Structure of the balance sheet of islamic banks

Finance, Banks

INTRODUCTION

Structure of the Balance Sheet of Islamic Banks

Liquidity is an important characteristic of banks. By their very nature, banks transform the term of their liabilities to have different maturities on the asset side of the balance sheet. At the same time, banks must be able to meet their commitments such as deposits at the point at which they become due. Thus, liquidity management lies at the heart of confidence in the banking operation. Customers place their deposits with a bank, confident they can withdraw the deposit when they wish. If the ability of the bank to pay out on demand is questioned, all its business may be lost overnight. The importance of liquidity transcends the individual institution, since a liquidity shortfall at a single institution may invoke systemic repercussion causing harm to the whole financial stability of a country. Therefore it is important for banks to have adequate liquidity potential when it can obtain sufficient funds promptly and at a reasonable cost. For Islamic banks, liquidity risk is a significant risk owing to the limited availability of Shariah-compatible money market instruments and Lender-Of-Last-Resort (LOLR) facilities. Hence, the recent introduction of commodity murabahah instrument based on tawarruq concept by Central Bank of Malaysia is deemed as an innovative approach to liquidity management. It certainly adds to the list of instruments for Islamic banks to manage their liquidity more effectively and efficiently. This paper reviews the structure and mechanism of commodity murabahah particularly for liquidity management purpose. As will be evident in this paper, this instrument has its own advantage which appeals to certain practitioners who

were previously uncomfortable with `inah-based instruments (www. acrobatplanet. com).

Liquidity management lies at the heart of confidence in the banking operation. Customers place their deposits with a bank, confident they can withdraw the deposit when they wish. If the ability of the bank to pay out on demand is questioned, all its business may be lost overnight. In general terms, liquidity refers broadly to the ability to trade instruments quickly at prices that are reasonable in light of the underlying demand/supply conditions through the depth, breadth and resilience of the market at the lowest possible execution cost (Pervez, 2000). A perfectly liquid asset is defined as one whose full present value can be realized, i. e. turned into purchasing power over goods and services, immediately (Tobin, 1987). Cash is perfectly liquid, and so for practical purposes are demand deposits, and other deposits transferable to third parties by cheque or wire, and investments in short term liquid government securities (Abdul-Rahman, 1999). The importance of liquidity transcends the individual institution, since a liquidity shortfall at a single institution may invoke systemic repercussion causing harm to the whole financial stability of a country. Therefore it is important for banks to have adequate liquidity potential when it can obtain sufficient funds promptly and at a reasonable cost (Heffernan, 1996).

The concern over liquidity management is also relevant to Islamic bank that holds illiquid assets while its liabilities are liquid, and holds assets unpredictable in value while guaranteeing the value of its liabilities. Thus, since Islamic banks follow the same structure and characteristics of a

commercial banks' balance sheet, they are not immune from liquidity risk. The potential mismatch between deposits and investment financing exposes Islamic banks to liquidity problems. On the other hand, if the banks maintain too much liquidity to avoid getting into the liquidity problems may in turn hurt its profitability, therefore creating a right balance between the two objectives of safety (www. acrobatplanet. com).

Off-balance-sheet financing

Also called synthetic leases, this is where a company uses rules from different systems, such as financial and tax, to account for an asset in different ways.

For example, I lease a computer from company A. Because I don't own the computer (and I am assuming this is not a capital lease), I get to take the rent expense (for the lease) as a deduction on the books, but I don't have to account for the asset or the debt, therefore it is not on the balance sheet. This is attractive because it creates no debt on the company's books. It is often done through a SPE (Special Purpose Entity). Though lucrative, it has contributed to the demise of companies such as Enron.

The lessor (company A) maintains the asset on their books and, if they financed it from another company (company B), the debt as well.

Credit card issuers, mortgage companies and various other entities also use a type of off-balance-sheet financing known as asset backed securitization (ABS). The ABS process effectively allows a company to sell a portion of the loans (receivables assets) to investors, effectively removing the assets from

their balance sheets (allowing a lower level of reserves, and, therefore capital) while managing the servicing of the debt (http://wiki. answers. com).

AIMS AND OBJECTIVES OF THE STUDY

- To study the structure of the balance sheet of Islamic banks
- To study the “ On Balance Sheet Financing” as compared to “ Off Balance financing”.
- Critical appraisal of the structure of the Balance Sheet of Islamic Banks.

BACKGROUND AND ANALYSIS

Risk management and liquidity are of crucial importance in the overall banking environment, and they have clear relevance also to the specific environment of Islamic banking. In itself, Islamic banking is of growing significance. Regulators have their own particular perspective on these issues.

As a regulator based in London the Financial Statement Analysis (FSA) should focus on the following:

- The importance of London as a centre of Islamic financing.
- The overall role of the FSA as a regulator – why sound regulation is of critical importance in any financial marketplace, how it can assist in facilitating competition and innovation.
- Risk management issues in banking: a summary of the key elements involved.
- Risk management and liquidity issues as applied to Islamic banking.

- The perspective of the regulator, and why the UK operates a single regulatory framework for all firms.

The importance of London as a centre of Islamic financing

London is clearly one of the pre eminent centres of Islamic finance, for two main reasons. These are the presence of sizeable Muslim community in the UK; and the importance of London as a financial centre with the expertise to develop new and innovative products. The FSA as Regulator welcomes the development of Islamic finance, and would be happy to see this grow further. Other important centres include Bahrain and Malaysia (www. financeinislam. com).

London plays a role in four areas of significance in Islamic banking:

Trade assets such as murabaha, istisna'a, and bai-al-salam. The market is probably worth US$ 10 billion in the UK.

Equipment leasing – asset and partner selection, operating leases and finance leases

Real estate – where investors are looking for rental and capital benefits. Investment routes include fund management, club transactions, leverage funding, and asset analysis, corporate structuring and tax planning.

Packaging and delivering assets engineering solutions. This includes a growing market in securitizations of pools of Shariah compliant assets.

The role of the FSA as a regulator

The Government has set the FSA four objectives:

Market confidence

Public awareness of the financial system

Consumer protection

Reducing financial crime

The new FSMA will bring in eleven principles for the handling of business, which set out at a high level how we expect a firm and its management to conduct themselves. In terms of minimum criteria, the FSA has to be satisfied that institutions have adequate capital, adequate liquidity and adequate control over large exposures. Banks of what ever origin must be prudently run and that their management must be fit and proper for the task. Satisfactory risk management, a realistic business plan, and adequate systems and controls need to be clearly demonstrated. The FSA must be satisfied also that each institution is subject to effective consolidated supervision – i. e., that one supervisory authority takes prime responsibility for supervising the bank or banking group as a whole (www. financeinislam. com).

RISKS, PROBLEMS AND CHALLENGES

Risk management issues in Islamic banking

Senior management in any business must be able to provide effective risk management. The consequences of failure to do so are dire, for example, the

collapse of Barings where proper controls and monitoring were not effectively in place:

Regulators need to be sure that such risks are managed so as to prevent a worst case scenario such as the systemic collapse of a whole banking system. Critical issues for Islamic banks are the reputational risks and legal risks of non-compliance from Shariah board requirements and/or from engaging in any activities that were not perceived as properly Islamic by the marketplace. The maintenance of trust amongst Islamic market participants is crucial (www. financeinislam. com).

Credit risk

This is the risk that customers default and cannot service their debts. Banks can also suffer from the excessive concentration of exposures to particular customers, industries or countries. Asset quality should be closely monitored using appropriate management information and systems support. Islamic banks run an asset book, just as conventional banks do, so the same disciplines must apply.

Liquidity risk

Banks face collapse or severe trading difficulties when they are unable to meet their liabilities. For example, many Japanese institutions operating in London in the late l990s were hit when the Japanese premium increased their funding costs and eroded their liquidity. This did not mean, however, that they became unable to meet their liabilities. For the FSA, liquidity is a key concern. The dilemma for the Islamic sector is that liquidity from the Gulf is currently very substantial, but there is the need to seek out appropriate

outlets for it. There is not a clearly defined lender of last resort for Islamic banks that might suffer liquidity problems, although support could probably be found from with in the overall pool of liquidity.

Interest rate risk

The risk of declines in earnings due to the movement of interest rates, most of the balance sheet items of banks generate revenues and costs that are indexed to interest rates. A key aspect of interest rate risk is also the possible mismatches that can arise between fixed and floating rates. In the Islamic banking context, interest rates per se are not a factor. However, commissions generated on Islamic transactions could also be vulnerable to market movements.

Market risk

The risk of adverse deviations of the mark-to-market value of the trading portfolio during the period required to liquidate the transactions. Islamic financial institutions take up “ risk sharing” funds, whereas conventional banks take “ capital certain” deposits where repayment must be made. There is the implicit requirement for both parties to a given transaction to share in the loss as well as the profit.

Foreign exchange risk

The currency risk of suffering losses due to changes in exchange rates. This principle applies equally to Islamic banks. Letter of credit and trade finance for example, a significant proportion of which is denominated in US Dollars, often pose an exchange risk. Currency transaction and translation Factors must be taken into account.

Solvency risk

The risk that financial institutions will be unable to hold sufficient capital resources to cover their different risks, regulators need to decide what amount is held, supervise, in order to maintain an appropriate level of solvency. Islamic banks need to be clear about the status of their deposits or liabilities. Any “ capital-certain” transactions generate more solvency risk than risk-sharing with investors.

Operational risk

There is no precise definition, but we view operational risk as being the risk that arises from human error and/or deficiencies in information systems or controls, resulting in direct or indirect loss. In the Islamic banking context, operational risks can impact just as much as in conventional banking, with the additional element of possible operational defects causing failure to comply with the Shariah (www. financeinislam. com).

FINDINGS

Risk management and liquidity issues as applied to Islamic banking

This is a very important area and a number of key regulatory issues are under review. For example, whether liquidity requirements should apply to all on-balance sheet funds, risk sharing as well as capital certain; and how liquidity should be managed for funds, which are held off balance sheet. The basic issue, however, as for any bank is how easily and quickly, and with what penalty, assets can be turned into cash. The establishment of a genuine inter-bank market or markets would be a significant step towards providing Islamic banks with the ability to maintain adequate liquidity without holding excessive amounts of very short-term assets. For example, it

was very interesting to note that the Bahrain Monetary Authority (BMA) announced the first issue of its Islamically-structured bonds – the Sukuk al-Salaam – worth US$ 25mn. ABC Clearing Company BC and ABC Islamic Bank have been active in offering overnight investment opportunities for Islamic funds for a number of years.

BNP Paribas and Kuwait Finance House signed a memorandum of understanding for the creation of a US$ 2bn Islamic money market fund (IMMF). Bank of America, Deutsche Bank, and ABN AMRO also plan to launch such instruments. Malaysia has also been developing an Islamic inter bank market. These developments offer potential flexibility to Islamic banks. UK practice is such that the Financial Statement Analysis (FSA) has scope to take account of such developments when agreeing liquidity guidelines with banks (www. financeinislam. com).

CONCLUSION

There are two different categories of commercial financing from an accounting perspective: on-balance-sheet financing and off-balance-sheet financing. Understanding the difference can be critical to obtaining the right type of commercial financing for your company. Put simply, on-balance-sheet financing is commercial financing in which capital expenditures appear as a liability on a company’s balance sheet. Commercial loans are the most common example: Typically, a company will leverage an asset (such as accounts receivable) in order to borrow money from a bank, thus creating a liability (i. e., the outstanding loan) that must be reported as such on the balance sheet.

With off-balance-sheet financing, however, liabilities do not have to be reported because no debt or equity is created. The most common form of off-balance-sheet financing is an operating lease, in which the company makes a small down payment upfront and then monthly lease payments. When the lease term is up, the company can usually buy the asset for a minimal amount (often just one dollar). The key difference is that with an operating lease, the asset stays on the lessor's balance sheet. The lessee only reports the expense associated with the use of the asset (i. e., the rental payments), not the cost of the asset itself (www. evancarmichael. com).

Why Does It Matter?

This might sound like technical accounting-speak that only a CPA could appreciate. In the continuing tight credit environment, however, off-balance-sheet financing can offer significant benefits to any size company, from large multi-nationals to mom-and-pops.

These benefits arise from the fact that off-balance-sheet financing creates liquidity for a business while avoiding leverage, thus improving the overall financial picture of the company. This can help companies keep their debt-to-equity ratio low: If a company is already leveraged, additional debt might trip a covenant to an existing loan. The trade-off is that off-balance-sheet financing is usually more expensive than traditional on-balance-sheet loans. Business owners should work closely with their CPAs to determine whether the benefits of off-balance-sheet financing outweigh the costs in their specific situation.

Other Types of Off-Balance-Sheet Financing

An increasingly popular type of off-balance-sheet financing today is what’s known as a sale/leaseback. Here, a business sells property it owns and then immediately leases it back from the new owner. It can be used with virtually any type of fixed asset, including commercial real estate, equipment and commercial vehicles and aircraft, to name a few.

A sale/leaseback can increase a company’s financial flexibility and may provide a large lump sum of cash by freeing up the equity in the asset. This cash can then be poured back into the business to support growth, pay down debt, acquire another business, or meet working capital needs.

Factoring is another type of off-balance-sheet financing. Here, a business sells its outstanding accounts receivable to a commercial finance company, or “ factor.” Typically, the factor will advance the business between 70 and 90 percent of the value of the receivable at the time of purchase; the balance, less the factoring fee, is released when the invoice is collected.

Like with an operating lease, no debt is created with factoring, thus enabling companies to create liquidity while avoiding additional leverage. The same kinds of off-balance-sheet benefits occur in both factoring arrangements and operating leases.

Keep in mind that strict accounting rules must be followed when it comes to properly distinguishing between on-balance-sheet and off-balance-sheet financing, so you should work closely with your CPA in this regard. But with the continued uncertainty surrounding the economy and credit markets, it’s

worth looking into the potential benefits of off-balance-sheet financing for your company (www. evancarmichael. com).

The perspective of the Regulator

The fundamental stance of the regulator is that the same principles in the handling of risk should apply for Islamic as for non-Islamic banks and financial entities. There has to be a level playing field.

For the regulator, risk management in the Islamic context is becoming easier to understand as the following develop:

A set of common international equivalent accounting standards. The AAOIFI is a doing a lot of good work in this area but we need to see more harmonization.

Greater standardization of products.

A clear role for the Shariah Board. For example, if there were to be one Board per country it should assist in giving consistency of interpretation of the Shariah.

The FSA has had no applications for authorization from purely Islamic banks. If an application were to be made, it would be considered against our minimum criteria and principles for business. For us, an important aspect of any application would be the effectiveness of the applicant’s risk management systems and controls (www. financeinislam. com).