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ISLAMIC BANKING

HOW TO MANAGE RISK AND IMPROVE PROFITABILITY

Amr Mohamed El Tiby

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Foreword

As many would say that the worst of the financial crisis is now behind us, it is indeed an opportune time for the expert materials (such as this book) on the issues of risk and profitability, particularly with reference to the Islamic financial services industry.

As is well known in the Islamic banking and finance industry, Islamic banking refers to a system of banking or banking activity that is consistent with the principles of Islamic law (*shari'ah*) and its practical application through the development of Islamic economics.

Islamic banking arguably emerged (and many view it) as a viable alternative model to conventional banking. The Islamic financial services industry, while still at a growing stage compared with its conventional counterpart, is progressing with a consistent pace.

Banks, conventional as well as Islamic, are subject to a wide range of risks in the course of their operations. Islamic banks, however, face an additional set of unique risks that arise from the shari'ah-compliant financing structures that they employ. I hope readers will have a better understanding of the risks associated with Islamic banking after reading this book.

There has been a growing amount of capital availability with the Islamic banks and they have been aggressively looking for new investment opportunities.

The supply of funds coincided quite naturally with the demand for infrastructure projects in the Middle Eastern Muslim countries. As a result, not only were Islamic banks able to participate in large-scale projects, but also innovation and financial engineering in refining the Islamic financing techniques experienced exponential growth. Put differently, Islamic banks now participate in a wide financing domain stretching from simple shari'ah-compliant retail products to highly complex structured finance products, which range from power projects and water desalination plants to roads, bridges, and other infrastructure projects. In sum, Islamic modes of financing are now being used for short-, medium-, and long-term project financing and hedging.

As for the role of Islamic banks in economic development, Islamic banks, while functioning within the framework of shari'ah, can perform a crucial task of resource mobilization. Their efficient allocation on both PLS (Musharaka and Mudaraba) and non-PLS (trading and leasing) based modes can strengthen the payments systems, and can thereby contribute significantly to the economic growth and development in their respective jurisdictions.

In order to ensure the maximum role of Islamic finance in economic development, it is necessary to create an environment that could provide an incentive for Islamic banks to earmark more funds toward the development of micro, small, and medium-size enterprises.

Islamic Finance: How to Manage Risk and Improve Profitability, written by a seasoned banker and scholar, Mr. Amr Mohamed El Tiby, is therefore timely and a truly welcome addition to the growing literature on the subject.

I sincerely congratulate Mr. El Tiby for this fine, aspiring contribution to the field of Islamic banking and finance.

ADNAN AHMED YOUSIF
President & Chief Executive
and Board member of Al Baraka Banking Group in Bahrain
and the Chairman of the Board of Union of Arab Banks

Preface

The global economic crisis brought to the fore the inadequacy of conventional banking regulations in general and their capital adequacy in particular in relation to the risks associated with their business; both aspects require serious reconsideration. Bankers, supervisors, and regulators across the globe are evaluating the causes and subsequences of the global economic crisis and the credit crunch facing banks. A better understanding of the role and importance of a solid regulatory framework and its weaknesses and strengths is crucial to ensure a safe and sound financial system.

Islamic banks were the least affected by the credit crunch due to their asset-based nature of operations. However, they still face many challenges; many bankers as well as regulators are assessing Islamic banks' robustness. The Islamic financial system, while still in its infancy if compared to the conventional financial system, has proven to have solid foundations. *The Banker's* third annual survey in 2009 of the top 500 Islamic financial institutions worldwide shows growth of assets at an extremely healthy rate of 28.6 percent to reach assets of $822 billion in 2009 compared to $639 billion in 2008, whereas in conventional banking the rate of growth of assets of the top 1,000 world banks has declined from 21.6 percent in 2008 to 6.8 percent in 2009 (*The Banker* 2009).

The book also explores the regulatory framework of the Islamic financial institutions, the regulatory issues and concerns, and the challenges facing the Islamic financial industry. It is important to note here that while much has been achieved in the regulatory framework of Islamic banks, much remains to be done.

The book has four parts: Part One provides an introduction and history of the development of Islamic banks. Part Two reviews the nature of risk in Islamic banks and Islamic financial instruments. It highlights the critical roles of regulation and supervision and sound corporate governance. Part Three considers the regulatory framework for both the Islamic and conventional banks. Part Four discusses corporate governance features specific to Islamic finance. A concluding chapter provides a summary and perspectives.

PART ONE: UNDERSTANDING THE ORIGINS

Part One consists of two chapters:

Chapter 1 gives an introduction and a brief overview of the book's contents.

Chapter 2, History and Development of Islamic Banking, offers a review of the historical background of Islamic banking, starting from the early days of Islam until now. The development of the modern Islamic banks is divided into four periods, beginning in the late nineteenth and early twentieth centuries. Each of the four periods is associated with a specific set of social and economic conditions and factors, which contributed collectively to the reviving and development of the Islamic financial system. This chapter will also show the development of the Islamic regulatory bodies and the supervisory agencies that support the Islamic financial system, as well as the development of Islamic banks in five countries: Egypt, Iran, Pakistan, Sudan, and Malaysia.

PART TWO: RISK IN ISLAMIC BANKING

Banks, conventional as well as Islamic, are subject to a wide range of risks in the course of their operations. In general, banking risk falls into four categories: financial, operational, business, and event risk. Islamic financial institutions face a unique mix of risks and risk-sharing arrangements resulting from the contractual design of the financing instruments, which is based on the principles of *shari'ah*; the nature of the liability base and the unique relationship between the bank and the Investment Account Holders (IAH); the liquidity infrastructure and constraints; and the overall legal framework and environment. Institutions offering Islamic financial services (IIFS) are set on different foundations from the conventional financial institutions. The first priority of IIFS is to adhere to shari'ah rules and principles, which take priority over profit.

IIFS are required to abide by the following ideals: (1) promotion of fairness in transactions and the prevention of an exploitative relationship, (2) sharing of risks and rewards between principals in all financial/commercial transactions, (3) the need for transactions to include elements of materiality leading to a tangible economic purpose, (4) the prohibition of interest, and (5) the prohibition of financing activities that are *haram* (forbidden, meaning anything that is against shari'ah), as all transactions must be legitimate and comply with the shari'ah rules and principles. Therefore, Islamic modes of finance, such as *murabaha* and profit and loss sharing (*mudarabah/musharakah*), display unique risk characteristics that must be accounted for in the calculation of capital adequacy requirements and in the development of the risk-management framework.

Part Two consists of four chapters:

In **Chapter 3**, The Nature of Risk in Islamic Banking, we explore the different types of risk that face banks, and the unique risks associated with Islamic banks in particular.

Chapter 4, The Inherent Risk in Islamic Banking Instruments, reviews and explains the basis and unique characteristics of the finance instruments used by Islamic banks, as well as compares and contrasts them with those used by conventional banks.

The chapter reviews the risks associated with the financial instruments used in Islamic banks and how such instruments operate. In addition, it will show the underlying fundamental differences in financial instruments between Islamic and conventional banks.

Chapter 5, Operational Risk in Islamic banking, discusses one of the most important risks that Islamic banks face. It explores and explains why Islamic banks have higher operational risk exposure than conventional banks. The chapter discusses three types of operational risk: (1) shari'ah noncompliance risk, (2) fiduciary risk, and (3) legal risk.

Chapter 6 is dedicated to the Islamic capital market. In it, we discuss the importance and role of capital market. We also delve into the Islamic bond market, referred to as *sukuk*. The chapter concludes with a look at the challenges and obstacles facing the development of the Islamic capital market.

PART THREE: CAPITAL ADEQUACY

The capital adequacy standard (CAS) is based on the principle that the level of a bank's capital should be related to and consistent with the bank's specific risk profile. The determination of the capital adequacy requirement (CAR) is based on the components of risk, namely credit, market, and operational risk. The Islamic banks' characteristic of mobilizing funds in the form of risk-sharing investment accounts, together with the materiality of financing transactions, impacts the overall risk of the balance sheet, and subsequently, the assessment of the capital adequacy requirements.

The nature of risk in Islamic banks differs from conventional banks because of the differences in the nature of assets between the two. Whereas the assets in conventional banks are based on debts, the assets in Islamic banks range from trade finance to equity partnership. Therefore, some of the Islamic banks' instruments carry additional risks that are not applicable to conventional banks. Subsequently, the calculation of risk weights for Islamic banks is different than it is for conventional banks.

Part Three has three chapters:

Chapter 7, The Importance and Role of Capital, sheds some light on and reviews the notion of capital. In this review, we follow two approaches: (1) the importance and role of capital in banking, and in Islamic banking in particular; and (2) historical reviews of the capital adequacy regulations and an examination of the different views regarding the necessity of banking regulations.

Chapter 8 pertains to The Regulatory Framework of the Conventional Banking System: Basel I and II. The regulatory framework of Islamic banking and the work of the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) are mainly drawn upon the work and regulatory framework of The Basel Capital Adequacy Accord I and II, which were issued by the Basel Committee on Banking Supervision (BCBS). Therefore, I found it necessary, in order to better understand the Islamic regulatory framework, to dedicate this chapter to these two accords. The discussion in this chapter focuses on the historical background of Basel I and II, and provides an overview of the framework and regulatory bodies involved, namely, The Bank for International Settlement and the Basel Committee on Banking Supervision. **Chapter** 9 looks at the regulatory framework for Islamic financial institutions, which includes the three pillars: (1) minimum capital requirements, (2) supervisory review process, and (3) market discipline. This chapter is dedicated to the first pillar of the capital adequacy framework for Islamic financial institutions, which is the minimum capital requirements. We examine the background and development of such regulations and the salient differences between Islamic and conventional banks, as well as how Islamic banks function within the conventional regulatory environment. This chapter also offers a recommendation to adjust the capital adequacy formula to account for the risk associated with the assets funded by IAH funds.

PART FOUR: CORPORATE GOVERNANCE

In the last few years, most countries across the globe have witnessed great difficulties in their banking systems—to the extent of the collapse of major banks in the United States and Western Europe. The year 2008 witnessed the collapse of Lehman Brothers, the largest investment bank in the United States, in addition to 130 local banks during 2009, and 42 local banks in the first quarter of 2010. Some other major banks were bailed out by their governments to save them from falling down. In some countries, like the United Arab Emirates, central banks had to step in to alleviate depositors' fears by issuing laws to guarantee all individual deposits for three years. Subsequently, the banking crisis has severely affected the whole economy and was one of the main factors for the international economic crisis we are now facing. The fact that all these problems arose, despite implementing global standards and regulations by the financial systems in these countries, has raised the importance of the issue of corporate governance.

Banks are extremely important to the development of the economy. In their role of collecting and utilizing funds, banks help in maintaining market stability and in providing low-cost capital, which stimulates growth in the economy. Corporate governance in such banks is a major element to this development. In addition, good corporate governance is considered an integral part of the institutional foundation of an economy and as a way to minimize the systemic risk in the financial system.

Part Four consists of four chapters:

Chapter 10, The Supervisory Review Process and Issues, focuses on the supervisory review process as one of the main contributing factors to the safety and soundness of the financial system. This chapter discusses the supervisory review process in Islamic banking, as well as issues in Islamic banking and Islamic windows with regard to this process. The relationship between risk analysis and bank supervision is also addressed.

Chapter 11, Corporate Governance in Islamic Banking, is dedicated to the issue of corporate governance in banks, and in Islamic banks in particular. It demonstrates the different models of corporate governance, as well as discusses in detail the corporate governance standards for Islamic banking and the recently established Shari'ah Governance System, which was issued by the IFSB in December 2009. This was done to further strengthen the existing standards and deepen the understanding of Islamic corporate governance for supervisors and stakeholders. The chapter continues to focus on the specific aspects of corporate governance that are unique to Islamic banks and Islamic windows, including the very important issue of Investment Account Holders (IAH) and Profit Sharing Investment Accounts (PSIA).

Chapter 12, Market Discipline and Transparency in Islamic Banking, examines transparency and disclosure requirements, which are major factors in the safety and soundness of any financial system. In Islamic banks, these are yet to be sufficiently developed, as there are major inconsistencies in the transparency and disclosure requirements across the different Islamic systems. This chapter shows the importance of market discipline in enforcing transparency. The main objective of this chapter is to examine market discipline, transparency, and disclosure of data in Islamic banking and to show how this differs from in conventional banks.

Chapter 13, Challenges Facing Islamic Banking and Recommendations, looks at the future challenges facing Islamic banking. It also presents conclusions and recommendations that aim to further enhance and strengthen the regulatory framework to ensure the development of a sound financial system. In addition, the chapter offers recommendations to adjust the capital adequacy formula—both the standard and the supervisory formulas—to take into consideration the risk assets that are funded by the unrestricted and restricted PSIA funds.

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Introduction

Demonstrating courage and tenacity, El Tiby has taken up the challenge of putting together a book on Islamic finance. *Islamic Banking: How to Manage Risk and Improve Profitability* provides a well-documented review of Islamic finance for specialists looking for a reference document as well as non-specialists seeking a comprehensive introduction to the topic. El Tiby brings to the table a thorough knowledge of the theory and practice of Islamic finance. This book provides an interesting historical overview of the origins of Islamic finance and its more recent developments, offering a historical depth that is not usually found in contemporary writings.

In focusing on risks faced by institutions offering Islamic financial services (IIFS), El Tiby highlights the role of regulatory framework, transparency, and corporate governance. The author has appropriately devoted a chapter to operational risk, as it is one of the areas where the specificity of Islamic finance is most obvious. The chapter on Islamic capital markets provides a good overview that will benefit readers wishing to refresh their knowledge on the subject. This book thoroughly covers capital adequacy issues, often dealt with by local regulators, the IFSB and AAOIFI. El Tiby brings together the conventional approach to capital adequacy as developed by the Basel Committee for Banking Supervision, and its adaptation to Islamic finance, developed most notably by the IFSB. *Islamic Banking: How to Manage Risk and Improve Profitability* is a worthwhile addition to the literature on Islamic finance.

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