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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 driven not only 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.

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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. A paper on Islamic banking addresses ongoing discussion and debate on the Islamic banks being "Islamic" according to a basic tenet of profit-and-loss sharing. 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 as follows: (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 "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