

# **Liquidity and Risk Analysis of Islamic Banking System during Global Financial Crises**

*Liquidity and Risk Analysis of Islamic Financial System during Financial Crunch 2008*

**Azam Shafique.<sup>(1)</sup>, Muhammad Asim Faheem<sup>(2)</sup>, Iqra Abdullah<sup>(3)</sup>**

<sup>(1)</sup> Assistant Professor, Hailey College of Commerce, University of the Punjab, Lahore, Pakistan

<sup>(2)</sup> Lecturer, Hailey College of Commerce, University of the Punjab, Lahore, Pakistan

<sup>(3)</sup> MS Scholar Department of Management Science COMSATS Institute of Information Technology, Lahore

## **Abstract**

During the recent financial crises many famous banks of the world went into bankruptcy. The major cause indicated by researchers was their less liquidity type nature. But at the same time it is observed that Islamic banks were almost unaffected due to this crisis and that was due to their nature of being more liquid. The liquidity analysis of Islamic banks through discussing the studies of various research scholars approves this assumption about the Islamic banks highly liquid type nature.

KEY WORDS: Global Financial Crisis, Financial crisis 2008, Islamic banks, Liquidity analysis

## **Introduction**

During the recession of 2008-2010, the issue of low liquidity in the banks caused many banks to become bankrupt. But Islamic banks stayed quiet safe from this recession. The main reason identified by the scholars is high liquidity of the Islamic banks. To start the in-depth discussion on this topic, it is important to clear some terms. Many people are not familiar with the Islamic banking system. Islamic banking system follows the rules set by Islamic Sharia. The basic principle set by Sharia for Islamic economy is that it doesn't support the fixed or floating payment and interest system. Ribba which means the excess, increase or in other terms interest is strictly prohibited in Islam (Wikipedia, 2012).

Liquidity refers to the ability of a company to convert its assets into cash and this term is also called marketability. But here it is important to note that assets can be sold without depreciating the price. It is preferable and safe for investors to invest in

the liquid assets because the investment can be retrieved anytime whenever investors want (Investopedia, 2012).

This study is discussing the issue that which system works better during financial crisis either conventional banking system or Islamic banking system? If Islamic system is working better than what are the unique features of this system that make it safe from crisis? One feature identified in this research is liquidity of Islamic banking system. Different studies of the research scholars have been discussed that is indicating that Islamic system is safe from the global crisis due to its unique feature of high liquidity. At the end conclusion is drawn on the basis of different researches done by experts.

## **Discussion**

### **Financial Crises 2008-2010**

The financial crises from 2008-2010 is considered a greatest financial crises after the great depression 1930. The crises resulted in breakdown of world stock exchanges, banking sectors, housing sector and different businesses. According to different analyses the crises in the banking sector was due to the crash in housing sector. Banks advanced the loans to the housing sector without keeping the security. And due to the collapse in the housing sector, banking sector also suffered. In fact the famous bank of America, Lehman Brother got insolvent. According to (Wikipedia, 2012) the financial crisis was triggered by a complex interplay of valuation and liquidity problems in the United States banking system in 2008.

### **Islamic System Stability during Financial Crises**

Islamic banks seem to be durable and flexible during global economic turndown and international financial crisis. The position of Islamic banks may be strengthening as alternate for source of financing. Islamic financial system consider as recovering vehicle for global financial crisis because there is no speculative activates that result in financial crisis which conventional system facing now a days. Islamic banks not completely protected from global financial crisis. On the one hand, Islamic banks are considered as save and less risky because of transaction is backed by fully assets and other unique features. On the other hand Islamic banks are in danger because of its high activity in real estate sector as compare to conventional banks (Beck, Kunt, & Merrouche, 2010). But according to the majority of financial experts Islamic banking system is crisis proofed because of its assets link nature as compare to conventional banks (Kalem, 2000).

### **Liquidity Analysis of Islamic Banks during Financial Crunch 2008**

Reckless lending practices, high liquidity, lack of risk management and faulty regularity supervision cause the global financial crisis which badly affects the conventional and

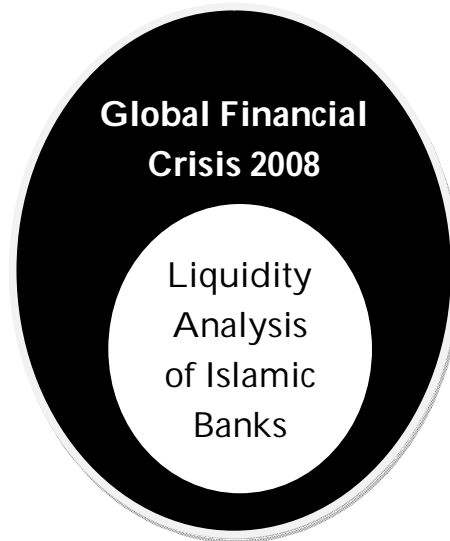
financial institution. Islamic financial system is saving from all such crisis because of interest free system and guidance of Shariah. Islamic financial system consider as an alternative to conventional system during global financial crisis. Islamic finance still positive and save after the global financial crisis, scholars have suggested that global financial crisis can be tackle if conventional system follow the Islamic financial principles and guidance of Shariah (Kayed & Hassan, 2011). After global financial crisis advanced economies like, Germany, Japan and France have recognized the Islamic Banking for securing credibility, stability and to alleviate the financial crisis (Wilson, 2007). As a study of (Amran, 2007) shows that the whole world is now facing economic problem that is great than Great Depression. The author studied that after dissolution of Lehman Brothers, Wall Street economists focus on a financial system who tackle all problems. The author concluded that Islamic Financial instructions are safe from global financial crisis and can be best alternative as global financial system to alleviate the crisis. According to (Bala & Nafis, 2007), as compare to the conventional banks, Islamic Banks during current financial crisis are safe in terms of fewer solvency and less liquidity risks. The authors suggested that no Islamic banks fail during the financial crisis but they need government recapitalization and Islamic banks are saving because their financing derived from deposits not by the borrowing. As (Ahmed A. , 2010) concluded that today world facing excess leverage and speculative risks, Islamic financial system is safe from all these threats. Islamic financial system is stable because of risk and profit sharing feature of Islamic finance. Because of greater transparency and disclosure in Islamic transaction stabilize the Islamic system during financial crisis. There is gradually growth of Islamic Finance in global financing because it is unaffected by financial crisis. Although Islamic finance is also affected by global financial crisis but it is segment of finance in world which is less affected by financial crisis because of its features and consider for alleviation of current financial crisis. Similar kinds of conclusions are drawn by (Kasim & Majid, 2010) while analyzing the impact of financial shocks on Islamic banks. Because of interest free nature Islamic financial system is sheltered from recent financial shocks (1997 to 2007). Islamic financial system is durable in financial crisis when we compare the Islamic bank's financing and deposit with conventional banks. The finding indicates that both Islamic and conventional banks are at risk during financial crisis but Islamic banks can tackle financial shocks due to its interest free feature. Some of finding suggested that interest free system although is save but it's minimize the financial stability. Islamic banks are limited to raise fund only in Muslim countries but on the other hand there is advantage of less risk as compare to conventional banking system which safeguard in financial crisis. According to (Samad & Hassan, 2002) Islamic banks are less risky and less insolvent as compared to conventional banks. But here it is important that according some of the scholars, there is no difference in the performance of Islamic banks and conventional banks, the only difference lies in the liquidity of Islamic Banks (Samad, 2004).

While discussing the safer sides of the Islamic banking system, it is also important to discuss the risks associated with the system during global financial break downs. Study of (Mavrakis, 2009) shows that during financial crisis Islamic Finance facing three challenges: theoretical, operational and implementations that result in limited future growth of Islamic Finance Industry. Therefore, as compare to conventional banking system, Islamic banking system is a

young industry and implemented on a small area of world. During global financial crisis, prospect of Islamic banking is huge and western world consider it as “Sleeping giant” (Salamon, 2004). But after the financial crisis Islamic banks not limited to Islamic countries but also extended to western countries. Islamic banks give good performance in west countries. Islamic banking experience in United Kingdom is extremely positive during recent years (Halabi, Alfieya, & Bala, 2004).

### **Study Design**

This research is a descriptive study that is based on the hypothesis i.e. Islamic banks are more safe from global financial crisis as compare to conventional banks due to its nature of being more liquid. As it is not possible to discuss all the crises in one article therefore the focus is on the financial crisis of 2008. For supporting this hypothesis famous studies of different scholars have been considered. Data is compiled through internet, published journals, newspapers and periodicals.



### **Conclusion**

It is concluded after discussing the studies of different writers that the Islamic banks stayed safer during the financial crisis 2008 as compare to the conventional banks. The major point of difference between the performance of two banks was the highly liquid nature of Islamic banks. So it is suggested that it is the right time for Islamic banks to expand their network in western world and world must realize the importance of the Islamic banking system especially during global financial crisis.

The second suggestion is that if other conventional banks want to stay safe from the global crises, they must maintain their position highly liquid otherwise Lehman Bros is an open example of being less liquid.

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