Examining the prudence of Islamic banks: A risk management perspective

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Riba (interest) free and Gharar (uncertainty) free nature of Islamic banking together with real asset/service-backed transactions ensure that an efficient, effective and robust risk management mechanism is in place in Islamic banks. Innovative collateral arrangements and keeping away from investments in complex, risky and speculative instruments maintains the risk quality of the assets of Islamic banking institutions. This article discusses and explains the theoretical foundations of Islamic finance and examines how Islamic banks ensure the risk quality of their assets facing additional risks than conventional banks due to their Shariah compliant operations. A brief comparison of the investment operations of conventional and Islamic banks is made and it is argued that Islamic banks are in a better position to manage risks and avoid such financial crisis which the banking industry is currently facing globally.

The theoretical foundation of Islamic finance

Islam is a complete religion in which we find teachings about all spheres of life, from beliefs to worship and from socio economic issues of life to ethical values. Adhering to the teachings of Islam does not merely fulfill our duty to Allah Almighty; it is also in favour of humanity in this world as well.

In our economic life, Islam provides certain rules to be followed in our economic pursuits. These rules are derived mainly from the sources of Shariah i.e. rules of Islam which are:

1. Holy Quran.
2. Sunnah (the way of the Holy Prophet, peace be upon him).
3. Ijma (consensus of Muslims on a particular issue).
4. Ijtehad and Qiyaas (inductively seeking ruling of Islam on a particular issue in the light of the Holy Quran, Sunnah, Ijma and objectives of Shariah derived from them).

If we try to cover all the rules of Islam concerned with our economic life, it would be very difficult to collect and mention all of them in this brief article. However, some of the basic rules would be worth mentioning, through which other rulings towards some particular business transactions could be determined. These basic rules are as follows:

Riba

Riba (Interest) is not allowed in Islam. Riba has two basic kinds:

i) Riba Al Dain: Any excess benefit required or given as the case maybe as consideration in a loan transaction. Due to the prohibition of Riba Al Dain, all of the following types of transactions are not allowed:
   - Interest-based loans.
   - Discounting of receivables.
   - Trade of debts with profit.
   - Trade of all interest-based securities.

ii) Riba Al Fadhl: Any excess in spot or deferred barter trade of some specific homogeneous commodities (such as gold, silver, all weighable or measurable things like wheat, petrol or commodities that are used as a medium of exchange like currencies). Any excess on spot or deferred barter trade of such commodities is not allowed if they are homogeneous, even if they are different in quality. However, if they are exchanged heterogeneously in a spot sale (one genre of good with another genre of good, i.e. wheat with barley or dates with salt), then excess of any one of the goods or difference in value is allowed.

This type of Riba was disallowed by the Sunnah (the Sayings of the Holy Prophet p.b.u.h.) and not by the Holy Quran. The reason for the prohibition of Riba-al-Fadl is that by exchanging these homogenous commodities in unequal amounts, there is a fear of developing the rationale in a person eventually leading to interest-based earnings. Therefore, spot and credit sale of unequal amounts of some specific homogenous commodities and the credit sale of heterogeneous commodities (one genre of good with another genre of good) is disallowed to avoid bringing interest from the back door.

Due to the prohibition of this type of Riba, the following transactions are not allowed:

- Spot or credit sale of gold with gold in excess.
- Exchange of currencies of same country in excess as all the currency notes of same denomination are considered same and equal.

- Credit sale of gold with silver in excess is not allowed. But in spot sale, difference in value is allowed as the market exchange rate is ascertainable in spot sale.
- Credit sale of one country's currency with the other country's currency with excess in amount is not allowed, but in spot sale, excess in amount is allowed.
- Trade of one litre petrol with two litres of petrol or one kilo steel with two kilos of steel is not allowed as sale of petrol with petrol and steel with steel falls under the ambit of sale of homogenous commodities.

Gharar

Gharar is not allowed in Islam. Literal meaning of Gharar is deception and uncertainty. In Islamic Shariah, it includes the following types of transactions:

- Deception, cheating or fraud in a transaction.
- Uncertainty or ambiguity in the transaction. It includes the following types of features in transactions:
  (i) Diction of the contract is unclear, subject matter or price of transaction is not known, or the contract is contingent to an uncertain event or chance.
  (ii) One party's consideration is certain and the other's is uncertain.
  (iii) One party's consideration is based on the loss of the other's. It means that either party only gains at the loss of the other as in a zero-sum game.

Due to the two prohibited types of transactions mentioned above, the following transactions are not allowed:

- Gambling or speculative transactions having any of the abovementioned elements present in such contracts.
- Purchasing a risk for any consideration without owning an asset, because of having the abovementioned second type of Gharar, as in the case of insurance.
- Sale of debt or receivable, because one party's consideration is predetermined while the other's is not certain. For instance, if the debtor defaults, the buyer of the debt does not remain to have any recourse to the seller of debt or receivable. Secondly, if there is any profit obtained by discounting of debt, it will be tantamount to Riba as any excess over and above the principal amount on a loan is Riba.
- Selling, transferring or assigning a risk with consideration is not allowed because if one party purchases the risk of the other party at a predetermined consideration, then one party's consideration is known while the other's is not known or uncertain. However, the following situations are allowed:
  (i) Assigning a debt having recourse to the assignor in case the debtor defaults.
  (ii) Providing a guarantee while the guarantor has recourse to cover the guaranteed amount from the guaranteed person if the guarantee is invoked.
  (iii) If some or any one person assumes the risks of the other voluntarily without any consideration.
- Future or forward transaction in which both sides of consideration i.e. price and subject matter of sale is deferred is not allowed due to the following reasons:
  (i) Sale of debt with debt.
  (ii) Sale contract is contingent to a future period, performance of which is uncertain as it is not executed now and it is not certain that both the parties as well as both the considerations i.e. price and subject matter of sale would be present or available at the time of maturity. They could only promise to do something at a future date, but cannot execute a transaction now which is contingent to a future date.
  (iii) Short sale or sale before goods actually come into existence or sale of a thing without owning, taking possession and bearing the risk and reward of the subject matter is not allowed because of uncertainty of deliverability of the subject matter in the sale contract.

Furthermore, Shariah compliance also ensures Corporate Social Responsibility (CSR) and ethical compliance. Islamic banks discourage business and transactions with companies producing tobacco, alcohol, drugs or engaged in the business of gambling, casinos, nightclubs, prostitution, etc.

Risk management in Islamic banking: An applied perspective

Now a question may be asked that if the abovementioned transactions are not allowed, then how can the different types of risks be managed or mitigated in a Shariah compliant investment framework?

Before we answer this question, we should keep in mind the abovementioned rules as well as the following rules:

- It is not allowed to earn money without taking risk of an asset.
- Risk alone cannot be sold or transferred with a consideration without transfer of ownership of the asset.
- On voluntary basis, one can assume the risk of other/s.

Now, we will answer the abovementioned question concerning how different risks could be managed, mitigated, covered or hedged in Islam. There are different types of risks in the trade and there are various ways available to mitigate these risks. We can name these tools as Shariah Compliant Risk Mitigating tools. First, we compare what are the types of risks in conventional banking and Islamic banking.

Risks in conventional and Islamic banking

Risk management is a continuous and vigilant process. It is an activity more than an action. It is designed to manage the risks inherent in the bank's business. The goal of an effective risk management system is not only to avoid financial losses, but also to ensure that the bank achieves its targeted financial results with a high degree of reliability and consistency.

A conventional bank is generally exposed to the following types of risks: credit risk, market risk, liquidity risk, operational risk, regulatory risk and reputation risk. A conventional bank lends money and earns interest on the lent money. It lends money for any financial need, be it for the purchase of assets or not. Even, if it provides financing for the purchase of assets, it does not own the assets and is only concerned with the return of its principal amount and interest. Therefore, it avoids facing many risks that Islamic banks have to face due to their Shariah compliant operations.

However, the flipside to this is that conventional banks – by way of freedom to lend money only – get themselves involved in excessive leveraging and their money – based financial assets are theoretically exposed to unlimited risks as compared to Islamic banks who by way of asset-backed financing are exposed to risks only to the extent of diminishing value of the real asset.

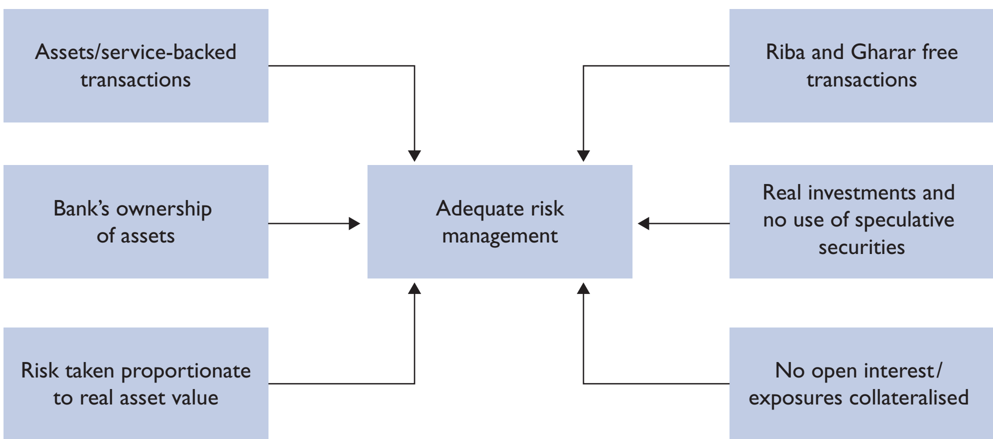
An Islamic bank faces a variety of risks in addition to the risks faced by a conventional bank i.e. reputation risk, Shariah non-compliance risk, product/mode of financing risk, process risk, counterparty risk, etc. Apparently, Islamic banking transactions look more risky compared with the conventional banking transactions. But, if we thoroughly consider many prevalent products of conventional banking and finance, we can easily differentiate that Islamic finance has limited risks on its assets as all financing provided by Islamic banks are real asset/service backed. Figure 1 shows the risk management framework in Islamic banking.

Risk mitigant tools in Islamic banking

There are different Shariah compliant ways to mitigate or minimise the risks mentioned above in Islamic banking which are as follows:

- Innovation in collateral arrangements. This mitigates the credit and default risk. Credit and default risks are more important in Islamic banks as rollover and sale of debt at a discount/premium is not allowed in Islamic Shariah.
- Third-party guarantees. This mitigates the credit, default and counter-party risk. This ensures that the bank has recourse to cover its actual losses in case the counter-party defaults.
- Seeking credit ratings of clients from specialised and credible institutions. This mitigates credit risk, default risk, counter-party risk, information risk and asset quality risk. Furthermore, it solves the problem of moral hazard and adverse selection arising from asymmetric information.
- Selection of appropriate financial instruments

Figure 1: Risk management framework in Islamic banking



available in the Islamic financial product mix to manage risks profitably. Appropriate use of Islamic financial instruments in a particular transaction mitigates process risk and liquidity risk. Wrong use of a mode of financing may result in profits going into charity or the bank having to disinvest immediately creating liquidity crunch for the bank.
- Precise cost estimation so that price is quoted after adding an appropriate profit margin for Islamic banks to cover the market and price risk. This mitigates transaction risk and price risk. It ensures that over the period of the term of financing, the bank is able to cover the actual direct costs it incurred incidental to ownership and earns a profit as well.
- Takaful coverage (an alternate to conventional insurance) to hedge against unforeseen events which can shorten the life of the asset and its effectiveness. This mitigates subject matter risk against fire, theft, marine accident, shipment failures, etc.
- Making prior Shariah approval for all financing transactions necessary to ensure Shariah compliance mitigates reputation risk. Furthermore, apprehensions about Islamic banking are removed by publishing and distributing books on Islamic banking, arranging seminars, designing and delivering Islamic banking courses, workshops and various training programmes.

Islamic and conventional banking operations: A risk management perspective

Now we will compare briefly the investment operations of Islamic and conventional banks. Following is a list of securities and investment operations which are very risky and prohibited in Islamic Shariah. But, they are allowed and used in conventional banking and finance and have caused financial crisis in East Asia in the 1990s and even more severe and disastrous financial and economic crisis today, the depth of which is still not known.

- Securitisation of receivables without being 100% backed by fixed assets.
- Issue of bonds especially junk bonds and convertible bonds which can disrupt the company's capital structure without it being willing to do so.
- Short selling of stocks, commodities and other securities.
- Future and forward transactions in stocks and commodities.
- Sale of debt or debt swap which increases the size of financial claims and not the real assets and hence eventually brings inflation in the economy.
- Discounting/factoring of receivables. The difference between the discounted value and par value is Riba and hence it is not allowed.
- Buy back agreements, and repos/reverse repos.
- Margin financing which multiplies the investment one can make and hence increasing the leverage. In economic downturns, it may result in loss beyond original investment.
- Lending financial securities as financial securities themselves are just equivalent to cash i.e. consumables and hence no consideration can be asked or given as the case maybe on consumables. Permissible financial securities (not involving Riba and Gharar and conforming to other Islamic Shariah rules) can only be sold with transfer of ownership as well as risk.
- Derivatives like forwards, futures, swaps, credit default swaps, FRAs, put options, call options, straddle options, etc.
- Hedge funds which take on unnecessary risk and make capital markets more volatile wherever they go.
- Credit sale of currencies for speculation.
- Other similar transactions.

Concluding remarks

The abovementioned transactions involve either Riba and/or Gharar. Therefore, they are not allowed by Islamic Shariah and if we analyse the current financial crisis, we would find that a major cause for such crisis is rooted in the use of Riba and Gharar based transactions. If the rules of Islamic Shariah are followed, we can save ourselves from very risky transactions ensuring smooth running of the financial institutions and hence the economy. Furthermore, the objectives of fair distribution of wealth based on real business and productive enterprise will be achieved as Islamic Shariah only permits taking on risk proportionate to the real value of asset and not beyond the value of the real asset.

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