



ISLAMIC FINANCE IN NATIONAL ACCOUNTS STATISTICS

1. IMPLICATIONS FOR FINANCIAL INDICATORS

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INTRODUCTION

This lecture describes some interactions between treatment of Islamic finance in the System of National Accounts (SNA) and in various indicators of the condition of the Islamic finance sector.

This session covers financial indicators compiled by the Islamic Financial Services Board (IFSB). These indicators already exist, are widely used and provide readily available measures to analyze the condition of Islamic finance.

There are differences between the IFSB and SNA approaches, but they apply to similar economic situations and can be used for economic analysis or policy. The differences – and the proper context for each – need to be understood. Which should be used in a given context?

The two approaches often use common source materials and can support each other for compilation purposes.

IFSB INDICATORS COMPILED IN THE GCC

- IFSB's indicators are called PSIFIs – Prudential and Structural Indicators for Islamic Financial Institutions
- All GCC countries compile PSIFIs and submit them to IFSB for publication.
 - Thus, in each country, data operations covering Islamic banks already exist. The compilers are often the bank supervisors. This should be a point of contact for national accounts compilers to draw on local expertise, share data, and possibly collaborate.
- A second set of accounts covering the sectoral income statements and balance sheets for Islamic banking has been developed by the IFSB. Currently, only Bahrain and Saudi Arabia compile the IFSB's "Detailed Financial Accounts" (DFS).
 - Compilation of Islamic banking data for the SNA can also be an opportunity to compile the parallel set of data for the DFS.

IFSB INDICATORS PROGRAM

- The IFSB began in 2003 as a global standard setter for regulation and supervision of Islamic finance.
- From the beginning, the IFSB began building a database of information on Islamic finance to support standards development and document the growth and structural development of the industry.
- It began by creating the PSIFI indicators of the soundness and risk of Islamic banks. The indicators were largely based on a new set of financial soundness indicators (FSIs) developed by the IMF, but customized to fit the unique characteristics of Islamic finance.
 - FSIs were largely based on prudential ratios used by bank supervisors.
 - An IMF survey with over 130 country responses helped in designing FSIs.
- After a slow start, PSIFI program expanded after 2014
 - Indicators expanded to reflect new Basel 3 supervisory standards. (Basel IV is coming!)
 - Many more countries began compiling indicators. Now covers over 90 percent of Islamic banking globally.

IFSB INDICATORS PROGRAM

- Initial indicators included measures on size and structure of Islamic finance sector based on selected items from income statement and balance sheet.
- A later decision was made to compile the full income statement and balance sheet for Islamic banking sector.
 - “Detailed Financial Statements” (DFS”)
 - Much fuller picture; structural detail available.
 - Apply AAOIFI-based standards
 - Methodology in *PSIFI Compilation Guide* (2019)
- Also added Concentration and Distribution Measures (CDM)
 - Often Islamic sector is quite concentrated; smaller sector and internalized transactions result in greater contagion, volatility, or higher risk.
 - Gini index indicates that Islamic banking is concentrated in almost every count

USES OF SNA AND IFSB DATA

- The data provide a basis for both providing data for SNA and for separate data for accounts of Islamic finance sector.
- All countries with Islamic banking will apply recommendations developed in this review to incorporate Islamic banks into the SNA and balance of payments, etc.
- With some changes in methodology, data can simultaneously be used to compile DFS or similar accounts.

IFSB INDICATORS

- Indicators cover bank positions based on “CAMELS” – Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk. 3 or 4 indicators compile in each category.
- Separate data are collected for stand-alone banks and windows.
- Indicators also for takaful and Islamic capital markets (ICM)

CAPITAL ADEQUACY RATIO

- The indicator on the Capital Adequacy Ratio demonstrates a key difference in capital between Islamic and conventional banks
- Focus on only one indicator – Basel 3 Capital Adequacy Ratio (CAR), which is the most important indicator and is widely followed.
- $CAR = \text{Capital} / \text{Risk Weighted Assets (RWA)}$
 - Initially, CAR had to be at least 8% of capital as protection against credit risk on assets.
 - Under Basel 3, capital requirement included 8% value plus surcharges for market risk and operational risk, with additional requirements for systemically important banks. Banks could have capital requirements up to 14%.
 - CARs for countries are often compared. Considered the single best measure of condition of national banking systems.

DIFFERENT ISLAMIC AND CONVENTIONAL CARS

- There are two major reasons why the CAR for an Islamic bank is likely to differ from the CAR for a conventional bank.
 - Profit Sharing Investment Accounts (PSIA) can give depositors a ‘quasi-equity’ position in banks’ returns with possible loss on deposits. Thus, the bank has less risk of loss and a lower capital cushion might be sufficient: supervisors might allow an Islamic bank to reduce the credit risk component of its RWA by a factor “alpha” (α).
 - Second, Islamic banks tend to carry higher capital cushions to compensate for lack of access to interest-rate based liquidity instruments.
 - Together, these factors tend to raise the CAR of Islamic banks.
- Thus, the CAR might systematically differ between the Islamic and conventional banking sectors, with the Islamic CAR higher.
- The national CAR might be an average of a higher Islamic CAR and a lower conventional CAR. Is the difference significant and what are policy implications?
- What are SNA implications?