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Capital Adequacy and Risk Management Requirements in Islamic Financial Institutions

INTRODUCTION

The robust growth of the Islamic financial industry in past years has led to much debate over regulatory issues. Corporate scandal has highlighted the importance of sound corporate governance and risk management procedures, and the Islamic finance world is not beyond scrutiny. To ensure effective risk management, conventional banks strive to abide by the Basel frameworks, in existence since the late 1980s. However these frameworks are inadequate to guide the management of risks in Islamic financial institutions, whose workings and risk profiles differ from conventional financial institutions.

The establishment of the Islamic Financial Services Board ("IFSB") has aided in filling the vacuum of regulatory guidance that hinders the effective functioning of Islamic financial institutions. The plugging of regulatory gaps has begun with IFSB's recent draft publication of a set of standards for capital adequacy[1] and guidelines for risk management[2] - tailored specifically to the unique products offered by Islamic financial institutions.

These new standards, based on the original Basel frameworks set by the Bank of International Settlements, illustrate that the broad principles of risk management can be maintained across both Islamic and conventional banking sectors.

THE DIFFERENCE IN RISKS

Islamic financial institutions are predicated on different foundations from conventional financial institutions. The rationale of the former is conformance to principles of Shari`ah law, the juristic code of Islam of the Qu'ran and the Hadith, as opposed to the profit-maximising objectives of the latter; these dissimilar roots give rise to contrasting risk profiles.

Islamic financial institutions abide by the following principles: the promotion of fairness in transactions and the prevention of exploitative relationships, the sharing of risk and reward between principals in a transaction, transactions should carry elements of materiality leading to a tangible economic purpose (the prohibition of interest), the sanctity of contracts should be upheld and the prohibition of financing of activities that are *haram*[3].

IN THIS ISSUE

[1] Islamic Financial Services Board, 'Exposure Draft No. 2:Capital Adequacy Standard for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services', 15 March 2005

[2] Islamic Financial Services Board, 'Exposure Draft No. 1: Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services', 15 March 2005

[3] Lee, Dr. John and Soong, Justin, 'Islamic Banks - Basel II and Islamic Financial Services Board Standards', Basel Briefing 8.

Financial institutions organised along these lines bear resemblance to asset-management companies - these institutions are co-investors and partners rather than providers or depositors of funds. Consequently, Islamic modes of financing - like the asset-based Murabahah or the profit-sharing Musharakah - display distinct risk characteristics which must be accounted for in capital adequacy requirements and risk management frameworks for Islamic financial institutions. An example of the distinct risk characteristics display by Islamic financial products is given in Diagram 1.

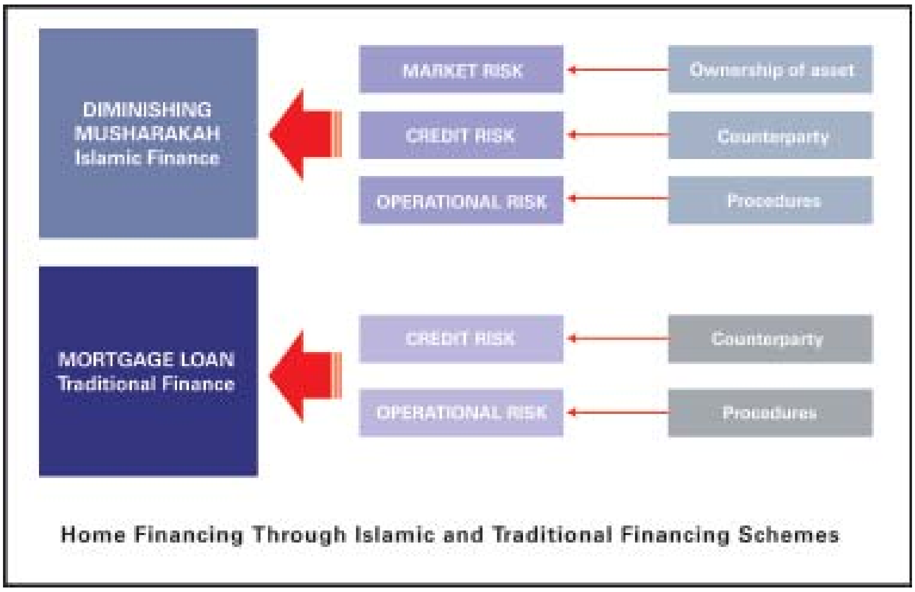

Diagram 1

CAPITAL ADEQUACY STANDARDS

The maintenance of adequate capital for the risk assumed by banks underpins the First Pillar of the Basel Capital Accord II ("Basel II"). There is no reason why these tenets should not be applied to Islamic financial institutions, which like conventional financial institutions, face credit, market and operational risks. However it is clear that the basis for the calculation of capital adequacy requirements will be different for Islamic financial institutions; the IFSB's capital adequacy standards draft expands and tailors the Basel II guidelines as necessary to serve the risk traits of Islamic financial institutions.

Credit Risk

The possibility of counterparties not fulfilling predetermined obligations is as distinct a risk to Islamic financial institutions as to conventional financial institutions. An Islamic financial institution, like a conventional financial institution, deals similarly with counterparties who at the outset of a contract, have agreed to meet stipulated terms. However, as with a conventional financial institution, there is the prospect that these counterparties will not meet these terms.

In an Islamic financial institution, credit risk exposures result from:

- Accounts receivable in Murabahah contracts;
- Accounts receivable and counterparty risk in Istisna contracts;
- Counterparty risk in Salam contracts; and
- Lease payments receivable in Ijarah contracts

The IFSB recommends that the capital adequacy for these credit risk exposures should be accounted for using the Basel II Credit Risk Standardised Approach. Thus risk weights are assigned according to the various credit risk exposures encountered. In the assignment of these risk weights, the following factors must be considered:

- The external credit assessment (by eligible external credit assessment institutions) of the counterparty or obligor;
- Any credit risk mitigation techniques used by the Islamic financial institution;
- The nature of the contract's underlying asset; and
- Specific provisions made for the portions of receivables not yet paid.

Islamic financial institutions are also exposed to credit risk in Musharakah and Mudarabah contracts, in which assets (not for trading) are held for investment returns from financing in the medium to long-term. These assets are risk-weighted according to the Basel II method for equity exposures in the banking book[4].

Market Risk

The IFSB abides by the definition of market risk outlined in the Basel framework: the risk of losses in on- and off-balance sheet positions arising from market prices. Conventional financial institutions are exposed to these risks from the positions they hold in financial instruments. These positions are held, amongst other objectives, intentionally to secure a short-term profit from price or interest-rate variations or to hedge against other elements of the trading book .

However, Islamic financial institutions are forbidden from earning returns from speculative transactions and contracts connected to the incidence or non-incidence of future events, like hedging or other derivatives, are disallowed[5]. But Islamic financial institutions are exposed to market risk in a unique manner. The Sha'riah principles, to which these institutions adhere, include the notions of materiality in transactions and the sharing of risk and rewards. As a result, Islamic financial institutions carry out many asset-based transactions in which they take ownership of physical assets as co-investors[6]. This setting exposes them to market risk - as the asset price may fluctuate.

In an Islamic financial institution, market risk exposures result from:

- Equity position risk in the trading book and market risk on Sukuk trading positions;
- Risk derived from foreign exchange; and
- Risk derived from holding commodities and inventory (including items held for future sale or leasing contracts)

[4] 'Amendment to the Capital Accord to Incorporate Market Risks', Basel Committee on Banking Supervision, January 1996
[5] Cornford, Andrew, 'Capital of Alternative Financial Institutions and Basel II: Credit Cooperatives and Islamic Banks', Third International Meeting: Ethics, Finance and Responsibility, Geneva, October 2004
[6] Hassan, Dr Sabir Mohamed, 'Issues in the Regulation of Islamic Banking (The Case of Sudan)', Research and Studies Series, Bank of Sudan, October 2004

The IFSB deals with the Sukuk position risks in a similar manner to the Basel framework - by using specific risk and general market risk capital charges to calculate adequate capital.

Foreign exchange risk in the IFSB framework encompasses the holding of positions in gold and silver, unlike the Basel framework, which treats silver as a commodity. The overall foreign exchange risk position is calculated using the Basel method: firstly by measuring the exposure in a single currency position and secondly by measuring risks inherent in an Islamic financial institution's portfolio mix of long and short positions in different currencies, gold and silver. However, the IFSB has altered the measurement to allow for the fact that Shari`ah law does not permit conventional forward contracts and other speculative transactions.

The Basel framework outlines a methodology for calculating minimum capital requirements for commodities and the IFSB has chosen to allow the use of either the Basel maturity ladder approach or the simplified approach. On the other hand, it disallows Islamic financial institutions from using internal models, which the Basel framework allowed, for the time being. The simplified approach is also used to calculate a capital charge for inventory risk - a risk unique to Islamic financing, and encountered when Islamic financial institutions enter contracts like Musharakah in which they hold the assets.

Operational Risk

Islamic financial institutions face a distinct operational risk over and above that which Basel II has defined. The potential of losses due to non-compliance with Shari`ah law is a key operational risk for Islamic financial institutions. For example, when engaged in Musharakah and Mudarabah contracts, the Islamic financial institution must invest capital in Shari`ah-compliant business activities (those that are not haram, which excludes, amongst others: gambling, alcohol and pornography). The reputational damage resulting from non-conformance may lead to major losses, and may even cause catastrophic impact on the financial institution.

Further, when an investment account holder enters a contract with an Islamic financial institution, the latter has a fiduciary obligation to the former to ensure that its funds are properly invested, like that of an asset manager to its investors. The Islamic financial institution is exposed to this direct fiduciary risk - as it is liable for the negligence, misconduct or breach of the mandate it has to invest the account holder's capital - that is only indirect for conventional financial institutions.

The capital adequacy for these two types of risk exposure are dealt with by the IFSB via the Basel II Basic Indicator Approach for operational risk, which sets a fixed percentage of average annual gross income over the previous three years. The IFSB set this percentage at 15% due to a lack of statistical data with regard to losses as a consequence of Shari`ah non-compliance and breach of the fiduciary risk. It allows for local supervisory authorities to adjust this percentage upwards for particular institutions if required. It also provides local supervisory authorities the flexibility to adopt the Basel II Standardised Approach for operational risk, as long as they have defined lines of businesses for Islamic financial institutions.

Displaced Commercial Risk

The notion of displaced commercial risk is peculiar to Islamic financial institutions. In certain situations, the Islamic financial institution will be commercially compelled to increase the rate of return to its investment account holders to persuade them to keep their funds in the financial institution. Thus it will give up some portion of its share of profits as Mudarib; the rate of return to the client is 'smoothed' at the expense of profits normally ascribed to the Islamic financial institutions' shareholders, as illustrated in Diagram 2.

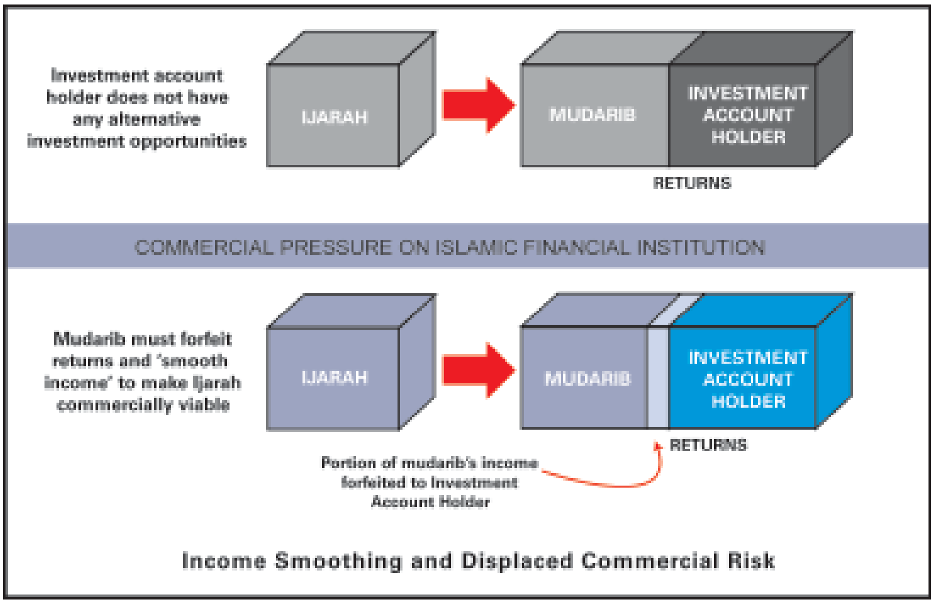

Diagram 2

Usually this displaced commercial risk is a result of rate of return risk. This occurs when funds are placed in assets like Murabahah or Ijarah, with a longer term of maturity and the rate of return is no longer competitive with alternative investments. Although in theory, Islamic financial institutions are not obligated to carry out such income smoothing - they may find that due to supervisory authority or commercial pressure, they are virtually forced to do so.

The IFSB indicates that an additional capital charge should be imposed on Islamic financial institutions that practice income smoothing. This involves including a certain percentage of assets financed by profit-sharing investment accounts in the denominator of the Capital Adequacy Ratio. Also suggested is the establishment of prudential reserve accounts to ameliorate any adverse affect of income smoothing on shareholders.

RISK MANAGEMENT GUIDELINES

Along with the proposed capital adequacy framework, the IFSB has concurrently issued a document marking out best practice for Islamic financial institutions' risk management. The IFSB incorporates risk management principles from the conventional financial institutions' sphere that are Shari`ah-compliant. Where risk management must diverge from these already established practices, the IFSB has recommended new guidelines adequate for Shari`ah-compliancy.

The risk management guidelines recommended by IFSB encompass credit, market and operational risk management guidelines, as dealt with in the capital adequacy standards above, and also liquidity, equity investment, and rate of return risk management guidelines. Each type of these risks exhibits itself in a manner unique to the Islamic financial environment and so the IFSB has derived specific guidelines to address the specificities of these risks in Islamic finance.

For example, equity investment risk usually arises from an Islamic financial institution's investments through Mudarabah and Musharakah instruments - where the financial institution enters the contract as a partner. One of the risk principles the IFSB defines in this case is the need for Islamic financial institutions to establish how they will exit these investment activities. Specifically, effective risk management will describe the conditions which will necessitate an exit and alternative exit routes. Such a risk management policy would not be required in a conventional financial institution, in which this kind of partnership arrangement does not exist.

The importance of a holistic approach to risk management is highlighted by the IFSB. This is particularly important in the context of Islamic finance as reputational risk is arguably a greater factor in the performance of an Islamic financial institution than in a conventional financial institution. A vital segment of reputational risk exposure originates from the possibility of Shari`ah non-compliance. Conformance to Shari`ah law is the raison d'être of Islamic financial institutions, and so any transgression of the laws of God will mean a total loss of credibility.

CONCLUSION

Risks are inherent in the operations of both Islamic and conventional financial institutions. Although the risk exposures of a conventional financial institution are dissimilar to those of Islamic financial institution, the main principles of risk management still apply. The IFSB's draft documents on capital adequacy standards and risk management guiding principles mark the first step in the ongoing process of filling regulatory gaps in the field of Islamic finance.

These seminal documents expand upon the Basel frameworks where they are insufficient to cater for Islamic financial institutions. More importantly however, they demonstrate that the broad maxims behind the Basel frameworks are appropriate for the Islamic financial industry. This applicability though, is subject to these principles being customised and fine-tuned to the specificities of Islamic finance.

This commonality between the Islamic and conventional finance spheres presents a stumbling block for those who believe that the Islamic financial institution is an exotic beast from the 'Middle East'. These standards and guidelines drafted by the IFSB may mark the beginning of the further integration of Islamic finance into the wider conventional financial sphere.

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