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Does Islamic finance spur banking sector development?☆,☆☆

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ABSTRACT

Islamic finance is one of the most prominent phenomena over the last decade in the banking industry in the Middle-East and South-East Asia. In spite of the substantial size and growth of this segment recently, the role of Islamic banking in the economy is still heavily debated and very few empirical work is available. This paper studies the empirical impact of Islamic banking on banking sector development. It circumvents the lack of data through a newly constructed and comprehensive database, "IFIRST", covering Islamic commercial banks worldwide over the period 2000–2005. This database is, to our knowledge, unique in the industry.

We find strong and consistent empirical evidence that the development of Islamic banking in Muslim countries leads to a higher banking sector development, as measured by the amount of private credit or bank deposits scaled to GDP. This effect occurs through the development of a new, Shariah-compliant, banking industry, which does not crowd out the conventional banking system. Additionally, we provide evidence that the Islamic banking sector acts as a complement to the conventional banking in Muslim countries, when both systems co-exist and the Islamic sector reaches a medium penetration in the total banking sector.

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1. Introduction

Islamic finance can be defined as a type of finance that respects the principles of the Shariah, i.e., the Islamic law. The Shariah involves a series of prohibitions as well as prescriptions regarding the practice of finance. In short, prohibitions include paying or receiving interest (called "riba"), speculating or gambling ("gharar" or "maysir"), and being involved in prohibited ("haram") industries, such as those related to alcohol, pork, pornography, weapons, or conventional banking. Obligations include almsgiving (one of the five pillars of Islam, called "zakat"), fairly sharing economic profits and losses through appropriate financial agreements ("PLS" or "Profit-and-Loss Sharing" agreements), and fostering a productive use

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of money through requiring a real, non-monetary, underlying in each financial transaction (such as a consumer good or a commodity).[1]

In practice, the application of Shariah rules to finance leaves a large room for interpretation by "Shariah scholars" and Islamic finance practitioners. The modern Islamic financial system has developed since the 1970s in two major poles, namely, the Middle-East and South-East Asia, with the foundation of several Islamic banks and the creation of a rapidly increasing set of specific financial instruments. After a series of ups and downs (several Islamic banking institutions went bankrupt in the 1980s), Islamic banking seems to have reached a favorable period since the mid-1990s and has displayed since then impressive growth rates, in terms of both assets and number of active institutions.

The theoretical motivation behind the development of Islamic banking is the enhancement of both economic and social welfare, e.g., through allowing more people to participate in a "fairer" banking system (see, for example, Karich, 2002, 2004). A stream of the literature highlights the welfare-enhancing role of Islamic finance, through the encouragement of ethical values and an alternative financial behavior (see, for example, Usmani, 2002; Saleem, 2008). However, at the same time, some researches argue that Islamic banking has detrimental economic consequences, e.g., due to the role of certain values or imposed restrictions on finance and economics (see, for example, Volker, 2006; Kuran, 1995, 2004; Cobham, 1992).[2]

The divergences in the literature on the effects of Islamic finance are far from being settled. It is however essential for the policymaker to know whether allowing Islamic financial institutions to operate has desirable, or, possibly, detrimental outcomes for the economy.

The objective of this paper is to test the empirical impact of the recent development of the Islamic banking industry on Muslim countries' overall banking sector development. We focus on assessing whether the presence of Shariah-compliant banks, in a Muslim environment, has stimulating or detrimental effects on the overall banking sector development, as measured by private credit or bank deposits over GDP.

Banking sector development is important in economics, as a large body of literature has confirmed its positive role in economic growth (for a genuine literature review, see Levine, 2005). Hence, any implication of Islamic finance on the banking sector development has potentially important consequences for economic growth.

To the best of our knowledge, no other paper so far has tested, at the macro-economic level, the overall empirical impact of Islamic finance, through Islamic banking, on the banking sector development. The recent work of Weill (2011) focuses on one dimension of banking sector development, i.e., market power. Weill observes, using a sample of Islamic and conventional banks in 17 countries over the period 2000–2007, that, contrary to his starting hypothesis, Islamic banks have a lower market power than conventional banks. According to this study, Islamic banks have a low ability to influence the price of products and hence need to compete effectively with their conventional counterparts. Beck et al. (2013) use a sample of 2956 banks (of which 99 Islamic banks) in 141 countries over 1995–2007, and show that differences between conventional and Islamic banks are smaller than expected in terms of business model, efficiency, asset quality, or stability. However, they find that the share of Islamic banks in a country significantly impacts conventional banks in the country. In particular, a higher share of Islamic banks leads to increased cost efficiency and decreased stability of conventional banks. Such empirical results support the hypothesis that the expansion of Islamic banking would spur, rather than distort, bank competition and hence could be beneficial to the overall banking sector.

Islamic banking can impact financial sector development through many channels. First, it may increase the participation in the banking system, through either a drop in the proportion of "unbanked" individuals, or a rise in the volume of money deposited per client. In particular, strong believers who refused to participate or restricted their participation in the conventional banking system may decide to become bank clients or to increase their formal banking activities if Shariah-compliant institutions offer them the requested "peace of mind" (this hypothesis is worked out and illustrated in the "Islamic Banking McKinsey Competitiveness Report", McKinsey and Company, 2005). Second, Islamic finance may bring financial innovation and foster the development of new financial products fulfilling the needs of depositors, investors or borrowers. A broader supply of financial products can lead to a higher participation in the banking system by economic agents, whether they are sophisticated or less sophisticated. Some new, Shariah-compliant, products may suit the needs of both Shariah-sensitive and conventional-minded agents. We may also expect that financial innovation spurred by Islamic banks pushes other banks to also expand their product offer in order to keep their competitive position ("spillover effect"). Third, the creation of new Islamic banking institutions, or the conversion of existing conventional banks into Islamic ones, may affect the banking market structure. Potential negative impacts include a too high market power of Islamic banks, or lower incentives to lend. Potential positive impacts include a higher degree of competition in the market due to an increased number of players, higher incentives for Islamic banks to lend money, or a low market power of Islamic banks. All these channels imply an effect of Islamic banking on the level of both deposit and credit in the economy, with the exception of the incentives to lend, which only impact the level of credit. The recent empirical findings of Weill (2011) and Beck et al. (2013) bring evidence on the effects of Islamic banking on specific features of the banking industry's competitive structure, such as, respectively, market

[1] It is not the purpose of this paper to detail the theoretical and practical functioning of Islamic banking. Excellent references on this include Vogel and Hayes, 1998; Warde, 2000; Ayub, 2002; Iqbal and Molyneux, 2005; Iqbal and Mirakhor, 2011.

[2] Between these two streams of the literature, several research pieces aim to shed light on the theoretical conditions under which Islamic finance have desirable, or undesirable, outcomes. See, for example, Bjorvatn, 1998; Aggarwal and Yousef, 2000; Ibrahim, 2003. In turn, Solé (2007) highlights the practical challenges in developing Shariah-compliant banking alongside conventional institutions.

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