

CIFE21, 22: RISK MANAGEMENT IN ISLAMIC FINANCE

Some have said "Banking is risk management." If you don't know anything about risk management this is the module for you. You learn the basics about risk management in Islamic finance and discuss the most common risks facing Islamic banks and the



mitigation techniques used to address them. Now you learn about how risk relates to each specific Islamic finance product. We go through each major Islamic banking product, namely Murabaha, Salam, Istisna, Ijarah, Musharakah and Mudarabah, and explain the specific risks associated with each.

Risk is defined as exposure to the likelihood of loss, where this loss takes on many forms depending on the kind of risk involved. It is the possibility that the outcome of an action or event could bring an adverse impact to the bank. Some of the many threats to a financial institution are low profitability, bankruptcy, fraud, false financial reporting and mismanagement.

For a transaction to be Shariah-compliant, the main principle with regard to risk is that in order to benefit, liability must be assumed.

Risk management is the process of evaluating and responding to the exposure facing an organization or an individual. It is a structured and disciplined approach employing people, processes and technology for managing the many uncertainties faced by an organization.

Forms of Risk

- **Credit risk:** Refers to the possibility of a counter party failing to meet its financial obligations according to agreed terms. It represents 80% of the risk linked to a bank's asset portfolio.
- **Equity investment risk:** Arises from entering into a partnership to finance a specific business activity. Mudarabah, Musharakah and most Sukuk are susceptible to equity investment risk.
- **Market risk:** Represents the market's volatility and its effects on an investment's value

- **Liquidity risk:** Refers to the potential risk of loss to financial institutions arising from the inability to meet financial obligations.
- **Rate of return risk:** Financial institutions are exposed to rate return risk in the context of their overall balance sheet exposures. Increased benchmark rates may result in investment account holders having increased expectations of higher rates of return.
- **Operational risk:** Refers to the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems.
- **Legal or Shariah non-compliance risk:** Relates to operational risk given the Shariah sensitivity to mistakes in operations

Risk Mitigating Tools

Personal guarantees

Guarantees of different types, such as a guarantee for timely payment, a guarantee for supplying goods at a specific time etc.

Pledges

A form of security, an asset or cash, taken from the client and maintained by the financial institution.

Earnest Money

Security the client deposits with the bank as security to serve as compensation in case he backs out from entering into a contract.

Promises

The client undertakes to purchase goods from the financial institution in order execute a contract.

Agency Agreements

In order to ensure goods are procured according to specifications the financial institution may appoint the client or a third party as agent for the job.

- Specific agency agreement
- Global agency agreement

Advance Payment

An amount paid at the time of contract execution and considered a part of the asset's price if client makes all payments within the agreed time period.

Options

Several options can be granted or possessed in order to mitigate risk in contracts.

For instance:

- Khayar al Shart – Optional Condition
- Khayar al Rooyat – Option of Inspection
- Khayar al Aib – Option of Defect
- Khayar al Wasf – Option of Quality
- Khayar al Ghaban – Option of Price

Takaful

An Islamic alternative to conventional insurance. Based on the concept of mutual indemnity in case of loss.

Shart al Jazai

A penalty that allows for a reduction in price of manufactured goods in case of a delay in their delivery. Such a penalty is permitted in manufacturing contracts.

Charity Clause

The charity clause serves as a deterrent to default, based on it the client undertakes to give a certain amount to charity in case of default in payment.

Risks in Murabaha

- Credit risk
 - Client backs out from purchasing the goods
- Market risk
 - Exposure to the fluctuating market price of goods
- Supplier risk
 - Supplier is unknown to the bank which may cause a delay in delivery time of goods and non-conformity to specifications
- Operational/Ownership Risk

- Client as agent gains possession of goods from the supplier without informing the bank
- Transit period Risk
 - The risk associated with goods after the bank purchases them from the supplier and before the client purchases them from the bank
- Documentation Risk
 - The risk that the counter party does not provide sufficient documentation.

Risks in Salam

- Holding risk
 - The risk of holding goods until the time of delivery
- Shariah non-compliance Risk
 - Arises if goods are sold before receiving their physical or constructive possession
- Settlement and Delivery Risk
 - Arises in the event goods are not delivered on time and do not conform to specifications
- Risk of Early Termination
 - Arises in the event the client terminates the contract before delivering the goods
- Rate of Return and Price Risk
 - The risk that a decrease in the commodity's price after contract maturity will result in a lower rate of return

Risks in Istisna

- Risk of hidden defects
 - Risk of defects inherent in the manufactured products
- Shariah non-compliance Risk
 - Arises as a result of not specifying the characteristics of goods, the time or place of delivery or lack of information about the supplier
- Settlement and Credit Risk

- Arises when the customer is unable to honour deferred payments
- Price Risk
 - Bank's exposure to the risk of selling goods to a third party for a lesser price as a result of contract cancellation
- Delivery Risk
 - The risk of not being able to make a scheduled delivery of manufactured goods for a Parallel Istisna
- Legal Risk
 - Litigation costs for claims against Istisna requestor that terminates the contract

Risks in Ijarah

- Risk associated with security that sells for a lower price in the market as a result of which the bank cannot cover its loss
- Asset Risk
 - Asset is stolen, damaged
- Price Risk
 - Bank's exposure to changes in costs during the Ijarah's term. The longer the term the greater the bank's exposure to price fluctuations
- Risk that the customer will back out from his promise to lease, the bank may have to sell the asset at a price lower than its market price
- Legal Risk
 - Litigation costs against the client who refuses to compensate the bank for losses resulting from unfulfilled promises

Risks in Musharakah and Mudarabah

- Shariah Non-Compliance Risk
 - Debt cannot be used as a substitute for equity
 - One partner cannot guarantee the other partner's principal or profit
 - Risk of the funds being from a prohibited source

- **Credit Risk**

- Managing partner manipulates reports to show lower returns
- Silent partner opts out of partnership while still owing money
- Working partner takes a percentage of the vendor's payment in return for awarding the vendor a mandate.
- Prohibition of any collateral to secure the bank's investment poses additional risk.

RECOMMENDED READING