Risk Management in Islamic Financial Institutions

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Depok, 23 November 2013
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Risk in *Sharia* Jurisprudence and *Sharia* Mechanism in Risk Management
• Risk is close to definition of gharar in sharia.

• Gharar is any uncertainty or ambiguity created by the lack of information or control in contract.

• By size, there are gharar fahish (big gharar) and gharar yasir (small gharar). The former should be controlled and minimized while the latter has characteristics of (i) Negligible (ii) Inevitable (iii) Unintentional; and could be borne or ignored.
• In gharar fahish, by behavior, there are natural gharar and created gharar.

• Natural gharar happens without any intervention of any party like business loss, natural disaster, asset destruction, etc. Islamic banks may or may not avoid this risk but cannot transfer it to other parties.
• Created gharar occurs because of human interventional like gambling, impermissible contracts, fake contracts, invalid contracts, etc. Types of intervention are taghrir al fi’li (fraudulent acts); taghrir al qawli (fraudulent statement); taghrir kithman (fraudulent concealment).

• Islamic banks may not do and must avoid this created gharar because created gharar means creating problem of uncertainty or playing with uncertainty condition.
Risk management in Islamic banking deals with minimizing lack of information and maximizing control through sharia approaches such as profit and loss sharing, al ghunmu billa ghurmi, al kharaj bid daman, positive or negative sum game, cooperation and coordination and sharia compliance business activities, etc.
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 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.
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
- Reputational risk
- External risk
- Equity investment risk

REAL SECTOR FINANCING
- Credit risk
- Default risk
- Counterparty risk
- Settlement risk

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

• 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.
Sharia Approaches on Liquidity Risk Management
Challenges Related to Liquidity Risk Management

• From liability side: the requirement to maintain adequate liquidity as a standby reserve. It contains two modes of reserves, namely cash reserve requirement in the central bank and statutory liquidity requirement in the bank itself.

• Another type of liquidity reserved for such purpose is placement in money market instrument essentially the very short-term basis.

• Usually, the instruments take form of debt based such as Murabahah inter bank or equity based such as Musharakah and Mudarabah inter bank and ready to be liquidated whenever the bank needs.
Challenges Related to Liquidity Risk Management

• From asset side: Islamic bank tends to allocate fund in just short-term investment basis (Gafoor, 1995:8). Even, in the short investment period, Islamic bank prefers debt based Islamic financing to equity based.

• The necessary challenge appears in the case of default by business partners because Islamic bank is prohibited from charging any accrued interest or imposing any penalty.

• The other challenges are lack of easily liquidated long-term investment, immature financial market, etc.
IFS shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their liquidity exposures in respect of each category of current accounts, unrestricted and restricted investment accounts (Principle 5.1).

IFS shall assume liquidity risk commensurate with their ability to have sufficient recourse to sharia compliant funds to mitigate such risk (Principle 5.2).

Best practices in many IB identify involvement of investors, Islamic bank, business partners and their stakeholders in dealing with liquidity risk mitigation.
Best Practices in ISLAMIC BANKS

DEPOSIT/ SOURCE OF FUNDING
- Understanding of Islamic banking principles.
- Understanding of Islamic banking operations and consequences.
- Understanding of non-Islamic activities (speculation, riba, etc).

Risk Sharing
- Types of products adjusted to projects to be financed.
- Balancing of financing needed and amount of fund to be collected.
- Managing maturity date of deposit products and projects financing.

ISLAMIC BANK
- Liquidity risk management (quantitative and qualitative).
- Prudential financing allocation and decision.
- Supporting information from credit bureau and credit rating company.
- High profit orientation of portfolio allocation (for consumer's confidence).

Risk Sharing
- Characteristics of deposit fitted to types of financing.
- Matching projects return with PLS executing date.
- Partners' selection (due diligent): behavior, ethics, business prospects, etc.
- Joint financing to minimize risk.
- Monitoring and cooperative business management.

REAL SECTOR FINANCING
- Liquid instruments preparation.
- External fund for emerging liquidity risk (central bank, government, money market).
- Insurance / Takaful.
- Default mitigation policy (guarantee in asset, third party guarantee, rescheduling, etc).
- Reserve in capital.
- International intervention (IDB, IIFM, etc).

Sharia Compliance, Islamic Rules and Regulations, Religious Responsibility
Investors Involvement in Liquidity Risk Management

• Sharia ties investors of the bank to be responsible and aware of liquidity risk. Their engagements are ultimately in forms of their deep understanding of Islamic banking principles, operations and business consequences.

• The most important one is their unwillingness to entail in the prohibited business activities such as:
  – speculation,
  – interest rate return seeking, etc.

• besides their willingness to share the risk and responsibility with the bank.
• The mature investors will be ready to accept:
  – risk sharing,
  – no periodic return in certain types of the banks’ products, and
  – all other following consequences.

• Meanwhile, for business partners, the understood investors will indirectly guarantee the availability of fund for business.
• IB develops internal sharia approaches facing liquidity risk problem:
  – Liquidity risk management policy that includes policy related to liability and asset side. It is established by Board of Director and followed up by special task body and continued by senior management in a very technical level.
  – Measuring and monitoring liquidity risk. Islamic bank is obliged to maintain adequate liquidity as its standby reserve and regularly review its limit.
  – Prudential and sharia compliance banking operation that deals with the bank’s financing decisions, business partners’ selection, and possibility of joint operation with other Islamic banks.
IB Roles in Liquidity Risk Management

– Sharia based liability management. IB follows three approaches:

• Adjusting types of deposit products into projects to be financed;
• Balancing of financing needed and amount to be collected and;
• Managing maturity date of both deposit products and projects financing.
IB Roles in Liquidity Risk Management

– Sharia based asset management. IB approaches are,
  • Fitting characteristics of deposit and projects financing;
  • Matching the flow of projects’ return with the due date of PLS payment;
  • Selecting business partners through due diligence;
  • Employing joint financing with other Islamic banks to share the risk and;
  • Monitoring and conducting cooperative business
End