

## Economy Downturn, Islamic Banking and the Indirect Consequences of the Global Financial Crisis

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**Abstract:** This paper theoretically reviews at different micro-levels some properties of Islamic banking that might have been negatively affected by economic downturn, namely, at the sector, operations and contract level. The discussion of the Selected Literature argues that while Islamic banking might have remained in a relatively better position compared to the conventional banking during the early phases of the crisis, they were less likely to continue outperforming their counterparts in conventional banking during the sequent economy downturn. This is largely due to their nature of evolving, scale-disadvantage, complex instruments and lax risk-mitigation tools available to them. That is, Islamic banks are exposed to a higher degree of risk, as well as many different and unique types of risk and possess few risk-mitigation tools, which could lead them to be relatively more vulnerable to financial shocks.

**Keywords:** Islamic banking; Global financial crisis (GFC); Gulf Cooperation Council (GCC); Operating performance

**JEL Classification:** G01, G21, G28, Z12

### 1. Introduction

The financial crisis that occurred between 2007 and 2009 did not leave the global economy unscathed, sending many economies from one recession into another. Unsettling economic events have continued since that time, beginning with the great economic difficulties that the crisis caused such as job losses, the loss of the public's trust in the financial sector, and governments with huge deficits. The financial crisis began in the private sector but spread to the public sector, triggering another financial crisis on the other side of the Atlantic, with European governments announcing that they would provide Greece with urgent financial aid to save it from bankruptcy. Shortly thereafter, other Eurozone countries required financial assistance packages, making the remaining members of the Eurozone nervous about their vast budget deficits. This situation is sometimes referred to as the second recession after the first recession of 2008 (Iley and Lewis, 2013) or the "double-dip recession" in some European countries. In March 2015, the European Central Bank (ECB) announced it was launching a €1.1 trillion quantitative-easing programme aimed to counter deflation and stimulate economic growth across the Eurozone.

The troubles in the US are not over yet, as in 2010, the US economy was generating new jobs at a slower pace than planned and recovering more slowly than was expected (Hall, 2011). Moreover, in August 2011, the Standard & Poor's rating agency announced a downgrading of US debt from triple A. However, more recently, in October 2015, the US unemployment rate reached 5%, down from 10% in October 2009 (according to the Federal Reserve Bank of St. Louis). This

drop in the unemployment rate is considered a sign of economic recovery, making the Federal Reserve willing to raise interest rates for the first time since June 2006. However, the Federal Reserve inflation is still well below the 2% target, Japan remains depressed, despite the efforts of the Abe administration, and a wide range of emerging economies are again slowing down (Iley and Lewis, 2013).

Islamic banking does not operate in a vacuum of all of these events because it is part of the global financial system and, therefore, not insulated from it. Despite not being directly exposed to the toxic assets because of following the principles of Islamic finance, which are enforced by multi-dimensional supervisory devices, Islamic banking was also indirectly affected by the financial crisis. Therefore, when the global economy goes into recession, the entire financial system and real economy sectors, including Islamic banks, will likely be affected.

There is a set of questions about Islamic banking that needs to be addressed: does the Islamic banking sector absorb financial shocks differently? What makes the Islamic banking sector different? How long does it take it to recover from financial shocks? Answering these questions is not an easy task. This paper intends to explain how the Islamic banks perform under distress by analysing them at the multi-level. The remainder of this paper is organised as follows: Section 2 discusses sector structure and operations; Section 3 analyses the nature of the underlying contracts offered by Islamic banks, and Section 4 presents the summary and conclusion.

## **2. Evidence from Prior Empirical Studies**

Early empirical studies have dealt with the direct impact of the crisis including but not limited to Beck *et al.*, (2013); Hasan and Dridi (2011); Kassim and Abdulle (2012); Parashar and Venkatesh (2010). Generally speaking, these studies' findings showed some evidence in favour of Islamic banks using several different approaches such as financial ratios, credit risk measures and efficiency models. It can be seen from the results of some selected financial indicators (Figure 1 on the next page) that similar results are found confirming the upper hand of Islamic banking in the early stages of the GFC.

Nevertheless, focusing on later stages of the crisis (Figure 1) namely the period between 2009 and 2011 which shows a sharp decline in the performance of Islamic banks compared to conventional banks based on some financial indicators obtaining from a sample of 100 banks in the GCC area. The later phases of the crisis had not attracted as much attention as the early phases and usually neglected in the literature. Recent studies try to investigate this issue conducting formal analysis such as Alqahtani, *et al.* (2016, 2017); Rosman, *et al.* (2014) among others. They found strong evidence of the negative impact of the indirect exposure of the crisis on Islamic banking. This paper discusses in greater details the theoretical basis of the indirect effect.



**Figure 1.** Difference in performance of Islamic banks compared to conventional banks using four financial indicators<sup>1</sup>

### 3. Sector Structure and Operational Level

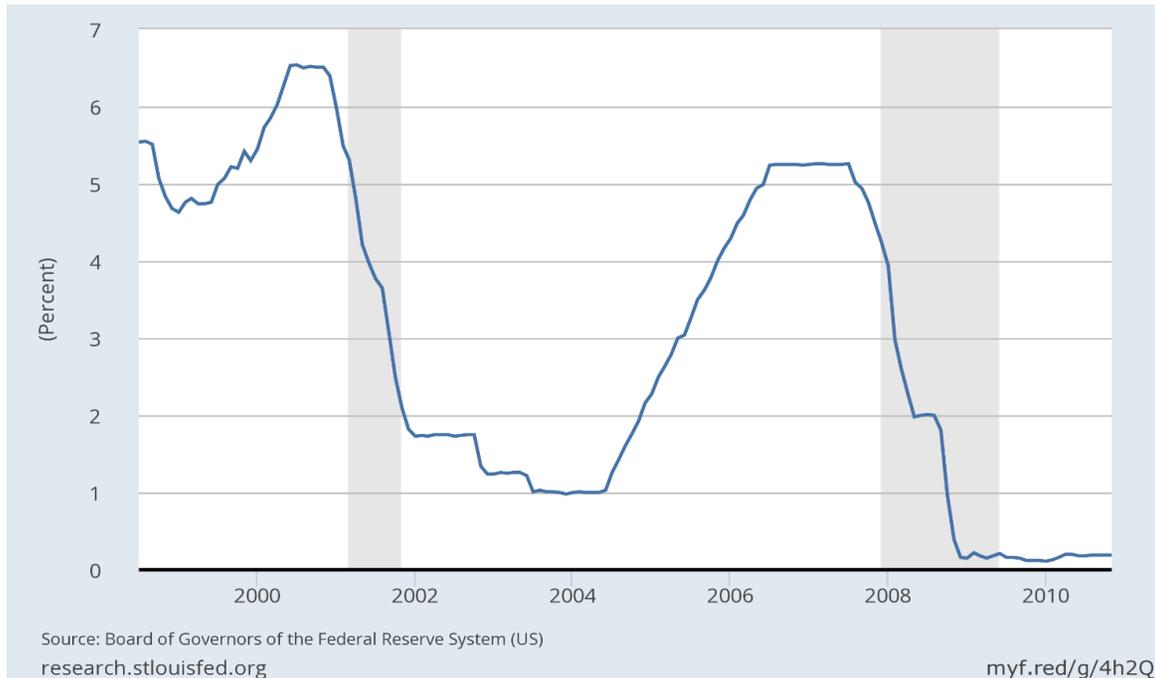
#### 3.1 Evolution of the modern Islamic banking sector

The Islamic financial sector has experienced substantial developments in the new century; these have boosted its size, products and number of institutions. These developments have created substantial funds and existing funds to be re-invested within Islamic countries such as the Gulf Cooperation Council (GCC) states and Malaysia, rather than reinvesting them in Western assets, which was the case for many decades. Simpson (2008), Warde (2012) note some of the developments in the Islamic financial industry, which can be summarised as follows:

- 1) The concerns about political risk played a key role after the terrorist attacks of 9/11, which boosted the fear of Western governments to freeze the assets of many institutional and individual investors of Islamic countries (Simpson, 2008; Warde, 2012). This fact created a perception that Islam as a religion was under attack, which resulted in religious reaction, in turn leading to higher demands for Islamic finance products by Muslim investors. As a result of the growth in demands and of the perception of being under siege, Islamic finance experts and regulators worked more closely than ever to develop new products such as *Sukuk* products and to form some new entities to harmonise and standardise the practice of Islamic banking, for example, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain and the Islamic Finance Services Board (IFSB) in Malaysia (Warde, 2012).
- 2) American and European economies have been less attractive because of the ‘dot com’ collapse, which took place in 2000 (Simpson, 2008).
- 3) Corporate governance failure and agency issues such as occurred with Enron and WorldCom have undermined investors’ confidence in American securities.

<sup>1</sup> In 2006 and 2008, the difference in NPLs ratio was not significant.

- 4) Oil prices have escalated to record levels, which has been yielding substantial revenues to many Middle-Eastern and Muslim economies.
- 5) US interests rates decreased significantly from 2002 to 2004, making the American market less attractive (see Figure 2) (Simpson, 2008).



Source: Board of Governors of the Federal Reserve System (US).

Figure 2. US federal funds rate from 2000 to 2010

As a result of all these developments, the economies of many Islamic countries have escalated and in some cases tripled in size, such as in the case of the GCC region during the period between 2002 and 2008 (Gulf Base, 2013). In relation to this economic boom, the banking industry, especially the Islamic banking industry, has been growing rapidly ever since.

### 3.2 Operational level

#### 3.2.1 Rate of Return

Table 1<sup>2</sup> demonstrates that during the period between 1998 and 2012 the Islamic banking industry of the GGC region grew 20-fold in its total assets compared to 468 per cent growth for the conventional banking sector. It also enhanced the market share of Islamic assets from a marginal level to being almost one-third the size of the conventional sector and one-quarter of the total banking industry. In Malaysia, Islamic banks account for 21.6 percent of the total market share of banking (Lewis, 2013). In Pakistan, the market share of Islamic banks is approximately 10 per cent, and the Pakistani government introduced a plan to increase it to 15 percent by 2018 (Vizcaino, 2014).

<sup>2</sup> The data are sourced from OSIRIS database and all the tables and data in this paper are available upon request from the author.

Previous figures indicate that Islamic banks still constitute a relatively small segment of the banking sectors in which they operate, which might place pressure on them to generate return that conforms to conventional banks (Lewis, 2013). This fact explains their reliance on some widely used conventional benchmarks such as the London Interbank Offered Rate (LIBOR) when they price some of their products, including, but not limited to, *Murabaha* and *Tawarruq* (Ayub, 2009; Khan and Bhatti, 2008). Moreover, the profit margin, which is based on LIBOR is fixed throughout the duration of the contract (Zainol and Kassim, 2012), leading Islamic banks to be exposed to the rate-of-return risk (Zainol and Kassim, 2012), which does not consider their assets' risk profile (Thomson Reuters, 2011) or risks related to sharia compliance (Nethercott, 2012b; Usmani, 2002). In an attempt to establish its own benchmark that best suits the needs of the sector, a new benchmark has been introduced and sponsored by Thomson Reuters, namely, The Islamic Interbank Benchmark Rate (IIBR) using contributions from a panel of 18 leading Islamic banks, which indicates the average expected cost of funding for the Islamic finance industry.

### 3.2.2 Risk Mitigation Tools

Securitisation, which is used to mitigate a variety of risks such as rate-of-return risk and provides liquidity to a financial institution (Zainol and Kassim, 2012), is not an accessible option for Islamic institutions. In principle, securitisation involves grouping together banks' instruments that have similar characteristics to create credit-enhanced claims against the future cash flows generated from this portfolio and sell them to a third party such as other financial institutions or investors (Greenbaum and Thakor, 2007). They have different classes depending on their risk profile and credit rating, for example, a hedge fund may buy the riskiest securities aiming to make a high return. Conversely, a pension fund may purchase relatively safer securities. In the context of Islamic banking, it is permissible for Islamic institutions to securitise some types of their assets where the financial institution has the title of the underlying assets such as in *ijara* and *Musharaka* contracts. In contrast, Islamic banking considers debt-based contracts, such as *Murabaha* and *Tawarruq* contracts, debt selling, which is forbidden under Islamic financial principles. In practice, in most of the markets in which Islamic banks operate, there are no functioning, well-developed and regulated money markets, which makes this option impossible for both types of banks (Jobst, 2007). Moreover, there has been a lack of consensus among Islamic-finance scholars about the degree to which tranching and swaps are permissible (Hanif and Johansen, 2012).

However, the conventional banks still have the advantage, as there are some other options, including the private sale of their loans or buying insurance covers such as credit default swaps (CDS), to avoid the risk exposure of these assets; such options are not available to Islamic banks. Another issue that complicates the operations of Islamic banks is the restrictions on many common tools to manage liquidity risk, such as the interbank market and government securities, due to the fact they all are based on interest<sup>3</sup>. The same is true for other risk-management tools such as options, futures and forward contracts. Such restrictions increase the risk involved in Islamic banks' operations (Sundararajan and Errico, 2002). In an attempt to manage the risk, Islamic banks have no choice but to maintain a relatively large portion of their assets in reserve accounts with the reserve bank, which may negatively affect their probability as result of not making full use of assets they hold.

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<sup>3</sup> Malaysia could be one of the few exceptions as it has developed its own Islamic interbank market (see Ismath Bacha, 2008). The central bank of the United Arab Emirates uses *tawarruq* as a liquidity-management tool in interbank (Nethercott, 2012b).

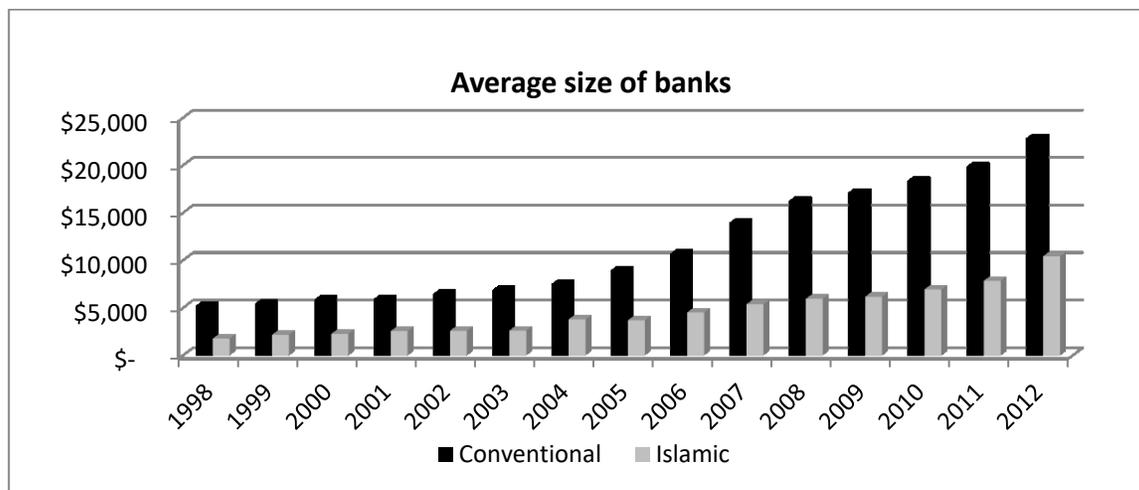
### 3.2.3 Innovative Products

Islamic banks have enjoyed a steady financial growth in the size and range of their new and innovative products, along with financial stability for prolonged periods, which has given Islamic banking its modern shape. The recent crisis has demonstrated that extended periods of financial stability can lead financial institutions to underestimate significant risks, causing innovative products to create unexpected problems (Mayes, 2009). For example, when the East Cameron Partners Gas (ECT) went bankrupt, it was unclear how its *sukuk* and the *sukuk* holders would be dealt with (Hanif and Johansen, 2012). Prolonged financial stability could explain the slow development of risk-management tools in Islamic banks compared with the rapid growth in their size and products.

### 3.2.4 Size Effect

Although there was a dramatic increase in the assets of Islamic finance in the past decade, the average size of Islamic banks remains a great deal smaller than their counterparts in conventional banks. This is demonstrated in Figure 3, which suggest that the increase in assets led to the formation of new Islamic banks, rather than increasing the size of existing banks.

It is widely reported that the size of any enterprise is important, which leads to the consideration of the classic and long-existing concept of ‘economies of scale’. Economy of scale refers to the ‘theory of the relationship between the scale of use of a properly chosen of all productive services and the rate of output of the enterprise’ (Stigler, 1958, p.54). Here attention is paid to the context of the banking sector and the effect of the classical economies of scale, which has been well documented in banking literature (Berger, 2003; Wheelock and Wilson, 2012). Another concept, which is relatively more recent, is that of ‘too big to fail’, which attracts particular attention in the literature treating financial crisis (Bertay, *et al.*, 2013). There are several benefits arising from the scale of operations of financial institutions; these are discussed below.



Source: Author’s calculations

**Figure 3.** Average Total Assets of Conventional and Islamic Banks in the GCC Region from 1998 to 2012 (\$US 1,000)

#### 3.2.4.1 The economies of scale

Diversification of bank portfolios is a crucial tool to mitigate unsystematic risk. That is, if investors form a coalition, they will be able to hold a higher diversified portfolio than an individual investor would have on their own. This implies the portfolio of the coalition is relatively less risky (Greenbaum and Thakor, 2007). According to Diamond and Dybvig (1983), a benefit of large scale is related to the nature of investments and liquidity needs. They suggest that a large number of investors would be able to invest in illiquid securities that are more profitable without facing a serious liquidity risk, as they would have enough liquidity to meet the liquidity needs of their investors.

Another benefit of economies of scale is based on transaction costs, which suggests that if a fixed cost is attached to financial transactions, lenders or borrowers tend to collate together to share the transaction costs. Another argument is based on informational reusability, which Greenbaum and Thakor, (2007) describe as ‘when information is cross-sectionally reusable, the larger the number of information producers in the intermediary, the greater the benefit of information reusability’ (Greenbaum and Thakor, 2007, p.108). Greenbaum and Thakor (2007) interpret this argument as demonstrating that information can frequently be used by a large number of brokers within the financial institution while the cost of producing this information occurs only once. Another point that is related to information is that larger banks can afford to acquire information-processing equipment and software, which smaller banks find too expensive to purchase (Wheelock and Wilson, 2012). In addition, smaller banks are found to acquire such equipment and software after larger banks, which creates another disadvantage for them (Berger, 2003). Based on the these theoretical and empirical benefits, and given the fact that Islamic banks are smaller than conventional banks, it can be assumed that Islamic banks operate in an environment of cost disadvantage and relatively higher risk, as well as being limited to fewer types of contracts, which would have several negative implications during periods of financial crisis and economic downturn.

#### 3.2.4.2 Too big to fail

Recent cases of rescue packages given by central banks to large troubled financial institutions during financial unease, has introduced a new benefit of bank size, namely, ‘too big to fail’, which has virtually become official government policy. This concept means that the economic and political consequences of the failure of a large financial institution would be devastating. For example, in 2008, failures of large financial institutions in Iceland triggered nationwide bankruptcy (Bertay *et al.*, 2013). Given the consequences of the failure of large financial institutions, governments often have no choice but to bail them out. This encourages a moral hazard because large financial institutions may take excessive risks because they know that the government will help them in times of need (Bertay *et al.*, 2013; Mayes, 2009). However, to some extent, when Lehman Brothers went bankrupt, the notion that large banks were too big to fail no longer held true, triggering the threat of a domino effect through the global financial system (Elliott, 2011).

As a result of the concept of too big to fail, there has been a great deal of debate on whether large financial institutions are necessary. For example, in the United Kingdom, the Bank of England has been evaluating the possibility of splitting up large banks to mitigate risks to the British treasury. Similarly, since 2010 in the US, bank mergers that result in a bank with total liabilities exceeding 10 per cent of its consolidated liabilities have been prohibited (Bertay *et al.*, 2013). Others suggest that this concept is outdated, and the banking system should have a means to continue functioning while permitting troubled banks to fail (Mayes, 2009). Another benefit of being an institution that is too big to fail is that the cost of funds is relatively cheaper than for

smaller banks due to government aid (Bertay *et al.*, 2013). For example, in the US, the average cost of funds between large and small banks widened from 29 to 78 basis points after the announcement of the Troubled Asset Relief Program (TARP). Based on the average size of Islamic banks compared to conventional banks (see Figure 2, and Table 2), Islamic banks would be less likely to be saved by their governments. This is because central banks have limited funds to be used for bail-out programmes, which means they tend to help the largest and the most influential players in the economy. Islamic banks are most likely not among the major players; therefore, they are less likely to benefit from such privileges, which in turn makes them more vulnerable to financial distress. It is worth noting that no Islamic institution in any country has had to be bailed out with taxpayers' money (Lewis, 2013).

El Moussawi and Obeid (2011) suggest that small Islamic banks should merge to benefit from economies of scale, which would reduce their costs and in turn enhance their competitive strengths. In 2012, three Islamic Bahraini-based financial institutions, including Capinvest, Elaf Bank and Capital Management House, agreed to merge to create a larger and more competitive entity (Bloomberg, 2012). Similarly, Bahrain Islamic Bank and Al Salam Bank (SALAM) have entered into negotiations for a possible merger (Bloomberg, 2012).

It can be concluded from the discussion on the sector growth that the Islamic banking sector might suffer from size disadvantages, which might disadvantage it during economic collapse following the financial crisis. In addition, extended financial stability might have given Islamic institutions a false sense of security or overconfidence, leading them to underestimate risks associated with their expansion in size and products.

### **3.3 Contract level**

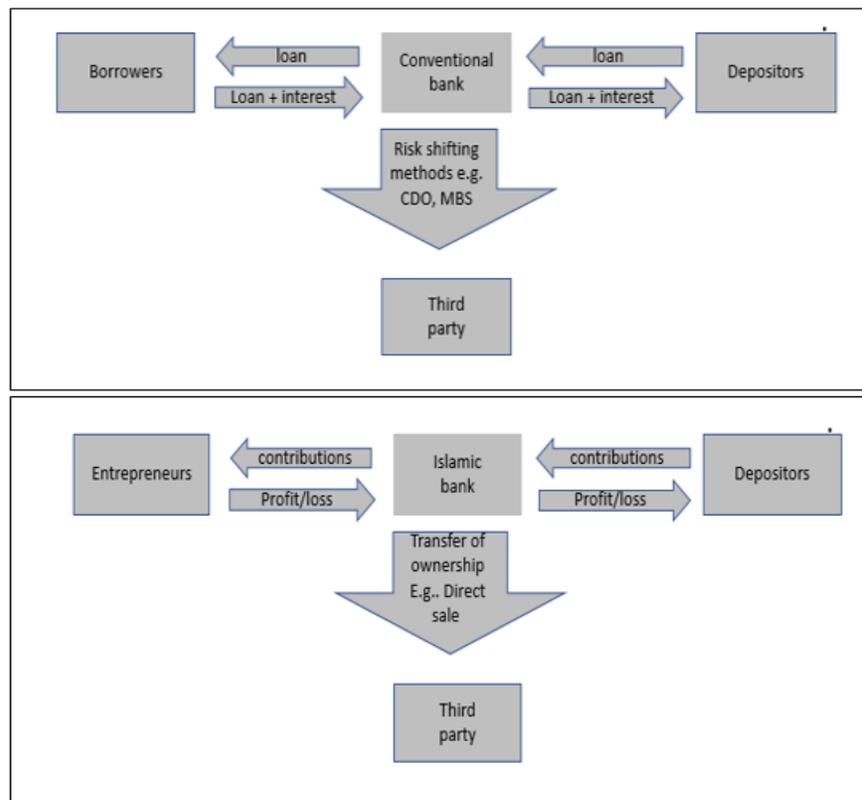
The theory of Islamic finance evolved based on the principles of profit-and-loss sharing. However, it has been derived from these principles and relies on debt-based contracts (Khan, 1996). Despite the fact that Islamic banking has existed for at least the past 40 years, the different types of risks attached to its contracts have not been fully comprehended and consequently, it is not clear how Islamic banks manage these risks (Ahmed, 2009). Each contract has its own nature and risk, ranging from full exposure to any type of risk faced by ordinary ownership, and this is the case with the profit-and-loss-sharing contracts of *musharaka*. Other instruments do not use this concept and use trading or debt-based contracts rather than investment, and therefore, the bank does not share the profit or loss with the buyer of the contract; this is the case with *Murabaha* and *Tawarruq* contracts.

In practice, Islamic banks tend to rely heavily on debt-based modes, which dominate the assets of Islamic banks, rather than profit-and-loss sharing or investment contracts (Aggarwal and Yousef, 2000; Nethercott, 2012b). Most Islamic banks are based in countries with developing economies that suffer from a great degree of information imperfection. This leads to agency problems, as entrepreneurs may use the funds provided by banks for their own benefits, which makes banks biased towards debt-based contracts (Sundararajan and Errico, 2002). Nethercott (2012b) argues that adverse selection explanation can lead banks to focus on debt-based contracts, especially with less knowledgeable borrowers. Another reason is that profit-and-loss-sharing contracts require the financial institution to invest more in managerial expertise to monitor the funded projects, which increases their expenses and consequently the cost of funds (Mirakhor and Zaidi, 2007). Therefore, critical discussion is needed on the underlying modern banking contracts that Islamic banks have to offer to meet the needs of their customers and partners, and to generate economic growth without breaching the principles of Islam. By understanding the nature of these principles, one can come to understand how Islamic banks would perform in a situation of economic turmoil.

### 3.3.1 *Musharaka* (partnership)

The *Musharaka* contract in Islamic banking is the most visible form of a participation contract or profit-and-loss-sharing model, which is simply a form of joint-venture contracts or pure equity (Johansen and Hanif, 2012).

During a period of economic downturn in which the losses are not solely caused by the entrepreneur’s management, all the parties of the transaction, including the depositors, the bank and the entrepreneur, would share the losses according to their stake in the project (IFSB, 2013a). This form of contract mitigates the distress faced by the bank and the losses to its shareholders, unlike with debt in conventional banks where the bank or a third party to which the contract has been shifted bears the entire losses. This type of contract can behave as a buffer to absorb shocks with depositors (partners) during crises, which has some similarity with contingent contracts in conventional banking. In addition to the sharing of profit and loss, *Musharaka* as a genuine joint venture gives the Islamic banks the choice to sell their stake in a project at any time, which is not permissible in other debt-based contracts in Islamic banking (e.g. *Murabaha*) (Abdul-Rahman, 1999). The exit choice can be conducted in several manners such as direct sale, issuing *Sukuk* or through ordinary shares.



**Figure 4.** Basic difference between the *Musharaka* structure and an ordinary bank loan

### 3.3.2 *Mudaraba* (money management)

*Mudaraba* is one of the investment contracts that Islamic banks offer to their clients. Under this contract, the financial institution acts as a money manager for its customers or as an agent for its customers to find other managers who meet the customers’ objectives (Abdul-Rahman, 2009).

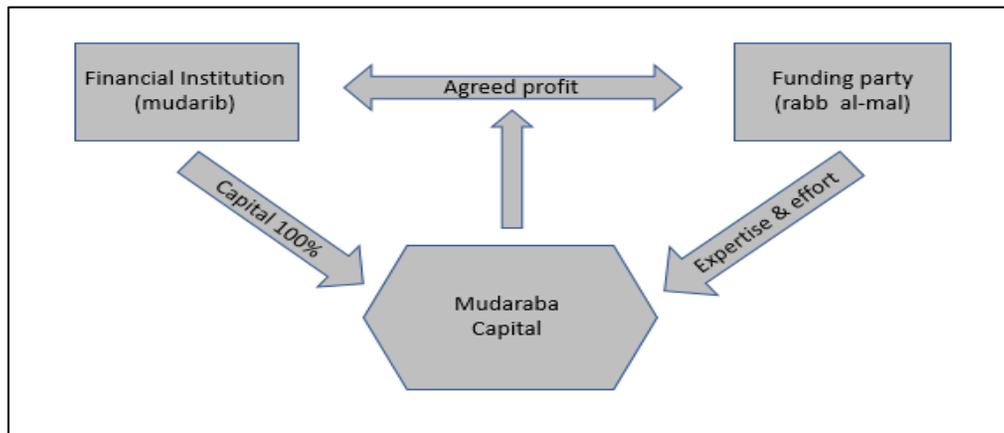


Figure 5. Basic structure of a *mudaraba* contract

In poor economic conditions, the financial institution or the entrepreneur who runs a project, in the case of a two-tier *Mudaraba* in which the financial institution enters into another *Mudaraba* contract with an entrepreneur, the *Mudarib* may lose part of or the entire *Mudaraba* fund. In this event, the fund's owners lose their capital. Although the financial institution is not exposed to any direct financial losses, it is exposed to other forms of losses such as time, effort and probably the loss of reputation as a money manager (Abdul-Rahman, 2009; Johansen and Hanif, 2012). In addition to these losses, there are another cost that the Islamic bank bears which are the opportunity cost of forgoing a possible profit if it devotes its resources such as personnel and time to other investments. Broadly, the manager (*Mudarib*) would bear some or all of the financial losses if there were strong evidence that they mismanaged or breached the *Mudaraba* agreement (Johansen and Hanif, 2012).

### 3.3.3 *Murabaha* (cost-plus or markup)

*Murabaha* is one of the trading contracts offered by Islamic banks and considered the most commonly employed contract in modern Islamic finance due to its flexibility and simplicity of use in practice (Nethercott, 2012b). *Murabaha* is simple because it has deferred sale or credit sale with fixed a cost and a profit margin settled in advance.

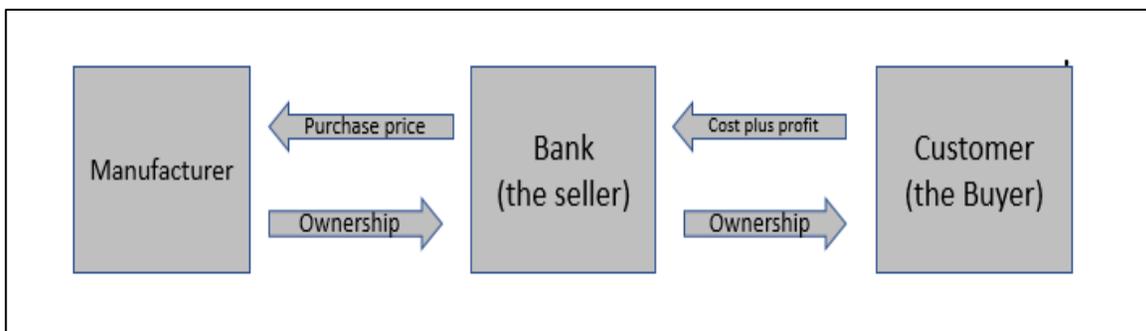


Figure 6. *Murabaha* structure

In this type of contract, the financial institution is exposed to at least two types of risk, including credit risk, as it involves deferred payment, which is similar to risk faced by conventional banks. Islamic banks are exposed to an additional type of risk, ownership risk, which conventional banks do not face (Harvard-SE Workshop, 2009). Ownership occurs, as the Islamic banks must first own the subject matter before selling it to the customer, and this sale is entirely based on a promise

made by the customer to buy the subject matter once it is in the possession of the bank. Until the ownership is transferred to the final buyer, the bank is liable for any damage or loss of the subject matter, which creates a unique risk for Islamic banks. As mentioned above, the transaction is based on a promise from the customer, and the extent to which this promise is enforceable is debatable.

In short, such promises range from those that are a mere promise that is not enforceable (non-binding), to a promise in which the customer may be penalised for any losses as result of breaching their promise (binding). However, it is permissible for the financial institution to take a security deposit (*Hamish jiddiyah*) but it is impermissible to take down payment (IFSB, 2013b). The bank can use this amount to cover the actual losses if the customer does not complete the transaction (which is specifically the difference between the cost of the subject matter and the selling price to a third party) and the bank is allowed to charge the customer for the loss of profit margin or opportunity (AAOIFI, 2010). Another manner in which to manage such risks is to appoint the customer to act on behalf of the bank to purchase the assets and then transfer the title to the customer on the completion of the transaction (Lewis, 2013). In an environment of economic downturn in which some many customers are likely to breach their promises, Islamic financial institutions might find it extremely difficult to liquidate or to find buyers for the subject matter immediately, or they may offer such subject matter at a great discount, exceeding the initial security deposits, which would place a liquidity pressure on the Islamic bank or cause capital losses.

#### 3.3.4 *Tawarruq* (monetisation)

Monetisation or *Tawarruq* is simply an additional phase of *Murabaha*, which is discussed above. It aims to liquidate the subject matter, which in the case of organised *Tawarruq* involves liquidating a commodity such as aluminium. Organised *Tawarruq* refers to a situation in which the Islamic financial institution acts as the seller and also as an agent acting on behalf of the buyer to buy and sell the subject matter and provide the buyer (*Mustawriq*) with the cash proceedings (Al-Suwailem, 2009). *Tawarruq* has been heavily criticised by Islamic-finance scholars and in some cases prohibited, as they believe it imitates ordinary bank loans, and all the trading processes are used solely to circumvent the prohibition of exchanging money for money with different amounts, which is exactly the same as conventional bank loans (Harvard-SE Workshop, 2007).

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Al-Suwailem (2009) takes a comprehensive view of *Tawarruq* and reverse *Tawarruq*, stating that if 'organized *Tawarruq* is a source of cash for the customer, then reverse *Tawarruq* becomes a source of cash for the bank itself. Cash financing (cash for cash) has become the base for the activities of many Islamic banks, in both assets and liabilities. This spells the end of the role of Islamic banks, which used to be based on real activities on both sides' (p.40).

Siddiqi (1983), a highly respected Islamic-finance scholar, adopts a macroeconomic view, arguing that *Tawarruq* shifts the economy from the asset market towards the debt market. He also argues that debt leads to gambling like speculation and greater instability in the economy and concludes that the effect of *Tawarruq* on the economy is far more harmful than beneficial (Harvard-SE Workshop, 2007). Even though this contract is asset based, it is not backed by tangible assets as

with most of other contracts in Islamic banking. This makes it riskier because there are no assets to cover losses, or at least part of losses, in the event of default. Overall, it can be seen that such products are not based on real economic activity and can be understood in the context of conventional banks' lending and borrowing transactions (Harvard-SE Workshop, 2009, Harvard-SE Workshop, 2007). There is no profit-and-loss sharing in this contract, which implies that the bank will bear the entirety of the credit risk and loss. In the case of a crisis in which many lenders (buyers) fail to pay their loans, the bank would be obliged to pay the depositors in full.

The expansion of debt-based contracts could lead Islamic banks to face a great deal of credit risk given that in principle, they are not permitted to shift risk to a third party such as is done when entering into CDS contracts. Unlike the investment contracts, securitisation is not an option, as these contracts are considered as debt-based contracts and in Islam, debt selling is prohibited, which might lead Islamic banks to face liquidity risk (Ahmed, 2009). *Tawarruq* creates an additional and unique type of risk, reputation risk, which Qattan (2006) states is a result of a lack of consensus and agreement on this type of contract, which can trigger bank failure. Similarly, Siddiqi (1983) suggests that debt-based contracts should be avoided or at least used restrictively, as they believe that such contracts can be used as a 'back door' to *riba* (interest). In Islamic law, no profit can be generated without being exposed to the risk associated with the transaction. Based on this, from the conventional banking perspective, not shifting the risk (or at least some of the risk) can lead to substantial losses in an economic downturn. Therefore, Islamic banks would suffer.

### 3.3.5 *Ijara* (usufruct lease contract)

*Ijara* is one of the contracts of usufruct (*manfa'a*) that Islamic banks offer to their customers. *Ijara* refers to giving something on rent (Usmani, 2002; Nethercott, 2012a), which is similar to a conventional lease where an Islamic bank (the lessor) leases the asset to a client (the lessee) for pre-scheduled periodic lease payments for a specified period. Similar to *Musharaka* contracts, The Islamic Institute remains the titleholder of the underlying assets of *Ijara*. Therefore, *Ijara* is permissible, and there are no restrictions on shifting the risk of such contracts to a third party by means of a direct sale or securitisation (*Sukuk*) (Ahmed, 2009), which transfers all risks attached to *Ijara* including default, ownership and market risk. However, as *Ijara* principally focuses on property funding, when a property market crashes, such as in the case of the subprime crisis of 2008, the Islamic financial institutions face a significant level of default because of job losses and because lessees believe they are paying too much for the lease as the market value of the property falls sharply. As a result of such a crash, financial institutions, including Islamic and conventional banks would find it extremely difficult to liquidate *ijara* property assets in a timely manner and at a value that covers the initial investment. This was the case in Dubai and Qatar during the financial crisis and the subsequent economy downturn. In such a situation, financial institutions are exposed to liquidity risk and might face liquidity shortage if their exposure to the property market is significantly high as in real estate. An example of this occurred in Dubai, which faced severe financial troubles in 2009 and requested a restructuring of 26 billion dollars of debt, of which 4 billion were in *Ijara Sukuk* (Salah, 2010). This event, termed the 'Dubai Debt Crisis', caused all financiers to be directly exposed and led all GCC markets into panic. However, the neighbouring oil-based state of Abu Dhabi decided to grant Dubai 10 billion dollars to repay some of its debts, which is believed to have stabilised the entire region's financial sector because most of the financial institutions were highly exposed to this crisis (Salah, 2010).

### 3.3.6 *Sukuk* (Islamic bonds)

*Sukuk* is defined by AAOIFI as 'certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular

projects or special investment activity’ (p.307). *Sukuk* plays a significant role in the development of Islamic finance and is sometimes described as the ‘Hollywood star of Islamic finance’ (Wouters, 2010). There are a variety of risks involved with *Sukuk*, for example, risks associated with the modes of *Sukuk*, asset structures and risk associated with the market. *Sukuk* faces all risk related to types of contracts such as *Musharaka*, *Mudaraba* or *ijara*. There are two principal asset structures in *Sukuk*, the asset-backed and asset-based structures (Hanif and Johansen, 2012; Khnifer, 2010b) and a less common structure, the hybrid structure, which can be converted into equity in the originator’s company or exchanged with the equity of a third party (Wouters, 2010). Asset-backed implies that the asset’s title is transferred (true sale) to a special purpose vehicle (SPV) and the *sukuk* holders are only exposed to risks associated with the assets (McMillen, 2008). Consequently, the *sukuk* holders are isolated from risks associated with the originator, which makes it ‘bankruptcy remote’ (IFSB, 2013b). Conversely, under the asset-based *Sukuk*, the originator keeps the title of the underlying assets and not the *Sukuk* holders, which implies that they would be directly exposed to the originator’s financial distress, for example, the originator’s bankruptcy risk, customers’ credit risk, as well as its operational risk (McMillen, 2008). Another type of risk of *Sukuk* is a sharia-compliance risk because there has been a lack of consensus among Islamic-finance scholars on the permissibility of many types of *Sukuk* (Usmani, 2007). Finally, the availability of a liquid secondary market remains a problematic issue in Islamic finance. The *sukuk* market was the most devastated segment of Islamic finance during the global financial crisis. According to Khnifer (2010a), in 2009 alone, there were 15 *Sukuk* default cases, which placed individual investors, as well as institutional investors and those involved with them, in serious financial distress.

#### 4. Summary and Conclusion

In this paper, I discuss some properties of Islamic banking that may have negatively impacted by economic downturn including sector, operations, and contract levels. The discussion of the literature argues that although Islamic banking might have stayed in a relatively better condition in comparison to its peers of conventional banking during the early stages of the GFC, Islamic banks were unlikely to keep their superior performance compared to their peers of conventional banking during the later stages of the GFC namely, the economy downturn. This is mainly owing to their nature of development, scale-disadvantage, instruments complexity and lax risk-management techniques available to them. That is, Islamic banks are exposed to a greater level of risk, as well as many different and unique kinds of risk and have few risk- management techniques, which may possibly lead them to be relatively more sensitive to financial shocks.

This indirect effect suggests that if Islamic banks had been relying on PLS rather than debt-based instruments, they would have been more resilient to financial shocks from the subsequent downturn in the real economy because losses would have been shared among all parties.

More empirical research should be conducted to evaluate the performance of Islamic banks compared with the conventional banks during relatively longer period than current studies tend to investigate. There should be research to discover at what stage Islamic banks were affected, as well as how long they needed to recover from the recession compared to their counterparts in conventional banks. Such research requires consideration of all the factors that might explain the differences in performance to ensure the empirical result is useful. This would offer an understanding of how the Islamic banking sector functions during financial crises and what economic and policy decisions should be considered to inject stability into this fast-growing industry.

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