

Unconventional Banking System in Distress

Wassim Rajhi (Corresponding author)

L.E.A.D. (Laboratoire d'économie appliqué au développement)

University du Sud Toulon Var

B.P. 20 132 - 83 957 La Garde Cedex Toulon, France

E-mail: wass78@yahoo.fr

Slim Ahmed Hassairi

CERGAM, IMPGT (The institute of Management and local Governance)

Paul Cézanne University Aix-Marseille III, 21, Rue Gaston de Saporta, 13100 Aix- en-Provence, France

E-mail: slim.hassairi@univ-cezanne.fr

Received: February 8, 2011

Accepted: February 22, 2011

doi:10.5539/ijef.v3n4p70

Abstract

With the proliferation of banking sector problems around the world, in the last few years the empirical literature on systemic banking crises has grown significantly. This literature has frequently focused attention on the factors connected with the onset of conventional banking distress, in order to identify the determinants of the crises or to look for “early warning indicators” of difficulty. In fact a number of studies have relied on factors determining bank failures related to conventional rather than Islamic information. A lack of study and comprehension therefore has been a major challenge. Regrettably Islamic banking still remains enigmatic. The central aim of this paper is to elucidate the sense of Islamic banking distress and expose collapse. This study contributes to this ongoing debate over the Banking Distress of Islamic bank with the following distinct features. First, we pay attention to size and the factors determining bank failures for the unconventional. Second, we try to identify some cases of banks facing these problems. As mentioned below banks face difficulties in the present-day environment, and Islamic banks are no exception. Given all these constraints, it would be necessary to adopt measures to avoid collapse which will be treated in the last part.

Keywords: Bank distress, Islamic banking crisis

JEL classification: G01, G21, G32, G33

Introduction

It seems that every ten to twelve years an international financial crisis erupts. The East Asia crisis erupted in 1997 hitting Thailand and spreading to many countries of the region and beyond. Following each crisis ten years are spent to assess and analyze what happened and live the consequences of the measures taken to contain the crisis. Reforms are pursued with the aim to avoid a repeat episode of distress. In the meantime, the next crisis is already in the making and soon it erupts where radar screens had not anticipated it. Unlike previous crises, the 2007-08 crisis erupted in the world's financial center and rapidly spread to its periphery with devastating effects. Thus the cycle of boom and bust resumes merrily, while humanity suffers great financial losses, grief and sufferings. But efforts to stabilize the system, or at least to limit the most damaging effects of its volatility cannot be abandoned, if not for the sake of maintaining growth, at least for limiting the human dramas that are the natural corollary of financial crises. The risk of a systemic crisis affecting Islamic Financial Services (IFS) and the way to cope with it if it occurs gains relevance in the wake of the 2008 worldwide financial tsunami that spread from the United States to the rest of the world. (Note 1) The international financial crisis naturally prompts the question of whether IFS are robust and resilient or may be swept into crisis by a global wave and if so through what channels. A corollary is whether relevant public authorities and market participants have tools at their disposal to deal with a systemic crisis affecting IFS. Conventional banking units in the Middle East are estimated to be exposed to sub-prime related assets in the order of as much as US\$1bn. Four regional banks have suffered from the fallout. Bahrain based Bank of Bahrain & Kuwait has announced write-downs of US\$62m. Abu Dhabi Commercial Bank has made provisions of US\$152m of bad debt, while the Arab Banking Corporation (ABC) reported that it had taken a hit of US\$230m. In the largest write-down in the region, Gulf International Bank (GIB) declared US\$757.3m net loss in 2007. (Note 2) Gulf

Bank's problems do not directly threaten to undermine the banking system in Kuwait. The losses, estimated at up to 200 million Kuwaiti dinars led to a run on the bank as customers scrambled to withdraw their cash. However, this amount is small compared to the bank's equity. The bank lost money when clients used currency derivatives to bet against the dollar's value, but suffered huge losses when the dollar strengthened. In contrast to their conventional counterparts, Islamic banks have been shielded from the direct impact of the US mortgage crisis mainly because sub-prime-linked debt spread through securities that would not comply with Sharia law. (Note 3) However the ensuing economic downturn, in particular its effects on the real estate sector are bound to impact their performance.

This paper considers channels through which the world financial crisis would affect IFS, their features that may help contain it and those that may foster post crisis recovery. The paper identifies channels of potential spill-over effects from conventional to Islamic finance and across Islamic banks. The focus is on systemic crisis and not on idiosyncratic distress in a single institution offering Islamic financial services (IIFS) without risk of contamination of other financial services.

The first section highlights the size of Islamic finance and its core features relevant for assessing its ability to absorb shocks. It also deals with the potential for contagion that may make a specific shock develop into a systemic crisis. A second section reviews the systemic crisis experienced by Turkey's special finance houses (SFH) at the beginning of the 2000s decade. It provides insights from an episode of distress and contagion affecting Islamic finance. The third section contrasts instruments available to policy makers and market participants to contain a liquidity crisis and deal with distressed institutions in the case of conventional and Islamic finance. The conclusion summarizes the vulnerability of Islamic finance to a systemic crisis and provides recommendation for an increased robustness and resilience of IFS.

Islamic Finance: Size, Features and Contagion Risks

Islamic finance has a significant presence in the financial landscape of a number of countries. Iran, Bahrain, Malaysia, and Sudan have been at the forefront of its development. The following highlights its geographical presence and size. It then overviews IFS main features and points out risks that may lead to contagion across the sector.

2.1 International Presence of Islamic Finance

While Islamic finance dates back to the early days of Islam, it has experienced a new life, since the early nineteen seventies and a tremendous explosion since the beginning of this new millennium. That explosion is manifest in the spectacular growth of the number and size of institutions offering Islamic financial services (IIFS), their geographical spread across numerous countries, the diversity of their activities, and the growing body and quality of regulations attending to the sector. The following presents estimates of the worldwide presence of Islamic finance, and then summarizes its essential features.

A significant presence in the financial landscape, Islamic finance should be considered on the basis of facts and analysis and not ideology. IFS pledge to respect a code of behavior based on values. The code's principles are enshrined in the contracts and product offerings. It happens to use the word "Islamic" as an umbrella qualification of its observance of the code. Possibly for that reason, in the current international context, it gathers champions and advocates, attracts many who see in it merely a business opportunity; it raises open as well as silent, sometimes vehement opposition; it often leaves many puzzled on its nature and value added. This leads to unnecessary mystification and often poorly based judgments on a financial markets' reality, the opportunities it offers and risks associated with its practice. (Note 4) A definite view on the size of Islamic finance is still difficult to reach. IIFS vary in their financial reporting, limiting the scope for aggregation. Efforts are being made by CIBAFI, the IsDB, AAOIFI, the IFSB and others to organize the systematic recording and collection of data on Islamic finance. However these efforts have not yet led to the development of a reliable set of information produced periodically to provide a comprehensive overview of the industry and track its development. (Note 5)

Notwithstanding the information collection challenge, modern Islamic finance has expanded since the middle of the 1970s at a rapid pace. Based on CIBAFI's Islamic finance directory and other sources, a joint effort of the IsDB, IRTI and IFSB offers the most comprehensive estimates of worldwide Islamic financial assets for 2005. This work puts the size of Islamic financial assets at more than \$500 billion in 2005. (Note 6) In addition more than \$300 billion of stocks of Sharia observant companies may have been traded on world bourses that same year. Observed growth in the sukuks market, investment and commercial banking activity have definitely expanded the assets managed by Islamic financial services. Though caution with the numbers is due, it is a best effort estimate and gives a reference point to the worldwide size of the industry. Assets under management are reported to have grown at annual rates ranging between 10% and 15% over the last decade. (Note 7) Many international banks provide Islamic finance services that are Sharia-compliant; they include Citibank, Hong Kong Shanghai Banking Corporation

(HSBC), Goldman Sachs, BNP-Paribas and Union Bank of Switzerland (UBS). (Note 8) The Institute of Islamic Banking and Insurance (IIBI) reckons there were 277 Islamic banks and financial institutions operating in over 70 countries in 2005. (Note 9) Beginning in the 1990s, the primary growth area and focus of Islamic banking were in the Gulf Cooperation Council (GCC) and South East Asia with Bahrain and Malaysia taking leading roles. (Note 10)

While the sector is rapidly growing with an increased number of participants, the share of Islamic banks in banking assets has expanded less in most jurisdictions. Islamic banking assets are almost a quarter and more than half of the banking assets in Kuwait and Yemen respectively. With three fully fledged Islamic banks, Islamic windows and the ongoing conversions, Saudi Arabia is likely to have a significant and growing share of its market with IIFS. The share is increasing in other markets but shows stability in Bahrain, an early starter. In Jordan, the Jordan Islamic Bank's share of the market would exceed 6.3%. There are reports that Islamic finance may have a 5% market share in Egypt. (Note 11) In Malaysia it is steadily expanding. It is also taking an increasing share of financial markets in Brunei, Indonesia and Pakistan.

2.2 Overview of Islamic Finance Features

At the core, IFS endeavor to have fair contracts, mitigate the risks of speculation and avoid hubris of human behavior. They are ethical finance with a defined source of ethics. While the devil is in the details and there are obviously differences across scholars, Islamic financial services may be seen as grounded in five basic principles: a) prohibition of riba; (Note 12) b) risk-sharing—the terms of financial transactions need to reflect a symmetrical risk/return distribution each party to the transaction may face; c) materiality—a financial transaction needs to have a “material finality”, that is, it is directly or indirectly linked to a real economic transaction; (Note 13) d) no exploitation—a financial transaction should not lead to the exploitation of any party to the transaction; (Note 14) and e) no financing of activities deemed to be harmful to society, such as the production of alcoholic beverages. Financial intermediation consistent with these five principles would be consistent with the pledged code of conduct. Islamic finance has developed on the basis of the foregoing principles. They have led Islamic banks to adopt the type of balance sheet stylized in (Box 1). The risk sharing is essentially enshrined in the use of the mudaraba contract. It is a contract between an owner of financial resources and someone who takes charge of managing them on behalf of the owner for a fee and a share of profit. This type of contract is extensively used in deposit taking where the bank is the manager of the resources and the depositor, the owner. It is also used in extending financing by the bank to an economic agent or entrepreneur with the bank taking this time the role of owner and the entrepreneur that of resource manager.

Under the profit-and-loss sharing (PLS) paradigm, asset-liability management (ALM) may be considered to be built in by construction. Assets and liabilities positions of Islamic banks are incorporated in the sense that borrowers share profits and losses with the banks, which in turn share profits and losses with the depositors. Adherents to Islamic banking, thus, argue that Islamic banking is better suited than conventional one theoretically to absorb external shocks because banks' financing losses are partially absorbed by depositors (Khan and Mirakhor, 1989), (Iqbal 1997). Also, the risk sharing feature of the PLS paradigm, in theory, allows Islamic banks to finance long-term projects with higher risk-return profiles and, thus, to promote economic growth (Chapra, 1992), (Mills and Presley, 1999). Moreover, the PLS paradigm, guarantees a greater market discipline. Finally, the PLS concept leads to a more efficient allocation of capital because its profitability depends on the productivity and viability of the project (Khan, 1986).

Mudaraba based investment account deposits may enable an IIFS to increase the rate of return on equity without incurring extra risk, under certain assumptions. (Note 15) A larger investment account deposit base enables an IIFS to increase market value while maintaining unchanged its weighted average cost of funding. Indeed, it does not entail a larger financial risk nor does it increase the probability of bankruptcy due to their underlying risk-sharing nature. Accordingly, shareholders would not be seeking higher rates of return, thus increasing the IIFS' cost of capital. Moreover, a larger investment account deposit base should not entail a higher capital requirement and accordingly raise the weighted cost of funds of the Islamic bank. Extending financing with a mudaraba compounds a bank's “credit risk”. For understandable risk management reasons, mudaraba is not an IIFS' preferred contract for funding risk bearing assets. Under that type of contract the bank, “owner” of the funds does not intervene in the management of the funded project. The bank has no legal means to control the agent-entrepreneur who manages the business. The latter has complete freedom to run the project according to his best judgment. The agent-entrepreneur commits to share profits according to the PLS share prescribed in the contract. A default on the part of the agent-entrepreneur is recognized when the contract expires, barring proven negligence or mismanagement. In fact, a “default” of PLS contracts means that the investment project failed to deliver what was expected, entailing lower or no profit, or a loss. In a mudaraba contract, the bank is entitled to receive from the entrepreneur the principal of the

sum it “invested” at the end of the period stipulated in the contract, if and only if, profits have accrued. If, on the contrary, the enterprise’s books showed a loss, the bank would not be able to recover its investment.

Musharaka contracts provide a better opportunity than mudaraba to monitor and control projects funded by the Islamic bank. Indeed, in a musharaka, the bank becomes an active shareholder of the project and all partners may concur to the management of the enterprise and hold direct voting rights. However, musharaka contracts are not extensively used by Islamic banks because of their generally longer maturity and the weak institutional infrastructure that limits conventional equity financing development in many jurisdictions where Islamic finance is present.

The materiality principle leads to the financing by the bank of a real economic transaction for the account of the economic agent needing the financing. Materiality is intrinsic to the ijara or leasing contracts as well as to the murabaha. The latter is essentially trade finance where the financier purchases the needed commodity for the account of the financed that takes spot delivery, and pays back with a mark up the financier at a later date. The prohibition of riba excludes the payment of interest to the amana depositor, basically a demand depositor who needs the guarantee of his principal and foregoes remuneration for that. The mudaraba depositor on the contrary, faces the opportunity of a return but also the risk of a loss. (Note 16) Amana deposits’ face value is guaranteed. They are redeemable on demand. An Islamic bank needs to anticipate withdrawals and manage the associated liquidity risk. The challenge is the ability of the bank to place surplus liquidity and to access market liquidity when needed. The challenge is compounded with a credit risk to the extent the Islamic bank pools demand and investment deposits to fund risk-bearing assets. In case the regulator does not mandate specific reserve requirements specific to demand and possibly investment deposits, variations in the portfolio of assets will affect net worth and bear on solvency. The no exploitation includes also the idea of no excessive risk taking, or risk taking in the nature of gambling. It also covers issues of asymmetric information as benefiting from non shared information entails an unfair contract and consequently exploitation. The prohibition of financing of harmful activities is self explanatory. In principle, the combination of risk-sharing and prohibition of riba, entails profit and loss sharing arrangements and a balance sheet structure as in (Box 1). It should limit the impact of external shocks on Islamic banks. Indeed, IIFS’ balance sheet incorporates an intrinsic hedge in principle as a loss of asset value would translate in change of value of the pool of resources that funded it, generally mostly investment accounts and not equity. Islamic banks pool depositors’ funds in providing them with professional investment management with associated returns and risks. Neither the face value of investment deposits nor their return is guaranteed. Investment depositors share in the bank’s net profit (or loss) according to the PLS ratio stipulated in their contracts. From the perspective of investment account holders, Islamic banks behave like mutual funds with a variable net asset value. In addition, investment deposits can be withdrawn only on maturity.

A stylized balance sheet (table 2) features the dominance of investments accounts (UIA) on the “liability” side and dominance of non-PLS investments on the asset side such as liquid assets, and ijara, or murabaha. (Note 17) Islamic banks do not use much mudaraba and musharaka contracts on the assets’ side, but rather non-PLS investments. Murabaha appears to be a dominant mode of extending financing across IIFS. It appears also to be gaining in importance. The average share of Islamic financing and investing assets (Murabaha, Ijara, Istisna) in the total balance sheet of selected banks ranged between 44 % and 52 %, between 2006 and 2008. Mudaraba and musharaka contracts ranged between 4 % and 11% during the same period. A stylized balance sheet features also the dominance of investments accounts (UIA) on the “liability” side. The share of unrestricted investment accounts in the total balance sheet of selected banks averaged about 50% over 2006 to 2008, within the 44 % to 71 % range. Current and other accounts’ share ranged between 16 and 18 % of the total balance sheet. The foregoing stylized balance sheet structure is not neutral for IIFS’ stability and performance. (Muljawan, Dar, and Hall, 2004) argue that IIFS’ fiduciary role can be enhanced by requiring them to adopt prudential rules regarding their asset-liability structure, including the maintenance of an adequate financial cushion. (Note 18) They point out that the excessive use of PLS contracts on the assets side can jeopardize the sustainability of banking operations without a sufficient equity-based capital. Examining the impact of IIFS deposit mobilization on their performance, (Shubber and Alzafiri, 2008) explore four assumptions namely: a) independence of the WACC from the level of deposits; b) a larger size of deposits does not entail higher financial risk; c) a larger deposit size entails higher earnings per share, and c) a large deposit size increases a bank’s market value. The authors use 1993 to 1996-1998 data, for four institutions, and consider correlations between the costs of equity, deposits and the WACC. (Note 19) The data appears to support the four assumptions. The correlation coefficient between market capitalization and size of deposits ranged between .72 for DIB and .88 for QIB with an average of .83. Accordingly, the authors conclude that a larger deposit base increases market value without affecting financial stability. (Beng Soon Chong and Ming-Hua Liu, 2009) show

in a study on Malaysia that only a negligible portion of Islamic bank financing is strictly PLS based and that Islamic deposits are not interest-free, but are closely pegged to conventional deposits.

2.3 Financial Risks and Contagion

In most jurisdictions, Islamic and conventional banks operate side by side. Both types of institutions mobilize financial resources and intermediate them to fund economic activities. It can be expected that both types of institutions are susceptible to shocks. For example one can imagine a failure of a conventional bank that induces a crisis of confidence that spreads to other banks conventional or Islamic or to the entire financial system. One can also imagine a macroeconomic failure in the form of unsustainable fiscal or current account deficits that hits the whole economy and shocks both Islamic and conventional banks. The combination of macroeconomic imbalances and idiosyncratic stress affected Ihlas Finans House in Turkey and spread to the country's IIFS in the early 2000s. (Note 20)

However, it is legitimate to ask whether the effects of shocks hitting conventional or Islamic banks would spill over to the other group or remain circumscribed. A related question is the degree of vulnerability and resilience of the two groups of banks. These two questions stem from the premise that Islamic and conventional banks have different features even if they are essentially engaged in the same type of business. The following reviews various types of risks financial institutions face and whether IIFS' features mitigate those risks or compound them. The section then overviews spill over risks across conventional and Islamic financial institutions. The basic outcome is that spillover risks are essentially idiosyncratic to each category of banks. However, spillovers can occur across these two groups of banks through effects on the broader economy. If a particular shock distresses profoundly one category of banks affecting their markets to the point of depressing the whole economy, then the other category of banks would be affected. Given the relative size of the two types of banking groups, one would expect that spillovers may be more pronounced from the conventional to the Islamic banks. However the latter's modes of operation when risk sharing and materiality of transactions are prevalent can be expected to mitigate the impact.

Conventional and Islamic financial institutions do face credit, market and operational risks. Each type can be at the origin of a shock that may remain circumscribed to one institution, spill over within one group or across them.

Credit risk is the risk of loss due to a debtor's non-payment of a loan or other line of credit. (Fatemi and Fooladi, 2006) argue that it arises principally from uncertainty in a given counterparty's ability to meet its obligations. Increasing variety in the types of counterparties (from individuals to sovereign governments) and forms of obligations (from auto loans to complex derivatives transactions) means that credit risk management is at the forefront of risk management challenges facing financial services firms. Important factors determining credit risk assessments include: i) rating of the counter-parties; ii) nature of the legal and judicial system; iii) quality of collateral; iv) maturity of credit facility; v) size of banking and trading books; vi) use of credit derivatives, and vii) internal control systems. IIFS and conventional financial institutions address the foregoing factors in conducting business, extending financing and assessing their own vulnerability to adverse events.

(Chapra and Khan, 2000) argue that IIFS face other risks arising from their inability to reschedule debts on the basis of a higher mark-up rate, or differences of opinion among fiqh schools, or also the dearth of Sharia compliant hedging instruments notably credit derivatives. Sharia forbids debt rescheduling with increased mark-up rates. This prohibition may represent an incentive to debtors to be lax in meeting debt service obligations, increasing financial institutions credit risk. However, the asset-based nature of Islamic finance transactions mitigates the risks by providing banks an ownership title to marketable collateral. (Note 21) Differences of opinion among Sharia scholars create another risk specific to IIFS. Some scholars consider the murabaha contract binding only for the seller, but not for the buyer. (Note 22) Others consider it binding on both parties, and most Islamic banks function on this basis. But the OIC Fiqh Academy believes that the party which defaults has the overall responsibility for the compensation of any losses to the wronged party. In another example of differences of opinions, some scholars have challenged the compliance of ijara ending in ownership, a type of transaction implemented by most Islamic institutions. This difference of opinion raises the degree of risk in the ijara contract. Finally, non-Sharia compliance of most hedging instruments and notably credit derivatives limits IIFS access to effective methods of credit risk mitigation.

In addition to the foregoing, Islamic financial instruments incorporate specific credit risk features. The salam contract may face a counter-party risk associated with a failure to supply on time, or at all, and failing to supply the agreed upon quality or quantity. When an Islamic bank participates in an istisna contract, it functions as supplier, manufacturer, constructor, and builder. As none of these roles are the bank's normal business, subcontractors must be used. Thus the bank is exposed to two-way counter-party risk. The risk of default of the customer is one of these, but there is also the risk of the sub-contractors failing to carry out their duties effectively and on time.

IIFS face indirectly market risk, through notably the mark-up price of deferred sale and lease-based transactions. Market risk may result in losses in on and off-balance sheet positions arising from movements in market prices. These would include volatility of market rates or prices such as profit rates, foreign exchange rates and equity prices. A typical loss would be a decrease in the value of an investment due to changes in market factors. (Note 23) The fact that IIFS operate under the principles of risk sharing and free-interest and compliance with Sharia principles does not remove market risk. Islamic banks often benchmark the pricing of their instruments to LIBOR. Thus, a change in LIBOR affects an IIFS income statement in the same way it does with a conventional bank depending on the share of the balance sheet linked to the benchmark. An increase in the LIBOR LIBOR leads to an increase in the mark-up charged on new transactions and expected returns by investment account holders, compared to the earnings from the banks' long-term investments. Furthermore, IIFS' balance sheets are exposed indirectly to variations of rates of return linked to LIBOR. The value of assets such as a deferred sale and lease transaction will vary with the wedge between the price at which they were issued and market changes in the benchmark. (Note 24)

Basel II and national regulators have shown increasing concern with operational risks. The Basel Committee defines operational risk as "the risk of loss resulting from the inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk". In addition, "legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements". (Note 25) Operational risk in IIFS would include Sharia non-compliance. (Note 26) One particular feature is that an IIFS may conduct business that is later considered as non Sharia-compliant. In this case the IIFS will have to forego the income earned. In addition, if this becomes a frequent occurrence, the IIFS would incur a reputational damage that would undermine its franchise as a Sharia compliant financial institution. Moreover the PLS modes of operation may be intrinsically more complex to run compounding operational risk. (Note 27)

Islamic Finance Distress Episodes and the Case of Turkey's Special Finance Houses

The probability of failure is related to the ability of a bank's capital to absorb losses. Regulations on portfolio composition are more effective in reducing failure risks, when they take into account their effect on overall return and its variance as well as covariance of expected returns from various assets. This section reviews cases of distress in Islamic banks then turns to the distress episode experienced by Turkey's SFH in the early 2000s.

3.1 Cases of Distress with Islamic Banks

There have been episodes of Islamic banks distress. They include the closing of Bank Taqwa in 2001 on grounds of AML/CFT; Faisal Islamic Bank closed its operations in the United Kingdom for regulatory reasons; the Kuwait Finance House engulfment in the Souk al Manakh crash (1986-87); the liquidation of the International Islamic Bank of Denmark due to excessive financing exposure to a single client (1986); and the failure of the Islamic Money Management Companies in Egypt (1988-89) for engaging in Ponzi like schemes. The Islamic Bank of South Africa (IBSA) failed in November 1997 with debts between R50 million and R70 million and went under registrar of banks curatorship. (Note 28) It has emerged that bad management and improper accounting and management systems caused the bank to fail. A large amount of insider unsecured lending had taken place which has resulted in a large proportion of Non-Performing Assets (NPA) in the balance sheet. (Note 29)

Dubai Islamic Bank experienced a fraud believed to be worth almost US\$300 million leading to its partial ownership by the state in 1998. The fraud caused a run on deposits, endangering the bank's stability forcing the government to underwrite the losses and take a 30% stake in the bank. A number of high-profile persons were detained in Dubai as part of a fraud investigation, though the precise circumstances were not disclosed.

Bank Islam Malaysia, a Sharia-compliant financial institution had incurred losses of RM457 million (US\$120.2 million at that time) in the year ending June 30, 2005, associated to a RM774 million provision against bad loans and investments. (Note 30) Most of these had been incurred by the bank's Labuan branch, which had only been converted from a subsidiary to a branch the previous December. The bank had a gross non-performing loan portfolio of around RM2.2 billion. (Note 31) Bank Negara Malaysia became involved, allowing suitors (initially Bahrain's Unicorn Bank and then Malaysia's own Commerce Tijari Bank) to open talks about taking stakes in the bank. Bank Negara also set up a special purpose vehicle with Bank Islam Malaysia to manage and restructure the debt and loan portfolio, ring-fencing RM1.6 billion, with the remainder, comprised mainly of Islamic home financing loans staying on the bank's books. By October 2006, a recapitalization had been completed. Bank Islam issued 845 million new shares for a cash injection of RM1.01 billion. In all, 40% of the bank, or 690 million shares, went to Dubai Financial, part of the Dubai Investment Group, for RM828.2 million. Another chunk, worth 9%, went to Lembaga Tabung Haji, a fund designed to help Malaysian Muslims with their pilgrimages. Bank Islam returned to profitability in 2007/2008 financial year. (Note 32)

3.2 The Case of Turkey's Special Finance Houses

Turkey's banking and financial crisis of 2000-2001 provides a context to consider the stability of the country's Islamic banking sector in a dual system. It presents an episode where stresses on the liquidity of the largest Islamic bank in conjunction with a broader economic crisis propagated to other IIFS. The experience provides an opportunity to identify channels and factors that can contribute to the propagation of financial distress in time of crisis. (Note 33)

Turkey's Special Finans Houses (SFH) offered Sharia-compliant financial services based on a decree of December 1983 on the "Establishment of Special Financial Houses". The SFH were Sharia-compliant financial institutions in which costs of borrowing and returns to financing are based on risk participation, rather than interest payments. In Turkey's dual banking system Islamic banks were competing with conventional banks that charge and offer interest. However, SFH were not covered by deposit insurance and accordingly were less susceptible to moral-hazard problems that may occur in the presence of insurance than their conventional counterparts. For the most part, they adopted conservative conduct in their approach to risk. SFH held 90% of their assets in short-term facilities (typically four to five months in duration) provided notably to small and medium-size companies. This sort of financing was extended in the form of murabaha. (Kuran, 1995) points out that the concentration of lending in this low-risk form implies that returns, if not guaranteed, are highly predictable. (Note 34) SFH also offered financial leasing and full or partial funding for long term business projects, in the form of mudaraba and musharaka participations. Following the general practice in mudaraba contracts, SFH kept 20% of the income perceived from their financing activities and distributed 80% to accountholders. While the SFH sector had been growing consistently, it constituted a tiny sliver of the banking sector, holding less than 3% of its total deposits, as of 2000. (Note 35)

Although SFHs were initially governed by a separate regulatory framework from that applying to conventional banks, the 1999 bank law brought them under the same regulatory umbrella. They were required to meet the same minimum capitalization as conventional banks, the same required reserve ratios, and the same liquidity ratios. SFH had similar reporting requirements to the central bank as commercial banks, notably on foreign-currency positions. However, SFH were not covered by deposit insurance, with the rationale that profit-and-loss accounts involved no guarantee of return of principal to be Sharia compliant. Also unlike commercial banks, a failed SFH would not be transferred to the Saving Deposit Insurance Fund for reconciliation. The SFH could engage in all commercial banking activities, as well as leasing and commodity trading. However, in compliance with Sharia, they could not take deposits and take loans in ways that involved payment or receipt of interest. Their main source of funds was profit-and-loss participation accounts. (Note 36)

Ihlas Finance House (IFH) was Turkey's largest SFH with close to 38% of the total deposits collected by the six SFH at the end of 2000. (Note 37) The decision to liquidate IFH was taken in February 2001 following a run on deposits amounting to US\$ 270 million out of a total deposit base of US\$1.17 billion. Liquidation procedures started on August of the same year. IFH's revealed how poor corporate governance can lead to crisis in an institution and that can become contagious and propagate to other IIFS whose challenges are compounded by the difficulty of managing liquidity in the absence of Sharia-compliant money markets. Lack of decisive early action against failing banks on the part of the regulators also contributed to compounding the problems. IFH had been a well-regarded market leader but was liquidated by the Turkish Banking Regulation and Supervision Agency (TBRSA) because it had illegally appropriated almost \$1 billion through connected lending to shareholders, virtually the entire value of the deposit base. When the bank was liquidated, the misappropriation of funds was so large that the bank was unable to pay back its 220,000 deposit accounts. (Note 38) Thus IFH became insolvent following irregular use of funds that have hindered its ability to cope with a run on deposits triggered by the general macro-financial crisis, and a loss of confidence and compounded by the lack of short term interbank Islamic financial facilities and instruments. (Note 39) IFH difficulties induced runs on other SFH, resulting in a sizable loss of deposits in the sector. (Note 40) Assets of all SFHs declined 63% in 2001; the assets of the five remaining houses fell by more than one-third (table 3). Many depositors sought to withdraw their funds before maturity, and initially the SFHs accommodated such requests. But as the runs continued, some had to restrict early withdrawals. On February 21, 2001, the SFH published advertisements in newspapers announcing their intention to set up a private insurance fund to cover deposits, with government approval but not financial support. However, it is unclear that this measure had any effect in stemming the outflow of deposits.

(Starr and Yilmaz, 2007) delve into depositors' behavior during bank runs. (Note 41) They find that both informational and self fulfilling types of dynamics were at work. (Note 42) The authors interpret their findings as consistent with (Chen, 1999)'s argument that there are both first-come-first-served and informational elements involved in bank runs. They argue that, while there were valid reasons for depositors to be concerned about the

safety of their funds, their sense of urgency about getting their money out of the SFH was out of proportion with the risk, and is best interpreted as prompt reaction to noisy bad news that escalated into a panic. Increased withdrawals by moderate-size accountholders tended to boost withdrawals by smaller counterparts, suggesting that the latter viewed the behavior of the former as informative with respect to the SFH's financial condition. However, the opposite appeared also true with increased withdrawals by smaller accountholders inducing withdrawals by moderate-size accountholders, and the latter spilling over to withdrawals by large accountholders, effects consistent with concerns about self-fulfilling elements of runs. This suggests a role of deposit insurance to mitigate inefficient aspects of runs. As much as overly generous deposit insurance may contribute excessive risk-taking by banks some amount of insurance may be important for ruling out risks of inefficient runs, by reducing uninformed depositors' incentives to rush to withdraw in periods of macro-financial uncertainty. (Note 43)

Conclusion

This paper is an effort for analyzing and underlining the reasons behind such financial distress and its effects on Islamic banking. Its perhaps first academic and systematic attempt to study these factors and bring lessons for all stakeholders. For this a case study of Ihlal Finance House (IFH) in Turkey is considered due to easier access to its information. Although, the conclusions drawn are quite generalizable but not all of them can be applicable to all Islamic financial institutions. Since, it's a single case study. IFS are not more prone to distress and crisis than conventional financial services. Most banking failures are precipitated by liquidity shortages though their troubles may have been building up earlier. The case of Ihlal Finans in Turkey reflects a sequence of poor management decisions, including non prudent intra group financing, and poor crisis management strategy that made the institution vulnerable to shocks. When the latter occurred with the macroeconomic crisis and the subsequent rush on deposits, IFH could not meet demands on its deposits. Its problems spilled over to other SFH and created distress in the sector. The contagion could not be contained due to the shallowness of inter-SFH money markets and the dearth of instruments to inject liquidity in the system. IFH's distress points to the need of ensuring a highly professional management with effective information system to allow both higher management and supervisors to monitor developments in an institutional risk profile. Regulatory and supervisory capability of IIFS needs strengthening. This entails the ability of regulators and supervisors to fully understand Islamic finance operations, and the allowance for a regulatory regime that is adapted to their risk profile without creating distortions. It is not sound to let IIFS operate in a regulatory twilight zone. It is not either sound for the regulator and the market to lack the necessary information to monitor each institution and the sector as a whole. The progress made to date to develop money markets accessible to IIFS is commendable, it is not sufficient, however. Licensing IIFS in dual financial systems entails a public authority responsibility linked to the authorities' accountability for the conduct of monetary policy and systemic liquidity management. Licensing an IIFS entails acknowledging the responsibility of being able to manage a system that includes IIFS. This is feasible and possible, but the issue needs to be addressed directly. In a crisis monetary policy and systemic liquidity management will be at the forefront of the stabilization efforts.

List of Abbreviations

AAOIFI: Accounting and Auditing Organization for Islamic Financial Institutions
BCBS: Basel Committee on Banking Supervision/ **BFR:** Base Financing Rate/ **BHD:** Bahrain Dinar
BIB: Bahrain Islamic Bank/ **BIS:** Bank for International Settlements/ **BNM:** Bank Negara Malaysia
CAH: Current Account Holders/ **CAR:** Capital Adequacy Ratios/ **CB:** Central Bank
CBB: Central Bank of Bahrain/ **CFS:** Conventional Financial Services
CIBAFI: General Council of Islamic Banks and Financial Institutions/ **DIB:** Dubai Islamic Bank
EPS: Earnings per Share/ **FAS:** Financial Accounting Standards/ **FSA:** Financial Services Authority
GAMC: Government Asset Management Corporation/ **GCC:** Gulf Cooperation Council
IFH: Ihlal Finance House/ **IIFS:** Institution Offering Islamic Financial Services
IFRS: International Financial Reporting and Accounting Standards
IFSB: Islamic Financial Services Board/ **IIFM:** International Islamic Financial Market
IIMM: Islamic Inter-Bank Money Market/ **IIRA:** International Islamic Rating Agency
IsDB: Islamic Development Bank/ **IOSCO:** The International Organization of Securities Commissions
LIBOR: London Inter-bank Offer Rate/ **LMC:** Liquidity Management Center
LOLR: Lender of Last-Resort/ **MII:** Mudaraba Inter-Bank Investment

PLS: Profit and Loss Sharing/ **PSIA:** Profit Sharing Investment Accounts

PSR: Profit-Sharing Ratio/ **QIB:** Qatar Islamic Bank/ **RIA:** Restricted Investment Account

SAMA: Saudi Arabia Monetary Authority/ **SFH:** Special Finans House/ **SSB:** Sharia Supervisory Board

TBRSA: Turkish Banking Regulation and Supervision Agency/ **UIA:** Unrestricted Investment Account

USD: US Dollar/ **WACC:** Weighted Average Cost of Capital

References

Al-Deehani, T. R, Karim, A. & Murinde, A. (1999). The capital structure of Islamic banks under the contractual obligation of profit sharing. *International Journal of Theoretical and Applied Finance*, 2, n° 3, 243-283. doi:10.1142/S0219024999000157, <http://dx.doi.org/10.1142/S0219024999000157>

Chapra, M. U. (1992) *Islam and the Economic Challenge*. Leicester (Eds.). The Islamic Foundation.

Chapra, U. & Khan T. (2000). Regulation and Supervision of Islamic Banks. *Occasional Paper*, no 3

Chen, Y. (1999). Banking Panics: The Role of the First-Come, First-Served Rule and Information Externalities. *Journal of Political Economy*, 107, n° 5, 946-968. doi:10.1086/250086, <http://dx.doi.org/10.1086/250086>

Čihák, M. and Heiko, H. (2008). Islamic Banks and Financial Stability: An Empirical Analysis. *IMF Working Paper*, n° WP/08/16.

El-Hawary, D. Grais, W. and Iqbal, Z. (February 2006). Diversity in the regulation of Islamic Financial Institutions. *The Quarterly Review of Economics and Finance*, 46, no 5, 778-800. doi:10.1016/j.qref.2006.08.010, <http://dx.doi.org/10.1016/j.qref.2006.08.010>

Fatemi, A. and Fooladi, I. (2006). Credit Risk Management: A Survey of Practices. *Managerial Finance*, 32, no 3, 227-233. doi:10.1108/03074350610646735, <http://dx.doi.org/10.1108/03074350610646735>

Grais, W. and Pellegrini M. (2006). Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services. *World Bank Policy Research Working Paper*, n° 4054

Khan, M. S. and Mirakhor, A. (1989). The Framework and Practice of Islamic Banking. *Journal of Islamic Banking and Finance*, 6, no 1, 22-32

Mills, P. and Presley, J. (1999). *Islamic Finance: Theory and Practice*. London: Macmillan Press Ltd. doi:10.1057/9780230288478, <http://dx.doi.org/10.1057/9780230288478>

Molyneux, P. and Iqbal, M. (2005). *Banking and Financial System in the Arab World*. New York: Palgrave Macmillan.

Okeahalam, C. (1998). The Political Economy of Bank Failure and Supervision in the Republic of South Africa. *African Association of Political Science*, 3, no 2, 29-48

Shubber, K. and Alzafiri, E. (2008). Cost of capital of Islamic banking institutions: an empirical study of a special case. *International Journal of Islamic and Middle Eastern Finance and Management*, 1, 10-19. doi:10.1108/17538390810864223, <http://dx.doi.org/10.1108/17538390810864223>

Starr, Martha, A. and Yilmaz, R. (2007). Bank Runs in Emerging-Market Economies: Evidence from Turkey's Special Finans Houses. *Southern Economic Journal*, 73, no 4, 1112-1132

Sundararajan, V. and Errico, L. (2002). Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead. *IMF Working Paper*, no 02/192

Notes

Note 1. Throughout the paper Islamic Financial Services (IFS) is used to refer to essentially Islamic Banking. The more general IFS expression is used as Islamic banks provide also non-bank financial services and cannot be considered to fall in a category such as conventional commercial banks.

Note 2. Zawya, Middle East Business Information, 05/03/2008, "Islamic banks are sub-prime winners". <http://cm3.zawya.com/marketing.cfm?zp&p=/Story.cfm/sidEIU20080401223346006>.

Note 3. Islamic finance scholars prohibit the trading of debt (*Bai al-dayn*) at market value or negotiated value, but allow it only at face value.

Note 4. The constitutions of Iran, Pakistan, and Sudan prescribe that the entire banking industry should follow Islamic principles.

Note 5. The conclusion of such efforts and attempts at harmonizing financial reporting are critical and should be a priority.

Note 6. Islamic Financial Services Industry Development, Ten-Year Framework and Strategies, Islamic Research & Training Institute Islamic Development Bank, Islamic Financial Services Board; Islamic Research and Training Institute.

Note 7. If the same rates are sustained, the industry's size could exceed US\$ 2 tn by 2015.

Note 8. See notably (Sundararajan and Errico, 2002) for an early account.

Note 9. Institute of Islamic Banking and Insurance (2008), <http://www.islamic-banking.com>

Note 10. (Molyneux et Iqbal 2005) estimate that Islamic banks in the GCC region held about 74% of Islamic banking system assets in 2002.

Note 11. August 10, 2007 news reported by IFIS, Islamic Finance Information Service.

Note 12. This term literally means an increase or addition and is recognized in Islamic jurisprudence to encompass both the notions of usury and interest. Any risk-free or "guaranteed" rate of return on a loan or investment is considered riba and therefore prohibited by Islam.

Note 13. Materiality need not be a one to one tight correspondence between the real economic transaction and the financial one.

Note 14. No exploitation entails no information asymmetry between the parties to the contract and requires full disclosure of information.

Note 15. (Al-Deehani, Karim and Murinde, 1999). Of course the result assumes the absence of a guarantee of the investment accounts face value.

Note 16. The prohibition of payment and receipt of a fixed or predetermined rate of interest is replaced by profit and loss sharing (PLS) arrangements where the rate of return on financial assets held in banks is not known and not fixed prior to the undertaking of the transaction. The actual rate of return can be determined on the basis of actual profits accrued from real sector activities that are made possible through the productive use of financial assets.

Note 17. A precise picture is not always easy to obtain because of the reporting made where some banks include restricted investment accounts into their liabilities while others do not. The stylized balance sheet is inspired from that of Al Baraka Banking Group and Bahrain Islamic Bank B.S.C.

Note 18. To enhance the capacity of a bank to maintain its solvency when facing temporary financial shocks a requirement for a minimum level of net-worth has been adopted. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) released a statement on the purpose and calculation of the capital adequacy ratio for Islamic banks. Like the Basel standards, the AAOIFI standard requires the CAR to be at least 8%.

Note 19. Kuwait Finance House (KFH); Dubai Islamic Bank (DIB); Qatar Islamic Bank (QIB); Bahrain Islamic Bank (BIB).

Note 20. See next section.

Note 21. In this way Islamic banking may be compared to collateral-based mortgages, which have less risk in comparison to commercial loans and are, therefore, given a lower risk-weight of 50% whereas the latter are given 100%.

Note 22. They include the OIC Fiqh Academy.

Note 23. Equity price risk arises from fluctuations in equity indices and prices. The non-trading equity price risk exposure arises from the Bank's investment portfolio. Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. The Bank takes an exposure to the effect of fluctuation in prevailing foreign currency exchange rates on its financial position. Commodity risk refers to the uncertainties of future market values and of the size of the future income, caused by the fluctuation in the prices of commodities. (Quémard and Golitin, 2005) argue that most conventional bank failures and banking problems historically have been attributable to poorly managed exposures to market risk.

Note 24. In PLS modes, the rate of return on financial assets is unknown or pre-fixed to undertaking the transaction. In purchase-resale transactions, a mark-up is determined based on a benchmark rate of return, typically LIBOR.

Note 25. Operational risk factors incorporate: mismanagement, Inadequate staffing, Malfunctions in information processing systems. Weak control systems, fraud and catastrophic events. Basel Committee on Banking Supervision, 2005.

Note 26. See (El-Hawary, Grais. And Iqbal, 2006); (Grais and Pellegrini, 2006).

Note 27. (Čihák and Hesse, 2008).

Note 28. (Okeahalam, 1998).

Note 29. The Reserve Bank has agreed to compensate the investors up to a maximum of R50 000 per depositor. This covers 80% of depositors since the primary depositor base of IBSA is small depositors.

Note 30. (Asiamoney, 2008). Islamic Finance: Why Islamic banks must offer a cushion against collapse, 09589309, Sep, Vol. 19, Issue 8.

Note 31. The precise reasons for these losses have, in some people's eyes, never been adequately explained, yet they threatened the bank's future.

Note 32. The bank delivered a net profit of RM253.68 million (US\$78 million) in the first nine months of its 2007/08 financial year.

Note 33. As in many emerging-market banking crises, the runs on the SFHs occurred during a period of macroeconomic and financial crisis. In 1999, Turkey had embarked on a stabilization program supported by the International Monetary Fund (IMF) that was intended to bring inflation down using a crawling exchange-rate peg, while reducing fiscal imbalances through privatization. However, by late 2000, continued heavy government borrowing created doubts about whether the peg could be sustained, the central bank ran down \$7 billion of its reserves to support the lira, and the crisis abated only when a \$10 billion loan was arranged with the IMF, the pressure on it became so severe that government had to let the lira float. It immediately depreciated by 30%.

Note 34. Indeed (Kuran, 1995, p. 162), among others, argues that Murabaha financing does not effectively involve risk-sharing and so should instead be seen as a "cumbersome form of interest." See (Starr and Yilmaz, 2007).

Note 35. As of 31.12.2000, 2.65% of the total deposits of the banks displaying activity in Turkey was collected by the Special Finance Houses see <http://www.ifk.com.tr/detay.asp?ContentID=754&lang=eng>.

Note 36. Profit-and-loss accounts represent 90-95 % of the value of SFH' deposits; these are also called Unrestricted Investment Accounts (UIA). The remaining 5-10% is "special current accounts", which are demand deposits that pay no return.

Note 37. Ihlas Finans in Liquidation, <http://www.ifk.com.tr/detay.asp?ContentID=754&lang=eng>

Note 38. Starr and Yilmaz, 2007).

Note 39. In 2000, ten banks had failed, eight of them state owned. They were transferred for liquidation or re floatation to Saving Deposit Investment Fund (SDIF).

Note 40. The category "loans" for the Special Finans Houses (SFH) includes certain commodity-related transactions in which SFHs place part of their liquid assets with foreign banks in special arrangements. For example. Citibank-England owns stock in London Metal Exchange Market; SFH buy these stocks from Citibank, then immediately sell them back on deferred payment terms. This enables the SFH to earn a safe, fixed, short-term return from commodity buying and selling.

Note 41. They analyzed detailed data on withdrawals from a financially strong SFH.

Note 42. The authors investigated how depositors of different sizes reacted to each other's withdrawals, using a vector autoregressive (VAR) framework. The framework allowed them to distinguish between informational and self-fulfilling elements of runs. Data cover the 48 business days of the run, starting on February 12, 2001, and ending on April 25.

Note 43. This implies a possibility that some level of partial insurance enough to cover average depositors, but not so generous to cause moral hazard problems could contribute positively to bank stability in emerging-market economies.

Table 1. Ten Largest MENA Commercial Islamic Banks' Assets and Equity – 2008

Bank Name	Country	Assets (\$ Billions)	Equity (\$ Millions)	Equity/Asset (%)
Al Rajhi Bank	Saudi Arabia	43.9	7208.4	16.4
Kuwait Finance House	Kuwait	38.2	5793.4	15.2
Dubai Islamic Bank	UAE	23.1	2430.3	10.5
Abu Dhabi Islamic Bank	UAE	13.9	1534.8	11.0
Al Baraka Banking Group	Bahrain	10.9	1550.1	15.5
Qatar Islamic Bank	Qatar	9.2	2024.4	22.0
Bank Al Jazira	Saudi Arabia	7.3	1263.4	17.2
Emirates Islamic Bank	UAE	7.1	455.8	6.3
Sharjah Islamic Bank	UAE	4.2	1132.5	26.8
Shamil Bank	Bahrain	2.8	404.0	14.0

Source: Bankscope website and annual reports

Table 2. Stylized Balance Sheet

ASSETS	2006	2007	2008
Cash and balances with central Bank, banks and other financial institutions	0.34	0.23	0.18
Balances from Financing receivables (Murabaha, Ijara, Istisna)	0.44	0.47	0.52
Mudaraba, Musharaka and Wakala Financing	0.04	0.11	0.11
Investment	0.15	0.16	0.15
Ijarah Muntahia Bittamleek	0.005	0.005	0.01
Property Furniture and Equipment	0.005	0.005	0.01
Other assets	0.02	0.02	0.02
TOTAL ASSETS	1.00	1.00	1.00
LIABILITIES			
Customer Current and Other Accounts	0.16	0.18	0.18
Due to banks and financial institutions	0.04	0.04	0.10
Other liabilities	0.02	0.02	0.03
Unrestricted Investment Accounts	0.50	0.50	0.50
Shareholders' Equity			
Share Capital	0.17	0.12	0.08
Share Premium	0.01	0.01	0.01
Reserves	0.07	0.08	0.05
Cumulative changes in fair values	0.005	0.01	0.01
Foreign currency translations	0.005	0.01	0.01
Retained Earnings	0.01	0.01	0.01
Proposed Appropriations, cash Dividend and bonus shares	0.005	0.01	0.01
Non-controlling interest	0.005	0.01	0.01
Total Shareholders' Equity			
TOTAL LIABILITIES AND EQUITY	1.00	1.00	1.00
OFF-BALANCE SHEET			
Assets under Management	-	0.17	0.06
Commitments and Contingent Liabilities	0.12	0.17	0.23
Restricted Investment Accounts	-	0.03	0.01

Source: Annual report of Al Baraka Banking Group; Bahrain Islamic Bank B.S.C; Masraf Al Rayan (Q.S.C.); Qatar Islamic Bank; Qatar International Islamic Bank; Shamil Islamic Bank; Emirates Islamic Bank; Dubai Islamic Bank and authors' calculations.

Table 3. Percent Decline in Deposits at the Special Finans Houses, December 31, 2000 to June 30, 2001

Special Finans Houses	Percentage Decline
Al Baraka Turkish Finance House	42.1
Family Finance House	29.4
Kuwait Turkish Evkaf Finance House	22.3
Anadolu Finance House	55.0
Ihlas Finance House	100.0
Asya Finance House	34.2
Total Special Finans Houses	63.0
Total excluding Ihlas	36.4

Source: (Martha A. Starr and Rasim Yilmaz, 2007). Bank Runs in Emerging-Market Economies: Evidence from Turkey's Special Finans Houses. *Southern Economic Journal*, 73(4), 1112-1132