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Reducing Fragility?
Risk Shifting and Islamic Banking

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Abstract

In the last five decades, advances in information technology and in financial innovations have made possible the emergence of an immense capacity for banks to switch regimes from risk transfer to risk shifting. The devastating power of this capacity was amply pronounced in the financial crisis of 2007/2008. The fallout of which has intensified calls for a re-examination of current banking model and its underlying incentives' structure. Risk shifting is, axiomatically, absent in an ideal Islamic financial system. The Islamic banking model, thus, provides unique paradigm with risk sharing at its core. However, the present formation of Islamic banking has grown out of conventional banking and uses many of its techniques and instruments. The main objective of this paper is to empirically investigate the risk shifting behaviour in Islamic banks in dual banking systems of OIC member states. The two-step dynamic difference GMM is applied to cater for the nature of Islamic banking data, which is characterized by a larger dynamic panel and a smaller timeframe. Findings tend to indicate that Islamic banking has a limiting effect on risk shifting. The effect however is not sufficient to fully nullify the overall risk-shifting incentives. The evidence supports strengthening risk sharing and reforming Islamic banking configuration as the way forward for sustainable finance.

Keywords: Risk Shifting, Risk Sharing, Islamic Banks, Sustainable Alternative Banking Model, Two-Step Difference GMM