

RISK MANAGEMENT IN AN ISLAMIC FINANCIAL INSTITUTION

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ISLAMIC VIEW OF RISKS

- From the Quranic verse 275 of Chapter 2, where Allah prohibits usury (al-riba) and permits exchange (al-bai'), it clearly implies that increase in wealth cannot but must be a consequence of risk taking (Abbas Mirakhor, "Wither Islamic Finance", unpublished)
- To mitigate risks, the above verse demands the sharing of risks and not transfer of risks

RISKS IN PRACTICE

- Since all transactions are contractual, they must meet certain conditions to make them valid. Two elements that would nullify any contract are al-riba and gharar (ambiguity)
- Every transaction to be Shariah-compliant must avoid these two elements
- In practice, Islamic Financial Institutions are not completely ready to fully share risks because of moral hazards
- We shall now investigate the risks involved in practice today

COST PLUS TRANSACTIONS (Murabahah)

- Murabahah is a trading transaction which can take different forms:
 - A supplier who sells his product at a mark up
 - In banking, the bank buys a product from a supplier and sells to a customer at its cost plus a mark up. The product can be buildings, land, cars, machinery, etc. Normally, the customer pays by installment
 - Commodity Murabahah involves buying a commodity or a basket of commodities, such as metals traded in London Metal Exchange which are held by another bank for a predetermined amount at a predetermined price

COST PLUS TRANSACTIONS (Murabahah)

- Nature of Risks under murabahah
 - Credit risks: customer may not honour his promise; customer has purchased the asset and wants the bank to finance it; damage to product before the customer takes possession
 - Mark-up risks: is based on accepted benchmarks such as LIBOR, but once determined, cannot be changed; changes in price, other costs, which may have adverse effects on the bank
 - Liquidity risks: customer defaults payment; cancellation of promise
 - Operational risks: assets have been owned, or consumed before financing take place
 - Commodity risks: banks may have to hold on to the product if the customer changes his mind and will find difficulty disposing it.

COST PLUS TRANSACTIONS (Murabahah)

- Managing murabahah risks
 - In addition to receiving a promise to purchase, the bank is allowed to take a deposit to cover losses in case the customer does not keep his promise
 - Proper due diligence on the ownership of the asset to be financed
 - Physical inspection of the asset to ensure quality, damage, defect, etc
 - To reduce defaults, banks impose a small penalty but the money is given to charity
 - To reduce liquidity risks, bank enters into murabahah with supplier and only pays when customer has agreed to purchase the product

PROFIT SHARING TRANSACTIONS (Mudharabah, Musharakah)

- Mudharabah contracts involve financier as provider of capital and entrepreneur as provider of entrepreneurship. Profits will be shared at a predetermined ratio and losses are borne completely by financier. It is normally used for longer term project financing
- Musharakah contracts involve two or more partners who put up capital to finance a project and share profits according to share capital or as pre-agreed. This is also used for long term project financing

PROFIT SHARING TRANSACTIONS (Mudharabah, Musharakah)

- Diminishing Musharakah is when the share of the financier diminishes as the project owner pays up the cost.
- Types of risks:
 - Equity investment risks: when the project is not making profits
 - Credit risks: when profit payments are delayed or not paid at all. Credit risks are very high because the project is long term and secondly there is no collateral

PROFIT SHARING TRANSACTIONS (Mudharabah, Musharakah)

- Operational risks: due to complexity of contracts and difficulties in implementation
- Mark-up risks: due to fluctuations in the market rate of return
- liquidity risks: depending on the size and nature of the funding. If funding comes from investment deposits and the depositors cannot take out money until maturity, then liquidity risk is reduced.

PROFIT SHARING TRANSACTIONS (Mudharabah, Musharakah)

- Managing these risks
 - First is to set up a strong analysis frameworks and strictly control and monitor processes. Proper evaluation of project must be done. Ongoing monitoring must be done to reduce misrepresentation of profits, etc.
 - Major losses due to operational risks can be covered by takaful (Islamic insurance)
 - At a more general level, diversification is essential, across countries, regions, industries, etc.

FORWARD CONTRACTS

(Salam)

- Salam is a forward contract on commodities with immediate payment of the full price. Quality, date and place of delivery must be predetermined and agreed by both parties
- Types of risks
 - Mark-up risk: the price at point of delivery may differ with that at time of purchase.
 - Commodity risk: may not be able to sell the purchased commodity to another party in the market. There are possibilities of quality risks, failure to deliver due to weather risks, crop failure,

FORWARD CONTRACTS (Salam)

- Types of risks (cont'd)
 - Credit risks: late or no delivery due to crop failure or weather risks, disputes over quality, etc. If the Islamic bank acts as a purchaser, it may have to incur storage costs, defective or damage or pilferage costs, etc
 - Liquidity risks: Salam contracts are not liquid because the Shariah disallows selling something that one does not yet possess; after taking possession, the bank may not be able to sell immediately giving rise to storage and insurance costs, etc. which will affect liquidity

FORWARD CONTRACTS (Salam)

- Types of risks (cont'd)
 - Operational risks: Looking at the nature of salam contracts, the purchaser faces with credit risks from the beginning. If delivery is on time, there might be quality disputes, mark-up risks and commodity price risks. If delivery is delayed, there is liquidity risk, commodity price risks, storage and insurance costs, etc

FORWARD CONTRACTS (Salam)

- Managing Salam risks:
 - Commodity price risks and liquidity risks may be hedged by a parallel salam contract. However, this may lead to fiduciary risk when the first salam contract is not fulfilled
 - Commodity price risk may be mitigated by choosing commodities that have steady and clear demand in the market
 - To limit credit risks, one may require collateral, specify in detail the quality and quantity of goods and force supplier to pay a penalty which will be given to charity

FORWARD CONTRACT (Istisna'a)

- Istisna'a like salam is a forward contract but on manufactured products. Quality, price, time and place of delivery must be predetermined. However, buyer may not have to pay for the full price
- Types of risks:
 - mark-up risks: due to long term nature of the contract and secondly the mark-up is normally fixed whilst the market rate fluctuates

FORWARD CONTRACT (Istisna'a)

- Types of risks (cont'd)
 - Operational risks: due to complexity of contracts, damage to manufactured products and other risks related to assets or to material employed
 - Credit risks: the bank may not receive the selling price for the underlying asset either in the construction stage or upon completion of the project. Similarly, there may be late delivery of completed products. In the case of contract failure, the bank has no claim on the materials that belong to the manufacturer. Unlike Salam, Istisna'a contracts are not binding as long as the work has not started

FORWARD CONTRACT (Istisna'a)

- Types of risks (cont'd)
 - Liquidity risks: exist because the contract cannot be traded. Nevertheless, both liquidity risks and credit risks in Istisna'a contracts are lower than in Salam contracts because payment is not in full and can be made by installments
 - Commodity risks: commodity price risks arise because of possible fluctuations in price

FORWARD CONTRACT (Istisna'a)

- Managing Istisna'a risks
 - Islamic Banks may require collateral to mitigate risks of non-performance
 - Islamic banks may enter into parallel Istisna'a contracts to hedge
 - Islamic banks may require quality guarantee from the supplier
 - While selling products under Istisna'a contract is not allowed, the banks may obtain promise to buy and request for deposits

FORWARD CONTRACT (Istisna'a)

- Managing Istisna'a risks (cont'd)
 - It is interesting to note that Istisna'a financing allows penalty to be collected for non-performance without having to give it to charity.
 - In the case of delays in delivery, a penalty can be imposed on the supplier through a reduction in the price to be paid by the purchaser. This exceptional rule is allowed by the Shariah scholars on the basis of "Shart-e-Jazai" allowing a clause to be inserted in the contract to that effect. This is to act as a fine to the manufacturer when he may not have devoted enough time to complete the product causing problems to the purchaser

LEASING CONTRACT (Ijarah)

- Ijarah contract is directly comparable to a leasing contract with some important differences:
 - First, it does not automatically lead to a final transfer of the underlying asset. This must be accomplished by using a separate sale contract or the lessor giving the object as a gift to the lessee at the end of the leasing period
 - Second, the lessor bears all risks during the leasing period as long as there is no negligence by the lessee. Maintenance and insurance costs are borne by lessor.

LEASING CONTRACT (Ijarah)

- Types of Risks:
 - Liquidity risks: Ijarah contracts often requires the bank to purchase the object and pay upfront before it can lease it to the lessee. The extent of liquidity risks depends on the tradability of the asset. Liquidity risks are also influenced by other risks (such as credit risks) but may be reduced in the ijarah-wal-iqtina contract when the sale price is built into the installment payments.

LEASING CONTRACT (Ijarah)

- Types of risks (cont'd)
 - Mark-up risks: it depends on how the rental payments are calculated. These may be linked to Libor which may reduce the impact of market return changes on the value of the instrument
 - Operational risks: related to the asset that may be damaged or destroyed. The loss will be treated depending on whether there is negligence on the part of the customer or some natural disaster.

LEASING CONTRACT (Ijarah)

- Types of risks (cont'd)
 - Credit risks: exist on the assumption that the customer may delay or not pay the rental
 - Commodity risks: since in Ijarah contract, the lessee is not obliged to purchase or take possession of the asset at the end of the leasing period, and hence the bank may have difficulty disposing the asset.

LEASING CONTRACT (Ijarah)

- Managing Ijarah risks:
 - Require guarantees or collateral from the customer to mitigate credit and liquidity risks
 - If a customer promises to lease the asset but breaks the promise, the lessor can use the deposit to recover some losses
 - For late payments, penalty can be charged but must be given to charity
 - Operational risks can be outsourced to takaful coverage

LEASING CONTRACT (Ijarah)

- Managing Ijarah risks (cont'd)
 - A separate promise to purchase the asset by the lessee at the end of leasing period can be made to mitigate the commodity risk.
 - Through a variable rental rate that is linked to benchmark rates of return (such as Libor) both mark-up risk and inflation risks may be reduced.

CONCLUSION

- This is not all, because there are financial services such as Islamic Fund Management, Islamic Structured Products, Sukuk, etc. that have their own peculiarities and hence the risk management may be slightly different.
- The object of this exercise is to provide an overview of some peculiarities in risk management of the Islamic transactions.

THANK YOU