Islamic banking: regulations and risks

Finance, Banks

Islamic banking is regulated under the principles of Shariah law. These principles prohibit interest-based transactions i. e. the receipt and payment of interest, known as " riba". According to Goh, the Islamic banks consider money as a medium of exchange in contrast to conventional banks which use money as an asset. Further, Shariah rules do not allow banks to take on ventures with excessive uncertainty, short sales and other ventures which are not considered ethical in Islam such as Alcohol, certain meat products etc. (Goh, 2018)

The underlying fundamental difference is about the factors of production. In the Islamic economic system, there are three factors of production land, labor and entrepreneurship and It does not recognize capital (money) as a factor of production. This basic difference has major implications for the Islamic banks such as they can only use either trading model or profit-loss sharing models for banking. According to Goh, " the balance sheet structure, as well as the risk profile of an Islamic bank, is different from that of a conventional bank. First, the 'pass-through' nature of the balance sheet of an Islamic bank. An Islamic bank's customers' return is linked to the return on the assets of the bank. This feature removes the typical asset-liability mismatch exposure of a conventional bank. Second, the assets of an Islamic bank contain financing assets where the tangible goods and commodities are purchased and sold to the customers. This practice creates distinct exposures. For example, in conventional car financing, a car is financed by a loan from the bank to the customer. But in the case of an Islamic bank, the asset and the financing are coupled together. Therefore, an Islamic bank is not limited to the exposure as a " banker" but may develop additional

exposures resulting from dealing with physical assets. Finally, due to the prohibition of interest, an Islamic bank cannot issue debt to finance the assets. This discourages the creation of leverage in the balance sheet. As a result, an Islamic bank is considered less risky. (Goh, 2018)"

Islamic banking started in the 1970s and since then it is gradually growing. However, the growth picked up the pace in the last decade especially after the industry became standardized because of the efforts of Islamic Financial Services Board (IFSB) " the standard-setting body to promote and enhance stability and soundness of Islamic financial services industry (International Financial Standard Board , 2019)". The standardization has made industry increasingly attractive for the investors, but it is still concentrated in some countries of the Islamic world. The nine countries have 93% of the total assets of the industry which are close to 2 trillion (MarketLine, 2019). In addition to the Islamic world, the United Kingdom is the biggest market for Islamic financial products. However, Islamic banks are uniquely positioned because they provide a unique opportunity to unbanked clients to become part of the financial system. It provides Islamic banks with a new set of customers and a huge growth opportunity.

This above-mentioned growth in the Islamic banking market has led to a higher market share in the respective markets. The higher market share of these banks has led to unique systemic to the respective markets and other associated risks for the banks which needed new assessment frameworks and control mechanisms. IFSB is setting new standards for Islamic banks to measure and mitigate those risks.

Unique Risks to Islamic Banks:

According to IMF, Islamic Banks will be considered systemically in any Country they have 15% or more market share (Nor Shamsiah Yunus, 2018). To manage those risks, the IMF endorsed the proposal developed by IFSB in coordination with the Basel Committee of Banking Supervision (BCBS) to use the Core Principles for Islamic Finance Regulations. Before understanding these core principles, the unique risks as identified by IFSB and BCBS related to Islamic banks are appended herewith:

Credit Risk: The Islamic banks are exposed to credit risk especially while dealing with Murabahah financing (cost plus profit). In contrast to conventional banks, Islamic bank purchases the underlying goods and then sell on profit to the customer. It exposes Islamic banks to additional risks because of the payment to the supplier and the change of ownership of the underlying asset multiple times. Further, the Islamic principles do not allow banks to charge interest or penalty to the customer in case of default which creates additional problems for the banks. (Nor Shamsiah Yunus, 2018)

Market Risk: in recent years, Islamic banks have introduced multiple new products by using commodities in their transaction structures. These structures expose Islamic banks to movements in market prices. These unfavorable movements can have a negative effect on the balance sheet of the bank. Historically, Islamic banks have hedged such exposures but with the growth of Islamic banks the transaction structures are getting complexed. (Nor Shamsiah Yunus, 2018)

Operational Risk: Operational risk is defined as " the risk of loss resulting from inadequate or failed internal processes, people and systems, or external events." In the Islamic banking environment, the operational risks are much higher than the conventional banks because each product/transaction should get the Shariah board approval. It also increases the reputational risk for the bank because the customer's faith is part of product offering and in case of any oversight in this regard can hurt the bank's reputation. In addition to these risks, the transaction structures involve real asset which carries their contractual risks especially buying and selling back transactions which involve multiple changes in ownership. (Nor Shamsiah Yunus, 2018)

Liquidity Risk: Islamic banks have faced liquidity because of the non-availability of wholesale funding in the market and Shariah-compliant products for short term liquidity from the governments except in markets such as Malaysia, Saudi Arabia, etc. Traditionally, the T-bills and government bonds are not Shariah-compliant even in the majority of Muslim countries. Therefore, financial institutions have to rely on a limited amount of Sukuks that are already available. However, the Sukuk market is growing which is increasing the availability of wholesale funding in the market. (Nor Shamsiah Yunus, 2018)

Rate of Return Risk: In contrast to interest rate risks, the Islamic banks are exposed to the rate of return risks. The Islamic Banks are concerned about the holding period returns when their investment matures because it cannot de pre-determined exactly. Further, Islamic banks cannot increase the rate

of return on their investments when the overall rate of return increases in the market due to monetary policy measures. Further, Islamic Banks have limited opportunities in the market because these institutions cannot invest businesses that are prohibited in Islam such as Alcohol, Gambling, etc. (Nor Shamsiah Yunus, 2018)

Core Principles for Islamic Finance Regulations:

The core principles for Islamic Finance Regulations were endorsed by the IMF to set the core principles for the regulation and supervision of the Islamic banking industry. The standards were made for the Islamic banks after taking into consideration their special needs and associated risks. These standards will also complement the financial stability of the sector and homogeneous regulatory framework across the globe. These principles will also help governments in supervising, regulating and creating an enabling environment for the Islamic Banking Industry. Further, these appended principles will apply to Islamic banks in addition to Basel Core Principles (BCP):

Treatment of Profit-Sharing Investment Account (PSIA) /Investment Account Holders (IAH): The deposits of Islamic banking are usually structured in the form of Mudarbah where Islamic bank acts as Mudarib or an agent. It means that the bank will act on the customers' behalf and will invest the funds. Under these accounts, the principles require both parties to disclose or agree upon the profit-sharing ratio upon entering into the agreement and the investor will be solely responsible to absorb the loss. However, the bank needs to act with the utmost caution as it is the fiduciary duty of the bank.

Therefore, the regulator is responsible to reinforce market discipline by introducing regulations that require timely and relevant information disclosures. Further, there must be prudential limits on the percentage of funds that can be invested in certain sectors such as real estate, capital markets, and large exposure limits. These will have regulatory implications in terms of appropriate governance (including Shariah governance), capital adequacy requirement, disclosure, and resolution framework (Nor Shamsiah Yunus, 2018). Moreover, the regulators must ensure the competence of Islamic banks to perform their fiduciary responsibilities at all times.

Shariah Governance Framework: Islamic Banks are exposed to Shariah non-compliance risk at all times in all transactions. It starts from the source of funding to the investment of funds. The non-compliance can result in a non-recognition of income, but the bigger risk is reputation risk which can result in a loss in future business, withdrawal of deposits and investment funds. Therefore, Islamic banks must have their Shariah board which will approve each product offering and the large transaction to ensure the compliance of Shariah Principles. In addition to banks, the regulator should also have the mechanism to assess the compliance of Shariah rules and regulations at all times. It should ensure that Islamic banks have the appropriate policies, systems, and procedures to manage the risk. To perform these responsibilities, the regulators must have in-house or external parties at their disposal. (Nor Shamsiah Yunus, 2018)

Rate of Return Risk: Islamic banks are more susceptible to the rate of return risk when the overall return in the market increases, but it is impossible for

them to change their investment returns because those are not linked with interest rates. However, the deposit holders expect higher returns which are in-line with the market. In such situations, banks sometimes let go of their share of profit to retain the customers. This decision should be made under the clear policies and procedures approved by the Board of Directors. In addition to such policies and procedures, Islamic Banks must build reserves against such losses. (Nor Shamsiah Yunus, 2018)

Equity Investment Risk: The funds invested by Islamic banks may be used to purchase shares in a publicly traded company or privately held equity or invested in a specific project, portfolio or through a pooled investment vehicle. In the case of a specific project, IBs may invest at various stages of the project. Besides, the delays and variation in cashflow patterns and possible difficulties in executing a successful exit strategy may pose a challenge. The capital invested by the provider of finance does not constitute a fixed return but is explicitly exposed to capital impairment risk in the event of losses. The supervisory authority should ensure that the Islamic Banks have appropriate and consistent valuation methodologies, define and establish the exit strategies in respect of their equity investment activities and have sufficient capital when engaging in equity investment activities, and that rules or guidelines are in place for measuring, managing, and reporting the risk exposures when dealing with nonperforming equity investments and providing provisions. (Nor Shamsiah Yunus, 2018)

Islamic " Windows" Operations: An Islamic window operation is part of a conventional financial institution that provides both fund management

(investment accounts) and financing and investment that are Sharī`ah compliant. Islamic windows raise supervisory issues beyond those posed by full-fledged IB, because of the potential for commingling of funds and regulatory arbitrage. In addition, supervisory practices for regulating Islamic windows related to capital requirements vary considerably across jurisdictions. The supervisory issues raised by such operations are substantially the same as those faced by full-fledged Islamic banks but include issues on the legitimacy of the generated profits and risk management in respect of the Shariah-compliant assets and liabilities. Therefore, Banks need to have internal systems, procedures, and controls to provide reasonable assurance that the transactions and dealings of the windows comply with Sharī`ah rules and principles, Islamic and non-Islamic business are properly segregated and the institution provides adequate disclosures for its window operations. (Nor Shamsiah Yunus, 2018)

Conclusion

The Islamic banking industry has seen unprecedented growth in the last two decades in terms of assets and market size. These banks are positioned to provide financial services to the unbanked population, but the risk is that the population is not financially savvy. This increases the responsibility of the regulator to protect the interests of depositors and the health of the overall financial system. Further, these banks have to comply with Shariah laws which makes it harder for them to integrate into the conventional economic system; hence, it needs government support for the enabling legal and regulatory environment to thrive. Further, the Islamic banks are less risky in

the long run because the transactions are based on real asset and it cannot create leverage without underlying real assets, but these banks are more susceptible to short term price movements of the market. Therefore, the IMF has endorsed the recommendations proposed by IFSB, in coordination BCBS, to provide a regulatory framework that assesses the risks associated with the industry. This is a huge step forward for the industry because it makes it easier for countries to adopt Islamic banking and from a regulatory perspective, it will be easier to create a regulatory framework and supervise the industry. The introduction of separate principles for Islamic banking supervision in addition to basic principles will provide a sound framework for supervisors and new opportunities for Islamic banks.

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