

The 16th Annual World Islamic Banking Conference 2009

Islamic Financial Services Industry Latest Developments and Future Direction

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Islamic Banks and the Financial Crisis

Views of proponents of Islamic Finance on the current global financial crisis:

- Islamic finance is the alternative to free market capitalist banking. To prove the validity of their arguments, some proponents quote the Vatican as offering “Islamic finance principles to Western bankers as a solution for worldwide economic crisis”
- A number of experts and officials of Islamic banks have confirmed that Islamic banks have not been affected by the global financial crisis and that any effects would be limited due to the nature of Islamic banking

Islamic Financial System

A well developed, competitive and stable financial system ensures the efficient allocation of resources across space and time

- Regulatory and supervisory framework
 - Robust system that addresses the unique nature of Islamic finance
- Legal environment
 - Ability of legal system to adapt to contracting needs of the economy
- Financial innovation
 - Increase the liquidity of markets and the availability of funds
- Risk diversification and risk management

Effect of Crisis on Islamic Banks

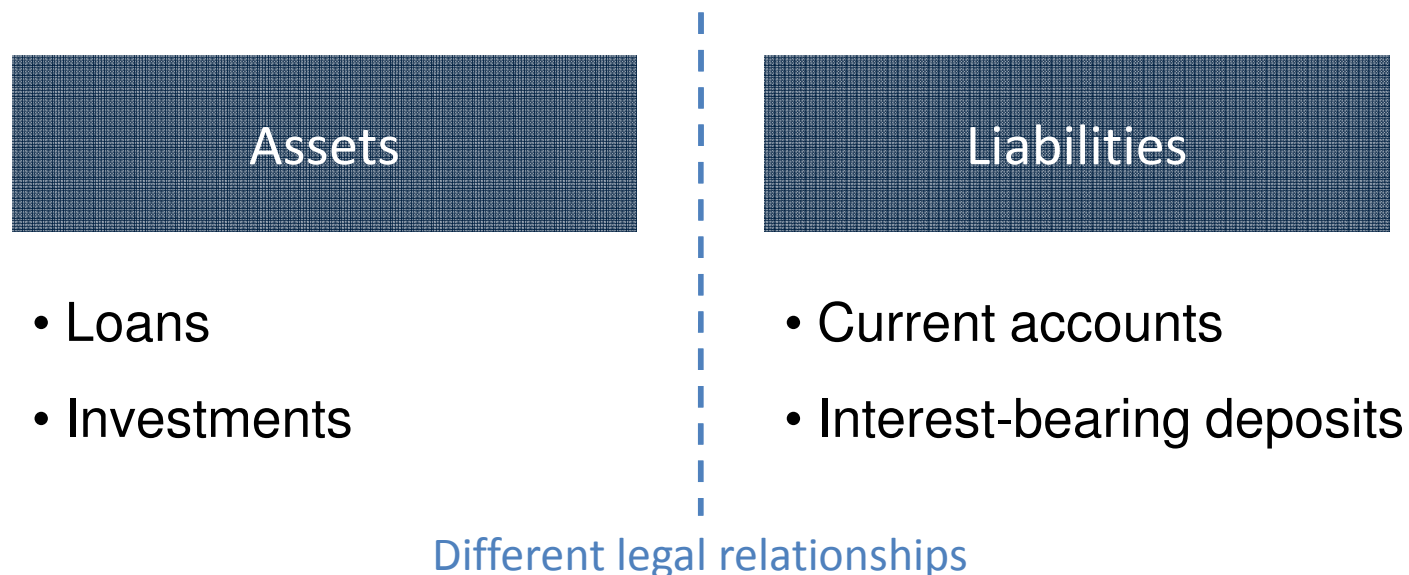
Two types of effects on the Islamic banking industry:

- Islamic banks were not directly exposed to the subprime markets since they were prohibited from investing in (non-Shariah compliant) toxic assets.
- However, they were less immune to the effects of the crisis on real economies

Nature of Relationship between Lenders and Borrowers

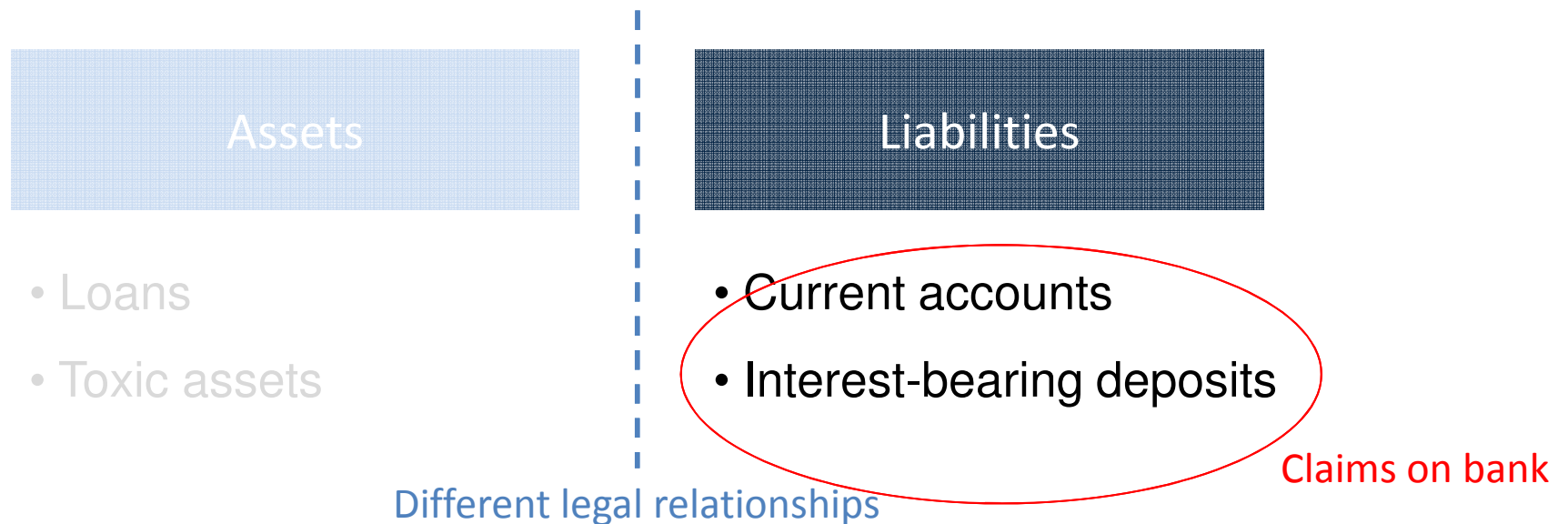
Different type of relationships between the bank and both the providers of funds and the users of funds:

- Conventional banking: Separate legal relationships
- Islamic banking: Financial intermediaries act as agents.



Conventional Bank

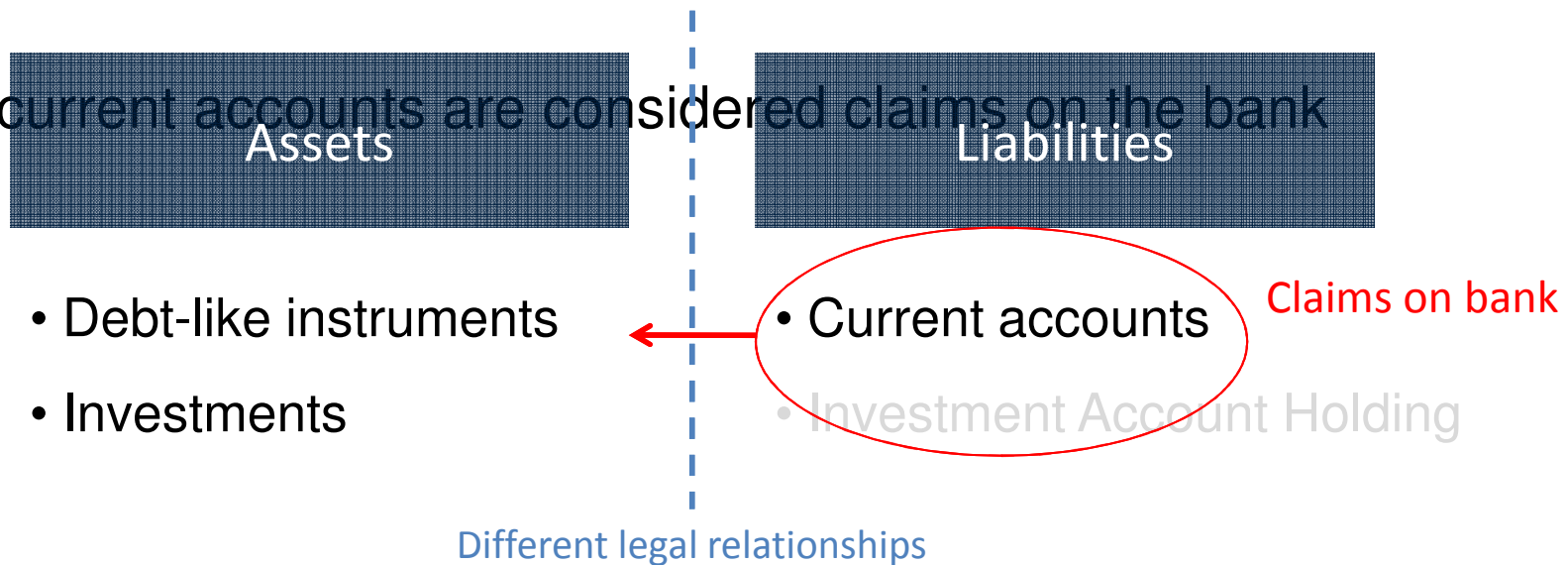
- Bank raises funds in the form of current and interest-bearing accounts
- Claims on the bank
- Bank provide loans and/or invest in securities
- Regardless of whether the bank makes profits or losses on its portfolio of assets, it must pay back its depositors



Islamic Bank

- Sharia prohibits the charging and earning of interest (Riba)
- Prohibition of buying (selling) future cash flows at a discount (premium)
- Depositors are left with the choice of either depositing their funds in the form of current accounts that do not yield any return, or place their funds in investment accounts and share the profit **and** losses with the bank

- Only current accounts are considered claims on the bank

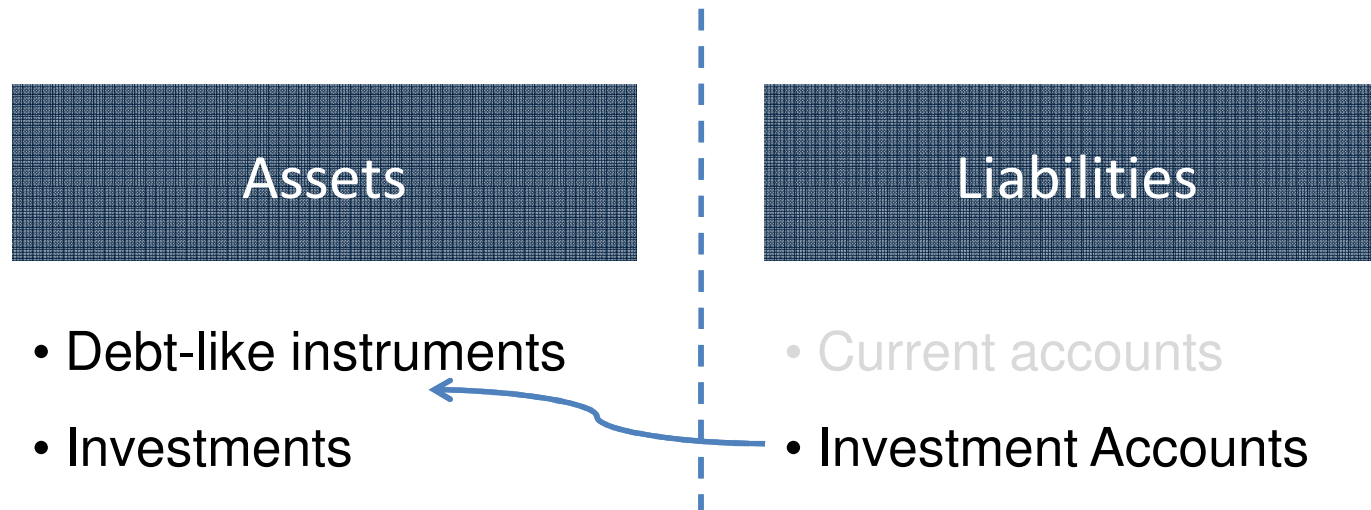


Current Accounts: The Twins Case

- Twins who studied engineering, went to work with the same company and borrowed each \$20,000 to buy a car.
- The only difference is that one of them got a loan from a conventional bank while the other signed a murabaha agreement with an Islamic bank.
- Both banks resorted to current accounts funding to finance the transaction
- As a result of the latest financial crisis, both twins became unemployed and were forced to default of their payments to the bank
 - current account outstanding: \$20,000
 - installments paid: \$10,000

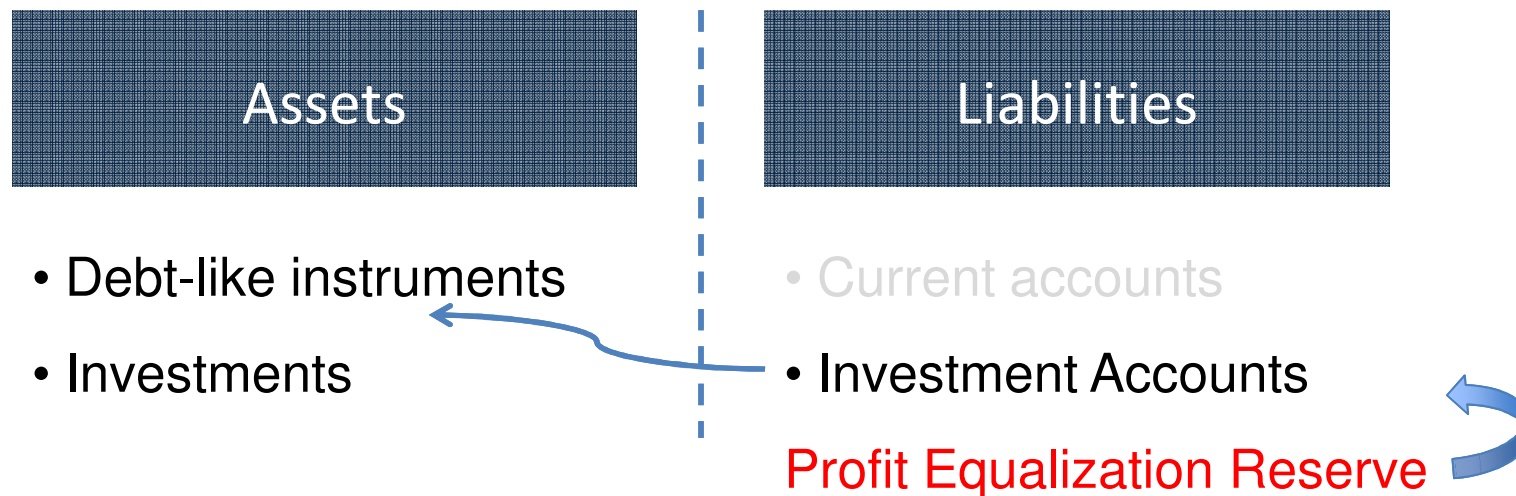
Islamic Bank's Investment Accounts

- Bank acts as an agent who collects funds and invest them on behalf of the IAHS
- In contrast to conventional banks who have to pay back the principal in addition to a pre-determined rate of interest, Islamic banks share profits and losses with IAHS
- They are not exposed to certain types of risks that conventional banks are faced with



Profit Equalization Reserve (PER)

- Under the pressure from the markets, some Islamic banks are smoothing returns
- When the bank return on its investments is lower than the market interest rate, it draws on its PER
- In this case, banks are exposed to certain types of risks in a similar way to that of conventional banks



Banks in the Gulf Region

Islamic banks reported large declines in profitability in the first half of 2009

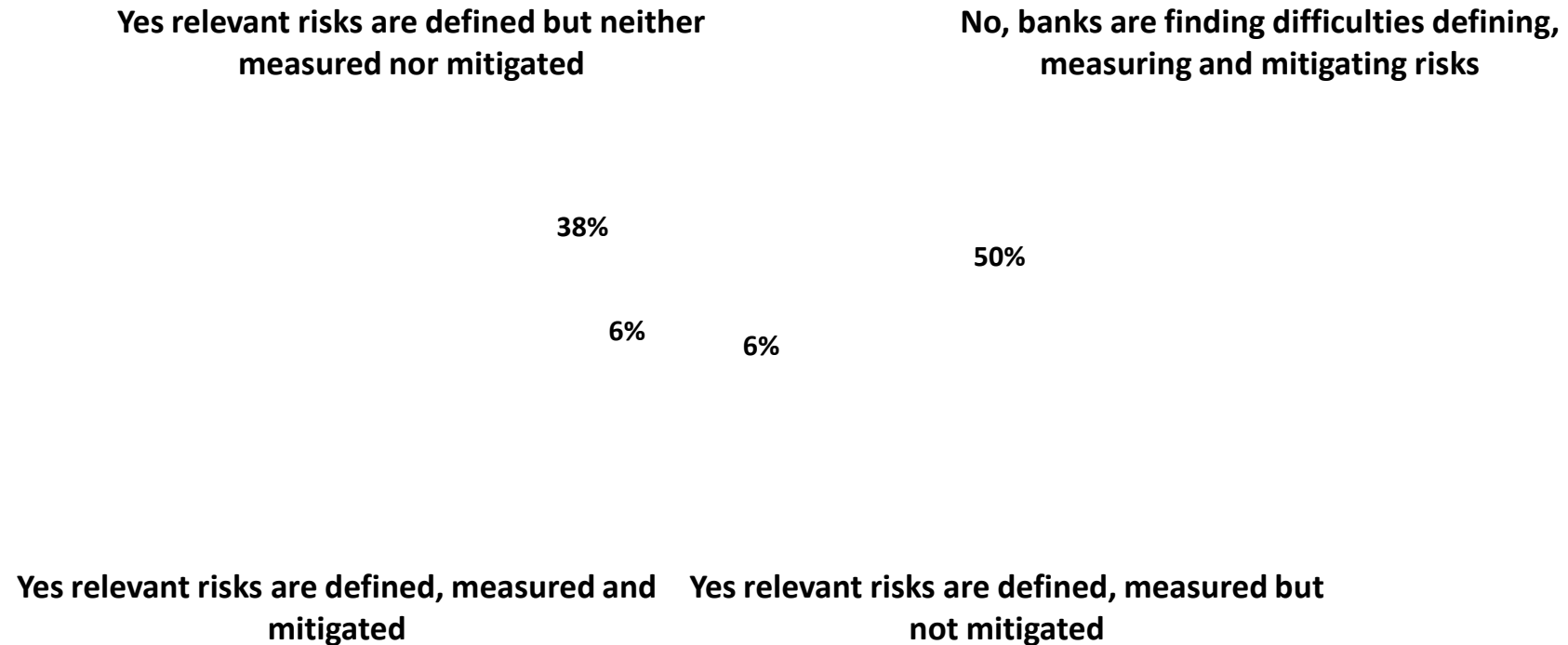
- Although there was a very low exposure to equity and derivatives: 1% in the case of conventional banks and 2% in the case of Islamic banks
- Concentration risk of Islamic banks in the real estate and construction sectors in UAE and Qatar
- Even if Islamic banks refrain from investing in the subprime markets, they will still have to deal with the impact of the financial sector on the real economy
- Islamic banks are better positioned to withstand shocks because of their large capital and liquidity buffers

Islamic Risk Management

Three broad categories of risk management:

- Standardized hedging products
 - ISDA/IIFM Ta'Hawwut (hedging) Master Agreement
- Islamic financing modes
 - Murabaha and Salam
- Sharia compliant risk management techniques

Are regional banks in full control of risk?



Source: McKinsey Risk Summit, November 2007

THANK YOU

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