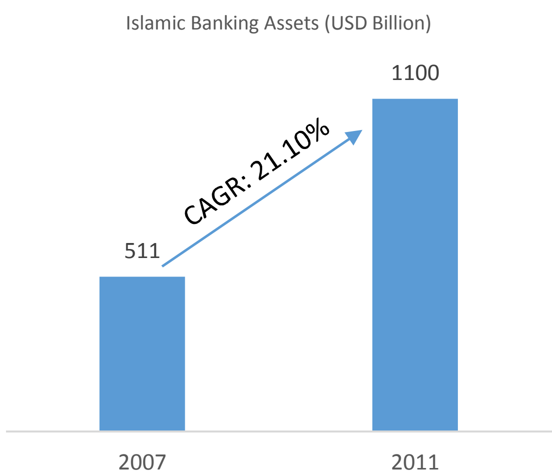
FALAK CONSULTING

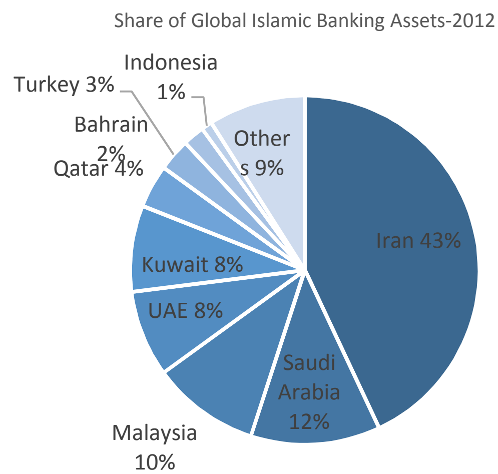
Islamic Banking – A Perspective

Islamic Banking- A Perspective

Overview of Islamic Banking

Islamic Finance has been able to establish itself as an economically viable, sustainable and stable financing model. At its heart, the concept modifies the traditional banking transaction between a buyer and a seller by strictly prohibiting three practices- Riba (Interest), Gharar (Uncertainty) and Maysir (Betting) and developing an alternative transaction model. At the same time, the concept of risk-sharing between the depositor and the bank capital makes it a model that is far more reliant on financing the real economy than other models are. This makes it a safer and an economically relevant model for credit creation. The ability of the financial system to continue to churn out methods of financing under the Islamic Banking principles is key to the growth of the Islamic Banking industry.



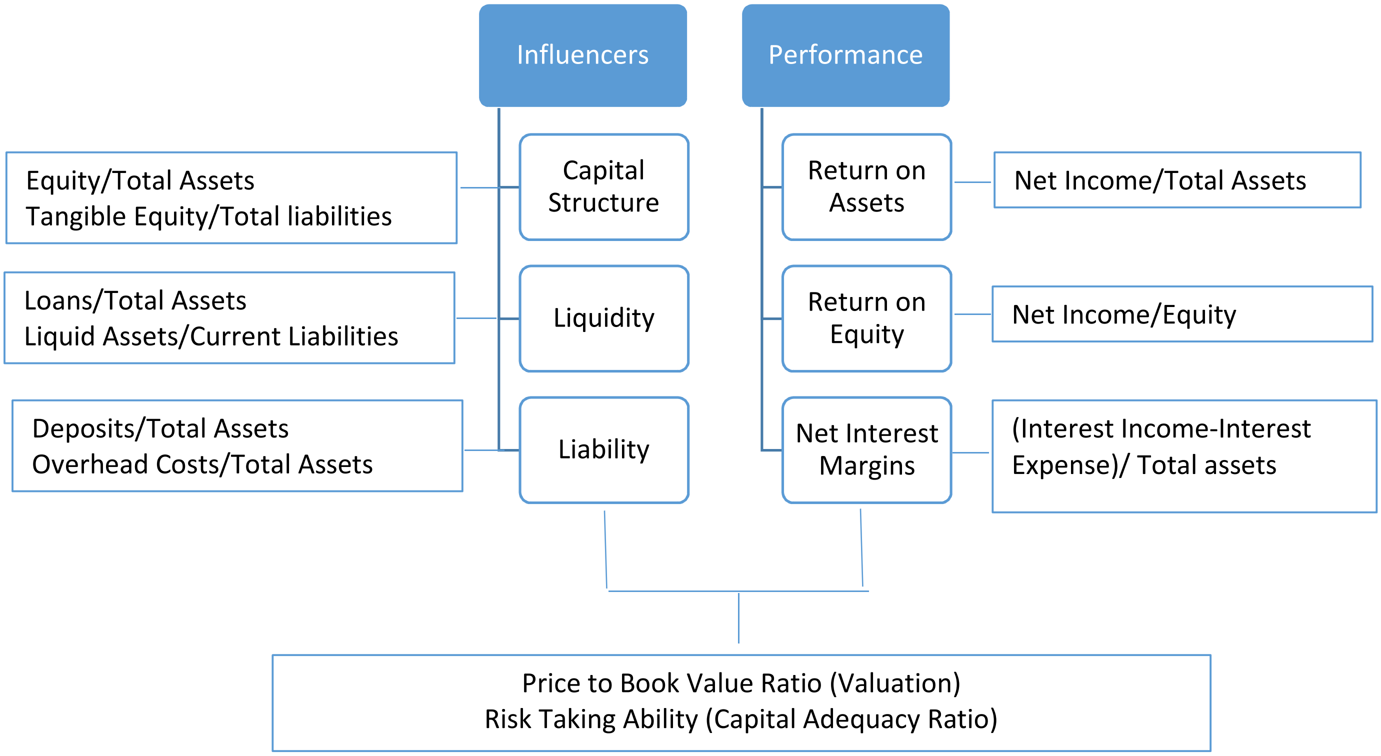


Source: Zawya.com

At present, Islamic banking has become the fastest growing segment in the international financial system. Since its inception, Islamic banking has been the main driving force of the global Islamic finance industry, with an estimated asset size of USD 1.1tln in 2011 representing 80.9% of Islamic finance assets worldwide and 1% of the total banking assets worldwide. Growth is mainly being driven by a fast increasing Muslim youth population, the fast growing halal food industry, lower penetration of Islamic finance products in Muslim dominated nations and government support for new products.

The GCC Islamic banking sector has experienced remarkable growth in the business/ financing activities and significant demand for Sharia-compliant products and services. The growth of the Islamic banking industry in the region was mainly driven by Saudi Arabia and Qatar. Islamic banks in these two countries are generally well capitalized and profitable with high capital adequacy and low NPF ratios. As at September 2012, Islamic banking assets in the GCC and Iran rose by 16.5% y-o-y. Growth was led by Qatar (+25.9%), followed by Saudi Arabia (+22.0%), the UAE (+16.9%), Kuwait (+7.8%) and Bahrain (+5.5%).

Evaluation Framework for an Islamic Bank



The profitability measures, highlighted above as performance metrics, determine the bank's market valuation and its ability to get funded in the deposit and equity markets. Higher returns are both necessary and sufficient for attracting additional deposits. In order for the bank to compete in equity markets, it must sufficiently leverage its capital to ensure high returns on Equity.

Seeking a higher return on assets, especially seen amongst smaller banks, can translate into higher risk on a low capital base, affecting asset quality requiring a higher capital adequacy ratio. Amongst larger banks, the ability to diversify and a higher leverage proportionate to a larger asset portfolio can amplify returns on equity translating into higher return ratios for valuation benchmarks. However, the total return on assets that larger banks can generate on a more diversified portfolio finally determines the NIMs they can generate and thus determine their relative position amongst the peer group to arrive at optimum market valuations.

In the traditional methods of Islamic finance, i.e., the Mudarabah and the Musharakah, Islamic banks act as agents when they accept deposits, and play the role of the principal when they lend on the basis of profit-and-loss-sharing. However, since the Islamic banks offer no fixed returns nor guarantee the nominal values of their deposits, bank managers have less incentives to pursue risk-taking behavior. As financial intermediaries, Islamic banks specialize in evaluating and monitoring their equity-financed ventures to reduce the moral hazard and adverse selection. Equity financing gives them access to information and enables them to guide the course of their borrowers.

PO Box 2241, Manama, Kingdom of Bahrain

Islamic Banks and Conventional Banks: Comparison in the Financial Crisis

It is imperative to see whether the Islamic Finance Model in spite of being lesser exposed to structured products, than the conventional banking models, fared better than their conventional counterparts. Recent studies cited in the International Journal of Finance and Research (2013) compare the performance of Islamic and Conventional Banks during and post the global financial crisis of 2009. This throws light on the performance of both the banking models on key evaluation parameters mentioned above. The essential findings point to the aspect that the performance on the profitability parameters for both the banking models was the same during the financial crisis. Therefore, an evaluation of the Islamic financial model on the key profitability parameters and judging the risk taking ability of the financial institutions is still called for.

However, it is important to note that the lesser exposure of Islamic Banks to speculative transactions stems from the foundations of the model, which make the relationship of the financial transactions with real economic flows of the funds, imperative. This calls for a healthy and transparent growth of the Islamic financial architecture under the evaluation framework mentioned in this article and a call for institutions to ascertain a risk and return model based on the same.

Bibliography

- “Future of Islamic Banking”: Sayyid Tahir
- “Risk and Profitability Measures in Islamic Banks: the Case of Two Sudanese Banks”: Abdel Hameed M. Bashir
- “Impact of Financial Crisis on Profitability of Islamic Banks vs Conventional Banks- Evidence from GCC”: International Journal of Finance and Research (2013)
- Tehran Times: Economy and Business, March 2013

PO Box 2241, Manama, Kingdom of Bahrain

Contact us

Jitender S Shekhawat
Principal Director
T: +973 13355441
M: +973 36419555
F: +973 13355442
E: jitender.s@falakconsulting.com

Ritwik Mohapatra
Director Corporate Finance
T: +973 13355441
M: +973 36161012
F: +973 13355442
E: ritwik.m@falakconsulting.com

Mohammad Usman Baig
Core team leader
T: +973 13355441
M: +973 36737629
F: +973 13355442
E: mohammad.usman@falakconsulting.com

Omkar Halady
Consultant
T: +973 13355441
M: +973 36552050
F: +973 13355442
E: omkar.halady@falakconsulting.com

Visit us at www.falakconsulting.com