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RISK MANAGEMENT IN ISLAMIC FINANCIAL INSTITUTIONS: THE CASE OF ISLAMIC DEVELOPMENT BANK

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ABSTRACT:
This study aimed to explore Shariah compliancy is impacting risk management techniques by studying the case of the Islamic Development Bank. The study identified the type of financial instruments and products that are used by Islamic financial institution. the major riskk faces in its operation and the risk management techniques it uses for each of those risks. A comparative analysis is carried out to compare case of Islamic development bank with a conventional financial institution of similar kind that is the world bank. The results revealed that there was a consistency in financial products and services of Islamic and conventional financial institutions and the risks they usually face are also similar but because of the underlying Shariah principles which structures the Islamic financial transactions in a modified way considering the ethical perspective behind it, so the risk mitigation techniques are accordingly taking a different shape that free from any unlawful deal or transaction in financial product, resulting in a fair shariah compliant risk management. Hence, there was a difference observed between the risk management techniques used by conventional and Islamic financial institutions. In addition, difference in risk management techniques of common risks, Islamic has a unique Shariah compliant or Shariah reputational risk that is due to consideration of Shariah (spirituality) and Islamic development bank also addresses this risk.

INTRODUCTION:

Islamic financial are modern part world economy and subject to the same economic laws as conventional (non-Islamic) financial market participants [1]. Islamic financial and conventional banks create competition to satisfy customers and fulfill their expectations and long term benefits for the economy [2]. Islamic financial prohibits interest (riba) and replaced with the profit and loss sharing (PLS) principle and based on Syari'ah rules [3]. Meanwhile, conventional bank is a bank conducting conventional business in its activities providing services in financial traffic payment [4]. Islamic financial is not limited to Islamic countries but spread over other countries such as the United States, Europe and the Far East [5]. There are 49% of total banking sector in Saudi Arabia, 39% in Kuwait and 26% in Qatar [6]. Islamic finance also ensures fair business by avoiding asymmetry of information, gambling or any unethical concerns from business whether it is a trade or any type of financial activity'. As such, it integrates the concepts of social benefits of the individual and the overall welfare of society into banking and financial transactions.Risk management process is a comprehensive system that includes creating an appropriate risk management environment, maintaining an efficient risk management, mitigating and monitoring process, and establishing an adequate internal control system. But in Islamic Finance there is a unique risk that is due to consideration of Shariah (spirituality) and is called Shariah Compliance risk which eventually makes risk management different in Islamic Finance. Shari'ah compliance risk is the possibility that a financial service or product is not or will not follow established Shari'ah principles and standards. It is important for any financial institution, mainly because it helps to limit (or prevent) risks of loss that may originate in its operations. Essentially, risk management occurs anytime a financial institution analyzes and determine what risks exists or may exist in an operation and then attempts to handle those risks in a manner best-suited to the objectives by taking the appropriate action. Risk measurement and techniques in the banks are vinitage analysis, risk plus, scenario analysis, stress tests, integrated risk management, internal rating method, standard method, legal barrier, firm rating, credit policy, credit demand evaluation and retroactive tests [7].Financial products and services designed especially for the Islamic financial marketplace are distinguished from their conventional counterparts by their compliance with Shari'ah precepts and principles. Meanwhile, these products and services may appear similar to conventional financial products and services, particularly from an economic perspective, the contractual and structural underpinnings of these products and services comply with the Shari'ah. A proper systematic process should be available in a financial institution to identify the uncertain and unfavorable events and risks that occur or may occur, analyze them and their impact, control and mitigate them. Besides, there is important to have an efficient risk management system in order to reduce or eliminate the risk of certain kinds of transactions and events happening or having an impact on the business.Though main elements of risk management include identifying, measuring, monitoring, and managing various risk exposures, these cannot be effectively implemented unless there is a broader process and system in place. Overall, risk management process should be comprehensive embodying all departments/sections of the institution so as to create a risk management culture. It should be pointed out that the specific risk management process of individual financial institutions depends on the nature of activities and the size and sophistication of an institution.

METHODOLOGY

This study was used a case study approach and explore the case of the Islamic development bank. This study was an exploratory study which is designed based on multiple cases such as case of Islamic development bank (main focus) and case of world bank (for comparison) to study and mainly used qualitative approach to support the analysis. The reason for choosing these multilateral development banks (MDB) for this study was that such financial institutions are intended for economic benefits and social welfare. Since Shariah also integrates the concepts of social benefits of the individual and overall welfare of society into banking and financial transactions, the cases of Islamic development bank and world bank were ideal situation to study.Islamic development bank was the main case to focus on in order to determine what risks Islamic financial institutions face, what financial products they have for their operations, how it is mitigating and managing the risks it faces in its operations. Then the case of Islamic development bank is compared with world bank as most appropriate benchmark that also has AAA rating such as Islamic development bank and has operations and projects of similar nature. Most of the secondary data was collected from official website of Islamic development bank and the world bank. This step has helped in identifying types of risks both the financial institutions are facing and methods and techniques used to control by reading the annual reports, financial statements report of the two financial institutions and information provided online on their websites.More relevant data is collected in addition to information obtained through documents for more focused analysis. Interviews were conducted with director of group risk management department, risk managers, staff in operations department and study department in Islamic development bank and staff from operations department at world bank.Data and information obtained from interviews is analyzed using comparative approach. The analyzed data is then compiled the results and findings are interpreted to highlight the similarities and differences. Significance issue of the study and the limitations are acknowledged and addressed, findings of the study are stated as conclusion.

Analysis

The Islamic Development Bank is a multilateral Islamic development institution with a goal to foster the socio-economic development of member countries and Muslim communities in accordance with the principles of Shariah. The bank has 56 members, with the condition for membership being participation in the OIC 3• Its functions are to participate in equity capital and grant loans for productive projects, and to provide financial assistance for economic and social development. The bank is authorized to provide financing through Shariah compliant methods.In the Islamic Development Bank, all the operations follow the principles of Islamic Shari'ah which consists of set of rules and principles derived from the Holy Quran, the authentic traditions (Sunnah) of the Prophet (peace be upon him) and the scholarly opinions

(Ijtehad) which are based on the interpretation of the verses of the Holy Quran and the Sunnah. For Islamic financial operations main considerations are:-

All financial transactions should be free of interest (riba),gambling, uncertainties (gharar) asymmetric information and any unethical issue. There should be participation in profit and loss sharing, since return is not guaranteed in an Islamic transaction. The Islamic development bank did not borrow from the market and its operations are sustained by share-holders capital, retained earnings and funds generated internally through its foreign trade and project financing operations. The IDB finances trade and development projects both for the public and private sectors, finances large and medium sized projects and small enterprises in the member countries.

According to world bank, there is important source of financial and technical assistance to developing countries around the world which made up of two unique development institutions owned by 184 member countries-the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). Each institution plays a different but supportive role in world bank's mission of global poverty reduction and the improvement of living standards. The IBRD focuses on middle income and creditworthy poor countries, while IDA focuses on the poorest countries in the world.World bank is a conventional financial institution with the operations running under the main principle of providing low-interest loans, and interest-free credit and grants to developing countries for education, health, infrastructure, communications and many other purposes."Both IDP and world bank has the same perspective of ethical investment for social benefits and economic welfare, and working on development projects but the main difference between both is that Islamic development bank implement those operations with Shariah principle of no interest based transactions whereas the world bank has interest based transactions for its operations no matter its principle is to keep the interest rates low.Islamic Development Bank uses many Shariah compliant financial instruments that includes loan financing, technical assistance, leasing, installment sales, istsna, equity participation and profit and loss sharing musharaka (in project financing by funds) but the major modes of finance that it uses in most of its operations are murabaha and installment sales financing, loans, istsna , ijarah muntahia bi tamleek , musharaka - profit and loss sharing- (in project financing by funds). Musharaka requires th partnership agreement between an Islamic financial institution and a customer [8].Murabaha financing and installment sales financing are agreements whereby the fund sells to a customer a commodity or an asset, which the fund has purchased and acquired based on a promise received from the customer to buy. The selling price comprises the cost plus an agreed profit margin. IDB purchases the machinery/equipment needed for a certain project then re-sells them to the beneficiary adding a mark-up which is mutually agreed upon between the Bank and the beneficiary.Loans represent amounts disbursed in respect of projects less repayment received relating to the outstanding capital portion of the loan as determined by the loan agreement. These IDB loans are interest free and based on Islamic principle of "Qard Hassan" which are considered as nonprofit bearing loans. IDB Loans are extended mostly to governments or to public institutions having the government guarantee and provide long-term financing for development projects in basic infrastructure and agriculture.Istisna'a is an agreement between the fund and a customer whereby the fund sells to the customer a developed asset according to agree upon specifications for an agreed upon price. istisna'a assets represent the disbursements made as of the date of the statement of financial position against the assets acquired for istisna'a projects plus income recognized, less repayment received. This mode is applied in the financing of manufacturing of goods and equipment, as well as in the financing of construction works.ljarah is an agreement whereby the fund, acting as a lessor, purchases according to the customer request(lessee), based on his promise to lease the asset for an agreed rent for a specific period. The fund transfers the title of the asset to the lessee without consideration upon completion of all payments due. Investment ijarah muntahia bittamleek consists of assets purchased by the fund, either individually or through a syndicate agreement and leased to beneficiaries for their use under ijarah muntahia bittamleek agreements. Profit sharing is fulfilled with the loan is given to borrowers who already have trading activities, the borrowers should be trustworthy in reporting their daily profit and the loan is spent to improve their trading activity not at personal consumable goods [9]. The profit accruing to (or loss incurred by) each partner is proportional to its share in the venture. This mode might be suitable for projects expected to have a high financial rate of return.On the other hand, world bank has the following four major modes of Finance in its operations such as flexible loans, local currency loan, special development loans and contingent financing with deferred drawdown option.A loan in which borrowers can benefit from long maturities (up to 30 years), transparent LIBOR-based pricing, built-in hedging products to manage financial risks over the life of the loan, and the ability to customize repayment schedules according to project needs or debt management requirements.Interest rates for the loan are reset semi-annually based on a variable reference rate (currently 6-Month LIBOR for USD, JPY and GBP and EURIBOR for EUR), plus a variable or a fixed spread. In addition, a one-time front-end fee of 0.25% of the loan amount is charged at the beginning of the project.This financial instrument consists of flexible loans with options embedded that gives to borrower access to local currency at the time of disbursement or at any time during the life of the loan to reduce future vulnerabilities to foreign exchange risk. The world bank offers special development loans for development of sub nationals with two options included financing with a sovereign guarantee on the same terms as national governments, or financing without a sovereign guarantee on commercial terms through the joint World Bank Sub national Finance program.This mode of finance flexibility is gained to rapidly fund financing requirements due to an unexpected shortfall in resources. The Deferred Drawdown Option (DDO) is a committed line of credit with similar pricing and the same built-in risk management features and flexibility as the flexible Loan. By comparing the major modes of finance used by lslamic development bank and world bank, both are using similar nature of products that are mainly loans or deferred payments with only difference in retribution amount which is interest in case of World Bank and profit or markup in case of IDB but the need for maintaining high liquidity is in case of Islamic financial institution is more as even if it is getting markups or cost plus but since it has profit and loss sharing operations as well like musharaka, it is therefore sharing in losses also along with the gains.Credit risk is the risk that may arise if counterparty defaults or fail to fulfill or pay the obligations, Market risk of three different types may arise for IDB if currency risk due to possibility of change in foreign currency that will affect the value of financial assets and liabilities, liquidity risk due to inability to meet its net funding requirement and mark up risk due to changes in markup that will affect the value of financial instrument. Operational risks may arise due to holding of assets and any loss that occurs due to failure of some internal process. Finally, Shariah reputational risk which may arise if any operation or financial product which are not satisfying shariah compliancy. Credit risk includes credit risk default, guarantor risk or counterparties of the derivatives [10].The world bank also considers credit risk, market risk and operational risk as its major risk same as IDB risks with an exception that there is no Shariah Reputational risk. Like in IDB, Credit risk in world bank may arise due to default of counterparty or settlement of obligations. Market risk may occur due to either changes in interest rates or inability to meet liquidity requirement. Operational risks may arise due to holding of assets and failure of internal process.The analysis shows that both Islamic development bank and world bank have similar major risks. However, IDB is addressing an additional unique risk i.e. Shariah reputational risk, a risk that may arise due to non shariah compliancy of transactions in products and operations. This Shariah reputational risk of IDB is same as Shariah compliance risk . Financial products and services designed especially for the Islamic financial marketplace are distinguished from their conventional counterparts by their compliance with Shari'ah precepts and principles.IDB has a formal infrastructure for risk management in the form of department called "Group Risk Management Department" which is independent from all business departments and affiliations of IDB. (At first IDB had small unit within treasury department to manage risk, then it had office reporting to Vice President but now it has taken shape of complete Department IDB group level Risk Management Department "GRMD")The GRMD is responsible for identification, assessment, mitigating, and reporting of all types of risks inherent in the Bank's activities with the view to achieve and maintain its sound, safe and sustainable low risk profile. The Bank has also established a Group Risk Management Committee which is responsible to ensure that, based on the risk appetite of the Bank. There are appropriate controls on all major risks arising from financing and investment operations through reviewing the risk management framework, policies, procedures, guidelines and risk reports.The Shariah committee of IDB performs audits on various IDB activities to ensure Shariah compliance and there is a dedicated unit for Shariah coordination at IDB. The IDB is a non-profit organization, and hence not seeking profits in its transactions. From this perspective, IDB faces less Shariah-risk than for-profit institutions and also IDB is committed to Shariah rulings and adopts only Islamic modes of finance which makes it easy to manage.Beside this, to manage Shariah reputational risk all IDB business activities are subject to the supervision of IDB group Shariah Committee Members. The Committee has the functions such as all transactions and products that are to be used for the first time, ensure their conformity with the principles of the Shariah, and lay down the basic principles for the drafting of related contracts and other document, giive opinion on the Shari'ah alternatives to conventional products which the business activities intends to use, and lay down the basic principles for the drafting of related contracts and other documents and to contribute to its development, respond to the questions, enquiries and explications referred to the documents by the Board of Executive Directors or the management of the business activities, submit to the Board of Executive Directors a comprehensive report showing the measure of the activities' commitment to principles of Shariah in the light of the opinions and directions given and the transactions reviewed.For managing financial risks in its products world bank uses the hedging products that are available in one of three ways: on a stand-alone basis to manage risk on the entire portfolio of World Bank loans; on a stand-alone basis to manage debt owed to other creditors; and built into the Flexible Loans as conversion options. Following are the main techniques:

Currency conversions and swaps has alters the currency terms of a loan obligation if risk management requirements have changed since the initial choice of loan currency. To access built-in conversion options simply request the desired type and terms of the conversion. For loans without embedded options or debt owed to creditors, access swaps by signing a Master Derivatives Agreement. Availability of currency hedging products presupposes a sufficiently liquid swap market in the desired currency.Transform the interest rate basis of a loan obligation from a fixed to floating rate or vice versa. To access built-in conversion options simply request the desired type and terms of the conversion. For loans without embedded options or debt owed to creditors, access swaps by signing a Master Derivatives Agreement.Limit interest rate variability with a cap or a collar. Caps set an upper limit on the variable interest rate of the loan. Collars set an upper limit (a cap) and a lower limit (a floor) on the interest rate of the loan. Both require payment of an up-front premium to purchase the interest rate protection. For loans without embedded options or for debt owed to creditors, access caps and collars by signing a Master Derivatives Agreement.Link debt service payments to the prices of a particular commodity or commodities in order to reduce commodity price risk. One set of cash flows is linked to the market price of a commodity or index. The other is a fixed cash flow or a cash flow based on a variable rate of interest. In this way, a commodity swap is a hybrid, spanning interest rate swap and commodity swap markets.By comparing the risk management techniques of Islamic development bank with world bank, we observed that in case of IDB, the risks are managed by sovereign guarantees, Commercial bank guarantees, hedging products-Murabaha based profit rate swaps, Established exposure limits for obligors, hedging product cross currency profit rate swaps and maintaining high liquidity levels. Whereas in case of World bank risk management tools are

Derivatives (currency swaps, currency forward, interest rate swaps) and guarantees (partial risk guarantees, partial credit guarantees, policy based guarantees).Studying the structure of the mitigation techniques, differences are found which shows that when mitigating similar types of risks in Islamic finance, risks are not considered separate or traded separated as in case of world bank by using derivatives like interest rate swaps. Mitigation techniques of Islamic development bank were integrated within transactions and underlying structure of financial product within each transaction. Beside the guarantees, most of the risk management techniques used by World bank (a conventional financial institution) are derivatives but Islamic development bank (an Islamic financial institution) is not using any derivative but other risk management strategies and hedging mechanisms that are acceptable according to Shariah also.

CONCLUSION

In conclusion, there is a consistency in financial products and services of Islamic and conventional financial institutions and the risks usually face are also similar but because of the underlying Shariah principles which structures the Islamic financial transactions in a modified way considering the ethical perspective behind it, so the risk mitigation techniques are accordingly taking a different shape that is free from any unlawful deal or transaction in financial product, resulting in a fair shariah compliant risk management. This implies that there is a difference between the risk management techniques used by conventional and Islamic financial institutions. In addition, difference in risk management techniques of common risks. Islamic financial institution has a unique Shariah compliant or Shariah reputational risk that is due to consideration of Shariah (Spirituality) and Islamic development bank also addresses this risk. Since Islamic Development Bank is a non-profit organization faces less Shariah-risk than for-profit institutions and IDB is committed to Shariah rulings and adopts only Islamic modes of finance. Therefore the impact of Shariah risk is less than in case of for-profit banks.

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