

WORLD BANK TREASURY



Managing the risks of risk management: Lessons from current financial crisis

By
Zamir Iqbal
Lead Investment Officer
Quantitative Strategies, Risk, and Analytics (QRA)

The World Bank
Treasury
1818 H Street, NW
Washington, DC 20433 USA
Treasury.worldbank.org

- Key observations on the financial crisis
 - **Structural** factors contributing to the crisis
 - **Systemic** issues identified
 - Failure of **Operational** processes
- Lessons of Islamic Financial Industry
 - Review Stability and resilience of Islamic financial system
 - Suggest policy recommendations

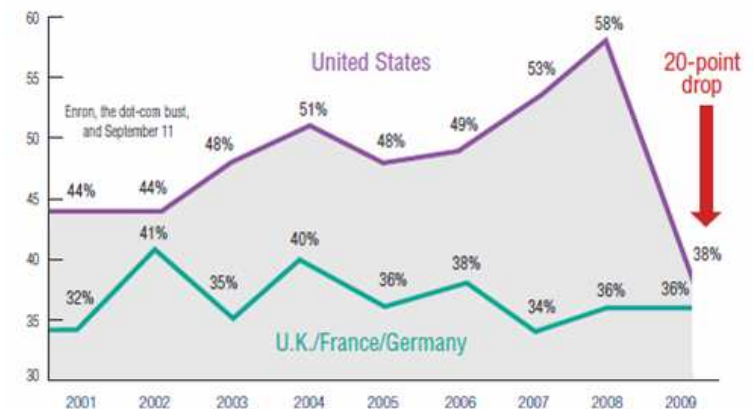
- Exposures due to inherit features of the structure of the financial system.
 - Debt -> *Excessive Leverage*
 - *Fractional Reserves System*
 - + Securitization => Rapid Money Growth
 - Classical Assets-Liabilities Mismatch
 - Remoteness (Real and financial sector)
 - Injudicious use of Derivatives
- Commonalities with previous financial crisis

Systemic Exposures



- Consistent **patterns, practices, and group thinking** across the financial system
 - Unregulated and uncontrolled *innovation*
 - *Corporate governance* lapses
 - *Failure of market discipline*
 - *Failure of board oversight and risk controls*
 - *Short-sightedness*
 - *Breach of Trust and confidence*
 - *Liquidity*
 - *Complexity and Transparency*

How much do you trust business to do what is right?



Informed publics ages 35 to 64 in the U.S. and U.K./France/Germany
Responses 6-9 only on 1-9 scale; 9 = highest

Source: Edelman (2009)

Operational Exposures



- Exposures due to failure of Controls, processes, operations
 - Operational Risk Framework
 - Failure of Risk Monitoring
 - Quantitative analysis over qualitative analysis

Lessons for Islamic Financial Industry - I



- Recognize and utilize inherent stability of Islamic system
 - 0 % Reserve system -> 0 Credit Multiplier
 - Assets backed by savings
 - Wealth creation
 - **“Pass-through”** intermediation
 - No Assets/Liabilities Mismatch

- Promote risk-sharing and discourage leverage
 - Equity-participation instruments
 - Institutionalize “*Musharakah*” and “*Mudarabah*”

Lessons for Islamic Financial Industry - II



- Establish linkage between “**real**” and “**financial**” sector
 - Develop truly “**Asset-Linked**” or “**ownership-sharing**” products
- Enhance Corporate Governance
 - Inclusion of Stakeholders
 - Enhance Transparency and disclosure
 - Financial sector development - **Institutions**
 - Develop Enterprise Risk Management Culture
- **Liquidity, Liquidity, Liquidity**
 - Develop products and mechanism to enhance **LIQUIDITY**

Lessons for Islamic Financial Industry - III



- Focus on the essence and the spirit of *Shariah* (*Maqasid-e-Shariah*)
 - Promote Social Justice and fair wealth distribution
- Reputational Risk
 - Be aware of reputational risk
 - One institution's act can do damage to the whole industry
- *Shariah* governance
- Develop Hedging mechanisms
- Operationalize “Operational Risk”



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Thank You !

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