To the uninitiated Islamic finance, which is inextricably bound to religious doctrines, often evokes a sense of mysticism and curiosity, as, by and large, modern conventional finance has been a product of the western hemisphere developed relatively independently from the influence of religious faith.

Yet the last decade has seen a remarkable blossoming of this field of finance. More than 240 financial institutions in more than 48 countries, including global giants such as Citibank and HSBC, practise some form of Islamic finance. Islamic banking assets worldwide are estimated at over USD200 billion with an average annual growth rate of 15 per cent in recent years.

Furthermore, in August 2004, the UK’s Financial Services Authority (FSA) granted approval for the first Islamic Bank, the Islamic Bank of Britain, to operate in the traditionally Anglican UK. Whilst Islamic banks have long been established in predominantly Muslim countries, the issuance of a banking licence by the FSA marks a bell-wether of sorts for the inclusion of Islamic banking into the mainstream of financial markets.

Islamic finance today is therefore an area of topical interest for financial market practitioners. Given the networked and global environment we find ourselves in today, the implications of Islamic finance on the global financial community and on the management of risks in Islamic financial institutions need to be considered thoroughly.

This article seeks firstly to provide some background on the concepts and features of the Islamic financial system, and secondly to examine the risk differentials of Islamic financial institutions. In part two of this article, the capital adequacy and risk management requirements will be considered.

**Foundations of the Islamic Financial System**

Islamic financial institutions are predicated on different foundations from conventional financial institutions. The rationale of the former is conformance to principles of Shari’ah law, the juristic code of Islam of the Qu’ran and the Hadith, as opposed to the profit-maximising objectives of the latter; these dissimilar roots give rise to contrasting risk profiles.

The fundamental tenet of Islamic finance is that of fairness, a similar concept to the English common law doctrine of equity. This motivating factor has been extended into the following principles:

1. Requirements that seek to promote fairness in transactions and prevention of exploitation of any one party over another;
2. Sharing of risks and rewards between principals to a transaction;
3. Transactions that carry elements of materiality leading to a tangible economic purpose;
Upholding the sanctity of contracts; and

Prohibition of financing of activities that are outlawed by Islam, such as transactions involving alcohol and gambling.

These principles are summarised in Figure 1.

Hence, Islamic financial institutions in its most basic level are often structured towards fee-based revenue for services rendered and on profit and risk sharing structures. In essence therefore, Islamic financial institutions are closer in spirit to asset management companies rather than conventional banking institutions.

Some of the common Islamic finance concepts used include the following:

- **Mudaraba**, which is a form of cost-plus or mark-up financing where an asset is acquired by the institution and sold on to the customer, with the institution deriving a profit based on the difference between the sales price and the original cost of the asset.

- **Bai’ Al-Ajal**, which basically allows the payment of instalments by a customer towards an asset, with the title to this asset being transferred from the institution to the customer once payment has been received in full.

- **Ijarah**, which is a contract of leasing where the institution acquires an asset from a supplier and leases it to a customer.

- **Musharaka**, which is an equity participation scheme in the form of joint-venture, characterised by clearly defined roles and profit distribution agreements between the principal parties to the transaction.

- **Mudaraba**, where the institution acts as a fund manager for the investors (depositors). The institution engages in investment or trading activities and pays the investors a pre-determined share of profits.

These and other Islamic finance concepts are often used in combination in order to derive a desired product structure that has similar product features to a conventional product financing.

However, the impact of Islamic product financing on the balance sheet of an institution is very different from that of conventional product financing. The primacy appearance of conventionality belies the structurally different asset and liability profile of the bank’s balance sheet.

### Risk Differentials in Islamic Financial Institutions

Understanding the risks faced by Islamic financial institutions requires us to understand the balance sheet of an Islamic financial institution. Figure 2 provides a conceptual balance sheet for an Islamic financial institution.

While the risk profiles of Islamic financial institutions are generally similar to those of conventional financial institutions, especially regarding credit risk, Islamic financial institutions face some unique risks since Islamic financial institutions on their most basic level are often structured towards fee-based revenue for services rendered and on profit and risk sharing structures. This includes their “depositing taking” activities, which are referred to as Investment Account Holders (IAHs) rather than depositors. Therefore, their key unique risks include:

- **Displaced commercial risk.** This risk arises when Islamic financial institutions are under pressure to pay a return that exceeds the rate that has been earned on assets financed by their IAHs, when the return on assets is under performing as compared with competitors’ rates. In such a scenario, the Islamic financial institution may decide to waive its rights to the profits, or a part of the profits, in order to retain its fund providers and dissuade them from withdrawing their funds;

- **Rate of Return Risk.** This risk is associated with overall balance sheet exposures where mismatches arise between the assets and liabilities of Islamic financial institutions. Revenue and expenses are generally accounted for on an accrual basis when deriving the exposure and the Islamic financial institutions are exposed to the expectation of IAHs when allocating their profits;

- **Asset price risk.** This risk is associated with exposures to price volatility of the underlying “real” assets inherent in some financing modes, which are in the form of trading and real investment;

- **Fiduciary risk.** This risk arises from a breach of the investment contract for management of IAHs’ funds; and

- **Shariah compliance risk.** This risk arises from non-compliance with Shariah principles in conducting the Islamic financial institutions’ business.

### Conclusion

The last decade has seen tremendous growth of the Islamic financial system. Due to this significant growth, Islamic financing is no longer just a fringe financial system, but a mainstream financial system. As a result, there is a need for greater consistency in practices and standards among financial institutions operating within this system. These standards will be considered in part two of this article.

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**Figure 2**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
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<tbody>
<tr>
<td>Asset-backed transactions</td>
<td>Demand Deposits</td>
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<tr>
<td>Trade finance/collateralised</td>
<td>Amana</td>
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<td>transactions</td>
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<td>Syndication</td>
<td>Investment Accounts</td>
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<tr>
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<td>Equity</td>
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<td>Off Balance Sheet</td>
<td>Direct Investors</td>
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<tr>
<td>Restricted Investments</td>
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</tbody>
</table>

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