البحث الأول

Risk Management In Islamic Banks

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بالتعاون مع

OUTLINE

- Introduction to Risk Management in Islamic banks.
- Comparison between Islamic banks and conventional banks.
- Determination of the strategic role assumed by the Board of Directors in an Islamic bank.
- General framework of risk management within the Shari'ah governance controls.
- Appendix for self-reading – details of operating risks in Islamic banking industry.

Al Ghunm bil Ghurm

- This means that the right in the return on any asset is essentially associated with the responsibility to bear the loss of this asset.

Al Kharaj bil Dhaman

- Accordingly, Islamic finance does not separate between the right in the return and the responsibility that entails the ownership. Islamic finance does not allow the risk to be borne by a single party in the contract only, and mandates that risk should be shared by the both parties.

A Brief Comparison Between Risk Management In Conventional Banks And Islamic Banks Shows The Following:

Conventional Banks

- A conventional bank gathers all kinds of savings. It's a financial mediator between the depositors and borrows, in that it secures to the depositor a defined interest and the value of the deposit, and the capital is charged with any loss borne by the bank, but the depositor does not bear any loss.

Islamic Banks

- the relation between the Islamic bank and investment account holders take the form of mudharabah and musharakah contracts, by virtue of which mudharabah-based investment account holders share the loss, if any, provided that no infringement or default is evidenced on the part of the bank.

Accordingly, Shari'ah risks are represented in the potential damages stemming from Shari'ah issues by reasons of executive decisions, products, or financial products related contracts, thereby jeopardizing the reputation of Islamic banks.

This leads us to identify the categories of main risks in Islamic banking industry

Risks

- Strategic Risks
- Market Risks
- Operational
- Risks
- Contractual & Compliance Risks

Strategic Risks

- The capital adequacy, and specifically the asset quality, taking into consideration the integrity of standards of Shari'ah controls on assets, with due consideration of Basel III recommendations.

- Conformity of Islamic banking products, such as Murabaha and Ijarah, with the strategic directions in terms of distribution of the Bank's assets.

- Risks related to the Bank's reputation, and specifically those risks related to the loss of credibility in dealing with customers related to characteristics of Islamic banking products and the scope of the seriousness of their conformity with Islamic Shari'ah principles.

Market Risks

- These Risks are represented in the Rate of Return, as follows: (i) Islamic banks cannot change the return on their financial products, specifically during the finance lifetime, but in revolving murabahat, they can rely upon reference indices to determine the rate of the revolving murabaha.

- Meanwhile, these challenges do not exist in conventional banks, since the variable interest rate is the basis for determining their conventional loans.

- Accordingly, Rate of Return in conventional banks varies in line with the changes in the discount rate announced by the central bank. (ii) the Rate of Return is not known in musharakat, wakalat (agencies) and mudharabat contracts, where such contracts are influenced by the principle of sharing the profit or loss.

- Risks related to fluctuations in the Market and Commodity Prices: Since the sale of Islamic financial products and sale of banking services are based on contracts, all of which are subject to market movements and fluctuations of commodity and services prices.

- This sometimes creates a challenge to the Bank, and directly impacts the margin of the anticipated profit. Commodities and services are sometimes exposed also to the supply and demand forces, in addition to the external factors related to the production of goods, their costs, the foreign exchange rates, among others.

- Fluctuations of Foreign Exchange Rates: When there are commercial contracts and transactions related to other countries that are priced in foreign currencies, the conclusion is that any change in the exchange rates of these currencies will affect the prices of commodities and services by which Islamic banks deal by way of sale and purchase, and will be reflected also on the prices of their financial products. The final conclusion would witnessed in the realized Rate of Return.

Operational Risks

- Operational risk is defined as the loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risks.
- Conformity of the measures of the business continuity plan and recovery from disasters with the Shari'ah requirements.
- All forms of deceive, misuse or fraud on Shari'ah requirements. The source of this risk could be internal or external, represented in the entry of a third party.
- Cyber security, and the scope of the conformity of protection measures with the Shari'ah control requirements, and specifically in protection of customer data.
- E-transactions and e-payment transactions through brokers and the scope of their conformity with Shari'ah requirements.

Contractual & Compliance Risks

- Conformity of contractual terms and conditions with Shari'ah principles, such as Murabahah and Ijarah contracts, and other financing and investment contracts.
- Compliance with the recommendations of the Shari'ah Supervisory Board and not to violate regulatory instructions.
- Exposure to penalties and legal accountabilities.

Factors leading to larger exposures to Shari'ah Risks

- Weak educational and practical qualification of workers in Islamic banks and financial institutions and their lack of knowledge of the nature of business in Islamic banks and the characteristics of Islamic finance formulas.

- The reduced activity of performance of Shari'ah control roles applied in certain Islamic banks, pertaining to non-employment of trained and qualified personnel and dedicated departments active in the Shari'ah auditing. This contributed to the weakness of Shari'ah control in certain Islamic banks and financial institutions.

- Non-compliance by some Islamic banks and financial institutions with the Shari'ah standards and fatawa issued by Shari'ah Supervisory Boards and resolutions of the Islamic fiqih think tanks, along with non- compliance with disclosure and transparency standards.

- Some contracts do not satisfy the Islamic finance rules because they are made by external legal firms which are not specialized in Islamic finance transactions, thereby leading to these contracts to stand invalid in case the Bank enters into a legal dispute with customers.

- Absence of conclusive approaches shall create further complexity of the various Shari'ah opinions about a single case, where it was noticed that there are several fatawas (Shari'ah opinions) about a single product, pertaining to the different doctrines, which could jeopardize the Islamic financial products.

- Over-reliance on exceptional solutions in several Shari'ah issues, where several Islamic banks and financial institutions expand and have concentration in Shari'ah exceptional solutions in Islamic banks businesses, such as Tawaruq, and this may lead to increase the bank's exposure to unmitigated losses.

- Computer operating systems are not compatible with the features and specifics of Islamic financing products and formulas.

- Absence of the legal impact of Shari'ah provisions governing Islamic banks, and their implications on the judicial orders, considering the gaps between the laws and Shari'ah opinions ,in the cases where difference exists.

- Absence of competent courts to decide upon the disputes related to Islamic financial transactions contracts.

The Active Role Assumed by the Board of Directors in Managing Shari'ah Risks

- Enhancing the independence of the Board of Directors and Board committees, mainly the Risk Committee and Audit and Compliance Committee

- Enhancing the coordination between the Board of Directors and Shari'ah Supervisory Board from the strategic and regulatory perspective

- Adoption of an effective reporting packs to monitor the levels of compliance with Shari'ah principles

- Determination of jurisdictions and responsibilities pertaining to endorsement of contracts and nature of products

- Ensuring that the bank is enhancing the knowledge and skills of its executive management and staff.

- Assets and liabilities of Islamic banks are based on the principle of sharing in profit and loss as per the ratio of capital.

- Islamic banks application is not confined to sharing (Musharaka) in the sides of assets and liabilities, but included forms in both sides other than the sharing.

- In the side of assets, the application included the following formulas:
  - o Musharakat: Mudharaba and Musharakah.
  - o Wakalat (Agencies): Wakala (Agency) in Investment
  - o Ijarat: Operational lease and complementary lease
  - o Forward Sales (Beu'e A~Jellah) Murabaha, Sale by Installments, Istisna'a and Salam.

Liabilities

- In the side of liabilities, the application included the following formulas:
  1) Loan (Qardh): As a formula for attracting call current deposits – current accounts.
  2) Musharaka and Mudharabah: As a formula for attracting investment deposits.
  3) Forward Sale: This is an updated formula for creation of fixed return deposits, based on that
  the bank buys goods from the depositors with a forward price for a definite period.
  4) Wakala (agency) in investment.
  5) Tawaruq.

The Philosophy of Liability and Profit in Islamic Finance

First: ((Al-kharaj bi al-daman)):

- This rule (Al-kharak bi al daman) is deemed to be one of the Islamic finance pillars. It means that: The benefit from a certain thing is in return for the liability that accompanies that thing. In other words, the return that one gets should be proportional to the risk assumed.

- A synonym in Meaning is the (al-ghurm bu alghunm) rule which means that the right to receive return is related to the liability (daman) to bear the loss.

- This rule is common in all financing formulas. Then there is no way to receive return without having title to the property and bearing the liability thereof.

The Philosophy of Liability and Profit In Islamic Finance

Second: ((Risk and Liability)):

- Risk is an essential factor in the economic activity. It is inherent in the economic activity and trading cannot be processed without risk. Risk creates the potentiality of the profit and loss as well.

- It is not meant in itself, but the intended thing is the economic activity.

- Shari'ah does not encourage exposure to risk, but it leaves room to allow for requirement of the liability (daman). Accordingly, the "Authentication Contracts" were created in Fiqih (Islamic Rules).

Risks, Challenges and Issues Unique to Islamic Banks

1) The risk of absence of sound understanding of risks in Islamic contracts.

2) Risks related to Islamic finance formulas

   - The customer withdrawal to complete the transaction, even after he gives a promise and pays the advance payment.
   - The price or the return is not increased in case of the customer's delay for repayment at the agreed date.
   - Non-delivery of the goods or the service at the due date, as in the case of Salam or Istisna'a contracts.
   - Non-Shari'ah compliant earnings must be disposed of in case of infringement of the Shari'ah Supervisory Board resolutions.

3) Some contracts are not allowed to be traded on regulated exchanges or over the counter directly, such as derivatives and others.

4) Damage of the goods owned by the Islamic bank before completion of their sale and delivery to the customer or their damage while they are under lease.

5) Lace of hedging instruments in Islamic banking.

6) The difference in Fatawa (Islamic opinions)and viewpoints oncontracts and innovated financial structure.

7) Shari'ah requirements in wording of contracts and their non-infringement of the (Al-Khraj bil Daman and earning a thing that has not been secured).

Risks Related to Islamic Financing Formulas

- Risks for Financing by Musharaka and Mudarabah

1) Total or partial loss of the capital.

2) The expected profit will not be realized.

3) Financial expenses and costs of Mudaraba.

4) Exchange rate risks: Specifically if financing the Mudaraba is made in foreign currency.

5) Commercial Risks: These risks are related to the nature of the Mudaraba activity. This nature handles the degree of the activity, its promotion or recession or the risks related to the general environment of investment.

Risks Related to Islamic Financing Formulas

- Risks for Financing by Murabaha

1) The banks funds are exposed to risk in event of the customer default of repayment and not obtaining sufficient collaterals, even when resorting to the judiciary.

2) The Bank's profits are fixed during the Murabaha term.

3) The bank holds the responsibility towards the goods.

Risks Related to Islamic Financing Formulas

- Measures that lead to mitigating risks in banking murabaha

1) The customer signs a binding promise to purchase the goods at cost, plus the agreed profit. Thus, the risks of fluctuations of the prices of goods and exchange rate are neutralized.

2) Seriousness margin (Hamesh Jadi~ah) to indemnify the bank for the actual damage in case of the customer's breaking his promise.

3) The option of returning the goods, based on a condition between the bank and the supplier. This option is used by the bank in case of the customer's breaking his promise.

4) Impose late payment charges on procrastinating debtors, provided that such charges shall be paid to charity societies and the bank shall not benefit therefrom.

Risks Related to Islamic Financing Formulas

- Risks of Ijarah Financing

- The purpose of financing by banking Ijarah (lease) or Ijara with the promise to owning, is to transfer the title to the leased property to the customer who promises to lease it and a promise from the bank to transfer the title to him/her at the end of the Ijara period.

1) Commercial Risks: These risks are related to damage of the asset prepared for lease or the leased asset. These can be covered by way of Takafuli insurance on the asset.

2) Credit Risks: These risks are related to the risks of non-repayment of the rent for the remaining period.

- Meanwhile, operating lease (Ijarah) is based on that banks own assets and then search for lessees. Hence banks face the risks of price fluctuations.

The Most Risks Facing Liquidity Management in Islamic Banks

1) The shortage in short-term financial instruments such as Sukuk, by which Islamic Shari'ah compliant liquidity is managed in Islamic banks, and such instruments enjoy the same benefits enjoyed by the financial instruments traded in the money markets and attract funds by these benefits.

2) Lack of diversification of the financial investments. Many Islamic banks depend on a product or two products for liquidity management, and Islamic banks now suffer the same risks which conventional banks suffer.

3) The need to innovate in financial products in Islamic banks.

Risk Management Instruments in Islamic Banks

1) Distribution and diversification of the investment and financing instruments: Murabaha – Ijara – Istisna'a, etc.

2) An environment, a management and proper monitoring.

3) Multiple contracts and the Islamic bank to rely upon several contracts as a basis for the investment and financing operations.

4) Accuracy in wording of contracts, in accordance with the Shari'ah requirements and the nature of the operations and the legal circumstances along with the prevalent legal condition in the bank's country.

5) Adequate reserves and provisions to encounter the potential risks (profit equivalent provision – investment provision).

Risk Management Instruments in Islamic Banks

6) Insurance (Takafuli).

7) Securities and collaterals.

- The value of the security at present and the future value to it upon maturity of the obligation, and the value of the compulsory sale when necessary.
- The convenience of liquidation of the security and the period taken for transfer of the security into liquidity.