



**FINANCIAL RECESSION, CREDIT CRUNCH
AND ISLAMIC BANKS: A CASE STUDY OF
AL RAJHI BANK IN THE KINGDOM OF
SAUDI ARABIA**

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ABSTRACT: The paper discusses how Islamic Banks are able to withstand the severity of financial recession, with special emphasis on Al Rajhi Bank in the Kingdom of Saudi Arabia. Al Rajhi is among the most profitable banks in the Middle East; its robust profitability has been largely driven by increasing business volumes, higher margins, and low labor costs. The financial recession has its impact on all banks in the middle east along with western counterparts, but its severity was not heavy for Islamic Banks compared to the latter and the paper concludes that there can be no doubt that Islamic finance has an exciting future; the quest for a financial system based on moral values rather than greed and fear, is bound to enhance its position in the global system.

KEYWORDS: Al Rajhi Bank, Islamic Banking, Financial recession, Saudi Arabia, Risk Management, Profitability

JEL Classification: G21, G32, G29, G39

Introduction

As the World has not yet recovered from the global recession, Islamic banking is gaining popularity in emerging economies as it bolstered financial institutions avoid the worst of the economic meltdown. With irresponsible banking practices taking the blame for bringing about the global economic crisis, there has been a surge of interest in Islamic finance. Islamic banking refers to a system of banking or banking activity that is consistent with the principles of Islamic law (Sharia) and its practical application through the development of Islamic economics (Amin, 1978). Sharia prohibits the payment or acceptance of interest fees for loans of money (Riba, usury), for specific terms, as well as investing in businesses that provide goods or services considered contrary to its principles (Haraam, forbidden). While these principles are used as the basis for a flourishing economy in earlier times, it is only in the late 20th century that a number of Islamic banks are formed to apply these principles to private or semi-private commercial institutions.

According to ratings agency Moody's, the global Islamic finance sector is worth \$700 billion and has the potential to be worth \$4 trillion. Islamic finance has been growing by 15 to 20 percent per year for some time and people are looking for alternatives to conventional banking products after the economic crisis (CNN-WB, 2007). There are a lot of non-Muslim countries, including the UK, France, Japan, Hong Kong and Singapore encouraging Islamic finance. In the West, banks including Lloyds TSB, HSBC, Deutsche Bank and Citibank all offer Islamic finance products

There are many differences between Islamic and conventional banking practices. One fundamental difference is that Islamic banks do not charge interest; rather than borrowers and lenders, the system is based on buyers and sellers. Conventional banking is biased to the seller; Islamic finance is trying to level the ethics between the two parties.¹ While Islamic banks allow to take advantage of financial services that are consistent with religious beliefs, it is the ethics underpinning Islamic finance that are attracting the interest of conventional finance institutions keen to learn lessons from the banking crisis

Although Islamic banks have slightly suffered from the global recession, they emerged largely unscathed from the initial banking meltdown as Islamic banks are not allowed to deal in mortgage-backed securities or credit-default swaps, two of

¹ The system is based on justice for the two parties and how one get to the justice is extracted from Islamic faith.

the practices behind the so called ‘banking crisis’ (CNN-WB, 2007). Islamic system has many more layers of risk assessment and management, which could help protect them from the problems afflicting conventional banks.

The present paper is an empirical discourse on the relevance of Islamic banking to deal with the financial crisis with special emphasis on Al Rajhi Bank in the Kingdom of Saudi Arabia. It reviews the sustainability of the bank by analyzing the performance of major financial indicators such as profitability, asset growth, liquidity, and risk management during the period between 2007 and 2010.

Financial Recession and Islamic Banks

A question that is often discussed is, if the global economic crisis triggered by the housing bubble burst and the sub-prime credit crisis in the US would have been averted, the Islamic finance framework were in place. It is a question that is asked often and one that has generated global interest. The answer is that in principle, Islamic finance may have prevented the sub-prime crisis leading to the global economic crunch.² The very founding spirit of Islamic finance is anti-speculation and “anti-bubbles”; improper risk management and lack of execution of principles in any financial system can potentially lead to similar negative results (Masud, 2009). However, understanding the general concepts behind Islamic finance, one may begin to appreciate the positives of this form of banking that is one of the fastest growing in the world.

Islamic finance has the potential to prohibit usury or charging interest for the use of money, investing in speculative financial products like certain derivatives and engaging in businesses, products and services that are considered forbidden in Islam. Furthermore, Islamic banking emphasizes partnership in profit and loss sharing, asset-backed investing and more importantly it is not restricted to Muslims alone (Farhad, 1994). As a matter of fact several secular states including Singapore have seen an increase in demand for Islamic financial products. In essence under Islamic law (Sharia) one cannot lend money to make money or engage in predatory lending which leads to poor getting poorer and rich getting richer, i.e. exploitation is strictly forbidden. Also, debt cannot be taken on without collateral or an asset backing (Hasan, 1994). One must refrain from gambling (Maisar) and uncertainty (Gharar). Both buyer and seller are involved in the transaction with a no-pain, no-

² As the mortgages were sold on to Freddie Mac and Fanny Mae, the arrangers were unconcerned that the sub-prime borrowers might be unable to meet their financial obligations. Indeed, gifts were provided to entice the feckless to sign up, and the mortgages often exceeded the value of the property.

gain approach to making profits or sharing losses. This sounds common sense, ethical, trust-fostering and would appeal to most people.

One of the major factors behind the success of Islamic banking is that all products of the Islamic banking are asset based unlike conventional banking where papers and securitization of the assets are in vogue. We should not see Islamic banking in isolation as the Islamic banking is not an exception to the global recession. However, as compared to the conventional financial regime, the Islamic financing is relatively safer due to its focus of prudence as well as quality of the assets.³

One of the major reasons for stability in the Islamic banking is that unlike conventional financial system it does not create value without assets which protect the Islamic system from any major loss (IRTI, 2007). The global financial meltdown stemmed from the sub-prime or mortgage system in the United States and the European countries, where the value of the mortgage was created with backing of the assets (Bernanke, 2007). Since Islamic banking does not have the structure of creating value without assets, it becomes relatively safer from any unforeseen damages. However, there are some risks faced by Islamic banking as well as conventional banking (Akkizidis et.al, 2008). If it provides some loans to the trade or industry for purchasing any product or for investment, Islamic banks do it on Halal basis or without interest as it becomes partner in profit or loss.

In the present credit crunch the highest losses by the conventional banks are on personal loans, which are not asset based and if customers default in their repayment, the banks have no option to recover it. Islamic banking does not believe in any product which is without asset base that saved them from huge losses.

Literature review

Islamic finance is taking tentative steps towards regaining its mantle as one of the fastest growing asset classes in the world. In spite of the financial crisis and the Dubai debt standstill, the industry is expanding in many emerging markets and introducing new standards that would help develop products and attract investors (Oakley, 2010a). The driver of this growth is retail banking, which is attracting more interest not just in the world's two biggest hubs of Islamic finance in the Middle East and South East Asia, but in China, Russia and Africa. The increasing

³ Many banks had shelved their consumer financing products in the face of economic slowdown and due to shockwaves of the world financial meltdown particularly the car and home financing, Dubai Islamic Bank continued to serve the people with these products which did not suffer from major defaults or non performing loans.

role of Islamic finance in the Asian countries is analyzed by Brown (2011) with both conventional and Islamic banks reporting a rise in attention in Sharaia compliant products. In a comparative study Haron (1998) analyze application of Sharia principles, funding sources and its utilization with the help of empirical data from eleven countries. The study concluded by notifying the variations including sectoral financing.

In the first quarter of 2011, \$32.4 billion of Islamic bonds (Sukuk) are issued compared with \$ 51.2 billion raised in the entirety of 2010 (Mishkin, 2011). Rising oil revenues and growing infrastructure spending in stable GCC countries including the Kingdom of Saudi Arabia should anchor the local Sukuk market. Because of differences in Sharia interpretation in many countries and regions, and competition between banks that were keen to make names for themselves as innovators – the Islamic finance markets is fragmented (Wigglesworth, 2010a). Nonetheless, experts anticipate that innovation will continue – albeit more cautiously – and they predict that new products will adhere more closely to Islamic law.

Being a niche industry, Islamic finance faces considerable challenges. The way the industry responds to these challenges will determine whether it will become a significant alternative to these conventional systems in global financial markets (Karuvelil, 2000). The study of Mohammed (1999) on Islamic Banking focusing on the rural and small sectors in Bangladesh shows that the commercial sector investment was more fruitful and viable. The study also observed the increasing number of customers at the both end of credit and deposits portfolio. The study on the soundness of Islamic banks, focusing on customers in Bahrain showed that religious belief followed by return and location are the pointing factors (Metawa & Almosawi, 1997).

In Malaysia the leader of Islamic finance in Asia, about 19% of banking assets are Sharia compliant, as are 88% of listed stocks on the Kuala Lumpur stock exchange (Brown, 2010). The sector has strong government support, including a friendly tax regime and predictable regulation, which have provided a high degree of legal certainty for issues and investor, which combined with government encouragement to state institutions to use Islamic financing has helped make Malaysia significantly more innovative than other countries in the region. Ahmad and Mansor (2002) assessed the role of Islamic banking industry in the overall monetary distributional channels in Malaysia. The study using Granger Causality test concluded high level of competition between Islamic and conventional term deposits rates. The paper shows that the effect of Central bank's monetary policy

would become less restrictive if Islamic and conventional banking systems in terms of depositing and financing rates are not close substitutes of each other.

Gafoor (1996) argued that the element of risk should not be excluded from the financial transactions of Islamic banks. He proved in his study that the profits would have accrued from one year to another according to the performance of the banking in its portfolio and not due to changes in interest rates. Haron and Shanmugham (1995) tried to empirically link the rate of interest to total Islamic deposits in Malaysia using Pearson Correlation and first order auto-regression models. It found strong negative relationship between interest rates and Islamic deposits.

Global Islamic finance banking assets have grown to \$900 billion, which is a doubling in size since 2006; impressive given the financial shocks, particularly amidst the global market crisis (Oakley, 2011). Islamic financial products remain one of the financial success stories of the decade as the opportunities arising in China, India and Africa are immense. There has been comparatively little innovation in the Islamic capital markets in the last couple of years, because there have been fewer deals as a result of the financial crisis (Sakoui, 2010). However, dynamic that will support supply is that several regional banks are converting to Islamic institutions and in certain regional jurisdictions these could soon outnumber conventional banks.

The study of Smolo and Mirakhor (2010) show that although the crisis had limited impact on Islamic financial institutions, the major flaws of the capitalist financial system are relevant to the development of such institutions; without learning and applying the lessons from the crisis, Islamic financial institutions runs a risk of committing the same mistakes. The study concludes that greater attention should be given to the fundamental principles of Islamic finance in order to ensure the future development of industry.

Studies on the role of shadow banking system on the financial crisis observed that the bankruptcy of insolvent institutions and the disappearance of the more exotic instruments' liquidity are gradually promoting an intense process of deleveraging and a forceful reconfiguration of the global financial system (Maryse et al., 2009).

Wigglesworth (2009) analyzes the implications of financial recession on the Islamic banks in Saudi Arabia. After a stock market rash in 2006, the Saudi banks entered the financial crisis with little leverage, modest real estate exposure and healthy balance sheet. Nor had relatively insular Saudi banks been active borrowers on international money markets, and a reliance on deposits has shielded

them from the liquidity problems that have played other Gulf banks. Study of Oakley (2010b) on a broader regional perspective also supports the same view and he wrap up that Islamic finance has weathered the financial crisis storm. One of the world's fastest growing asset classes before the financial crisis hit in August 2007 continues to expand albeit at a slower pace.

The important challenges for the Islamic banks to maintain its momentum in facing crisis include mismatch between short-term debt and long term investments, sector concentration, poor risk management, and a reliance on bulky but volatile market-to-market investment revenue, rather than diversified, fee based income streams (Wigglesworth, 2010b). However, the field of Sharia finance remains one of the fastest growing areas in the global finance industry, with estimates range between 20% and 40% growth annually for the next five years (Jones, 2010). Furthermore, interest in hedge funds and alternative products in the Middle East in particular is on an upward trend. Structuring derivatives that comply with the principles of Sharia has long been one of the most complex niches of Islamic finance. But it is an increasingly important one, as the industry continues to grow and risk management becomes vital. To stimulate the use of Islamic derivatives, the International Islamic Financial market, a Bahrain based Islamic Capital market industry body, and the International Swaps and Derivatives Association drafted a 'Tahawwut Master Agreement' with standardized documentation for Islamic derivatives.

Al Rajhi Bank

Founded in 1957, Al Rajhi Bank is one of the largest Islamic banks in the world with total assets of SAR 184 billion (USD 49 billion), market capital of over USD 4 billion, employing 7500 associates (Al Rajhi Bank, 2010). Deeply rooted in Islamic banking principles, the Sharia compliant banking group is instrumental in bridging the gap between modern financial demands and intrinsic values, whilst spearheading numerous industry standards and development. With an established base in Riyadh, Saudi Arabia, Al Rajhi Bank has a vast network of over 466 branches, 2,750 ATM's, 21,000 POS terminals installed with merchants and the largest customer base of any bank in the Kingdom (Al Rajhi, 2009). As one of the leading and most progressive banks in Saudi Arabia, Al Rajhi Bank recorded net income profit of SAR 6,771 million (equivalent to USD1.8 billion) in 2010 (Al Rajhi, 2010). Al Rajhi Bank operates in multiple segments and continues to grow through diversification of income resources and development of the investment and corporate banking sectors which build on the strong retail banking base.

In addition to local growth, Al Rajhi Bank ventured into the Malaysian market in 2006 after being the first foreign bank to be awarded a full-banking license by the Bank Negara Malaysia. Malaysia marked the bank's first foray into the South East Asian banking scene, whereby the core banking products are introduced to the Asian market providing a whole new Islamic banking experience. Al Rajhi Bank currently has 19 branches in Malaysia with plans to increase this number in the future. Al Rajhi Bank is now fully operational in Kuwait with one branch opened. The Central Bank of Jordan has granted Al Rajhi Bank the license to operate a fully fledged Sharia Compliant Bank and operations are expected to commence in 2011. Al Rajhi Bank bagged AAA rating (long term) for the tenth consecutive term of International Islamic Development Bank (Al Madeena News, 2011). As one of the largest privately owned Islamic Banks in the world (in terms of assets and profitability), Al Rajhi bank is focused on continued growth both at home and abroad.

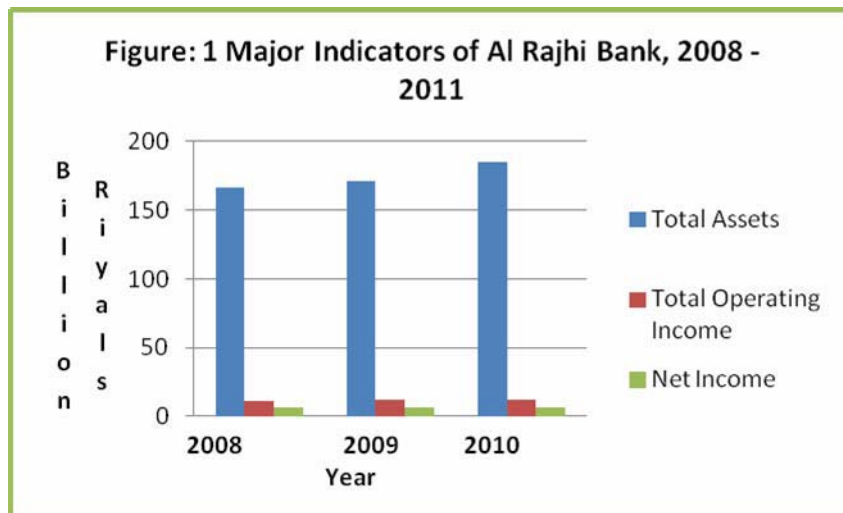
Performance during the Recessionary Period

Al Rajhi bank focuses on several main groups; retail, corporate, and investment; the retail banking group represents the heart of the bank's activities with a full suite of products targeted towards different segment needs. This includes deposits, credit current accounts, share trading, remittances and consumer financing, including cars, personal, real estate loans and credit cards. The Corporate Banking Group has a special focus on corporate and commercial sectors. For these two sectors, the bank offers a wide range of financial and investments services, which are operated within the framework of Sharia principles.

Robust credit ratings received from Moody's (A1) and from Fitch (A positive) during the recessionary period are driven by Al Rajhi's healthy customer franchise in the retail sector, excellent profitability, concentration in loans, deposits and strong capitalization. The rating is supported by the bank's strong and defendable domestic franchise and sound core financial performance. Al Rajhi is the largest fully fledged Sharia compliant financial institution globally and one of the very few mass-market banks in Saudi Arabia; such as the collection of non-remunerated deposits.

During the beginning of recessionary period in 2007, when compared to any other banks globally, financial indicators of Al Rajhi Bank were stronger, even though some of them declined marginally. In the year 2007, the bank's bottom line profits were down by 11.7% to SAR 6.45 billion (USD 1.714 billion) on the back of a sharp decline in fees from brokerage operations (Moody's Investors Services, 2008). However, during the period core banking operations continued to perform

well, with net intermediation income up by 13% to SAR 7.7 billion. Total assets also increased by 18% to SAR 124.9 billion (USD 33.2 billion) over the year, and grew by another 31% during the first three quarters of 2008 (Standard & Poor’s, 2008). These figures reveal that the new assets booked on Al Rajhi’s balance sheet incrementally carried a lower yield than in previous years. Accordingly, the banks shifted its corporate strategy towards a less profitable and more volume-driven one when opportunities in the lucrative retail banking arena are slowly becoming less widely available. Over all, Al Rajhi’s financial performance in 2007-08 can be considered steady, as very limited amounts of non-recurring income and expenses were recognized during the period. Major indicators of Al Rajhi bank between 2008 and 2011 is given in Figure 1.



Source: Al Rajhi Bank, Annual Reports, Various Years

As an Islamic retail bank mainly focusing on Saudi Arabia’s large domestic market, Al Rajhi is to a great extent defended from imported credit turmoil, which affected many of the Western banks during the period. The bank recorded a 60% increase in its lending portfolio during the first nine months of 2008. The price to pay for increasing market shares has resulted in lower return on assets, reaching a still very strong annualized 4.7% compared with 5.6% in 2007, and a slightly declining return on equity, standing at an annualized 26.6%, compared with 27.3% in 2007 (Moody’s Investor Services, 2008). Al Rajhi bank could maintain its lending volumes during the recessionary period at the expense of liquidity. However, the stability of deposit base was strong.

Table: 1 Comparison of Al Rajhi Bank's financial performance with other major banks in the Kingdom of Saudi Arabia, 2008

Financial Indicators	Al Rajhi Bank	Riyadh Bank	Saudi British Bank	Saudi American Bank
1. Dividend per share	3	1.4	0.96	1.65
2. Earnings per share	4.35	1.76	4.87	4.95
3. Investment On/ Deposits %	119.71	38.39	30.2	38.35
	18.02	17.13	19.39	22.05
4. Book Value per share	12.87	12.05	11.1	10.36
5. Price to Earnings	3.11	1.24	2.78	2.32
6. Price to Book Ratio	24.14	10.27	25.1	22.44
7. Return Equity %	3.96	1.65	2.22	2.49
8. Return on Total Assets %	5.36	6.6	1.78	3.22
9. Dividend Yield %				

Sources: Al Rajhi Bank, Annual Report 2009; Riyadh Bank, Annual Report 2009; Saudi British Bank, Annual Report 2009; Saudi American Bank, Annual Report 2009.

Table 1 compare the major financial indicators of Al Rajhi Bank vis-à-vis other major banks in the Kingdom of Saudi Arabia. Almost all the indicators of Al Rajhi Bank are financially sound and superior to the domestic peers during the early period of recession. Along with a cost to income ratio of 26%, in 2007, Al Rajhi has a strong grasp of its operating expenses through the cycle. With gross credit exposures making up 71% of total assets in 2007, Al Rajhi displays higher credit leverage than domestic and regional peers.

Sustainability of Al Rajhi Bank

Al Rajhi has a strong business franchise as it is the third largest bank with 12% share of Saudi Arabia's total banking assets, and it fully operates on the principles of Islamic banking. Being less selective in segmenting its market, Al Rajhi has managed to attract about 3 million customers, a level that has proved to be stable and profitable despite the high costs attached to running a network within excess of 400 branches. Such an exceptionally strong franchise results in non-remunerated deposits making up more than 80% of total customer deposits.

With a funding cost of about 85 basis points in 2007, Al Rajhi's profitability is built on strong business model that fully exploits the value of the specific retail-banking market in Saudi Arabia (Al Rajhi, 2007). Al Rajhi's strong franchise in

retail banking, especially through installment sales (consumer loans), which account for about 50% of total lending, provides a very appealing risk-return trade-off. Indeed the vast majority of credit exposures are based on salary assignments, with borrowers often employed in the public sector, which drives the cost of risk at very manageable levels by international standards.

Table 2. Key Indicators of Al Rajhi Bank, 2006-2009

Indicators	Year			
	2006	2007	2008	2009
1. Total Assets (Billion Riyals)	105.2	125	165	171
2. Customer Deposits (Billion Riyals)	73.3	90	117	121
3. Total Operating Income (Million Riyals)	9510	9321	10575	11505
4. Net Investment (Billion Riyals)	89.56	104.88	142.29	151.59
5. Net Profit (Million Riyals)	7302	6450	6525	6767
6. Net Profit from Funding (Million Riyals)	6826	7722	8494	9354
7. Earnings per share (SAR)	10.82	4.30	4.35	4.51
7. Tier 1 Capital ratio	25.30	23.60	14.6	13.82

Source: Al Rajhi Bank, Annual Reports, 2006 - 2009

Following the guidelines of the Saudi Arabian Monetary Agency (SAMA) aimed at restricting the expansion in household leverage to combat recession, a slowdown in the growth of consumer loans occurred in 2007. However, between December 2007 and September 2008, difficult period of financial recession, lending portfolio of the bank increased by 60% (Standard & Poor's, 2008). Simultaneously, in line with a strategic shift initiated over the past years, Al Rajhi enhanced its corporate banking franchise and entrenched in investment banking (which includes brokerage asset management and corporate finance). The trends in the key financial indicators of Al Rajhi Bank between 2004 and 2007 are given in Table 2.

Tier 1 capital is the core measure of a bank's financial strength and is composed of core capital, which consists primarily of common stock and disclosed reserves (or retained earnings), but may also include non-redeemable non-cumulative preferred stock. The Tier 1 capital ratio is the ratio of a bank's core equity capital to its total risk-weighted assets. Risk-weighted assets are the total of all assets held by the bank weighted by credit risk according to a formula determined by the Regulator (usually the country's Central Bank). Most central banks follow the Basel

Committee on Banking Supervision guidelines in setting formulae for asset risk weights. Al Rajhi's capitalization is strong; regulatory capital ratios remain well above the minimum requirements, with a Tier 1 capital ratio of 14.6% in December 2008 and 13.82% at September 2009 (Al Rajhi, 2009). Capital ratios also reflect the very high quality of Al Rajhi's equity base, with a marginal contribution of non-core capital to the bank's equity.

Risk Management practices are being developed by Al Rajhi Bank in a manner consistent with SAMA guidelines and within the Basel II project framework, advanced risk management models and related systems are already developed (Wilson, 2008). Over the past few years, the bank has also strengthened its network of counter-party banks and increased its exposure to Murabha placements with other banks, and lengthened the maturity profile of its Murabha funding.

Since 2002, Al Rajhi Bank as per the SAMA directions tried to utilize money markets by creating new instruments and to invest in interest-bearing government securities in compatible with the Shariah laws. By investing in these instruments Al Rajhi improved its liquidity management, as up to 75% of its investment in these instruments can be repo-ed, and up to 75% can be included as part of its statutory deposits with SAMA.

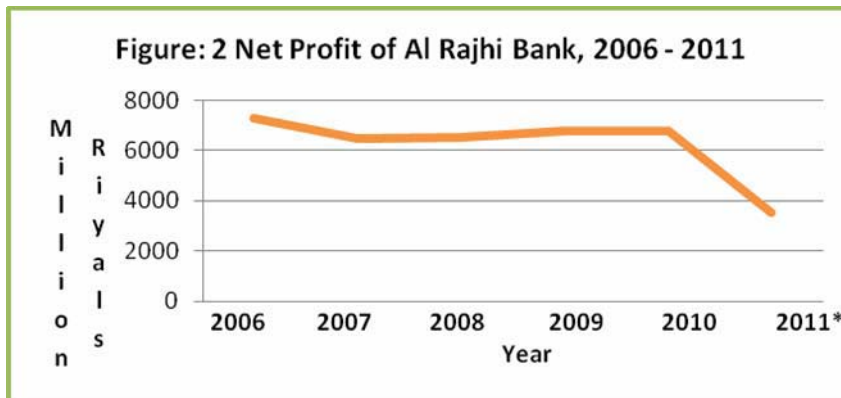
Al Rajhi's market risk appetite is moderate and has no major proprietary equity or hedge funds positions, and is primarily not exposed to interest rate and foreign currency risk. Market risk exposures are increasingly and more regularly quantified, however, in terms of risk mitigation, Al Rajhi has less flexibility to use hedging/derivatives instruments used by conventional banks, as these may not be Sharia compliant.

Financial Performance and Rating

As discussed earlier the fundamental features of Al Rajhi Bank in the financial front are its healthy customer franchise in the domestic retail sector, superior and sustained profitability, better concentration in loans and deposits than other competitors, and strong capitalization. With the most extensive distribution network in the Kingdom, the bank has built up the widest demand deposit base; and the rating agencies treat Al Rajhi to be a systematically important bank in Saudi Arabia.

Profitability

Al Rajhi is among the most profitable banks in the Gulf; impressive profit profile is attributed to several factors, which include low funding costs, good control over operating expenses, robust market position and low risk domestic retail market, and relatively high credit leverage and no corporate taxes. Al Rajhi has the largest distribution network in Saudi Arabia, which gives it an exceptionally strong mass deposit-gathering ability. As an Islamic bank, it could extract very cheap funding from its retail franchise; with 80% of its liabilities in the form of non-remunerated deposits, funding costs were only 85 basis points in 2007 (Moody's Investor Services, 2008). The Net Profit of Al Rajhi Bank between 2006 and 2011 is shown in Figure 2. Even though there is slight reduction in the net profit in 2007, it bounced back in the growth path during the coming years.



Note: 2011 figures are for the first two quarters.

Source: Al Rajhi Bank, Annual Reports, 2006 - 2009

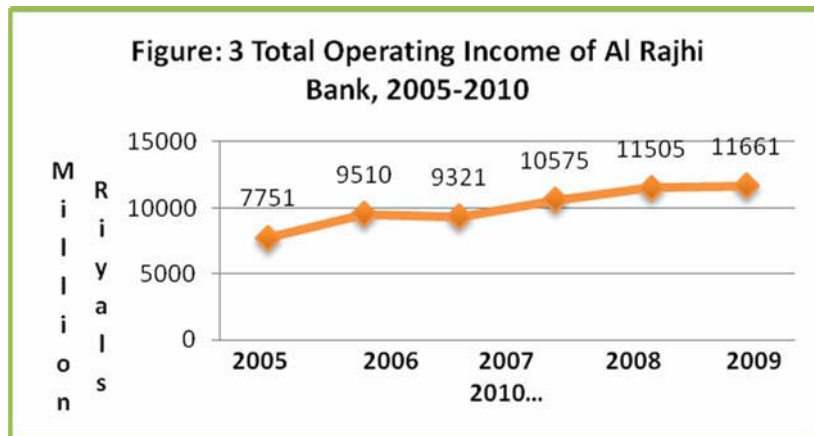
Income Growth

Despite its extensive network, Al Rajhi's cost-to-income ratio was as low as 26% in 2007, which compares very favorably to that of domestic and regional peers, and has remained stable in 2008. Instability in the bank's efficiency indicators through unstable income in the revenue stream generated during 2005-06. However, in 2007 the costs-to-income ratios are in line with the level displayed over pre-2005.

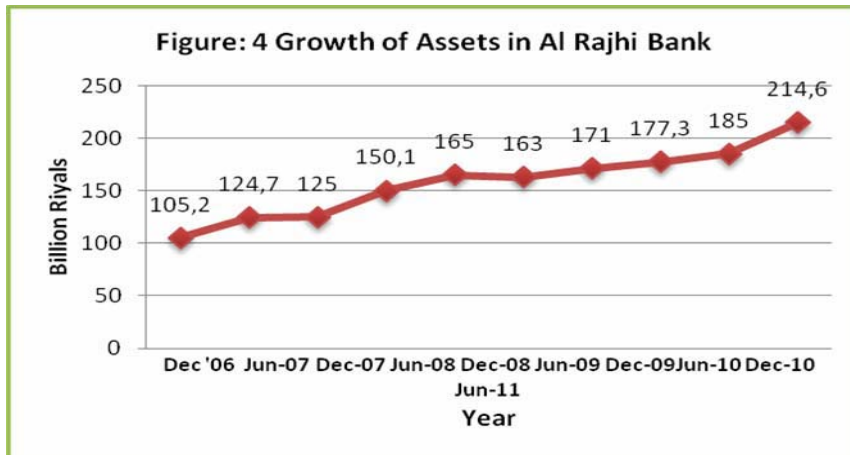
Figure 3 display the trend in the operating income of Al Rajhi Bank between 2005 and 2010. It shows a positive trend over the years with a marginal fall during 2007.

Asset Growth and Liquidity

During the severity of economic recession, in September 2008, Al Rajhi's assets strength was worth 163.3 billion Saudi Riyals (USD 43.5 billion). Al Rajhi operates the kingdom's largest domestic branch network, allowing excellent access to individuals and small and medium size enterprises. The large amount of non-remunerated sight deposits captured through its domestic network accounts for one of the bank's main strengths. As a result, Al Rajhi's liquidity position remained adequate. Liquidity management is not an easy task for Islamic banks as most instruments used for liquidity management (on either the money market or the securities market) are based on interest, which is unlawful as per the principles of Sharia compliant finance. Fast grown lending volumes have been achieved at the expense of liquidity, with core liquidity ratios declining to 11.7% in September 2008, compared with an average of 28% during 2005-2007 (Moody's Investor Services, 2008). The asset growth of Al Rajhi Bank between 2006 and 2011 is as shown in Figure 4; it doubled during the five year period.



Source: Al Rajhi Bank, Annual Reports, 2005 – 2010

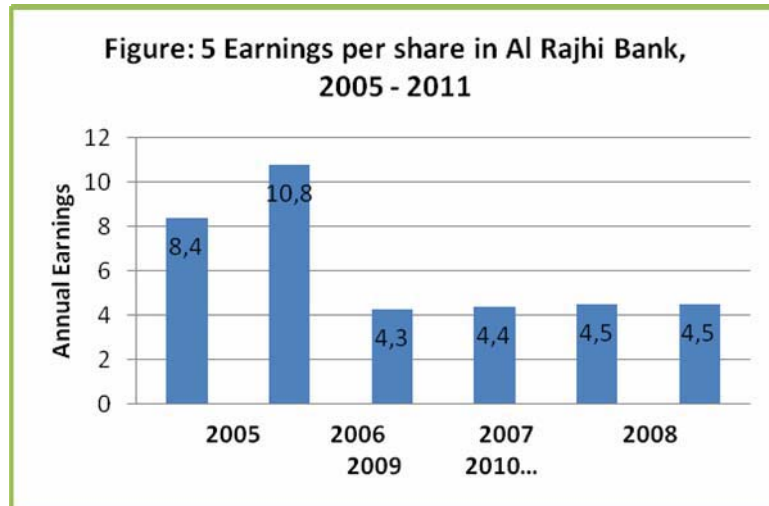


Sources: Al Rajhi Bank, Annual Reports, 2006 – 2010 and Al Rajhi Bank, Quarterly Report, 2011

Al Rajhi features a strong funding profile; it benefit from a huge pool of consumer deposits, which funds loans and enables the bank to maintain liquid short-term placements. Concentration in deposits is very limited, customer deposits amount to 74.9% of liabilities and equity. The remainder is made up of on-balance-sheet ‘direct investments’ by customers, which are the only funds carrying a cost, as well as some long-term debt.

Although most customer deposits are short-term but are effectively rolled over, the bank remained exposed to the transformation risk from funding long-term loans with current and short-term deposits.

Earnings per share in Al Rajhi Bank between 2005 and 2010 are as given in Figure 5; after a slump in 2007 it could maintain momentum.



Source: Al Rajhi Bank, Annual Reports, 2005 – 2010

Prohibited from dealing in fixed-income securities, the bank instead holds a portfolio of short-term special placements with SAMA, about 15.5 billion Riyals as of September 2008 (Standard & Poor's, 2008). Al Rajhi is allowed to withdraw from SAMA up to 75% of the volume of such placements for short-term liquidity needs, a percentage equal to the one allowed for conventional repo transactions, thus limiting dependence on the interbank rate. Al Rajhi had an additional liquidity cushion in the form of short-term bank placements of close to 11.7 billion Riyals during the period.

Risk Management

Al Rajhi's risk architecture is on the same line anticipated from any Islamic Banks in the Middle East. The bank is subject to the same regulatory oversight despite the specificities of its business model as an Islamic bank. Towards the implementation of Basel 2 requirements, Al Rajhi was the first Islamic bank in the region to publicly disclose according to pillar 3, in 2008. Credit risks are mitigated by lower than average concentration and market risks remain limited despite an interest rate decline. Funding remains short-term by nature, while asset tenors are widening. There are proposals for an organization of the industry that would allow it to develop in compliance with its principles and prudent risk management and facilitate its regulations (Dahlia El-Haway, 2004). Limited access to liquidity

management tools, as any Islamic bank, requires the bank to maintain a large portion of its balance sheet in simple liquidity products.

Al Rajhi's enterprise risk management is adequate and has been strengthened significantly during the recessionary period. The risk management function is independent, and recently spearheaded the overhauling of risk policies, procedures, and tools across business lines. At the same time the bank has got an average credit risk profile, which is linked to the fact that it is serving the entire Saudi economy, including a wide range of retail banking segments and small and medium enterprises. Al Rajhi did not even show the concentration risk usually found among domestic peers. Al Rajhi's financial rating for 2007-08 periods is given in Table 3; except asset quality all the other rating factors demonstrated either neutral or improving trends.

Table 3. Al Rajhi's Financial Rating, 2007-08

Qualitative Rating Factors	Trend
1. Franchise Value	Neutral
2. Risk positioning	Neutral
3. Operating environment	Improving
4. Profitability	Neutral
5. Liquidity	Neutral
6. Capital adequacy	Neutral
7. Efficiency	Neutral
8. Asset quality	Weakening

Source: Moody's Investor Services, 2008

Management risks in Islamic banks could usefully be addressed through appropriate CAMEL (Capital, Assets, Management, Earnings and Liquidity) ratings framework (Errico and Farahbakh, 1998). Saudi banks have to deal with the strong endowment effect caused by unremunerated deposits; which usually they suffer when rates come down. Al Rajhi Bank is not an exception in this regards and it pays no remuneration to three-quarters of customer deposits. Moreover, it does not have a fixed rate bond portfolio, meaning it cannot hedge its interest rate risk in a straight forward way. Foreign exchange risk is also limited as it holds a very small equity portfolio in the form of investments in mutual funds. Al Rajhi reported no exposure to subprime assets or other structures products, since Sharia compliance requirements prevent the bank from investing in these assets. Al Rajhi's credit strength and challenges during 2007-08 is as given in Table 4; the

foundational credit strength of Al Rajhi is stipulated to be stronger than its challenges.

Table 4. Al Rajhi's Credit Strengths and Challenges

Credit Strengths	Credit Challenges
1. Solid mass market, Shari'ah-compliant franchise and loyal customer base. 2. Robust financial fundamentals, driven by low funding costs, wide margins, ample capital and a rapidly improved risk management and corporate infrastructure. 3. Leading position in retail banking, ensuring both granularity in the retail credit portfolio and predictable, sustainable revenue streams. 4. Strong domestic operating environment expected over the medium term. 4. Very high likelihood of support from the Saudi authorities when need arise.	1. High concentration risk by name, sector and geography in the corporate banking book. 2. Rapid past and expected credit growth, resulting in more aggressive credit leverage that at peers, untested credit portfolios and slightly declining asset quality indicators. 3. Despite a vast pool of stable deposits, a still imbalanced funding mix inadequately addresses the risks attached to widening maturity mismatches between longer-tenor assets and short-term liabilities. 4. Limited track record in managing controlled growth overseas. 5. Increasing competition within the Kingdom's Islamic banking market.

Source: Moody's Investor Services, 2008

Table 5. Ratio analysis results of Al Rajhi Bank, 2006 – 2009

Ratios	Year			
	2006	2007	2008	2009
1. Earnings per share	10.82	4.78	4.35	4.51
2. Investment on /deposits %	118.57	113.07	119.71	123.39
3. Loans/ deposits %	0.95	0.98	0.63	0.57
4. Book Value share	29.9	17.49	18.02	19.16
5. Price/ Earnings Ratio	17.84	27.26	12.87	15.79
6. Price / Book ratio	6.46	7.45	3.11	3.72
7. Return equity %	36.18	27.32	24.14	23.55
8. Return on Total assets %	6.94	5.16	3.96	3.96
9. Dividend Yield %	0.77	1.54	5.36	0.25

Source: Computed from the Annual Reports

The ratio analysis of the major financial indicators of Al Rajhi Bank, as given in Table 5 shows that most of the ratios have dwindled after the financial crisis, however, the financial health of the Bank is still stronger. The investment on deposits ratio increased to 123% in 2009, as compared to 118.5% in the pre-recession period. However, loans deposits ratio marginally declined from 0.95% in 2006 to 0.57% in 2009; which shows the bank's portfolio adjustments as a precaution to the global credit crunch.

Conclusion

Islamic banks have to appraise credit risk, and indeed are more cautious about who they should finance than conventional banks. The banks in the West charged high arrangement fees for sub-prime borrowers which are used to pay bonuses for those signing up new clients. The banks became mere booking agents, with no long term commitment to their clients. When the credit crunch came and borrowing from wholesale markets was halted, Islamic banks are not exposed. In contrast to conventional banks, no Islamic bank has failed and has needed government recapitalization which ultimately becomes a burden on the society.

The soundness of Islamic banks is accounted for by the fact that they use a classical banking model, with financing derived from deposits, rather than being funded by borrowings from wholesale markets. Consequently when the credit crunch came and borrowing from wholesale markets was halted, Islamic banks are not exposed. However, Islamic banks are not immune from the effects of the global recession, and the fluctuations in oil prices will inevitably have a negative impact on Gulf-based Islamic banks.

Al Rajhi Bank's risk management measures to combat eventualities such as financial recession are sufficient to facilitate liquidity in its operations. Robust financial fundamentals, driven by low funding costs, wide margins, ample capital and rapidly improved risk management and corporate infrastructure point to the sustainability of its financial operations at least in the short-run. However, rapid credit growth and the resultant credit leverage and portfolios, declining asset quality indicators and imbalanced funding mix could emerge as the challenges in its future operations.

From the foregone discussion it could be seen that Islamic banking provides a viable alternative to conventional banking and is less cycle prone. There are certain structural factors which can hinder the sustenance of Al Rajhi Bank in future. These include concentrations in lending and deposits, mismatches in the maturity

profile of assets and liabilities, lack of geographic diversification, scarce human capital, limited diversification of the economy beyond hydrocarbon sector and volatility in the real and nominal output of the economy. There can be no doubt that Islamic finance has an exciting future, and the quest for a financial system based on moral values rather than greed and fear, is bound to enhance its position in the global system.

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