Islamic Finance as a Mechanism Design Problem

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Recently Islamic Financial Institutions (IFI) experienced unprecedented growth. Sharia-compliant financial assets grew approximately 2.6 times during last 10 years. A good source of information about principles of Islamic finance is Kettell [1].

This growth is further fuelled by petrodollar liquidity and worldwide growing Muslim population. However, the growing demand for Islamic Finance (IF) services has not been matched by adequate supply. In particular, there remains lack of depth across asset classes and products. This is partially explained that though a lot has been written about a proper regulatory framework necessary for operation of Islamic banks and the necessity of levelling the field among Islamic and conventional financial institutions (for a discussion of regulatory issues in the Australian context, see Ahmad and Hassan [2], importance of proper regulation and using a variety of instruments is demonstrated by Laldin [3], using the Malaysian experience), theoretical understanding of the issues involved in modelling of performance IFI is lacking.

I propose that the Mechanism Design (MD) framework provides one with the proper tools to address the issues that arise in IF. The development of the MD approach in the mid-seventies represented an important step into understanding of real life contracts and has aided significantly to the formation of economic policy. As an example of a practical success of this approach one can cite the British spectrum auction.

IF is derived from Sharia law, which imposes some restrictions on the forms of contract that can be signed between parties. The most important among them is a ban on a charge of interest. Many important contracts, for example, a mortgage, a credit contract to start-up for a business should be modified to cater for the need of this restriction. This suggests that the difference between a contract offered by an Islamic bank and a similar contract offered by the conventional bank is similar to the difference between levered and unlevered firms. It is well understood that differences in performance of such firms are to a large extent determined by existence of imperfect information on the side of the decision makers.

Since Sharia law provides not only economic restrictions on the set of allowable contracts but also a set of behavioural norms a particular branch of the MD theory, which studies the interaction of social norms and incentives may be of a particular importance. Existence of social norms is both a blessing and a curse. On the positive side it helps to alleviate the moral hazard problem. On the negative side, it restricts the set of allowable contracts.

The latter trade-off was investigated in Basov and Bhatti [4], who consider the following model. An agent is engaged in a business venture. The expected profit of the venture depends on the effort put by the agent. Though the effort is non-contractable, the principal may offer a suggested effort level. In accepting the contract the agent promises to exert the suggested effort, though this promise cannot be enforced in a court. The agent, however, faces a psychological cost of breaking the contract as long as she is not exposed to too much risk. Basov and Bhatti [4] call it a norm of trust and reciprocity and show that the ability to rely on a norm mitigates the moral hazard problem, but restricts the class of allowable contracts. As a result the medium powered incentives get eliminated. Basov and Bhatti [4] also considered a situation when the degree of the agent's trustworthiness is not observable and suggested that the issue can be overcome if the principal offered a menu of contracts. Though the social norm investigated in Basov and Bhatti [4] is not motivated by Sharia law, we suggest that similar trade-offs will be relevant for IFI.

To conclude, applying MD approach can help to better understand and improve Islamic financial products. Since well-designed contracts allow a better matching of human resources to the economic needs and provide proper performance incentives for economic agents, they are as much a part of the technology as machines. Since they also allow eliciting and putting to good use the private information of economic agents, they can actually promote the culture of innovation. Taking into account cultural constraints, when devising optimal contracts, increase overall welfare.

References

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