Risk Management in Islamic Financial Institutions

Rifki Ismal

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Associate Professor Rifki Ismal is both central banker and lecturer. He earned bachelor degree in economics from University of Indonesia, master degree in economics from University of Michigan, Ann Arbor (USA) and PhD in Islamic economics and Finance from Durham University (England). An Associate Professor in Islamic Banking and Finance is from the Australian Government (Australian Center for Islamic Financial Studies). He has published more thirty papers in international journals and a book titling Islamic Banking in Indonesia: New Perspective in Monetary and Finance (John Wiley and Sons, March 2013)
DAY ONE
Introduction:
What is Islamic Economics and Finance?
ISLAMIC AND ISLAMIC ECONOMICS/FINANCE

Aqidah is the core relationship between man and the Creator

Sharia is the transformation and manifestation of aqidah into actions

Akhlaq is the behavior, attitude and work ethics of a human.

Ibadat is the way people worship their God

Muamalat is Business transactions (Muamalat), the way people interact with others in terms of economic and non economics activities
Pre-Islamic Arab Traditions:
- trade based economy (south, north trade links).
- ka’bah was the most respected center.
- legal and illegal trade practices.
- wars and competition among tribes

Arab Business Tradition complied with Sharia

Life of the Prophet

Islamic Law and Jurisprudence

Islamic Finance Practices (Sharia Based Contracts):
- Islamic contracts approved and applied by the Prophet, companions, imam mahzab (school of thought), etc.

Baitul Maal

Fiscal Policy
<table>
<thead>
<tr>
<th>Islamic Finance Contracts (Sharia Based)</th>
<th>Non Islamic Arabic Contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mudarabah</td>
<td>Riba Jahiliyah</td>
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<tr>
<td>Musharakah</td>
<td>Riba al Fadhl</td>
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<tr>
<td>Murabahah</td>
<td>Riba an Nasyiah</td>
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<tr>
<td>Salam</td>
<td>Talaqi ruqban</td>
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<tr>
<td>Istishna</td>
<td>Ikhtikar</td>
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<tr>
<td>Ijarah</td>
<td>Bay kali bi kali</td>
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<tr>
<td>Musaqah</td>
<td>Bay Najasi</td>
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<tr>
<td>Muzaraah</td>
<td>Gharar</td>
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<tr>
<td>Sukuk</td>
<td>Qimar, Maysir</td>
</tr>
<tr>
<td>Wadiah, Kafalah, Hiwalah</td>
<td>Zulm</td>
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<tr>
<td>Core Values</td>
<td></td>
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<tr>
<td>----------------------------------------------------------------------------</td>
<td></td>
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<tr>
<td>All principles of Sharia should be part of man’s obedience and worshiping</td>
<td></td>
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<tr>
<td>God.</td>
<td></td>
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<tr>
<td>Every Sharia contract should aim to improve the welfare of people and</td>
<td></td>
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<tr>
<td>societies.</td>
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<tr>
<td>Businessmen have to have trust, support each other and, sharing risks</td>
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<tr>
<td>Prohibition of Riba, gharar, maysir, zulm, haram and unfair business</td>
<td></td>
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<tr>
<td>transaction.</td>
<td></td>
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<tr>
<td>Final target is falah, reflected in the implementation of Maqasid al</td>
<td></td>
</tr>
<tr>
<td>sharia</td>
<td></td>
</tr>
<tr>
<td>Referring to Islamic law: Qur’an, Hadist, Ijtihad, Ijma, Qiyas, Urf,</td>
<td></td>
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<tr>
<td>Istishsan, Istislah, etc</td>
<td></td>
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<tr>
<td>Honouring property right, individual and social obligation, work and</td>
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<tr>
<td>self interest, etc.</td>
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<tr>
<td>Encouraging working hard, blessed wealth, healthy competition.</td>
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<tr>
<td>The ultimate owner of all property is God, human is only His vicegerent.</td>
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<tr>
<td>Obligation to pay zakah, and highly suggested to pay shadaqoh, waqf,</td>
<td></td>
</tr>
<tr>
<td>hadiah, infaq, etc</td>
<td></td>
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</tbody>
</table>
DAY ONE

Types and Characteristics of Risks in Banking Operations
Risk management determines the *successfulness* of financial institutions in managing funds and providing well-expected return to stakeholders.

It *prevents* a bank from financial failure, insolvency, liquidity distress, etc and build a good communication/coordination with stakeholders.

It *measures and explains* every type of risk which will allow a bank to take necessary actions to anticipate and mitigate any risk.
RISK MANAGEMENT IN FINANCIAL INSTITUTIONS

• In general it is necessity for the robustness of the overall financial system and economic stability at the end.

• Risk management unexceptionally becomes part of Islamic banking institution with its unique characteristics and operations.

• Risk in financial terms is usually defined as the probability that the actual return may differ from the expected return (Howells and Bain, 1999:30). There are in fact three broad categories of risk namely (1) Financial risk, (2) Business risk and lastly (3) Operational risk.
TYPES OF RISKS IN BANKING

FINANCIAL AND BUSINESS RISK

Financial Risk
- Credit Risk
  - Default Risk
  - Down Grade Risk
  - Counter party Risk
  - Settlement Risk
- Market Risk
  - Commodity Price Risk
  - Equity Price Risk
  - Interest Rate Risk
  - Exchange Rate Risk
- Liquidity Risk
  - Asset-Liability Imbalance
  - Maturity Mismatch Risk

Business Risk
- Management Risk
  - Planning Risk
  - Organization Risk
  - Reporting Risk
  - Monitoring Risk
- Strategic Risk
  - R & D Risk
  - Product Design Risk
  - Market Dynamic Risk
  - Economic Risk
  - Reputation Risk

Operational Risk
- People Risk
  - Relationship Risk
  - Ethics Risk
  - Processes Risk
- Legal Risk
  - Compliance Risk
  - Control Risk
- System Risk
  - Hardware Risk
  - Software Risk
  - Models ICT Risk
- External Risk
  - Event Risk
  - Client Risk
  - Security Risk
  - Supervisory Risk
  - System Risk
  - Equity Investment Risk

Followed by
- Insolvency Risk
- Gov’t Taken Over Risk
- Reputation Risk
- Legal Risk

Source: Tariqullah Khan, 2006 (modified)
Risk can be expressed within a casual and interactive system, as the impact of each risk can’t be seen isolated, since they correlate and influence each other.

Financial risk is the exposures that result in a direct financial loss to the assets or liabilities of a bank. Besides credit, market risk and liquidity risk, Islamic banks face equity investment risk.

Credit risk relates to the performance of entrepreneurs: failure to fulfill their payment obligations, settlement, clearing, etc.
• **Market risk** happens due to unfavorable price movement or economic/financial condition such as RoR risk, exchange rate, inflation, etc. Unlike conventional one, Islamic banks bear risk of tradable, marketable, leaseable asset and mark up risk.

• **Liquidity risk** consists of 2 part: (i) Liquidity of financial instruments in financial market and; (ii) Liquidity related to solvency.
• Business risk links with the performance of bank’s business and internal action such as business policy, infrastructure, payment system, etc.

• Thus business risk deals with (i) management risk which asks how is bank’s planning, organizing, monitoring, reporting, etc and (ii) strategic risk is like R&D, product design, etc.
Operational risk occurs if a bank fails to manage people, system, legal, external risk and equity investment. It is internal process risk which brings together harmonization of:

- People (relationship, ethics, process, etc);
- Legal (compliance and control risk);
- System (hardware, software, etc) and;
- External risk (event, clients, security, supervisory, etc).
- Equity investment (asset, pricing, valuation).
• **Mark up risk** is risk because of fluctuation of benchmark rate or inaccurate/unfavorable mark up determination.

• **Commodity price risk** happens due to the fluctuation of price of a commodity.

• **Legal risk** is because of improper regulation, lack of regulation, etc.
• **Withdrawal risk** is when depositors take out their money for regular or irregular reasons.

• **Fiduciary risk**, when Islamic bank operates unislamically (violating sharia principles).

• **Displaced commercial risk** occurs when depositors switch their deposit into conventional one which offers more profitable/attractive return.
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Islamic Banking Principles and Internal/External Factors Leading to Risks
• **Islamic contracts** require depositors to fully understand consequence of dealing with Islamic bank particularly: no guarantee/fixed return on deposit, no return on demand deposit, periodical withdrawal on long term time deposit and risk/return sharing.

• **Islamic bank** mitigates its risk through risk sharing with depositors and entrepreneurs particularly profit and loss sharing (PLS) or return sharing scheme.
Economic / financial market risks are pure risk that can not be hindered by all parties but have to be minimized, avoided and handled properly. Islamic bank does not eliminate risk (interest based) but sharing/handling risk.

Regulator coordinates and designs proper legal and regulatory standard to control and manage performance of Islamic banking as well as preventing any unfavorable economic/business condition.
ISLAMIC WAY OF MITIGATING RISK IN BANKS

DEPOSIT/ SOURCE OF FUNDING
Withdrawal risk, Displaced commercial risk, Liquidity Risk

ISLAMIC BANK
People risk, Legal risk, Reputation risk, External risk, Equity investment risk

REAL SECTOR FINANCING
Credit risk, Default risk, Counterparty risk, Settlement risk, etc

BANKING AUTHORITY
Legal risk, Supervisory risk, Systemic risk, Monitoring risk

ECONOMIC & FINANCIAL MARKET
Exchange rate risk, RoR risk, Inflation risk, Price risk

Risk Sharing
Coordination and Regulation

Pure Risk
• Every Sharia contract connects/relates with performance of real sector. Interest rate disconnects financial sector with real sector.

• Market risk applies directly or indirectly in every Islamic contract.
PROBLEMS IN HANDLING RISK IN ISLAMIC BANKS

• Due to its early stage of development, Islamic banking industry faces lack of infrastructure, technology, regulation, lack of eligible human resources, lack of product innovation, etc. All of them might invite risk into the operation of Islamic bank.

• Islamic banks are free from interest rate risk but indirectly impacted by it.
DAY ONE

Islamic Financial Services Board (IFSB) Guides on Risk Management in Islamic Financial Institutions
IFSB GUIDES ON RISK MANAGEMENT

• IFSB Principles of Risk Management:
  – Islamic financial institution (IFI) shall have a sound process for executing all elements of risk management.
  – IFI shall ensure an adequate system of controls with appropriate checks and balances.
  – IFI shall ensure the quality and timeliness of risk reporting available to regulatory authorities.
  – IFI shall make appropriate and timely disclosure of information.
• IFSB Principles of Credit risk:
  – **Principle 2.1**: Islamic financial institutions (IFI) shall have in place a strategy for financing using the various Islamic instruments in compliance with sharia, whereby it recognizes the potential credit exposures that may arise at different stages of the various financing agreement.
  
  – **Principle 2.2**: IFI shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instruments.
• IFSB Principles of Credit risk:

– **Principle 2.3**: IFI shall have in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instruments.

– **Principle 2.4**: IFI shall have in place sharia compliant credit risk mitigating techniques appropriate for each Islamic financing instruments.
• IFSB Principles of Market risk:
  – Principle 4.1: IFI shall have in place an appropriate framework for market risk management in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.

• IFSB Principles of Liquidity risk:
  – Principle 5.1: IFI shall have in place a liquidity management framework taking into account separately and on an overall basis their liquidity exposure in respect of each category of current accounts, unrestricted and restricted investment accounts.
  – Principle 5.2: IFI shall undertake liquidity risk commensurate with their ability to have sufficient recourse to sharia compliant funds to mitigate such risk.
End of the Day