The resilience of Islamic banks and conventional banks in the global financial crisis

[1]Seyed Hossein Mirjalili,Ph.D

Abstract

Islamic banks had demonstrated significant resilience during the global financial crisis, because of relying on real economic activities, avoiding toxic financial derivatives, and keeping higher liquid assets. However, they were vulnerable afterward in economic crisis. Canadian banks as an example of the most successful conventional banks during both the global financial and economic crisis, also had demonstrated significant resilience, because of institutional setting, prudential regulator, high capital-asset ratio, leverage cap, and conservative mortgage market. Islamic banks can learn from this experience and make a reform on liquidity management, corporate governance and consider the experience of resilient conventional banks.

1 Associate prof., Faculty of Economics, Institute for Humanities, Tehran and former senior advisor to Executive Director, The World Bank Group

1- Introduction

Rapid growth of Islamic banking raised the questions on whether they are resilient to financial crises. There are empirical evidences which support their relative resilience. Farooq and Zaheer(2015,p.1)by using data from Pakistan, where Islamic and conventional banks co-exist, they compared these banks during a financial panic. The results was that Islamic bank branches are less prone to deposit withdrawals during financial panics, both unconditionally and after controlling for bank characteristics. They also found that Islamic bank branches grant more loans during financial panics. Thus, Islamic banking may enhance the stability of the banking system.

In a cross country analysis, Hasan and Dridi (2010) found that during 2008-09, Islamic banks fared better than conventional banks in terms of credit and asset growth. In another study by using the data of 141 countries for the period 1995-2007, Beck, Demirgüç-Kunt et al. (2013) concluded that during the global financial crisis, Islamic banks had a higher intermediation ratio, higher asset quality and were better capitalized and recorded better stock market performance.

These evidences suggest that Islamic banks were resilient to the global financial crisis of 2007-2008. Some conventional banks also were resilient to the crisis. The question is what are the reasons behind their resilience. First, I discuss the probable reasons for the resilience of Islamic banks during financial crisis and then I argue for the resilience of Canadian banks in both, financial and economic crisis. Finally I discuss the lessons that Islamic banks can learn from the experiences.

2- Islamic banks in the Global financial Crisis

During the global financial crisis, Islamic financial institutions had demonstrated significant resilience. It was one of the realities of the global financial crisis that Islamic banks remained stable. The most important reasons behind the resilience of Islamic banks in the crisis are as follows:

First, Islamic banks' mode of financing are more tied to real economy than conventional banks. Musharakah and Mudharbah provide risk sharing and these modes have a link with the real sector. Murabaha , Ijarah and Istisna modes of financing also has related strongly with real sector activities. Murabaha and Ijarah transactions require Islamic banks to know the clients' purpose and use of finance. Thus, it keeps credit tied to real economic activity for each transaction and throughout the tenor of contract. [2]While Ijarah, Murabaha and Istisna provide credit, they do so against usufruct, commodity and a future tangible asset. Thus, these modes keep a tab on the ballooning of debt and credit.[3]

Second, Islamic banks avoided direct exposure to toxic financial derivative products. The portfolio of Islamic banks did not include any collateralized debt obligations (CDOs), credit default swaps (CDSs) and the like which considered toxic[4] for conventional banks

2 In conventional bank financing the client is not required to disclose the use of funds as long as the client is creditworthy or can post suitable collateral.

3 The practice of tawaruq by some Islamic banks in the Persian Gulf region was loosening the tie of finance with real economic activity. The fatwa of OIC Fiqh Academy on the prohibition of organized Tawaruq targeted that issue.

4 The term toxic assets refers to certain financial assets whose value has fallen significantly and for which there is no longer a functioning market, so that such assets

in the crisis. It means, the lack of exposure to the type of assets associated with most of the losses that many conventional banks experienced during the crisis have shielded Islamic banking from the impact of the crisis.

Third, Islamic banks have kept a larger proportion of their assets in liquid form than conventional banks. That happened mostly for two reasons: (1) Islamic banks do not have access to market liquidity in the form of the interbank market, in a dual banking system, therefore, high liquidity buffers maintained by Islamic banks for risk management purpose. (2) Excess liquidity is also needed by Islamic banks, because investment in the real economy requires some gestation period. [5]

However, Islamic banks and financial institutions affected by economic crisis, followed by financial crisis. As Islamic banks rely mostly on Murabaha financing and invested in the real sector, they suffered during the recession. Moreover, downturn in the real estate markets in which Islamic banks have large exposures is also a source of risk and that made them vulnerable to the effects of economic crisis. Thus, Islamic Banks in some countries faced larger losses compared to their conventional banks. That could be a reason behind higher nonperforming loan ratio for Islamic Banks than that for Conventional Banks in economic crisis that followed by financial crisis. (Hasan and Dridi,2010,p.17)

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cannot be sold at a price satisfactory to the holder. The term has become common during the financial crisis of 2007–10,in which they played a major role . Complicated financial assets such as some collateralized debt obligations and credit default swaps falls in this category. These assets are not Shariah compliant and hence Islamic Banks could not invest in them.

5 Salman Syed Ali ,(2011), “Islamic Banking In The MENA Region ” , Islamic Development Bank , Islamic Research And Training Institute,pp.34-36

Hasan and Dridi(2010) examined the effects of the Global financial Crisis on Islamic and conventional banks. The key variables used to assess the impact were the changes in profitability, bank lending, bank assets, and external bank ratings. In terms of profitability, Islamic Banks fared better than Conventional Banks in 2008. However, this was reversed in 2009 as the crisis hit the real economy. In terms of asset and credit, Islamic Banks'growth in credit and assets were higher than that of Conventional Banks. In terms of risk assessment of rating agencies, Islamic banks has been better than or similar to that of Conventional Banks. Hence, Islamic Banks showed stronger resilience, on average, during the global financial crisis. However, Islamic banks business model gave rise the adverse impact on profitability in 2008 and 2009. [6]

All in all, and given the link to real economic activity as a benchmark, we can argue that although Islamic banks had demonstrated resilience in the global financial crisis, but they were not resilient as expected in economic crisis afterward.

3-Conventional banks in the global financial crisis: Case of Canada

Canadian banks had demonstrated significant resilience during the 2007/2008 financial crisis as compared to banks in other countries. Canada was the only G7 country that did not have a government bank bailout. Canadian banks remained profitable throughout the crisis.[7]

6 .Maher Hasan and Jemma Dridi,(2010),"The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study", IMF working Paper, WP/10/201, p.7

7 According to the International Monetary Fund, USA has almost 7,000 chartered

In 2007 and 2008, no Canadian financial institutions failed. There were no government bailouts of insolvent firms. Canada was the only G-7 country to avoid a financial crisis. For the last six years (leading to 2013), the World Economic Forum has ranked Canada first among more than 140 countries in banking stability.(P.22)[8]

The most important reasons for the resilience of the Canadian banks during the financial crisis are as follows:

First: Institutional setting: The relative stability of the Canadian banks in the crisis compared to the United States is due to institutional foundations laid in place in the early 19th century in the two countries. The Canadian banking system could absorb the key sources of systemic risk—that is, the mortgage market and investment banking—and was tightly regulated by one overarching regulator. In contrast the relatively weak, fragmented, and crisis prone U.S. banking system that had evolved since the early nineteenth century, led to the rise of securities markets, investment banks and money market mutual funds (the shadow banking system) combined with multiple regulatory authorities. The consequence was that the systemic risk that led to the crisis of 2007-2008 was not contained.[9]

banks, while Canada has just 80 banks, six of which hold 93 percent of the market share. It has a single overarching financial regulator, the OSFI, which oversees financial institutions such as banks, mortgage lenders, insurance companies, pension funds. Securities markets are regulated by Canada's 13 provincial and territorial governments, but their regulations are largely harmonized.

8 Renee Haltom,(2013),"Why was Canada Exempt from the financial Crisis?", Economic Focus, Fourth Quaeter,p.22

9 Michael, Bordo, Angela Redish and Hugh Rockoff,(2011),"Why didn't Canada have a banking crisis in 2008(or in 1930 or 1907 or…)?",NBER working paper series17312, p.30

Second: prudential bank regulator: Office of the Superintendent of financial institutions(OSFI) is a single financial regulator in Canada that works with banks to anticipate and mitigate risks. It has the power to issue guidance and interpretations of guidance, and to bring about compliance with these. OSFI has principles-based supervisory approach.

Third: Capital-asset ratios: Canadian banks were required by OSFI to be well capitalized. OSFI requires Canadian banks to hold 7% of Tier 1 capital and 10% total capital, above the Basel II requirements of 4% and 8%. Canadian Tier 1 requirements were the highest among the G7. Moreover OSFI insists on high quality Tier 1 capital: 75% or more must be common equity. Single name exposures are limited to 25% of regulatory capital.

Therefore, an adequate level of bank capital relative to assets, which was important in Canada, has been recognized as important. The emphasis on common shares in Tier 1 capital has been contributed to the resilience of Canadian banks.[10] The Basel Accord requires internationally active banks to hold tier 1 capital of at least 4 percent and total capital of at least 8 percent of risk weighted assets. Canada imposed capital requirement target that are higher than the Basel minima: tier 1 capital of 7 percent and total capital of 10 percent.(p.16) In addition, Canadian capital regime requires that at least 75% of tier 1 capital is formed of common equity, and restricts innovative instruments to 15 percent of tier 1 capital.

In addition to risk-based capital, Canada uses an assets-to-capital multiple (inverse leverage ratio) calculated by dividing the insti-

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10 Tony Porter,(2010),"Canadian Banks in the financial and Economic Crisis", McMaster University, pp.3-7

tution's total assets by total (tiers 1 and 2) capital. The maximum multiple is set at 20 (leverage ratio of 5%). Exemptions for the multiple of up to 23 may be granted on an individual basis by OSFI. (p.16)[11]

Canada has one of the most restrictive capital adequacy regulatory standards in the world in risk-weighting, allowable capital deductions, and definitions of permissible regulatory capital.(p.30)[12]

Fourth: Leverage cap: Canada regulator imposed leverage caps on its banks. OSFI included some off-balance sheet exposures in its definition of assets that the US did not, including credit derivatives. The Canadian leverage cap was a maximum asset to capital (Tier 1 and 2) ratio of 20. The leverage ratio, which provides a more constraint on banks than the Basel II regulations on capital-asset ratios, contributed in its resilience.

Fifth: Conservative mortgage markets: A 2009 IMF staff report on Canada noted that "Only 5 percent of mortgages are nonprime and only 25 percent are securitized (compared with 25 percent and 60 percent, respectively, in the United States).The Canadian non-prime market was terminated in 2008 when the Canadian Mortgage and Housing Corporation stopped insuring such mortgages. [13]Legally, defaulting on loans is more difficult in Canada than the US.

11 Lev Ratnovski and Rocco Huang,(2009),"Why are Canadian Banks more resilient?",IMF Working Paper, WP/09/152, p.16

12 "Crisis-Proofing financial integration: Canada", Golden Growth, Country Benchmarks, p.30

13 Tony Porter,(2010),"Canadian Banks in the financial and Economic Crisis", McMaster University, p.7

4- What Islamic banks can learn

Although the global financial crisis gave Islamic Banks an opportunity to prove their resilience,but economic crisis highlighted the need to address the challenges of Islamic banks in the downturn. It also provided an opportunity to learn from successful experiences of conventional banks during both financial and economic crisis. Some important areas of learning for Islamic banks are as follows:

First: The crisis underscored the importance of liquidity risk management. While Islamic Banks rely more on retail deposits and, hence, have more stable sources of funds, they face fundamental challenges when it comes to liquidity management. Some Islamic banks have addressed this issue by keeping a liquid balance sheet, but with less profitability. Although, this approach to liquidity has mitigated risks during the crisis, but Islamic banks need to enhance their ability to manage their liquidity, through for example by improving the Sukuk market.

Second: The crisis has led to greater recognition of the importance of institutional setting. The existence of higher Non-Performing Loan(NPL) for Islamic banks than conventional banks, is due to a weakness of institutional setting. Islamic banks need to enhance their corporate governance and Institutional quality.

Third: Canadians' banks resilience is a good example for the Islamic banks to consider for the financial reforms in the wake of the global crisis. Islamic banks may consider leverage cap, higher capital adequacy requirement and conservative derivative market.

For Islamic banks, it is crucial opportunity to learn and make the necessary reforms, before the next financial or economic crisis occurs. As Asian economies were more resilient during the global financial crisis of 2007-2009, because they learned from Asian crisis of 1997 and conducted the necessary reforms. Islamic banks authorities need to be aware that the global financial crisis of 2007-2009 and economic crisis afterward were not the last crisis. Therefore they have to prepare and mobilize for the next ones.

5- conclusion

Islamic banks were relatively resilient during the financial crisis of 2007-2009, however they were vulnerable in economic crisis occurred thereafter. Canadian banks as an example of conventional banks had demonstrated resilience during both financial and economic crisis, because of institutional, regulatory and financial factors. Islamic banks can learn from this experience in liquidity management, institutional quality and prudential regulations.

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