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INVESTIGATING RISK SHIFTING IN ISLAMIC BANKS

in the Dual Banking Systems of OIC Member Countries

An Application of Two-step Dynamic GMM

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The original intent of conventional banking was to serve as pure intermediary between surplus fund holders and deficit units in the economy. In this role banks transferred risk from depositors to borrowers. An edifice of deposit insurance system and supervisory/regulatory structure was erected to protect the creditor at the expense of the debtor. In the last five decades, however, advances in information technology and in financial innovations have made possible the emergence of an immense capacity for rapid regime switching from risk transfer by risk shifting was amply pronounced in the financial crisis of 2007/2008. The fallout from the crisis has intensified calls for a re-examination of current banking model. Banks' tendency to shift the risk of losses to external parties, while internalizing gains through debt-based contracts (Sheng, 2009), creates a minority class (equity holders and financiers) that benefits from economic and financial growth and excludes a majority (depositors and tax payers) from sharing in the prosperity. Worse still, the majority stands to bear the brunt of recurrent risk-shifting-induced crises.

> It offers first time coverage of OIC member states in the empirical risk shifting literature and applies the two-step dynamic difference GMM; to cater for the nature of Islamic banking data, which is characterized by a larger dynamic panel and a smaller timeframe.

Risk shifting is, axiomatically, absent in an ideal Islamic financial system, where risk sharing is argued to be the principal modality (The Kuala Lumpur Declaration, 2012). In such a system, equity holders are expected to share assets' upside and downside potential with investment account holders (depositors). A "credible threat of loss" is envisaged to strengthen investment account holders' monitoring incentives (Distinguin, Kouassi and Tarazi, 2013, based on Calomiris, 1999). The Islamic banking model, thus, provides unique paradigm with risk sharing at its core. Eliminating any opportunity for risk shifting can, therefore, be a litmus test of the authenticity of Islamic banking. Empirical evidence of risk shifting by Islamic banks would suggest that that the present industry is

undermining the contribution of Islamic finance to shared prosperity.

However, the present formation of Islamic banking has grown out of conventional banking and reverse-engineers many of its techniques and instruments. Whereas significant work has delineated the theoretical foundations of Islamic banking and its axiomatic characteristics, empirical assessment of the implications of present form Islamic banking is relatively limited and often focused on issues of efficiency, profitability and stability. To this end, this paper contributes to an issue of timely relevance for Islamic finance and the international financial community at large by empirically investigating the risk shifting behaviour in Islamic banks in dual banking systems of OIC member states. It offers first time coverage of OIC member states in the empirical risk shifting literature and applies the two-step dynamic difference GMM; to cater for the nature of Islamic banking data, which is characterized by a larger dynamic panel and a smaller timeframe.

Incentives for pervasive risk shifting are found to be lower in a majority of Islamic banks even though they are not fully eliminated. Islamic banks, therefore, engage in risk shifting to a varying degree. The mitigating impact of Islamic banking remains significant in all specifications despite including a number of bank and country specific variables. This confirms that some inherent features of Islamic banking deter risk shifting over and above other characteristics.

The evidence of risk shifting by Islamic banks - regardless of its magnitude - goes against theoretical predictions. But it appeals to the prevailing view that the prerequisites to the axiomatic model are at best partially met and that the development of Islamic financial instruments has concentrated on debt-like instruments (Mirakhor and Askari, 2010). The deterring impact of Islamic banking is worth strengthening through the expansion of risk sharing and removal of risk transfer incentives in the present corporate, regulatory and supervisory frameworks (CIBAFI, 2015; Haneef and Mirakhor, 2014; AbdulRahman and Romsan, 2013). This could be achieved through market-oriented approach to incentivising risk sharing and removing debt biases in central banking, governance, taxation, accounting and bankruptcy laws. Malaysia's Islamic Financial Services Act (IFSA 2013) may provide significant impetus in this regard.

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