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Malaysia Deposit Insurance Corporation

Assessing Risk Profiles of Islamic Banks

SEMINAR ON ISLAMIC DEPOSIT INSURANCE, KUALA LUMPUR
18-19 AUGUST 2008

Key Question

What are the differences between Islamic banking and conventional banking from risk perspective?

Scope of Presentation

1. Characteristics of Islamic Banking
2. Risk Matrix
3. Issues and Challenges

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Characteristics of Islamic banking

Salient Features of Islamic Banking

Islamic financial transactions are based on Shariah principles (Islamic jurisprudence) …

- **No element of usury**
- **No element of uncertainty**
- **No element of gambling**
- **No trading/investment in prohibited commodities**

Contractual Relationship

Islamic contracts in Islamic banking operation …

Shariah Principles	*Islamic contracts*	*Relationship*
Free from Usury No Uncertainty No element of gambling No prohibited commodities	➢ Cost-plus (*Murabahah*) ➢ Future delivery (*Salam*) ➢ Purchase by order (*Istisna*') ➢ Leasing (*Ijarah*) ➢ Profit sharing (*Mudharabah*) ➢ Joint-venture (*Musharakah*) ➢ Wadiah (safe custody) ➢ Others	In addition to debtor-creditor, other relationship includes custodian, lessor-lessee, investor-entrepreneur and buyer-seller.

Contractual Relationship

	Islamic banking	Conventional banking
Relationships in sources and Application of funds		
Savings/demand deposits	Custodian	Debtor-creditor
Investment deposits	Buyer-seller → Debtor-creditor	
Capital	Investor-entrepreneur	
• Financing • Securities • Others	Investor-manager	Investor-manager
Ownership and risks	100% owned by the bank	100% owned by the bank
	Co-ownership of asset	Risk • Fully borne by bank
	Risk • Fully transfer to depositor • Partially transfer to depositor • Fully borne by bank	

Balance Sheet Components

Islamic banking	*Conventional banking*
ASSETS	**ASSETS**
Cash and cash equivalents Sales receivables Investment in securities Investment in leased assets and real estates Equity investment in joint ventures Equity investment in capital ventures Inventories Other assets Fixed assets	Cash and cash equivalents Securities portfolio Loan and advances Other assets Statutory deposits Investment in subsidiaries Investment in associates Fixed assets
LIABILITIES	**LIABILITIES**
Current account Other liabilities Profit sharing investment accounts Profit equalisation reserve Investment risk reserve	Deposits Other liabilities
OWNERS' EQUITY	**OWNERS' EQUITY**

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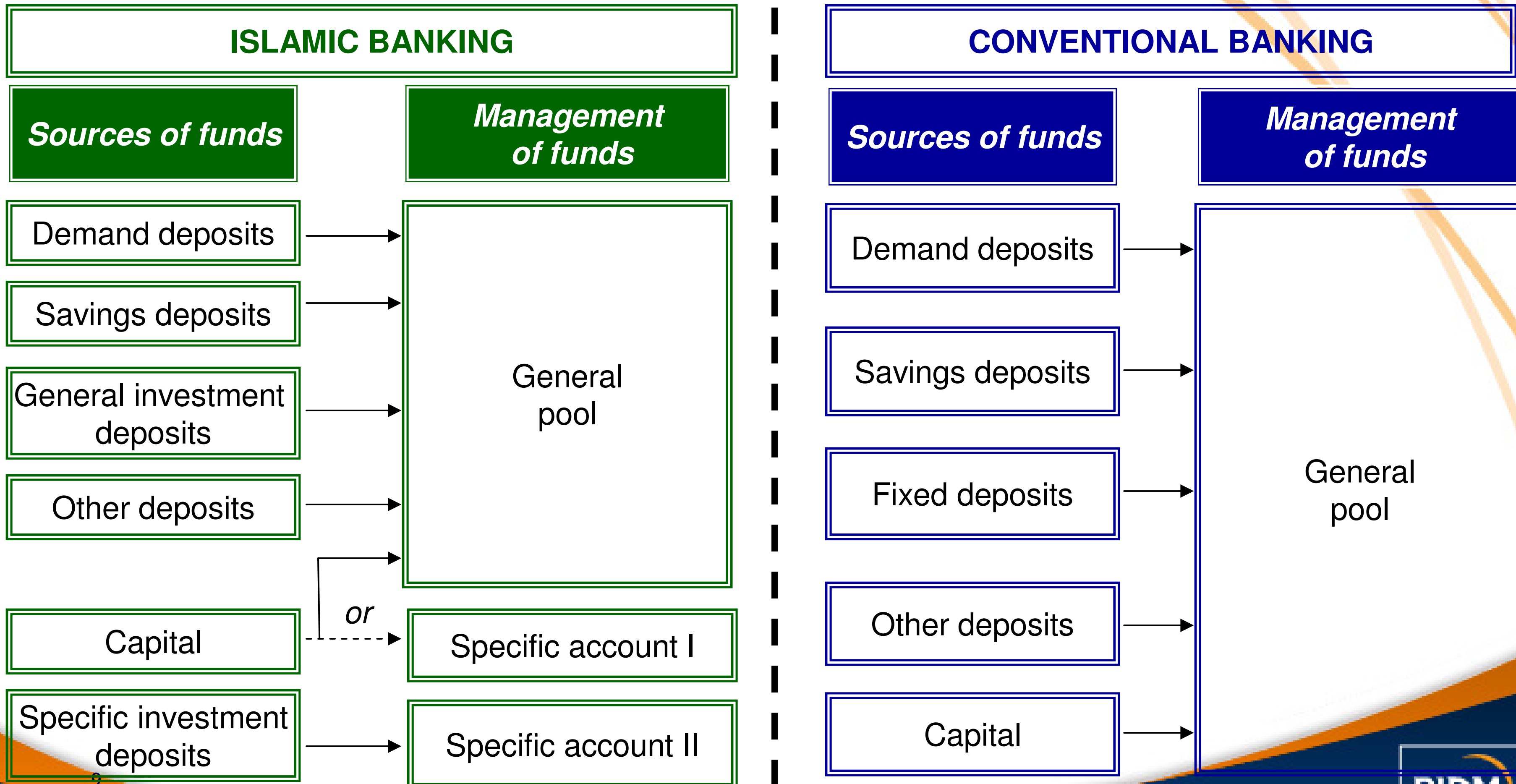
Management of Funds

While conventional banking funds are managed on pool basis, Islamic banking funds are managed on <u>pool or separate basis</u> …



Risk Matrix

Risk Matrix

	Islamic banking	Conventional banking
Credit Risk	✓	✓
Equity Investment Risk	✓	✗
Market Risk	✓	✓
Inventory Risk	✓	✗
Liquidity Risk	✓	✓
Rate of Return Risk	✓	✗
Operational Risk	✓	✓
Interest Rate Risk	✗	✓

A number of risks unique to Islamic banks.

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Credit Risk

Counterparty fails to meet its obligations in accordance with agreed terms

- Generally similar to conventional banking
- Credit risk prevalent across the Islamic financing contracts - whether sale-based, leasing or profit-and-loss sharing ("PLS") contracts.

Equity Investment Risk

Risk arising from entering into partnership

- Risks inherent in holding of equity instruments or investment purposes
- Risk profile of potential partners
- Under PLS contracts, the capital invested by the provider of finance (the bank) does not constitute a fixed return, but explicitly exposed to impairment in the event of losses (capital impairment risk)

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Market Risk

Arising from movement in market prices

- Relates to current and future volatility of market values of specific assets
- Additional issues to consider for Islamic banks:
  - Importance of asset-liability management
  - Limited hedging instruments against the market risks

Inventory Risk

Where ownership of assets lies with the banks

- Some Islamic financing contracts involves Islamic banks taking ownership of assets
- The bank is exposed to inventory risk in the event the customer does not buy the asset (credit risk)
- Holding of the inventory also exposes the bank to price volatility (market risk)

Liquidity Risk

Loss arising from inability to meet obligations

- Limited liquidity management instruments
- Limited interbank and money market
- Limited secondary debt market which may hamper liquidity of Islamic debt instruments
- Lender of last resort facilities
- Use of Commodity Murabahah to manage liquidity

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Rate of Return Risk

Rates of return risks is potential impact on the returns caused by unexpected change in the rate of return

- Returns to profit-sharing investment account holders are not fixed up-front – theoretically, investors will accept profit or loss on investment
- Practically, Islamic banks are wary of potential withdrawal of funds due to uncompetitive profit rate
- Displaced commercial risk
- Profit Equalisation Reserves and Investment Risk Reserves

Operational Risk

Risk of losses resulting from inadequate or failed internal processes, people and systems or from external events

- Crucial for Islamic banks
- Compliance with local legal framework
- Compliance with Shariah rules
- Reputation risk
  - For an Islamic bank - Reputation is even more important

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MDIC's Risk Assessment

- Common methodology but two different applications
- For Islamic banks, the additional risk perspectives are considered and analysed
- Additional financial indicators identified and developed
- Currently developing new benchmark for Islamic banks in terms of financial ratios

Issues & Challenges

Issues & Challenges

- Islamic banking fairly new
- New products being developed and introduced
- Information disclosure
- To monitor changes and develop new financial indicators where necessary

Conclusion

- There are differences in terms of risks faced by Islamic banks compared to conventional banks
- As a result, the risk assessment techniques need to consider these risks
- The fast-paced development of Islamic banking means that risk assessment approach needs to be continuously refined
- Are Islamic banks more risky?

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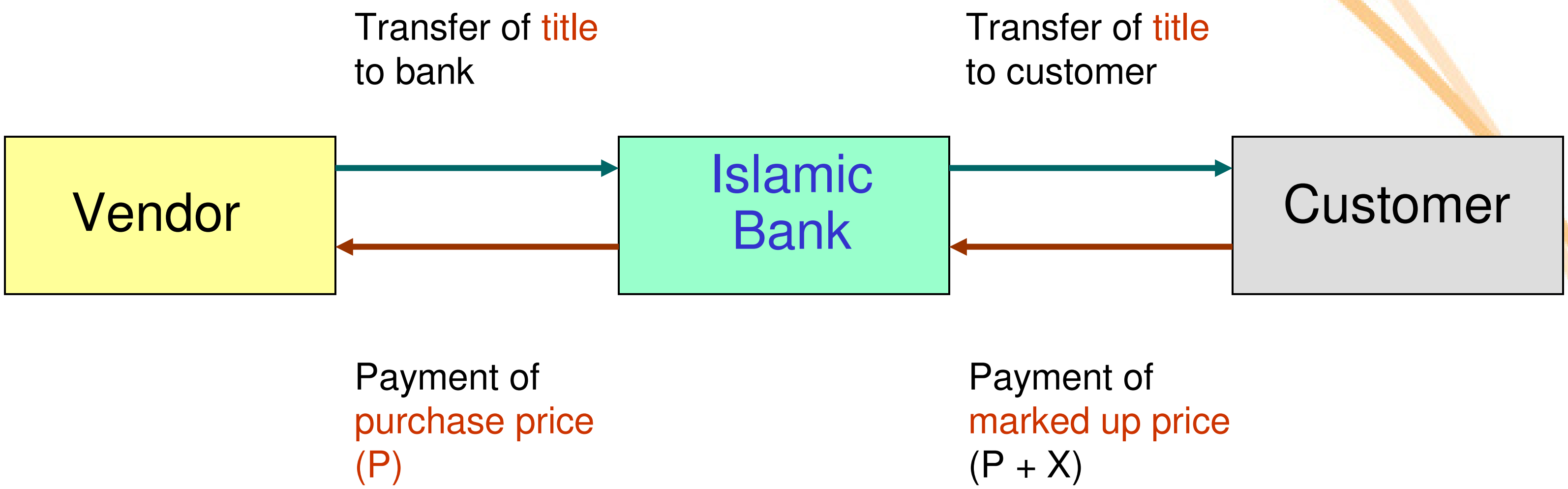
Thank you …

MURABAHAH (Cost Plus)

Murabaha refers to contract in which FI purchases goods upon request of a client, who makes deferred payments that cover costs and an agreed profit margin for the FI.

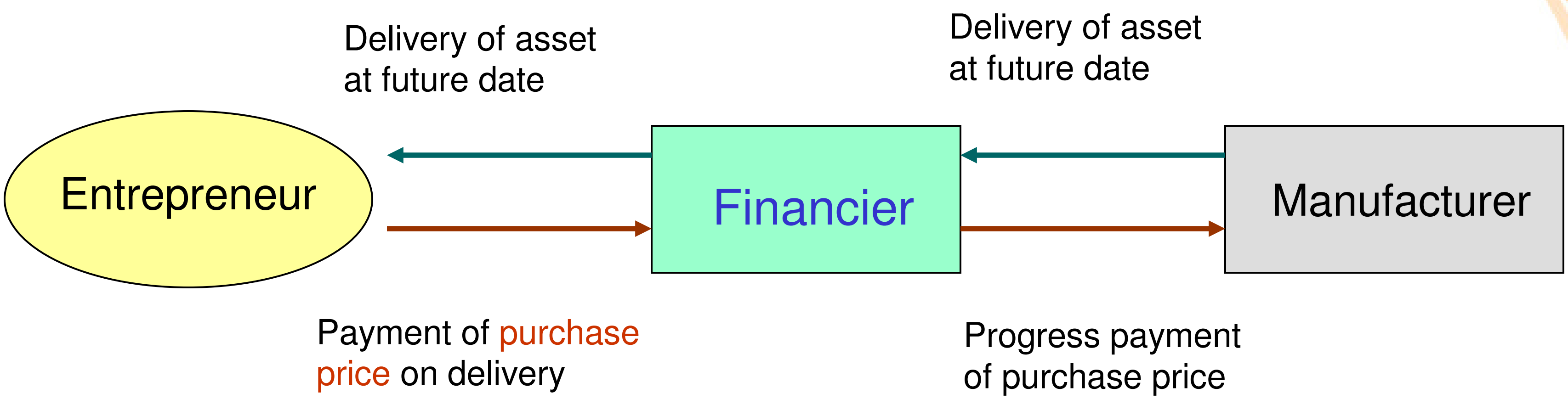


The responsibilities of various parties to a Murabaha contract are set out below:

- Bank buys asset from vendor for P
- Customer then buys asset from bank at a marked up price (P+X), which is payable on a deferred payment basis
- The period covering the deferred payment is effectively the period of financing
- Title to assets is transferred to customer at time of purchase but usually customer provides same or other assets as collateral to the bank for the period of financing

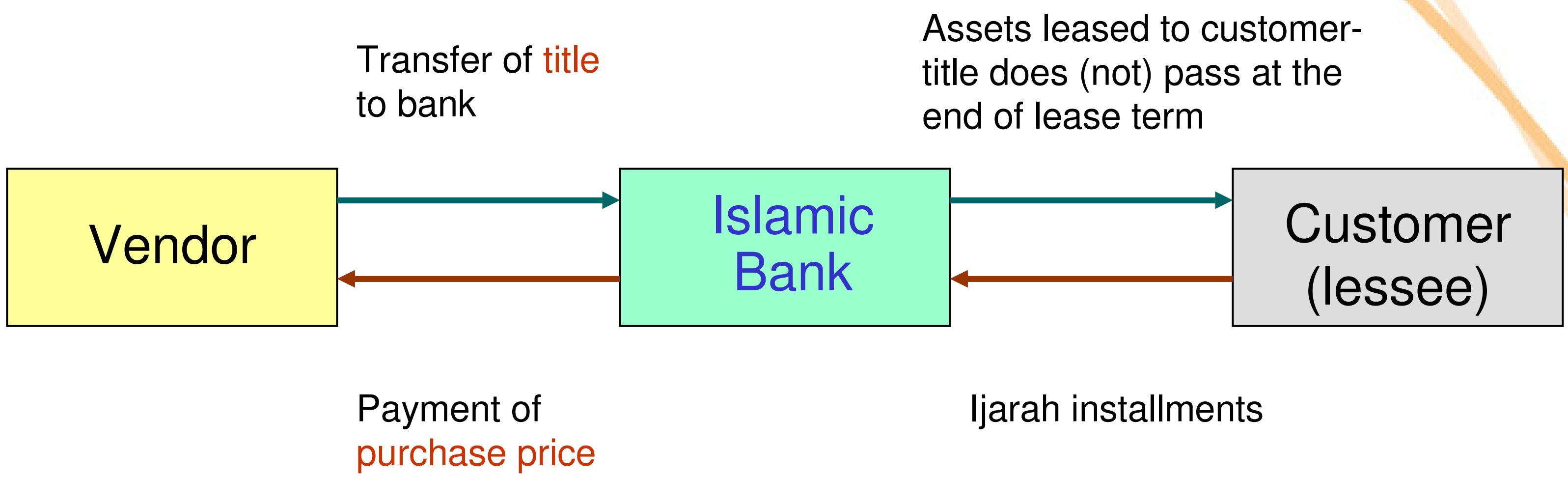
ISTISNA’

Istisna is primarily a deferred delivery sale contract. It is similar to conventional work in progress financing for Capital project. In practice it is usually used for construction and trade finance such as pre-shipment export finance.



IJARAH (Leasing) MUNTAHIA BITTAMLEEK

An Ijarah is a lease purchase contract in which FI purchases capital equipment or property and leases it to an enterprise. FI may rent equipment through its use.

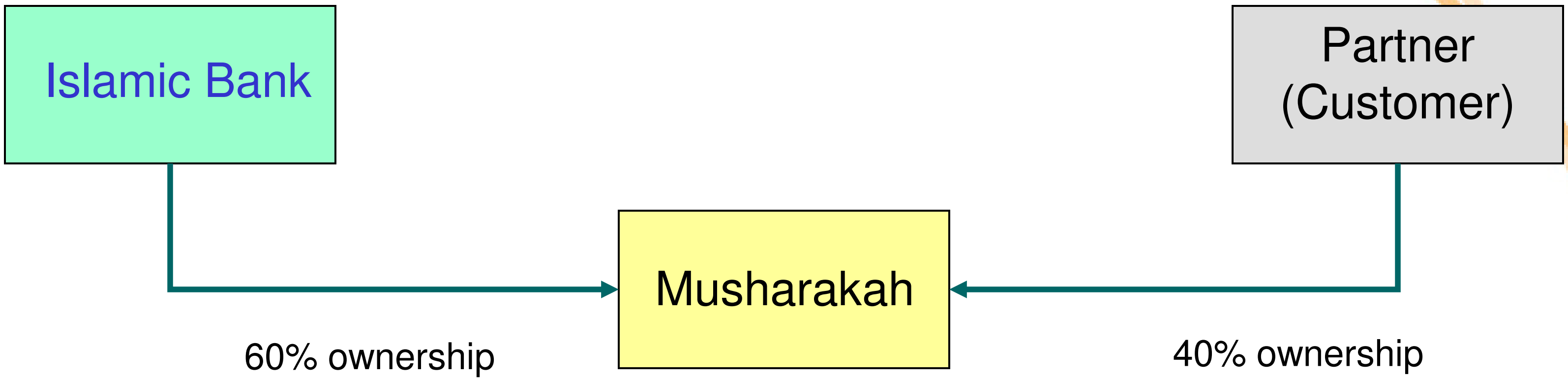


The responsibilities of various parties to a Ijarah contract are set out below:

- Bank buys asset from the vendor and then leases asset to customer
- Periodic rentals are collected by the bank
- Title of asset remains with bank under an operating Ijarah
- Title passes to the customer under an IMB at the end of contract.

MUSHARAKAH (Joint-venture)

Musharakah is a partnership between a FI and an enterprise in which FI supplies working capital. Notes of participation sold to investors provide the funding.

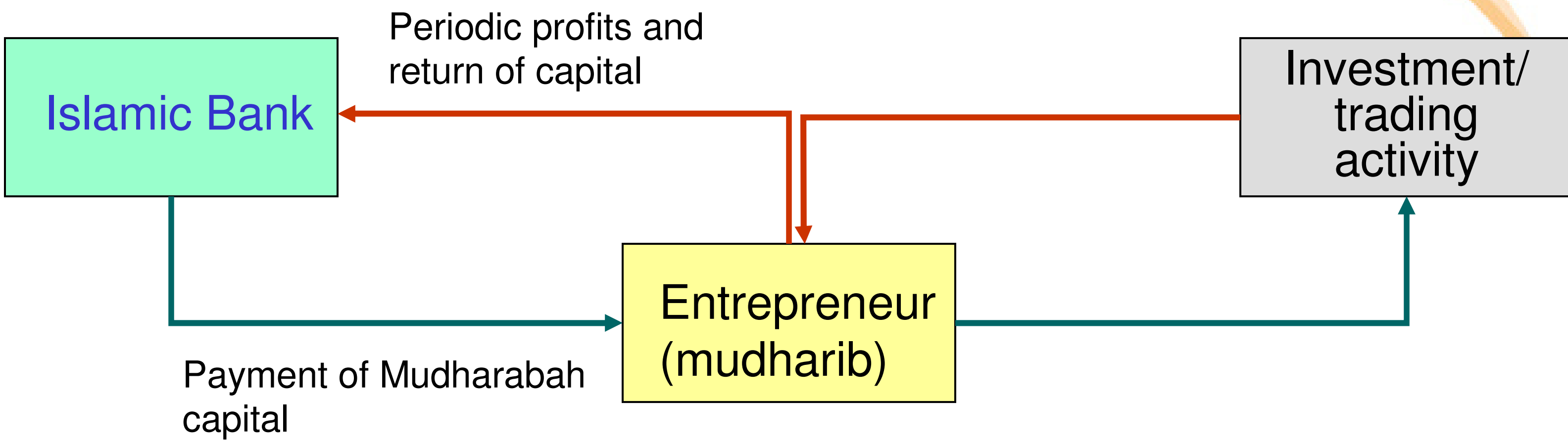


The responsibilities of various parties to a Musharakah contract are set out below:

- Both customer and bank contribute toward the capital of the enterprise
- Under diminishing musharakah, customer buys out bank's share over a period of time
- Customer and bank share in profits according to agreed proportions, which may be different from proportions of capital contributed. Any losses of enterprise will be borne by customer and bank according to their capital contributions.

MUDHARABAH (Profit Sharing)

Mudharabah is a contract between investors and FI that acting as a silent partner, invests in a commercial activity that earns each partner an agreed portion of profits of the venture. Mudharabah investments may be made for fixed terms and arranged through negotiable instruments and thus may have characteristics similar to those of shares.



The responsibilities of various parties to a Mudharabah contract are set out below:

- Bank provides to customer (mudharib) the capital to fund a specified enterprise
- Customer does not contribute capital but contributes management expertise (or entrepreneurship)
- Customer is responsible for day-to-day management of enterprise and is entitled to deduct its management fee (mudharib fee) from the enterprise's profits
- If the enterprise make a loss, bank has to bear all losses unless resulted from negligence