GRAS Newsletter 55

February 2013

Islamic Banking and ORM

Summary
Products and operations in Islamic Banking differ from those in conventional banking through the adherence to an additional set of rules. These rules are typically restrictions on the use of certain instruments and are often characterized by a tighter bond between the bank's and the client's interest. This puts a greater burden on ORM, through increased levels of business risk, asset liquidity risk, compliance risk, fiduciary risk and general operational risk. Islamic Banking, so it would seem, requires and "Islamic ORM programme".

Dear reader,
In the literature[1,2] on Risk Management in Islamic Banking, most space is naturally devoted to the prohibition on interest (which is indeed a cornerstone), and the aversion to derivatives as speculative and excessively uncertain. A raft of alternative financing mechanisms have been developed over the years, most of which are based on some form of profit/loss sharing and some form of co-ownership of risk. And while Islamic Banking is meant to reduce risk and avoid excessive uncertainty, many publications highlight that the overall risk profile of the institution is not necessarily lower and that careful risk assessment is required. This is also true for OpRisk. This newsletter looks briefly at the products where OpRisk is at increased levels for Islamic Banking and asks the question whether the standard OpRisk toolset is adequate to manage these risks.

Examples of Islamic Banking
From an operational risk perspective Islamic Banking is best viewed as an additional set of rules and regulations. To get some insight into the kind of products involved, we take a few typical examples and their effects on counterparty risk, business risk, asset liquidity risk, fiduciary risk and overall operational risk. Table 1 on the next page outlines how the specific products affect the risk profile.

The first thing we notice is that Islamic Banking operates under increased levels of OpRisk. Most of this is due to increased levels of legal/compliance risk, but that is not the only source. Increased levels of business risk through participations, the need to manage assets on an ownership basis, as well as higher duty-of-care levels which increase fiduciary risk, all contribute to OpRisk in excess of conventional banking practices. The fundamental question for OpRisk managers must therefore be: Is the usual toolset of RCSAs, KRIs, New Product Assessments and Loss Data collection sufficiently robust to cater for the increased levels of risk? The short answer is no. The next paragraph proposes a set of steps to take in ORM to deal with the increased level of risk, starting with business risk.

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[1] The area of Risk Management in Islamic Banking may be unfamiliar to many readers. An introduction outlining many of the issues can be found in: Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability,* John Wiley & Sons, 2011.

[2] Typing *{"Risk Management", Banking}* produces 1,168 matches on Amazon while *{"Risk Management", "Islamic Banking"}* produces not even 1%, with only 9 matches. Even with the bias towards English language publications on Amazon, this seems to be a low number. *{"Islamic Banking"}* by itself produces 364 results.

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Legend
↑ Risk levels increase / Additional risk mitigation is desired
↔ Risk levels are neutral / Some alternate risk mitigation may be needed
↓ Risk levels decrease / No further risk mitigation is required

Type of structure	**What are the consequences?**	**Effect on Risk types:** **Credit**	**Business**	**Asset Liquidity**	**Legal / Compliance**	**Fiduciary**	**Operational**
A. Trustee Finance whereby the bank offers the capital and the borrower offers labour etc. Collateral is limited to avoid moral hazard. Profits may only be a %, not a lump sum.	If there is no surplus at the end of the project, the bank has no recourse, not even to the loan itself. Since collateral is severely limited, both pure credit risk and business risk increase. Asset liquidity risk increases, especially since a loss making project is not deemed to be a default, which leaves the bank with a little recourse. Compliance risk and Fiduciary risk are not affected, but overall Operational Risk levels increase.	↑	↑	↑	↔	↔	↑
B. Equity Participation where Profits and Losses are shared proportionally to capital contributions. The bank may have representatives at the board.	Since the bank has voting rights proportional to its participation to the firm's equity, it is in essence taking the responsibility for the firm's business. Counterparty and Credit risk are thus traded for business and operational risk. Asset Liquidity is also at increased levels depending on the product, as well as compliance risk (including non-banking regulations).	↔	↑	↑	↑	↑	↑
C. Direct investment. No formal difference with conventional banking, other than the restriction on non-Islamic products.	The bank's risk profile is affected by increased levels of compliance risk and fiduciary risk. There is still considerable asset liquidity risk, but less fiduciary risk. There is some limitation on Credit risk, but not much more than in conventional banking.	↓	↑	↑	↑	↔	↑
D. Beneficence Loans. A zero interest loan with a fixed service fee for administrative expenses.	In theory, the fee may not be linked to the amount or the maturity of the loan and may not be changed over time. Credit risk and counterparty risk are higher for lack of recourse. Operational risk is only marginally higher.	↑	↔	↔	↔	↔	↔
E. Deferred Payment Sale. The price is set between buyer and seller at the time of the sale without charging for deferring payments.	Here, a fixed and pre-determined rate of return is agreed, with a markup to ensure a profit margin for the bank. The purchased assets act as collateral, which does add to the asset liquidity risk. The bank's responsibility in the trade may increase the fiduciary risk and operational risk, but leaves credit risk and business risk neutral compared to that in commercial banking.	↔	↔	↑	↔	↑	↑

Islamic Banking and ORM

An ORM toolset for Islamic Banking

Although OpRisk is typically executed using a set of standard tools irrespective of the banking process, it can be made more efficient by adding tools that cater to the specific circumstances of Islamic Banking. In practice this means we need to do the following:

1. Set up a general checklist for business risk
2. Run the checklist against the banks true experience in the specific business
3. Perform multiple business scenarios (no less than 5), all assuming the true ownership split of the asset
4. Perform multiple business scenarios (no less than 5), all assuming the bank owns 100% of the asset
5. Add an explicit asset liquidity analysis to each scenario
6. Remove the 10% best performing scenarios.
7. Run the remaining scenarios against legal / compliance.
8. Remove the 10% most advantageous outcomes.
9. Account explicitly for the fiduciary risk in the remaining scenarios
10. Remove the 10% most advantageous outcomes.
11. Price the OpRisk charge based on a mix of the remaining scenarios

The focus is on business risk and on running multiple scenarios across market developments, price movements, execution capability and risk management capability. This usage of scenarios serves an additional purpose over and above the usual ORM purpose. The scenarios serve as a starting point to evaluate the increased levels of asset liquidity risk, insecurity regarding the (timely) enforceability of contracts and the possibility of fiduciary disputes. By accounting for all these factors explicitly, the bank will be in a better position to price the risk ex-ante.

This ex-ante risk pricing is of course a good idea in general, but it is crucial in Islamic Banking since there are fewer options to modify agreements once they have been concluded or to re-price deals.

Conclusion

OpRisk requires additional tools in assessing Islamic Banking deals. These additional tools are largely focused on assessing business risk and then pricing that risk ex-ante. To make that as realistic as possible, we make start with two kinds of business scenarios and add additional risk levels to arrive at an OpRisk charge for the deal. The challenge will be to develop these scenarios, but it is worth remembering that an inability to do that means that, from a risk perspective, the deal cannot be priced and the deal should not be done.