

II Forum Francais de la Finance Islamique

The Development of Islamic Finance in the Context of the
World Financial Crisis

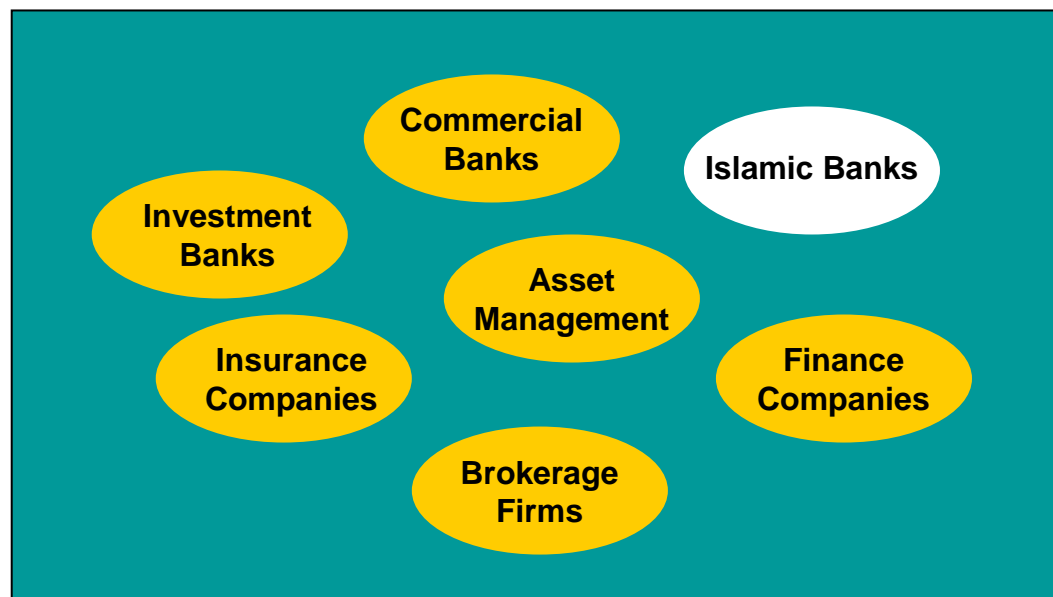
Risk Management in Globalized Islamic Finance

Ahmad Jachi, Ph.D

Paris, 26 November 2008

Financial System

- ❖ An efficient, competitive and stable financial system facilitates the allocation of resources across space and time
 - ✓ Robust regulatory and supervisory framework
 - ✓ Effective legal framework



Monetary Stability

↓
Low and stable inflation

↓
**Basis for better LT
economic performance**

↓
**Necessary but not
sufficient condition for
promoting**



↑
**Stable monetary
transmission
mechanism**

↑
Support



↑
**Presence of
imperfections or
frictions in capital
markets**

↑
Complicate



Financial Stability

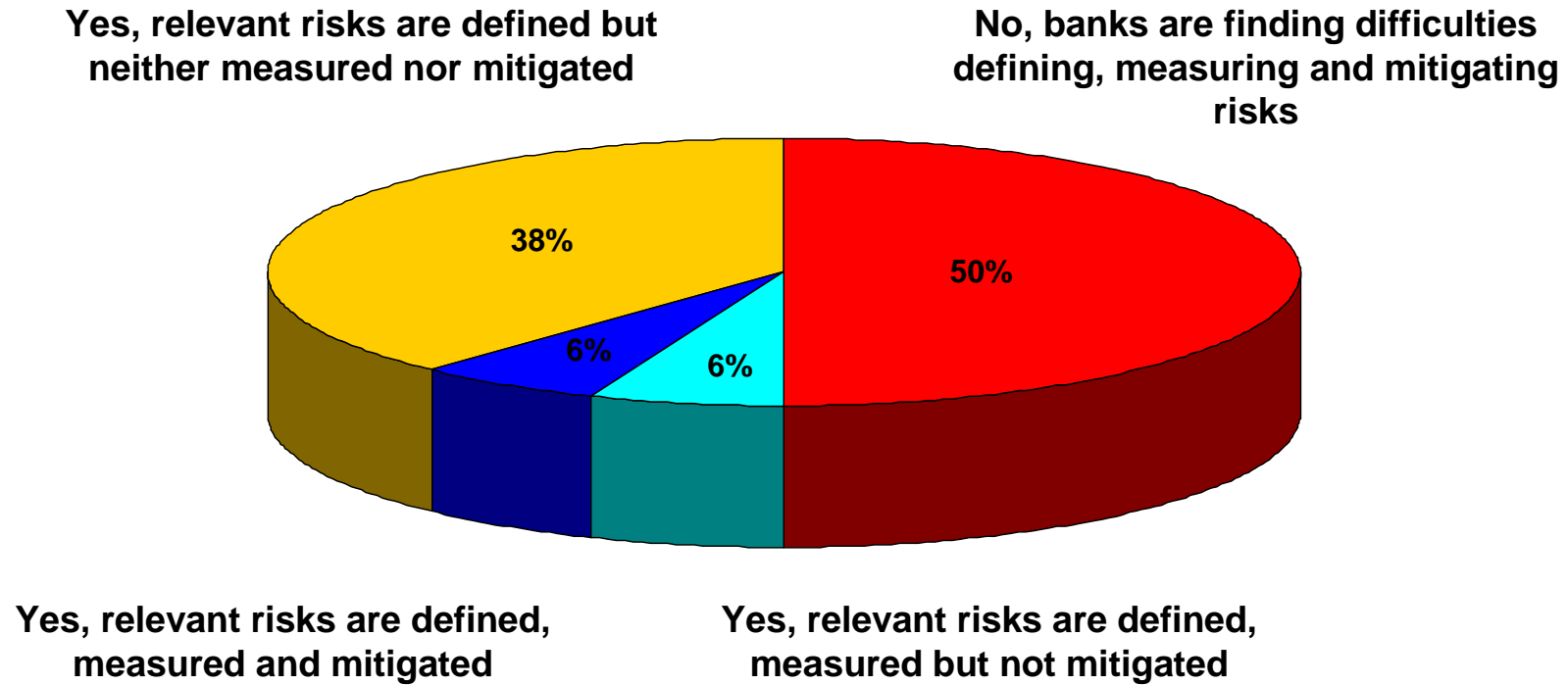
Crises

- ✓ *Systemic risk* phenomenon is what makes banking and financial institutions different from gas stations and furniture stores
- ✓ A banking crisis can ignite a currency crisis (and vice versa)
- ✓ *Myth:* Banking and/or currency problems are features of emerging markets only
- ✓ More than 130 of the IMF's 180-plus member countries had experienced serious banking problems over the last two decades

Costs of Crises

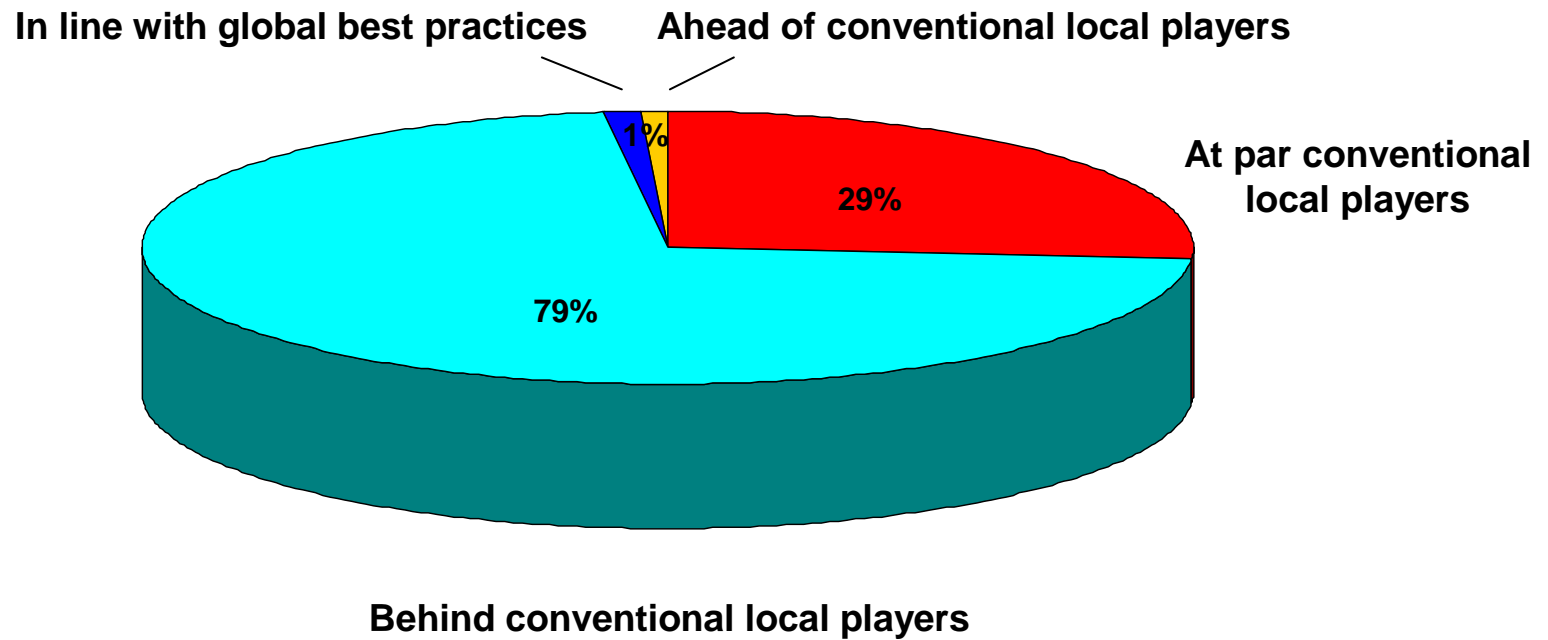
	Number of crises	Average recovery time (years)	Cumulative loss of output per crisis (%)
<i>Banking crises</i>	54	1.6	11.6
Industrial	12	1.9	10.2
Emerging market	42	1.5	12.1
<i>Banking & Currency</i>	32	3.2	14.4
Industrial	6	5.8	17.6
Emerging market	26	2.6	13.6

Are regional banks in full control of risks associated with Islamic Finance? (N=16)



Source: McKinsey Risk Summit, November 2007

Where do you see risk management practices among Islamic Banks in the GCC? (N=17)



Source: McKinsey Risk Summit, November 2007

Credit Risk – Commercial Banks

ASSETS

Loans

LIABILITIES

Current Accounts

Interest bearing deposits



- ✓ **Preservation of capital**
- ✓ **Return – Predetermined fixed interest rate**

Credit Risk – Islamic Banks (1)

ASSETS

Murabaha

LIABILITIES

Current Accounts



✓ Preservation of capital

Credit Risk – Islamic Banks (2)

ASSETS

Murabaha

LIABILITIES

Investment Accounts



✓ Profit and loss sharing

Credit Risk – Islamic Banks (3)

ASSETS

Murabaha

LIABILITIES

Investment Accounts

↓
Profit equalization reserves
↓

- ✓ Preservation of capital
- ✓ Return equivalent to market interest rate

Credit Risk – Islamic Banks (4)

ASSETS

Murabaha

LIABILITIES

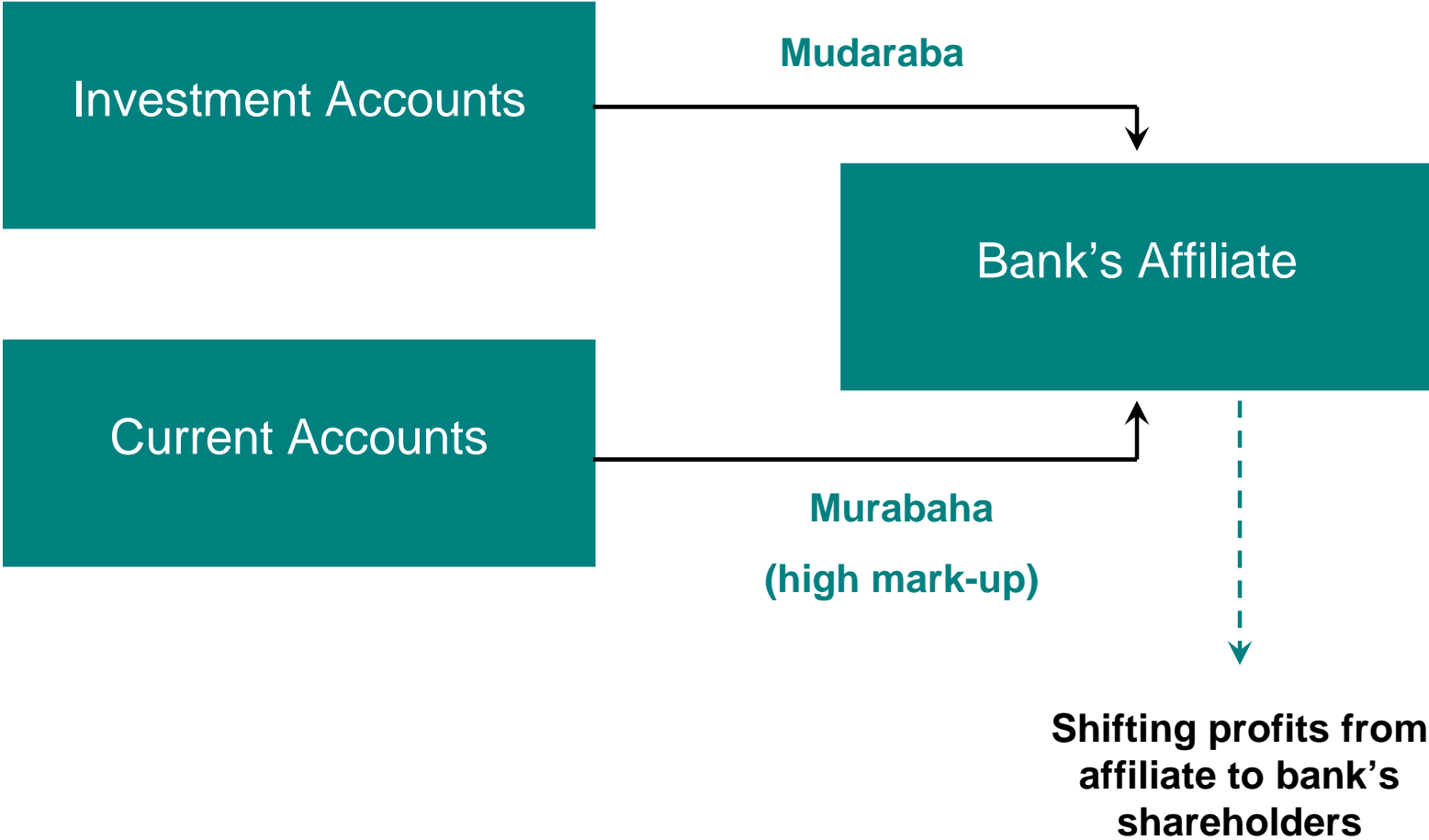
Current Accounts

Investment Accounts


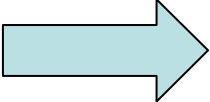




- ✓ **Preservation of capital**
- ✓ **Profit and loss sharing**

Other Exposures – Islamic Banks



IFIs Risk Profiles : Main Differences

- Different range of asset classes  Investment and Liquidity Risks
 - Weak position of Investment Account Holders
 - Rate-of-return risk
 - Importance of Sharia'a Supervisory Board  Legal and Sharia'a Risks
-   Displacement Risk
- New Operational Risks such as Reputation risk
 - Difficulty in distinguishing between risk categories in a large number of contract especially between credit and market risks
 - In case of default, the IFI - more than any conventional bank – becomes a merchant behaving in the field of commerce rather than financial intermediation (Inventory Management)

IFRM Program : Basic approach



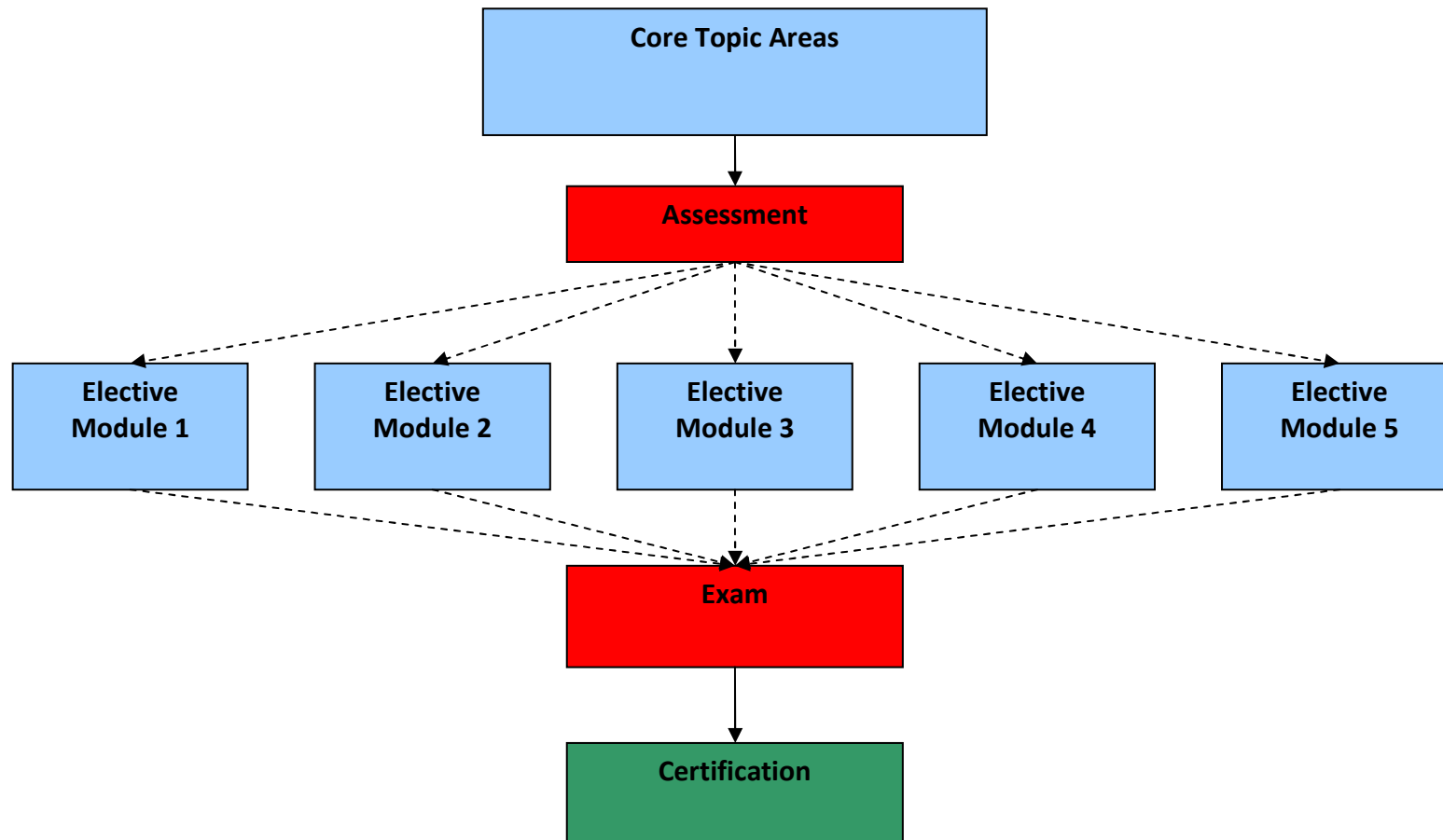
The approach presents the financial statements for IFIs and compares them to the conventional ones thus enhancing the analytical aspects that should enable the identification of the different classes of risks, their measurement and finally their management.

IFRM Program : Basic approach


On completion of this program, IFIs Risk managers will be able to:


- A. **Demonstrate an understanding of Islamic financial markets** and products, including knowledge of the unique features and characteristics of these products
- B. **Demonstrate an understanding of the risk measurement** and management approaches for credit, market and operational risk, and the approaches used to establish capital requirements dictated by the Basel II risk-based regulatory framework, and the equivalent international standards for Islamic banks.
- C. **Demonstrate the ability to apply risk measurement** and management methods to Islamic financial products and the ability to derive regulatory capital requirements associated with these products.
- D. **Demonstrate the ability to define, measure and mitigate risks** embedded in any new Islamic financial structure.

IFRM Program : Structure



IFRM Program: major topics

1. Conventional banking and classes of risks
 2. Islamic Financial institutions and classes of risk.
 3. Risk measurement of Islamic financial instruments
 4. Risk management of Islamic financial instruments
 5. Enterprise Risk Measurement and Management in Islamic Financial Institutions
- 
- Core

1. Regulatory Issues in Islamic Finance
 2. Derivatives and Hedging in Islamic Finance
 3. Islamic Capital Markets
- 
- Electives