Risk Management and Challenges in Islamic Banks

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Abstract

The use of financial services and products that confirm with the Shari'ah principles cause special issues for supervision and risk management. Efficient risk management in Islamic financial institutions has assumed particular importance as they try to cope with the challenges of globalization. This paper highlights the special and general risks surrounding Islamic banks. It also explains the key challenges ahead to promote further development of Islamic banking in the global financial system. The development of a new financial instruments and institutional arrangements for providing an enabling operational environment for Islamic finance is also emphasized.

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1. Introduction

Islamic Banking has grown in a large number of countries in the world. In Iran, Sudan and Pakistan all financial institutions have fully adopted to the *Shari'ah* laws. Other countries such as Egypt, Saudi Arabia, Jordan, UAE, Kuwait, Malaysia, Indonesia, Brunei and etc Islamic Banks operate alongside with conventional banks. This is done either throw the opening of Islamic windows in conventional institutions or the establishment of separate banks or branches under the Islamic law that specialized in Islamic financial operations.

The Islamic financial services industry includes an increasingly diverse range of institutions, such as commercial and investment banks, mutual insurance and investment companies. Banks, however, remain the core of financial services in many Islamic countries.

Effective risk management in Islamic banks deserves special attention. However, it has many complex issues that need to be better understand. In particular, the nature of specific risks facing Islamic banks together with the virtually unlimited number of ways available to them to provide funds through the use of combinations of the permissible Islamic modes of financing – PLS[2] and non-PLS – raise a host of issues in risk measurement, income recognition, adequacy of collateral and etc. Thus,

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[2] Profit and Loss Sharing modes of financing.

innovative solutions and an appropriate adoption of available risk management are needed to reflect the special characteristics of Islamic financial products and services.

This paper examines the above challenging issues.

2. Specific Risk Surrounding Islamic Banks

The features of Islamic banks and the modes of financing that they follow include special risks that needed to be recognized to help make risk management.[3] The PLS modes of financing raise several important considerations. Specifically, while PLS modes shift the direct risk of Islamic banks to their investment depositors, they may also increase the overall degree of risk of the asset side of banks. In practice, PLS modes make Islamic banks vulnerable to risks normally borne by equity investors rather than holders of debts. There are a number of reasons for this, including:

- The administration of PLS modes is more complex than conventional financing. These modes imply several activities that are not normally performed by conventional banks, including the determination of profit / loss sharing ratios on investment projects in various sectors of the economy, as well as the ongoing auditing of financed projects to ensure proper governance is doing.

  Also, there is a number of activities that Islamic banks can engage in, in addition to a number of ways they can provide funds through the use of the PLS and non-PLS modes.

  When Islamic banks provide funds through their PLS facilities especially in *Mudarabah* contract, there is no recognizable default on the part of the entrepreneur until PLS contracts expire. A default of PLS contracts means that the investment project failed to deliver what was expected. In this case the low profit or loss is shared between parties according to stipulated PLS ratios.

  Islamic banks have no legal means to control the entrepreneur who manages the business financed through *Mudarabah* contracts. This individual has complete freedom to run the enterprise according to his judgment. Banks are entitled only to share profit or loss from the agent according to the contract ratio. In *Musharakah* and direct investment contracts, banks have better opportunities to monitor the business because, in these contracts, partners may influence on the enterprise and use the voting rights.

  In Islamic finance PLS modes cannot logically be made with collateral or other guarantees to reduce credit risk.

[3] Special risks in Islamic banking can be seen in Chapra and Khan (2000).

The mentioned considerations underline operational risk in Islamic banking.

Operational risk may arise from various sources:

a) The unique activities that Islamic banks must perform.

b) The non-standardized nature of some Islamic products.

c) The lack of an efficient and reliable *Shari'ah* legislation system to enforce financial contracts.

Non-PLS modes of financing also carry special risks that need to be recognized. Specifically, *Salam* (purchase with deferred delivery) contracts expose Islamic banks to both credit and commodity price risk. This is because banks agree to buy the commodity on a future date against current payment and also hold the commodity until it can be converted to a cash. Similar risk is also involved in *Ijarah* (leasing), because this contract do not provide Islamic banks with the ability to transfer substantial risks and rewards to the lessee as leased assets must be carried on the balance sheet of banks for the term of the lease.

In the liability side, the specific risk inherent the operations of Islamic banks arise from the special nature of investment deposit, that is the capital value and rate of return are not guaranteed. This feature coupled with asymmetric information resulting from the unrestricted PLS and non-PLS contracts where banks manage deposit of people at their own discretion.[4] This increases the potential of moral hazard and creates an incentive for risk taking and for operating Islamic financial institutions without adequate capital.

3. General Risk Surrounding Islamic Banks

In addition to the specific risks mentioned above, there are other more general factors that make the operation of Islamic banks riskier and/or less profitable than traditional banks. These are:

- Lack of risk-hedging instruments. The prohibition against *riba* and some *fiqh* issues in the interpretation of *gharar* mean that many risk hedging instruments based on traditional tools, such as option, futures and forwards are not available to Islamic banks in the current state of Islamic banking.
- Underdeveloped money market and government securities based on profit – loss sharing. This may difficult to manage the liquidity in term of mismatching the asset-liquidity and increases the liquidity shocks. Fortunately, significant progress has been made in Iran for government securities and short-term instruments such as National Participation Certificates and Central Bank *Musharakah* for such issues.

[4] According to the unrestricted contract, depositors agree that their funds be used by banks at their discretion and they expect to share with banks the overall profits that the bank may earn.

- Limited availability to access to lender- of- last resort (LOLR) facilities by central banks. The lack of *Shari'ah*-compatible LOLR facilities is associated to the prohibition of interest and thus discount rate.
- Islamic banks have historically been forced to hold a large proportion of their assets in reserve accounts in central banks or in correspondent accounts than conventional banks. This has significantly affected their profitability because central banks give minimum or no return to these reserves. This in turn, has affected their competitiveness and increases their potentiality to the external shocks with its consequences.

4. Reducing Special Risks of Islamic Banks

Based on the above considerations, effective and efficient risk management in Islamic banking should consider a strategy based on suitable regulatory and disclosure framework and adequate institutional development.

Adequate capital and loss – offsetting reserves, as well as appropriate control of risks are key elements to ensure a sound operation of Islamic banks. These factors may be:

- To reduce the potentiality of moral hazard in the PLS modes, it is essential for bankers to have adequate amount of their own capital at risks;
- According to the asymmetric information in unrestricted contracts, such as *Mudarabah*, adequate capital and reserves provide depositors with a psychological reassurance to help maintain their confidence against possible loss on the performance of individual banks.
- Increasing the ability of banks to attract more demand deposits which are not remunerated. On the part of bank, these deposits may share the same risks as investment deposits.
- To prevent a gradual destruction of investment deposits in the event of losses, which may to lead a liquidity crisis which Islamic banks are perhaps less well equipped than traditional banks.
- To take into account the fact that financing through PLS and non-PLS modes comprise several unique forms of risks that need to be considered and also monitored, depending on the specific nature of the contracts and the overall environment.

Adequate capital and loss – offsetting reserves for Islamic banks could usefully be viewed with in a comprehensive risk management. These should be considered to all critical dimensions of the operation of banks in an Islamic environment as well as an appropriate disclosure regime for Islamic banks. Suitable information system with a well organized accounting system is needed as part of the regulatory framework for Islamic financial institutions. These help the market to overcome the non transparency inherent in some aspects of Islamic financial products and also, in turn, would help to better understand the special risks surrounding the operations of Islamic banks.

To reduce the risks of the operation of Islamic banks to overcome the above issues some key elements may be considered. These may be:

Capital Adequacy

- Capital adequacy is measured according to the volume of risk assets. In principle, the bulk of the assets of Islamic banks should be made of PLS modes, which are mostly uncollateralized. These assets carry more risk than those of made from non-PLS modes which, in principle, are collateralized. Thus, the ratio of riskier assets to total assets should typically be higher in an Islamic framework than in conventional banks. Capital adequacy norms in an Islamic framework should therefore more emphasize. It should be noted that in practice, PLS modes are a small fraction of Islamic banks' total asset. Aggregate data indicates that *Mudarabah* and *Musharakah* assets account for about 25 percent of the operation of Islamic bank' in the asset side[5]. The majority of the asset side of Islamic banks are made up of non-PLS modes, notably mark-up transactions. Thus, it may be reasonable to conclude that the assessment of capital adequacy for Islamic banks should be based not only on a thorough evaluation of the degree of risk of each bank portfolio, but also an assessment of the mix of PLS and non-PLS assets.

Asset

- In the Islamic banking system asset represented by *Mudarabah* contracts cannot be classified until the underlying contracts expire. Until that time, there is no recognizable default or mismanagement on the part of agent.

  As noted previously, default of PLS transactions means that the investment project failed to deliver what was expected, that is, a lower profit or a loss. Therefore, it would be appropriate to take a practical control to monitor carefully the PLS assets that are estimated to yield a lower or no profit before the expiration of the contracts.

Management

- Management is evaluated according to technical ability, leadership, administrative capability, ability to plan and respond to changing circumstances and also willingness to serve the legitimate needs of the community. All these factors should be considered in Islamic financial

[5] For more information, see the balance sheets of Iranian banks and also AAOIFI reports.

institutions. Given the complexity of many Islamic banks' operations, monitoring of investment projects, managing the assets at times, legal uncertainties relating to the *Shari'ah* litigation system, control of risks and validation of contracts play a vital role in the effective management of operational risks.

Earnings

- Earnings are associated with the ability of banks to cover losses and provide for adequate capital and also the earning trends. Earnings are considered of high quality if they are sufficient to cover losses and the accumulation of capital for the growth of bank. These two considerations are applicable to Islamic banks as well. In an Islamic bank, losses would first result in a depreciation of the value of deposits and then affect the bank's equity position if it had also used its own resources to finance the loss of a specific project, for example through *Musharakah*. The mentioned risks may lead to liquidity crises and possibly solvency problems.

Liquidity

- Liquidity is measured with the volatility of deposits, availability of assets readily convertible into cash and access to the money market including interbank or other sources of cash like lender of last resort facilities at the central bank. As discussed earlier, Islamic banks compared with the traditional banks have limited opportunities to obtain funds through LOLR facilities.

  However, Islamic banks have obligation to the demand deposit holders, while conventional banks have obligation to all depositors. It may be reasonable to conclude that the adequacy of liquidity in Islamic banks should be developed for a suitable broader systematic liquidity arrangement.

Sensitivity to Market Risk

- Sensitivity to market risk is assessed by the degree of adoption to changes in market prices, like interest rates, exchange rates, commodity prices and equity values. The same concepts are also applicable to Islamic banks to some extents.

  According to the prohibition of interest in the *Shari'ah* interest rate risk affects Islamic banks only indirectly through the mark-up price of deferred sale and leased based transactions.

  Islamic banks are directly exposed to commodity price risk. This is because; Islamic banks carry inventory items, for instance for mark-up or leased transactions. They are also directly exposed to equity price risk than traditional banks as the nature of Islamic banking is equity financing through PLS modes. Islamic banks are also exposed to exchange rate risk in the same way as conventional banks.

However, Islamic banks carry fewer risk-hedging opportunities than traditional banks. This is because, according to the *Shari'ah* risk hedging instruments such as futures, options and swaps contracts are not yet available to Islamic banks at the current situation of Islamic finance.

5. Suitable Clear Information Strategy

A Clear information system in Islamic banks is more important than the conventional banking system. This is because the impact of PLS methods on depositors and the need for such investments is at the core of Islamic banking. The more depositors are needed, the more public disclosure of information about banks' strategy become necessary to enable depositors to monitor banks' performance. Moreover, in the Islamic banking system, depositors have more incentives to monitor banks operations than traditional banks, because in Islamic banks return to depositors depends on the performance of the bank. Monitoring ensure depositors that the rates of return paid to them reflect the application of PLS principle, which are the cornerstone of Islamic finance, by banks and also reduces the possibility of asymmetric information and thus, adverse selection and moral hazard. The advantageous of such a system are:

- This System helps depositors to choose a specific bank in which they can allocate their funds according to its performance.
- A clear information system in Islamic banks assists depositors with regard to diversification of their portfolio.
- Disclosure provides information on the main risk factors associated with the investment portfolio.
- Good governance and internal controls which reduce mismanagement and also brings market confidence for banks.
- Providing data for depositors for the expected rate of return which is an important consideration of the public.
- Providing information on the education and professional background of the banks' staff and management.

6. The General Risk Factors in Islamic Banks

Several general factors currently make the operation of Islamic banks riskier and thus less profitable than traditional banks. They are:

- Underdeveloped or nonexistent money markets. Thus, there is a need to establish a systemic liquidity - domestic and international - Islamic money market for Islamic financial institutions which should be compatible with the *Shari'ah*.
- Limited availability to access to LOLR facilities. This limitation is associated to the prohibition of discount rate. A practical approach to help and solve this issue should be developed for a wider availability of Islamic banks to a reliable money market.
- Legal uncertainties and limited market infrastructure which limit the availability of hedging instruments. The lack of legal framework can raise operational risk and undermine market development. For instance, the question on whether derivatives or future contracts can be utilized to reduce risk of Islamic financial transactions, the answer is still being debated. In this regard, uniformity on religious principles is also an important issue which should be concerned.

7. Concluding Remarks

The basis for the above considerations for more developing of Islamic banking in the future is an Islamic financial regime which could compete with the international financial organizations.

One of the major pillars required to be put in the place in order to strengthen both international and domestic financial system is; to develop a uniform supervisory and regulatory frameworks which are consistent with internationally accepted practices for banks and non-banks financial entities.

Organizations such as Islamic Development Bank can play a major role in the development of Islamic banks and the essential dissemination of information on the above issues to its global membership. The issues include such vital topic as:

- The need for regulation and uniform supervisory of Islamic Banks.
- Issues of risk management and guidelines on risk weight of assets.
- Capital adequacy, liquidity management and issues of controlling of the asset side of Islamic banks.

- Issues in profitability and good governance.
- The necessitate of adoption of new financial methods to Islamic banks.

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