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Risk Management for Islamic Banking Products

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Abstract

Risk management is one of the most powerful indicators of high business reputation of the bank. Its level is reflected in the Bank's credit rating, which in this aspect affects the value and volume of funding. Effective risk management is the key to stable relations with supervisors and minimizes the possibility of risk events. In modern conditions the question is often asked about the diversity of the economy, as well as the elicitation of alternative sources of financing, including methods of risk management. According to many scholars, Islamic finance can act not only as alternative, but complementary ways of financing. Islamic finance is used, regardless of religious beliefs of a person; at the same time the traditional banks do not always find their application in Islamic countries. It says about the competitiveness of Islamic finance and the free movement in all economic systems of the world. This article describes some of the local risk management techniques of Islamic banks, which contain a detailed description of the procedures for individual components of the risk management process, peculiar features of the management of individual types of risks, the analysis of the bank's stability to risks, the procedure of using the results obtained in the process of risk management and analysis of the stability of the bank, and other necessary procedures, orders and regulations.

Keywords: Islamic banking, Islamic banking products, Islamic finance and credit organizations, risk management.

1. Introduction

In connection with the expansion of lending and investing activities, the introduction of new loan products and borrowing on the capital markets, the differences in standards for banks, the most urgent problem is a formulation of a balanced system of management of credit and investment risks. In the Russian banks in one way or another some individual elements of credit and investment risk management have already been operating, however, as a rule, they do not meet modern requirements for risk management[1].

The most dangerous among the global economic crisis are credit risks. They are very difficult to determine, even under the condition of government support. Analyzing the situation that has developed with Western banks, it is possible to judge about the inevitability of a second wave of the crisis for the Russian banks. According to the Deputy General Director of JSC “Interfax Business Service”, Ph.D. A.Buzdalin: “... Russian subsidiaries of foreign banks and the banks with a dominant share of the state in the authorized capital adhere to moderate credit policy that can protect them from crisis events. Credit risks may increase significantly in the credit portfolios of private Russian banks.”[2]

In order to strengthen the stability of the financial system in whole, European banks used the document of the Basel Committee on Banking Supervision as a basis for improving the quality of risk management, including credit - “International Convergence of Capital Measurement and Capital Standards: New Approaches”, which contains methodical recommendations on banking regulation, referred to as “Basel II”.

Later, the Basel Committee on Banking Supervision in September 2010 approved a global reform of the world’s banking sector and adopted a set of new rules and standards for the structure and quality of bank assets called “Basel III”. “Basel III” involves the increasing of the financial stability of the global banking system, primarily due to the increasing of a bank liquid reserves and improving their quality.

The main idea is to increase the available free capital of banks to cover their financial losses. Thereby the power of the banks’ ability to withstand financial crises increases.

Risk management has become the object of study not only by foreign scholars such as Andrew Holmes, Thomas L. Barton, William G. Shenkir, Paul L. Walker, but also by Russian, in particular, such scientists and representatives of banking examined risk management: Alpigina A.P, Fomicheva A.N., Stupakova V.S, Tokarenko G.S. and others.

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[1] Bekkin (2009).
[2] http://www.buzdalin.ru/text/bdm2.pdf.

Thus the main aim of the article is to show the focal points of risk management in Islamic banks, as risk management system has long been recognized as a vital element in the management of any bank and this guarantees its competitiveness.

Precise and rapid implementation of operational procedures, the absence of errors and failures, performance of the obligations of banks are the key factors to attract customers in any economic environment. The reliability itself is the guarantee to stable development, as well as the high confidence of the customers.

2. Problem formulation

In the context of a variety of internal and external risk factors can be used various ways to reduce the risk that affect one or another aspect of the bank.

Risk management can be divided into:

1. The methods of risk aversion
2. The methods of localization of risks
3. Methods of risk diversification
4. Payment Methods risks

When choosing a particular method of risk management bank must apply the following principles:

- do not risk more than they can afford their own capital;
- do not risk much for the small;
- should anticipate the consequences of risk.

Risk management - a process related to the identification, risk analysis and decision-making, which include maximizing the positive and minimizing the negative consequences of risk events. The risk management process typically includes the following procedures:

a. Risk Management Planning;
b. Identification of risks;
c. Qualitative risk assessment;
d. Quantitative evaluation;
e. Risk Response Planning;
f. Monitoring and controlling risks.

All these procedures interact with each other and with other procedures. Each procedure is performed at least once in each project. Despite the fact that we consider in this paper risk management in Islamic banks, data elements with well-defined characteristics, in practice may overlap[3].

Thus, we propose to move in risk management to an integrated approach, in

[3]http://www.risk24.ru/upravlenie.htm.

which the means and methods are shared across the enterprise, and in the management of the company has a well-thought-out strategy. Integrated approach - an active position, since it implies foresight rather than a passive response to the risk that such an approach provides more possibilities and limits of danger.

3. Problem solution

Of course, any bank activity has some risks. But returning to Islamic finance as one of the sources of sustainable development it is possible to offer an alternative to the risk management instruments mentioned above[4].

Risk assessment and risk communication systems.

The Bank's risks are measured using a method which reflects both the expected loss, which could be likely arisen in normal circumstances, and unexpected losses, which are an estimate of the ultimate actual losses based on statistical models. The models use the probabilities derived from historical experience and adjusted to reflect economic conditions. The Bank also creates the "worst scenario", which will take place in the case of events that are considered as hardly probable.

Monitoring and controlling of risks are primarily based on the limits established by the Bank. Such limits reflect the business strategy and market conditions of the Bank as well as the level of risk which the Bank is ready to accept, with additional emphasis on selected industries. In addition, the Bank monitors and measures its inner ability to bear risks in relation to the overall position in all risk types and activities.

The information received from all the businesses is examined and processed in order to analyze, control and identify early risks. The mentioned information is presented and explained to the Board, the Committee on Asset and Liability Management and the Credit Committee. The report includes the aggregate credit exposure, predictive credit metrics, hold limit exceptions, liquidity and changes in the level of risk. The information is available monthly about the risks in the branches, customers and geographic regions. The Management of the Bank monthly assesses the necessity of the bank reserve for credit losses. The Board of Directors receives on a quarterly basis a detailed risk report, which contains all the necessary information for the risk assessment of the Bank and making appropriate decisions. For all the levels of the Bank various risk reports are made, which are distributed in order to give an access to necessary and relevant information to all the business divisions. The Bank actively uses facilities to reduce its credit risk.

[4] Nurmuhanbetov (2009).

Excessive risk concentration.

Concentrations of risk arise when a number of counterparties are engaged in similar business activities, or their activities are done in the same geographic region, or they have similar economic characteristics, and as a result of changes in economical, political or other conditions have similar effects on the ability of counterparties to meet contractual obligations. Such concentrations indicate the relative sensitivity of the Bank activity to the changes in conditions that affect a particular industry or geographic region.

In order to avoid excessive concentrations of risk, the Bank's policies and procedures include specific guidelines to focus on maintaining a diversified portfolio. The control and management of the identified concentrations of credit risk are fulfilled.

Credit risk.

Credit risk is the risk that the Bank will bear a loss due to the fact that its clients or counterparties failed to discharge their contractual obligations. The Bank manages credit risk by setting limits on the amount of risk which it is willing to accept for some individual counterparties and for geographical and industry risk concentrations, and by monitoring of compliance with risk limits.

The Bank develops a procedure of a credit quality check in order to provide early identification of possible changes in the creditworthiness of counterparties, including regular collateral revisions. The counterparty limits are established by using a credit risk classification system, which assigns a risk rating to each counterparty. The ratings are reviewed regularly. Credit quality review procedure allows the Bank to assess the potential loss on the risks to which it is exposed and take corrective actions.

The bank manages the credit quality of financial assets using its internal system of credit ratings. According to the Bank's policy the Bank should maintain accurate and consistent risk ratings across the credit portfolio. This facilitates the possibility of focused management of the applicable risks and allows to compare the credit exposures across all lines of business, geographic regions and products. The rating system is based on a number of financial analytic methods, combined with processed market data which are the main inputs for the measurement of counterparty risk. All internal risk ratings are modified in accordance with the Bank's rating policy. Attributable risk ratings are assessed and updated regularly.

The evaluation of impairment.

The main factors that are taken into account when checking the accounts receivable from the activities of Islamic finance for impairment are as follows: if the overdue payments on the receivables are more than 90 days; if it is known about financial difficulties of the counterparties, the downgrading of their credit rating, or violation of the original terms of the contract. The Bank addresses impairment assessment in two levels – the reserves, estimated on an individual basis, and the reserves collectively assessed.

Individual basis reserves.

The Bank determines the reserves creating of which is necessary on each individually significant account receivables from the activity on Islamic finance, on an individual basis.

In determining the amount of reserves the following circumstances are taken into account: the reliability of the business - plan of the counterparty; his ability to improve the activity in case of financial difficulties; projected amounts receivable and the expected dividend payout in the event of bankruptcy; availability of other financial assistance; realizable value of collateral; as well as the timing of the expected cash flows. Impairment losses are evaluated at each reporting date, except in cases when more attention to contingency is required.

Collective basis reserves.

The reserves on accounts receivable from Islamic financing activities are measured collectively, which are not individually significant and for individually significant receivables for which there is no objective evidence of individual impairment. The reserves are measured at each reporting date with each portfolio receiving a separate review. In assessing on a collective basis the impairment is determined based on the portfolio, which can occur even in the absence of objective evidence of individual impairment. Impairment losses are determined on the basis of the following information: previous losses on the portfolio, current economical conditions, the approximate period of time from the moment of the possibile loss and the moment of the establishment of the fact that it requires an individually assessed impairment allowance, and the expected receipts and recoveries once impaired. The Management of the unit is responsible for the definition of such a period, which can last up to one year. Impairment allowance is then verified by a division of risk management for its compliance with the general policy of the Bank.

Liquidity risk and funding management.

Liquidity risk is the risk that the Bank will be unable to meet its payment obligations when they fall due under normal and stress conditions. To limit this risk, the Management has arranged an accessibility of diversified funding sources in addition to its minimal deposit base. The Management guides assets management paying attention to the liquidity, and daily monitoring of future cash flows and liquidity. This process includes an assessment of expected cash flows and the availability of high grade collateral which could be used to secure additional funding if required.

The Bank maintains a diverse portfolio of highly marketable assets that can be quickly implemented for cash in the event of an unforeseen interruption of cash flow. The Bank has also concluded an agreement on lines of credit that it can use to meet liquidity needs. Liquidity position is assessed and managed by the Bank primarily on a standalone basis, based on certain liquidity ratios.

Market risk.

Market risk is the risk that the fair value or future cash flows of financial instruments will fluctuate due to changes in market variables such as exchange rates.

Currency risk.

Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. The Committee on Asset and Liability Management sets the limits of the risk level by currency and in accordance with directions. These positions are monitored on a daily basis.

Operational risk.

Operational risk is the risk of direct or indirect loss arising from a wide variety of causes associated with the processes, staff, technology and infrastructure of the Bank, as well as external factors, while credit risk, liquidity risk and market risk arises from changes in legal requirements and the principles of Sharia and regulatory requirements and generally accepted principles of the corporate management. Operational risks arise from all the Bank's operations.

The purpose of the Bank is to manage operational risk so as to balance the prevention of financial losses and damage to the Bank's reputation with overall finance effectiveness and to avoid the control procedures that restrict initiative and creativity.

The primary responsibility for the development and implementation of controls regarding operational risk is assigned to senior management in the financial and operational units. This responsibility is based on the development of common standards for the Bank's operational risk management in the following sectors:

- Requirements for appropriate segregation of duties, including the independent authorization of transactions;
- Requirements for the reconciliation and monitoring of transactions;
- Compliance with the principles of Sharia, regulatory and other legal requirements;
- Documentation of controls and procedures;
- Requirements for the periodic assessment of operational losses and proposed remedial actions.
- Developing action plans in case of emergency;
- Education and training;
- Ethics and business standards;

– Risk reduction.

Compliance with the Bank standards is provided with a program of regular checks carried out by the internal audit and the audit in accordance with the principles of Sharia. The results of the internal audit and the audit of Sharia are reviewed and discussed with the department which they relate to; and brief conclusions are submitted to the Board of Directors, the Council on the principles of Islamic finance and he senior management of the Bank.

The general responsibility for the risk identification and control over them corresponds to the Board of Directors, but however, there are separate independent bodies responsible for managing and monitoring risks.

The Board of Directors is responsible for the overall risk management approach and for approving of the strategy and risk management principles.

The duty of the Board is to control the risk management process in the Bank.

The Department of Risk Management in the Bank is responsible for the control of compliance with the principles and general risk management policy performance limits on the risks of the Bank, for the independent control of risks, including monitoring of the positions under the risk in comparison with set limits and the assessment of risks of new products and structured transactions. This department also provides a complete information acquisition in the system of risk assessment and reporting of risks. It tracks and monitors the quality of the loan portfolio, credit risk cover with collateral. The Department in conjunction with the business units of the Bank is responsible for the implementation of the Bank’s credit policy and compliance with other internal documents of the Bank and government regulators. The Department participates in the decision-making on a variety of risks. The Department is developing methods to quantify the risks specific to the Bank and provides recommendations to the different units of the Bank to minimize and control risks effectively. The Department of Risk Management develops and implements a variety of methods and analytical tools that allow a person to assess the risks, to control the level of risks and organizes procedures to reduce risk.

The Council on the principles of Islamic finance is responsible for monitoring the operating, financing and investing activities of the Bank, ensuring their compliance with the principles and rules of Sharia. As the Supervisory Board they are subject to audit the business activity of the Bank by the rules of Sharia and to present the independent report to the shareholders regarding the implementation of the principles and norms of Sharia to the Bank’s activities. The Coordinator of Sharia, the representative of the Supervisory Board on the principles of Islamic finance, is also responsible for compliance with the regulations and instructions, which are from time to time published by the Supervisory Board on Islamic finance, including the consideration of standard and non-standard contracts, product parameters, financial reporting and auditing in accordance with the principles Schariata, etc.

The Treasury of the Bank is responsible for managing the assets and liabilities of the Bank, as well as the overall financial structure. It is also primarily responsible for the funding and liquidity risks of the Bank.

Risk management processes in the Bank are annually audited by the internal audit department, which examines both the adequacy of the procedures and the implementation of these procedures by the Bank. The internal audit unit discusses the results of all audits with the senior management, and reports its conclusions and recommendations to the Board.

4. Conclusion

Thus Islamic Bank manages the risks in a process of constant identification, evaluation and monitoring, as well as the risk limits and other measures of the inner control. The risk management process is critical to the support of the Bank's continuing profitability and each individual member within the Bank is responsible for the risk exposures relating to his or her responsibilities. The Bank is exposed to credit risk, liquidity risk, the risk of non-compliance with Shariah principles and market risk, which, in its turn, is divided into the risk associated with trading and the risk of non-trading activities. The Bank is also subject to operating risks. The independent risk control process does not apply to business risks, such as for example changes in the environment, technology, or changes in the industry. Such risks are monitored through the Bank's strategic planning process[5].

Investors and financiers working in the financial environment, may be interested in aspects of risk management. Investment or financing methods are a means of diversification of Shariah investment. Speculative investments or companies with large amounts of borrowed funds are likely to be prohibited by the Shariah; Sharia-compliant element can thus reduce the overall risk of the portfolio. The rapid development of the global Islamic finance industry can continue to remain stable only if its underlying products are properly structured and if you use their financial institutions know how to protect themselves from the risks and mitigate the risks.

[5]Bekkin (2008).

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