

Risk Analysis for Islamic Banks

Hennie van Greuning and Zamir Iqbal



THE WORLD BANK
Washington, D.C.

CONTENTS

Foreword–Kenneth G. Lay	xiii
Foreword–Dr. Shamshad Akhtar	xv
Acknowledgments	xix
About the Authors	xxi
Acronyms and Abbreviations	xxiii

Part One: Principles and Key Stakeholders

1	Principles and Development of Islamic Finance	2
	Principles of Islamic Financial Systems	4
	Development and Growth of Islamic Finance	10
2	Theory and Practice of Islamic Financial Intermediation	16
	Structure of Financial Statements	18
	Basic Contracts and Instruments	21
	Islamic Financial Institutions in Practice	25
3	Corporate Governance: A Partnership	30
	Supervisory Authorities: Monitoring Risk Management	32
	The Shareholders: Appointing Risk Policy Makers	34
	The Board of Directors: Ultimate Responsibility for a Bank's Affairs	35
	Management: Responsibility for Bank Operations and the Implementation of Risk Management Policies	37

The Audit Committee and Internal Auditors: An Assessment of the Board's Risk Management Implementation	41
External Auditors: A Reassessment of the Traditional Approach of Auditing Banks	44
The Role of the General Public	45

4 Key Stakeholders	50
Internal Stakeholders	50
Multilateral Institutions	53
Regulatory Bodies	58

Part Two: Risk Management

5 Framework for Risk Analysis	64
Risk Exposure and Management	64
Understanding the Risk Environment	68
Risk-Based Analysis of Banks	72
Analysis versus Computation	74
Analytical Tools	76
Analytical Techniques	79
6 Balance-Sheet Structure	88
Composition of Assets	91
Composition of Liabilities	96
Equity	99
Balance-Sheet Growth and Structural Change	99
7 Income Statement Structure	102
Composition of the Income Statement	104
Income Structure and Earnings Quality	109
Profitability Indicators and Ratio Analysis	114
8 Credit Risk Management	120
Formal Policies for Managing Credit Risk	120
Policies to Reduce Credit Risk	121
Credit Risk Specific to Islamic Banks	126

Analyzing Credit Risk in the Asset Portfolio	127
Asset Classification and Loss Provisioning Policies	133
Review of Risk Management Capacity	138

9 ALM, Liquidity, and Market Risks 144

Asset-Liability Management (ALM)	146
Liquidity Risk	150
Market Risk	156
Market Risk Measurement	163
Market Risk Management	168
Notes	172

10 Operational and Islamic Banking Risks 174

Operational Risk	174
Risks Specific to Islamic Banking	176
Reputational Risk	181

Part Three: Governance and Regulation

11 Governance Issues in Islamic Banks 184

Stakeholder-Based Governance Model	184
Role and Responsibilities of <i>Shariah</i> Boards	187
Issues in <i>Shariah</i> Governance	189
<i>Shariah</i> Review Units and Other Structures	191
Improvement in <i>Shariah</i> Governance	192
Investment Account Holders as Stakeholders	193
Financial Institutions as Stakeholders	196

12 Transparency and Data Quality 200

Transparency and Accountability	200
Limitations of Transparency	203
Transparency in Financial Statements	204
Disclosure and Data Quality	206
Deficiencies in Accounting Practices	210
Applicability of IFRS to Islamic Banks	211
Transparency and Islamic Financial Institutions	214

13	Capital Adequacy and Basel II	218
	Significance of Capital in Banking	219
	Basel I and Basel II	221
	Pillar 1: Capital Adequacy Requirement	222
	Capital Adequacy Methodology for Islamic Banks	224
	Pillar 2: Supervisory Review	231
	Pillar 3: Market Discipline	233
	Managing Capital Adequacy	234

14	The Relationship between Risk Analysis and Bank Supervision	240
	The Risk Analysis Process	241
	The Supervisory Process	245
	Consolidated Supervision	251
	Supervisory Cooperation with Internal and External Auditors	254

Part Four: Future Challenges

15	Future Challenges	258
	Areas for Improvement	258
	Steps Forward: Some Recommendations	261
	Regulation, Governance, and Transparency	269

References	276
------------	-----

Appendices

A	Glossary of Islamic Terms	281
B	IFSB Standard on Risk Management	285
C	Proposed Outline for Bank Analytical Reports	293

Index	297
-------	-----

BOXES

1.1	Principles of an Islamic Financial System	7
3.1	Accountability of Bank Management	38
3.2	Fit and Proper Standards for Bank Management	39
3.3	The Responsibilities of Management	40
3.4	The Responsibilities of Audit Committees and Internal Auditors	44

3.5	The Responsibilities of External Auditors	45
8.1	IFSB Principles of Credit Risk	122
8.2	Content of an Investment and Financing Asset Review File	134
8.3	Signs of a Distorted Credit Culture	134
8.4	Asset Classification Rules	135
9.1	IFSB Principles of Liquidity Risk	152
9.2	IFSB Principle of Market Risk	154
9.3	IFSB Principles of Rate-of-Return Risk	157
9.4	IFSB Principles of Equity Investment Risk	158
11.1	IFSB Principles of Corporate Governance for Islamic Banks	196
12.1	Criteria for Evaluating Accounting Standards	203
12.2	Survey on Public Disclosure of Banks	210
12.3	AAOIFI Standards	211
13.1	IFSB Principles for Minimum Capital Adequacy Requirements (CAR)	224
13.2	IFSB Standard Formula for CAR	225
13.3	IFSB Supervisory Discretion Formula for CAR	225
13.4	Computation of CAR for an Islamic Bank	229