Credit Crisis and Islamic Banking

By Klaus Peter Follak, May 2009

Banks applying the principles of Islamic banking have so far performed relatively well. They cannot escape the detoriation of the global economy and falling asset prices. However, they were not much affected by the first round core crisis of the financial industry, because they are much less exposed to the systemic drivers of the liquidity squeeze:

- They have minimal direct exposure to the credit fallout of toxic securities – for obvious reasons. Regularly, these instruments are interest (riba) based and structured on interest cash flows and hence not shariah-compliant.
- Due to the closer link of Islamic finance instruments (murabaha and ijara-based sukuk) to the real economy, there is less leverage in the system. In general, Islamic banks have a strong commitment to asset-based transactions, which insulates them from specific internal risks of the financial system.
- The liquidity base of shariah-compliant trust account deposits is less volatile than the wholesale, in particular inter-bank, capital markets.
- Derivatives are only shariah-compliant for hedging purposes, i.e. risk mitigation instead of building up of open risk positions. Hence, proprietary trading can normally not endanger the capital base of Islamic banks.
- The concept of risk sharing (rather than selling off origination risks) supports an interest in the proper management of credit risk.
- Islamic bonds (sukuk) are strictly based on cash flows of the real economy (in particular ijara).
- Sharia compliance is based on the principles of gharar (contractual certainty) and maysir (i.e. profit or loss shall not be left to chance).

Nevertheless, the crisis has also revealed a few weaknesses which deserve some attention:

- Short-term liquidity management in the money market can be a problem, in particular funding through the overnight interbank market. The basis of shariah-compliant repo transactions (in particular sukuk) needs more critical mass. Perhaps governments and central banks of Islamic monetary unions could support the money market for Islamic banking by issuing suitable instruments.
- A further problem arises for Islamic banks seeking access to liquidity provided by non-Islamic central banks. On one hand, the repo-eligibility criteria of “traditional” central banks are based on interest-related instruments and would require some amendments. On the other hand, as mentioned above, the market of shariah-compliant tradeable instruments needs more critical mass.
- Whether or not the “profit equalisation reserves” of Islamic banks need more support in the direction of deposit guarantees, is uncertain. There is an implicit guarantee by Islamic regulators (which is explicit in certain states).

Under traditional supervisory standards, the Islamic regulators have done their homework by applying the international standards, supported by the Islamic Financial Services Board (IFSB).