Risk Management and Islamic Banking

An Overview

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Basel III Implementation and Islamic Banks

Key Issue	Is it a problem for Islamic Banks?
Liquidity Standard (LCR)	Yes, there are insufficient eligible HQLA that are also Shari'ah-compliant
Definition of Capital	No, Islamic banks did not issue hybrid debt prior to Basel III. But, Tier 2 capital (in the form of perpetual sukuk) is now available.
Risk Coverage (eg Counterparty Credit Risk)	No, Islamic banks' counterparty credit relationships generally not complex.
Capital Conservation Buffer	No, no reason why Islamic banks can't be required to hold additional capital.
Countercyclical Capital Buffer	No, as above
Leverage Ratio	No, no reason why Islamic banks need to have higher/lower leverage than conventional banks.
D-SIB	Would regulators decide that a bank that has a large share of domestic Shari'ah-compliant business is a D-SIB, even if its share is not large in relation to the whole (conventional and Shari'ah-compliant) market?
G-SIB	Unlikely that an Islamic bank will be a G-SIB any time soon.

Are Islamic Banks Inherently More Risky Than Conventional Banks?

Net losses declared by GCC commercial banks	Islamic Banks	Conventional Banks	Total
2010	3	2	5
2009	6	6	12
2008	0	8	8

Source: Darien Middle East, Gulf Commercial Bank Rankings

An IMF comparison of the effects of the Global Crisis on Islamic and conventional banks concluded that they were affected in different ways, but not that Islamic banks had suffered more (or less) than conventional banks.
(IMF Working Paper, WP/10/201)

Qatari Banks: Comparison of Deposit Maturities

Percentage	Customer deposits < 1 month % total customers deposits	Customers deposits < 3 months % total customers deposits	Statement Date (year-end)
Qatar National Bank	61	82	2013
Commercial Bank of Qatar	63	87	2013
Doha Bank	61	89	2013
Al Khalij Commercial Bank	68	82	2013
International Bank of Qatar	73	85	2012
Ahli Bank	52	82	2013
Conventional Banks, Average (unweighted)	**63**	**84**	
Qatar Islamic Bank	33	59	2012
Masraf Al Rayan	72	94	2012
Qatar International Islamic Bank	59	65	2012
Barwa Bank	14	73	2012
Islamic Banks, Average (unweighted)	**44**	**73**	

Qatari Banks: Comparison of Asset Maturities

Percentage	Assets < 1 month % total assets	Assets < 3 months % total customers deposits	Statement Date (year-end)
Qatar National Bank	15	18	2013
Commercial Bank of Qatar	19	24	2013
Doha Bank	37	46	2013
Al Khalij Commercial Bank	17	20	2013
International Bank of Qatar	31	43	2012
Ahli Bank	16	27	2013
Conventional Banks, Average (unweighted)	**22**	**30**	
Qatar Islamic Bank	18	31	2012
Masraf Al Rayan	56	58	2012
Qatar International Islamic Bank	15	25	2012
Barwa Bank	5	15	2012
Islamic Banks, Average (unweighted)	**24**	**32**	

Origin of Actual Losses Declared by Middle East Banks

GCC Banking Systems

- Real estate exposure
- Investment in overseas financial instruments
- NPLs when oil prices decline
- Poor Governance (leads to poor strategy)

Non GCC banking Systems

- NPLs due to poor lending procedures and/or lending to poorly-performing state-owned enterprises
- Political upheavals (“winners” become “losers”)
- Poor Governance (leads to poor strategy)
- Note also: lack of transparency (losses may not be visible)

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Key Risk Factors for Islamic Banks (1)

Liquidity: lack of highly rated, tradable instruments to invest in.

Credit risk: heightened credit risk for Islamic banks because they cannot recover missed payments (e.g. interest on missed interest).

Inflexibility of contracts: difficult to compensate for when clients/instruments do not behave as originally expected.

Franchise value: during times of strong liquidity, many Islamic banks are established that may not be strong enough to survive during difficult economic conditions.

Shari'ah risk: standards of Shari'ah-compliance are changing.

Governance: uncertain role of the Shari'ah audit committee

Supervisory competence: Do bank supervisors have expert knowledge of Islamic finance?

Key Risk Factors for Islamic Banks (2)
Focus on Liquidity

Liquidity: lack of highly rated, tradable instruments to invest in

- ***Difficult to comply with regulatory liquidity requirements***
- ***Loss of earnings as funds are placed in (unremunerated) cash accounts***
- ***Shari'ah risk, if funds are placed in instruments with unsure Shari'ah credentials***

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Liquidity Notes: Sizing the Challenge (1)

- Total Balance Sheet of Islamic Retail and Wholesale Banks in Bahrain: **$23,027mn**
- Issuance of 91-day Shari'ah compliant Salam Securities by Central Bank of Bahrain: **$191mn**
- Issuance of 3 – 10 year Shari'ah compliant leasing securities by Central Bank of Bahrain: **$3,140mn**
- Rating of Government of Bahrain: **Baa2**

(All figures for September 2013. Rating for February 2014)

Liquidity Notes: Sizing the Challenge (2)

- International Islamic Liquidity Management Corp (IILM) has **$1,350mn** of 90 day sukuk outstanding, rated A-1 by Standard & Poors.
- The Islamic Development Bank – rated Aaa – is planning to issue short-term sukuk in 2014.
- Aggregate balance sheet of the 25 wholly-Islamic active commercial banks based in the GCC: **$309bn** (end 2012)
- Aggregate balance sheet of the Islamic banking system in Malaysia **$132bn** (end 2013)
- Total sukuk issuance in 2013 **$115bn**, of which **$79bn** was by Malaysian issuers.

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International Islamic Liquidity Management Corp.

August 2013	Issuance of $490mn of 3-month sukuk
November 2013	Re-issuance of $490mn 3-month sukuk, first issued in August
January 2013	Issuance of $860mn of (new) 3-month sukuk
February 2013	Re-issuance of $490mn 3-month sukuk, first issued in August

Total outstanding $1,350mn ($490mn + $860mn)

All issues rated A-1 by Standard & Poors

Primary Dealers for IILM Sukuk Issues (Feb. 2014)

Abu Dhabi Islamic Bank	Abu Dhabi, UAE	Islamic Bank
National Bank of Abu Dhabi	Abu Dhabi, UAE	Conventional Bank
Kuwait Finance House	Kuwait	Islamic Bank
KBL Private Bankers	Luxembourg	Conventional Bank
CIMB Bank	Malaysia	Islamic Bank
Malayan Banking (Maybank)	Malaysia	Conventional Bank
Qatar National Bank	Qatar	Conventional Bank
AlBaraka Turk	Turkey	Islamic Bank
Standard Chartered	United Kingdom	Conventional Bank

International Islamic Financial Market

Development of Standard Documentation for Shari'ah-compliant instruments

Examples include:

- **Unrestricted Master Wakalah Agreement (interbank placements)**
- **"Iaadat al-Shira" (Repo Alternative)**
- **"Tahawwut" (master hedging agreement)**
- **"Mubadalatul Arbaah" (equivalent to interest rate swap)**

Notes to Slides on Deposit Maturities and Asset Maturities of Qatari Banks

1. The percentages were calculated from figures published in the banks' financial statements. Specifically, figures were taken from Note 4. (Financial Risk Management) to the financial statements and from the balance sheet.
2. The denominator for the calculations on deposit maturities is "total deposits" (including equity of investment account holders, in the case of Islamic banks). The denominator for the calculations on asset maturities is total assets.
3. Qatari banks were used because there is a clear distinction between banks that operate on a Shari'ah-compliant basis and those that operate on a conventional basis.

Questions and Discussion