Navigating Through Rough Waters

2008-2009 Islamic Banking Competitiveness Report
World Islamic Banking Conference
Bahrain, 23-24 November, 2008
Islamic assets ended 2007 with high growth in all key markets...
Islamic assets as part of total banking assets, %

SELECTED MARKETS

Growth in Islamic asset base, CAGR (2002-07)

* Excluding Doha Bank

Sources: Central banks; bank annual reports; Capital Intelligence reports; Zawya; team analysis
Islamic banks also achieved strong profit performance in 2007

Return on Average Assets
2007, %

-5 0 5 10 15 20

Bahrain* Kuwait Qatar Saudi Arabia UAE Malaysia Indonesia

GCC Non-GCC

* Onshore only
** Recently converted to Islamic
Source: Central banks; annual reports; Bankscope; team analysis
2008 is turning out to be one of the most difficult years in financial history

LIBOR – US dollar 3-month spread to treasuries

* Through October 27, 2008

Source: Bloomberg; company reports; press search; team analysis
Events in just the past two months have caused volatility to jump four-fold

* CBOE VIX Volatility Index
** Through October 24, 2008

Source: Bloomberg; press search; team analysis

**Through October 24, 2008**

- **Fannie Mae** and **Freddie Mac** in US conservator-ship; $200B at risk
- **Lehman Brothers** files for bankruptcy
- **Merrill Lynch** acquired by Bank of America
- **Short selling** of financial stocks prohibited
- $700B **bailout plan** proposed by US Treasury

**Wk 3**
- **Goldman Sachs and Morgan Stanley** convert to bank holding companies
- **Washington Mutual** placed under the receivership of the FDIC

**Wk 4**
- **Fortis** nationalized by Benelux governments
- **Wachovia** acquired by Citi
- **Dow Jones** sees largest one day drop in history
- $700B **bailout plan** passes
- **European governments** pass laws increasing federal deposit guarantees

**Wk 1**
- **Iceland** seizes all its major banks; government and banks loans downgraded
- **S&P500** sees steep drops not seen since the Great Depression
- **World stock markets** collapse, triggering trading suspension in several markets
- **Central banks** from all over the world announce rate cut

**Wk 2 and 3**
- **Global stocks** post record highs after G7 emergency meeting and new guarantees
- **US Treasury** takes $250B equity in largest banks
- **UAE** adds another $19B in liquidity to its banks and provides deposit guarantees
- **DJIA** suffers largest percentage drop since 1987
- **Iceland** becomes the first western country to request an IMF loan since 1976
- Inability to borrow money forces several other countries to seek **IMF funding**

* Chicago Board Options Exchange Volatility Index
Equities in key markets have not been immune to the global financial crisis

Equitation market performance
Indexed to 100 in July 2007

* Morgan Stanley Capital International Index
** Through to October 31, 2008

Source: Bloomberg; team analysis
CDS spreads of leading banks have widened considerably

Perceived lending risk in the market has skyrocketed, with some banks having as much as a 260% increase in their CDS spreads

CDS spreads*  
2008, basis points

* CDS spread average of EBI, DIB, Maybank, ADCB, Samba, CBQ, NBAD and NCB starting from July 18, 2008 through to October 10, 2008

Source: DataStream; team analysis
Islamic banks are less leveraged than their conventional peers

Asset-to-equity ratios
2007 (year end) - Asset weighted average

<table>
<thead>
<tr>
<th>Country</th>
<th>Islamic banks</th>
<th>Conventional banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>KSA</td>
<td>5.2</td>
<td>8.5</td>
</tr>
<tr>
<td>UAE</td>
<td>4.4</td>
<td>7.9</td>
</tr>
<tr>
<td>Qatar*</td>
<td>6.4</td>
<td>8.1</td>
</tr>
<tr>
<td>Kuwait</td>
<td>5.4</td>
<td>11.2</td>
</tr>
<tr>
<td>Bahrain</td>
<td>8.3</td>
<td>14.7</td>
</tr>
<tr>
<td>Malaysia</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Turkey</td>
<td></td>
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</tr>
</tbody>
</table>

* Excludes Masraf Al Rayan

Source: Bankscope; bank annual reports; team analysis
Islamic banks are more reliant on customer deposits for liquidity

Consolidated commercial bank balance sheets across the KSA, Kuwait, Qatar and the UAE, 2007

Breakdown of liabilities, %

<table>
<thead>
<tr>
<th></th>
<th>Islamic banks¹</th>
<th>Conventional banks²</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds &amp; other long term liabilities</td>
<td>10%</td>
<td>23%</td>
</tr>
<tr>
<td>Equity</td>
<td>17%</td>
<td>11%</td>
</tr>
<tr>
<td>Interbank liabilities</td>
<td>7%</td>
<td>8%</td>
</tr>
<tr>
<td>Customer deposits</td>
<td>66%</td>
<td>58%</td>
</tr>
</tbody>
</table>

1 Includes all Islamic banks in the UAE, KSA, Kuwait and Qatar
2 Includes all conventional banks in the UAE, KSA, Kuwait and Qatar

Source: Central banks; annual reports; Zawya; team analysis

“People will be more comfortable depositing their money in Islamic banks because of their perceived better liquidity position.”

- Senior manager of conventional bank
Islamic financial institutions market values have also largely tracked the market

Total market value
Starting point indexed at 100

<table>
<thead>
<tr>
<th>Country</th>
<th>Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qatar</td>
<td>1 May 2008 to 14 October 2008</td>
</tr>
<tr>
<td>UAE</td>
<td>1 May 2008 to 15 October 2008</td>
</tr>
<tr>
<td>Bahrain</td>
<td>4 May 2008 to 9 October 2008</td>
</tr>
<tr>
<td>KSA</td>
<td>3 May 2008 to 15 October 2008</td>
</tr>
</tbody>
</table>

Source: Bloomberg; team analysis
How to look at the future now?

**Approach**

• Assume we do not (yet) fully understand

• Prepare for the worst, hope for better

• Think from the future and work our way back

• Seek full transparency in the organization, and no sacred cows

• Act quickly – not months or weeks, but days will matter

**Implications**

• Need to understand the macro picture first

• Identify the major risks, review exposures

• Take tactical short term actions as well as strategic long term moves
It is important to understand the macro drivers …
And how they could impact one’s business

**Banking system loop**
- **Asset value**
- **Liquidity**
- **Credit volume**

**Asset loop**
- In some markets, exposure to investment securities led to losses for banks
- **Economic activity**
- **Performance of borrowers/corporates**

**Real economy loop**
- **Sustainability of the economy**

**Oil and foreign funding loop**
- Foreign funding trend reverses due to global crisis; commodity prices decline
- **Macroeconomic policy and regulation loop**
- **Sustainability of the economy**
Islamic Banks do face liquidity management risk

Net liquidity gap by contractual maturity*

As a % of total assets, Dec 2007

<table>
<thead>
<tr>
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<th>Islamic banks</th>
<th>Conventional banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 3 months</td>
<td>-23.7</td>
<td></td>
</tr>
<tr>
<td>3-12 months</td>
<td>8.6</td>
<td>6.8</td>
</tr>
<tr>
<td>1-5 years</td>
<td>15.0</td>
<td>10.9</td>
</tr>
<tr>
<td>&gt; 5 years</td>
<td>0.1</td>
<td>-10.8</td>
</tr>
</tbody>
</table>

Liquidity management in the short-term could be more difficult under certain circumstances

* From a sample of the 7 largest Islamic and Conventional banks in the GCC
Source: Bank annual reports; team analysis
In several countries, Islamic banks are exposed to real estate, and a potential market correction could be a serious source for concern.

Reported exposure of Islamic Banks to construction and real estate assets*
2007 (year end) – percent of total lending

<table>
<thead>
<tr>
<th>Country</th>
<th>Exposure</th>
</tr>
</thead>
<tbody>
<tr>
<td>UAE</td>
<td>26%</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>5%</td>
</tr>
<tr>
<td>Kuwait</td>
<td>16%</td>
</tr>
<tr>
<td>Qatar</td>
<td>33%</td>
</tr>
<tr>
<td>Bahrain**</td>
<td>14%</td>
</tr>
</tbody>
</table>

Actual exposure is much higher if direct investments in properties and real estate subsidiaries as well as indirect exposures are included therefore many Islamic banks are very vulnerable in the event of real estate market crash.

* Only includes real estate and construction assets as reported and identifiable in the financial statements
** Only includes top 3 onshore Islamic banks

Source: Central banks; annual reports; team analysis
Action will need to be on two fronts

I. Work our way through the crisis

- Manage liquidity – Carefully monitor liquidity needs and ensure sufficient sources and level of capital available
- Measure main exposures by asset class and stress test positions
- Ensure appropriate level of credit risk management and strong collection capabilities
- Create scenarios for possible evolution of the sector, and define possible challenges and opportunities

II. Work with a “through the cycle” mindset

- Drive operational excellence to close the efficiency gap with conventional banks
- Focus on managing growth in core Islamic banking segments

Source: Team analysis
1. Have I taken all measures at my disposal to manage liquidity?

2. Is my institution resilient enough to cope with an unprecedented down cycle?

3. Is my corporate business prepared well enough to avoid excessive losses and navigate through the anticipated down cycle?

4. Have we developed the skills and capabilities to manage risks associated with our fast growing and increasingly complex retail business?

5. Does anyone in my institution have the confidence to say how much we could possibly lose through our investments and trading positions?

6. What is my institution’s plan to handle a potential real estate slowdown?
## Sound risk management can start to be put into place immediately

<table>
<thead>
<tr>
<th>1-to-4-week measures</th>
<th>1-to-3-month measures</th>
<th>1-to-12-month measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Liquidity oversight at CEO level</td>
<td>• Review and adapt 2009 business plan and budget</td>
<td>• Diagnose risk management function and close gaps in priority areas (e.g., remedial, collections)</td>
</tr>
<tr>
<td>• Holistic balance sheet management and stress testing that goes beyond reporting of interbank flows and short term cash flow projections</td>
<td>• Review cost projections and set target levels</td>
<td>• Improve the supporting infrastructure for liquidity risk measurement and monitoring (modelling, including stress tests, systems)</td>
</tr>
<tr>
<td>• Active targeting of large depositors</td>
<td>• Identify quick-wins in cost reduction</td>
<td>• Review and adapt corporate strategy and business model</td>
</tr>
<tr>
<td>• Launching structured deposit products</td>
<td>• Undertake tactical initiatives to enhance bottom line (e.g., pricing)</td>
<td>• Conduct a structured cost rationalisation and operational improvement programme</td>
</tr>
<tr>
<td>• Re-pricing of credit lines</td>
<td>• Develop a good understanding of capital consumption by business line</td>
<td></td>
</tr>
</tbody>
</table>
There is still a significant operational gap between Islamic and conventional banks.

Operating costs as a % of average assets
2007, %

* Onshore only
** Recently converted to Islamic

Source: Central banks; annual reports; Bankscope; team analysis
Specific cost initiatives can help close operational gaps

Source: Team analysis
### All institutions need to ask a set of questions and seek answers

1. Have I taken all measures at my disposal to manage liquidity?

2. Is my institution resilient enough to cope with an unprecedented down cycle?

3. Is my corporate business prepared well enough to avoid excessive losses and navigate through the anticipated down cycle?

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6. What is my institution’s plan to handle a potential real estate slowdown?
There are opportunities in all business lines if you can manage the risk!

• Retail banking
• Wealth Management
• Wholesale banking
• Takaful
Thank You!