CHAPTER 15

Islamic risk management

15.1 Introduction

Risk management is a developing science throughout the financial services sector. The changing regulatory environment and expectations-set challenges firms both in terms of the way they manage their business and also in the ways that they are governed. Islamic financial institutions have these prevailing concerns to contend with combined with more specific encumbrances. While Islamic finance is a growing segment of the financial services arena, it needs to deal with the risk management conundrum with solicitude and ardour.

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 traditional concerns facing all banks, in order to ensure that Islamic financial institutions continue to thrive in the future.

15.2 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 rehearsed 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 standardised procedures and documents; 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 understanding in risk management.

Islamic finance has not developed in the same way. From the beginning, 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 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 operate quite differently with perhaps Saudi Arabia and Malaysia representing the extremes. The failure to achieve global consistency, regardless of the worthy efforts of AAOFI in Bahrain and the IFSB in Malaysia, has represented not only a barrier to the international cross border development of Islamic finance but effectuated an even 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 IFIs 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 taken the Islamic qualifications promulgated by bodies such as the UK based Chartered Institute for 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.

15.3 Risk management and Shari'a compliance

Islamic risk management is different to conventional risk management in some specific areas. Clearly there is one major additional risk – the institution must remain Shari'a compliant. For any Islamic financial institution (IFI), the risk that a competitor would seek to publicise their concerns over the Shari'a credentials of an IFI would be extremely damaging.

Islamic banks have Shari'a boards to confirm that the business conducted by the firm is Shari'a compliant and in accordance with the board's interpretation of the relevant rulings in Islamic law. In most countries, they are likely to take account of the materials produced by the IFSB but they are not in any way bound to follow them. Under the structure of Islamic finance, it is generally accepted that the Shari'a 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 Shari'a audit team, normally independent of the regular internal audit team and tasked with reviewing Shari'a compliance. The effect of this is that the risk management function often ignores Shari'a 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 Shari'a boards' objective is to ensure compliance with relevant rulings at all cost. They are not charged with ensuring shareholder value is achieved, or that fiduciary responsibilities are understood and monitored. Also, they are generally not 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 Shari'a compliance. As we shall see this could represent one of the greatest challenges the industry will have to face.

15.4 The changing global market and its impact on risk in Islamic finance

Islamic finance has generally coped extremely well with the recent financial turbulence. Since IFIs avoid explicit interest based products, they did not get involved with the complex instruments that were at the heart of the problem. They also benefited from the global reduction of 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 the conventional financial institution and the IFI 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 itself to be fit for purpose in a changed environment.

A central concern is how Islamic finance and the customers that use this service react to changes in the global financial environment. A major impact to some of the Islamic finance drivers could require changes in the market and its structure. The focus, thus, needs to be on the tenets that are at the heart of Islamic finance and how they will cope with such major change.

15.5 The changing economic cycle and Islamic finance

The growth of Islamic finance occurred during a period of declining interest rates and limited interest rate volatility. However, following the global financial crisis, the markets are staggering into a period of uncertainty and apprehension, and the real possibility of changes in business paradigms. Henceforth, the pertinent question which arises: how will Islamic finance cope within this new environment? When interest rates peaked in the period 1980 to 1982, it resulted in significantly volatile interest rates. Rates varied significantly week to week, and the weak could not survive.

Today, we are now leaving what has been a period of declining interest rates which has operated effectively since 1982 – that is throughout the gestation period of Islamic finance. Arguably, Islamic finance is entering unchartered territory, thereby producing a series of problems. Clearly nobody can be sure whether a business model that operates effectively during one part of the business cycle will be effective in another part. Furthermore, risk managers will be faced with a paucity of information on which they will be able to calibrate and assess the risks within the IFI. They will also be burdened with the consequences of the limited vision of the Shari'a boards 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 IFIs also maintain relationships with non-IFIs. Of course, IFIs cannot be seen to be changing the return on deposits in the light of changing interest rates. Solutions to such re-pricing could be devised but these will take time to design and to be accepted. The differential between the return that is received from an IFI and from a conventional 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 IFI, what is the differential at which you will start to question the level of reserves you will leave with the IFI? It 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 IFIs, which fail to increase depositor returns in line with market forces. However, there is a second concern for the Islamic bank. If interest rates increase, 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. Conventional 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 Shari'a board 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. As mentioned above, in the period 1980 – 1982, there was a period of extreme interest rate volatility. Interest rate volatility is perhaps the greatest risk that IFIs face since it is likely to result in requests to the Shari'a board which will show interest rate transparency and therefore cause authenticity problems. So the IFI will potentially be confronted by declining deposits and unprofitable debt instruments.

15.6 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 IFIs. However IFIs have an additional problem – their inability to charge customer penalties for failure to pay on time without such a penalty being given to charity. This tends to make the IFI slower to react to the changing financial stability of their customer resulting in them being paid out last. The customer who has a series of relationships with various financial institutions will pay off those that chase the hardest or charge the most. The IFI will rarely feature high on the list to payback.

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

15.7 Actions to be taken

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 talent. Most of all, it requires leadership from the top and a perspicacity.

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 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 Shari'a board such that the firm has solutions developed and approved for scenarios that could develop in the short to medium term.

The boards of IFIs 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". The 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 IFI 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, the understanding of Islamic risk management needs to increase with teams that truly appreciate the consequences of applying risk management principles to a developing industry. If this transition is properly managed, then the industry will be successful but the level of divergence in opinion between Islamic markets will continue to be a barrier. Increased convergence of ideas and principles and effectively a reduction in the overarching ability of Shari'a 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 finance is different and the industry needs to look at these challenges seeking to inform and recalibrate its governance structures without causing undue concern. The industry is currently robust and well managed – the objective is to keep it so in order that it can achieve its potential.