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Shariah Compliant Financial Intermediation in Dual Banking System

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Abstract. Islamic principles of financial intermediation require that IFIs refrain from impermissible financial transactions and play an active role in pursuing objectives of Shariah. Muslim countries have implemented dual banking system in their economies that in turn affect the achievement of these goals. This study examines Islamic perspective of the theory of financial intermediation and assesses if its desired objectives can be achieved in dual banking system. It is found that, in a dual banking environment, it is extremely difficult to achieve the desired objectives of Islamic financial intermediation, due to the high competition with conventional banks, lack of suitable products, inability of system to support IF transactions and lack of expertise of the staff of IFIs to effectively perform risk sharing based transactions. Muslim governments should design effective liquidity management frameworks for Islamic banks and focus on developing strong Islamic financial institutions and integrated Islamic money markets, in order to achieve the desired goals of Islamic financial intermediation.

Keywords: Islamic Banking, Dual Banking, Islamic Finance

JEL Classification: G21

Introduction

In the course of last 200 years, the technological advancements, growth in modes of communication and integration of global financial markets has resulted in extraordinary economic activity, countless cross border transactions and regulated/unregulated flow of capital. In this scenario, the financial intermediaries, in addition to their traditional functions, i.e. the reduction of frictions like transaction costs and asymmetric information as posited by traditional intermediation theories, also facilitate risk transfer and dealing in complex financial instruments

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(Allen & Santomero, 1997). The traditional intermediation theories rest on the assumptions of perfect markets and argue that intermediaries (like banks, insurance companies and mutual funds) are in a better position to gather information, share the relevant costs with the individuals (Gurley & Shaw, 1960) and reduce information asymmetry through signaling (Brealey, Leland, & Pyle, 1977) or by performing delegated monitoring (Diamond, 1984). Nevertheless, with the increase in breadth of international financial markets and their changing risk profile, the focus is moved from 'institutional perspective' to 'functional perspective', since the functions are more stable in the long run as compared to the institutions (Merton & Bodie, 1995). After global financial crisis (GFC) of the year 2008, and the collapse of major financial intermediaries (FIs) across the globe, several questions were raised on the effectiveness of the role of conventional financial intermediaries in performing these functions. There is a plethora of research investigating the causes of this crisis, which generally blames functional practices of FIs (like excessive risk taking, high leverage and dealing in toxic securitized receivables) and ineffective supervision by regulators (Claessens, Demirgüç-Kunt, & Moshirian, 2009). Islamic finance is portrayed as an alternative to the current intermediation pattern in global financial markets, and its proponents claim that it can help in averting recurring crises owing to its distinguished design and instruments (Usmani, 2002). Nevertheless, Muslim countries have generally resorted to implementing dual banking system in their economies and it is not clear how this practice can, possibly, contribute to the achievement of the desired objectives of Islamic principles of intermediation. This study contributes to the existing literature through the examination of Islamic perspective of the theory of financial intermediation and the assessment of the effects of dual banking system.

The emergence of Islamic financial institutions and their notable growth in the last 20 years has remained a key interest in the existing literature, especially after GFC. *Shariah* compliant financial products are not only consistent with the religious beliefs of Muslims, but are also deemed preferable over conventional products, owing to their risk sharing and equity like features, while the conventional banking transactions suffer from issues like unequal distribution of risk and maturity mismatch between deposits and loans (Beck, Demirgüç-Kunt, & Merrouche, 2013). The Muslim countries have, largely, refrained from instituting full-fledged Islamic banking and have mostly relied upon dual banking design. There are several benefits of this approach. To begin with, conventional banking is well established across the globe and consumers are well aware of its products and services. Furthermore, the liquidity management is well defined and conventional money markets are capable of meeting, virtually, any liquidity needs. Finally, there is no restriction on any financial transaction in conventional markets, due to religious or social implications. It is, however, difficult to practice dual banking system, due to certain complexities. For example, Islamic finance (IF) transactions need to comply with the core principles of Islamic finance and, due to this reason, it is difficult for Islamic Finance Intermediaries (IFIs) to raise or dispense *Shariah* compliant funds. Similarly, the financial structures of Muslim countries have various dilemmas like pegged exchange rate regimes, interest rate controls and shallow financial markets. To address these issues, they need to develop Islamic domestic interbank markets, *Shariah* compliant liquidity management instruments and operational framework for central banks.

Table 1.

Financial Intermediation: Conventional Vs. Islamic Institutions

Feature	**Conventional**	**Islamic**
Objective	Agency	*Mudarabah* Agency
	Secular	Objectives of *Shariah*
Design	Commercial Banking	Mutual Fund
Returns	Fixed/Predetermined	Profit/Loss Sharing Based
Monitoring	Moderate	High
Capital Guarantee	Guaranteed	Not Guaranteed
Maturities Pattern	Volatile	Smooth

As per the survey of empirical works conducted by Narayan and Phan (2017), several studies compared the performance and resilience of Islamic banks (IBs) in comparison to their conventional counterparts during GFC and there is a significant number of research papers that found IBs better than conventional banks in terms of both of these traits, although many studies found the reverse or no difference at all. Nevertheless, existing literature does not provide conceptual assessment of whether Islamic financial intermediation is sustainable / effective in dual banking system and what are the ensuing challenges. The present study fills the existing gap in literature.

The study finds that it is challenging to achieve the desired objectives of Islamic financial intermediation, due to high competition with conventional banks, lack of suitable products, inability of system to support IF transactions and lack of expertise of the staff of IFIs to effectively perform risk sharing based transactions. Moreover, the role of central bank is found to be ineffective in this respect, due to lack of commitment, non availability of efficient human resources and inadequate supervisory guidelines.

The rest of the work is organized as follows: Section 2 reports brief review of the literature, section 3 explains research methodology, section 4 lists results and section 5 concludes the study.

Literature Review

The financial intermediaries perform various important functions (Mishkin, 2007). Firstly, they channel surplus resources of capital providers to the users of capital through asset transformation, in shape of deposits, advances, investments, insurance etc. Secondly, they facilitate payments through checks, electronic fund transfer, clearing, settlement etc. Thirdly, they offer brokerage/agency services and provide financial advice, guarantees, and custodial services.

The traditional theories of financial intermediation explain how the information asymmetry limits the ability of lenders to advance their capital to credit worthy borrowers (Brealey et al., 1977). The borrowers have better knowledge of their capacity to run the business, collaterals, business conditions and the feasibility of their future projects. They do not pass on this inside information to the lenders leading to moral hazard (in the shape of exaggerating positive qualities of their projects in the hope for substantial rewards). It can be difficult for the outsiders to verify the information provided by the borrowers due to lack of resources or high information costs. The financial intermediaries bridge this gap by virtue of their ability to collect insider information about the potential borrowers and recover transaction costs. The lending made by a FI serves as a signal to other outsiders that the borrower is deemed credit worthy by that institution. In addition to transaction costs, the compensation for intermediaries comes in different shapes. For example, the banks pay and recover fixed returns. The mutual funds charge upfront management fees and receive a percentage of profits.

Allen and Santomero (2001) term these theories as incomplete and stress the need to incorporate dynamic aspects of intermediation to develop a comprehensive theory. They argue that the financial sector faces new challenges and pressures owing to financial innovation and divergence in risk orientation across the globe. In the countries where financial intermediation is dependent on commercial banks, the risk management function is performed through intertemporal smoothing, i.e., creating a buffer of short term liquid securities to meet any liquidity needs in bad times. The growth in financial markets makes it more difficult to create these buffers, as they offer higher-than-bank returns. The banks are, therefore, bound to innovate and be more entrepreneurial by offering services like asset management, distribution, underwriting, insurance and fee-based arrangements. In many cases, the role of traditional FIs is transforming from principal to agent.

In an Islamic economy, the financial intermediation function should stretch beyond conventional intermediation goals and, primarily, contribute to the realization of broad socio-economic goals as laid out in *Maqasid Shariah* (Chapra, 1985). Instead of mere channelizing of surplus funds to capital deficit units, Islamic financial intermediaries (IFIs) should participate in the efforts to achieve full employment and optimum rate of economic growth. They are also required to ensure justice and equity while mobilizing investments and distributing returns. In pursuing these objectives, IFIs are bound to refrain from dealings in *riba* (interest) based instruments, performing transactions containing extreme risk (*gharar*) and investing in *haram* (impermissible) businesses and activities.

Islamic bank is an example of a *Shariah* compliant financial intermediary which can be termed as a hybrid between an investment bank and a conventional bank (Iqbal & Mirakhor, 2011). Theoretically, the transactions are made by using traditional Islamic finance modes and the profits/losses are shared upon the basis of the underlying economic activity. The asset portfolios of IBs resemble open ended mutual funds, which are offered to the investors/depositors. They act as agents and create a pass-through intermediation for both the parties. Since they do not accept deposits at pre-agreed rates, there is no fixed liability for the banks and the propensity of asset/liability mismatch is very lower than conventional banks. Nevertheless, they require enhanced monitoring, owing to the partnership nature of the contracts and high probability of moral hazard and adverse selection in the business transactions. In order to effectively perform this monitoring, they need to spend on the development of managerial skills and ability to assess different kinds of investment projects.

Table 2.

Comparison of Conventional and Shariah Compliant Financial Instruments

Issuer	Conventional	*Shariah* Compliant
Government	Bonds	*Sukuk*
Banks	Deposits	Investments
	Acceptances	*Mudarabah/Musharakah* Certificates
	Loans	Participatory Agreements
Investment Banks	Equity	Equity in *Shariah* Compliant Business
Leasing Companies	Lease	Ijarah
Firms	Equity	Equity
	Bonds/Convertibles/Commercial Papers/Warrants	*Sukuk*
	Preferred Stock	
Exchanges	Commodity Futures	Commodity *Wa'ad*

The commercial banks face unique agency problems as, on one hand, they act as agents of depositors/investors whereas, on the other hand, they practically appoint borrowers as their agents, by lending money against contractual returns (Beck et al., 2013). The risk sharing component of IBs significantly influences their agency problem, as the depositor will monitor the bank's activities more intensely, due to the equity like nature of contracts whereas, the bank will have incentive to reduce monitoring of entrepreneurs as it will not be facing the threat of immediate withdrawals. The excess monitoring cost can be burdensome for the customers and may adversely affect the demand for IB products. It is mainly due to this reason that contemporary IBs are seeking refuge in financial products that are *Shariah* compliant in form but do not possess best risk sharing features.

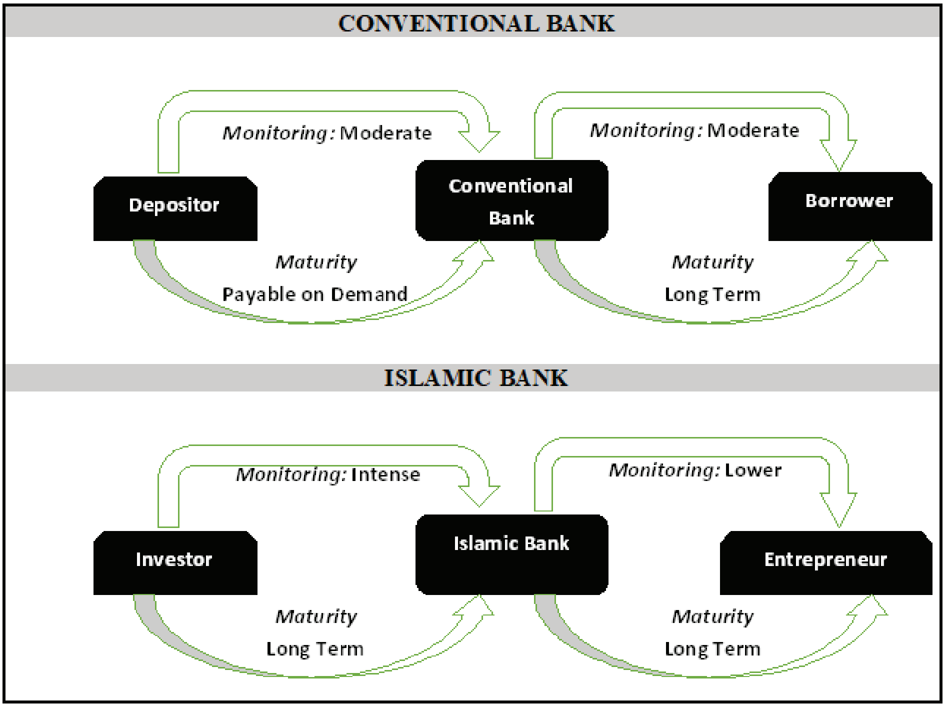

Figure 1. Agency Problems: Conventional Vs. Islamic Banks

Source: Author's contribution

IF industry should strive to uphold certain values i.e. developing community banking, promoting responsible finance, contributing to real economy and expanding the ownership base of society (I. Khan, 2007). The current IF practices, however, seem to focus more on profit taking and ignore the pursuit of all these values (Asutay, 2007). Their prime objective is profit maximization and they generally ignore social responsibility. In essence, IF industry has emphasized on 'efficiency' thereby neglecting 'equity' (Asutay, 2012).

In general, Muslim countries practice dual banking system (with the exception of Iran) and Islamic and conventional banks coexist in the financial system. There are certain implications of this phenomenon for the conduct of monetary policy by the central banks (Khatat, 2016). Firstly, in this scenario, the effectiveness of bank lending channel depends upon the capacity of the central bank to supply liquidity and the ability of IBs to change their pattern of lending/financing in response to changes in reserve requirement by central banks. Secondly, in case of fairly developed financial markets, the profit sharing ratios of IBs converge with conventional interest rates and the traditional interest rate channel of monetary policy is effective. Thirdly, as most of the Muslim countries effectively follow fixed exchange rate regimes and experience high capital mobility, the effectiveness of policy rate as a monetary instrument is questionable. Fourthly, the market segmentation between conventional and Islamic money markets can hamper the development as well as well-functioning of money markets in dual banking countries.

Research Methodology

The literature review suggests that the objectives of IFI extend beyond the function of commercial intermediation. The focus of our research is to conceptually evaluate whether these goals can be achieved in a dual banking system or not. The first step is to develop the metrics that are required for the desired assessment, in the light of existing literature. The next step is to transform these metrics in research questions.

We list below these research questions: -

1. Can IFIs be successful in avoiding impermissible characteristics of financial transactions like interest, gambling, excessive risk taking and ignorance?
2. Can they contribute in creation of full employment?
3. Can they play effective role in the achievement of optimum rate of growth?
4. Can they develop community banking?
5. Can they promote responsible finance?
6. Can they contribute to real economy?
7. Can they widen the ownership base of the society?

In order to find out whether IFI function can achieve, or contribute towards the achievement, of these broad objectives, we have performed the assessment, in the light of arguments found in existing literature as well as our personal understanding of these issues.

Evaluation and Results

Avoidance of Impermissible Characteristics of Conventional Financial Transactions

IFIs appoint *Shariah* boards comprising eminent scholars, who monitor every transaction and certify compliance to *Shariah* guidelines related to business transactions and confirm that these transactions do not carry elements of *riba*, *qimar*, *gharar* and *jahalah* (Iqbal & Mirakhor, 2011). In hindsight, this arrangement is adequate and the IF transactions may be deemed as *Shariah* compliant in the legal form. Nevertheless, many Muslim scholars and researchers widely criticize prevailing IF practices, as only a trivial portion of global IF transactions comprises profit/loss sharing contracts and IFIs mostly use contracts like *Murabahah* and *Ijarah* and use conventional interest based benchmarks to price these contracts (F. Khan, 2010). It is not difficult to understand that these practices are adopted to compete with conventional banks, which offer fixed returns and charge fixed interest rates on their advances to address agency issues and moral hazard problem. In the absence of conventional banks, it will be easier for IBs to develop risk sharing products and participatory finance.

Creation of Full Employment

Several suggestions are available in existing literature (e.g. refinance ratio by Siddiqi (1982), central deposits by Al-Jarhi (1983), and framework of fiscal deficits and diversion of high powered money to government by Chapra (1983)) on how central bank, in an Islamic economic system, can use unique monetary policy tools. The careful assessment of these proposals reveals that they can be implemented only in an interest free environment. In case of dual banking system, the consumers' arbitrages may result in a convergence of returns of Profit Sharing Islamic Accounts and costs of Islamic financing to conventional deposits and lending rates (Khatat, 2016), and the desired outcome of these monetary tools may not be achieved. Although the generous investment of conventional banks in corporate social responsibility (CSR) initiatives, that outshines IBs (Sairally, 2007; Alamer, Salamon, Qureshi, & Rasli, 2015), reflects that the IBs can learn a lot from these institutions and compete in respect of giving back to society as well. It should be noted that welfare is among primary objectives of IFIs, whereas in case of conventional institutions, it is merely a tool to improve the corporate image and reputation.

Achievement of Optimum Rate of Growth

In an Islamic economy, the high rate of growth does not carry the prime importance and, in addition to the attainment of material prosperity, Islamic values require that growth should not be attained through the production of inessential or morally questionable goods and services (Chapra, 1985). Likewise, the economic progress should not result in widening the gap between the rich and the poor. Finally, in pursuit of growth, it should be ensured that moral and physical environment should not be damaged and the interests of future generations should not be compromised. It is very difficult to achieve such 'optimum' growth rate in the presence of conventional banks. Although many conventional institutions take into account the ethical considerations, their focus is limited. Therefore, even if IBs refuse financing to companies offering products and services harmful to society, they will end up losing profitable business opportunities as conventional banks will be willing to serve those industries.

Developing Community Banking

Islamic banks desire to take active part in capacity building in the communities and contribute to the social cause, but they argue that they are not charitable organizations and, in order to survive in the competitive global environment, they need to focus on profit maximization (Warde, 2000). Evidently, they are afraid of extra costs that may affect their efficiency and make their services more expensive.

Promoting Responsible Finance

Although most of the IBs have adopted AAOIFI standards and incorporated IFSB guidelines in their reporting mechanism, they seem to comply only with the legal form. They prefer transactions based on debt-financing in order to earn higher profits and assume lesser risk. Moreover, even though IFIs do not invest in impermissible sectors, there is little indication that they are entirely ethical. Owing to intense competition, they cannot afford to neglect profitable business opportunities. For example, if conventional financial institutions are willing to finance coal power plants, although they are not considered environment friendly, it is very difficult for IFIs to decline this investment project and lose an important customer. In an environment where IFIs are independent, they are in a better position to promote responsible finance.

Contribution to Real Economy

Islamic banking and finance could not become a part of the Islamic moral economy and has failed to exhibit meaningful macroeconomic consequences (Asutay, 2012). Instead of promoting equity financing through risk sharing agreements, they use debt-financing to invest their liquidity and contribute in widening the gulf between rich and poor. It is not appropriate to shift the whole blame on dual banking system, as the rent seeking approach of IFIs is equally responsible for this behavior. Nevertheless, as IBs have lesser access to liquidity as compared to their conventional counterparts, they cannot take the risk of losing existing customers by offering innovative products, since the cost of switching is very low.

Widening the Ownership Base of Society

In principle, IFIs accept deposits on the condition that returns will not be guaranteed and customers may face losses. They are in a position to positively affect social capacity building and promote venture capital investments or profit/loss sharing contracts, in order to contribute to widening ownership. In reality, however, IFIs generate deposits on the basis of past performance as most of the depositors compare tentative rates of return on IF investments with declared interest rates on conventional deposits before making placements. In such environment, it becomes almost impossible to educate the customers and convince them to join hands in widening the ownership base of the society.

Conclusion and way forward

Islamic principles of financial intermediation require IFIs to not only refrain from performing financial transactions with impermissible traits but also play an active role in the achievement of objectives of *Shariah* and promote equity and distributive justice in financial dealings (Alziyadat & Ahmed, 2018). On the other hand, conventional financial institutions, by design, do not possess any such moral values and, at best, they invest a portion of their income on CSR related activities, considering it sufficient in respect of their obligations towards the society. It is difficult for IFIs to compete in a dual banking system, as they cannot meet their liquidity needs from conventional money markets and by using interest based instruments. In this scenario, they need to compromise on many values and restrict themselves to meeting merely the legal requirements of *Shariah* compliant financial transactions and neglecting the broader objectives. Theoretically, they can operate in a better manner in a single banking economy.

We understand that in the present global financial settings, it is very difficult for any state to manipulate the financial markets and hamper the competition. Muslim governments should, nevertheless, design effective liquidity management frameworks for Islamic banks. The central banks and securities commissions of these countries are required to develop Islamic domestic *Shariah* compliant interbank and government *Sukuk* markets. In order to develop these markets and incorporate the required regulatory change, the fiscal and monetary authorities need proper coordination and strong commitment. Muslim countries should also consider establishment of strong IFIs jointly owned by a group of countries (like Islamic Interbank Liquidity Management Corporation) and integrated financial Islamic money markets, in order to provide IFIs with the independence to experiment risk sharing contracts and achieve the goals of Islamic financial intermediation.

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