Standing Committee
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Risk Management in Islamic Financial Instruments

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RISK MANAGEMENT IN ISLAMIC FINANCIAL INSTRUMENTS

The analytical study titled "Risk Management in Islamic Financial Instruments" has been prepared specifically for the 3rd Meeting of the COMCEC Financial Cooperation Working Group, to be held on October 16th, 2014 in Ankara, with a view to enriching the discussions during the aforementioned Meeting.

This study examines the risk management practices specific to the Islamic finance industry. It focuses on risk management practices at both the institutional and infrastructure levels. In addition, an empirical analysis is conducted that compares the bank performance of conventional and Islamic banks in several key regions and compares risk management practices in Islamic banks across regions. The results provide key insights into the current trends and effectiveness of risk management processes in the Islamic finance industry. It also illustrates current trends in the industry as well as the potential avenues of future industry growth.

The Islamic finance industry grew from having USD 150 billion in assets under management in the mid-1990s to USD 1.3 trillion in 2011. Much of this growth has been due to growth in several key geographical regions, including the Middle East and Southeast Asia. Governance mechanisms both inside the finance industry and external regulators have become increasingly open to the spread of Islamic finance, particularly after the Financial Crisis of 2008. As a result, the Islamic financial markets have expanded both the scale and scope of operations. For example, Islamic indexes and funds have developed to expand the global reach of Islamic finance and increase diversification benefits available to Muslim investors. Secondly, the creation of *sukuk* securities has expanded the set of Islamic investment alternatives to include Islamic bonds; typical debt instruments are prohibited under *Shari'ah*. Thirdly, the development of *takaful* companies has allowed Islamic institutions to benefit from products similar to that of conventional insurance, but they have been modified to uphold *Shari'ah* principles. Finally, the development of Islamic micro-financial products, particularly in impoverished regions, has expanded the reach of Islamic finance and helped with the goals of economic equality and poverty alleviation.

In conventional financial systems, attempts are made to quantify and mitigate risk; however, as illustrated by the recent global financial crisis, the governance mechanisms of conventional financial systems do not always function in a way that prevents financial collapse. In a similar fashion, Islamic institutions and markets strive to reduce risks; however Islamic institutions have a more fundamental motivation for developing effective risk management strategies. Islamic principles specifically prohibit the use of uncertainty in financial transactions; thus, the implementation of financial products and risk management strategies are paramount within the Islamic finance industry. Chief components of risk management at an institutional level are *Shari'ah* boards that independently monitor financial activities and ensure each transaction is congruent with Islamic principles. In addition, regional and national governance mechanisms can also be implemented that monitor and control the systemic risk in Islamic financial systems.

The international financial landscape is changing, especially in light of the failures seen during the recent financial crisis, and the financial governance mechanisms are changing to ensure compatibility with the increasingly integrated world financial markets. There are many challenges that are of particular concern to Islamic financial institutions. For example, the *ISDA/ IIFM Tahawwut (Hedging) Master Agreement* attempts to provide guidelines for the use of certain derivative securities in Islamic financial markets, which has been a contentious issue in recent times. There are other arrangements that will similarly impact the risk of the global Islamic financial infrastructure. For example, the Basel III capital and liquidity requirements, while unlikely to have a large impact on Islamic institutions, will have a significant impact on the international financial system. Additionally, The Islamic Financial Services Board (IFSB) is set up as an international platform to promote and enhance the soundness of the industry by issuing global prudential standards and

guiding principles for the Islamic financial services industry. Likewise, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) creates standards on accounting, auditing, governance, ethics, and Shariah for IIFS. These regulatory bodies, among others, augment the *Shari'ah* boards already in place at the institutional level to create the regulatory and risk management framework of the Islamic financial system going forward.

This study presents an empirical analysis that utilizes comprehensive data on banking institutions to compare and contrast the performance of conventional and Islamic banking institutions in different regions of the globe. The analysis uses data from 57 OIC Muslim countries, which are divided into several major regions: Asia, MENA, and Sub-Saharan Africa. Performance measures are calculated that account for several aspects of banking operations, including: Asset quality, capital adequacy, operational efficiency, and liquidity. The results provide important insights as the efficiency and efficacy of Islamic finance in an international context.

Additionally, an analysis is conducted regarding the risk management practices of several Islamic banks across geographic regions: 18 IFIs from across 14 countries of the MENA region, Southeast Asia and South Asia. The most important risk is operational risk, followed by credit risk, liquidity risk, and mark-up risk. These risks are relatively more important in the *Mudarabah*, *Murabahah*, and *Musharakah* models of financing, when compared to the *Ijarah*, *Ijtisna*, and *Salam* modes of financing. Results show that banks in the developing MENA and the Southeast Asian countries exhibit better risk management practices and policies, when compared to other regions. Lack of understanding, unavailability of Islamic money markets, and the limited regulatory framework in handling problem loans are identified as three major problems. These problems are closely connected to the types of risks inherent in financial institutions.

The study concludes with a discussion of the current initiatives and projects that are relevant for the future growth of the Islamic financial system. Aside from traditional bank management techniques, such as risk reporting, internal and external audit, GAP analysis, RAROC, and internal rating, Islamic institutions continue to develop *Shari'ah* compliant products and governing bodies. In addition, there are other sources of potential growth for the industry across the globe. The *Ten-Year Framework* formulated in 2007 elaborates a roadmap for the development of the Islamic finance industry for the next ten years. Opportunities for the Islamic finance industry include increases in cross-border investment, the development of standardized *Shari'ah* products, and improving micro finance and *takaful* efforts.

The Study also provides recent examples of cross-border *sukuk* issuance and the potential risks in its appendix section.

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