

## IMF on Islamic Banks: Build Skyscrapers, Not the *Titanic*

By Paul Wouters

Bankers try to make profits. For their clients as well as for themselves. Such is the mantra of financial institutions; and for that matter, is usual for all kinds of business.

Despite the unparalleled growth of Islamic banks, the question of whether they will be able to withstand future economic upheaval continues to be debated. After seeing how the bubble burst for conventional finance following the US subprime crisis, it pays to evaluate the situation.

Some organizations try to address the question from a statistical perspective on financial stability, governance, sustainability, risk management etc. Although such reports are sometimes deemed impractical as they fail to address daily problems and experiences, they can provide insights that we may have overlooked as we tackle our day-to-day activities.

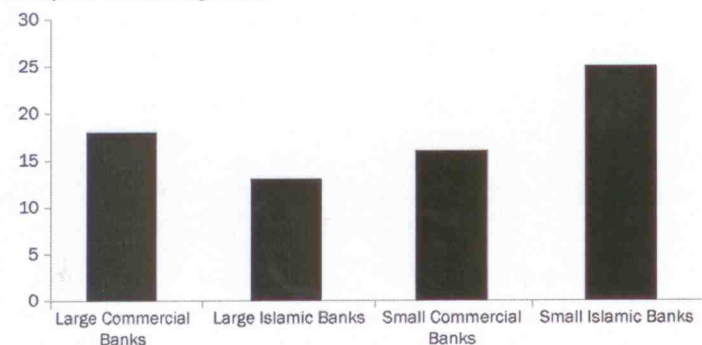
Recently, the International Monetary Fund (IMF) issued a working paper entitled "Islamic Banks and Financial Stability: An Empirical Analysis". It tries to determine whether Islamic banks are more or less stable than their conventional counterparts, and uses the "z-score" as a benchmark.

The z-score is a popular tool used to measure a bank's soundness. It is considered an objective measure because it focuses on the risk of insolvency, i.e. the risk that a bank (whether commercial, Islamic or other) will run out of capital and reserves. From the sample provided, basic data analysis indicates that Islamic banks may be more stable than commercial banks.

Large Islamic banks (which own more than US\$1 billion worth of assets) have, on average, higher loan-to-asset ratios compared to large commercial banks. This may be due to the fact that Islamic banking prohibits investments involving non-lending operations such as regular bonds or T-bills in Islamic banking.

Large Islamic banks have higher cost-to-income ratios than commercial banks of the same asset worth, and this is in line with the literature on efficiency. Here, the Islamic banks in the sample are, on average, bigger than commercial banks.

Comparison of average z-scores



Source: IMF Working Paper – Monetary and Capital Markets Department: "Islamic Banks and Financial Stability: An Empirical Analysis", by Martin Čihák and Heiko Hesse, IMF, January 2008

The survey shows that:

- (i) small Islamic banks tend to be financially stronger than small commercial banks;
- (ii) large commercial banks tend to be financially stronger than large Islamic banks; and
- (iii) small Islamic banks tend to be financially stronger than large Islamic banks.

The result suggests that it is significantly more complex for Islamic banks to adjust their credit risk monitoring system as they become bigger.

Due to the limitations on standardization in credit risk management, monitoring the various profit-loss arrangements becomes more complex as the scale of the banking operation grows. Because of the larger scale, better governance is needed to avoid adverse selection and moral hazard. Another possibility is that small banks concentrate on low-risk investments and fee income, while large banks do more profit-loss sharing (PLS) business.

While mergers of small Islamic banks should be encouraged from an efficiency viewpoint, the paper suggests that to reap these efficiency benefits, attention needs to be paid to prudential risks, which – other things being equal – tend to play a greater role for larger Islamic banks.

A bigger market penetration of Islamic banks in a country's financial system does not appear to have played a significant part in the outcome of the results.

However, we believe that the findings in this paper should be viewed as preliminary. This is because it uses only one benchmark and lacks complete coverage of the database. On top of that, it relied on unconsolidated statements and focused its research only on full-fledged Islamic banks. The Islamic "windows" or Islamic branches operated by some commercial banks were largely ignored.

Data limitations also prevented the authors from fully taking into account all aspects of Islamic financial contracts, for example, by distinguishing differences between PLS and other investments. And precisely those aspects could have partly influenced the results.

The report is reassuring because in a way, it praised small-sized Islamic banks (with assets worth below US\$1 billion). Although larger banks will not find the revelations alarming, they must not ignore the implicit warning it carries. As we build our Islamic mega banks, we should be reminded that they should be solid like a skyscraper and not the Titanic, which can be easily sunk by an iceberg. Simple pooling of money can sometimes mean multiplying risk, not stability. ☺

**BENER**  
Istanbul – Turkey

Paul Wouters is a consultant to Bener Law Office in Istanbul, Turkey. He can be contacted via email at paul.wouters@bener.av.tr