

Procedures for Reporting Financial Risk in Islamic Finance

by Daud Vicary Abdullah and Ramesh Pillai

Executive Summary

- Uncertainty is a defining feature of the economic environment. Economic agents' perceptions of risk, together with their willingness and ability to bear it, fundamentally shape decisions, transactions, and market prices. Well-considered decisions should be based on information that helps to highlight existing risks and uncertainties. An important component of the information system of an organization or economy is financial reporting, through which an enterprise conveys information about its financial performance and condition to external users, often identified with its actual and potential claimants. It stands to reason, therefore, that financial reporting should provide a good sense of the impact of those risks and uncertainties on measures of valuation, income, and cash flows.
- It is important to reconcile the perspectives of accounting standard setters on the one hand, and prudential authorities on the other, on what information should be reported, and on how it should be portrayed. The final goal is a financial reporting system that is consistent, as far as possible, with sound risk management and management practices and that can serve as a basis for well-informed decisions by outside investors as well as prudential authorities.
- Outside investors, be they equity or debt holders, would normally require certain information about the financial performance of a firm so as to guide their decisions. First, they would surely wish to form a view about the firm's past and current profitability, solvency, and liquidity at a given point in time. Second, they would probably also like to develop a picture of the risk profile of those attributes over time and, hence, of their potential future evolution. Third, they might additionally wish to gain a sense of how reliable or accurate those measures are. Combined, these three elements would provide the raw material to inform views about expected returns properly adjusted for risk and for the inevitable uncertainties that surround measurement. These three types of information correspond to the key categories into which the ideal set can be divided—namely, first movement, risk, and measurement error—and they are equally applicable to financial reporting in an Islamic finance environment.

Introduction

The key elements of Islamic finance can be summarized as follows:

- **Materiality and validity of transactions:** There is no profit sharing without risk taking, and earning profit is legitimized by engaging in economic venture. Money is not a commodity but a medium of exchange, a store of value, and a unit of measurement.
- **Mutuality of risk sharing:** Clearly defined risk and profit sharing characteristics serve as an additional built-in mechanism. There are clearly laid out terms and conditions.
- **Avoidance of riba (interest), maysir (gambling), and gharar (uncertainty).**

The key elements of Islamic financial risk can be summarized as follows:

- The reporting of financial risk in an Islamic financial institution (IFI) requires greater transparency and disclosure than does its conventional counterpart.
- This is particularly true with respect to additional shariah governance and some risk areas that are unique to Islamic finance.
- IFIs have greater fiduciary duties and responsibility to their stakeholders than do conventional institutions.
- The additional duties and responsibilities of IFIs are overseen by the IFI's shariah board.

First-movement information describes income, the balance sheet, and cash flows at a point in time. It is the type of information with the longest tradition by far in accounting.

Risk information is fundamentally forward looking. Future profits, future cash flows, and future valuations are intrinsically uncertain. Risk information is designed to capture the prospective range of outcomes for the variables of profit as measured at a particular point in time.

Measurement error information designates the margin of error or uncertainty that surrounds the measurement of the variables of profit, including those that quantify risk. The need for this type of information arises whenever these variables have to be estimated. For instance, measurement error would be zero for first-movement information concerning items that were valued at observable market prices for which a deep and liquid market existed. But it would be positive if, say, such items were marked to model and/or traded in illiquid markets, since a number of assumptions would need to be made to arrive at such estimates.

There has been a wide array of change and development in Islamic finance in recent years. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has tackled several of the pertinent issues in its Financial Accounting Standards (FAS). In particular, FAS 1 relates to general presentation and disclosure in the financial statements of Islamic banks and financial institutions. FAS 5 relates to the disclosure of bases for profit allocation between owners' equity and investment account holders. FAS 17 concerns Investment. FAS 22 and FAS 23 deal with segment reporting and consolidation, respectively. AAOIFI Governance Standards 1–6 also provide relevant guidance. In particular, Governance Standard 6, Principles of Governance Section 7, gives guidance in respect of risk management.

Understanding Islamic Banking Risk

Islamic financial institutions are exposed to all the risks that a conventional one is. However, there are some fundamental differences, particularly in the aspect of *shariah* compliance, where noncompliance can lead to reputational risk and worse.

Typical banking risk exposure includes the following:

- financial: balance sheet, capital adequacy, credit, liquidity;
- operational: fraud, product, business services, system failure, delivery, and process management;
- business: country, reputational, regulatory, legal, macropolicy;
- event: political, banking crisis, contagion.

Basic Risk Analysis

Ratios and analytics are in a constant state of evolution in order to reflect the growing challenges of Islamic finance and the constant stream of new products. In particular, the convergence of international supervisory standards, initiated by the Islamic Financial Services Board (IFSB) since its inauguration in 2002, have contributed to this developing landscape. Typical ratios relate to liquidity, capital adequacy, insider and connected financing, financing portfolio quality, large exposures, and foreign exchange positions

Peer group benchmarking is a relevant measurement criterion. Here the behavior of an individual institution can be measured against peer group trends and industry norms. Significant areas such as profitability, product risk, the structure of the balance sheet, and capital adequacy come to mind. Any significant deviations of the individual institution from what is considered to be the norm must be investigated and understood, as they may well represent an early warning for negative trends in both the IFI and the industry.

What's Different in an IFI?

Islamic contracts and the allocation and sharing of risk: The analysis described above should also include the nature of the Islamic contracts included in the balance sheet and a basic understanding of how the risk is allocated or shared. Therefore a fundamental understanding of the IFI's balance sheet is required.

Liabilities: These include equity capital, reserves, investment accounts (*mudarabah* and *musharakah*) and demand deposits (*amanah*). Money is deposited in investment accounts in the full knowledge that the deposit will be invested in a risk-bearing project, where the profit will be divided between the institution and the depositor on a prearranged profit-sharing ratio. The depositor is also exposed to the risk of loss if the projects invested in do not perform. In many ways these types of deposit have a similarity with an equity investment in the bank, and it is this lack of clarity between shareholders and investors/depositors that can lead to a perception of increased riskiness. IFSB and AAOIFI guidelines have provided significant help in clarifying this issue.

Assets: These include short-term trade finance (*murabahah* and *salam*), medium term financing (*ijarah*, *istisna*, etc.), long-term partnerships (*musharakah*) and fee-based services (*kifala*, etc.).

These asset and liability contracts carried in the balance sheet of an Islamic financial intermediary give a clear indication of two fundamental differences between Islamic financial intermediaries and their conventional counterparts. First, the relationship between the depositors and the bank is based on profit and loss sharing principles; and second, the asset side of the bank may include “risky” assets such as *mudharabah* and *musharakah* that a conventional bank may not carry.

Key Elements of Good Corporate Governance

Good corporate governance is defined by the set of relationships between the institution’s senior management, its board, its shareholders, and other stakeholders:

- Corporate strategy defines how success can be measured.
- Responsibilities include assignment and enforcement.
- Strong financial risk management should be independent of the business, with good internal control and separation of duties.
- Good values and a code of conduct should be well articulated and maintained, especially in the area of related parties.
- Proper incentives must be consistent with objectives, performance, and values
- The roles of stakeholders must be clearly set out.

The Roles of Stakeholders

- Regulators monitor the statutory environment and help to create an enabling environment
- Shariah boards protect the rights of all stakeholders in accordance with the principles of shariah.
- The board of directors sets the direction of the bank and ensure its soundness.
- The executive management executes the direction of the board and has sufficient competence and knowledge to manage the financial risks.
- The board audit committee and internal audit are logical extensions of the board’s risk management function. They assist executive management in identifying and managing risk areas.
- External auditors are responsible for validating the results and providing assurance that appropriate governance processes are in place.
- Market participants should accept responsibility for their own investment decisions. They therefore need transparent disclosure of information from financial institutions
- Shareholders can appoint officers in charge of the governance process, subject to appropriate screening on related party transactions.

The Role of Shariah

Shariah boards are unique to IFIs. They have a responsibility to monitor the activities of the financial institution and to ensure compliance with *shariah* principles. As such, the *shariah* board acts as a governance body to protect the rights of the stakeholders in the IFI.

In some jurisdictions, national *shariah* boards have been formed, which work closely with regulators and supervisors in protecting the rights of all investors.

Transparency and Disclosure

Practices in IFIs have improved significantly in recent years, but there is still room for improvement in a number of areas:

- Quantitative methods for the measurement of risk still need improvement. AAOIFI is driving changes in this area.

- The decisions and methodology of the shariah boards should be disclosed more publicly. This will enhance the credibility of IFIs and also help to educate the public on the shariah decision-making process.
- There needs to be a clear demarcation between equity and depositors' funds.
- The financial information infrastructure requires constant improvement to ensure that a “virtuous cycle” of information continually forces practitioners to adopt sound corporate governance practices.
- Standardized reporting practices throughout IFIs would significantly assist in improving the collectability and analysis of data from them.

Conclusion

There are many similarities between conventional and Islamic risk management, as well as some significant differences, which have been highlighted above. The risk management process itself in an IFI does not differ much from conventional banking practices. However, it is the analysis and the identification of the risk environment that differ.

The balance sheet of the IFI needs to be structured in a way that will allow the easy identification of risk, particularly in the area of sources of funding and in the application of those funds for financing purposes.

The role of the *shariah* board is significant in protecting the rights of all stakeholders and ensuring that the business of the IFI is conducted in accordance with the principles of *shariah*.

Making It Happen

Good financial risk management is about changing behaviors and attitudes. Boards and executive management are responsible for setting the implementation process, and regulators are responsible for creating a conducive environment. For example:

- The board must set the direction.
- Regulators must ensure a supportive environment that encourages transparency and good market discipline, thereby creating a virtuous cycle.
- The market must value good financial discipline and risk management and must reward compliant companies accordingly.
- All stakeholders must recognize their responsibilities.

More Info

Books:

- Greuning, Hennie Van, and Sonja Brajovic Bratanovic. *Analysing and Managing Banking Risk: A Framework for Assessing Corporate Governance and Financial Risk Management*. Washington, DC: World Bank, 2000.
- Karim, Rifaat Ahmed Abdel, and Simon Archer (eds). *Islamic Finance: The Regulatory Challenge*. Singapore: Wiley, 2007. See in particular Sundararajan, V. “Risk characteristics of Islamic products: Implications for risk measurement and supervision,” pp. 40–68.

Article:

- Grais, Wafiq, and Zamir Iqbal. “Corporate governance challenges of Islamic financial Institutions.” Paper presented at Seventh Harvard University Forum on Islamic Finance, 2006.

Websites:

- AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions): www.aaofi.com
- IFSB (Islamic Financial Services Board): www.ifsb.org
- PRMIA (Professional Risk Managers' International Association): www.prmia.org

See Also

Best Practice

- [Identifying the Main Regulatory Challenges for Islamic Finance](#)
- [Islamic Modes of Finance and the Role of *Sukuk*](#)

Checklists

- [Business Ethics in Islamic Finance](#)
- [Key Islamic Banking Instruments and How They Work](#)
- [Key Principles of Islamic Finance](#)
- [An Overview of *Shariah*-Compliant Funds](#)
- [The Role of the *Shariah* Advisory Board in Islamic Finance](#)

Finance Library

- [An Introduction to Islamic Finance Theory and Practice](#)

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