



UNRAVELING RISK AND RETURN IN ISLAMIC BANKING: DOES THE PERCEIVED HIGH RETURN EXIST?

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ABSTRACT

Using mixed qualitative and quantitative methods, this study analyzes the risk and return results of Islamic banks versus their conventional counterparts in Malaysia in order to evaluate arguments that adherence to shariah based banking principles minimizes risk exposure. Using comparative data from eight Malaysian banks, our empirical investigation provides limited support to theoretical arguments that the Islamic banks minimize risk. Our results show that there is no statistically significant difference in returns and risk between Islamic and conventional banks. We interpret these results as providing support for theories of convergence between conventional finance and Islamic finance. Further, we argue that policy makers thus need to take into account conventional models of systemic and structural risk when regulating burgeoning Islamic financial markets.

JEL Classification

A13,G12, G15, G18

1. INTRODUCTION

Islamic finance is one of the fastest growing segments of the global financial industry and in some countries, such as Malaysia, it has become a structurally important sector. The global industry is estimated to be worth \$1.35 trillion and the total value of its assets has grown by 150% since 2006 (Zawya State of the Global Islamic Economy Report Team 2014). But, while Islamic banks provide intermediation similar to conventional banks, fundamental differences exist between Islamic finance and conventional finance. The main difference, for example, between Islamic and conventional banking is that the former operates in accordance with the rules of shariah, legal codes of Islam. Islamic investing is based on five main principles, which include the prohibition of interest (*riba*), excessive uncertainty (*gharar*), speculation (*maysir*), and investment in 'unethical' industries. In addition, shariah principles include a prescriptive requirement that risks and returns should be shared between all parties (Shanmugam and Zahari 2009).

Recently, the financial crisis has stimulated interest in the requirement for parity of risk and return. And many researchers, both in the academic community and the public sector, have begun to see ethical investment practices as a critical element in managing systemic risk. As a result of the crisis, within conventional finance the link between

market morality and structural failure is now viewed as a central issue. And, because Islamic Finance centers on risk sharing rather than risk shifting, it is now being freshly evaluated as an ethical alternative to conventional finance (Balz 2008).

Although there have been a significant number of studies of the management and identification of risks in Islamic banks, there is minimal quantitative analysis on the comparison of risks and returns of Islamic and conventional banks. This study, therefore, explores the returns and associated risk exposures of both Islamic and conventional banks in Malaysia. As such, this study investigates claims made by industry experts that Islamic banks offer higher returns and lower associated risks than conventional commercial banks. Although the choice of the eight banks in our sample is dictated primarily by data availability and considerations of size and role in the industry, their experiences convey a warning about the overall exposures of Islamic banks in Malaysia. We find no statistically significant difference between the risks and returns of the Islamic and conventional banks. This result negates the widely held perception that Islamic financial institutions offer higher returns at lower risks than their conventional counterparts. However, from a practical point of view, this result is not surprising given that shariah compliant products are often replicated from conventional product templates (El-Gamal 2006). While we found no significant difference, we hypothesize that industry perceptions related to risk and return may operate reflexively to actualize claims of equitability in Islamic finance – rendering these claims truer over time. This hypothesis is based on comparing our quantitative analysis with qualitative data from industry practitioners who, while agreeing that Islamic finance is not yet what they view as properly, equitable, or shariah compliant, nevertheless seek to bend products and practices toward their ideal model of risk and returns. First, we provide an overview of the theories on risk and return in Islamic versus conventional banks. Second, we analyze risk and returns of eight Islamic banks and their conventional counterparts of Malaysia from 2008 – 2012 using financial ratios. Next, we investigate thorough interviews and qualitative analysis the reflexive creation of risk and return contracts at these Islamic banks. Finally, we frame our hypothesis in relation to the burgeoning of Islamic finance globally. While our data are restricted to Malaysia, we argue that these results may provide a window into larger, structural processes at work in global financial regimes.

The paper proceeds as follows. Section 2 discusses the theories of risk and return. Section 3 looks at the data and methodology. The main results are presented in section 4 and section 5 concludes.

2. THEORIES OF RISK AND RETURN IN ISLAMIC FINANCE

The majority of studies on risk and return have been focused on conventional banks. However, there is little existing empirical literature on the performance and stability of Islamic banks as compared to their counterpart conventional banks. Among previous studies, we identify three discursive streams in the literature. The first group argues that Islamic finance entails lower risk than conventional finance because the profit-sharing system of Islamic banking is intrinsically more stable than the system based on debt and interest (Chapra 1985; Kahf 1982; Khan 1982; Mohsin 1982; Pervez 1990; Siddiqi 1983; Zarqa 1983). Among these analysts, there is a consensus that the prohibition of interest,

speculation, and excessive uncertainty within Islamic finance tends to increase stability. In addition, Islamic finance theory argues that Islamic banks are inherently more stable because they are minimally leveraged and also because these banks view customers as equity holders which, in turn, entails different investment criteria. A recent International Monetary Fund report provides significant support for this view by showing that, in the aftermath of the 2007 global banking crisis, Islamic banks fared differently from conventional banks during global crisis (IMF Staff 2010).

Indeed the researchers in this study argued that Islamic banks were both more stable and more resilient (Hasan and Dridi 2010).

Another group of theorists argue that equity-based financing in the Islamic framework will increase the exposure of the Islamic banks to risk (Kuran 2004; Naqvi 1981; Qureshi 1984). In addition, Sundararajan and Errico, argue that Islamic financial institutions can be riskier than conventional financial institutions due to the specific nature of contract risk, namely the unlimited number of ways to finance a project using either profit and loss sharing or non-profit and loss sharing contracts (2002). Lack of standardization in each type of contract is another reason why these theorists view Islamic financial institutions as riskier than conventional institutions. Risk in Islamic finance includes not only volatility in earnings but also undertaking unlawful (haram) transactions. Over and above the basic risks in conventional banking (market risks, interest rate risks, credit risk and operational risks), Islamic banks also face shariah compliance risks. Shariah compliance risk arises from the Islamic banks' failure to comply with the shariah principles. Banks must monitor, for instance, whether all investments made free from uncertainty (*gharar*).

Akkizidis and Khandelwal explain that the scarcity of hedging instruments, undeveloped inter-bank money markets, and a lack of markets for shariah compliant government securities, render Islamic financial institutions more vulnerable to unfavorable events than conventional financial institutions (2008). Theorists within conventional and Islamic finance also argue that Islamic banks are inherently exposed to additional contract risks, for example the risk of shariah non-compliance on contracts. In addition, due to the disallowance of derivatives in most Islamic financial markets, Islamic banks have fewer tools to manage risk. Malaysia is an interesting test case in this regard as it is the only Islamic financial market that allows the use of derivatives for hedging in financial transactions. In persuading the industry to allow derivatives in Malaysia, Malaysian jurists associated with government sponsored think tanks and regulatory agencies successfully argued that the institutional advances of modern futures exchanges eliminate all excessive uncertainty (or *gharar*) from futures contracts (by specifying in standardized contracts the characteristics of objects of sale and the compensation options for various delivery options for future and short contracts) (Kamali 1999). Cihak and Hesse add that Islamic financial institutions pose risks to the financial system that differ from those posed by the conventional financial system (2008). However, evidence shows that many of the conventional products can be redrafted as shariah compliant products, so that the differences are smaller than expected. Comparing conventional and Islamic banks and controlling for other bank and country characteristics, the authors find few significant differences in business orientation, efficiency, asset quality, or stability.

A third stream of critical analysis, state-led development theory, focuses on the role of the state in incubating development, in this case development of Islamic banking and finance. Theorists of state-led development argue that the state, rather than the market, plays a primary role in fostering economic development (J. A. Evans 2010; Kohli 2004; Wade 1990). While these theorists have not addressed Islamic economics directly, they have viewed Malaysia as a case study for state-led development.

According to this theory the developmental success stories of Asia and Latin America are not cases of state triumphing over market (or the reverse) but rather state intervention in support of profits for private investment, which the market reinforces (P. Evans 1995; Kohli 2009). Atul Kohli provides a rough characterization of three historical patterns of how state authority is organized in the developing world: (1) neo-patrimonial, (2) fragmented-multiclass, and (3) cohesive-capitalist or developmental states. Neo-patrimonial states, like “rentier” states, are those states where public office holders use public resources as their own patrimony and power is concentrated among cohesive authoritarian elites with strict class allegiance, e.g. Nigeria (Watts 2004). Fragmented multi-class states rest on a broader class alliance and less centralized authority and the resulting patterns of state authority are messier and more incomplete in their penetration into society. In fragmented multi-class states, industrialization is only one among many state goals and, as these states are not able to achieve tight control of labor, they tend to be middling in developmental success, e.g. India.

At the other end of the spectrum, “cohesive-capitalist” or developmental states have centralized and cohesive authority structures that penetrate into society. These states have often designated economic growth in terms of national security in the cold war context and pursued growth as a primary national goal. Because any alliance between state and capital is subject to fluctuation, these states have tended toward authoritarian political structures and have all achieved tight control of labor, e.g. South Korea (Kohli 2004, 9–12). In the case of developmental states, scholars appear to agree that foreign aid, wartime stimulus, and technological transfer should be treated as dependent variables while the role of the state is the independent and therefore decisive variable. In terms of risk and return within Islamic banks, theorists of state-led development argue that the state’s role in standing behind firms will cause risk and returns to bend out of alignment with conventional economic theory – causing for example moral hazard.

Indeed in the wake of the Asian Financial Crisis, after first imposing capital controls, the Malaysian state put the entire force of its newly re-liberalized economic policy behind building a Malaysian brand of Islamic finance in order to compete globally (Laldin 2008; Rudnyckj 2014). In addition, the ruling coalition (in power continuously since independence in 1957) has used political patronage to transfer assets to ethnically demarcated, politically connected businessmen. After the imposition and subsequent removal of capital controls in the early 2000s, for example, the government nationalized failing banks, forced the consolidation of those remaining, and then subsequently liberalized by favoring well connected Islamic entrepreneurs with Islamic bank or Islamic window licenses (Edmund Terrence Gomez and Jomo 1999; Edmund Terrence Gomez 2004; Edmund Terrence Gomez and Saravanamuttu 2012).

3. DATA AND METHODOLOGY

In the conventional finance theory, risk and return are related in a Capital Asset Pricing Model (CAPM). In 1990, William Sharpe won a Nobel Prize in Economics for his work in developing the Capital Asset Pricing Model (CAPM). Following is the basic equation of CAPM.

$$K_i = K_{rf} + \text{Beta}(K_m - K_{rf}) \dots\dots\dots(1)$$

The required rate of return (K_i) is a function of a risk free rate of return (K_{rf}), market return (K_m) and beta which is a measure of systematic risk. The only factor affecting risk in this model is market risk. We cannot use this model in Islamic finance as no risk free rate exists. In addition, the model does not capture risks unique to Islamic finance such as shariah compliance risk. In recent years, the CAPM has been attacked as an incomplete model for explaining market pricing behavior even in conventional finance, but academics and practitioners cannot agree on a good replacement.

The literature review has provided some examples of how industry practitioners and theorists evaluate risk and return. In this study, the profitability measures used include the rate of return on assets (ROA) and the rate of return on equity (ROE). The rate of return on assets, ROA, is the most comprehensive accounting measure of a firm's overall performance. Since it is defined as net income over total assets, it shows the profit earned per dollar of asset. It is viewed as an indicator of bank efficiency and a measure of the bank's ability to earn profit from its total operations. More important, it gauges how effectively a bank uses its financial and real investments to generate profits. The ROE, defined as net income divided by average equity, measures bank accounting profits per dollar of book equity capital. It reflects how effectively a bank management is using shareholders' investment. This measure is viewed as an indicator to the bank's shareholders of how much the institution is earning on the book value of their investment (Goudreau 1992). In fact, the return on equity is often seen as the most important measure of banking returns because it is influenced by how well the bank has performed on all other return categories and indicates whether a bank can compete for private sources in the economy. ROA measures profitability from the point of view of the overall efficiency of a bank's use of its total assets while ROE captures profitability from the shareholders' perspective.

The data used for this study is derived from the financial statements of eight banks in Malaysia. Malaysia has been selected as a sample for this study because Malaysia was a forerunner in incubating Islamic finance in Southeast Asia and also because of the phenomenal growth of Islamic banks in Malaysia as compared to other countries (Venardos 2006). Malaysia offers a wide range of Islamic financial products through its various Islamic financial institutions namely Islamic banks, Islamic capital markets and Islamic insurance (Takaful). After more than a decade in operations, Malaysian banks have proved to be viable institutions with their activities expanding rapidly throughout the country and across Southeast Asia. Malaysia is the key player as a country, outside the Middle East, with market share of about 10% in Islamic banking (Zawya State of the Global Islamic Economy Report Team 2014). As of September 2013, 16 Islamic banks were operating in Malaysia, comprising 10 local Islamic banks and 6 foreign Islamic banks, with

assets of Ringgit Malaysia 423 billion or 21% of the entire banking system in Malaysia at the end of February 2014 (Wong and Lee 2014).

Table 1: List of Participant Banks

The study includes eight banks from Malaysia: four Islamic banks and four conventional banks

Islamic Banks	Conventional Banks
<i>Bank Islam Malaysia - Berhad</i>	<i>Bank of Tokyo Mitsubishi UFJ - Berhad</i>
<i>Affin Holdings - Berhad</i>	<i>BNP Paribas Malaysia - Berhad</i>
<i>Maybank</i>	<i>Citibank Malaysia - Berhad</i>
<i>HSBC Amanah Malaysia</i>	<i>Deutsche Bank Malaysia - Berhad</i>

Because Islamic banks in Malaysia have as yet as short track record, we supplement our quantitative analysis with qualitative data gathered in Kuala Lumpur, Malaysia during the summer of 2013. Qualitative data include interviews with regulators, lawyers, analysts, and shariah advisors in Islamic finance as well as participant observation at Securities Commission sponsored training sessions for industry professionals and industry sponsored road shows. Interviewees were chosen through a snowball sampling method of all Islamic banks and associated industry support in Malaysia. Due to the division of labor within Islamic finance between bankers, lawyers and jurists, we argue that our qualitative data is necessary for interpreting the anomalies in our quantitative analysis. In this division of labor bankers seek an efficient allocation of their resources and good return for their partners by synthesizing or reengineering shariah compliant products; lawyers help to take these products to market by ensuring that the product is compatible with conventional regulatory systems, by making the products as similar as possible to conventional ones, and explaining the Islamic structure to regulators; and jurists represent an Islamic moral framework by assigning contract categories and status, and by performing informal marketing functions through networking (El-Gamal 2006; Rudnycky 2014). Because this division of labor mirrors that of the financial regime globally, particularly with regard to self-regulation in the banking industry and the retention of proprietary models for evaluating risk (Helleiner 2009; Porter 2009; Strange 2004; Tabb 2004; Tooze and May 2002), we believe that qualitative analysis is necessary to disambiguate the differences between conventional and Islamic banking returns.

4. EMPIRICAL RESULTS

On the average the mean value of Return on Equity is 8.45 percent for conventional commercial banks and the mean value of Return on Equity is 10% for Islamic commercial banks. Based on these results, the profitability of Islamic banks appears to be greater than that of conventional banks. However, we find no statistically significant difference in return or risk between conventional and Islamic banks. We propose an explanation of this divergence through supplementing our quantitative analysis with qualitative data. Interviews and participant observation show that many of the conventional products are replicated as shariah compliant products.

We argue that this results in smaller risk-return differences than conventional measures would predict. Indeed, comparing conventional and Islamic banks and controlling for other

bank and country characteristics, we find few significant differences in business orientation, efficiency, asset quality, or stability (Beck, Demirguc-Kunt, and Merrouche 2010).

Table 2: Return on Equity

This table shows the average return on equity for Islamic and conventional banks for the years 2008 – 2012.

Year	ROE Islamic Banks	ROE Conventional Banks
2008	12.23%	18.55%
2009	4.98%	14.09%
2010	10.09%	14.14%
2011	10.28%	7.51%
2012	12.43%	5.82%
Mean ROE	10.00%	8.45%
Standard Deviation	5.01%	2.52%

Table 3: Return on Assets

This table shows the average return on equity for Islamic and conventional banks for the years 2008 – 2012.

Year	ROA Islamic Banks	ROA Conventional Banks
2008	1.32%	1.53%
2009	0.97%	1.28%
2010	1.67%	1.45%
2011	1.97%	-0.21%
2012	2.41%	0.67%
Mean ROA	1.67%	0.35%
Standard Deviation	0.74%	0.76%

Like conventional banks, the Islamic banks have to face three major risks namely credit risk, market risk, and operational risk (Faridah and Bhatti 2010). Although initiated in 1975, Islamic banking gained international acceptance in the late 1990s. Islamic banks are, therefore, relatively new players in the market as compared with conventional banks. From the point of view of investors, their novelty creates additional risk, as they do not have track record of raising funds in the capital market. On the other hand, greater documentation requirements limit the exposure of Islamic banks.

However, the difference between Islamic banks and conventional banks is narrowing in both in terms of the purposes for which financing is provided and the modalities through which financing are processed. This may narrow the gaps in the performance of Islamic

banks and conventional banks. Looking outside of Malaysia, Krasicka and Nowak found no significant difference between returns on Islamic and conventional banking especially in the most recent years (2012). This supports Mahmoud El-Gamal's prediction that the gap between Islamic and conventional financial practices is shrinking (2006).

Table 4: Participant Banks (2008 – 2012)

This table shows an overall comparison of profitability measures between Islamic and conventional banks in Malaysia. Profitability appears to be higher in Islamic banks but stability is lower in those banks.

Year	ROA		ROE	
	CB	IB	CB	IB
2008	1.53%	1.32%	18.55%	12.23%
2009	1.28%	0.97%	14.09%	4.98%
2010	1.45%	1.67%	14.14%	10.09%
2011	-0.21%	1.97%	7.51%	10.28%
2012	0.67%	2.41%	5.82%	12.43%
Mean	0.35%	1.67%	8.45%	10.00%
Standard Deviation	0.76%	0.74%	2.52%	5.01%
CV	37.97%	45.22%	29.84%	50.14%

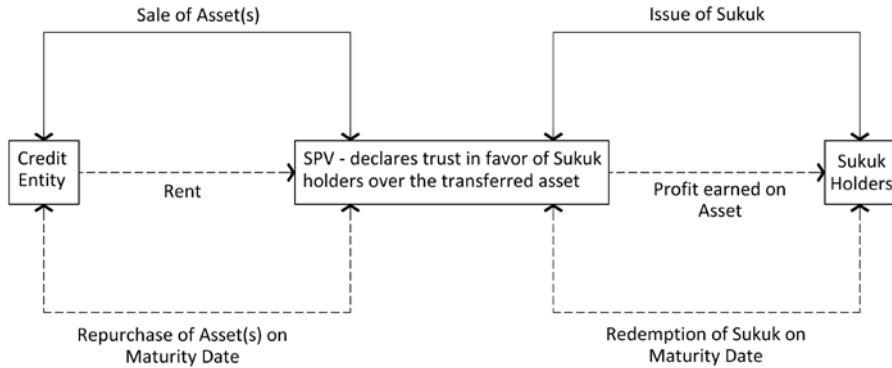
The closing of this gap, which we view as a change in purposes and modalities of financing within Islamic finance, can be seen in the use of contracts that transfer risk in "reverse istisna'" or parallel commission to manufacture contracts. Technically an istisna' contract is an agreement to sell to a customer an asset that is not yet in existence but will be manufactured according to the agreed specifications and delivered on a specified future date at a mutually agreed and predetermined selling price. A parallel istisna' consists of two linked series of separate istisna' contracts: the first contract is between the ultimate purchaser (customer) and the seller (an Islamic financial institution, responsible for delivering the specified asset to the purchaser) while the second contract is between the seller and a third party (manufacturer) who will build the asset and deliver it to the seller who will then deliver it to the ultimate purchaser (customer) (See Figure 1 for an example of this structure). Because they are separate contracts, the seller has no obligation to pass on discounts from the manufacturer to the customer. Further, the obligations of each party are not dependent on the others' obligations (Bank Negara Malaysia 2010, 19–20).

In the case of a reverse or parallel istisna', the seller takes on the role of the buyer. (See Figure 2 for an example of a "parallel istisna' sukuk" structure.) In the new, parallel contract, she agrees to buy from a third-party seller the same underlying asset of the original istisna'.

The buyer in an istisna' contract may seek a reverse istisna' in which she assumes the role of the seller, agreeing to sell to a third-party buyer the same asset subject matter of the first istisna' contract. In this sense, istisna', in its two forms, provides a viable substitute for debt financing, provided that the two contracts (the original and the parallel) are not linked or made contingent upon each other. Of interest here are two corresponding issues: the way that risk may be transferred in the creation of these contracts and the way

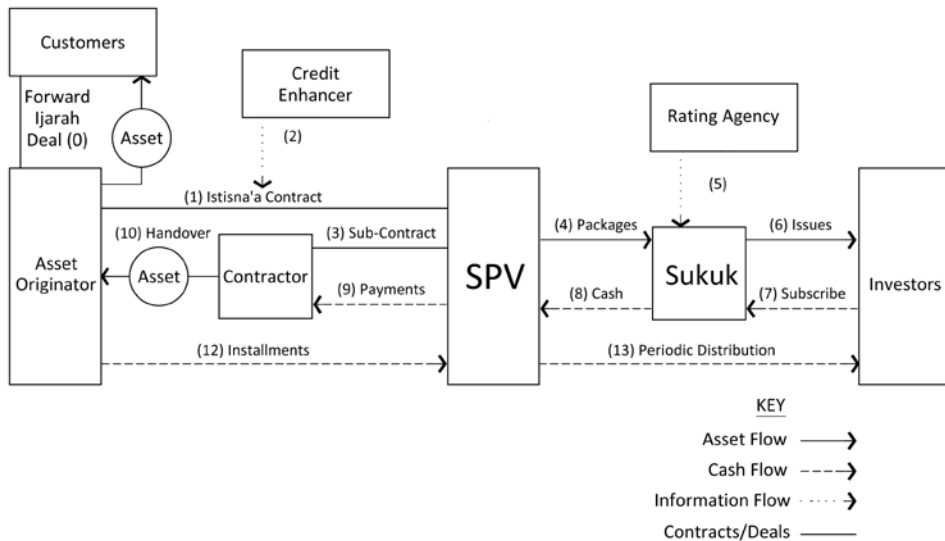
that practitioners at Islamic banks are developing their expertise in re-creating conventional finance products.

Figure 1: Standard Sukuk Structure



At a July 2013 Securities Commission training session, for example, regulators and Islamic bankers and analysts were pushed to standardize training and improve quality, thereby making Malaysian expertise more valuable. The expert trainer was a mid-30s male Malay-Malaysian, trained at the University of Malaya in Fiqh and Usul al-Fiqh as well as applied economics. He spent years at HSBC Amanah Malaysia as well as at CIMB Islamic but is now working in the Middle East. While the seminar was entirely in English, he was careful to throw in occasional jokes and phrases in Malay “boleh faham” (you understand, yes?) and use examples from the local context. There were roughly 20 participants in these sessions including regulators and auditors at Bank Negara, bankers from Maybank, and HSBC and other banks, and several lawyers, and five shariah department representatives.

Figure 2: Reverse Istisna' – Ijarah Sukuk Structure



The sessions were particularly focused on adherence to risk sharing and profit sharing and maintaining a link to actual productive activities within product development and certification. For example, the trainer admonished the students that, while the goal should always be to harmonize risk sharing between three parties, it is the case that contract documents usually protect the bankers. He viewed equitable sharing as the central purpose of Islamic finance: if it is a “genuine shariah contract, then liabilities must be shared with business and construction, the agent and the principle should have the same liabilities.” But over the course of the session, he ended by reinforcing the profit seeking and separation of risk and reward seen in conventional finance. For example, in this session, professionals were given the following case study to solve:

Some landowners come to X Islamic bank, requesting the bank to construct buildings on their lands, which they own or which they may have purchased on deferred payment [meaning the title has not yet been transferred]. The request is that, the bank should undertake all the construction expenses, including the expenses to execute the project, agreement with the building contractor and supervising the execution of the project, in accordance with the required specifications.

Thereafter, the bank takes delivery of the building after its completion and then delivers it to the owner of the land. This is done on an agreement between the owner and the bank, on an agreed price, out of which 25% is paid in advance, before the beginning of the project, while the balance would be paid by monthly or yearly installments. In some occasions, the installment payments will only commence three years after the contract is signed. [Draw a shariah compliant structure for this transaction.]

Working in groups, the industry professionals “solved” this problem by developing a build own transfer structure similar to that explained above.

The trainer, however, then suggested creating a reverse istisna' thereby mitigating the associated contract risks for the bank but not for the landowner – in this structure the bank appoints the customer as the agent to find and develop on behalf of the bank. Further, he pointed out that given the government's tax incentives for sukuk structures, a reverse sukuk istisna' structure will certainly provide the best returns for the bank. In this case we can see, as products are operationalized, the transfer of risk to consumers slides in through the modality of duplicating conventional products.

5. CONCLUSIONS AND POLICY IMPLICATIONS

Numerous studies compare the performance of Islamic banks and conventional banks during the recent financial crisis, and find that Islamic banks, on average, showed stronger resilience during the global financial crisis (Hasan and Dridi 2010). However we find limited support for the argument that Islamic finance minimizes risk. In the case of Malaysian Islamic banks, we found no statistically significant difference between the risks and returns of the Islamic and conventional banks. These results contradict the widely held view that Islamic financial institutions offer higher returns and lower risk than that of conventional counterparts.

Because, in the Malaysia case, derivatives are allowed as risk management tools it may be that, by allowing Islamic Banks to take on additional risk, the use of derivatives explains the rate of return. Indeed shariah committee members in Malaysia, who rule on the legitimacy of product compliance in relation to moral principles, are well aware of the ambiguity of derivatives. For example, one shariah committee member at a multinational bank in Malaysia argued, "For derivatives the main thing we are looking at is real transactions "risk management is fine but we want to see that its not just paper trails because from Islamic perspective this is just bubbles." She continued, that is where we are different from conventional finance – leveraging and overleveraging – these layers of other assets. Here, we need to have that option but what the layers show is that it becomes conventional finance when you have cross currency hedges, etc. Here we have to show that each trading obligation is tied to an actual transaction, the idea is to give more stability within Islamic finance (personal interview July, 2013).

If widely adopted, at the industry-wide level, we suggest that the ambiguity of the Malaysia's allowance of derivatives may indeed force a convergence wherein the stability of Islamic banks converges on the instability of conventional banking models. Her concerns were echoed by some of the analysts and regulators interviewed in Malaysia. Indeed further support of her contention can be found from Islamic bankers internationally who, according to recent international survey data, do not view Islamic banks as significantly more stable (Islamic Finance News 2013). We thus view our data as further support for theories projecting a convergence between Islamic finance and conventional finance. In so far as these conclusions hold, they imply that policy makers should not ignore the potential for increasing structural risks to the global financial system originating within Islamic banking practices.

As Charles Tilly has argued, historically, governments have continually demarcated markets as bounded moral spaces, embedded in specific cultural, geographic, and political zones of difference.

Capital market makers, however, are continually moving to cross these zones – creating relationships between moral spaces (1990). Indeed, this is the nature of arbitrage – seeking to profit from exploiting discrepancies between market spaces. Islamic finance has historically been construed as a framework for market morality, and in particular, an ethical basis for exchange in capital markets (Henry and Wilson 2004; Warde 2000). Islamic finance, however, confronts the same historical dilemma – how to deal with regulatory arbitrage and regulatory capture (Bassens et al. 2013). At another level, while our results show no statistically significant different in risk and return, the perceived support for Islamic banks from the Malaysian government may be construed by Malaysian investors as decreasing the risks faced by Islamic banks. In the long run, and in contrast to the IMF study with which we began, these multiple levels of “moral hazard” may imply further additional risks for Islamic banks.

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