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The Myth about Exchange Traded Derivatives
The Future of Islamic Risk Management

Global Risk Update Editor-in-Chief, Dennis Cox (BSc, FCA, FCSI), is an international expert in risk management and more recently Islamic bank risk management. Recent work includes having restructured the risk management of the largest Islamic bank in the Gulf and advising a central bank on Islamic liquidity risk in southern Asia. In this article he looks at the risks that are facing the industry and the actions that need to be taken to ensure its long terms survival with a focus on the liquidity issues and the impact that a failure of an Islamic bank would have on the industry as a whole and considering Islamic risk management and the differences between what might be called traditional risk management and Islamic risk management.

Risk management is a developing science throughout the financial services sector. The changing regulatory environment and expectations set firms challenges both in terms of the way they manage their business but also in the ways that they are governed. Islamic financial institutions have all of these concerns to deal with combined with additional concerns. While Islamic finance is a growing segment of the financial services arena it needs to deal with the risk management conundrum needing to solve the questions that all firms are facing.

But there is an additional concern. Islamic finance is much like traditional banking some of the time yet entirely different at other times. It is these differences which need to be addressed in addition to the normal concerns to ensure that robust Islamic financial institutions continue to thrive in the future.

The Growth of Islamic Finance and its Impact on Risk Management

Many books have been written on the growth of Islamic finance and the reasons for its emergence. These will not be rehashed here rather we will applaud the success of Islamic finance over the last 20 or so years and consider why risk management has perhaps not reached the level of sophistication that has in theory been achieved by traditional financial institutions.

With any new industry there are always issues that need to be addressed. In the early 1980s derivative instruments were in their infancy. Individual risk managers had to understand the risks inherent in these instruments without the assistance of detailed research and publications. They had to appreciate how such instruments should be priced and valued without agreed valuation methodologies. They had to grapple with counterparty credit risk and collateral implications when these were also developing areas of the industry. They had to review documentation and regulation when neither had fully kept up to date with the industry. Did risk managers make mistakes? Certainly, but they learnt how to deal with the issues developed standardisation and attempted to develop solutions that whilst not solving all of the problems at least assisted with addressing such issues. Roles of bodies such as the International Swap Dealers association (ISDA) provided the clarity and certainty that was required and their leadership certainly led to improved risk management understanding.

Islamic finance has not developed in the same way. From the earliest days it was always recognised that for derivatives to achieve their potential it was necessary for there to be standardisation in terms of documentation and understanding, enabling transactions to take place internationally. As those of you involved with Islamic finance are only too painfully aware such standardisation does not exist within Islamic finance. The structure of the industry varies considerably between jurisdictions. Even the largest markets for Islamic finance are quite different with perhaps Saudi Arabia and Malaysia representing the line opposites. The failure to achieve consistency globally regardless of the worthy efforts of AAOIFI in Bahrain and the IFSB in Malaysia has represented a barrier to the international cross border development of Islamic finance but even a greater challenge for risk management.

Clearly if an industry is developing there would not be a talented pool of risk managers available with expertise in the instruments that are being traded. To solve this conundrum most Islamic institutions have sought to recruit professionals from the traditional banking market. The majority of these people have no real experience of Islamic finance or the basis on which it is formed. Few have sat the Islamic exam qualifications
global market and its impact on risk in islamic finance

islamic finance has generally coped extremely well with the recent financial turbulence. since islamic institutions avoid explicit interest-based products they did not get involved with the instruments that were at the heart of the problem. they also had another trend which caused significant benefits to them – declining global interest rates. in such markets and particularly when deposit interest rates in traditional banking fell to little more than nominal levels the differential of return achieved between traditional and islamic firms was significantly reduced.

at a time when investors were seeking a home for their funds which would be safe and secure, islamic banks appeared to be a refuge from turbulence. the concern does exist that a level of complacency has developed within islamic finance risk management which future events will disturb. a structure and system that operates effectively in one market may need to develop and reinvent it to be fit for purpose in a changed environment.

at the heart of the concern is likely to be how islamic finance and the customers that use this service react to changes in the global financial environment. this suggests that a major change to some of the islamic finance drivers could require changes in the market and its structure. the issue of increased consistency within islamic finance already having been raised, this time the focus needs to be on the tenets that are at the heart of islamic finance and how they will cope with such major change.

the changing economic cycle and islamic finance

the growth of islamic finance has occurred during a period of reducing interest rates with only limited interest rate volatility. the question to answer is how will islamic finance cope with what could be the future business paradigm? the peak of interest rates in the last economic cycle was in the period 1980 to 1982. not only did this period demonstrate the impact of high interest rates but it also resulted in significantly volatile interest rates. rates varied significantly week to week and the weak could not survive.

we are now leaving what has been a declining interest rate scenario which has operated effectively since 1982 that is throughout the entire period during which islamic finance has actually been developed. this produces a combined series of problems. clearly nobody can be sure that a business model that operates effectively during one part of the business cycle will be effective in another part. secondly the risk managers will be faced with a paucity of information to enable them to calibrate and assess the risks within the islamic institution.

they will also be burdened with the consequences of the limited vision of the shariah committees at certain institutions. this could inhibit the ability of some institutions to deal effectively and quickly with the issues that are likely to be faced.

let us first consider the impact of increasing interest rates. most customers of islamic institutions also maintain relationships with non-islamic institutions. of course islamic institutions cannot be seen to be changing the return on deposits in the light of changing interest rates, solutions to such repricing could be devised but these will take time to design and to be accepted. the differential between the return that is received from an islamic institution and from a traditional institution is likely to increase. this raises a series of questions and again there is a shortage of information on which to base judgements.

if you are a customer of an islamic institution what is the differential at which you will start to question the level of reserves you will leave with the islamic firm? this will not be a single move causing a large removal of liquidity from the islamic market rather it is a trend that is likely to accelerate. the question is what level of differential would cause such a movement and what would be the impact on the core/volatile deposit analysis? it is hard to provide guidance but a customer that is willing to accept a 2% differential may have real concerns over a 10% differential.

so there is likely to be some element of deposit erosion for islamic

the future of islamic risk management

promulgated by bodies such as the uk chartered institute of securities and investment cisi. indeed in many cases the risk management function looks identical to the risk management function that would operate in a traditional bank.

risk management and shariah compliance

islamic risk management is different in some specific areas. there is one major additional key risk to which the institution remains shariah compliant. for any islamic institution the risk that a competitor would seek to publicise their concerns over the shariah credentials of an islamic institution could be extremely damaging.

islamic banks have shariah boards to confirm that the business conducted by the firm is shariah compliant and in accordance with their interpretation of the relevant rulings. in doing this they are likely (in most countries) to take account of the materials produced by the ifsib but they are not in any way bound to follow them. under the structure of islamic finance it is generally accepted that the shariah board must maintain their independence and cannot be challenged. they are experts and as such hard to question even if it were acceptable to do so.

they are backed up by a shariah audit team, normally independent of the regular internal audit team and tasked with reviewing shariah compliance. the effect of this is that the risk management function often ignores shariah issues as indeed do the internal audit function. effectively a division exists within the institution which is at best unhelpful and at worst could become catastrophic.

the shariah boards’ objective is to ensure compliance with relevant rulings at all cost. they are not for example charged with ensuring shareholder value is achieved, or that fiduciary responsibilities are understood and monitored. they are also not generally experts in local regulation or indeed the general banking market itself. what effectively this means is that they are able to make their judgements based solely on their views of shariah compliance. as we shall see this could represent one of the greatest challenges the industry has had to face.
The Future of Islamic Risk Management

Institutions which are unable to increase depositor returns in line with market forces. However there is a second concern for the Islamic bank. If interest rates rise the customer who has a fixed interest rate loan will be extremely comfortable – as interest rates rise it is the bank that fails not the customer. Traditional banks will have this problem but the issue faced by the Islamic bank and its risk management team is the limited solutions available. The inability of the Islamic bank to reprice a facility without offending the Shariah committee is likely to cause them to be slower in ensuring that there is an adequate loan/deposit rate margin available to them.

But it could be worse. In the period 1980 – 1982 we had a period of extreme interest rate volatility. Interest rate volatility is perhaps the greatest risk that Islamic institutions face since it is likely to result in requests to the Shariah Board which will show interest rate transparency and therefore cause problems.

So the Islamic institution will be potentially confronted by declining deposits and unprofitable loans since Islamic institutions loans are generally effectively fixed with the confines of the specific instruments.

The Challenge of Declining GDP

The deficit reduction programmes that will of necessity be implemented globally will certainly impact global GDP. How can China continue a growth pattern when there is a paucity of customers available? How can the oil and copper price continue to increase as global demand reduces?

Declining GDP will put pressure on financial institutions as the expected repayments from customers slowly decrease; bad debts increase and corporate deposits are withdrawn. This will be the case for all institutions, not just Islamic firms. However Islamic firms have an additional problem: their inability to charge penalties on a customer without such a penalty being given to charity. This tends to make the Islamic firm slower to react to the changing financial stability of their customer resulting in them being paid out last. The customer which has a series of relationships will pay off first those that chase the hardest or charge the most. The Islamic firm rarely achieves this.

So apart from the declining liquidity position discussed above the Islamic firm could also suffer from increased bad debts.

Taking Action

It is no longer acceptable for the risk management function of an Islamic bank to pretend that it is not in an Islamic bank. The challenge for many of these firms is to develop a risk management capacity which understands all of the new risk management requirements associated with for example model risk and stress testing while at the same time also taking Islamic finance principles into account. This requires both training and the hiring of relevant experience. Most of all it requires leadership from the top and vision.

The risk management functions need to look closely at the nature of the customer base of the firm and then undertake stress tests. These will not be based upon historic information since as we have discussed such data is unlikely to be relevant. They need to understand the implications of plausible scenarios on the business model of the firm and design solutions to meet such requirements. These need to be discussed with the Shariah Board such that the firm has solutions developed and approved for scenarios that could develop in the short to medium term.

The Boards of Islamic institutions need to fully appreciate the impact of changing business environments on their business models. Through careful development of appropriate scenario analysis the risk managers will be in a position to both inform and educate the governance team to enable them to deal with what is likely to be a difficult environment.

The current financial crisis has raised the profile of “too big to fail”. Our concern is that this is likely to be replaced by “too small to succeed” in the short to medium term. Rules developed to support the majority of institutions are unlikely to fit the demands of the Islamic firm so it is incumbent on the risk managers and governance committees to engage early in the process and ensure that their regulatory environment continues to meet their needs.

Most importantly understanding of Islamic risk management needs to increase with teams developed that truly appreciate the consequences of applying risk management principles to a developing industry. If this transition is properly managed that then industry will be successful but the level of divergence between Islamic markets will continue to be a barrier. Increased convergence of ideas and principles and effectively a reduction in the overarching ability of Shariah Boards to overturn globally accepted Islamic principles will form a barrier to the ability of some firms to achieve their objectives. The concern is that failure of a few could cause concerns over the industry in its entirety impacting the industry as whole.

Islamic risk management is advised to ‘wake up’. Islamic finance is different and risk managers will need to look forward at these challenges seeking to inform current governance structures without causing unnecessary concern. The industry is currently robust and well managed and the objective is to keep it so in order to achieve its potential.

Send your comments and feedback dwc@riskrewardlimited.com