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Banking Regulation and Financial Soundness Nexus in View of the Crisis: An Islamic Banking Perspective

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ABSTRACT

The COVID-19 pandemic significantly affected global finances and economies, posing a risk of global GDP decline. This research examines the soundness and dynamics of Islamic banks from 2017Q1 to 2023Q1. The study focuses on eight countries selected based on the systemic importance of their Islamic banks: Saudi Arabia, UAE, Bahrain, Oman, Pakistan, Malaysia, Brunei, and Indonesia. The analysis is based on several key indicators including size, profitability, non-performing financing, and capital adequacy. Our analysis shows that the Islamic banks' response to the pandemic is not uniform across jurisdictions. Saudi Arabia and Southeast Asian countries (Malaysia and Indonesia) are expected to remain stable. This reflects the Islamic banks' desire to integrate more closely into the global financial system by holding higher capital adequacy ratios. Effective banking regulation is necessary to ensure the stability and credibility of the financial industry. Other regions may face challenges that require additional policies to ensure the stability of their Islamic banking sectors. Several financial soundness indicators and jurisdictions have shown notable improvements, with some levels reaching pre-pandemic levels. This reflects the effectiveness of the COVID-19 policy support measures implemented since 2020.

Keywords: Islamic Bank, Banking Regulation, COVID-19 Pandemic, Islamic Bank Soundness
JEL Classifications: G21, G28, G28

1. INTRODUCTION

Previous research has examined the historical development of Islamic banking, tracing its origins from the early years of Islam to the present day. The emergence of Islamic finance is credited to the 1970s, a decade marked by rising oil prices and resurgence in the religiosity of Muslim communities worldwide. The evolution of Islamic finance is marked by important events. First was the creation of the Organization of the Islamic Conference (OIC) in 1970, which set up the concept of Islamic banking. In 1974, the Islamic Development Bank (IDB) was established in Saudi Arabia as a multilateral organization with 56 member countries, its focus was on financing foreign trade, overcoming poverty, financing some infrastructure (roads, dams, etc.), and some social projects such as the construction of schools or hospitals. Islamic banking system emerged with the creation of the first Islamic commercial bank, the Islamic Bank of Dubai, in 1975, followed by the Sudanese Islamic Bank "Faisal" in 1977 and the Islamic Bank of Bahrain in 1979. Compliance with Sharia standards and principles is the foundation of an Islamic financial institution (Baklouti, 2022; Septiana et al., 2022). According to Kahf (2002)[1], the first initiative to introduce Sharia compliance supervisory body within the Islamic banking profession was by Faisal Islamic Bank of Egypt in 1976 and the Islamic Bank of Jordan in 1978. Currently, the confirmation of the Islamic character of a financial product or a financial transaction is the role of a Sharia board (SB) (formed by respected

1 Kahf, M (2002), «Strategic Trends in the Islamic Banking and Financing Movement», in Proceedings of the *Fifth Harvard University Forum on Islamic Finance*, Cambridge, Massachusetts, USA, 2002.

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Muslim Jurisconsults). Indeed, according to Islamic Financial Services Board (IFSB) (2009), the confirmation of the Islamic character of a financial product or transaction of an institution offering Islamic financial services is the role of a SB[2]. In this way, confidence in Islamic Bank (IB) is strengthened, as a fundamental issue in Islamic finance which can be considered as a compartment of Ethical finance given its moral and socially responsible dimension. Offering an ethical framework based on the ontological and epistemological principles of Islamic Sharia Law, IBs prohibit riba (interest), gharar (speculation), and Maysir (gambling). These obligations result in significant differences in the financial intermediation, product design and development, and marketing processes of conventional and Islamic banks.

Other IFSB standards, such as that on risk management, capital adequacy, and the supervisory review process, also provide requirements and recommendations to ensure that an appropriate Sharia governance system is in place (Alam et al., 2019). For example, the guidelines on risk management, known as IFSB (2005), state that an institution offering Islamic financial services (IIFS) should establish an appropriate policy to manage legal and Sharia compliance risks, indicating by implication the need for a robust Sharia governance system to manage Sharia compliance risks. The standard on the supervisory review process, known as IFSB-5 (2007), recommends that supervisors should ensure that appropriate systems are in place, including SB. In addition, another current of literature has investigated Islamic banking under different aspects, such as financial stability (Abedifar et al., 2013; Beck et al., 2013; Čihák and Hesse, 2010; Daoud and Kammoun, 2020b; Othman et al., 2023), supervisory and regulatory issues (Nastiti and Kasri, 2019; Smaoui and Ghouma, 2020; Daoud and Kammoun, 2022), and corporate social responsibility (Hanic and Smolo, 2023; Jusoh and Ibrahim, 2017), expanding the debate on Islamic banking by focusing on the risk characteristics of the Islamic banking system (Aydemir et al., 2023; Mateev and Nasr, 2023; Umar et al., 2023). The Islamic banking sector has also benefited from relative advancements in terms of technological innovations and supporting infrastructure and regulation (Alshater et al., 2022). These were helpful in driving the industry's expansion in the midst of adjusting to the COVID-19 lockdown measures. Attention to the development of the regulatory framework for Islamic banking has also been a key focus in many jurisdictions. Improvement to this framework has been initiated to support the growth of Islamic banking assets, among other risk management and corporate governance measures. Such developments contribute to a positive outlook for stable growth of Islamic finance, which is expected to improve on its current market share of 1.5% (IFSB, 2022).

Our research aims to contribute to the existing body of knowledge on Islamic regulatory issues and the stability of Islamic banks. We provide an up-to-date overview, discuss recent trends and suggest recommendations for bankers, fund managers, regulators and policymakers in the Islamic financial services industry. Given the rapid growth and increasing complexity of the IB sector, understanding the inherent risks is critical, especially for regulators ensuring financial stability.

This paper is structured as follows: Section 2 addresses issues related to Islamic banking and presents the current state of knowledge in this sector. Section 3 presents a literature review. Section 4 outlines the approach adopted and discusses the findings. Finally, Section 5 proposes policy recommendations and concludes.

2. ISLAMIC BANKING: A GENERAL OVERVIEW

In 2021, the global IFSI grew by 11.3% to reach USD 3.06 trillion. Despite the challenges posed by the COVID-19 pandemic and the ongoing Russia-Ukraine conflict, the IFSI displayed resilience (Taera et al., 2023). The Islamic banking sector, valued at USD 2.10 trillion and growing by 6.5%, held the majority (68.7%) of IFSI assets. This sector is expected to continue growing due to increased digitalization, its strong focus on ethical and impactful investments, and its access to a development of Islamic banking regulation (IFSB, 2022). Accordingly, we choose in this paper to focus on Islamic banking sector and examine the importance of risk management. The comparison of Islamic banking with conventional counterparts is common, but understanding the inherent risks in the Islamic Financial Services Industry (IFSI) is crucial for assessing Capital Adequacy Ratios (CARs). Islamic finance emphasizes risk sharing over transfer, limiting conventional hedging like derivatives. While this constrains IBs in managing balance sheets, it enhances overall resilience compared to conventional banks. Additionally, the unique challenge of Sharia compliance risk poses potential threats to the liquidity, solvency, and overall financial stability of the Islamic financial system.

Since the advent of the financial crisis in 2008, the world has discovered serious economic and financial dysfunction and the conventional banks' (CBs) unethical risk-taking behavior (Nguyen et al., 2019). IBs have been less affected by this crisis (Berger et al., 2019). Presented as an alternative to the global financial system hit by an "ethical crisis," Islamic finance (as ethical finance) attempts to offer a different vision of trade and investment, based primarily on the principle of profit and loss sharing (PLS), the prohibition of interest, and the backing of all financing with real assets (Daoud and Kammoun, 2014; Mia, 2023; Jatmiko et al., 2023). This could increase financial discipline and introduce greater stability into the system. It is in this context that Islamic finance can offer her thoughts on an "ethical revision" of the economic and financial system in crisis. Ethical finance consists of integrating extra-financial criteria (ethical, solidarity-based, environmental, and governance criteria) into investment decisions and portfolio management. These criteria are increasingly taken into account by investors.

2 According to the (IFSB, 2009)-10 standard, SB are usually comprised of a panel of Sharia scholars acting as special advisers to the institutions, and may alternatively be called a Sharia Committee or Sharia Supervisory Board (SSB). The SB or Sharia advisory firm that carries out the Sharia compliance review/audit shall produce reports, indicating whether the IIFS has complied with Sharia requirements throughout the financial year. http://www.ifsb.org/standard/IFSB-10%20Shariah%20Governance.pdf

Islamic finance shares similarities with ethical finance. In fact, several prohibitions distinguish Islamic finance from conventional finance. In Islamic law, the concept of riba prohibits the acceptance of interest on a given monetary amount. Money is regarded merely as a medium of exchange, devoid of intrinsic value if not linked to human effort (Rab, 2019). Consequently, paying interest on such funds is deemed unlawful. Uncertainty (Gharar) and gambling (Maysir) are also prohibited in any commercial transactions. Islamic economics is based on the principle of profit and loss sharing, according to which contracts where one party receives profits with no risk are considered unfair. Additionally, according to the asset-backing principle, contracts must relate to legal assets in order to meet ethical criteria.

Islamic financial principles are therefore geared towards creating a culture in which economic agents spend and redistribute only the funds they really have at their disposal. These principles provide the ethical basis for Islamic finance as a business ethic, with an orientation towards the welfare of society in general; risk sharing, integrity, and justice. Zakat is another important concept in Islamic finance. It represents an obligatory charity system in Islamic finance, according to which the entrepreneur or financial institution must redistribute part of his profit annually among the poorest people, and aims to soften inequalities in society. Since effective collection is still a small fraction of the potential in many countries, efforts are underway to improve the collection, distribution, and effectiveness of zakat. Zakat helped offset the loss of household income due to the COVID-19 pandemic (Hassan et al., 2020; Rabbani et al., 2021). For the most convinced, the prowess and resilience of Islamic finance during the severe crisis may suggest a powerful paradigmatic shift towards a more responsible and Ethical form of finance (Iqbal and Mirakhor, 2017). Moreover, amid the challenges posed by the sanitary crisis and economic shutdowns, certain central banks of some IsDB Member Countries (Bahrain, Bangladesh, Brunei, Indonesia, Iran, Jordan, and KSA) have announced programs to support the financial sector to face the impact of the COVID-19 over a period of up to 6 months. Several measures were used, including payment reprieves for affected borrowers, a reduction in fees, liquidity support, capital requirement reductions, and reserve requirement reductions, among other measures (IsDB, 2020). The IsDB has also provided a contribution to support innovation in order to alleviate the negative impact of the COVID-19 pandemic on its member countries.

In the 1950s, Muslim professionals and economists began to devise an alternative financial system in line with the teachings of the Quran's precepts. Islamic finance gradually gained widespread acceptance and began to prosper as a result of the Muslim world's growing religious devotion and the oil price boom. For decades, Islamic finance has been trying to create financial products that comply with Islamic Sharia guidelines. IBs are trying to ensure partnership intermediation particularly in Middle-East and North Africa (MENA). Islamic banks (IBs) are actively pursuing partnership intermediation, particularly in the MENA region. In developing nations, specifically in North African countries, a substantial portion of Islamic project finance is directed towards critical infrastructure sectors. This includes investments in energy, transport, water and sanitation, and urban services. Additionally, Islamic project finance is prominently allocated to sectors vital for sustainable development, such as agriculture. Moreover, there is a significant focus on human development, with Islamic project financing being channeled into key areas like health, education, and finance, notably in the form of microfinance. This strategic approach aligns with the overarching goals of Islamic finance, emphasizing ethical investment and fostering socio-economic development in the MENA region and beyond (Daoud and Kammoun, 2020a).

3. LITERATURE REVIEW

The subprime crisis attracted more attention to Islamic financial intermediation from national and international standard-setting bodies, policymakers, and academics (Nastiti and Kasri, 2019). IBs are developing all over the world and recording significant growth rates. Islamic banking assets have retained its dominance in terms of asset size of USD 3.06 trillion as of the end of 2022 (2021: USD 2.10 trillion), accounting for 69.3% of the value of global IFSI assets (2021: 68.7%). The Islamic financial system differs significantly from the conventional system. As discussed, deposits in IBs are exposed to different risks, and IBs manage their assets differently from conventional banks. Therefore, due to these structural differences, conventional prudential regulation must be modified to account for these distinctions.

Regulators are working to adapt prudential regulation for Islamic banks, but Sharia-compliant financial instruments are not covered by the Basel II agreement. Islamic finance faces challenges related to interpreting Islamic law, risk management, innovation, and compliance with international standards such as Basel III while respecting Sharia principles. To overcome these challenges, market participants must enhance their understanding of Sharia and strengthen cooperation. These represent the responsibilities of Islamic finance regulators, such as the AAOIFI and IFSB. The first capital adequacy framework for IBs is issued by the AAOIFI, similar to Basel I, marking a significant step. While IBs focus on real-economy asset-backed operations and profit-sharing, they prohibit speculation, debt sales, and derivatives usage. However, insolvency risk is inherent in their two-tier Mudaraba model, with investment account holders bearing full responsibility in case of losses. To maintain trust and prevent massive withdrawals, IBs distribute profits even in loss situations, leading to higher capital adequacy ratios (CAR) compared to conventional banks (Mateev and Nasr, 2023). Basel III, not originally designed for Islamic finance, can be adapted as a foundation. Organizations like AAOIFI and IFSB have worked on CAR guidelines for Islamic banks. While these guidelines focus on the liability side of the balance sheet, they don't provide detailed CAR calculation instructions. The IFSB's "Capital Adequacy Standard" draws from Basel III but addresses credit, market, and operational risk. The Islamic financial system is structurally different from the conventional system, requiring adjusted risk weightings. IBs don't guarantee capital for investment accounts, and losses from these accounts are borne by account holders, so they should be excluded from CAR calculations.

$$CAR = \frac{Tier1^{3} + Tier2^{4}}{\left[\begin{array}{c} Risk - Weighted\ Assets(RWA) \\ -RWA\ funded\ by\ restricted\ PSIA \\ -\left(1-\alpha^{5}\right)RWA\ funded\ by\ unrestricted\ PSIA \\ -\alpha\ RWA\ funded\ by\ PER\ et\ IRR\ of unrestricted\ PSIA \end{array}\right]}$$

Without profit smoothing for Investment Account Holders (IAH), IIFS aren't obligated to maintain regulatory capital for commercial risks from assets funded by Profit-sharing investment accounts (PSIA). This excludes associated RWA from the CAR, leaving only operational risk in consideration. The global financial crisis showed that a requirement concerning the quality and level of capital was insufficient to support the stability of the banking sector. To address the risk of banks running short of liquidity, the Basel Committee has introduced two liquidity ratios: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).

$$\text{LCR} = \frac{\left(\text{Stock of high quality, Sharia compliant liquid Assets}\right)}{\text{(Totalnet cash flows over the next 30 calendar days)}} \geq 100\%$$

$$LNSFR = \frac{Available\ stable\ funding^{6}}{Required\ stable\ funding} \geq 100\%$$

According to the IFSB report (2023), the Islamic banking sector is adequately liquid and has ensured a natural asset-liability management to cover long-term financial stability by maintaining both the LCR and NSFR over 100%. Islamic banks' solid CAR and Tier 1 capital ratios are driven by increased internal capital generation from retained earnings. This boost is associated with heightened income resulting from economic reopening, recovery, and improved profitability (Gabr and ElBannan, 2018; Khemiri, 2022).

4. ANALYSIS AND FINDINGS

The purpose of this paper is to forecast the trend of Islamic banks' dynamics, namely growth, nonperforming financing, stability, and profitability. A quarterly dataset from the first quarter of 2017 (2017 Q1) to the first quarter of 2023 (2023 Q1) is built to forecast Islamic banks' dynamics for the period ranging from 2017 Q1 to 2023 Q1. Furthermore, a quarterly dataset of IMF forecasted GDPG, is also ranging for this period.

According to the IFSB's Financial Stability Report (2023), Iran and Saudi Arabia are the world's leading holders of Islamic banking assets. Malaysia, the UAE and Bahrain hold 11.2%, 10% and 3.3% of total assets respectively. The choice of jurisdictions depends on their total share of global Islamic assets and the availability and usefulness of data. Therefore, eight countries are selected for this study: GCC countries (Saudi Arabia, UAE, Bahrain and Oman), one Middle Eastern and South Asian country (Pakistan) and Southeast Asian countries (Malaysia, Brunei and Indonesia). This research utilised descriptive analysis techniques to identify trends and relationships in current and historical data. The findings are presented in tabular and graphical form to enhance clarity. Following the studies of (Mohd Noor et al., 2020; Nosheen and Abdul Rashid, 2021; Ramady, 2015), the main indicators used to assess the resilience of banks are considered. Table 1 explains the main indicators GDPG, ROA, CAR and NPF.

The GDPG is used as a macroeconomic indicator because it measures economic growth over time. During economic downturns, the GDPG is likely to decrease, which can significantly impact households, and small and medium-sized enterprises (SMEs), leading to an increase in NPF. This increase in NPF can also cause a decline in banks' profitability and a deterioration of their capital adequacy ratio. Therefore, ensuring banks' resilience is critical in such situations. The variable SIZE captures possible scale effects across jurisdictions, while the variable ROA reflects banks' profitability.

As IBs' dynamics are subject to macroeconomic changes, the GDPR is considered to evaluate their response to such shocks. The IFSB's Prudential Structural Islamic Financial Indicators (PSIFI) database is used to extract Islamic banking dynamics. The International Monetary Fund (IMF, 2023) is the source of GDP growth data by country (Figure 1).

Table 2 presents the descriptive statistics of the main variables by jurisdiction. The data shows that Malaysia, Saudi Arabia, Pakistan, Brunei, and Bahrain have the highest ROA ratios, indicating that these jurisdictions are more likely to generate higher income when deploying their total Islamic banks' assets. Conversely, Indonesia and Oman have the lowest mean values.

Similarly, it has been shown that IBs in Saudi Arabia and Malaysia have lower NPF ratios, whereas Bahrain has the highest mean values. A higher NPF may indicate a higher probability of default

Table 1: Description of variables

Indicators	Symbol	Measurement
Gross domestic product growth	GDPG	Percentage of gross domestic product growth
Return on assets	ROA	Total net income to total assets
Capital adequacy ratio	CAR	Total regulatory capital to risk weighted assets
Non performing financing rate	NPF	Total non-performing financing to total financing

Source(s): FSB's Prudential Structural Islamic Financial Indicators (PSIFIs) database and author's calculation. And IMF World Economic Outlook, October 2023 (For GDPG data)

3 Tier 1 capital is composed of: 1) common Equity: includes common equity, retained earnings, and specified reserves; 2) additional capital, which comprises Sharia-compliant instruments and certain reserves.

4 Tier 2 capital includes instruments issued by IIFS meeting specific criteria, general provisions for potential losses, premiums from Tier 2 capital instrument issuance, and instruments or qualifying capital from consolidated subsidiaries meeting Tier 2 criteria (for more details, see IFSB, 2013).

5 "Alpha (α)" represents the percentage of assets funded by unrestricted PSIA, a determination made at the discretion of supervisory authorities. The precise value of α is subject to the authorities' case-by-case judgment.

6 Available stable funding is the dependable part of equity and liability financing over a one-year horizon, even in extended stress. Required stable funding is based on assessing asset liquidity and residual maturities under an extended stress scenario, encompassing both on- and off-balance sheet exposures for IIFS.

Figure 1: Quarterly GDP percentage growth across jurisdictions from 2017Q1 to 2023Q1

Source(s): IMF World Economic Outlook report 2023

Table 2: Descriptive statistics

	UAE				KSA			
	Mean	Max	Min	Std.Dev	Mean	Max	Min	Std.Dev
GDPG	0.017	0.079	−0.050	0.043	0.020	0.087	−0.043	0.044
ROA	0.015	0.021	0.008	0.003	0.024	0.028	0.019	0.002
CAR	0.178	0.201	0.158	0.009	0.202	0.219	0.167	0.011
NPF	0.061	0.073	0.048	0.009	0.011	0.014	0.008	0.002
	Pakistan				**Oman**			
GDPG	0.041	0.061	−0.009	0.027	0.007	0.043	−0.034	0.028
ROA	0.020	0.036	0.010	0.007	0.005	0.011	−0.011	0.006
CAR	0.157	0.195	0.129	0.019	0.156	0.214	0.132	0.021
NPF	0.040	0.053	0.030	0.006	0.014	0.031	0.001	0.011
	Malaysia				**Indonesia**			
GDPG	0.036	0.087	−0.055	0.048	0.037	0.053	−0.021	0.029
ROA	0.038	0.078	−0.087	0.042	0.010	0.013	0,005	0.002
CAR	0.177	0.188	0.167	0.006	0.213	0.263	0.161	0.030
NPF	0.015	0.017	0.013	0.001	0.034	0.048	0.023	0.007
	Brunei				**Bahrain**			
GDPG	0.005	0.039	−0.016	0,021	0.019	0.049	−0.046	0.034
ROA	0.018	0.029	0.007	0.006	0.016	0.033	0.002	0.006
CAR	0.188	0.228	0.158	0.016	0.185	0.195	0.175	0.006
NPF	0.041	0.057	0.028	0.006	0.089	0.129	0.055	0.024

Source(s): Author's work

because, in most jurisdictions, almost 50% of total Islamic financing is allocated to household financing. Due to the lack of diversification, this higher concentration can lead to a higher risk of default during economic downturns.

Table 2 illustrates also that Saudi Arabia has the highest CAR ratios as measured by the mean, whereas Pakistan and Oman have the lowest mean values. This implies that jurisdictions with higher CAR are more likely to ensure banking resilience. Specifically, IBs are able to operate safely because total regulatory capital is significantly higher than risk-weighted assets.

The quarterly GDPG exhibits excessive variation in all jurisdictions, with a significant gap between maximum and minimum values. This gap is expressed in terms of standard deviation, confirming the excessive volatility of GDPG over the period under review. Figure 1 illustrates the change in GDPG between the first quarter of 2017 and the first quarter of 2023, based on the IMF's World Economic Outlook. As illustrated in Figure 1 quarterly GDPG is expected to decline for all jurisdictions in 2020 due to the impact of the COVID-19 pandemic on the global economy. The COVID-19 pandemic's adverse effect on the global economy necessitates anticipating the dynamics of IBs during this critical period. This will provide regulators and policymakers with additional insights to ensure the resilience of the Islamic banking sector.

This research aims to evaluate the Islamic banking sector's capacity to absorb losses and sustain profits, as measured by capital

adequacy and profitability indicators. Additionally, it analyses the quality of the Islamic banking sector's assets by examining the ratio of NPF and Provisions for Gross NPF. The analysis begins by examining trends in the size of IBs as a structural indicator of the Islamic finance industry.

4.1. Islamic Banks' Size

Figure 2 shows the trend of Islamic banks' size (as a structural Islamic financial indicator) from 2017Q1 to 2023Q1. The data suggests that the assets of IBs in Pakistan, Malaysia, Indonesia, and Brunei are expected to increase. This is supported by the GDPR of these countries, which amount to 1.18%, 0.61%, and 0.54%, respectively. The assets of IBs in three GCC countries follow an increasing trend from 2017 to 2023. Saudi Arabia's IBs are expected to dominate with a market value of $336 billion by 2023Q1, followed by the UAE with a value of $175.5 billion. Bahrain is the only country where the assets of IBs are expected to decrease at a negative slope in 2022 and continue decreasing in 2023. Figure 2 displays the fluctuations in total assets, which are expected to decrease from $70.1 billion in 2021Q4 to $44.5 billion in 2023Q1.

4.2. Capital Adequacy Ratio

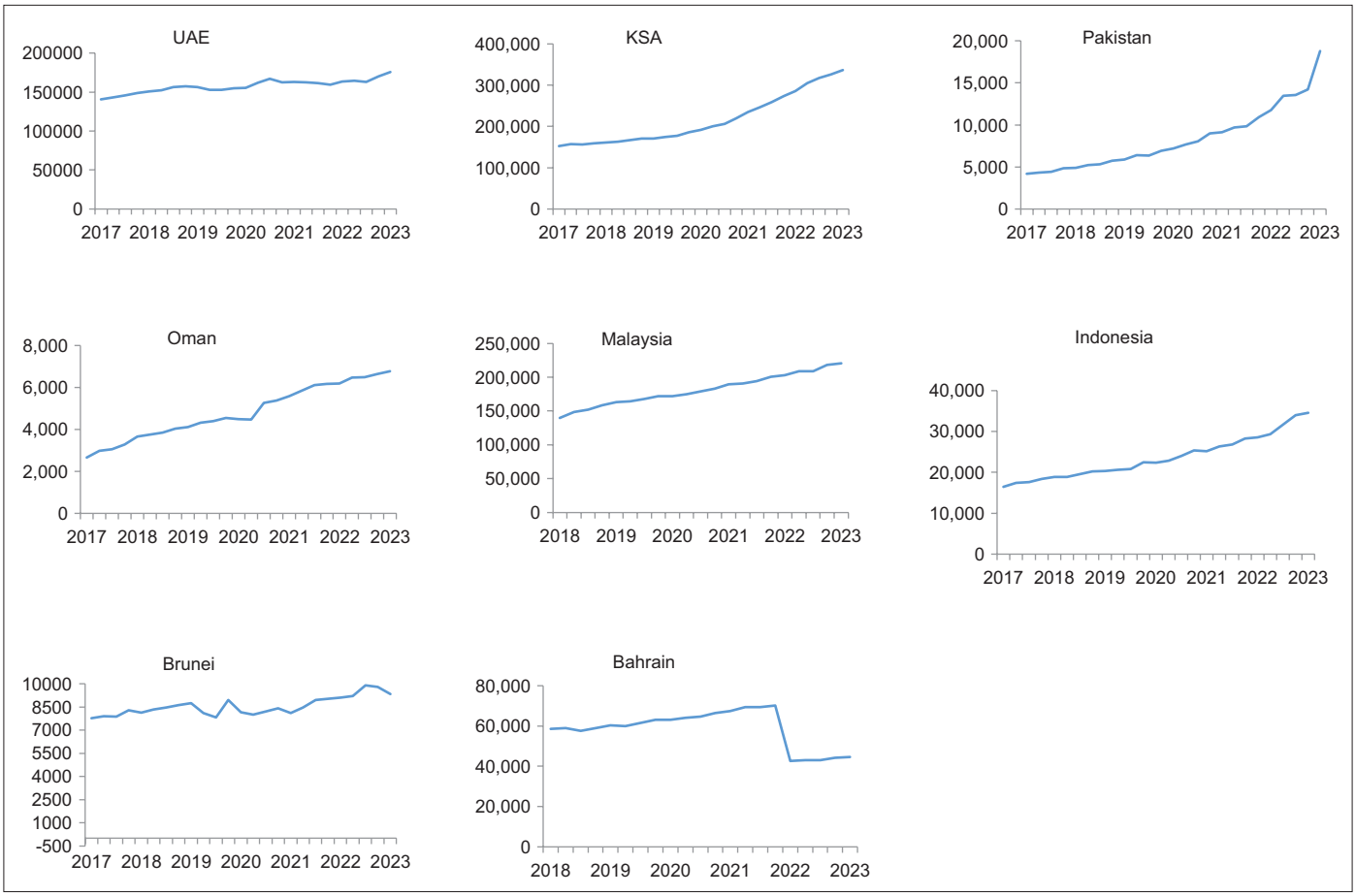
Figure 3 shows the evolution of Islamic banks' CAR from 2017Q1 to 2023Q1. The results indicate that the CARs of all jurisdictions meet the Basel Committee on Banking Supervision (BCBS) capital adequacy requirements, with all values exceeding the minimum Basel III threshold of 12.75%. The CAR values of almost all jurisdictions have not fallen below the last observation of the post-COVID periods and during the third quarter of 2019. This implies that there has been a consistent trend in CAR values. Saudi Arabia has the highest CAR at 20.5% in 2022 Q4, which is attributed to the size of Islamic banks' assets relative to other countries in the sample. Indonesia's high capital CAR may reflect the substantial stability of Islamic banks. In the case of Oman, the relative stability of the CAR may be attributed to the fact that only a small proportion of the assets of IBs are subject to the Basel III weighting. As a result, the proportion of assets with no risk, e.g. cash and no-risk investments, has been high by historical standards and will probably decline.

4.3. Profitability Ratio

The analysis of trends in the ROA of IBs from 2019Q4 to 2021Q4, which is shown in the Figure 4 reveals that the ROA exhibits alternating upward and downward variations with an increasing trend in the first quarter of 2023, surpassing their pre-pandemic levels, for four countries: UAE, Pakistan, Indonesia, and Brunei.

However, the Omani Islamic banking sector faced pressure on profitability due to the effects of the pandemic. In this case, the ROA decreased from 0.8% in Q1 2019 to -1.1% in Q3 2019, but then started to increase again, reaching a maximum value of 1.1% in Q2 2022.

Figure 2: IBs' total assets in USD million

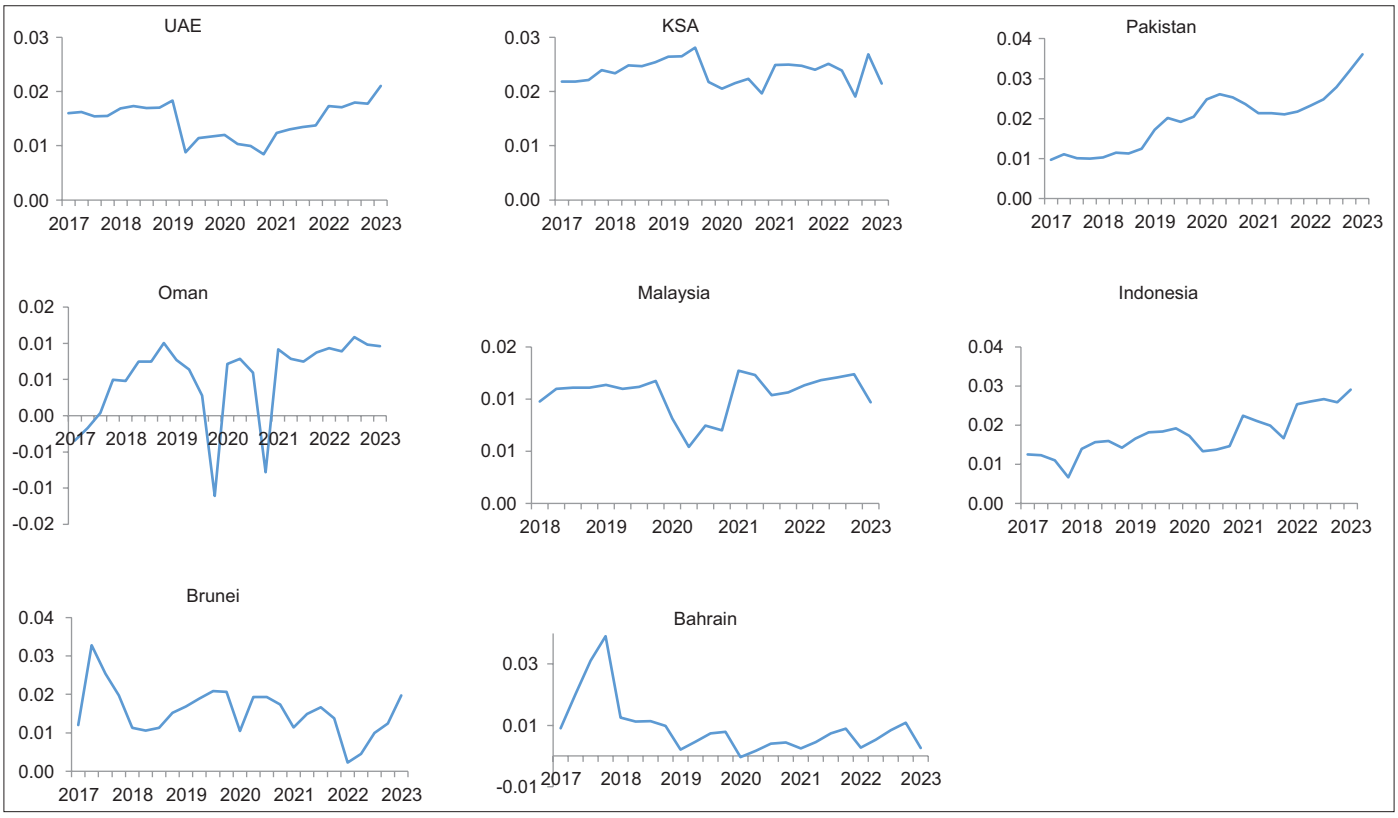


Source(s): Author's work

Figure 3: CAR of IBs across jurisdictions

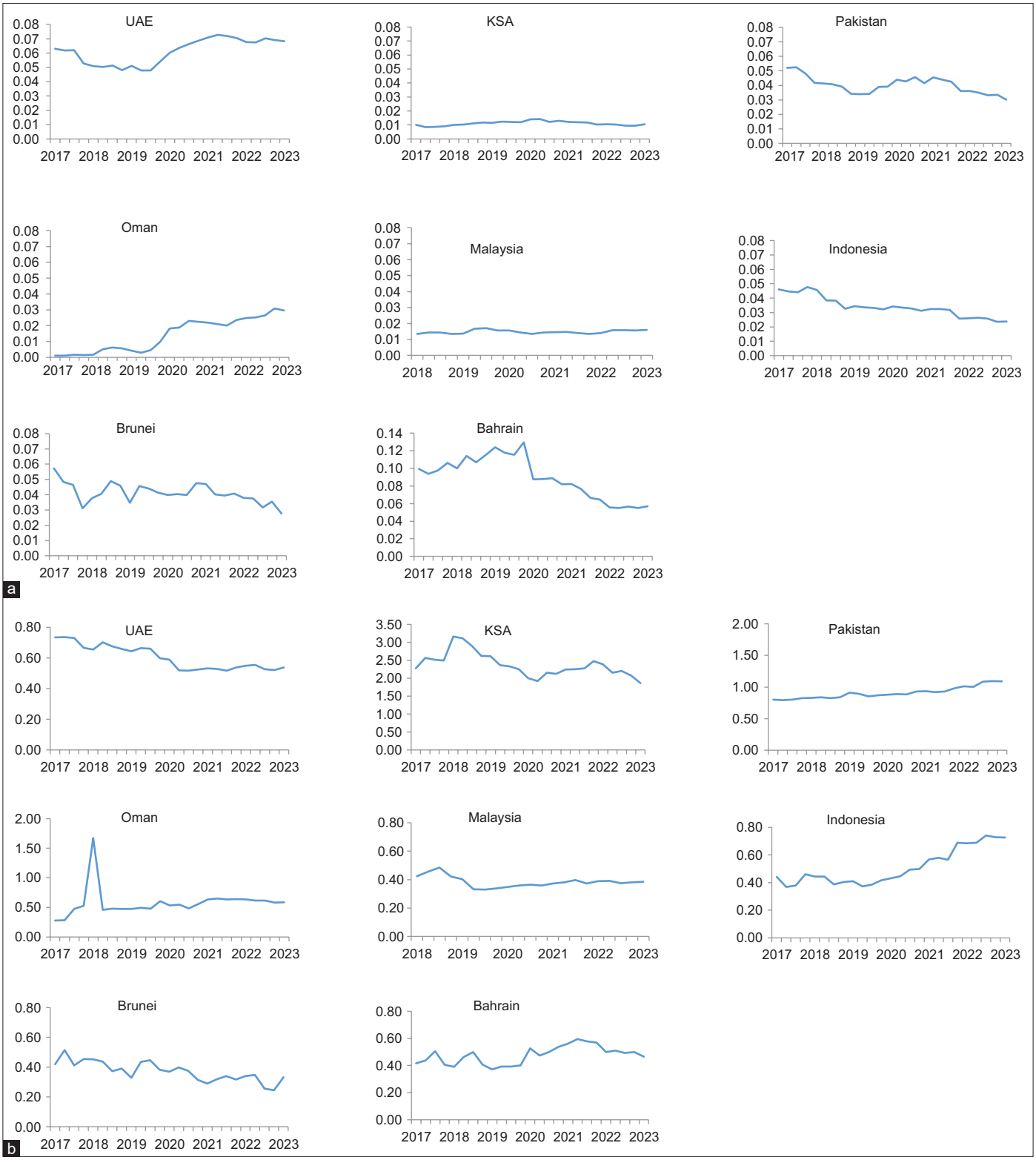
Source(s): Author's work

Figure 4: Proftability of IBs across jurisdictions



Source(s): Author's work

Figure 5: (a) Non performing financing (gross NPF) ratio, (b) Provision for Gross nonperforming financing (gross NPF) and Source(s): Author's work



The ROA values continue an upward trend over the first quarters until reaching peak values of 2.8% in Q3 2019, 1.2% in Q4 2019 and 0.8% in Q4 2019 for Saudi Arabia, Malaysia and Bahrain respectively. This upward trend will reverse to a decline reaching 1.90% 2022Q3, 0.7% 2020Q4 and 0.2% in 2021Q1 for Saudi Arabia, Malaysia and Bahrain respectively.

Our results reveal that the effect of the COVID-19 pandemic affects the profitability of all countries during the post-Covid phase, but in a slightly different way.

4.4. Asset Quality

Regarding the UAE case, it is observed that the NPF rate decreased from 6.2% in 2017Q4 to 4.8% in 2019Q3. Subsequently, the rate

increased and reached its peak at 7.0% in 2022Q3, which is the highest recorded value during the study period. Additionally, provisioning also decreased during this period. In 2023 Q1, it is expected that asset quality will improve, leading to better provisioning for NPF. Although unchanged year-on-year, adequate coverage for credit risk is still provided (Figure 5).

In addition Figure 5 shows that, with the exception of a decrease in the NPF value in 2022, the NPF of Pakistani IBs followed a similar trend in the first quarters as in the UAE.

For Bahrain, the values of NPF showed an upward trend in the first quarters, reaching a peak value of 12.9% in 2019Q4, followed by an immediate decline to 8.8% in 2020Q1. The asset quality of IBs in Bahrain continued to improve, with the NPF falling to 5.7% at the end of 2023Q1.

The Saudi Arabian and Malaysian cases are characterised by lower values of NPF. This can be explained by the over-performance of IBs in these jurisdictions, which is due to the impressive increase in their total assets and increased provisioning.

From its peak of 4.8% in 2017Q4, Indonesia's NPF value decreased to 2.4% in 2023Q1. This period was marked by a downward trend. The Indonesian Islamic banking sector's position has improved due to increased loan provisioning. It is expected that the asset quality of the Islamic banking sector will continue to improve in 2023Q1.

Inversely Oman has recorded an upward trend in NPF values, and the provision for NPF has also increased during the last period. The asset quality of the Omani Islamic banking sector has slightly improved since 2021Q4, with NPF decreasing to 3.0% in 2023Q1 from 3.1% in 2021Q4. For Brunei, the outlook for asset quality appears favorable, based on the improvement in NPF provisioning recorded in the latest period.

5. CONCLUSION

This study analyses the dynamics and soundness of Islamic banks, taking into account indicators such as size, profitability, non-performing financing, provision for NPF and capital adequacy ratios. Saudi Arabia and Southeast Asian countries (Malaysia and Indonesia) are expected to remain stable, while other regions may face challenges, requiring additional policies for the stability of Islamic Banking sector. IBs in Brunei and Oman are particularly affected, which may require higher provisions for non-performing loans. Notable improvements were observed in several financial soundness indicators and jurisdictions, with some levels reaching pre-pandemic levels. The use of PLS-based contracts allows IB to share risks rather than bear them in difficult economic conditions. IBs in Pakistan have adopted PLS contracts, which enable risk-sharing. This innovative policy, which has already been implemented to support SMEs, aims to ensure stability and sustained growth of Islamic banks. Highlighting the success of such mechanisms in supporting SMEs globally, the study recommends reconsidering regulatory reforms to allow for equity-based financing. However, the paper acknowledges the potential vulnerabilities of Islamic banks, particularly in Indonesia, to the ongoing COVID-19 pandemic. It suggests that policymakers should consider providing additional liquidity and reinforcing provisions.

The paper concludes by highlighting the importance of equity finance for SMEs and economic recovery, and provides recommendations for policymakers to address the challenges and maintain the stability of Islamic banks.

The study acknowledges that its findings may be affected by global economic conditions deteriorating, such as those resulting from the Russian-Ukrainian war or conflicts in Palestine. In such cases, Islamic banks in various regions may become more vulnerable to shocks, which could prolong their recovery periods. This underlines the importance of being aware of unforeseen geopolitical and economic events and their potential impact.

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