of Accounting and Finance, Monash University, P.O. Box 197, Caulfield East, Victoria 3145, Australia

ARTICLE INFO

Article history:
Received 1 August 2014
Accepted 8 March 2015
Available online 14 March 2015

JEL classification:
G21
G24

Keywords:
Islamic banks
Moral hazard
Islamic joint venture finance

ABSTRACT

This paper attempts to explain the dominance of asset side debt contracts in Islamic banks, even though many consider alternative Islamic joint venture (IJV) contracts to be the ideal Islamic financing mode. Theoretical models based on asymmetric information are used to argue that adverse selection and moral hazard alone cannot explain this phenomenon. The model is augmented with risk averse depositors to show that the emergence of asset side IJV could be deterred by Islamic banks' liability side. This paper suggests that for IJV, affiliated venture capital and private equity might prove more successful institutions than banking.

1. Introduction

The concept of risk sharing is a key feature that distinguished Islamic from conventional banking. Islamic joint venture (IJV) finance[3] is perhaps the best example, but Islamic banks (IBs) in practice seem to prefer more conventional looking debt contracts. Several authors (Khan, 2010; Chong and Liu, 2009) have criticised this practice and suggested change. Our study adds to this literature by developing a model to help explain this position. We propose that risk averse depositors drive this Islamic bank preference for an intermediation model whose risk reward framework causes debt rather than IJV to become the preferred choice when financing borrowers. We also contribute to the asymmetric information and costly state verification literature (Leland and Pyle, 1977; Diamond, 1984; Townsend, 1979; Gale and Hellwig, 1985; Ueda, 2004) by suggesting

* Corresponding author. Tel.: +61 3 9903 1053; fax: +61 3 9903 2422.
E-mail addresses: saad.azmat@lums.edu.pk (S. Azmat), Michael.Skully@monash.edu (M. Skully), Kym.Brown@monash.edu (K. Brown).
[1] Tel.: +92 42 111 11 5867.
[2] Tel.: +61 3 9903 2407; fax: +61 3 9903 2422.
[3] IJVs are equity style products based on partnerships, where the creditor is a partner in the venture. This entitles the creditor to a pre-agreed percentage of the profit, but also to share any loss according to their investment ratio.

http://dx.doi.org/10.1016/j.pacfin.2015.03.001
0927-538X/

that asymmetric information alone cannot explain the lack of joint venture contracts on the asset side of Islamic banks. The nature of risk averse bank depositors must also be considered when explaining why Islamic banks do not invest in VC type technology to neutralise asymmetric information.

Islamic finance has grown rapidly and expects to reach $2 trillion in assets by 2015 (EY, 2014). To support this initial growth, Islamic banks hired conventional bankers as well as applied conventional banking models across their operations. Islamic banks, currently, use a traditional banking model taking deposits on the liability side and making predominantly debt contracts on their asset side. As their customers had mainly dealt with conventional banks, some Islamic banks look all too similar to conventional ones. Supporting this stance, Beck et al. (2013) concluded that Islamic banks' business models may not be dissimilar to those of conventional banks.[4] Likewise some instrument techniques have been applied with only a modest consideration of true risk and reward positions that Islamic finance affords (Khan, 2010). Building on the context developed by Chong and Liu (2009) and Khan (2010) we consider if Islamic banks can ever offer more profit and loss sharing (PLS) on their asset side, rather than the current predominance of debt styled contracts, and thus become more 'Islamic'.

In a Miller and Modigliani world of perfect information, specialised financial institutions, such as banks and venture capitalists, with their abilities to neutralise problems of asymmetric information would not exist (Akerlof, 1970; Leland and Pyle, 1977). In such a world the question of whether an Islamic bank should use Islamic joint venture (IJV)[5] or debt financing to fund its borrowers would be unimportant. Unfortunately, such a world is far from reality. Given the presence of asymmetric information, Islamic banks must select a mode of finance that will maximise their return while minimising risk. Asymmetric information could be one reason therefore why debt based Islamic products have come to dominate the Islamic bank assets, even though Islamic scholars consider Islamic joint ventures as the ideal religious and ethical alternative to debt based conventional financing (Usmani, 2002; Ayub, 2007).

Asymmetric information results in moral hazard and adverse selection problems. These in turn may affect the investment preferences of financial institutions. Private equity and joint venture products, which have much in common with IJV, are more susceptible to moral hazards and adverse selection problems than traditional debt. Venture capitalists (hereafter VCs), through better screening, contracting and monitoring, can more effectively neutralise these problems than banks (Kaplan and Stromberg, 2001). This allows them to offer the joint venture type products which banks tend to avoid (Landier, 2001; Ueda, 2004). The question that arises, however, is that if profits are sufficiently large, banks should specialise in VC type funding to increase their profitability. A possible explanation stems from differences on their liability side. VCs raise their funds for around a 7 year commitment and so can avoid withdrawal risk (Gompers and Lerner, 1999). In contrast, a banks' reliance on short-term deposits exposes them to considerable liquidity risk (Diamond and Dyvbig, 1983). This causes them to prefer debt instruments which can be liquidated on the asset side.

Unlike conventional banks, the withdrawal risk for Islamic banks should be less of an issue to the extent that their liability side is joint venture funded.[6] From an idealistic viewpoint, Islamic customers should be considered like equity fund investors where the Islamic bank has no obligation to redeem or guarantee the principal (Usmani, 2002). This means that Islamic banks should be able to pass on any losses to their customers as well as refuse withdrawals. In such a world, withdrawal risk, would not fully explain why VC type financing has failed to dominate Islamic banking. In practice of course, customer pressure and competition may force Islamic banks to be reluctant to enforce these powers fully.

[4] In Malaysia the Islamic Financial Services Act 2013 has enabled an Islamic bank to run from its inception to its winding up under Shariah compliance. This should support such banks to use Islamic conventions and not be required to comply with conventional bank rulings. Part IV of Division 28 of the Act requires Islamic banks to be fully Shariah compliant.

[5] IJVs are equity style products based on partnerships, where the creditor is a partner in the venture. This entitles the creditor to a pre-agreed percentage of the profit, but also to share any loss according to their investment ratio.

[6] While some might suggest that Islamic banks have a captive clientele and so a rather limited interest rate or displaced commercial risk compared to conventional banks, this might not be the case. Firstly, Islamic banks compete with each other and so poor returns in one Islamic bank could cause clients to shift to a better performing Islamic bank. Secondly, Islamic banks can have non-Muslim clients (once an important source of Islamic bank funding in Malaysia) that would have no problems in moving funds to a conventional bank. Finally, while religion might seem to afford strong client retention within the industry, this has not been the case in Indonesia where despite the predominance of Muslims, Kasri and Kassim (2009) found that depositors changed from Islamic to conventional banks when the latter offered more attractive returns.