

Risk Management in Islamic Finance Revisited

Rodney Wilson

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- Reputational or *Shari'ah* risk
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Risk mitigation

Late settlement of obligations due to genuine financial difficulties

Quranic teaching

- “If the debtor is in difficulty, grant him time till it is easy for him to repay. If ye remit by way of charity, that is best for you if ye only knew”
- *Sura 2:280*

Practical measures

- Rescheduling but keeping same financing method and terms with no penalty to borrower
- Swap existing obligations for a *qard hasan* loan without interest
- Remission which may bring goodwill from other clients

Repayments risks

Moral hazard problems

- High degree of trust in Islamic finance, but this can be abused
- Peer pressure can make borrowers acknowledge their responsibilities

Asymmetric information

- May make concealment of financial position easy
- Deterrent to *mudarabah* and *musharakah* financing

Unscrupulous defaulters

“Cannot pay” compared with “will not pay”

- If no penalty for deliberate late payments then danger that Islamic finance abused

Possible non-financial penalties

- Blacklisting of defaulter
- Seeking redress through the courts involving imprisonment or confiscation of passport

Financial penalty

- Fine for late payments
- Proceeds given to charity, as no gain permissible for financier

Payments safeguards

Sequestration of assets

- *Murabahah* and *ijara* involve financing real assets
- Can be seized if default, but asset may not be worth much to financier, as resale value limited

Personal financing

- Car and home purchase finance based on salary being directly paid into the bank making the advance
- Bank can impose limits on personal access to salary until bank claims met

Collateral

Qualifying assets

- Real goods and commodities
- Suited for *murabahah* and *ijara* financing

Not permissible

- Accounts receivable
- Financial assets such as bonds or other securities

Hierarchy of capital suppliers

- Unsecured debt junior to secured debt
- Notion of hierarchy of entitlement in event of default repugnant to most *shari'ah* scholars
- Investment partners all share losses as in *mudarabah* and *musharakah*

Liquidity risk

Shariah compliant treasury management

- *Murabahah* inter-bank deposits
- How liquid are *sukuk*? Activity in secondary market

Reducing asset and liability mismatch

- Promotion of *mudarabah* notice deposits to reduce on-demand liability
- Limiting liabilities by moving specified investment accounts off-balance sheet

Assurance for demand depositors

- Investment *mudarabah* deposits lower in pecking order and not guaranteed

Controlling operational risk

Adequacy of reporting systems

- Concept of *amanah* or trust extends to disclosure to stakeholders
- Concept of justice - *adalah*
- Responsibility through trusteeship - *khilafah*

Employee loyalty and motivation

- Religious factor in employment choice
- Common cultural ethos by workforce
- Principle of unity - *tawhid*

Emphasis in Islam on formal contracts

- “Believers, when you contract a debt for a fixed period, put it in writing” *Sura 2:282*

Foreign exchange risks

Permissible hedging instruments

- *Salam*, a purchase contract with the price, time of purchase and quantity involved specified
- *Bai al-Salam* is an immediate payment for future delivery
- Parallel with forward transaction, as aim is to execute transaction
- Swaps also possible, but not of like for like – gold for gold, silver for silver

Problematic hedging instruments

- Options and futures where aim is speculation, not to carry out transaction
- Debate over whether *arbun* (*arboun*) can be used, a down payment to secure a call option, with the buyer losing their deposit if the contract not carried out. Can it be applied to put options- the right to sell?

Rate of return risk

Implications of prohibition of *riba*

- Islamic banks potentially price makers, not price takers
- Returns on *mudarabah* investment accounts may not vary with market interest
- *Murabaha* mark-up and *ijara* rental costs not necessarily related to interest changes

Indirect interest rate effects

- Asset liability management (ALM) still required as interest rate developments can effect spreads
- GAP analysis may continue to be needed, the assessment of the difference between interest sensitive liabilities and assets for a given time period
- Fixed variable return swaps involving *murabahah/ijara* possible rather than interest rate swaps

Islamic bank specific risks

- Reputational or *Shari'ah* risk
- Ownership risks
- Profit sharing risks
- Risk mitigation

Shari'ah risk

- Issuance of new *fatwa*
 - Former *Shari'ah* compliant contract no longer valid
 - Example of *musharakah sukuk* with capital guarantee
- Conflicting *fatwa*
 - Example of *tawarruq*
- Reputational issues
 - *Shari'ah* scholars become discredited
 - Approved contracts subject to litigation as with Investment Dar
 - Lack of legal indemnity by scholars

Ownership risks

- *Murabahah*
 - Bank has first purchaser obligations on resale
 - If default bank can retain ownership of commodity being financed, but may have difficulty finding a buyer and exposure to capital loss
- *Ijara*
 - Bank has lessor responsibilities as lease an operating contract
 - If property or equipment defective bank is obliged to remedy the matter
 - Where unexpected breakdowns or damage to property arises which is not due to lessee negligence the bank will have unlimited liability
 - The bank will be responsible for the insurance of the leased asset
- *Musharakah*
 - The bank is a co-owner obliged to share ownership responsibilities and potential losses
- *Mudarabah*
 - The bank as *raab al maal* bears all the losses

Profit sharing risks

- Unpredictability of profit rates
 - Profit projections for *mudarabah* and *musharakah* may not be realised
 - Profit share known, but not funds to be distributed
 - Bank not equipped to be involved in day to day running of the business
 - Financiers lack control as they do not manage the business
- Disclosure
 - Bank dependent on quarterly statements and annual financial reports but these represent historical data
 - Financiers may not have access to management accounting information
- Monitoring
 - Close surveillance is time consuming and expensive
 - Pre-emptive action better than reactive intervention but often unclear when action is justified
 - Too much monitoring can adversely affect entrepreneurs and be counter productive

Risk mitigation

- Due diligence on client
 - Client's employment status, whether employed or self employed
 - Length of time in present occupation and job security
 - Income level and variability with bonuses etc.
 - Other debt obligations of the client and their servicing costs
- Appraisal of project proposed
 - Consumption finance as with a vehicle
 - Investment finance as with real estate for owner occupation or rent
- Specification of repayments
 - By direct debit from a current account or by standing order
 - Monthly or quarterly repayments versus a lump sum on termination
- Valuation of any collateral pledged
 - Independent valuation
 - Possible re-valuation if financing long term

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