On Risk-Sharing and Islamic Finance: Implications for Financial Stability

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Outline

- The Rapid Growth of Islamic Finance
- How is Islamic Finance Different from Conventional Finance?
- Performance of Islamic Finance During the Global Financial Crisis
- The Role of Risk-sharing in Islamic finance
- Outstanding Policy Issues in Islamic Finance
- World Bank's Engagement with Islamic Finance

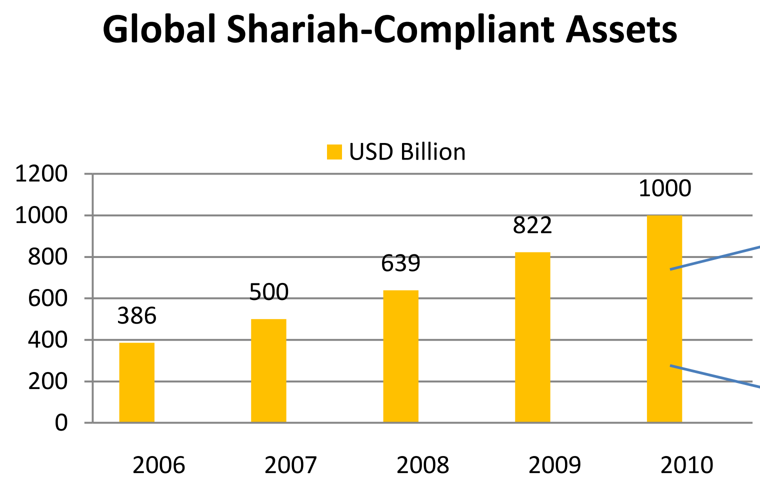
The Growth of Islamic Finance

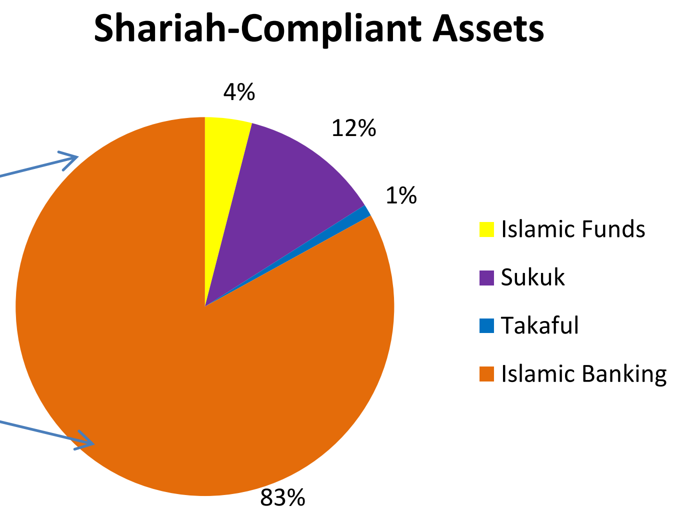
- Since the early 1970s, global *Shariah*-compliant financial assets have grown at about 10% annually
- *Shariah-compliant* assets were estimated by IFSB to be around US$1 trillion in 2010* representing almost 0.5% of Global Financial Assets that totaled to around US$ 228 trilion**.
- Islamic finance industry's profits totaled USD15 billion and is expected to more than double to USD32 billion over the next 5 years
- Islamic banks deposits ratio to total deposits widely varies between countries (March 2011: Indonesia:3%, UAE:11%, Malasyia:19%), some studies suggest that it will account for up to a range of 40-50% of total deposits in countries with majority Muslim populations within 8 to 10 years.

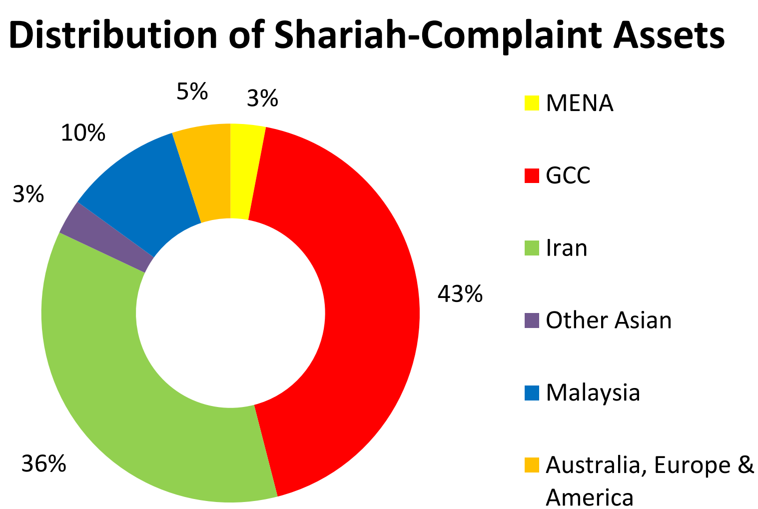
* *Source: Islamic Finance and Global Financial Stability, April 2010, Islamic Finance Stability Board and Islamic Development Bank*

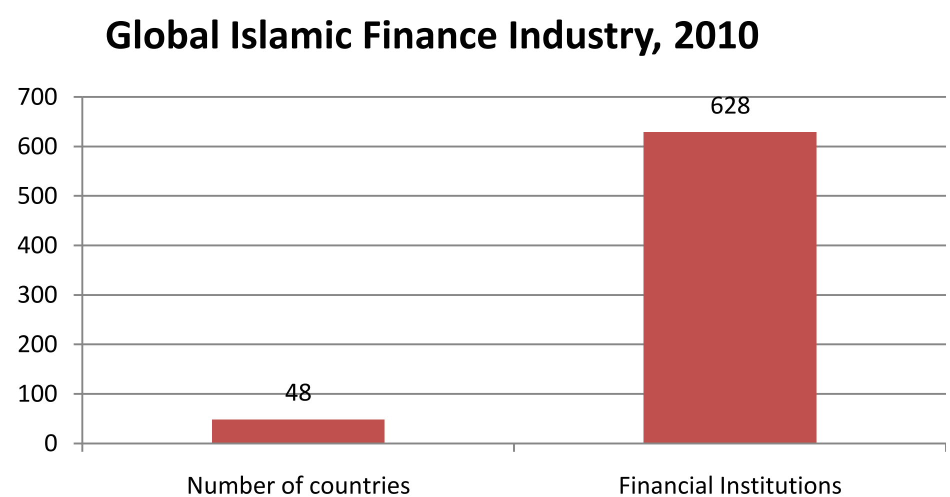
** *Source: Global Financial Stability Report, April 2010, International Monetary Fund*

Share of Global Shariah-Compliant Assets





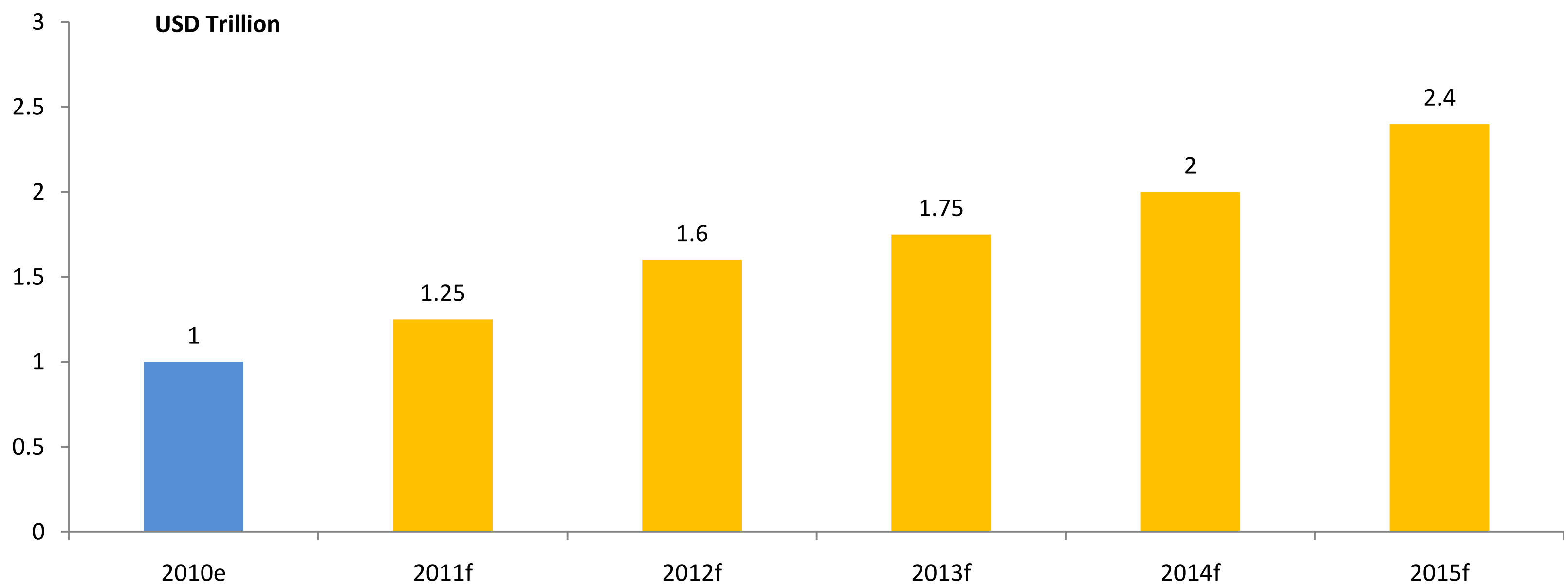




Source: The Banker, PricewaterhouseCoopers, MIFC

Growth of Global Shariah-Compliant Assets

- IFSB estimated Islamic assets to reach about USD1,600 billion, with revenues of USD120 billion by 2012
- Continued expansion expected in countries with sizeable Islamic Finance sectors (e.g. Bahrain, Brunei, Indonesia, Iran, Malaysia, Pakistan, Sudan and the UAE)
- In addition, strong prospects for further growth in financial centers (e.g. Ireland, UK and Luxembourg)



Source: Maybank Islamic

How is Islamic Finance Different from Conventional Finance?

- Conventional financial institutions operate within a system based on debt and transfer of risk
- This raises the probability of disconnecting financial instruments from their underlying assets
- Some of the financial tools created to share risk actually resulted in a concentration and intensification of risk
- In contrast, Islamic finance emphasizes asset-backing for transactions and is anchored on the principle of risk sharing
- *Shariah* principles ensures a direct link between financial transactions and real sector activities
- *Shariah* principles also prohibit(*Gharar*) , the use of excessive leverage and avoids forms of controversial complex securitization

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ISLAMIC FINANCE IN EGYPT

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The analytic conceptualisation which has developed since the 1980s, has established that the Islamic financial system has several advantages over the convent ional one, mainly:

- It is more equitable as it establishes a direct relationship between lenders and borrowers through which they share the outcome of the 'partnership' be it profit or loss.
- Their is a close and direct relationship between the return on savings and investment.
- The Islamic system offers a flexible adjustment mechanism in the case of unanticipated shocks.
- It ensures that the real values of assets and liabilities will be equal at all points in time.
- The rate of return is determined by the real sector, and not by the financial sector.
- It protects the exchange/transaction role of a banking system by limiting the risk on deposit balances

[1] An earlier version of this paper was presented at the Twenty-Ninth Annual Conference of the Middle East Studies Association (MESA), December 6-10, 1995, Washington D.C. The author wishes to thank Tony Addison, Ahmad Galal, Alan Roe and Fathy Sakr for useful suggestions and comments. Usual disclaimer applies.

Performance of Islamic Finance During the Global Financial Crisis

- The recent Global Financial Crisis underscored the dangers of debt-based financial transactions and the speculative use of financial instruments
- Irrational lending practices, high levels of leverage, and the so-called “atomization” of risk through imprudent securitization undermined the very foundations of financial systems in advanced countries
- The crisis generated significant adverse effects:
  - Global economic slowdown with many advanced countries experiencing recessions and sharp increases in unemployment
  - Emerging and developing countries also suffered a sharp fall in export volumes, a deceleration in GDP growth, increased unemployment and a rise in poverty levels in the low-income and middle-income countries

Performance of Islamic Finance During the Global Financial Crisis

- A recent World Bank policy research working paper emphasized that the global financial crisis has not only shed doubts on the proper functioning of conventional "Western" banking, but has also increased the attention on Islamic banking. Academics and policy makers alike point to the advantages of Shariah compliant financial products, as the mismatch of short-term, on-sight demandable deposits contracts with long-term uncertain loan contracts is mitigated with equity elements. In addition, Sharia-compliant products are very attractive for segments of the population that demand financial services that are consistent with their religious beliefs. However, little academic evidence exists on the functioning of Islamic banks, as of yet.
- Islamic banks escaped the direct impact of the crisis, as they were not exposed to sub-prime and toxic assets
- A recent IMF Working Paper** found that the business model of Islamic banks helped them to mitigate the impact of the crisis
- As Islamic banking services are more connected to the real sector, initially performed well during the crisis yet were severely hit by the second round effects:
  - Increased losses threatened the viability of some Islamic financial institutions
  - Some Sukuk issuers defaulted

* Beck, Demirguc-Kunt and Merrouche (2010)

* *Hassan and Dridi (2010)

Some Reflections on the Global Financial Crises …Seeking Islamic Finance Solutions?

- "*Western policymakers and economists often portray Islamic financial systems, with their emphasis on shared risk and responsibility in lending, as less efficient than western systems that put no strictures on debt. Yet one can equally argue that Western financial intermediation is far too skewed towards debt, and as a consequence generate many unnecessary risks.*" Kenneth Rogoff, Banque de France Conference , Paris, March 2011

In an attempt to identify a better link between credit-expansion and GDP growth, some macro-prudential measures have been developed:

- Credit-to-GDP gaps, play a key role in distinguishing between "due and undue" momentum in financial cycles and thereby function as a trigger for many of the countercyclical measures (including capital buffers).
- Setting economically meaningful trigger points is however far from obvious, considering cross-country heterogeneity.
- The BIS has found that lower and upper thresholds of 2% and 10% for credit-to-GDP gaps do a reasonable job in anticipating excessive credit growth.

Some Reflections on the Global Financial Crises …Seeking Islamic Finance Solutions?

- *"Yet perhaps scholars who argue that Islamic financial systems' prohibition on interest generates massive inefficiencies ought to be looking at these systems for positive ideas that Western policymakers might adopt. ….. In the meantime, the IMF and the G-20 can help by finding better ways to assess the vulnerability of each country's financial structure – no easy task, given governments' immense cleverness when it comes to cooking their books. Policymakers can also help find ways to reduce barriers to the development of stock markets, and to advance ideas for new kinds of state-contingent bonds, such as the GDP-linked bonds that Yale's Robert Shiller has proposed. (Shiller bonds, in theory, pay more when a country's economy is growing and less when it is in recession.)"* Kenneth Rogoff, Project Syndicate, March 2011

Some Reflections on the Global Financial Crises …Seeking Islamic Finance Solutions?

- "The Islamic financial system has so far been able to gain a very small share of the global financial market and, even if it operates perfectly as desired by the *Shari'ah, it may not be able to create a significant impact on the international* financial system in the near future." Umer Chapra, October 2008

- However, he emphasized that the only option for further development of Islamic Financial Services is to explain the system rationally and implement it seriously and sincerely to enhance effectiveness and promote financial health and stability.

Risk-sharing in Islamic Finance:1

- Risk-sharing characteristics of Islamic finance can also foster financial stability
- By design, Islamic financial instruments do not rely on interest rate-based debt contracts
- *Mudaraba* (profit-sharing) and *Musharakah* (joint venture) emphasize equitable risk allocation among different parties
- *Musharakah* in particular ensures that the impact of an adverse development is spread among the participants
- *Takaful* also has the potential to spread risk among a large number of participants
- *Sukuks* (certificates of ownership) use the concept of joint ownership of an asset by several financiers, making it more like equity-type financing as opposed to a bond which is a debt instrument

Risk-sharing in Islamic Finance:2

- Reliance on equity and equity-type financing arrangements helps to restrain excessive leveraging
- The close linkage between the amount of financing and an underlying asset also helps to limit leverage
- The sharing of risk and reward (*Al Ghonm bel Ghorm*) implies that long term targets become more important and excessive short term risk taking is discouraged
- Financial institutions are more like business partners with their clients and have stronger incentives to evaluate financing requests carefully and exercise prudence in extending such financing

Risk-sharing in Islamic Finance:3

- As “business partners”, financial institutions are also more likely to assist borrowers in working through bad times, thus reducing the pressures to sell assets as “fire-sale” prices
- This protects the system against a general fall in asset prices and reduces the probability of cascading defaults
- The sharing of losses also reduces the probability of contagion to the rest of the financial system

Risk-Sharing in Islamic Finance: 4

- Nonetheless, imprudent behavior of some market participants cannot be completely ruled out
- Strong supervisory oversight therefore is required to ensure proper use of risk-sharing instruments
- Financial institutions also need to enhance their capacity to assess clients through <u>ex-ante screening</u> in terms of ability to manage the project and business, and follow that with <u>ex-post monitoring</u>

Outstanding Issues in Islamic Finance

- Need to address the currently favorable tax treatment of debt in many countries, which puts equity and profit/loss sharing arrangement at a disadvantage and encourages leverage
- High concentration in banking business, small size and institutional fragmentation
- Islamic capital markets are still relatively young, small and underdeveloped
- Other non bank financial instruments: mortgage, takaful, leasing, microfinance are still very much underdeveloped

Outstanding Issues in Islamic Finance

- Inadequacy of exit rules relating to bankruptcy and insolvency of Islamic financial institutions and sukuk defaults
- Concerns about liquidity risk management
- Weaknesses in corporate governance in some Islamic financial institutions
- Need for more qualified management: the proper mix of skill and conviction
- Limited application: still in transition?
- Compliance with Basel III … and consistency with global norms?

World Bank's Engagement with Islamic Finance

- Established the Islamic Finance Working Group in 2009 and has been re-lounched as the Islamic Economics and Finance Working Group (IEFWG) in 2011. The IEFWG adopts a strategy structured around four pillars
  - Capacity building and knowledge management
  - Advocacy to influence policy directions, regulations and standards as well as the development of new products
  - Diagnostic and analytical work on Islamic finance
  - Technical assistance on issues relating to legal, regulatory and institutional frameworks
- The Bank has established close working relations with bodies such as the Islamic Financial Services Board (IFSB), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Development Bank (IDB)
- In addition to activities at the global level, the Bank has been active in providing country-level support for Islamic banking
  - Islamic microfinance in Sudan
  - Investment guarantees by the Multilateral Investment Guarantee Agency (MIGA) to cover Islamic financing structures in Djibouti and Indonesia

Thank you