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Risk Analysis for Islamic Banks

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Review by:

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Risk Analysis for Islamic Banks is a joint work of Hennie Van Greuning and Zamir Iqbal. Hennie van Greuning who joined the World Bank in 1994 as a Senior Financial Sector Specialist in the Financial Sector Development Department is working since July 2000 as an Advisor in the Bank's Treasury. He has authored *International Reporting Standards: A Practical Guide*, and a joint work *Analyzing Banking Risk*.

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The World Bank Group, to which the two authors belong, has presented many important monographs, research papers and studies with respect to Islamic banking and finance. The IMF's interest in Islamic banking and finance goes back to 1980s and kept on growing. The present work is the latest valuable publication that deals with risk analysis for Islamic banks.

Islamic banking, or banking without interest, is one of the most discussed and practiced parts of Islamic economics, and maximum literature is available on the subject. However there is still dearth of writing on the risk analysis part

of Islamic banks. *Risk Analysis for Islamic Banks* is an important addition and a timely publication in the area of Islamic banking. In recent years, banks were increasingly involved in new information-based activities, such as trading in financial markets and generating income through fees, securitization and variety of other volatile and risky financial instruments. These developments have posed complex problems for measurement, management and control of risk. Islamic banks have not been immune of these challenges. It is with this feeling that this book has been authored. It provides a comprehensive overview of topics related to the assessment, analysis, and management of various types of risks in the field of Islamic banking.

This book is organized into four parts: Principles and Key Stakeholders, Risk Management, Governance and Regulation, and Future Challenges. The first part deals with a wide range of issues which assist in understanding the various aspects of Islamic banks. The second part provides a comprehensive explanation of the framework for risk analysis, the balance sheet and income statement structures. It also deals with the operational risk that includes credit risk, liquidity and market risk and risks specific to Islamic banking, such as reputational risk. The third part is concerned with governance and regulation dealing, with issues in Shari'ah governance, transparency and data quality, capital adequacy and Basel II. The fourth part deals with future challenges covering areas for improvement and some valuable recommendations. In total the book is divided into fifteen chapters in addition to three useful appendices: A) Glossary of Islamic Terms, B) Islamic Financial Services Board (IFSB) Standard and Risk Management, and C) Proposed Outline for Bank Analytical Reports. The book contains numerous boxes which give the reader at a glance the key messages of the chapters. It also consists of a large number of explanatory figures and tables which make its content comprehensible even for the non-experts. Aimed at non-specialist executives, no doubt, it is a successful attempt to provide a high level framework attuned to the current realities of changing economies and Islamic financial markets. Following is a little bit extended review of the chapters:

Chapter One deals with the principles and development of Islamic finance. In this connection the authors highlight Islamic teaching of justice and equity in economic matters, spiritual and moral dimensions of Islamic paradigm, balanced relationship between the individual and society, and recognition and protection of the property rights of all members of the society reminding them of their responsibilities. These teachings require elimination of *riba* (interest), *gharar* (contractual ambiguity), *maysir* (games of chance), monopoly practices, underselling, speculative hoarding and bidding up of prices without the intention of purchase. The authors present objections of Western analysts on

feasibility of a financial system operating without interest. They also note the counter arguments of Islamic economists. The chapter ends on a quick survey of the modern development of Islamic banking and finance both in the East and the West.

In Chapter Two which discusses theory and practice of Islamic financial intermediation, the authors affirm that the “financial intermediation in Islamic history has an established record. Such intermediaries were “bankers without banks’ (p. 17, with reference to Udowitch, 1981). In this chapter their statement about *mudarabah* is a little bit ambiguous, if not erroneous. It reads: “In a *mudarabah* contract, the owner of capital forms a partnership with an entrepreneur or manager who has certain business skills, and both agree to share the profits and losses of the venture undertaken” (p. 18). On page 195 the phrase “a pre-determined profit- and loss-sharing ratio” and on p. 226 “on the basis of profit-sharing and loss-bearing *mudarabah* contracts” have been used. It may be noted that in *mudarabah* the entire money-loss is borne by the capital owner. No loss-sharing by the entrepreneur or *mudarib* except that his labor will go unrewarded. However, on p. 24 they have correctly stated that “The investor bears the loss, but the agent does not share in any financial loss unless there is evidence of misconduct or negligence”. On the next page again the definition of *musharakah* is confusing when they say that: “*Musharakah* is a form of partnership in which two or more persons combine either their capital or their labor, ...”. The correct is that in case of *musharakah* both parties contribute their capital and both work (at least in theory). Another name for such a partnership is *sharikat al-`inan*. As far combining only their labor is concerned, it is termed as *sharikat al-`abdan* or *sharikat al-`amal*.

Under the section “Islamic Mortgage Companies” the authors present four models of Islamic mortgage practice and observe that the chances of success for Islamic mortgages are bright in Western markets, where capital markets are liquid, transparent and well-regulated” p. 28.

In Chapter Three which is entitled “Corporate Governance: A Partnership”, at the outset the authors emphasize the importance of sound corporate governance with respect to Islamic banks but Islamic input is missing in the rest of the chapter.

Chapter Four deals with the key stakeholders and their role in the industry. The internal stakeholders consist of bank regulators and supervisors, board of directors, executive managers, audit committee and internal and external auditors, Shar`iah boards, public and depositors, and shareholders. Out of these internal stakeholders, the Shar`iah boards are a distinct feature of Islamic banks.

They are responsible to protect the rights of all stakeholders according to the principles of Shar`iah. From the multilateral institutions IDB is committed to develop and promote Islamic banking and finance. Institutions like IMF and the World Bank have contributed through research. With the development of Islamic banks, several new institutions have emerged to strengthen the regulatory framework of Islamic banks. These include Accounting and Auditing Organization for Islamic financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB), International Islamic Financial Market (IIFM), International Islamic Rating Agency (IIRA) and Liquidity Management Center (LMC). This chapter gives a concise account of these institutions.

In Chapter Five, a framework for risk analysis has been provided. Although Islamic banks are different from conventional banks in many ways, nevertheless they are in need of a similar framework for analyzing their risk exposures. According to the authors “in the case of Islamic banks , added attention must be paid to the contractual role of the bank concerned, when analyzing the risks inherent in the bank’s assets and liabilities” p. 69. The central technique for analyzing financial risk is the detailed review of a bank’s balance sheet and financial reports. The problem with Islamic banks is that their financial reports generally do not contain all the information needed to perform effective financial analysis. In this chapter, the authors provide a conceptual framework to explain the background of various analytical tools with the intention to facilitate the development of similar tools for Islamic financial institutions.

Chapter Six which is entitled “Balance-Sheet Structure” highlights the importance of the structure and composition of liabilities and assets, as well as the related income statement items. It also illustrates the ways in which a bank’s risk managers and analysts can analyze the structure of balance sheets and income statements. In this connection figures depicting composition of an Islamic Bank’s balance sheet, structure of its assets, structural change and asset growth year on year have been used for analysis purpose. At the end it discusses the key principles of effective risk management.

Chapter Seven deals with the income statement structure, as it is a key source of information about the sources of its income. In this connection, composition of the income statement of an Islamic bank for the years 2005-06 has been used as an example. It was not made clear whether the statement is hypothetical or a real case. If it was real then what is the source?

Chapter Eight is on credit risk management which, is defined as the chance that a debtor or issuer of a financial instrument will not repay the principal and other investment-related cash flows according to the term specified in a credit

agreement that affects a bank's liquidity. Credit risk is considered as the principal cause of bank failure. The authors have clearly dealt with the credit risk specific to Islamic banks. They recommend that 'all staff involved in credit origination, appraisal, supervision, and other credit processes need to be trained in Islamic products and fundamental Shari`ah principles pertaining to defaults, penalties, and investor rights' pp.139-40.

Chapter Nine is on asset-liability management, liquidity, and market risks. Asset-liability management involves the raising and use of funds of which liquidity management is integral part and key banking function. In the authors' opinion, 'Islamic banks should theoretically be less exposed to asset-liability mismatches than their conventional counterparts. This comparative advantage is rooted in the "pass-through" and the "risk-sharing" nature of Islamic banks' p. 145. As far market risks are concerned, for Islamic banks they are similar to the market risks of conventional banks except that there is not interest rate risk. In the opinion of the authors, for certain reasons, liquidity risk is one of the most critical risks facing Islamic banks.

Chapter Ten discusses operational and Islamic banking risks. Operational risk is defined as the risk of loss resulting from the inadequacy or failure of internal processes, as related to people and systems, or from external risks. In addition to such risks, Islamic banks are exposed to several other risks specific to them, such as displaced commercial risk, withdrawal risk, fiduciary risk, Shar`iah risk, and reputational risk. The chapter deals with these kinds of risks. Under the fiduciary risk the authors' statement about mismanagement of the funds of current account holders needs to be reviewed. In fact such funds are accepted by the Islamic banks as a loan or *qard hasan*. This is explicitly declared or implicitly understood, to avoid complications arising out of juridical difference between *amanah* and loan. By declaring this the banks have one benefit, the permission to use them and have the profit, plus or minus. The other benefit will be for the depositors, banks will be liable to return the loaned amount irrespective of gain or loss. This was the practice used by Companion Zubayr b. al-Awwam and *imam* Abu Hanifah.

While discussing the transparency risk, Shari`ah risk and reputational risk, the authors have given valuable suggestions on how to circumvent them. Transparency and standardization of contracts and practices are necessary elements in all of them to avoid those risks.

Chapter Eleven is related to governance issues in Islamic banks. In addition to corporate governance of the conventional shareholder corporation, two broad sets of issues require specific treatment in the case of Islamic banks: full

compliance of financial activities with the Shar`iah precepts which is *raison d'être* of Islamic finance, and promotion of stakeholders' financial interest to their best satisfaction in terms of efficiency, stability, and trustworthiness as providers of financial services. Banks' compliance with Islamic law is ensured by Shar`iah boards which comprise scholars and Shar`iah experts. However, their services being remunerative, may compromise their independence. Such doubts are generally expressed.

According to the authors, a stakeholder view of governance based on the principles of property rights and the sanctity of contracts is fully supported by the Islamic economic system. These two elements differentiate the functions and obligations of an Islamic financial institution from those of a conventional bank. They consider investment account holders as quasi-equity holders. They should be provided opportunity to participate in governance of the financial institution. In the opinion of the authors since they do not participate in governance, they are at the mercy of public policy makers, regulators, and Shar`iah boards. A transparent and efficient governance arrangement is needed to include and protect their rights. The book examines its various aspects.

Chapter Twelve is on transparency and data quality. Islamic corporate governance must promote transparency to provide healthy environment for stakeholders because transparency is necessary for accountability, especially to borrowers and lenders, issuers and investors, national authorities and international institution. Transparency and accountability being mutually reinforcing, improve the quality of decision making in policy-oriented institutions. Transparency in financial statements requires the provision of relevant information, faithful representation, comparability and understandability. According to the authors 'Islamic banks have made considerable efforts to improve the level of transparency and the quality of information disclosed in the market in recent years. However, several areas still require attention' p.214. The concluding portion of the chapter gives an account of them.

Chapter Thirteen discusses capital adequacy and Basel II. Adequate availability of capital is necessary for safety and soundness of a bank. An adequate base of capital serves as a safety net for a variety of risks to which an institution is exposed in the course of its business. However, capital cannot be a substitute for good management. In this connection, the book gives contribution of Basel I and Basel II Accords. Basel Capital Accord of 1988, known as Basel I, which emerged as a result of 1980s' initiative, comprises a definition of regulatory capital, measures of risk exposure, and rules specifying the level of capital to be maintained in relation to these risks. It introduces a de facto capital

adequacy standard, based on the risk-weighted composition of a bank's assets and off-balance-sheet exposures that ensures that an adequate amount of capital and reserves is maintained to safeguard solvency' p. 221. Within a decade of Basel I accord so many changes in world financial system occurred that Basel I accord appeared to be inadequate and need was felt to have revision and improvement upon it. As a result a new Capital Accord (Basel II) was concluded in 2005. 'A significant aspect of Basel II Accord is the greater use of the banks' internal systems as an input to capital assessment and adequacy calculations and the allowance of more national discretion in determining how specific rules may be applied' p.222. On the pattern of Basel Accords, Bahrain-based the Accounting and Auditing Organization for Islamic financial Institutions (AAOIFI) and Malaysia-based the Islamic Financial Services Board (IFSB) have prepared standards on capital adequacy of Islamic financial institutions. In this connection they have taken into consideration the differences in the nature of intermediation by Islamic banks. The book enlightens the readers with a comparative analysis of Basel II and the Islamic Financial Services Board.

Chapter Fourteen deals with the relationship between risk analysis and bank supervision. The whole chapter is discussed in technical way without a reference to Islamic banks as if there is no difference between Islamic banks and conventional banks in matter of risk analysis and supervisory process. Islamic banks, with their specific risks, as noted at various occasions, must have some differences in terms of certain application, emphasis, inclusion or exclusion. These differences should have been made clear in the discussion. On page 241 there is a reference to Appendix D, but the book has no such appendix. Perhaps it should be Appendix C.

The last Chapter presents future challenge. It also contains a few warnings and a number of recommendations for healthy development of Islamic banks. According to the authors, 'the immediate need is to develop instruments that enhance liquidity; to develop secondary, money and interbank markets; and to perform asset-liability and risk management'. They make certain suggestions to enhance liquidity, widen the scope, diversify the investment, and strengthen the risk management and governance. While it is difficult to abide by their all recommendations, no doubt, most of them need serious consideration and effort for implementation.

The book is free from printing and typographic errors. However, there are some mistakes in transliteration system, the correction of which in the next addition or any reprint is recommended. For example: '*salam*' is everywhere written as '*salaam*' except on p.213; '*istisnah*' (at more than a dozen places)

should be written without 'h' as *istisna`*; *sukuk* p. 140 (singular = *sakk*, meaning check, security or certificate) is already plural, so it should not be made plural as '*sukuks*' (with s) on pp.14, 94, 95, 110, 158; *qard hassan* p. 274, or *qard ul-hasan* p. 282 should be simply *qard hasan* or *al-qard al-hasan*; *kifalah* pp. 19, 69, 267 (*kafalah*); *rab* pp. 20, 162 (*rabb*); *tikaful* p. 22 (*takaful*); *mu'ajjal* pp.23, 69 (*mu'ajjal*); *maysur* p. 6, *myisur* and *saysur?* P.282 (*maysir*); *hiba* p. 194 (*hibah*); and *bay`* pp.23 and 69, and *bai`* p. 275 (need consistency).

In spite of this minor flaw, the book is successful in its objective. It applies the modern methods of risk avoidance to Islamic banks wherever pertinent, or suggests alternative in cases where they are not applicable to Islamic banks because of their specific condition. The book presents the case of Islamic bank faithfully and understandingly. Due to its clear language, lucid style, and simple expression it is equally good for practitioners, teachers and students. In the absence of a textbook on the subject, it can be adapted and adopted as a textbook in institutions where risk analysis is part of the curriculum on Islamic banks.