Conference Paper

Vulnerability of Islamic Financial Institutions in a Financial Crisis

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Abstract

This article examines the risks that the Islamic Banking industry may be exposed to in a financial crisis. In order to set the context, it first discusses the sources of bank finance in both the conventional banking industry and Islamic banking. It then examines the various types of risk exposure by conventional banks and Islamic banks. It analyses the types of problems which are unique to Islamic banking in contrast to conventional banking. It then considers what lessons can be learned from the global financial crisis, particularly for Islamic banking. This article argues that in order to ensure stability for Indonesian Islamic Financial Institutions, banks must address each of the identified risks. It points to recent illustrations of institutional failure because of failure to address the risk.

Keywords: Islamic Financial Institutions, financial crisis, vulnerability, risks

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1. Introduction

Financial institutions are crucial to the proper functioning of economies. Inadequate regulatory control and a weak financial system can lead to economic crisis. The emphasis in this article is on the failure of government and financial institutions to respond to systemic risks to the economy.

Islamic Financial Institutions have expanded vastly over the past decade, growing at 10–12 percent annually. The total value of Islamic banks, Islamic insurance, capital market and money markets [3] is estimated at US$ 2 Trillion. Interestingly, there has been a surge of interest in Islamic finance from non-muslim countries such as the UK, Luxembourg, South Africa and Hong Kong. The trend shows that over the past decade, Islamic finance is considered to be one of the effective tools for financing development worldwide. It is seen as a mechanism to increase shared prosperity and reduce extreme poverty [3]. It also provides alternative measures for tackling the type of risks that led to the global financial crisis.

While some may argue that the Islamic financial system is the impartial adoption of the conventional financial system with some modifications, a more credible argument is that the Islamic financial system provides a unique response to risk. The profit and loss sharing (PLS) contract such as *Mudaraba, Musyarakah* and the prohibition on the payment of interest are the key planks upon which the Islamic financial system depends.

This article argues that Islamic financial institutions are vulnerable in an economic crisis. The emphasis in this article is on Indonesian banks. A key factor is the lack of sufficient management control by the bank and exposure to similar risks as the conventional banking system. Other risks unique to Islamic banks will also be discussed.

2. Literature Review

Several articles have outlined the risks inherent in Islamic banking. Khan and Ahmed (2001) state that the return of PLS in Islamic financial institutions may affect the fund withdrawn by investors, and they argue that different types of instrument in Islamic banks have their own risk characteristics due to various constraints enforced by Sharia law. Errico and Farahbakhsh (1998) also claim that there should be strong supervision and regulations towards the operational risk and information disclosure. In some cases, the Islamic bank cannot mitigate the risk in the project financed in the form of *Mudarabah* (partnership) due to the lack of control and access to this instrument. Further, Sundararajan and Errico (2002) suggest that the bank should take seriously the problem in PLS in the modes of finance and risk in order to establish more effective risk management. Obaidullah (2005) argues that a run on the bank by depositors where the bank's return is less competitive in the market may persuade Islamic banks to disobey the sharia financing principles.

According to Akin, Iqbal and Mirakhor, Islamic financial institutions require monitoring, accountability, transparency and governance as well as development of asset-backed- and equity-based financial products and it develops instruments for income redistribution to lower socio-economic groups (2016).

Transparency and accountability are very important aspects of Islamic finance as they are characterized by PLS in the theory; however, a study conducted by Chong and Ming (2006) reported that in reality they are very much affected by the actual interest rate in the market and the contract margin is often calculated in accordance with the market interest rate.

2.1. Structure of the Study

The study is divided into six sections. Section 1 is the introduction. Section 2 discusses the source of bank finance. Identifying risk and the Islamic financial institutions' exposure to risk is described in Section 3. Section 4 asks what lessons can be learnt from the GFC and how Basel accords address these risks, particularly, Basel capital adequacy requirements. Evidence relating to Islamic bank vulnerability is also discussed. Section 5 contains the conclusion and recommendations.

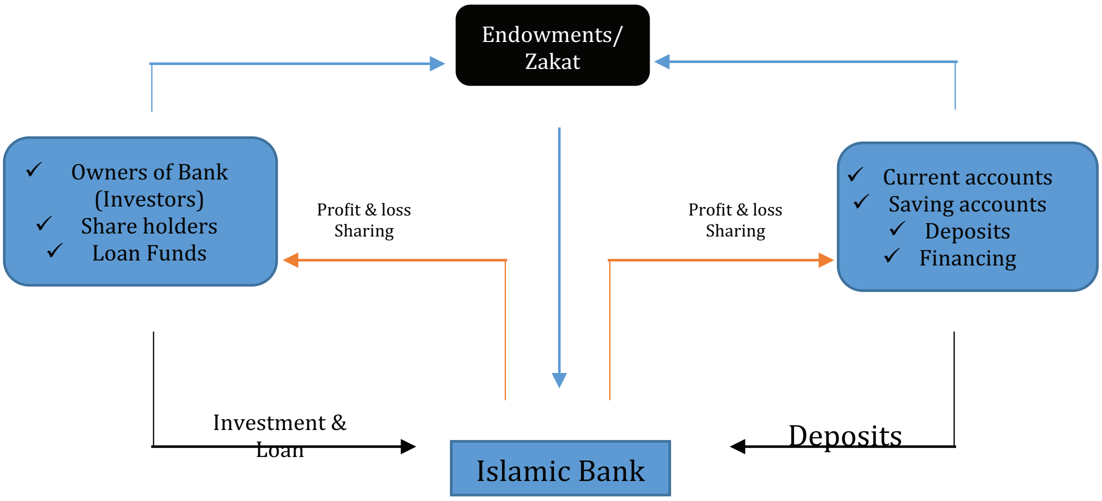
3. Sources of Bank Finance

Islamic banks have to implement standards according to Sharia law and have to comply with the main sources of Sharia; the holy *Quran*, *Hadith*, *Sunna*, *Ijma*, *Qiyas* and *Ijtihad*. *Quran* is the revelation of Allah given to prophet Muhammad, *Hadith* is a prophetic tradition it utterances or deeds of prophet, *Sunna* refers to practices and behaviours of prophet during his life time, *Ijma* is the consensus of Islamic scholars about certain issue that is not provided in the *Quran* and *Sunna*, *Qiyas* means analogy to provide an opinion for the case not mentioned in *Quran* and *Sunna*, *Ijtihad* represents to jurists reasoning to decide a certain rule or case that does not exist in the *Quran* or *Sunna* [18].

Sharia banks have a duty to comply with Sharia law that includes condemnation of interest (*Riba*), exclusion of speculation and unproductive activities (*Maysir*), prohibition on involving with dubious acts (*gharar*), prohibition on using destructive and illegal things (*bathil*), and their scope is limited to activities that are declared *Halal.*

In conventional banking, sources of funds are deposits, borrowings, shareholder funds and investments. In Islamic banks, the sources of funding are similar, but limited to the *halal* sources and subject to the Sharia principles. Investment in Sharia banks is only permitted if it's considered truly *halal* and according to Islamic Sharia so that Islamic banks must operate within the limits of Sharia law [32]. In contrast, there are no such restrictions on conventional banks. So, it is apparent that Islamic banks have access to much more limited funding than conventional banks. Islamic banks, unlike conventional banks, are unable to charge or receive interest. Profits are gained from margins on sale and purchase, profit sharing on financing, rental fees and commissions or fee-based income. As will be indicated further, the inability to charge or receive interest makes Islamic banks much less competitive than their conventional counterparts.

Described further are the funding sources for private Islamic banks in Indonesia.



In Islamic private banks, the source of finance is divided into three categories; first, the owners of the bank and public shareholders. Second, the borrowed funds. The funds can come from overseas or domestic investors who provide loans to the bank. The borrowing funds are subject to approval from the Bank Indonesia, because loan funds are required if the bank has difficulty in maintaining required capital, and to meet the minimum requirements of Capital Adequacy Ratio required by the Bank Indonesia. Third, funds derived from the community, through products offered by Islamic banks [28]. However, there are Sharia banks owned by state-owned companies, for example, BNI Syariah, where the majority of shares are owned by PT Bank BNI Tbk (a state-owned company). In such a case, BNI Syariah is not a state-owned bank, but a private bank whose shares are owned by a state-owned company. In Indonesia, most of Sharia windows have been separated and established as independent Islamic banks [12].

Islamic banks also serve as an important social function for the empowerment of the poor through implementation of Zakat fund raising, *infaq, sadaqah* and *waqf*, as well as other fines and receipts disbursed. For example, providing financing for community development in the form of microfinance to Small and Medium Enterprises (SMEs) using loan schemes of *qardul hasan* (return only of principal without payment of interest), and further social activities being held in cooperation with other social institutions [25].

4. Identifying Risks in Banking

The Basel Committee on Bank Supervision (2016) defines interest rate risk as the risk which is caused by the fluctuation of interest rates. The changes in interest create a

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change in present value and time of future cash flows which affects the value of assets, liabilities and bank earnings. There are other risks applying to conventional and Islamic banks; liquidity risk refers to when the bank is unable to meet their cash flow need, due to the maturity transformation. Such as the bank transforms the short-term liabilities to the longer-term assets [30]. It is argued that banks collapsed during the global financial crisis because they had not maintained their liquidity risk prudently. In response to this, the Basel Committee on Banking Supervision developed the Basel III to improve bank's ability to absorb the liquidity shocks. Basel published two international standard frameworks: The Liquidity Coverage Ratio (LCR), to promote short-term resilience of a bank's liquidity risk profile by ensuring that a bank has adequate high-quality liquid asset that can be easily converted into cash in short-term period; and the Net Stable Funding Ratio (NSFR) to strengthen the bank by ensuring that banks manage their funding appropriately to the composition of their assets [6].

Market risk refers to a condition where the bank may experience loss due to fluctuation in market prices. Islamic banks strictly ban the speculative transaction, hedging instrument is not allowed but IBs mostly have smaller off-balance sheet structures [23]. Operational risk which means the risk caused by the failure of internal processes, people and systems, or from external events. The definition includes fraud and malice, failures of information, human error, commercial disputes, accidents and other failure in internal processes, but it excludes reputational risk. Reputational risk is the risk that raise from negative perception of customers, counterparties, shareholders, investors, debt-holders, market analysts and other relevant parties or regulators that can badly affect the bank's sources of funding and existence [5].

Systemic risk is defined as the risk of disruption to financial services due to impairment of all or part of the financial system, which can have a negative impact for the real economy [9].

In general, all risks which are faced by conventional banks are also relevant to Islamic banks. However, Islamic banks have unique risks depending upon the type of contract. The products such as *Mudaraba* (partnership) and *Musharaka* (joint venture) are included into category of financing on a PLS basis categorized as credit risk in the form of capital impairment risk. While, *Murabaha* (cost-plus sales), *Ijara* (leasing) and Islamic 'forwards' *Bai' Al-salam* and *Istisna'* are included into debt-based Islamic financing products and treated as account receivable and counterparty risks [1].

5. Islamic Banks' Exposure to risk

Islamic banks face the same risks as conventional bank do, as indicated in the previous section but with the added risk of Sharia non-compliance risk. According to the International Monetary Fund (2017), there are at least six risks in Islamic Banks (IBs); credit risk, market risk, operational risk, liquidity risk, rate of return risk and displaced commercial risk.

In Islamic banking, banks offer products based on equity investment. There are two contracts used on this, first *Mudaraba* and *Musharaka*. Equity investment risk exists if there is a fall in the value of the equity position held by the Islamic bank. The equity can be either, direct investment in the project or joint venture, and indirect investment, such as in stocks. The decline in equity may lead to loss of capital investment. This can in turn lead to other risks such as credit risk and liquidity risk. Continuous monitoring of investments is required to reduce this risk.

Islamic banks do not provide fixed returns for the customers' deposits or investment; the banks provide PLS instead. The rate of return in profit (especially when the profit earning is small) may be displaced commercial risk. This deters investors from depositing with Islamic banks [23]. As a result, Islamic firms face under market pressure in displaced commercial risk as they are forced to pay the return to investors even if the underlying assets earn less profit to compete with their conventional bank competitor's rates. In order to attract more investors, IBs may waive their right and render all the profit to Islamic Account Holders (IAH). However, this type of activity is subject to approval from IBs' board of directors. Unfortunately, in Indonesia most Sharia bank customers are investing their money in the form of long-term or short-term deposit accounts. This accounts for 60 percent of Islamic bank customers; only 40 percent of customers save their money in the form of saving accounts [29]. This forces Islamic banks to pay higher amounts for the profit sharing to the customers. This in turn causes the cost of Sharia products to be higher than conventional banks. This higher cost is a disincentive to do business with Islamic banks. This is a challenge for Islamic banks to ensure adequate returns but to remain price competitive. Banks need to diversify their products and systems to tackle this risk when investment returns diminish.

Rate of return risk in Islamic finance arises due to unexpected changes in the market rate of return, which significantly affects profits. In contrast, returns are fixed in conventional banks; both bank and investor know in advance what their returns will be. However, in Islamic banking, returns are uncertain. Though the consumers know that they have to follow the PLS system, when the banks provide less return, investors may withdraw their money if the returns are lower than market benchmark rates. As a result, the Islamic firms feel the pressure to provide market-matching returns. Failure to respond to the market-rate increase may lead to liquidity risk due to a run on banks from withdrawals by customers. It may also lead to displaced commercial risk if it responds to the market pressure.

Credit risks are exposed in a *Murabahah* contract, the IBs provide a debt-type contract by delivering the underlying goods to the client, but the client (due to some circumstances) is unable to give the money back on time to the bank. In this case, the client can negotiate to change multiple times of their plafond (increase the term of instalment) to the bank that causes the liquidity risk.

While a credit risk exposure in a *Mudarabah* refers to when the bank as the fund provider have to give the money in advance to the client (agent), and the bank have no accurate way to monitor this agent whether the agent performs well or losses [23].

Islamic banks are also exposed to a market risk, this risk occurs in IBs due to the fluctuation of market price in the value of leasable assets or commodities. Although IBs have taken measures to deal with this risk, for example, positioning limits and stopping loss provisions, the market risks have strengthened in recent years due to interdependence of volatility in price of commodities and trade value [23].

Islamic banks are subject to unique reputational risks because of the need to be Sharia-compliant. If the bank is considered to be deviating from Sharia law by Islamic scholars, it will suffer reputational losses. The Sharia board of Islamic banks may reject new products purposed by the board of directors of the bank. This can result in a lack of diversity of Shariah-compliant products. According to International Monetary Fund (2017), IBs are also exposed to fiduciary risk, when the bank acts not in accordance with their explicit and implicit standard, which results in losses in investment with the potential for the bank to fail. It can also lead to inability to pay rate of return to IAH, due to poor investment decisions.

Lack of human resources and knowledge of Sharia products is a particular aspect of operational risk in Sharia banks, particularly in Indonesia. The difficulty in comparing *riba* and non-*riba* products are also major problems affecting the development of Islamic financial institutions [14]. Weak management of Islamic financial institutions is the most significant factor affecting their financial stability. Trust is crucial in the banking industry and banks must take immediate action to mitigate the poor regulatory control by both the state and the industry.

The case of Bank Muamalat Indonesia is the example of operational risk. The Indonesian economy is experiencing a slowdown and primarily depends upon domestic consumption. The Islamic financial industry has faced financial crisis since the new Chief Executive Officer for Bank Muamalat Indonesia was appointed. Profit was reduced from Rp 106.54 billion (June 2015) to Rp 30,51 billion (June 2016). Non-performing finance (gross) increased from 4.93 percent in June 2015 to 7.23 percent in June 2016. The Capital Adequacy Ratio is also a problem. As at December 2015, it was 12.36 percent, reduced to 11.71 percent in May 2016. There are also allegations concerning fictitious financing fund by the board committee [26]. The bank now has serious financial problems and is seeking investors to whom it can transfer some of its risk. The difficulties with the bank were studied by Akin, Iqbal and Mirakhor (2016) who pointed to the problems of accountability and weak management by the Bank.

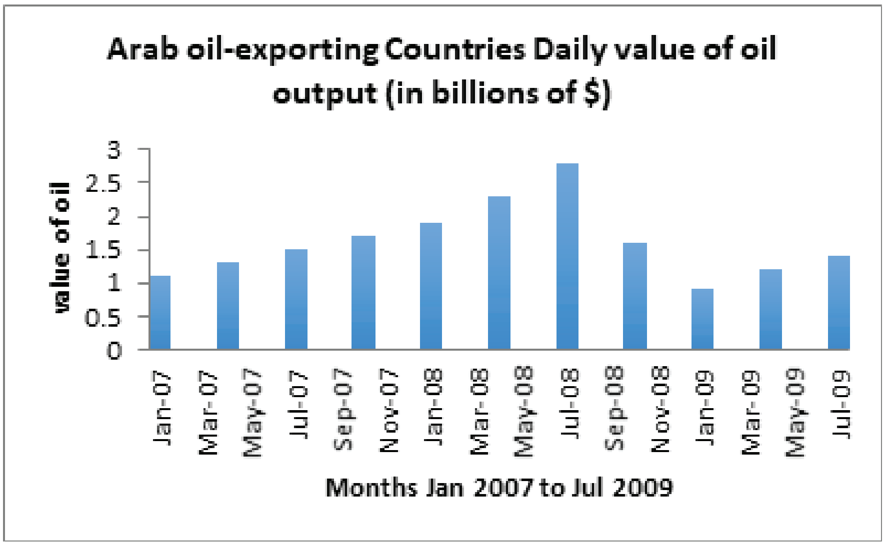
6. Lessons from the Global Financial Crises (GFC)

When a financial crisis occurs, Islamic banks as well as conventional banks are exposed to risk. This is because Islamic finance is highly interconnected with the global financial system. Many Islamic banks provide equity financing so that when the price for real estate falls, the value of investment portfolios also decreases. But it should be noted that although Islamic finance is not immune to the global financial crisis, there is evidence that it has performed better than its conventional counterparts. Syed and Shaikh (2011) found that Islamic banks had shown great resilience than conventional banks in the global financial crisis because Islamic finance are proscribed from investing in toxic assets and from engaging in speculative investments. In 2007, the global market for Islamic financial services increased by 37 percent to US$ 729 billion, although it began to fall in 2008 due to the GFC. However, in 2008, two Islamic banks (Gatehouse Bank and European finance House) were established and operated *sukuk* issuance; the total of accumulative *sukuk* increased to $10 billion listed on the London Stock Exchange. Islamic financing is particularly attractive when interest rates are high but much less attractive when interest rates are low so that cheaper financing can be obtained through conventional banking sources.

When the currency depreciates in value, the increasing price of import commodities in raw materials may cause industrialists and the business owners to be seriously affected [10, 21]. This in turn affects the banks' risk-sharing profits. This occurred as a result of the GFC.

As in the US, the fall in the value of real estate portfolios was a key driver for the GFC. This was not limited to the US. Illustrative is the case of the Dubai World, an investment company in which the government of Dubai was the major shareholder. It entered into a joint venture providing US$60 billion. A US$ 3.52 billion Sharia bond was financed by Dubai World to a subsidiary Nakheel, for the purpose of developing the prestigious Palm Islands. Following the GFC, there was a reported 40–50 percent drop in real-estate prices [34]. Nakheel faced huge losses due to the downturn in property prices caused by the GFC. This affected the return to Dubai World and the value of equity investment. As Dubai World's provision of finance was based on risk sharing, both of the companies have to bear the loss cooperatively.

Middle East countries were less affected by the GFC in 2008. Their market received large volumes of new investment in 2004–2007 and received substantial income from the increasing price of oil, as well as the repatriation of their foreign investments by Arab private companies after the September attack. Islamic banks had limited exposure to the GFC, and governments in the Middle East took various measures to support their stock markets and banking systems such as injection of funds to public companies and banks by the government. The real estate in Dubai was booming with speculators and international investors dominating that market. In 2009, real estate prices in Dubai were in decline and the state-owned conglomerate Dubai World suffered significant losses in terms of asset values. Following government intervention, there was some recovery. Problems were ameliorated by significant increases in the price of oil during the period 2005–2008; the oil price increased in March 2009 up to $72/barrel, although it was declined from June 2008 ($133) to January 2009 ($39; Habibi, 2009).



Source: US Energy Information Administration, www.eia.doe.gov. The calculations based on monthly average price of crude oil (WTI) and aggregate daily oil output of Arab oil exporting countries (excluding Iraq; Habibi, 2009).

Although there is a sharp decline of oil revenues in Arab countries, it did not lead to a significant reduction in fiscal spending. Data from IMF reveals that the Arab oil exporting countries' fiscal expenditure increased in 2009, despite the lower oil price. Saudi Arabia, for example, increased their fiscal expenditure from 29.6 percent of GDP in 2008 to 40 percent in 2009. Nevertheless, Arab oil-exporting countries received huge surpluses during 2005–2007 and were able to overcome the oil revenue shortfalls in 2008 and 2009 from the previous surpluses [22].

Islamic financial institutions were largely not adversely affected by the GFC. But the illustration from Dubai World, (aforementioned) illustrates how easily Islamic banking could be affected by downturns in property values. Sharia banking benefited from the economic conditions and was very strong in the face of the GFC in 2008.

Conventional and Islamic financial institutions are not immune from the effects of a GFC. Where Islamic banks seek to develop products similar to those in the conventional banking system, this will result in Islamic banks carrying similar risks to the conventional banks, thus making them more vulnerable in a financial crisis.

The evidence shows that the current condition of Sharia banking began to weaken in 2016 despite the absence of a global financial crisis. It is clear that the economic conditions pertaining in the Middle East, particularly oil prices, have had an impact more generally on Islamic banking. Also, important is that Islamic banking products are less attractive where international interest rates are very low and conversely more attractive when interest rates are very high.

Fitch Ratings (2017a) report that UAE Islamic banks' performance in 2016 was hit by higher funding costs and financing impairment charges (FICs). FICs in 2016 increased to 1.4 percent (2015: 1.1%) due to the weakening of the SMEsegment. The growth of Islamic banking slowed in 2016 falling to 10 percent (2015: 19%) due to the significant adoption and wide structuring of Sharia-compliant products. Most Islamic banks in the UAE are affected by higher funding costs in 2016, the main reason behind this is the UAE bank's high reliance on profit-bearing time deposits and lower liquidity due to lower oil prices.

Although Islamic financial institutions are mature in Saudi Arabia, the government cut many projects and reduced expenditure to match lower oil revenues. The deterioration of the economic condition is expected to continue until at least 2018. This affects earnings, and the profit of Saudi Arabia Islamic Banks is likely to decline [15]. The asset-quality metrics of banks in Saudi Arabia will probably worsen from their present position. The government has injected liquidity to Saudi's banks but the demand for financing is slower. The profit is likely to decrease due to slower financing growth.

The stability of Islamic banks is also affected by the political environment. It is also reported that some parts of MENA bank's operation is still significantly risky, nine Qatari banks : Qatar National Bank (QNB), The Commercial Bank (QSC) (CBQ), Doha Bank (DB), Qatar Islamic Bank (SAQ) (QIB), Al Khalij Commercial Bank PQSC (AKB), Qatar International Islamic Bank (QIIB), Ahli Bank QSC (ABQ), International Bank of Qatar (QSC) (IBQ) and Barwa Bank QSC (Barwa) are affected by the crisis due to diplomatic isolation, and the economic growth will be slow in 2017 and 2018, that will cause a contraction in current spending and lead to a slow grow of both private and public sector [17].

In contrast to the strong position of Islamic banking during the GFC, the current prospects for growth in the Islamic banking sector are relatively poor. Economic factors, particularly, the oil price has had a direct impact on the sector. Now, with the 'Arab spring' and political turmoil as well as the slow growth of economies due to the decline of oil price, Islamic financial institutions have limited growth.

In Indonesia particularly, Islamic banks' growth shows a downturn trend due to the slow-down in economic growth in 2016 at +9.53 percent (y/y) and decline in export–import growth as a result of persistently low commodity prices. Furthermore, the increasing demand for credit is also followed by increases in non-performing loans from (2015) 2.2 to 2.5 percent in 2016. The overall net profit of banks declined 6.7 percent to IDR 104.6 trillion in 2015 (Today's headline, 2016).

	2012	**2013**	**2014**	**2015**
Net Profit (in IDR trillion)	92.8	106.7	112.2	104.6
Source: Today's headline, 2016				

Because of market fluctuation, Islamic banks in Indonesia are exposed to market risk, and their net profit trends downwards as a reflection of a slowing economy and currency depreciation.

7. Importance of Basel Capital Adequacy Requirements

Islamic banks have an equity-based capital structure, dominated by shareholders' equity and investment deposits based on PLS. However, the Islamic banks, in order to ensure stability, need to have a minimum capital requirement and to improve corporate governance. The Basel III framework is directed to strengthen the banking industry through three strategies: capital adequacy, leverage ratio and liquidity requirements. The focus of Basel III is strengthening capital regulations with the goal of promoting a more powerful banking sector as well as improving the ability of banks to maintain stability in the face of economic stress. Basel II provides a methodology for measuring the capital requirement for major risk categories [7].

According to Ghandour (2017), if Islamic bank implements the pure PLS system, then it does not require the capital adequacy regulation. But as has been seen in relation to Dubai World, Islamic banks were unable to respond to the crisis even though PLS system applied. Islamic banks are required to disclose to their customers and the market their capital adequacy ratio. In order to protect against failure, Islamic banks need to meet capital adequacy standards to protect depositors and investors. Pure PLS contracts such as *Mudarabah* and *Musyarakah* may not comply with Basel requirements involving as it does both parties contributing capital and management. Furthermore, collateral or warranty in these contracts may be in breach of Sharia principles [27].

Ahmad (2008) argues that the Capital Adequacy Requirement is a crucial part for IBs. As noted earlier, IBs have unique risks that may require additional strategies. The provision in Sharia banking may not be in accordance with Basel international guidelines in regulating risk, some sources of funding for IBs cannot be invested and used by bank due to restricted deposit in which only the depositors will be allowed to allocate the money for the business purpose. The fund derived from restricted deposit could not be included in determining the capital adequacy ratio. However, another type of deposit product is unrestricted money, where the bank can use this fund for their operational purposes and business.

In 2014, some measures have been taken by the Indonesian Financial Service Authority (OJK) to boost the growth of IBs. Under these measures, all IBs must comply with capital adequacy ratios (14%) as compared to previous (8%) to ensure that IBs can withstand any financial crisis. OJK also have signed an MoU with National Sharia Board of Indonesian Ulema Council to ensure the uniformity of Sharia provisions in IBs in Indonesia, and to monitor the compliancy of Sharia banks.

According to Global Business Guide Indonesia (2016), the market share of IBs in Indonesia in 2015 remained slow at the rate below 5 percent of total Indonesian banking assets based on data released by OJK as per July 2015. This sluggish growth is due to the national economic slowdown, causing the Islamic financing growth to slow throughout the year. Another reason is due to the weakening of the rupiah which is responsible for the increase of NPF ratio to 4.73 percent in 2015 from 3.9 percent in 2014 and declining of Capital Adequacy Ratio of IBs. At the beginning of 2015, CAR of three Islamic banks (BRI Syariah, BJB Syariah and BSM) decreased to below 15 percent but above 11 percent and still well above the required level. Indonesian banks are required to have a CAR at 8 percent in compliance with the Basel III global regulatory framework on Capital Adequacy. Local banks' overall CAR stood at 21.35 percent in November 2015, well above the required level [4].

Islamic banks in Indonesia are still unable to compete with their conventional counterparts. The lack of capital is considered the major constraint on competitiveness within the market. This is exacerbated by a government tax on Sharia deposits equal to conventional deposits because Islamic deposit margin is floating, the tax should be equal to mutual funds.

In 2016, some Islamic banks plan to increase their capital to expand their business coverage. For example, BSM will increase its capital by 500 billion IDR, BNI Syariah will get the fund from its parent Bank by 2 Trillion IDR. Increased capital expected will enable the expansion of Islamic bank financing in Indonesia [20].

8. Conclusion

During the GFC, Sharia financing benefited from improved financial conditions in the Middle East. Conversely, in 2016, this situation is now changing. Current evidence shows that the growth of Islamic financial institutions began to decline due to the weakening economic conditions in the Middle East caused by political instability and declining revenues from oil and gas sector. It can be concluded that Islamic finance institutions are not necessarily resilient in the face of financial crisis but are subject to general economic conditions.

The declining growth of Sharia banking indicates that Islamic banks are not immune from changing economic conditions. Islamic banks will certainly be affected by a financial crisis as well as conventional banks. Islamic banking must also obey the rules of international banking (Basel) if the bank wants to meet international standards, maintain its reputation and stability. It must at the same time comply with Sharia principles.

The most common risks in Sharia banking are depreciation of currency, financing in equity and operational risks relating to management. While in Indonesia the most serious problem is market risk and operational risk, in addition, the primary reason behind the slow growth of Islamic Banks expansion in Indonesia is lack of capital.

The next study proposes to examine the implementation of the Basel accords in Sharia banking, as well as the need for clarity of Sharia products that must be modified to match with international standards. This study also suggests that understanding the Islamic financial institutions in a financial crisis is important for Sharia bank practitioners and scholars. Various strategies will be recommended to protect Islamic financial institutions from vulnerability in a financial crisis.

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