

Special Comment



August 2009

The Liquidity/Leverage Trade-Off for Islamic Banks – and its Impact on Their Ratings

Summary Opinion

The Islamic banking industry has experienced exponential growth over the 30 years since its inception and we expect Islamic banking assets and assets under management to reach US\$1 trillion by 2010. The total assets held by Islamic banks globally amounted to around US\$840 billion at year-end 2008 and the entire global potential market is worth at least US\$5 trillion.¹ Islamic banks often rely conservatively on their excessive liquidity base, largely in the form of surplus liquid assets, which has to some extent sheltered them from the global financial meltdown. Nevertheless, they have not fully escaped the effects of the credit crisis and are experiencing the woes of an evolving industry characterised by extremely high growth rates, but also by lagging corporate governance and risk management issues.

The aim of this research report is to evaluate the liquidity and leverage trade-offs for Islamic banks in a changing environment and to judge the impact that this exchange has on Moody's ratings. In the Gulf Co-operation Council (GCC) region and Turkey,² we currently rate ten Islamic banks whose ratings range from Aa3 to Baa2 (issuer credit ratings) within the investment-grade category. All the banks' ratings have stable outlooks.

The ratings are supported by the banks' still ample liquidity levels, resilient capital bases, high asset returns and relatively low funding costs. In the specific context of sufficient liquidity, low leverage and competitive profit margins, the rated banks' financial performance parallels industry averages and supports their ratings' stable outlooks in most cases.

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¹ Source: McKinsey & Co.

² See Appendix 1



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These strengths are partly offset by the banks' weak asset/liability management and below-par qualitative characteristics such as corporate governance and risk management, which highlight the volatility of this emerging market sector. Moreover, the overall assigned bank financial strength ratings (BFSRs) are below the Moody's bank financial strength scorecard outcomes in most cases. Our view is that the sector's high profitability may not be sustainable and that this will eventually affect ratings, given that the banks' ratings are influenced by restricted asset diversification and inefficient corporate governance structures.

Overview

Liquidity tends to be a financial crutch for Islamic banks. Islamic financial institutions (IFIs) have traditionally held high levels of cash/liquid assets, ideally to safeguard the interests of their depositors, investors and shareholders against credit upheavals and liquidity crunch. This excessive liquidity syndrome (also known as 'good liquidity') of IFIs reduces liquidity risks in an economic downturn. Also, from a leverage perspective, IFIs' operational models are built upon conservative fundamental values that discourage the use of disproportionate levels of debt to finance assets, as well as speculative and doubtful investments, which have inhibited the industry in terms of its use of leverage. As a result, IFIs' funding portfolios are highly concentrated in a few liquid assets and are deficient in terms of a securitised asset base.

At the same time, underutilised surplus liquidity on most IFIs books has led to weak asset-liability management, which translates into liquidity risk. This risk arises from the scarcity of medium- and long-term funds to reduce the gap between assets and liabilities. Currently, IFIs are highly dependent on short-term funds to manage their longer-tenure liabilities. This issue has become even more crucial in today's capital market environment because the frequency of asset write-downs is on the rise. In the wake of macroeconomic global developments, such as fluctuating oil prices and declining real estate prices, a class of informed investors is emerging – as are widening gaps between accounting capital and Tier 2 assets.

IFIs are also morphing their regulatory dynamics to fit the evolving Islamic financial industry. Major industry players are diligently working with the Shari'ah council to develop new asset classes that allow for a more efficient investment of excess cash, without underestimating the basic laws that require these financial institutions to place socio-ethical goals before profit goals.

Moody's believes that one of the fundamental problems for IFIs is their inability to monitor risk efficiently, primarily liquidity risk. Liquidity management has always been challenging for IFIs, but it is now being exacerbated by the shortcomings of this nascent industry – shortcomings such as a scarcity of liquid instruments, a lack of regulatory consistency and the underdeveloped nature of the Islamic money market.

We expect most IFIs to survive the declining property prices and to rebound with the help of systemic government support and the resurgence of global markets. However, liquidity-risk-related issues will persist, unless they are addressed by innovative solutions such as the introduction of a range of Shari'ah-compliant instruments and the management of asset-liability mismatches, originating from the shortage of long-term funds. Progress in this field is essential as their underdeveloped funding portfolios are not nearly sufficient to maintain their current performance and allow them to develop into a dominant financial industry.

As is often the case in the field of Islamic banking, larger banks and smaller contenders have reacted differently to the liquidity stress that the overall market has been experiencing for several months. Larger Islamic financial institutions, like Saudi Arabia's Al Rajhi Bank or Kuwait's KFH, prefer to protect their asset liquidity, capitalisation and reputations at the expense of growth and profitability. However, smaller banks are keen to quickly gain market share (when they can afford to adopt such an opportunistic view).

Such a strategy is apparent in the competitive UAE market. With market liquidity scarce, most banking players have tended to refrain from lending (thus keeping credit leverage at relatively low levels), leaving room for those competitors with ample asset liquidity to use their own balance sheets to capture extra shares of the lending market. For instance, Dubai Bank (one of the UAE's smaller Islamic banks) has pursued such tactics: prior to the crisis, the bank managed to accumulate sizeable asset liquidity on its balance sheet, which it used extensively throughout 2008, resulting in a doubling of its size despite the worsening global credit situation, but at the expense of capitalisation, which declined as financial leverage rose.

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Balance Sheet Concentration in Asset Portfolios

Islamic banks are prohibited from participating in *riba* and *gharar* and therefore, by their very nature, have a lower tolerance for risky debt-based transactions. The whole Islamic banking system is contingent upon profit/loss-sharing (PLS) arrangements in which the rate of return is not predetermined, but is dependent upon the actual earning power of an asset. The PLS arrangements are conducted among the depositors, banks and entrepreneurs and must be backed by a physical asset.

As a result, there tend to be multiple portfolios of a short-term nature on the asset side of the balance sheet. In recent years, however, there has been a visible tendency for IFIs to lengthen the average tenor of credit exposures by increments. This situation presents some challenges in terms of asset and liability management: the IFIs' funding mixes remain largely dominated by short-term PLS or non-PLS deposits, thereby generating wider mismatches between both sides of their balance sheets. In the case of a conventional bank, assets and liabilities are mostly fixed-income contracts with a much wider variety of maturities.

Liquidity is a dual concept. On the one hand, it is defined as a bank's ability to capture and retain funding sources that are cheap enough to maximise intermediation margins, but stable enough to accompany growth plans, massive withdrawals or even bank runs, which means liquidity risks have materialised into solvency issues. On the other hand, liquidity is also measured by a bank's capacity to quickly book alternative sources of cash, either by selling assets without excessively discounting their prices at a cost, or by superior financial flexibility, thereby giving it access to market funds in the form of debt or capital. Asset and liability management is essentially balance sheet optimisation from a cash perspective, and it is usually monitored by an ALCO (asset and liability committee) with daily implementation being the responsibility of a bank's treasury.

In an Islamic banking system, liquidity is first measured by the size of deposits that customers provide. The current-account deposits (*qardh hasan*) as well as savings and term deposits (in the form of *murabaha* or *wakala*) are principal-guaranteed in their entirety by the bank that offers them. However, investment deposits or profit-sharing investment accounts (PSIAs) are, as the name implies, entirely for investment purposes and their face value is at risk – with negative returns always possible, although rare in practice.

Some industry experts are of the opinion that IFIs need to maintain only a certain portion of their deposits in reserves, which past experience has shown to be unstable. Nevertheless, this practice is seldom observed (*cash reserves* reach levels of 90% at most banks); the reason being that there is little relevant historical data available to support such a theory. Moreover, Islamic banks belong to an emerging and conservative industry, so they purposely maintain high levels of liquidity to mitigate the adverse effects of any potential run on deposits. Overall, less granular deposits or deposit concentrations have been a negative rating factor for the IFIs.

Furthermore, an IFI's balance sheet is based on a "pass-through" mechanism or PLS asset-backed arrangements that allow it to link the returns on its PSIA deposits to asset yields, mitigating its asset/liability mismatch exposure. This is a risk factor commonly faced by conventional banks. However, at an Islamic bank, such a risk is more direct and "mechanical" and is known as "displaced commercial risk" (DCR), which is defined as the risk of liquidity suddenly drying up as a consequence of massive withdrawals should the IFI's asset yield returns for PSIA-holders be lower than expected or, worse, produce losses. From an operational perspective, this feature creates risks pertaining to premature deposit withdrawals.

On the asset side of their balance sheets, Islamic banks' investment and financial assets consist of various contracts, such as *murabaha*, *musharaka* and *mudharaba*, the liquidity profiles of which can vary substantially. The short-term assets are equivalent to money market instruments, but are not as profitable, and they tend to be more costly because of the involvement of third parties (especially brokers supplying commodities as underlying assets). The most frequently utilised instrument is *murabaha* due to its low-risk qualities, but it comes at a higher cost. *Musharaka*, meanwhile, is a financial contract with several Islamic features attached to it, but is less popular because of its long-term-commitment requirement and high risk, which can erode investment deposits. Because of the involvement of commodities (which are limited in their availability) and an undeveloped inter-bank money market, these instruments are not large enough to accommodate bank transactions that run to billions of dollars.

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Other financial instruments, such as derivatives, are scarce, expensive and still evolving. Shari'ah-compliant derivative contracts are very few in number, so there is a natural inclination towards shorter tenor, less costly solutions, or often sub-optimal back-to-back hedging. Additionally, assets of medium- to long-term duration, such as Islamic bonds (sukuk), still constitute a very small proportion of the balance sheet despite the recent rapid growth in this funding source. Still illiquid, dominated by local issuances and hardly traded globally, sukuk cannot be considered an effective fixed-income instrument for active management of balance sheets and liquidity. Most repurchase agreements (repo) with bank counterparts or central banks are *riba*-based (i.e., interest-free), so sukuk can hardly be used as repo collateral and very seldom serves as the basis for raising emergency liquidity in the event of need.

Conservative Leverage Usage: A Double-Edged Sword

Riba-free transactions prohibit the issuance of excessive debt to finance assets. Transactions are supported by assets and the lending capacity of an IFI is bound by the availability of economically sound assets, thus reducing the need for leveraged credit.

By contrast, most conventional banks have employed intense financial leveraging techniques to magnify their gains in expansionary economic times. The use of leverage amplifies returns during a boom cycle, but it can also have a reverse effect during a recessionary phase when managements not only have to write down losses on their declining asset portfolios, but also have to pay interest on their outstanding loans – the exact situation that most conventional banks are presently faced with.

In the ongoing economic downturn, falling asset prices, credit seizures and liquidity crunches have created a difficult situation where retail-funded, commercial Islamic banks are better placed than their rivals. They enjoy low leverage (which excludes exposures to structured instruments) and abundant liquidity. Shari'ah-compliant investment banks, meanwhile, are wholesale-funded with a concentrated deposit base and are also highly exposed to cyclical and illiquid asset classes such as real estate, private equity and venture capital. Consequently, they have suffered far more, with two of them defaulting recently: Global Investment House and The Investment Dar (both not rated). Another Islamic bank whose ratings have come under pressure for the same reasons is Tamweel (rated), which is merging with its rival Amlak (not rated) under Real Estate Bank (REB).

Traditionally, IFIs have not been heavily leveraged, neither in terms of credit leverage (nor in the proportion of illiquid credit exposures in asset allocation), nor in terms of financial leverage (nor in the proportion of debt-like liabilities in overall funding sources). The primary reasons for conservative financial leverage maintenance are: (i) IFIs have limited incentives to grow debt-like liabilities because their assets tend to be highly profitable; (ii) they needed to set aside extra capital buffers to prepare for expansion; (iii) funding is usually cheap, thanks to easy access to non-remunerated *qardh hasan* current-account deposits; and (iv) the necessity to set aside capital charges for specific risks like DCR, reputation risks and concentration risks as per Basel II's Pillar 2.³

IFIs generally maintain financial leverage of around 5.4x (total assets to capital), according to data produced in the GCC region. On the other side of the balance sheet, the average credit leverage of GCC IFIs is close to 55% (credit exposures to total assets), which in turn reflects Islamic banks' keenness to keep ample asset liquidity in the event of funding sources becoming unavailable.

IFIs use cash from deposits and short-term liquid assets to finance long-term liabilities. These are universal, but they vary greatly among the banks in their composition because of their business characteristics. As a result, the liability makeup affects the IFIs' funding structures differently and reflects an institution's specific asset-liability management policies. In comparison with conventional banks, asset-backed transactions (depending on the character of the asset) can expose an IFI both as an investor with high credit risk and also as an owner when dealing with long-term assets such as property and/or infrastructure. In order to mitigate this long-term liability-related risk, an IFI should have a vast pool of assets with a maturity range at its disposal to close the asset-liability gap.

³ Refer to Moody's Special Comment, entitled "Islamic Banks in the GCC: A Comparative Analysis", published in March 2008

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As a result, the Islamic banking industry is faced with a conundrum: its institutions maintain high concentrations in current/short-term assets such as deposits and expensive liquid assets, but, at the same time, they are exposed to highly profitable, but illiquid, long-term assets (e.g. property and infrastructure, and sukuk), and they have limited access to long-term funding solutions. The nature of the Islamic banking model and Shari'ah-compliant laws applicable to the available asset classes means that these banks are persistently faced with a swap between liquidity and profitability.

Simplified Balance Sheet of an IFI	
Assets	Liabilities
Cash	Non-remunerated current accounts (<i>qardh hasan</i>)
ST interbank <i>murabaha</i>	ST <i>murabaha</i> , interbank and due to customers
Investment sukuk	LT syndicated <i>murabaha</i>
Other investments (<i>murabaha</i> , <i>musharaka</i>)	Issued sukuk
Credit portfolio	Unrestricted PSIAs
Participants (<i>musharaka</i>)	Profit equalisation reserves (PERs)
Others	Equity

Strong Liquidity: A Growth Lever

Their liquidity profiles have perhaps been one of the most important strengths of the IFIs. In the context of Moody's ratings, liquidity is a credit strength because it provides a financial institution with surplus cash to use as shock absorber against possible future shortages pertaining to investment opportunities and payment obligations.

Under the current difficult economic conditions, most IFIs in the GCC region have been able to seek out opportunities by using their surplus liquidity to aggressively boost deposit volumes and thus to increase their market shares by growing lending volumes, while maintaining their focus on the retail and corporate sectors. This is a strategy employed by GCC banks to de-couple their retail lending business from global markets by focusing on extending credit locally.

With very few exceptions (especially in Dubai in recent months), funding has been less of a constraint for IFIs because of the market's perception that these players will be more resilient than their conventional peers to the global credit turmoil. The market has acknowledged that Islamic banks cannot carry assets such as highly leveraged structured instruments or global investment banks' shares on their balance sheets because these are considered *haram* (forbidden) and therefore are not eligible for investment according to the Shari'ah boards' *fatwas*.

In practice, customers are switching their savings from conventional banks (perceived as riskier), to Islamic banks (perceived as less directly exposed to sub-prime). This activity has been recorded in a number of countries, especially the UAE, Kuwait and Bahrain. The latest figures on these banks show an increase of 34.37% in their Q3 2008 deposit base over the previous year. This retail entrenchment is a good strategic shift – one suitable for the current environment with wholesale funding restricted and liquidity ratios lower (albeit not severely so).

Another contributing factor to lower liquidity ratios is the IFIs' move into disintermediation services, such as property and investment, as alternatives to pure lending services. However, given the ongoing property crisis, this could be an adverse move in terms of the ratings, as seen in the case of Tamweel, whose property-related business has been hit hard.⁴ Additionally, double-digit growth rates and cheap funding in Islamic banking have attracted new entrants alongside commercial banks, which are retail/specialized banks and investment banks. Although commercial banks are more prevalent because of the growing specific needs of their clientele,

⁴ Refer to Moody's Credit Opinion on Tamweel PJSC, published on 29 January 2009

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investment and specialised retail banks have also spread quickly. Larger and more granular deposit bases, greater disintermediation and the frequent usage of liquidity to leverage assets have resulted in stable returns and strong recurring earnings power for the IFIs. Because of these large deposit bases, moreover, IFIs can afford to increase their loan leverages without further weakening their liquidity ratios.

The recent drop in liquidity ratios is an industry-related phenomenon and therefore not likely to lead to downward pressure on Moody's ratings. Even though these ratios have declined from previous years, they remain healthy by industry comparisons and by our rating standards. Additionally, IFIs can afford to use this approach because they have strong systemic support through government backing and shareholdings.

Key Concern: Underutilised Liquidity and Poor Asset/Liability Management

The ample liquidity of Islamic banks is not without its drawbacks. Despite the success they have enjoyed for over 30 years, these banks find themselves grappling with the issues of liquidity, balance sheet management and overall risk monitoring – all of which have depressed their ratings. Limited asset classes are able to be invested because of the small amount of existing Islamic assets; moreover, illiquid liability concentrations can aggravate these institutions' asset/liability management-control policies.

The major risk that a bank could face in this regard is obviously a liquidity shortage. Dangerous deposit runs, also known as "funding volatility",⁵ can arise from various macro- and micro-economic factors that can influence an IFI's policies and can lead to a significant decline in a bank's cash reserves, thus retarding its ability to raise additional deposits. They are potential threats to liquidity and are a key concern for all banks. One Islamic bank that recently found itself in such a situation is Dubai Islamic bank (DIB, rated A1). After some adverse publicity, DIB was unable to attract deposits. This escalated into a liquidity shortage and then inferior asset quality. However, these factors were offset by DIB's strong global franchise network, high earning power, granular and stable deposit base, and good quality access to long-term liabilities, which eventually earned it a stable rating.

The acceleration of deposit withdrawals is certainly a possibility when depositors do not earn the returns they expect because their contribution is primarily for capital appreciation through PLS. However, this is not a typical phenomenon – indeed, past studies have shown that most depositors renew their agreements after one year mainly due to religious reasons. We therefore consider the majority of deposits to be of medium- to long-term duration, leading to a lower likelihood of short-term liquidity shortages.

It is quite clear that the policies implemented and practiced by Islamic banks have worked to their advantage so far because of the fragmented and emergent market system, which has enabled them to earn high profits and more than cover their costs. From an asset-liability management perspective, however, (and in light of the financial crisis) IFIs are using unstable policies without growing their liquid asset supply and monitoring their risk levels. As the market matures and crisis deepens, the negative impact of these policies could lead to bankruptcies due to inaccurate liquidity management and defective asset qualities. That said, the chances of an IFI becoming insolvent are low due to the availability of GCC government support and support from other financial institutions.

The greater use of innovative asset classes will also complement the currently variety-starved asset section on the balance sheet and help IFIs deal with liquidity and ALM concerns more efficiently. Along these lines, Moody's believes that Malaysia and other South Asian countries are at the centre of ground-breaking Islamic banking solutions. In order to market these instruments beyond Asia, they are targeting affluent Middle Eastern investors.

⁵ Some Aspects of Liquidity in Islamic Banks – Case Study in MENA Region – Badr-El-Din A. Ibrahim and K.C. Vijaykumar, 2004

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Sukuk Growth is Positive, But More is Needed

The high dependence on short-term solutions to finance longer-tenor asset-backed (unsecured sukuk)⁶ transactions and the resulting asset/liability mismatch has been an industry-wide concern for many years. To address this asset/liability dichotomy, one of the latest products is a type of Islamic bond called sukuk. Prior to 2000, this particular market was virtually non-existent, but in the past few years it has experienced tremendous growth. The size of the sukuk market at year-end 2008 was US\$106 billion, having reported a 10% increase over the previous year (US\$97 billion at year-end 2007).⁷ The popularity of sukuk has contributed to further invention in terms of alternative Islamic assets, with 14 different sukuk structures used so far. Sukuk growth has been a factor in local debt capital market (DCM) growth, which was also virtually non-existent before 2000.

Taking advantage of sukuk was a much-needed solution to the problem of increasing the Islamic banks' funding variety. Sukuk allows Islamic banks to allocate excessive funds to alternative classes of instruments; it has thus helped them to move away from conventional strategies related to equity and property alone. Similarly, sukuk varieties have been used by Islamic banks as tools in their investment portfolios to hedge against their more volatile credit exposures.

Despite enormous success, the sukuk market is not as deep or liquid as a regular bond market. Regardless of growing demand fuelled by banks, corporations and governments in the GCC region, there is a shortage of supply. Additionally, the sukuk market is still stagnant: holders keep their bonds to maturity and there is relatively little secondary market trading. The ability to trade their bond portfolios gives banks the flexibility to adjust their asset/liability management process to their liking and to hedge themselves against sudden movements in asset prices by matching durations on both sides.

Furthermore, the ongoing global economic crisis has dampened demand in the sukuk market and local debt issuance in general, leading to widening spreads and causing Islamic banks to retreat to the sanctuary of their high liquidity levels.

Sukuk Market Replaced by More Private Equity Placements and New Products

With increasing spreads and a consequent drop of around 50% in sukuk issuance and investment, which is greater than that seen in the traditional bond market, sukuks have taken a back seat.

Some analysts believe that one deterrent to growth in the sukuk market and derivatives of sukuk, aside from the economic crisis, is simply the lack of compliance with Shari'ah. They argue that the key selling point of Islamic banking is greater transparency in the use of instruments that are more socio-economically focused than pure profit-making products.

This gap left behind by sukuk is being filled by private equity ventures for the time being. Given high levels of capital and liquidity at IFIs, vast supplies of quality undervalued securities are presenting themselves as an opportunity for Islamic private equity ventures, which are on the rise. The low leverage and clean balance sheets of many Islamic banks enable them to acquire businesses from other privatised entities, such as government-linked companies and partly privatised local and foreign corporations. According to one estimate, this market is already worth US\$3 billion-US\$4 billion, primarily in the US. There are presently 180 conglomerates in the GCC region looking for a private equity injection.

IFIs are gradually moving away from single-asset private-equity transactions in order to deepen their involvement in equity funds, mixing both (i) listed stocks (via exchange traded funds or ETFs), provided that Shari'ah-compliant stock indices are available, and (ii) private equity/venture capital funds. These asset classes are gaining interest from Islamic investors because multiples have declined sharply, valuations are

⁶ Please refer to Moody's Special Comment, "The Future of Sukuk: Substance over Form?", published in May 2009, which concludes that most existing sukuk transactions are asset-backed in substance as opposed to asset-based. The correct classification of sukuk under this analysis would be secured and unsecured structures.

⁷ See Moody's Special Comment, "Islamic Banks and Sukuk: Growing Fast, but Still Fragmented", published in April 2008.

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tremendously liquidity-dependent and IFIs' investor constituencies (in the retail segment, but also high net-worth individuals and institutional clients) are increasingly asking for such alternatives for yield.

Additionally, Malaysian Islamic bankers have been assiduously involved in creating innovative versions of Western financial instruments. There have already been Islamic instruments introduced that qualify as substitutes for warrants, forward contracts and treasury products. Whether or not these will become ubiquitous in the Islamic banking industry is not yet clear – particularly given the various disagreements over their characteristics and functionality in terms of them not corresponding with the principles of Shari'ah law.

Considering their dire need to address liquidity risk and corporate governance concerns, IFIs would benefit from having access to better consistency in applying Shari'ah, so that they can follow a single set of rules and principles that support the necessary new product expansion. This would minimise problems relating to standardisation and bring the focus back on addressing the major hurdles that the Islamic banks must surmount.

Stable Ratings Outlook Supported by Liquidity and Leverage Metrics

Moody's rates nine Islamic banks in six countries in the GCC region and one in Turkey. IFIs receive bank financial strength rating (BFSRs, which map to baseline credit assessments, BCAs) and global local currency (GLC) deposit ratings, which all reflect their ample liquidity, conservative leverage, strong probability of systemic support, strength of wholesale deposits and creditworthiness.

GCC banks have **C to E+** BFSRs (mapping to **A3 to B1** BCAs) and **Aa3 to Baa1** GLC deposit ratings. The BFSRs are low because they are heavily influenced by qualitative or non-financial factors displayed by the Islamic banks. The qualitative scores reflect their fragile operating environment, constrained risk positioning and weak franchise value in comparison with those of peers.

The nine GCC Islamic banks exhibit a common theme with respect to some key financial metrics and new trends arising from the global effects of interconnected markets. The commonalities relate to increased disintermediation business, reduced capitalisation and lower liquidity levels, larger market shares, low risk lending, conservative leverage and strong connections with the government. These developments led to slightly reduced liquidity, ROE and ROA levels in 2008 when compared with previous years, although these ratios were stabilised by cheap funding costs and wholesale deposits through fast growth in lending volumes. Moody's outlook is stable for the majority of these banks' ratings.

The table below shows 2006 liquidity, leverage and capital adequacy ratios for the rated Islamic banks in comparison with industry averages. These financial fundamentals receive high scores from Moody's⁸ and, as can be seen, the figures are strong. We expect these trends to continue, given the heightened willingness of industry bankers to reduce asset and geographic concentrations, minimise and monitor risks efficiently and fortify balance sheets by improving liquidity and asset supply, to name a few measures which are currently under the radar screen.

⁸ Figures extracted from report on "Islamic Banks in the GCC: a Comparative Analysis."

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Funding, Liquidity and Leverage Ratios of Islamic Banks Included in the Comparative Panel (2006) *

		Industry Average
Market Funds -Liquid Assets % Total Assets	18.99%	NA
Total Equity % Total Assets	13.93%	18.40%
Net Islamic Financing % Total Assets	41.31%	54.7%
ROA	3.83%	4.5%
ROE	22.26%	24.3%

Note: Tamweel (A3) is a specialized commercial bank with very strong financial ratios and it was excluded from the averages of the above rated IFIs. If it is included in the above table, the rated banks' averages would be higher than the industry averages.

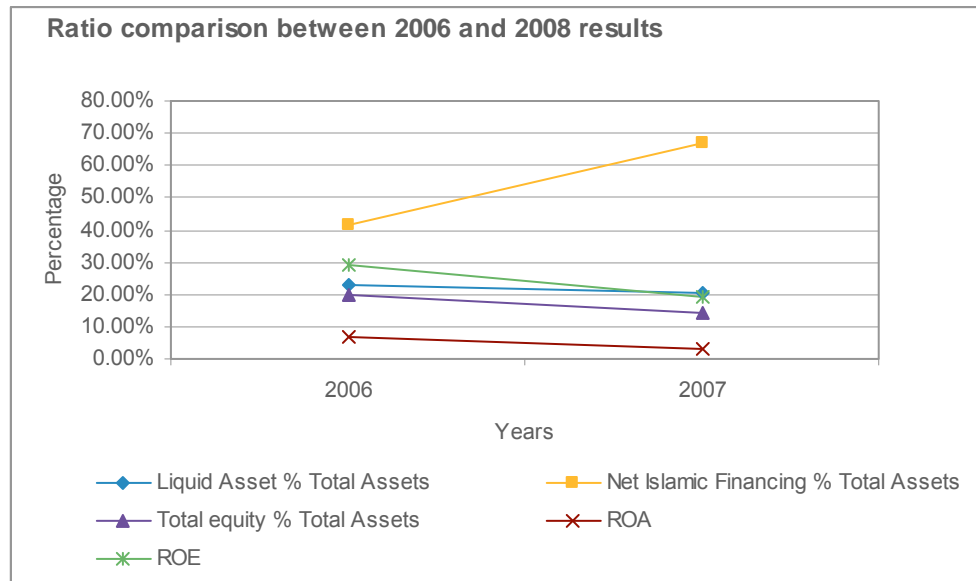
* Refer to Moody's Special Comment, "Islamic Banks in the GCC: a Comparative Analysis", published in March 2008

Rated Islamic Banks' Financial Performance in Q3 2008 (Ratios are annualised)

Liquid Assets % Total Assets	20.45%
Total Equity % Total Assets	14.32%
Net Islamic Financing % Total Assets	67.07%
ROA	2.97%
ROE	19.19%

Those Islamic banks that have geographically diversified their operations have received favourable ratings. The strength of their franchises has allowed these IFIs to increase their earnings power, raise margins, attract wide and loyal deposits and maintain high international standards. Other positive rating factors are aggressive growth in market shares through high volume lending, but at the cost of lower liquidity and capital ratios. This is a new trend whereby the IFIs are extending low-risk credit (primarily retail and corporate lending) to grow faster than the market amid the global financial crisis and are using retail deposits as a source of cheaper funding.

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Declining liquidity ratios and strong deposit bases have allowed IFIs to increase their loan leverage without further damaging their current liquidity positions, which is another positive factor. The liquidity crunch appears to be fairly regional because most IFIs are using their cash deposits to expand and gain market share. IFIs with strong government connections and Islamic banks are generally performing better than private banks because of the availability of systemic liquidity support, which plays a crucial role in Moody's ratings.

The IFIs' ratings are constrained by their following characteristics: (i) their credit portfolio concentration (high correlation); (ii) their inadequate liquidity and balance sheet management; (iii) their considerable exposure to property, thereby adversely affecting asset quality; (iv) their pure banking intermediation; (v) their lack of corporate governance; (vi) their heightened competition; (vii) their limited asset innovation (the Islamic product range remains shallow); and (viii) the non-availability of Shari'ah-compliant liquidity and hedging instruments.

Declining property prices mean that the task of liquidity management is more difficult because banks have to create future provisions that reduce profitability and affect internal controls. From a long-term perspective, IFIs' ratings could be adversely affected if the economic crisis continues to worsen without improvement in offsetting factors such as further disintermediation in services and innovation in liquidity management assets.

Is Ample Liquidity Sustainable in the Evolving Islamic Financial Industry?

The main liquidity and capital ratio drivers in the Gulf region at the beginning of this decade were recycled petrodollars from high oil prices and repatriated funds from abroad soon after the events of 9/11. The abundant flow of liquidity into the IFIs encouraged shareholders and investors to demand more alternative assets for bigger gains, which led to the emergence of sukuk. New product appeal, premium pricing, low costs and growing demand allowed IFIs to reap soaring returns.

Nevertheless, the advantages, from cheap funding costs to high prices, will eventually dry out once low-return *qardh hasan* deposits are replaced with PSIA as investors gravitate toward more lucrative forms of investment. The PSIAs behave more like investment deposits in terms of risk and return: they can be withdrawn at the will of investors if their financial goals are not met prior to the end of an agreement.

The dependence of IFIs on petrodollars is also slowing and banks concentrate more on building their alternative asset portfolios through supplemental and tertiary forms of capital such as subordinated debt and hybrid securities. Given reduced oil prices and the stagnant sukuk market, the IFIs are in the process of becoming more leveraged to accommodate Islamic financial products' widening appeal domestically and beyond the GCC borders. Currently, the application of derivatives and hybrid/subordinated debt is limited, but

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management teams intend to expand these offerings. An additional driver of this trend is the gradual improvement in the regulatory environment, greater economic liberalisation and major infrastructure developments. The UK, France and Germany are the most prominent European countries that support Islamic banking.

It is not clear whether the low cost of doing business and high profit margins will be sustainable in the long run, especially given the ongoing sharp economic downturn. According to the latest reports emerging from the GCC, IFIs are already tightening their belts and are using their surplus liquidity deposits to meet their basic financing needs and to replace recent deposit withdrawals. Most IFIs have placed property-based projects on hold because of declining demand in the real estate sector and foreign direct investment. There have been financial stimulus packages supplied by the governments to assist IFIs with their liquidity constraints. Those banks that are on the brink of liquidity crunch and have been unsuccessful in attracting additional deposits will either have to issue more sukuk or merge with their financially stronger counterparts. In the final analysis, the key concern for these banks is to invest their excessive funds in more innovative assets and to manage asset/liability maturity divergences more effectively.

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Appendix 1

List of IFIs rated by Moody's

IFI Name	Country	Bank Financial Strength Rating	Baseline Credit Assessment	Local Currency Ratings	Foreign Currency Ratings	Rating Type	Outlook
Abu Dhabi Islamic Bank	UAE	D	Ba2	A2/P-1	A2/P-1	Issuer Ratings	Stable
Al Rajhi Bank	Saudi Arabia	C	A3	A1/P-1	A1/P-1	Deposit Ratings	Stable
Asya Katilim Bankasi A.S.	Turkey	D	Ba2	Ba1/NP	B1/NP	Deposit Ratings	Stable
Bahrain Islamic Bank	Bahrain	D+	Ba1	Baa1/P-2	Baa1/P-2	Issuer Ratings	Stable
Bank Al-Jazira	Saudi Arabia	D+	Baa3	A3/P-2	A3/P-2	Deposit Ratings	Stable
Boubyan Bank	Kuwait	D	Ba2	Baa2/P-2	Baa2/P-2	Deposit Ratings	Stable
Dubai Bank	UAE	D	Ba2	A3/P-2	A3/P-2	Issuer Ratings	Stable
Dubai Islamic Bank	UAE	D+	Baa3	A1/P-1	A1/P-1	Issuer Ratings	Negative
Kuwait Finance House	Kuwait	C-	Baa1	Aa3/P-1	Aa3/P-1	Deposit Ratings	Stable
Tamweel PJSC	UAE	E+	B1	Baa1/P-2	Baa1/P-2	Issuer Ratings	RUR

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Definitions

Riba

is commonly defined as interest and sometimes equated with usury, but its meaning is broader. The literal meaning is 'an excessive increase', and its prohibition is meant to distinguish between an unlawful exchange in which there is a clear advantage to one party in contrast with a mutually beneficial and lawful exchange.

Gharar

is uncertainty in a contract or sale in which the goods may or may not be available or exist (e.g. the bird in the air or fish in the water). The term also refers to ambiguity in the consideration or terms of a contract – as such, the contract would not be valid.

Qardh Hasan

is a virtuous loan in which there is no interest or mark-up. The borrower must return the principal sum in the future without any interest.

Murabaha

is a contract of sale with an agreed profit mark-up on the cost. There are two types of murabaha sale: in the first type, the Islamic bank purchases the goods and makes them available for sale without any prior promise from a customer to purchase them, and this is termed a normal or spot murabaha; the second type involves a promise from a customer to purchase the item from the bank, and this is called murabaha to the purchase order. In this latter case, there is a pre-agreed selling price that includes the pre-agreed profit mark-up. Normally, it involves the bank granting the customer a murabaha credit facility with deferred payment terms, but this is not an essential element.

Waqala

is an agency contract that generally includes in its terms a fee for the agent.

Cash reserves

are defined as the ratio of cash and cash equivalents on the asset side of the bank as a percentage of a certain type of deposits, which in this case are PSIAs.

Mudharaba

is a form of contract in which one party brings capital and the other (the mudarrib) personal effort. The proportionate share in profit is determined by mutual consent, but the loss, if any, is borne by the owner of the capital, unless the loss has been caused by negligence or violation of the terms of the contract by the mudarrib. This contract is typically conducted between an Islamic financial institution or fund as mudarrib and investment account holders as providers of funds.

Musharaka

is an agreement under which the Islamic bank provides funds that are mingled with the funds of the business enterprise and possibly others. All providers of capital are entitled to participate in management, but are not necessarily obliged to do so. The profit is distributed among the partners in a pre-determined manner, but the losses, if any, are borne by the partners in proportion to their capital contribution. It is not permitted to stipulate otherwise.

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