Islamic Finance
and Financial Crisis

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Agenda

- Crisis has impacted GCC markets. However GCC plays a positive role in banking and financial sector
- Islamic finance (IF) is not immune from risk
- Islamic finance can also play a role as a factor of stability
- However, IF has been affected by the crisis and possibilities for abuse exist
- Can the region and IF make the most of the attention it is now receiving

Crisis impact on GCC markets.

- Impact on GCC markets: value losses, credit cost increase, liquidity tightening, international investors offloading GCC positions, reduced lending, GCC central bank support to market/banks
- Impact on banks: losses in investments in international markets (including US troubled institutions), curbing lending on large ticket projects and real estate, sub-prime losses close to $.3 bn, syndication business disrupted
- **GCC Central banks' support** enhances credit quality, role of Sovereign Wealth Funds (btwn $1100-1700), oil prices within range of $$50-70pb

Islamic finance is not immune from risk …

- In spite of its insularity, IF is exposed to a market correction (including in the real estate sector), reduced business and revenue
- This stems from the rapidly increasing international dimension of IF and the expanding scope including private equity, project finance, sukuks, and fund, asset and wealth management activities.

… and legitimate questions arise

- Are the risks the same in IF in various regions? IF often exhibit differences in their accounting operations, or in the way Shariah law is interpreted in various parts of the world.

- IF growth and development has required a significant evolution of its regulatory and legal framework. Is this evolution adapted to the challenges posed by the financial crisis? Has it tackled in depth the specific corporate governance challenges? Does it respond to the differences of IF in Different Countries?

Islamic finance can also play a role as a factor of stability

- Fastest growing niche of the financial sector: $1 trillion of combined asset value, and 10-15% growth/annum as per some estimates
- IF emphasis on asset backed transactions offers an opportunity in the financial crisis. May be instrumental in overcoming the challenges posed by the current credit crunch
- The close link between financial flow and productivity of IF contributes towards insulating it from the potential risks resulting from excess leverage and speculative financial activities
- High level of disclosure and transparency. The risk and profit-sharing feature of IF transactions requires a high level of disclosure and transparency in the IF system. Is T&D of IF up to the expectations?
- IF institutions have not reportedly invested in credit default swaps and of the US subprime mortgages

However, IF has been affected by the crisis and possibilities for abuse exist

- From a systemic point of view, IF has been less affected by the crisis;
- Some Islamic institutions had been affected in terms of liquidity and capital might be due to:
  - Undercapitalized
  - Highly leveraged / many commitment
  - Scarce Market Financing
- Impact in terms of market confidence, pricing of products and valuation of assets
- Biggest impact of the credit crunch on the sukuk market:
  - Investors are cautious and pricing is a problem;
  - Valuations of assets of sukuk (especially real estate) already issued have also been affected;
  - Potential losses of investors in sukuk, which are about to mature

Can MENA/GCC region and IF make the most of the attention it is now receiving / Challenges

- Despite the recent boom of IF – largely concentrated in the MENA and SE Asia – it still lacks global scale
  - Less than 0.5% of the world's total of banking assets (Prof. Rodney Wilson, Durham University), while worldwide sukuk debt represent only 0.1% of the global bond market
- The following challenges require action in order to take advantage of the opportunities offered by the current crisis
  - Risk management
  - Legal system testing (Islamic transactions inducing sukuk). Untested foreclosure laws on government and related party assets
  - Enforceability of international rulings vis-à-vis Shariah compliance

Challenges (cont'd)

- Risk issues of particular importance for Islamic banks:
    - Liquidity –still developing money market; commodity risk; communication risk; equity risk; operational risk; Sharia Board Issues, Corporate Governance issues
- Need for appropriate measurement of risks specific for Islamic banks (especially adjustments on capital adequacy calucations to reflect risks associated with investment accounts)
- Importance of appropriate stress testing
    - Comprehensive: tests convering market, credit and liquidity risks
    - Considering the effects of prolonged market tensions and illiquidity
    - Reflecting the nature of the portfolios of Islamic Institutions
    - Factoring the time needed to manage or hedge risks

Challenges (cont'd)

- Promoting transparency and financial discipline through better market disclosure:
  - Specially on complex Islamic financial products, their valuation and the respective measurement of inherent risks;
  - Qualitative disclosure, explaining approach to risk management; Improved disclosure to stakeholders of the profit and risk sharing implications of shariah based investment;
  - Availability of financial data, especially historic data, is a challenge for Islamic banks
- Role of supervisors
  - Emphasis on the internal audit function (ensure comprehensive reviews of Risk Management -RM and internal controls)
  - In monitoring IF, treat T&D as a priority
  - Guidance on sound RM and CG
  - Evaluation of expertise and integrity of BoD