

A Different Risk

As Financial Risk Management for Islamic Banking and Finance (Palgrave Macmillan) is hitting the shelves, co-author Ioannis Akkizidis spoke with us to explore risks related to Islamic finance and private banking.



Ioannis Akkizidis explores Islamic finance

bg: How would you describe Islamic finance clients?

Ioannis Akkizidis: Clients want an alignment between ways of lending and investing money, on the one hand, and Islamic finance principles on the other. These principles are: the lender cannot ask for interest on the loan; and a loan granted for investment purposes implies that the lender and the borrower will share profits and losses. These principles, based on

strong beliefs, are designed more for a clientele of individuals, rather than institutions.

Islamic products are created mainly for retail investors. Are there specific procedures and structures to manage the risks of these products?

In fact, Islamic products such as the *murābaha* target individual clients. These products are structured in such a way that

risks are carried mainly by the clients. However, this can also be the other way round. For example, in the *murābaha* contracts, the bank buys a specific product to respond to the client requests. The client will make a series of payments in the future that are defined in advance, plus an additional fixed amount called “profit.” This amount is theoretically set to cover the profit of the bank and its exposure to potential risks. Essentially, this looks like a long-term loan with a fixed interest rate. Any substantial over- or underestimation of this profit might have a strong impact on the bank and its clients (see graph next page).

What are the most popular products in Islamic finance?

The *murābaha* covers around 75 to 80 percent of the retail market. The *mushārakah* and the *mudārabah* are essentially structured to implicate management, the bank and the rules to split the profits and losses. The Islamic bond *sukūk* is gaining a lot of popularity. The *sukūk* is a structured product whose return is linked to the underlying assets, and whose structure is designed to secure the initial investment.

Comparison between Islamic and traditional finance

Characteristics	Islamic banking	Non-Islamic banking
Business framework	Based on financial, social/political and religious framework	Only secular banking laws
Balance of moral and material requirements	Given	Excessive use of credit and debt financing
Equity financing	Available with risk (equity participation) and profit sharing (pre-agreed ratio)	Not available through commercial banks, only through private equity
<i>Gharar</i> (hazard, uncertainty, chance, risk)	<i>Gharar</i> transaction forbidden	Trading in various derivatives are allowed
Profit and risk sharing	Returns are variable depending on performance, risk is shared	Not applicable
Others	Shariah board at each bank	Not available

Islamic finance glossary

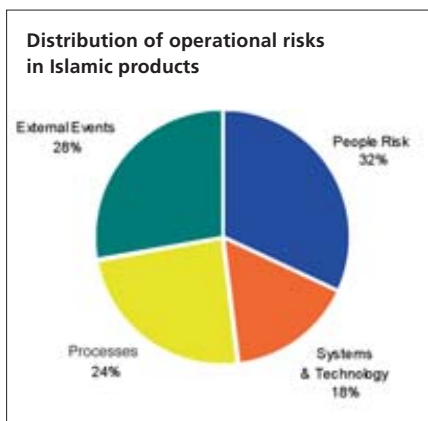
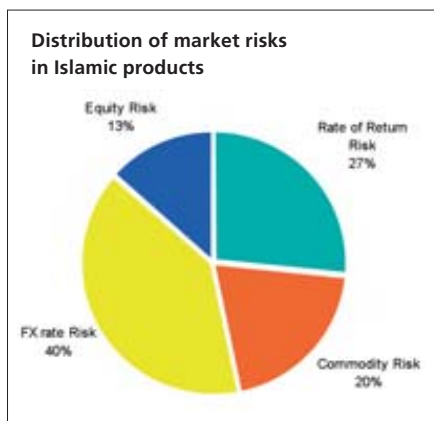
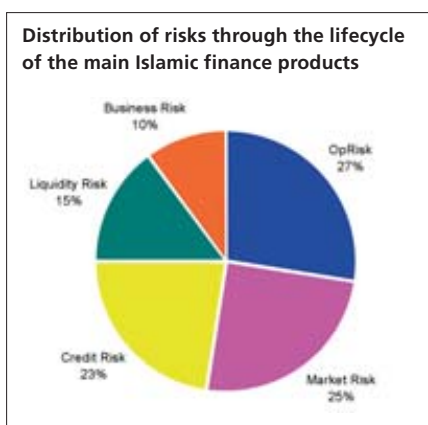
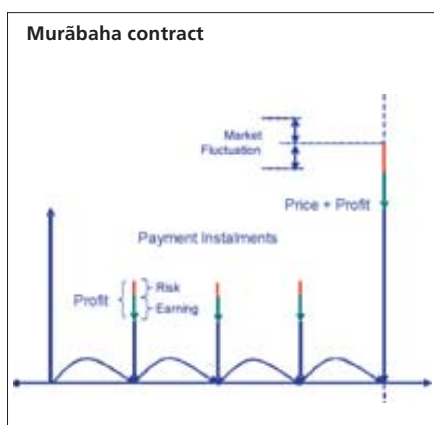
Mushārakah: investment structure where the bank invests with its partners and manages investments. Share of profits and losses

Murābaha: loan structure with ongoing reimbursements of the initial amount accrued of profit

Mudārabah: investment structure where the bank invests the total amount (and bears all the losses). It is advised in its investments by third party partners

Profit: interests and risk coverage

Sukūk: bond



Are Islamic financial products subscribers well informed about the risks borne by their investments?

Not really. Islamic financial products have unique features, notably regarding who is to bear the burden of losses. For example, in the case of Islamic financial products based on the share of losses and profits – such as the *mushārahah* partnership – the investor (the bank) and the partner are informed of the risk they will be taking as they both will have to bear any potential losses. In the *mudārahah* contract, the potential losses are borne by the investor (the bank), and not the agent (the partner). The bank becomes the business partner and is involved in the management.

Do you think that private bankers are well trained and equipped to manage the risks borne by Islamic financial products?

Islamic financial products are pretty simple. There are no complex derivatives, no hedging of trading products. The difficulty is in fact linked to compliance with the Shariah and the way the products are structured. Thus, the bank managing a *sukūk* is de facto an investor in this bond, as the profit is integrated in the product. This means that the bank is compelled to have a strate-

gy to avoid loss. According to Shariah, earning money from investments is allowed, but not from money itself. Games, tobacco, alcohol and sex are prohibited investment areas. This can prove to be particularly difficult in practice. Charities are therefore used frequently for “impure” profits.

How does Islamic finance affect risk management in private banks?

The same as with other institutions. Credit risk is particularly difficult to manage, because until now, the family link has

served as collateral with the shame associated to default payments. There is no possible use of credit derivatives, and there is no knowledge of the real risk exposure.

Are Islamic products compliant with Basel II agreements?

There is a desire to comply with Basel II in order to be accepted by the Western world (ed. note: see bg, issue 1/08, p. 46). Promoters of Islamic finance have set up an equivalent of Basel II to prove that they do manage risks. In fact, they manage market risks, but credit risk is a difficult issue. The default rate is measured, which means that they could adopt advanced methods. S&P has started to do analyses to rate the counterparts. Internal rating remains difficult. It is essentially qualitative, and hence subjective, but it is necessary to show the regulator that this was done efficiently. But it remains to be proven.

What about the operational risk?

Operational risk remains a major issue. It is the biggest risk and the source of the greatest losses – more than credit risk or market risk. It is mainly related to people, to employee turnover and to frauds. Processes remain chaotic, as well as systems – there are very few records and reports. Insurances are poorly used or rarely used. The fact that there is a time lag in implementing operational risk is a determining factor: action is only taken when losses have occurred. That is why Islamic products promoters do not manage risks, but losses, and thus make sure they have enough capital. This will allow them to be compliant with Basel II, but the market risk is high. ■

Interview: Cyril Demaria

Ioannis Akkizidis

Dr. Ioannis Akkizidis is a consultant in risk management for IRIS Integrated Risk Management AG in Zurich. He has developed international expertise in risk management, notably by creating and implementing risk management solutions for the banking industry. He is the main author of the best seller *Integrating Market, Credit and Operational Risk: A Complete Guide for Bankers & Risk Professionals* (Risk Books, 2006), of *Guide to Optimal Operational Risk & Basel II* (T&F, 2006) and of *Financial Risk Management for Islamic Banking and Finance* (Palgrave Macmillan, 2008).



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