

## THE ASSESSMENT, MANAGEMENT AND CONTROL OF RISKS IN AN ISLAMIC TREASURY ENVIRONMENT

### BACKGROUND



The guiding principles of Islamic banking focus on the avoidance of interest or usury (Riba), that of unfair advantage arising from ambiguity or uncertainty in a contractual relationship (Gharar), and the prohibition of unacceptable businesses as stated in the Quran.

Islamic banking practice is built on a strict model of compliance with Sharia'h law.

In classical Islamic terms, the definition of Riba is "surplus value without counterpart." Today the popular interpretation of Riba is effectively one and the same with the concept of interest, or usury, and is thus unlawful and forbidden.

Instead of Riba the concept of sharing both risk and profit or loss is practiced, as opposed to the concept of transferring it.

Gharar encompasses contracts where the deliverability or nature of the physical (or underlying) subjects of a contract are uncertain or in doubt. This uncertainty infers risks which make the trade akin to gambling.

Where any such ambiguity exists, a contract would be immediately null and void. In addition to the cancellation of a contract and the loss of business, any organization which sells a product that is subsequently found to have these characteristics and is declared void, potentially faces serious reputational risks.

The acceptable face of Islamic banking focuses therefore on those financial vehicles which are compliant with Islamic principles:

- Murabahah, which is 'cost-plus' financing and applicable in mortgages, car and corporate loans; and
- Bai Inah, which is a contract involving the sale and repurchase of an asset by a seller. The seller will sell the asset to a buyer on a cash basis then immediately buy back the same asset on a deferred payment basis at a price that is higher (or lower) than the cash price.

### SHARIA'H COMPLIANCE

Islamic banks and conventional banks with Islamic windows need to be Sharia'h-compliant.

Banks must have a Sharia'h board or an accepted Sharia'h counsellor to ensure conformity.

Globally, there is still a lack of standardization in the approach to Islamic banking evidenced in slight variations of practice from region to region.

For example, there are differing opinions of how to interpret and apply Sharia'h law between the Middle East and Malaysia.



The Islamic Financial Services Board (IFSB) is the international standard-setting organization, whose objective is to promote the strength and stability of Islamic financial services by issuing global prudential standards and guiding industry principles. However, whilst these standards and principles are strong

in the Middle East, they may not yet be so willingly embraced in other centres.

### GENERAL RISK MANAGEMENT

Both dedicated Islamic banks and conventional banks operating Islamic banking windows need to address all of their risks. Not only do these institutions have to cover many of the same risks as conventional banks, but Islamic banks must also address their unique risks:

- Commodities and inventory risk (from holding items in inventory either for resale under Murabahah contracts, for lease under Ijarah contracts or for distribution under Sukuk contracts);
- Legal and Sharia'h compliance risk, which could potentially lead to financial or reputational loss;
- Equity risk arising from exposures in Mudharabah financing contracts; and
- Pricing risk, as Islamic banks use market valuation as opposed to interest rates to benchmark their product pricing. There is thus a risk associated with any changes to the benchmark rate.

### SEGREGATION OF FUNDS

It is not permissible for Islamic banks and conventional banks maintaining Islamic windows to allow funds from conventional banking operations to coexist with Islamic funds.

Conventional banks operating Islamic windows must maintain a separate balance sheet and deal wholly in Islamic compliant investments. Funds intended for Sharia'h-compatible investments should not be mixed with non-Islamic investments so that the purity of the Islamic transactions and banking practices is strictly maintained.

Typical Islamic transactions may also involve some of the following financing vehicles:

**Mudarabah:** A profit-sharing agreement, typically used for equity financing.

**Tawarruq:** The sale of an asset with deferred payment where the asset is sold to a third party for cash at a lower price than the deferred price. This provides immediate access to cash and is also known as reverse Mudarabah. However, this practice was declared impermissible by the Islamic Fiqh Academy in 2009.

(Note: The Islamic Fiqh Academy is an Academy for advanced study of Islam based in Jeddah, Saudi Arabia. It was created at the decision of the second summit of the Organisation of the Islamic Conference (OIC) 1974 and inaugurated in February 1988).

**Sukuk:** Asset backed bonds, used in investment products.

**Musharakah:** Equity financing, used for working capital or investment funds.

## TRENDS IN ISLAMIC BANKING

Contemporary issues facing the Islamic banking community include the need for money market instruments that are Sharia'h compliant. There is also a need for short-term money market investments and, particularly in the current financial climate, tools for liquidity management.

Most available conventional banking instruments for liquidity management are interest based and therefore not Sharia'h compliant. Until new products or solutions are developed, this will continue to hinder development of the Islamic inter-bank money market. Key issues facing Sharia'h compliant banks trying to grow their liquidity management products suite:

- Limited Islamic secondary markets – cash and liquidity issues
- Sharia'h interpretations – cross-border incompatibility
- Small number of participants – limited market liquidity
- Slow development of Islamic financial instruments

Murabahah remains a primary instrument for short-term investments and liquidity management. However this can be an inefficient use of funds due to the low effective returns generated.

There is a clear need for Islamic bank treasuries to replicate some of the conventional inter-bank markets into an Islamic equivalent.

The International Islamic Financial Market (IIFM) acts to develop and harmonise the Islamic capital and money markets and as well as promoting standardisation across the industry, actively encourages the development of new compliant hedging and liquidity management tools. One example of this is to create a more active secondary market where Sharia'h compliant financial instruments are used to help improve liquidity management among Islamic banks.

The rapid development of the Sukuk market and the introduction of new instruments to aid in liquidity management has been a major factor in the growth of the overall market in the last few years (The sukuk market has grown considerably and new issuances worldwide grew from \$19bn in 2008 to 23bn in 2009 – despite the global downtrend in the financial markets).

Worldwide Sharia'h-compliant assets, including deposits at Islamic finance institutions, have been estimated at \$950 billion and are predicted to grow to \$1.6 trillion by 2012.

## TREASURY RISK MANAGEMENT

At the leading edge of market and liquidity management in Islamic banking institutions sits the treasury function.

Whilst the rules and constraints associated with Islamic banking products tend to encourage a 'back-to-back' or 'match-funded' approach in the management of Islamic treasury risks, there are inevitably risks and risk-gaps similar to those faced by commercial bank treasuries:

Commercial (non-Islamic) Treasury Risks	Islamic Treasury Risks
<b>Interest Rate Risk</b> <ul style="list-style-type: none"> <li>• Maturity mismatch / gaps</li> <li>• Cashflow risks</li> <li>• Repricing risks</li> <li>• Transaction risks</li> <li>• Basis risks</li> <li>• Market liquidity risks</li> </ul>	<b>Murabaha, Bai Inah Risks</b> <ul style="list-style-type: none"> <li>• Maturity mismatch / gaps</li> <li>• Cashflow risks</li> <li>• Refinancing (cost-plus) risks</li> <li>• Transaction risks</li> <li>• Basis risks</li> <li>• Market liquidity risks</li> </ul>
<b>FX &amp; Translation Risk</b> <ul style="list-style-type: none"> <li>• Open currency exposures</li> <li>• Transaction risks</li> <li>• Basis risks</li> <li>• Assets &amp; liabilities in other currencies</li> <li>• Market liquidity risks</li> </ul>	<b>FX &amp; Translation Risk</b> <ul style="list-style-type: none"> <li>• Trade timing</li> <li>• Transaction risks</li> <li>• Basis risks</li> <li>• Assets &amp; liabilities in other currencies</li> <li>• Market liquidity risks</li> </ul>
<b>Instrument Risk</b> <ul style="list-style-type: none"> <li>• Contractual terms</li> <li>• Differing cashflows</li> <li>• Differing repricing behaviours</li> <li>• Basis risks</li> <li>• Market liquidity risks</li> </ul>	<b>Instrument Risk</b> <ul style="list-style-type: none"> <li>• Contractual terms</li> <li>• Differing cashflows</li> <li>• Differing repricing behaviours</li> <li>• Basis risks</li> <li>• Market liquidity risks</li> </ul>
<b>Liquidity Risk</b> <ul style="list-style-type: none"> <li>• Differing contractual maturities</li> <li>• Differing pricing/contractual terms</li> <li>• Liquid / non-liquid assets</li> <li>• Optionality (e.g. non-maturing deposit)</li> <li>• Qualifying instruments (regulation)</li> <li>• Basis risks</li> <li>• Market liquidity risks</li> </ul>	<b>Liquidity Risk</b> <ul style="list-style-type: none"> <li>• Differing contractual maturities</li> <li>• Differing pricing/contractual terms</li> <li>• Liquid / non-liquid assets</li> <li>• Optionality (e.g. non-maturing deposit)</li> <li>• Qualifying instruments (regulation)</li> <li>• Basis risks</li> <li>• Market liquidity risks</li> </ul>
<b>Operational Risk</b> <ul style="list-style-type: none"> <li>• People risks / errors</li> <li>• Transaction and settlement risks</li> <li>• Systems risks (inadequate systems)</li> <li>• Poor / inadequate MIS</li> <li>• Process risks</li> <li>• Legal risks</li> <li>• Environmental risks</li> </ul>	<b>Operational Risk</b> <ul style="list-style-type: none"> <li>• People risks / errors</li> <li>• Transaction and settlement risks</li> <li>• Systems risks (inadequate systems)</li> <li>• Poor / inadequate MIS</li> <li>• Process risks</li> <li>• Legal / Sharia'h risks</li> <li>• Environmental risks</li> </ul>
<b>Credit Risk</b> <ul style="list-style-type: none"> <li>• Counterparty/customer risk</li> <li>• Sovereign risks</li> <li>• Settlement risks</li> <li>• Concentration risks</li> </ul>	<b>Credit Risk</b> <ul style="list-style-type: none"> <li>• Counterparty / customer risk</li> <li>• Sovereign risks</li> <li>• Settlement risks</li> <li>• Concentration risks</li> </ul>

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## IDENTIFICATION OF RISKS

It is an imperative to accurately identify, measure and assess all of the above risks objectively and timeously (in real-time if possible), not only within the context of the overall balance sheet, but also at a micro-level. Only then can potentially costly (and often unnecessary) situations be averted.



But the implication of this imperative is that to be able to identify the risks, an organisation must have a means of measurement in the first place.

In some cases, the data sets which contribute to the overall picture can be poorly organised, inaccessible or dispersed in different parts of the organisation. Pulling these together in a 'common data format' and amalgamating the balance sheet may be an extremely labour-intensive process and effectively exclude the possibility of real-time or even frequent reporting.

This represents a potential threat to any financial organisation.

## MANAGEMENT AND CONTROL OF RISK

In order to adequately manage and control risk emanating from the Treasury environment, a combination of visibility, overview and pragmatism is essential.

The ability of the risk manager to oversee risks as they arise (or indeed as they are covered/hedged) is a powerful tool to keep command of a bank's exposures and assess any threats which may exist.

In addition to preventing disasters, good risk management at all levels is a strong contributory factor in maximising the bottom line for any financial organisation.

## CONCLUSION

Whilst the rules and tenets applied to Islamic banking and practiced in Islamic financial markets may differ in their philosophy and nature from their non-Islamic counterparts, it can be seen from the table above that many of the same risks are faced by and Islamic financial institution as those in 'conventional' banks.

It is critical that all financial institutions recognise, identify and manage these risks as assiduously in an Islamic environment as it is in any other.

There is a real danger that in the race for progress in a fast-evolving marketplace, new or subtly different risks go unnoticed or unrecognised.

And if that happens they will remain unquantified or unmeasured. It may then be the case that the only time these risks come to light is when there is a problem.

Only by understanding, assessing and measuring all the risks will banks have the ability to avoid significant problems in the future.

Right now it is unclear whether the risk management culture is keeping up with the growth and development of Islamic institutions and that of the market at large.

## HOW CAN WE HELP?

XMI has a wealth of practitioner experience in identifying and addressing the true risk gaps in a Treasury environment – risks that can be missed or wrongly assessed by internal departments or other external advisers.



This is not to imply that there may be insufficient skills within an organisation, but rather that the skill sets specific to truly understanding the dynamics of the Treasury function are simply not always

available within the support and control mechanisms of the Bank.

This might happen as a result of an evolving marketplace or an expanding organisation. Often in the quest for growth, resources are stretched managing business expansion, with little left to stay ahead of or even keep up with the greater risks that rapid change implies.

At XMI we have helped a wide range of international and GCC financial institutions to get on top of this in a focussed process of review, identification and quantification of risk and the implementation of change - effectively tuning risk mechanisms to the needs of the organisation.

Our ethos is one of partnership with our clients – understanding their needs and helping to implement the most appropriate and tailored solutions to suit their needs.

Our services are always closely aligned to our clients' true requirements

Further information on our range of services and products may be found at our website: [www.xmi-associates.com](http://www.xmi-associates.com)



## About XMI

XMI is a results-driven Treasury and Capital Markets consultancy which helps financial institutions and others to reduce risk and attain maximum value from their Treasury front, middle and back offices. Founded by business practitioners, XMI offers a depth, breadth and reach of knowledge and experience that is unsurpassed in the Treasury sphere.

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