DOI: 10.21637/GT.2017.3-4.10

Risk Analysis for Islamic Banks

[Hennie van Greuning - Zamir Iqbal: Risk Analysis for Islamic Banks. Washington World Bank, 2008. 978-0-8213-7141-1]

***Rafiei Arman*[1]**

The authors of the book "Risk Analysis for Islamic Banks" are Hennie van Greuning and Zamir Iqbal. Hennie von Greuning is working at the World Bank since 1994; he is a senior advisor in the Treasury department. Zamir Iqbal is a principal financial officer with the Quantitative Strategies, Risk and Analytics (QRA) Department of the World Bank Treasury.

In the last few decades Islamic finance has gained a rapidly growing share in the financial sector in the world. Nowadays there are 250 financial institutions in over 45 countries that practice some form of Islamic finance.

This book explains the principles and functions of an economic, banking, and financial system operating under Sharia. It begins with two forewords. The first is written by Kenneth G. Lay, who is the vice president and treasurer of the World Bank, and the second is from the governor of the State Bank of Pakistan (in office 2006-2009), Dr Shamshad Akhtar, the first woman in this position. She was the former Director-General of the Asian Development Bank as well.

The book consists of four main sections. The first main section deals with the principles and stakeholders. The authors describe the rapidly growing Islamic finance sector and emphasize the importance of Islamic principle in daily finance. The main principles of the Islamic Financial system are the prohibition of interest and speculative behavior, risk sharing between the bank and the customer, social justice and sharia-approved activities.

The history of Islamic banking begins in the 1970s. The first Islamic bank was established in1974 in the United Arab Emirates, followed by the establishment of the Islamic Development Bank in 1975 as a regional development bank. The accumulation of oil revenues and petrodollars increased the demand

[1] Rafiei Arman, PhD Student, University of Sopron, Alexandre Lamfalussy Faculty of Economics, Sopron

for Shariah-compliant products. The 1980s proved to be the beginning of a period of rapid growth and expansion of the Islamic financial services industry. In 2007 the annual turnover of all Islamic banks was estimated to be $350 billion, compared to $5 billion in 1985. The Islamic Republic of Iran, Pakistan, and Sudan have converted their Western type banking systems to an interest-free one. Since 1998 the number of conventional banks offering Islamic windows have been growing, as for example the Hong Kong and Shanghai Banking Corporation (HSBC). In the 1990s the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in Algeria. The purpose of the organization is standardization and harmonization of international Islamic finance practices and financial reporting in accordance with Sharia.

The Islamic balance sheet differs from the conventional balance sheet, though both have two sides: assets and liabilities.

The assets are: cash balances; financing assets – murabahah (interest-free commercial credit, cost-plus sale), salaam (agriculture based sales contract), ijarah (leasing), istisnah (contract manufacturing); investment assets – mudarabah and, musharakah (partnership between bank and entrepreneur, profit and loss shareing); fee-based assets – joalah (agreement with an expert in a given field to undertake a task for pre-determined fee or commission), kifalah (stewardship Guarantee or Surety); non-banking assets – property.

The liabilities are: demand deposits – amanah (safe keeping); investments accounts – mudaraba; special investment accounts – murabaha, musharaka; reserves; equity capital.

The second main part of the book is about risk management. The authors summarize the types of banking risk exposure, namely financial-, operational-, business and event risks. The development of a risk-based analysis of the bank is necessary to meet the challenges of innovation and new developments and, partly, accommodate the convergence of international supervisory standards and practices.

The cornerstone of financial risk analysis is the bank's balance sheet. The issue of usefulness and transparency is critical, as is accountability (these are the basic principles of international accounting standards).

Similarly to conventional banks, Islamic banks are exposed to some form of asset-liability mismatch risk. Islamic banks prefer leasing, instead of trade-based instruments, as leasing is considered to be less risky and have less uncertain returns than partnership-based instruments. Mudaraba is the first choice of Islamic banks representing 41 per cent of all deals, followed by musharaka (11 percent), mudaraba (12 percent), ijara (10 percent) and others (26 percent). Beyond these, Islamic banks offer only a small number of long-term investment opportunities.

Liquidity risk emerges when the bank's ability to match the maturity of assets and liabilities is impaired. There are two types of liquidity risk in the Islamic Banking System: lack of liquidity in the market and lack of access to funding. There are some examples for reducing the liquidity risk: the Central Bank of Sudan has introduced the Shariah compatible securities; Malaysia also has taken steps to promote Islamic banks and reduce liquidity risk. The central bank, Bank Negara Malaysia, introduced the Islamic Interbank Money Market (IIMM) in early 1994.

The next chapter discusses the operational and Islamic banking risks. Islamic banks are more exposed to operational risks associated with the failure of controls, information technology systems and the specific risks of Islamic banking, such as displaced commercial risk, withdrawal risk, governance, fiduciary risk (fiduciary risk is the risk that arises from an institution's failure to perform in accordance with explicit and implicit standards applicable to its fiduciary responsibilities), transparency, Sharia risk and reputational risks.

The third main part is devoted to the problems of governance and regulation. According to the authors a stakeholder view of governance that is based on the principles of property rights and the sanctity of contracts, is fully supported by the Islamic economic system. Islamic corporate governance must promote transparency to provide healthy environment for stakeholders because transparency is necessary for accountability, especially to borrowers and lenders, issuers and investors, national authorities and international institutions. The authors discuss both capital adequacy requirement and the consequences of Basel II in case of the Islamic banking. As in conventional banking, adequate availability of capital is necessary for the safety and soundness of Islamic banks as well. The authors examine the Capital Adequacy Standards for Credit Risk, for Market Risk and for Operational Risk, in Basel II and in Islamic Financial Services Board. Islamic banks have established capital requirement standards considering the conventional Basel approaches. The Islamic Financial Services Board has created a capital adequacy standard in 2006. Islamic banks differ from conventional banks; an important difference is the one between their risk weights. For example, Islamic banks carry partnership and profit- and loss sharing assets that have a higher risk profile.

The final chapter of the third part deals with the relationship between risk analysis and bank supervision. The authors conclude that there is no difference in the risk analysis and the bank supervision between conventional and Islamic banks. All banking systems have a regulatory and supervisory authority. The bank supervision is usually responsible for the issuance and withdrawal of banking licenses an; issuance and enforcement of prudential regulations and standards.

The final chapter introduces the future challenges. Islamic banks have to develop their instruments that enhance liquidity, money and interbank markets, and to perform asset-liability and risk management. Islamic banks are operating with a limited set of short-term traditional instruments, and there is a shortage of products for medium- to long-term maturities. Therefore Islamic banks are less liquid than conventional banks. The limited scope is also a problem in the case of Islamic banks, because they do not provide mixed financial services with non-banking services, although in conventional banking this is the global trend. We can find some countries in the Middle East, where the institutional environment is weak and the non-bank financial sector is poorly developed. Furthermore, Islamic banks have to improve the risk management and governance framework as well. Operational risk is as important as financial risk; however most Islamic banks do not pay enough attention to it.

The authors introduce the Islamic banks and their risk analysis understandingly. Due to its clear language, and simple expression it is good for practitioners. The book contains some comparisons between conventional and Islamic banks, these comparisons could be more, because this topic very interesting.