

Regulatory and Financial Stability Issues Facing Islamic Banks



**World Islamic Banking Conference
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Outline:

- Islamic banks and the Financial Crisis
- Liquidity Management Challenges
- Challenges for the Sukuk Market

Forceful Government Interventions (Some Examples)

MENAP Oil Exporters: Policy Responses to the Crisis

Country	Financial Sector			Macroeconomic		
	Deposit Guarantees	Liquidity Support	Capital Injections	Equity Purchases	Monetary Easing	Fiscal Stimulus
GCC						
Bahrain		✓			✓	
Kuwait	✓	✓	✓	✓	✓	
Oman		✓		✓	✓	
Qatar		✓	✓	✓		
Saudi Arabia	✓	✓			✓	✓
United Arab Emirates	✓	✓	✓		✓	✓
Other						
Algeria					✓	✓
Iran		✓				
Libya	✓			✓	✓	✓
Yemen					✓	

Sources: National authorities; and IMF staff assessments. IMF, Middle East Regional Economic Outlook, October 2009

Islamic Banks in the Middle East during the Crisis

- ❑ Islamic banks were less affected during the initial phase of the crisis, reflecting a stronger first-round impact on conventional banks through mark-to-market valuations on securities in 2008.
- ❑ But, in 2009, data for the first half of the year indicate somewhat larger declines in profitability for Islamic banks, revealing the second-round effect of the crisis on the real economy.
- ❑ The weaker performance of Islamic banks in 2009 was largely driven by the U.A.E. and Qatar, where they had a considerably higher exposure to the real estate and construction sectors. Islamic banks' exposure to the risky real estate and construction sectors is lower in Saudi Arabia, Kuwait, and Bahrain.
- ❑ With larger capital and liquidity buffers, Islamic banks are better positioned to withstand adverse market or credit shocks.
- ❑ On average, Islamic banks' capital adequacy ratio in the GCC is higher than that for conventional banks (except in the U.A.E.).
- ❑ Beyond the crisis, what should be the role of IFSB guidelines?

Performance of Islamic Banks in the GCC

Table 2

GCC: Selected Indicators for GCC Islamic Banks and the Banking System

(Percent; 2008)

	Saudi Arabia ¹		Kuwait		United Arab Emirates		Bahrain		Qatar		GCC Average ²	
	Islamic	All	Islamic	All	Islamic	All	Islamic	All	Islamic	All	Islamic	All
Capital adequacy ratio	22.1	16.0	21.7	16.0	12.8	13.3	24.5	18.1	17.9	15.6	19.8	15.7
Change in profitability (2007–08)	2.0	-11.8	-42.7	-70.1	0.7	7.9	18.8	-4.6	4.5	21.7	-6.6	-13.9
Change in profitability (H1 2009–H1 2008)	2.9	-11.9	-71.9	-65.3	-34.2	-19.5	-46.5	-33.7	0.0	5.1	-29.0	-23.5
Change in profitability (2008 and H1 2009 compared with 2007) ³	4.3	-7.2	-49.7	-65.8	-0.8	10.0	8.2	-3.2	2.8	25.4	-8.8	-10.2
Return on assets	3.7	2.1	1.6	3.2	1.7	2.2	2.6	1.3	6.6	2.6	3.2	2.3
Exposure to real estate and construction ⁴ (as percent of total loans)	5.6	7.3	22.1	31.4	25.7	12.9	11.3	26.2	38.3	18.4	20.6	19.2

Sources: National authorities; banks' financial statements; Zawya; and IMF staff estimates.

¹ The analysis for Saudi Islamic banks does not include Islamic windows in conventional banks.

² Simple average except for change in profitability.

³ Based on average monthly profitability.

⁴ It is not clear from published data whether exposures to real estate and construction include household mortgages. Exceptions Islamic bank data for Qatar, where it is clear that household mortgages are included, and banking sector data for Kuwait, which do not include household mortgages. This renders the comparability of exposures difficult.

Liquidity Management is a Challenge

Concept of liquidity lies at the heart of ALM

- ❑ Ability to capture and retain funding to maintain intermediation margins/ growth, and withstand chance of insolvency (deposit runs)
- ❑ Capacity to secure alternative funding via selling assets and/or superior financial flexibility
- ❑ ALM: balance sheet optimization from cash perspective
- ❑ Liquidity risk management of Islamic banks is an important challenge and is constrained due to limited availability of tradable Islamic money market instruments and weak systemic liquidity infrastructure.

Islamic Inter-Bank Market

- GCC: No Islamic money market and debt securities account for less than 5% of capital market
 - High oil revenues
 - Reliance on bank finance
 - Deficient governance standards and infrastructure

- Malaysia: Islamic Inter-bank Money Market (IIMM)
 - Introduced by Bank Negara Malaysia in 1994
 - Wholesale transactions (Islamic banks and Islamic windows)
 - But still 2/3 conventional

Balance Sheet of IFIs – Funding Structure

- Focus on ample short-term liquidity
 - Suboptimal term structure transformation due to religious constraints

- **Assets: High transaction costs**
 - Ample short-term (fixed) assets, such as *murabaha*, less profitable
 - Long-term assets entail disproportionate credit risk (which can erode investment deposits), such as *musharaka*
 - Natural limits to diversified asset side: underdeveloped inter-bank money market and dependence on commodities as generic collateral

- **Liabilities: Uncertain funding liquidity and term risk**
 - Principal-guaranteed checking account deposits and savings/term deposits
 - “Pass-through” mechanism (*displaced commercial risk*, DCR): Investment deposits and profit-sharing investment accounts (PSIAs) contingent on capital appreciation → cash reserve → endogenizes mutual cost of deposit protection (self-insurance)

Trade-off between Profitability and Liquidity

Excessive Liquidity Syndrome: Blessing and Curse

Assets

Under-utilized surplus liquidity generating suboptimal revenue and concentrated nature of asset side

Liabilities

Vulnerable funding pattern of long-term assets via short-term PLS and non-PLS deposits and payment of long-term liabilities from deposits and short-term assets

Maturity Mismatch Dilemma

High concentration of liquid (but expensive) short-term assets and illiquid (but profitable) long-term assets *without* access to long-term funding and hedging instruments but high credit risk from asset-linkage

Risk of Liquidity Shortfall

→ recent tendency to lengthen average tenor of credit exposure

Solutions for More Efficient Liquidity Management

- Regulatory dynamics to allow for more efficient investment of excess cash and lower credit risk concentration
- **Assets – Credit Leverage**
 - More liquid (and diverse) assets over different tenors to avoid short-term asset/deposits funding long-term liabilities
- **Liabilities – Financial Leverage**
 - More long-term funding sources to balance long-term exposures to real estate, etc.

Challenges for the Sukuk Market

- ❑ Implicit versus explicit government backing
- ❑ Transparency and complexity of sukuk structures
- ❑ Legal and regulatory framework
- ❑ Shari'ah versus conventional law
- ❑ Differences within Shari'ah law

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