Risk-Sharing Financing of Islamic Banks: Better Shielded against Interest Rate Risk

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Abstract : In theory, risk-sharing-based financing (RSF) is considered a corner stone of Islamic finance. It is argued to render Islamic banks more resilient to shocks. In practice, however, this feature of Islamic financial products is almost negligible. Instead, debt-based instruments, with conventional like features, have overwhelmed the nascent industry. In addition, the framework of present-day economic, regulatory and financial reality inevitably exposes Islamic banks in dual banking systems to problems of conventional banks. This includes, but is not limited to, interest rate risk. Empirical evidence has, thus far, confirmed such exposures, despite Islamic banks' interest-free operations. This study applies system GMM in modeling the determinants of RSF, and finds that RSF is insensitive to changes in interest rates. Hence, our results provide support to the "stability" view of risk-sharing-based financing. This suggests RSF as the way forward for risk management at Islamic banks, in the absence of widely acceptable Shariah compliant hedging instruments. Further support to the stability view is given by evidence of counter-cyclicality. Unlike debt-based lending that inflates artificial asset bubbles through credit expansion during the upswing of business cycles, RSF is negatively related to GDP growth. Our results also imply a significantly strong relationship between risk-sharing deposits and RSF. However, the pass-through of these deposits to RSF is economically low. Only about 40% of risk-sharing deposits are channeled to risk-sharing financing. This raises questions on the validity of the industry's claim that depositors accustomed to conventional banking shun away from risk sharing and signals potential for better balance sheet management at Islamic banks. Overall, our findings suggest that, on the one hand, Islamic banks can gain 'independence' from conventional banks and interest rates through risk-sharing products, the potential for which is enormous. On the other hand, RSF could enable policy makers to improve systemic stability and restrain excessive credit expansion through its countercyclical features.

Keywords : Islamic banks, risk-sharing, financing, interest rate, dynamic system GMM
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