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The effects of formal institutions and national culture on equity-based financing in Islamic banks

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ABSTRACT

This study investigates the effects of formal institutions and national culture on equity-based financing across different countries. The sample is taken from 60 Islamic banks from 10 Middle East, South Asia and Southeast Asia countries between 2011 and 2019. Using generalized least squares (GLS) regression and two-way system Generalized Method of Moment (GMM) as a robustness check, we consistently find a positive and significant effect of formal institutions on equity-based financing. This finding indicates that the good quality of formal institutions plays an important role in promoting equity-based financing. In addition, we find that culture is important and even a key determinant of equity-based financing. Power distance has a more powerful impact than other cultural values, indicating that social trust greatly influences Islamic bankers' decisions to channel this particular financing. The link between formal institutions and equity-based financing is weaker in countries with cultural values that are more individualistic (less collectivist) and more uncertainty-avoidant. These findings suggest the necessity of enhancing the quality of formal institutions and taking culture into consideration when formulating policies to increase financing in accordance with the principles of Islam.

1. Introduction

The lack of equity-based financing on Islamic bank assets has become a global phenomenon and it has drawn much criticism. Theory suggests that the ideal Islamic financial model is based on risk-sharing (Aggarwal and Yousef, 2000; Iqbal and Mirakhor, 2013) via equity-based financing because it is so purely Sharia financing and has many key benefits, such as being close to the real sector, reducing inflationary pressures, creating jobs, and supporting economic growth (Aggarwal and Yousef, 2000; Chowdhury et al., 2018). However, in practice, Islamic banks do provide a substantial portion of debt-based financing (based on a mark-up or cost-plus principle), indeed >80% of it (Iqbal and Mirakhor, 2002; Meslier et al., 2020). Although this financing is still done under Sharia principles, its acceptability in terms of Islamic law is still debated, as it implies a fixed return on investment (Aggarwal and Yousef, 2000). Further still, it can potentially be abused and used as a “back door” for interest-based financing (Khan and Mirakhor, 1990) and exposes Islamic banks to interest rate risk (Chong and Liu, 2009; Šeho et al., 2020). In addition, such dominance of debt-based financing suggests unethical rent-seeking practices by Islamic banks, where fixed returns are set for those entrepreneurs in a weaker collective bargaining

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