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How Islamic Finance can affect the Financial Stability?

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**Abstract**

The subprime mortgage crisis during the years 2007-2010 demonstrated the weaknesses of the conventional system of finance. The inherent speculative element of this system, which is fueled through the logic of interest additionally, brought attention to alternative approaches in order to recover control over the financial system. Islamic finance, a system relatively young in practice, contributed its part to the ongoing discussion on financial stability and has to present its own tools for this huge task. This paper wants to outline the ongoing theoretical discussion and empirical evidence concerning the question of financial stability and the role of Islamic finance in it. Main results found was Islamic finance has contributed to the overall financial stability. The survival of this financial system through the crisis of 2007-2008 has made it more and more interesting to investigate and to develop. The question of tradeoff between stability and profitability of this financial system remains under investigation as the conventional financial sector continues to be more profitable but less stable. The new avenue of the research channel in the financial sector could measure this tradeoff taking into account the future challenges.

**Keywords:** Islamic finance, stability, conventional finance, risk sharing, interest
Introduction

The Islamic system of finance has been used over some four decades in the Islamic world where no developed financial institution or organization in the modern sense ever existed before economic modernization during the past century. This system derives its rules, laws and customs directly and mainly from the Sharia. In the Islamic religion, Sharia is compound both of Quran as holy book and the Sunna, which contained sayings and customs provided by the Prophet Mohammad. Being the region where Islam was founded, the economic activities on the Arabic peninsula back in the time were either small scale agriculture due to insufficient water availability, or trade respectively. Under that circumstances Islam introduced a new philosophy of dealing with legal problems. This was also the case for conflicts in general as well as monetary issues, the handling of profits and unpredictable loss in the regional trade sector. At that time the process of implementing generally accepted institutions to monitor and guide economic activities in the Islamic world had only just begun. Not even a few years after that, the first Islamic civilization had reached the stage of an empire, ruling the major part of the then known world. While these major achievements had long been forgotten for various reasons, yet the current financial crisis due to the failure of the conventional western way of dealing with economic issues of all different kinds has put the system of Islamic finance into the spotlight, giving it a vast amount of attention not only among scholars but increasingly on the public as well.

The system of Islamic finance and the demand on its products have been growing over the last decades since its establishment in the early 1970s (Alharbi, 2015). The private-sector association and industry lobby group (theCityUK, 2015) expect the market on Islamic finance to top $3.0 trillion by 2018. According to researcher Rodney Wilson Islamic finance began to develop in the 1970s due to the huge cash flow from the oil and gas boost in the Gulf Corporation Countries (GCC) (Wilson, 2009). In 1999, the first Islamic market indices were introduced at the Dow Jones. The still ongoing increase of Muslim population around the world has also played a role in the development of this specific financial sector. Besides that, another important factor of attracting interest beyond majoritarian Muslim countries was the relative stability of the Islamic finance system during and after the shock of the global financial crisis in 2008. Explanatory reasons for the stability of the Islamic finance system during the crisis were the structural prohibition of interest, the ban on activities with speculative uncertainty and
especially the cash management system. In the post crisis period the IF sector has experienced exponential growth on its financial services and products.

One impact of Islamic finance (IF) after the crisis in countries, where Muslim communities are in minority, is that the conventional financial banks were obliged to change their policy by reducing their credit risk to maintain their competitiveness on the market. In a sense, this necessary policy of risk reduction through re-linking a capital market out of control with the real world economics made, unconsciously and following necessary logical considerations, a step towards the principles which are fundamental and inherent Islamic finance.

In the following some remarks on the growth of IF over the past decades will be made. Subsequently, the literature concerning the impact of IF on financial stability will be reviewed. The results will be discussed afterwards and we will answer the research question, namely how Islamic finance could affect financial stability according to recent research.

**Islamic finance: Stable growth**

As to the growth of IF, the increase in Muslim population in Europe is one of the drivers which catalyzes the growth of IF services and products. Over the last two decades the value of Islamic financial assets worldwide increased from USD 150 billion in the mid-1990s to an estimated USD 1.6 trillion by end-2012 (Filippo di Mauro et al. 2013). After the financial shocks of the 2008 the non-Muslim countries in Europe started as well to contemplate the Islamic option of finance or at least some central elements of it such as risk sharing and alternative approaches with handling interest. Those risk distributing aspects were boosted especially after the wake form the financial crisis.

![Graph 1: The Size of Islamic Finance Assets (USD Billion) (Source: World Bank, 2015)](image)
In Europe, the UK is the leading nation in hosting several Islamic banks and Luxemburg is also recognized as a leading hub for Islamic funds. In addition, the official newspaper of the Vatican, ‘L’ Osservatore Romano’, has stated: “The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service.” This publication was suggesting the option of IF and its principles as a potential solution to financial crisis just after the 2008 global depression hit. Thus, and after all the ongoing talk about the IF system and its relationship to conventional finance, it has special interest to review the ongoing academic discussion about the question, if and to which extent the IF system affects financial stability.

### Review of literature

Belouafi et al. (2015) made it their business to evaluate the pre- and post-subprime crisis literature on Islamic finance and the question of its impact on financial stability. They used some forty studies published over the last three decades, structuring them in theoretical and an empirical publications as well as along the pre- and post-sublime crisis timeline. Beginning with the quest of finding the very definition of financial stability itself they conclude that the field of stability research is to great extend still uncharted water even to conventional economic research. Consequently, studies which propose the thesis of universal solutions for questions of economic stability should in general be seen with skepticism. This holds especially for an emerging business field as it is the case with IF.

While there seems to be no doubt that the ‘tenets’ of IF (1. Risk-sharing, 2. Asset-backing principles) are “the most important ‘build-in’ features that may stand behind the inherent stability of the IF [system]”, it must be said that, rather among IF scholars than banking directors and office holders, there exists an idealization of IF and its impact of financial stability. Additionally, it cannot even be stated that IF is a homogenous field with standardized methods and approaches. This is also the reason why the authors have difficulties with universalizing approaches, countering them with the hint that there exist various understandings of what IF is and which the permitted operational tools are.

Thus, and as expected due to the prior critique, the reviewed empirical analysis which firstly appeared in the post-crisis period provided mixed results concerning the impact of IF on financial stability. The authors conclude that the interpretation of the empirical results through
the concept of Profit-and-Loss-sharing (PLS) in IF (see point 1. in the brackets above) does not provide sufficient attention to the fact that the reality in IF is still far from having realized this inherent and central idea of IF.

Haven got a clear and broad survey on the state of the research concerning IF impact on financial stability, we expand our own review by including additional studies on the subject into our work. None of the following papers was included by Belouafi et al.

Abu-Alkheil et al. (2017) have used the monthly return of 32 indices from the Islamic and the conventional financial system from 31 January 2002 until the end of December 2014. The comparison was moderated by the use of one currency (US Dollar) and the average monthly return. The data was rearranged into three periods: pre-crisis-, crisis- and post-crisis-period. The method used was the stochastic dominance (SD) analysis and the Johansen’s co-integration approach to test the performance, risk behavior and the long run relationship. The SD method was applied in preference to the CAPM model because of the risk free market absence in the Islamic finance principles. The result shows no long run relationship between the two financial systems. The SD analysis shows that investors may switch to the conventional system, looking for more profit and diversification. It may therefore be claimed that, despite the existence of IF banking sector and some actual elements of risk reduction in the finance sector, risk seeking investors and ordinary depositors may want to choose either those IF indices which are related to relatively higher risk, or simply switching to conventional banking and the riskier assets over there. This link reveals one important issues in the coexistence of conventional and IF banking (including alternative Finance institutes with similar aims as in IF, such as sustainability, ‘clean’ investment, etc.). In a sense, IF also lives, at least party, in the backwash of conventional and less risk-reducing banking, mostly relying on the degree of consciousness of the depositors for their responsibility and their willingness to sacrifice profit in form of dividend or interest.

The issue of how stable and predictable the behavior of depositors in Islamic Bank is, has been tried to be answered by Aysan et al. (2017). This question has special interest, since the, in theory, depositors agree on the PLS-principle contractually and therefore should have an indirect impact on their contribution on financial stability through the expected behavior of agents in IF. Sharing profit and loss consequently, has the assumed effect of choosing objects of investment on the one hand more carefully and also clarifying the mutual responsibility in case of investment failure. However, Aysan et al. find high responsiveness of IF depositors to the interest rate in economies with a coexistence IF and conventional finance, although the
interest shouldn’t matter for them. They identify missing scale effects in trust due to the absence of large and important depositors, who could potentially signal publicly their trust towards the system of IF. Another reason is also identified in the very attitude of small scale depositors themselves, namely to rather ‘park’ their money at Islamic Banks, but being easily willing to withdraw if interest rates in conventional banks promise profitable return.

An interesting result concerning the impact of IF on overall financial stability in a dual-banking system, is presented is made by Abedifar et al. (2016). They analyze 22 Muslim countries and the relationship between conventional and Islamic finance with an OLS regression and find, that the relationship between both is not so much competitive as it is the case between conventional banks. Instead, because the fields of investment and the clientele are structurally different, they complement each other and therefore contribute to financial stability by directing willing depositors in ‘calmer waters’ and mitigating overheating through the availability of an institutional and codified alternative. In this finding, IF sector depicts in a sense a ‘collecting basin’ for depositors who already ceteris paribus would avoid the extensive use of conventional finance services.

Taking up and analyzing the impact of the regulatory framework of the European Union after the financial crisis of 2008 and the following liquidity problems, a new regulatory framework has been introduced to the international banks and financial services by the Basel Committee on Banking Supervision. The new liquidity requirements were presented on an international meeting called Basel III. The net stable funding ratio (NSFR) and the liquidity coverage ratio (LCR) were the most significant resolutions of that meeting in order to avoid future shocks due to speculative investment activities of conventional banks. All banks have time until 2018 to meet the new standard. Dawood Ashraf et al. (2016) were examining the impact of a new modified NSFR ratio on Islamic finance on their financial stability. To do so, they calculated the modified NSFR ratio of 136 Islamic banks covering the period of time 2000 to 2013. Applying a modified version was mainly necessary due to the structural differences between the IF and conventional finance system.

In another interesting study, Faye et al. (2013) have investigated the recent trend and promises of Islamic finance in Africa. Their empirical analysis shows that Islamic finance has been effectively introduced in Africa and still has a relatively positive impact when compared to the conventional system. The paper provides an overview of Islamic finance in Africa, the benefits
that IF system has brought to the continent and how the system has been performing when compared to the conventional one. They argue, that the continent is still underperforming with respect to the rest of the world in terms of financial Islamic services provided. The development of Islamic finance on the micro-level has been successful but still is insufficient for the requirements of the continent. The authors also highlighted that the limitation of such financial systems may be stronger linked to the political decision making process. One example mentioned is Morocco in the recent years. The country has no Islamic financial services in operational use.

Faye et al. (2013) compared the efficiency of the conventional and Islamic financial system in Africa. For their analysis, they used the Generalized Least Squares method as presented below and introduced ‘Islamic as their dummy variable.

\[ perf_{i,j,t} = \alpha + \beta_{\text{Islamic}i} + \gamma_{\text{Bank controls}_{i,j,t}} + \delta_{\text{Controls}_{j,t}} + \varphi_{\text{Year}_t} + \epsilon_{i,t} \]

The main finding of the estimation model was the following: Islamic banks in the sample have a lower cost income ratio and higher return in average assets and equity assets ratio. The main conclusion according the empirical investigation is that Islamic banks are more efficient and more stable with a lower insolvency risk than the conventional ones in Africa. One balanced conclusion of this paper is that IF seems to realize more stable but less profitable businesses when compared to conventional banks. However, on the other hand, loss is due to the structure and requirement of IF also below the mean of conventional banks.

The theoretical work by Ozsoy (2015) presents Islamic finance based on an interpretation of one saying (Hadith) by the Prophet Mohammad where he just extracted almost 144 types of trade and basic rules. He argues that Islamic finance could contribute effectively to the financial stability as it is impossible to balance between exponentially by interest driven earnings and the physically limited productivity of capital. He adds that interest-driven income is inherently based on uncertainty. This automatically results in more income and macroeconomic instability. The main result of his work is that Islamic finance affects the real economy by its services, products and transactions with respect to its size deeper than the conventional system, since the latter is operating more or less with decoupled global capital flows and does not prioritize real economy as field of investment per se.
Beck et al. (2013) have come to the conclusion that Islamic banks are better capitalized than the conventional ones, as the Islamic finance system has less risk exposure and is less sensitive to the market volatility. The equity-based and risk-sharing rules help to give more stability. Djennas (2016) conducts a study based on comparative analysis to assess the impact of Islamic finance on the economy of a country. A composite index was modeled for the empirical needs. To do so, fourteen industrialized countries of the world, which include eight of the significant leaders in Islamic finance, were tested. The covered time period spanned from 1980 to 2013. The selected time range was characterized by different crisis periods in different regions. The results show a relatively similar performance of both financial systems on the economy. However, specific index analysis has proven that economies using Islamic finance have a strong probability to avoid crisis situations and have a more stable economy. The author has argued, too, that income inequality might be reduced in an Islamic financial system compared to the conventional one that is based on interest regime where wealth is not distributed on an equitable base. The composite index was mainly a combination between the Exchange Market Pressure Index (EMPI) and the resistance index (RI).

**Results and Discussion**

The main investigated difference between Islamic and conventional finance is the performance of their stock indices. Islamic finance, clearly differs from the conventional one in its fundamental rules and investment criteria which have to be respected and applied both by creditor and debtor ex ante. In IF, which is based on the laws of Sharia, gain and loss should be shared equally between partners. The risk free profit or so called ‘Maysir’ is prohibited, as well as interest use for both sides contract. Additionally there is also the prohibition of excessive uncertainty investments, namely the so called ‘Gharar’. Even the real economic activity to which financial services contribute should follow the religious rules by avoiding to take part in investments which contradict the ethical principles of Islamic religion. This circumstance can and should be seen as a limitation on the contract of freedom by institutional means. It seems to be the main channel of addressing general stability issues in the financial sector as well as in the real world economy.

Some researchers have argued that Islamic finance provides a high return due to the small financial institution and that Islamic stock index bears a higher risk. On the other hand other researchers opinion tend to the stance that the low exposure to risk in this type of financial
services would naturally generate less return and also limit the factor diversification with regard to the variety of undesirable fields of economic activity.

Since the financial crisis of 2008 the world has witnessed an increase in the consciousness for the dependency on interest rates and the multiplied multidimensional consequences which arise out of this dependency. From a theoretical point of view the conventional banking system and its stability are mainly based on the clearly speculative assumption that not all depositors will come concentrated on one day to withdraw all the deposited assets they have saved. In an unlikely event like this the banking system may face the same danger of collapse as seen e.g. in Greece in the recent years, where people had lost trust on their financial system and initiated a bank run.

Although this risk is not completely banned with an Islamic bank, as the depositors run with the İhlas Finans Bank in the years 2000-2001 showed, IF is obviously related to religious rules, restricting potentially harmful behavior in finance from the very beginning of a contractual relationship between creditor and debtor. In the theory of social capital, trust in socially predictable behavior has the potential to increase the trust in IF institutions. The fact that individuals are indeed seeking for ethical banking as it is the case with Islamic Banks in general, can and should therefore lead in the long run to a rise in social capital and an atmosphere of trust in this sector. However, research shows that the developments on this field are still ‘fresh’ and dynamic and way too much in motion in order to provide absolute answers concerning the question of IF and financial stability. Giving definite answers at such a volatile stadium, does not seem to show seriousness. One of the critical problems that can be derived from the literature and the actual financial situation is that this new financial system is still in its early stages of development and the lack of experience comparing to the conventional banking system might result in problems in the long term if they are not handled well. The answer to the question of how Islamic finance specifically may contribute to financial stability, depends therefore on the developments in this field.
To compare both financial systems we have tried to construct this table using scaling method to quantify the variable measurement in order to summarize the results from the existed literature.

|                          | Islamic Finance | Conventional Finance |
|--------------------------|-----------------|----------------------|
| **Efficiency**           | 8               | 8                    |
| **Profitability**        | 6               | 8                    |
| **Stability**            | 9               | 6                    |
| **Resilience**           | 8               | 5                    |
| **Macroeconomic Impact** | a positive-sum game | a zero-sum game     |

Scale 1 to 10 was used, source: our results

Table 1: A comparison between the Islamic and the conventional financial system resulting from the literature

Nevertheless it is permissible to mention the contributions of IF to financial stability. Although they are often still mainly theoretical by nature, its attractiveness for application is highly up-to-date and noteworthy. Up to this date, the clear principles of minimizing uncertainty through reduction of speculative contractual relationships can be identified as the main driver behind observed and theoretically financial stability on a micro- and macro basis.

**Conclusion**

The save survival of the IF system during the years of the recent financial crisis has clearly raised the interest on the principles which frame the operative system of IF. The question of tradeoff between stability and profitability of this financial type of services remains under investigation as the conventional financial sector continues to be at least more profitable, but less stable. The new avenue of the research channel in the financial sector could measure this tradeoff taking into account the future challenges.

The world has been through different economical systems and schools of thought throughout its history. After the Second World War, especially after the breakdown of Bretton Woods system and its stabilizing elements, liberal capitalism and its device of deregulation has been dominating a major part of globalized economic system. Amongst other crises, the financial
shock of 2007 has brought the weaknesses of this system to the surface. In this situation, Islamic finance has, at least theoretically, provided a modest and discrete approach of regulation on the crucial ‘adjusting screws’ of the global financial system in order to have a positive impact on financial stability. It holds that the positive and fruitful input of Islamic finance and its ideas with respect to the question of financial stability can’t be denied. However, future research has to be undertaken in order to provide both further theoretical and empirical insights on the direction and the extend of this impact.

Empirical findings concerning the contribution of Islamic finance to financial stability are mixed yet and still very new. Further research, data collection and observation is needed in order to be able to give more definite answers to this question. The idea behind Islamic finance and the set-up of its tools, is stability itself and the avoidance of gain in exchange for stability. What should be in any case avoided therefore, is any kind of naive optimism concerning the system of IF and its short term abilities. This, indeed, would be contradicting the very principles of IF and undermine its target, namely: Behaving thoughtful and responsible and leaving speculative elements aside.

Another research could start by the question: if the Central Banks adopt the Islamic financial system what will be the tool for a monetary policy or how to hedge against an economic Recession? As the classic approach still used by most of the central banks all around the world is the IS/LM Model. And according to this model the central bank could implement its monetary policy or correction only through the adjustment of the interest rate for the short and the long term.
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