

How do Islamic Banks Respond to Inflation? A Macro-Stress Testing Perspective from Saudi Arabia

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Abstract: This paper investigates the resilience of Saudi Islamic banks to inflationary shocks (2019–2023) using a VAR framework. Stress tests reveal that moderate inflation was manageable; however, severe shocks caused the Capital Adequacy Ratio (CAR) to fall close to critical levels, the Liquidity Coverage Ratio (LCR) to slip below Basel III thresholds, and NPLs to exceed safe limits. Despite these pressures, Saudi Islamic banks showed relative strength, supported by strong capital buffers and Shariah-based financing principles. The findings highlight the value of stress testing as a proactive supervisory tool to preserve systemic stability.

Keywords: Stress testing, Inflation, Capital Adequacy Ratio, Islamic Banking, Saudi Arabia

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