Financial intermediation and monetary transmission through conventional and Islamic channels

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7 Conclusion

The impressive performance of Islamic banking and finance (IBF) during last several years and during the financial crisis 2007-09 especially, IBF received great attention worldwide. Especial studies have been conducted not only at academic institutes such as Harvard University and London School of Economics but also at global and regional financial institutes like IMF, World Bank, BIS and ECB. Recently, ECB, coordinated a research on "Islamic finance in Europe" to analyze the prospects of IBF in European countries.[101]

This thesis has studied basic features of IBF and its implications at micro and macro level using theoretical and empirical analysis. The aim of the thesis has been to analyze the theoretical foundations of this growing financial sector and to study the structure of the Islamic banks in practice in comparison to the conventional financial system. Also, the objective of the study has been to review the critical issues in IBF, and the gaps between principles and practice of IBF that could harm the reputation of the industry. Through application of bank-time fixed effects the thesis has contributed to fill the gap in contemporary research on IBF and investigated whether Islamic banking institutions are different from conventional ones in terms of structure, efficiency, stability and asset quality. Lastly, the dissertation has examined, at macro level, how monetary policy is transmitted through Islamic banks and conventional banks.

Chapter 2 has reviewed the academic and historical foundations of IBF, its main characteristics, and the contemporary structure of Islamic banks adopted in different countries. Although equity financing is considered ideal according to principles of IBF, due to agency problem, however, Islamic banks prefer trade and leasing based modes of financing which are backed by some real assets. The study has shown that the most important issues to be addressed in IBF pertain to liquidity management and lack of interest-free monetary policy instruments. Inadequate *sukuk* (Islamic securities) issuance and absence of standing credit facility in many states are impeding the development of efficient money markets and monetary transmission. Standardization of products, differences in accounting treatment of various products, issues in minimum capital requirement, difference in shariah ruling in various regions and regulatory issues must be

[101] I have also contributed in this paper. The study is available on ECB website in the following link http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp146.pdf. The study include six chapters.

resolved for the future expansion of the Islamic banking. The chapter has served as a preamble to the succeeding chapters.

IBF mainly emerged because of negative screening based on religious principles which exclude interest-based transactions, gambling, short selling, sale of debt and excessive uncertainty in contracts. It is, therefore, expected that IBF would have a unique financial structure. Chapter 3, therefore, has tested this hypothesis empirically using the quarterly data of conventional and Islamic banks in Pakistan during 2002:II to 2010:I. The results show that Islamic banking institutions (IBIs), that comprise full-fledged Islamic Banks (IBs) and Islamic banking branches (IBBs) of mixed banks, depends less on non-deposit funding which implies that they are more engaged in core banking business. However, their asset portfolio reveals that they have lower loans to total asset ratio than that of Conventional banking institutions (CBIs) that included exclusive conventional banks (CBs) and conventional banking branches (CBBs) of mixed banks. This outcome indicates that IBIs are less involved in financial intermediation than their conventional counterparts. On the other hand, IBIs are less cost efficient than CBIs. However, with increase in their size the differences between IBIs and CBIs in terms of cost efficiency and business structure decline. Analysis on disaggregate level of IBIs, show that both IBs and IBBs of mixed banks with both Islamic and conventional operations rely less on non-deposit funding, have less loans to assets ratio, and are less efficient. However, as IBIs become larger their cost efficiency level also improves and the difference between IBIs, and CBIs fades away. Similarly, with the increase in size IBs rely more on non-deposit funding and are engaged less financing activities. But IBBs rely more on non-deposit funding and financing activities as they grow bigger. The model with bank-time fixed effects show that Islamic windows of both large and small mixed banks depend less on fee based income. Moreover, contrary to Islamic windows of large mixed banks, Islamic windows of small mixed banks are more involved in financial intermediation shown by their higher loans to assets ratio. However, Islamic windows of both small and large of mixed banks are less efficient than CBBs as their cost indicators are higher than those of CBBs.

After the current financial crisis, there has been a renewed discussion about the potential contribution that ethical based IBF can make in stabilizing the global financial system. The proponents of IBF argue that financial intermediation based on Islamic principles would provide better asset quality and greater stability in domestic economy, financial markets and even in international economy. Chapter 4 tests this conjecture empirically using the data of traditional and Islamic banks in Pakistan during 2002:II to 2010:I. Our results indicate that full-fledged IBs have higher stability index and thus are more stable than CBIs. Also, these banks are better capitalized than their conventional counterparts. Moreover, full-fledged IBs also have less volatility in return on their assets, have lower non-performing loans (NPLs) and, therefore, lower loan loss provisioning. Similarly, IBBs of mixed banks, with both conventional and Islamic windows, have better asset quality as they have lower NPLs and loan loss provisioning than that of CBIs. The model with bank-time fixed effects show that Islamic windows of small mixed banks are better capitalized and higher return on assets. However, due to higher volatility in returns of their assets, their stability index is lower than that of CBBs of mixed banks. Conversely, NPLs and thus loan loss provisioning by IBBs of both small and large mixed banks is lower in comparison to conventional banking branches of mixed banks. This shows that Islamic windows of mixed banks have better asset quality than their conventional windows.

Chapter 5 has examined recent defaults Islamic capital market due to the gaps between the principles of IBF and practice of the market players. The chapter is essentially case studies of four major *sukuk* (Islamic bonds) defaults that occurred in recent past around the same time when global economy experienced financial crisis 2007-09. *Sukuk* are presented as an alternative to the interest based conventional bonds with a view that these are asset-backed securities, free of interest and are more transparent. However, while structuring most of the *sukuk*, several clauses were put in the offering circulars which made them equal to conventional bonds. For example, (i) undertaking by the originator/obligor to repurchase the *sukuk* at face value on maturity of the *sukuk* (iii) offering a fixed return to musharakah (joint venture) *sukuk* and (iii) credit enhancement through some promissory notes or guarantees for the principle amount in equity-based *sukuk* by the originators or third parties. Further, most of the *sukuk* did not transfer the underlying assets to the *sukuk* holders, and thus violated a basic condition for *sukuk* to be valid according to Islamic *shariah* (Islamic law). So, in the event of default, *sukuk* holders have no recourse to any asset, as effectively there were no underlying assets in their ownership. The paper concludes that the default of the *sukuk* occurs mostly because of incorporating the features of conventional bonds in *sukuk*, the imprudent business practices, forgeries in the originating companies and week financial positions of originator, i.e. liquidity mismatch and high leverage. However, even in a purely shariah compliant *ijarah* (leasing) *sukuk* the defaults cannot be ruled out as the bad market conditions can also affect the financial position of the originators and render them unable to pay the rentals and honor their commitments regarding repurchase undertaking of *sukuk*.

Lastly, Chapter 6 has checked the implications of the Islamic banking at macro level. The chapter has addressed the question if Islamic banks transmit the monetary policy shocks differently from conventional banks in an economy where both types of banks co-exist under conventional monetary policy regime. The bank lending channel essentially depends on the ability of the central bank to affect bank loan supply. For that it matters whether banks can or not attract time deposits perfectly elastically at interest rates outside the control of the Central Bank and whether they consider the loans granted and securities held in portfolio as perfect substitutes. It is also a requisite for this channel that firms are mainly bank dependent and cannot substitute bank lending through issuing bonds. Islamic banks may, on the one hand, be unable or unwilling to issue wholesale time deposits at a fixed rate and may not consider their Islamic loans substitutable for any of the securities they would alternatively hold in their portfolio. This may make Islamic banks to transmit monetary policy shocks more strongly. On the other hand, Islamic banks that uniquely attract deposits and lend under interest-free arrangements, are likely to be approached by depositors and borrowers for religious incentives. These contractual and motivational features on both their liability and asset sides may allow Islamic banks to protect themselves from monetary policy shocks. Consequently, whether the transmission of monetary policy through the bank lending channel would change when the Islamic banks also have some market share in the economy is an empirical question. Thus the aim chapter 6 has been to is to investigate the differences in banks' responses to monetary policy shocks across bank size, liquidity, and type, i.e., conventional versus Islamic, in Pakistan between 2002:II to 2010:I. The results show that following a monetary contraction, small banks with liquid balance sheets cut their lending less than other small banks. In contrast large banks maintain their lending irrespective of their liquidity positions. Islamic banks, though similar in size to small banks, respond to monetary policy shocks as large banks. Hence ceteris paribus the credit channel of monetary policy may weaken when Islamic banking grows in relative importance.

The thesis concludes that the implications of introducing IBF principles in conventional financial system would bring positive changes in terms of structure of the banks and capital market, stability in financial system and overall economy. Also, monetary policy transmission through bank lending channel may be different in IBF from conventional banking sector. Last but not least, allowing IBF to co-exist with the conventional system would result in financial inclusion of the segment of the society that does not channel their investment through interest-based banking system.

More research is needed in this field. Regulatory framework of IBF needs to be more standardized across all the jurisdictions. In this regard, to avoid conflict of interest some check and balance has to be put in place for the role of *shariah* scholars. At macro level a general equilibrium model should be developed based on the principles of IBF to gauge the implications of these doctrines on macro variables of an economy.

In near future, I would work on liquidity crisis and lending behavior of Conventional vs. Islamic banks, a study sponsored by IMF. Further, I am intending to work on analyzing the value of saving and investment deposits of Islamic banks relative to their assets' value of the Islamic banks, and impact of tight monetary policy on sectoral financing by the Islamic banks.