The recent global crisis has renewed interest in the relationship between Islamic banking and financial stability—and, more specifically, the resilience of the Islamic banking industry during crises. Some argue that the lack of exposure to the types of loans and securities associated with the losses conventional banks experienced during the crisis—because of the asset-based and risk-sharing nature of Islamic finance—shielded Islamic banks from the crisis. Others contend that Islamic banks relied on leverage and took on significant risks, much like their conventional counterparts, making them vulnerable to the “second-round effects” of the global crisis.

Our study looks at the actual performance of Islamic banks and conventional banks in countries where both have significant market shares, and addresses three broad questions. Did Islamic banks fare differently from conventional banks during the financial crisis? If so, why? And what challenges for Islamic banks has the crisis highlighted?

Using bank-level data covering 2007–10 for about 120 Islamic and conventional banks in eight countries—Bahrain, Jordan, Kuwait, Malaysia, Qatar, Saudi Arabia, Turkey, and the United Arab Emirates (UAE)—we focused on changes in four key indicators: profitability, bank lending, bank assets, and external bank ratings.

The Islamic banking model

The central concept in Islamic finance is justice, which is achieved mainly through the sharing of risk. Stakeholders are supposed to share profits and losses. Hence, charging interest is prohibited.

While conventional intermediation is largely debt based and allows for risk transfer, Islamic intermediation, in contrast, is asset based and centers on risk sharing (see table). “Asset based” means that an investment is structured on exchange or ownership of assets, placing Islamic banks closer to the real economy than conventional banks, which can create products that are mainly notional or virtual.

During the boom period of 2005 to 2007, Islamic banks’ profitability was significantly higher than that of conventional banks. During this period, real GDP growth for countries in our sample averaged 7.5 percent a year before decelerating to 1.5 percent during 2008–09. If this profitability was the result of greater risk taking, one would then expect a larger decline in profitability for Islamic banks during the crisis (defined in our study as beginning at end-2007).

We found that factors related to Islamic banks’ business model helped contain the adverse impact on this group’s profitability in 2008. In particular, smaller investment portfolios, lower leverage, and adherence to principles of Shariah (Islamic law)—which precluded Islamic banks from financing or investing in the kind of instruments (such as collateralized debt obligations and credit default swaps) that adversely affected their conventional competitors—all contributed to better results for Islamic banks than conventional banks that year.

In 2009, however, weaknesses in risk management practices in some Islamic banks led to a larger decline in profitability than that seen in conventional banks. The weak 2009 performance in some countries was associated with sectoral and name concentration—that is, too much exposure to any one sector or borrower. In some cases, the regulatory author-
financial institutions carry 40 percent more liquidity than
that generate a lower rate of return than loans and many
count window.
for borrowing or discounted (sold) at the central bank dis-
participants; and
liquidity management, including
conventional banks and hence have more stable sources of
ment.
issues that will have to be addressed if Islamic banks are to
its is more easily directed to conventional banks.
The slower asset growth during 2009 could be attributable to
it started decelerating in 2009, indicating that Islamic banks
were less affected than conventional banks by deleveraging.
The slower asset growth during 2009 could be attributable to
the weaker performance of Islamic banks that year or to the
fact that liquidity support in the form of government depos-
its is more easily directed to conventional banks.
Our findings were corroborated by external rating agen-
cies’ reassessment of Islamic banks’ risk, which was generally
found to be more favorable than—or similar to—that of con-
ventional banks (with the exception of the UAE).

Challenges must be addressed
While the global crisis gave Islamic banks an opportunity to
show their resilience, it also brought to light some important
issues that will have to be addressed if Islamic banks are to
continue growing at a sustainable pace.

Absence of a solid infrastructure for liquidity risk manage-
ment. While Islamic banks rely more on retail deposits than
conventional banks and hence have more stable sources of
funds, they face fundamental difficulties when it comes to
liquidity management, including
• a shallow money market due to the small number of
participants; and
• the lack of instruments that could be used as collateral
for borrowing or discounted (sold) at the central bank dis-
count window.
Some Islamic banks have responded by running an overly
liquid balance sheet (that is, having more cash-like assets
that generate a lower rate of return than loans and many
types of securities), thereby sacrificing profitability. Islamic
financial institutions carry 40 percent more liquidity than
their conventional counterparts (Khan and Bhatti, 2008).
This approach to liquidity mitigated risks during the cri-
sis, but it is not an ideal solution in normal circumstances.
The establishment of the International Islamic Liquidity
Corporation in October 2010 was a step toward enhancing
Islamic banks’ ability to manage international liquidity. But
such efforts need to continue.
More generally, monetary and regulatory authorities
should ensure that the liquidity infrastructure is neutral
to the type of bank (for example, by developing sovereign
sukuk, or Islamic bonds, in addition to conventional bonds
and certificates of deposits) and strong enough to address
the problems highlighted during the global crisis.

Need for appropriate institutional arrangements for the
resolution of troubled financial institutions. This is especially
relevant for Islamic banks, given the absence of precedents.
A mechanism for cooperation between regulators within
and across jurisdictions for the resolution of Islamic banks
is essential to contain spillovers beyond national boundaries.

Lack of harmonized accounting and regulatory stan-
dards. This proved a key problem for regulators and market
participants during the crisis—one exacerbated by the lack
of standard financial contracts and products across institu-
tions. The standards for Islamic banks’ operations continue
to be fragmented, despite initiatives by the Accounting and
Auditing Organization of Islamic Financial Institutions
and the Islamic Financial Services Board to create international
industry guidelines.

Insufficient expertise. Expertise in Islamic finance has not
kept pace with the rapid growth of the industry. Islamic bank-
ers, regulators, and supervisors need to be familiar with both
conventional finance and the different aspects of Shariah,
given the increasing degree of sophistication of Islamic finan-
cial products. The shortage of specialists also inhibits prod-
uct innovation and could hinder the effective management of
risks particular to the industry.
In the recent global crisis, Islamic banks proved their
mettle. But the crisis has led to greater recognition of the
ways in which they still need to develop. As financial regula-
ory reform presses ahead on a global level, now is the time
for the Islamic banking regulators to address the industry’s challenges.

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