Islamic finance: risks and risk management

The Islamic financial sector is one of the fastest-growing segments of the financial industry. Since the start of the financial crisis, there has been a growing emphasis on the stability and ethical basis of the Islamic financial sector. Although this sector appears to be relatively unaffected by the crisis, it is nevertheless exposed to a variety of risks, making more effective risk management essential. This Special Report addresses the challenges faced by the Islamic financial market and the risks and risk management systems of Islamic financial institutions.

Balance sheet of Islamic financial institutions

Islamic financial institutions (IFIs) (in the form of either a bank or an 'Islamic window'[1]) have the same objective as conventional banks, namely to mobilise capital by attracting excess funds from savers or investors and to provide these funds to entrepreneurs, traders or consumers who need them. However, the main difference is that Islamic law (known as 'Sharia') must be complied with (see Special Report 2011/22), both on the liability side and on the asset side. As an alternative to interest products, IFIs use a variety of financial methods that are in accordance with Sharia.

Liability side

On the liability side IFIs mobilise capital, usually on the basis of a *muđāraba* contract and in some cases *wakāla*[2] or *mushāraka* contracts, i.e. investment accounts or partnership accounts (see Figure 1). In the case of the latter, it is not common in practice to let customers pay for losses, as is the case with actual *muđāraba* contracts. IFIs generally provide a guarantee for the principal of the deposits. Furthermore, they can also offer *qarđ al-ħasan* accounts: savings accounts on which customers do not earn any fee. These accounts are designed to provide the IFI with funds for the *qarđ al-ħasan* (i.e. interest-free) loans.[3] In addition, IFIs also offer interest-free current accounts whose nominal value is officially guaranteed by the IFI. They provide this guarantee because these types of assets are considered as merely entrusted (*amāna*): customers may withdraw these funds at any time (Khan & Ahmed 2001, Visser 2009).

Asset side

On the asset side, IFIs make almost no use of partnership contracts. The bulk – roughly 80% – of the loans is provided based on mark-up contracts (e.g. *murābaħa*) or lease agreements (*ijāra*). Under these types of contracts, IFIs are exposed to less risk than with partnership arrangements. This is because the mark-up contracts are provided based on an asset underlying the loan. When subject to partnership contracts, the bank itself may incur substantial losses if a business is not doing well. This exposes the bank to the risk of suddenly being faced with losses if it has no, or limited, access to the business's accounts. In addition, a business may report lower profits to the fund provider to lower the profit share they have to pay. Furthermore, there may be a substantial moral hazard involved due to the fact that the borrower does not always share in the losses (Sundararajan 2005, Visser 2009, Hasan & Dridi 2010).

[1] Separate legal form of a conventional financial institution that offers Islamic financial products and services.

[2] The difference between *wakāla* and *muđāraba* contracts is that, under *wakāla* contracts, an agreed ratio is distributed rather than the full profit being divided.

[3] These loans are provided, for example, to the less privileged or to students.

Figure 1: Stylized balance sheet of IFI

Assets	Liabilities
Inventory	**Equity**
Asset-backed financing (including mark-up contracts - *murābaḥa* / leasing – *ijāra)*	**Current account** (*amāna*)
Investment financing (profit sharing and loss acceptance *muḍāraba* / profit and loss sharing - *mushāraka*)	**Investment accounts** (*muḍāraba*)
Interest-free loans (*qarḍ al-ḥasan*)	**Limited investment accounts*** (*mushāraka / muḍāraba / wakāla*) *subject to maximum profit compensation
Fee-based services (*ju῾āla* etc.)	**No-interest accounts/savings accounts** (*qarḍ al-ḥasan*)

Source: edited by the author; from: IFSB 2010

Theory versus practice

The theoretical ideal is that IFIs maintain investment accounts on the liability side and only use partnership contracts on the asset side. In theory, any shock on the asset side is absorbed by the risk-sharing of the liabilities. As a result, equity can remain intact for longer, which is believed to ensure a stable system (Khan & Ahmed 2001). This has worked out differently in practice, however, and the frequently used mark-up contracts are sometimes constructed such that they are very similar to interest products, which has drawn much criticism from Muslim scholars and economists (Khan & Ahmed 2001, Čihák & Hesse 2008). In addition, there are also significant differences between IFIs in terms of how they structure their products, which, in turn, has an effect on the IFI's balance sheet and risk levels. This is due mainly to the lack of international standardisation of, for example, Islamic rules and training programmes.

What risks do IFIs face?

IFIs are faced with two main types of risks. First, the standard risks that apply to any financial institution, Islamic or conventional. Additionally, IFIs are exposed to specific risks on account of the special products they offer. As an added factor, the Islamic financial market, due to factors such as its rapid growth, globalisation and stricter regulatory rules (as a result of the crisis) is faced with significant challenges. For instance, there is insufficient international standardisation for Islamic regulations and guidelines for regulation and supervision, a substantial lack of liquidity instruments and of a secondary market. In order to eliminate these barriers, the sector has established a variety of standardisation and regulatory institutions[4] over the past decades. However, these institutions must still be approved by a majority of the IFIs.

Almost no interest-rate risk

IFIs are theoretically not exposed to interest-rate risk – which constitutes one of the main risks faced by conventional financial institutions – since no interest is paid or demanded. As a result, IFIs are virtually unaffected by interest-rate movements in the market.

Credit risk

Since IFIs, on the asset side, mainly use what are referred to as 'mark-up contracts' or 'trade contracts', credit risk (i.e. the risk that debtors default on payment, due to insolvency or otherwise) represents one of the main risks for IFIs, as it does for conventional financial institutions. In fact, credit risk may even be larger for IFIs, since the profit mark-up agreed in the contract may not be adjusted during the contract period as a result of which IFIs cannot restructure their debts like their conventional counterparts (Eigari 2003, Sundararajan 2005).

Additional liquidity risk

IFIs are faced with increased liquidity risk, defined as the risk that an institution has insufficient funds available to meet its immediate commitments. This is because IFIs have very limited access to the conventional money market (due to the prohibition against interest and other factors) and there is a lack of liquidity

[4] Including: Accounting and Auditing Organization of Islamic Finance, Islamic Financial Services Board and Islamic International Rating Agency.

instruments, interbank money-market and 'lender of last resort' facilities that are Sharia-compliant. Additionally, the specific structure of Islamic financial makes it difficult, if not impossible, to trade them. IFIs are therefore compelled to maintain more cash assets than conventional banks. Liquidity management is a key issue for all financial institutions, but, as the above shows, even more so for IFIs. One of the solutions being created is the further development of the issue of *sukūk* (Islamic investment certificates) and the development of 'lender of last resort' facilities in accordance with Islamic rules (Čihák & Hesse 2008).

Sharia non-compliance risk

IFIs must guarantee at all times that all their products and activities are Sharia-compliant, or else it will incur reputational risk, which negatively affects its sustainability. Sharia non-compliance risk is therefore one of the largest specific risks facing IFIs. This risk is created when an IFI fails to comply with the Sharia rules and principles prescribed by the IFI's Sharia Board, e.g. due to an operational error. IFIs are also exposed to this risk due to a lack of agreement in the Islamic financial market as to what is and is not Sharia-compliant. Consequently, an IFI may run the risk of debtors attempting to avoid their commitments by claiming that the underlying contract is not Sharia-compliant (Bälz 2008, Shafii et al. 2010). For example, The Investment Dar (TID) attempted in 2009 to cancel a transaction it entered into with Blom Bank (Blom) in 2007 on this ground, despite the TID's Sharia Board having approved the transaction in 2007. This case is currently being disputed before an English court, which believes that it represents a triable issue (Howladar 2010). In order to limit Sharia risk somewhat, IFIs include a 'waiver of Sharia defence' provision in their transactions (Bälz 2008).

Market risk: price risk

As the majority of contracts entered into by IFIs are based on asset-backed transactions, IFIs are exposed to substantial price risk on equity, real estate and raw materials. This is evident in Dubai and Qatar, for example, where a large number of Islamic financial contracts use real estate as collateral. Due to the crisis, real estate markets in these countries have been faced with dramatic price drops (Hasan & Dridi 2010, Kahf 2006).

Stability versus risk

The specific risks associated with Islamic finance discussed above are offset by a number of issues that actually improve the stability of these institutions, such as avoidance of unnecessary risk and speculative transactions; strict limitations for derivative transactions; and a ban on short-selling and excessive leverage (Hasan & Dridi 2010). Furthermore, the limited access to liquid assets compels IFIs to adopt a more prudent approach and take fewer risks. IFIs maintain more cash assets and higher capital reserves than do conventional institutions (Čihák & Hesse 2008, Hasan & Dridi 2010).

Risk management and regulation

The quality of its risk management determines to a large extent whether, in practice, a financial institution is exposed to additional risk or less risk. In this respect, the risk management strategies employed by IFIs do not differ much from those of conventional institutions. However, since IFIs are faced with different types of (unique) risks, the special risks must be identified in order to make risk management truly effective. This means there is a requirement for multiple risk identification processes, multiple risk management methods and techniques, and multiple forms of regulation (Khan & Ahmed 2001). In order to mitigate Sharia non-compliance risk, for example, internal processes and departments (including a Sharia compliance audit) must be in place alongside the (independent) Sharia supervisory board that approves the products in order to guarantee Sharia compliance. In addition, external developments and discussions relating to Sha-

ria rules must be monitored (Shafii et al. 2010).
Risk management is not yet properly organised at all IFIs: a recent Deloitte survey showed that only 5% of IFIs have maintained a risk management department for more than ten years, and that 79% had only established such a department within the past five years. Due to the rapid growth of the sector and the complexities this involves, as well as due to the crisis, IFIs are under considerable pressure to establish an effective risk management system. Without an effective system in place, IFIs will be unable to develop in a stable manner and be competitive in the long term (Deloitte 2012). Due to an underdeveloped risk management system, this market has therefore not remained unaffected by the current crisis (Hasan & Dridi 2010).

Derivatives

Derivatives are one of the main risk management tools employed by conventional financial institutions. However, the use of derivatives is highly controversial in the Islamic financial market due to the ban on 'avoidable uncertainty', 'unnecessary risk', 'gambling' and entering into financial transactions without underlying assets. Only since the sector has become aware of the importance of effective risk management have leading standardisation agencies attempted to establish Sharia guidelines for hedging risk. Developing guidelines for 'Islamic' derivatives is a key objective that has, however, not yet been achieved to date. Although, there are derivative transactions that are used by a number of IFIs, many IFIs steer clear of these on account of the major controversy involved. Any derivatives that *are* permitted may only be used for hedging purposes and not for trading purposes (Jobst & Solé 2012).

Regulation

Financial market regulators that apply conventional standards have a difficult time assessing new and exceptional risks faced by IFIs, creating a need for specific supervision and regulation of the Islamic financial market. This need has existed for some time, and, due to the efforts of the International Monetary Fund (IMF), the Islamic Development Bank (IDB), and a number of central banks based in Muslim countries, the Islamic Financial Services Board (IFSB) was established in 2002.

Concluding remarks

The current crisis has brought attention to the stability aspects of the Islamic financial sector, while at the same time exposing weaknesses in the market more clearly. In order to accommodate the rapid and steady growth and maintain the system's stability, the market must be committed to further development of a solid risk management system and sound risk management methods, as well as standardisation of Islamic regulation and accounting and auditing guidelines. In addition, the money and capital markets must become more accessible to the Islamic financial sector. In order to achieve this objective, there must be sufficient qualified staff to dedicate themselves to these efforts. However, due to the rapid growth of the sector, there is currently a major shortage of such professionals. The Islamic financial market must therefore make considerable efforts to overcome these challenges and ensure stability. The market is faced with the challenge of further expanding within an international conventional market while remaining in compliance with Islamic principles.

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