

The displaced commercial risk and Islamic banks

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Abstract— This Islamic Finance has attracted an ever-increasing interest over the last forty years and has undergone a remarkable expansion in asset value. Nevertheless, the peculiarity of Islamic financing modes proposed by these institutions may present certain limits in their execution which exposes these banks to risks that emanate from the characteristics of their particular modes of operation. The aim of our article is to analyze the main risk specifically to Islamic financial institutions namely the displaced commercial risk. This risk arises from participatory investment accounts. In other words, this situation occurs when the banks, under pressure from the environment, are forced to give up part of their profits to pay the depositors, in order to prevent massive withdrawals that can be translated into a liquidity crisis later. In order to avoid such a situation, Islamic banks highlight income smoothing mechanisms on participatory investment accounts.

Keywords-component: *Islamic banks; risk; participatory investment accounts; competition.*

I. INTRODUCTION

This template, Since the first experience of Islamic finance in Pakistan in the 1950s, followed by Egyptian experience in the 1960s, Islamic financial institutions are present in almost 30 countries with rapid growth in the Arabian Gulf countries Persique (65 banks), Malaysia (17 banks) and the United Kingdom (5 banks) . Thus, the amount of assets held by these banks exceeds 1.650 billion dollars [15] with an average annual growth rate of 15% [14]. Indeed, according to Al-Jarhi and Iqbal (2002) [9], the Islamic bank is an institution that receives deposits and conducts all banking activities except the interest-bearing loan and loan operation. While these banks, like conventional banks, rely on their financial intermediation business models by collecting deposits and distributing credits. However, Islamic banks have a number of notable differences with conventional banks which explains their existence [6].

These banks then proceed to the collection of funds and their reallocation by making investments in the framework of the Shari'ah. As a result, Islamic banks have a different understanding of financial intermediation as the denial of usury in transactions is a key pillar in the work of Islamic banks.

In this context, and facing of these different challenges, Islamic banks should be immune to the interest rate risk.

That said, according to Luis Miotti and Dominique Plihom [13]:

« Interest rate risk is defined as a significant risk that arises because interest rates can vary significantly over time, while banking involves intermediation that generates exposure to maturity mismatches ».

It seems obvious that for conventional finance, interest rate risks are frequent because the interest-bearing loan is the basis of the financial intermediary mechanism. However, since interest is prohibited in Islamic finance, does the variation in the interest rate have a direct influence on the performance of Islamic banks?

Indeed, a multitude of empirical studies carried out especially in Malaysia and Indonesia explicitly affirm the exposure of Islamic banks to the risks of interest . The first study is conducted in Malaysia for the period between 1999 and 2006 through which Kassim et al. (2009) [11] demonstrate that Islamic banks are more sensitive to changes in monetary policy than conventional banks. For these authors, the fluctuation of interest rates on conventional deposits causes the variability of rates of return on investment deposits in Islamic banks. As a result, the increase in interest rates causes the increase in the volume of conventional deposits and the decline in the volume of Islamic deposits.

These results seem consistent with findings from other studies, such as those conducted by Kader and Leong (2009) [2] and Haron and Ahmad (2000) [7] on the Malaysian banking market and by Kasri and Kassim (2009) [11] on the case of Indonesian banking market. Some studies also show that Islamic banks adjust their rates of return up (down) when this rate is lower (higher) than conventional rates. The purpose of this article is to study in detail the nature of the risk generated by the participative investment accounts, the reasons for this exposure and its impact on the activity of Islamic banks. Then we will expose the various risk management methods developed by these institutions to control the risk associated with investment accounts.

II. INTEREST RATE IDENTIFICATION AMONG ISLAMIC BANKS

With the exception of Iran and Sudan Islamic banking institutions have coexisted with conventional banks for several years. The former are based on the crowdfunding system where interest is prohibited while the second on interest credit [16]. Nevertheless, the duality of the two systems faces some difficulties since the target clientele of the two banks remains common, which constitutes a belt of transmissions between the Islamic and conventional spheres [19]. In other words, in view of the competitive environment in which Islamic banks operate, customers have the opportunity to change banks easily in case of dissatisfaction.

Moreover, a low rate of return on the participative investment accounts could lead to dissatisfaction among depositors. The latter therefore risk withdrawing their funds to place them in a competing bank, thus seeking a higher remuneration on other alternative investments [18].

In this context, the clientele that seeks to maximize its gains by seeking to arbitrate between the offer of conventional banks and those of Islamic banks expose the latter to the displaced commercial risk which mainly concerns the management of non-restrictive participative investment accounts. Thus, the Islamic bank is exposed to a risk of massive withdrawal of funds and must face a liquidity problem.

Under commercial pressure and to avoid this risk, Islamic banks will try to increase their rate of return on participatory investment accounts when it is low and take a portion of the income from these accounts to feed a reserve when it is high. Trade pressure prompts Islamic banks to smooth investment account revenues to mitigate displaced commercial risk [18].

In this logic of behaviour of the holders of these accounts, Islamic banks align their practices with those of traditional finance, to reduce the risk of volatility of its client's [1].

By adjusting the returns of PSIA (Profit Sharing investissement accounts) accounts to the credit rates of conventional banks, Islamic banks therefore resort to the use of certain rates such as London Inter-Bank Offering Rate (LIBOR) and EURIBOR as reference rates faults of alternatives [8]. This situation could seriously affect the liquidity of an Islamic bank, or even its solvency.

To summarize, this is a transfer of risk, associated with deposits, to the shareholders of the bank. This situation occurs when banks, under pressure from the environment, are forced to yield part of their profits to pay depositors, to prevent massive withdrawals caused by low rates of return [12]. This displaced commercial risk implies that, despite the Bank's compliance with the Shari'ah injunctions, the latter is unable to pay competitive rates of return in comparison with their counterparts or other competing institutions. This can cause deposit resubmission. To prevent this situation, shareholders of the bank will have to take a puncture from them in profits for the benefit of depositors / investors.

III. MODALITY OF MANAGEMENT FOR DISPLACED COMMERCIAL RISK

In order to limit the damage caused by the displaced commercial risk, the Islamic bank can engage in a set of practices that serve to guard against this type of risk.

A. Investment Risk Reserves (IRR)

Under the prudential framework, the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) recognize the exposure of Islamic banks to the displaced commercial risk and respect of certain prudential reserves such as the constitution of Investment Risk Reserves or IRR.

Indeed, it is a reserve for investment risk to protect the holders of investment accounts against possible losses [3]. The IRR is deducted from Mudaraba's income which represents the share of the profit attributed to the owners of the investment accounts. It is levied after the calculation of the bank's remuneration as Mudarib.

However, according to C.Karim (2008) [5], the use of this type of reserve may present some obstacles from the Islamic point of view as they increase the risk of manipulation of financial information and reduce the transparency of Islamic banking institutions.

B. Profit Equalization Reserves (PER)

Unlike the IRR, the PER is deducted from the gross profit of the Islamic bank before the allocation of profits between the shareholders of the bank and the owners of the investment accounts. This type of reserve reduces the funds actually attributable to investment account holders and shareholders. At a time when the rate of return on investments is higher than that of comparable investments in the market, the Islamic bank can maintain a remuneration comparable to that retained in the market while taking a portion of the income to feed the PER [17].

The amount of the reserve belongs to the holders of the participative investment accounts and to the shareholders according to the same profit sharing ratio fixed in the Mudarabah contract and it will be used to smooth the rate of return, which is admittedly low but positive.

To summarize, we can divide the situation in two scenarios. The first scenario, the rate of return on participatory investment deposits is very low compared to the reference rate but it still remains positive. In this case, the Islamic banking institution uses the share of the PER which is normally returned to the owners of the investment accounts in order to smooth the rate of return. If it turns out that the share of the holders of the investment accounts is not sufficient, the bank in this case can use the share of shareholders' PER. In the second scenario, the rate of return on participating investment deposits is negative. The Islamic bank uses two types of reserves. Firstly, the IRR to absorb the losses. Then, the PER to increase the depositors' remuneration up to the reference rate to guarantee a competitive remuneration to the holders of the investment

accounts compared to their competitors. However, the major challenge in dealing with this type of risk is the proper evaluation of the amounts of PER and IRR reserves to be withdrawn.

IV. PRUDENTIAL REGULATION AND DISPLACED COMMERCIAL RISK

A. *Basel II agreements and Islamic banks*

Despite the rapid and dramatic growth experienced by Islamic banks in recent years, international prudential regulation has not provided for special treatment of this category of banks. Indeed, Basel II prudential banking regulations do not recognize the specificity of Islamic banks, especially participatory investment accounts [8].

By applying the Basel II agreements, some Islamic banks tend to account for off-balance sheet investment accounts. By applying the Basel II agreements, some Islamic banks tend to account for off-balance sheet investment accounts [4]. This practice can hinder the smooth operation of these financial institutions.

Moreover, if we try to map the Islamic banking risks and the Basel II agreement, typically, the first pillar refers to credit risk, market risk and operational risk. As for the second pillar, it will include the steps of the prudential supervision process by the regulatory authorities through governance and capital management risks. However, a significant number of risks related to the activity of Islamic banks are not taken into consideration or are poorly taken into account by the Basel II guidelines, which include the displaced commercial risk and other categories of risk as securities. We quote as an example: the risk of interpretation of religious rules or good compliance with Shari'ah.

B. *International Islamic Regulatory Authorities*

For the international Islamic regulatory authorities, like the AAOIFI and the IFSB, they seek to fill the gap left by the Basel agreements by putting in place global risk management and reporting mechanisms to evaluate the potential impact of market factors affecting asset rates of return, compared to the expected rates of return for investment account holders [10].

Whether for the AAOIFI and the IFSB, the retention of PER and IRR as prudential reserves is not mandatory but just highly recommended. For the AAOIFI, share the PER share reserved for the shareholders as an unavoidable component of the total reserves and integrate it at the equity level. On the side of the IRR, the AAOIFI recommends to consider it as a component of the capital of the holders of the investment accounts, which is quite the opposite for the IFSB which recommends not imputing the two prudential reserves with the equity.

However, the majority of the regulatory authorities do not indicate the methods for calculating the rate of return on the participatory investment accounts as well as the calculation of the PER and the IRR. In this context, Islamic banking

institutions are forced to develop their own internal models to quantify the displaced commercial risk.

In some cases, the regulatory pressure to smooth the rates of return on participatory investment accounts is subject to the diversity of regulatory environments in the countries in which Islamic banks operate. For dual banking systems, central banks use a protective approach to participatory investment account holders. In such a situation, Islamic banks are forced to smooth the rates of return on investment accounts with the only difference is the fact that instead of exposing Islamic banks to commercial risk moved under the constraint of competition, this practice becomes mandatory according to the regulations.

It therefore appears that under commercial or regulatory pressure, Islamic banks that operate in a regulatory environment that does not take into account their particularities may not be able to comply with the principle of sharing profit and loss in accordance with the principles of Shari'ah law. Thus, in seeking to promote a fair situation between conventional banks and their Islamic counterpart's regulatory authorities risk falling into a dilemma to ensure the development of this expanding industry ensure their roles as religious regulators.

V. CONCLUSION

In this work, we have focused on the problem of the exposure of Islamic banks to the commercial risks and the impact of this exposure on the performance of these Islamic banking institutions. This risk, which seems specific to Islamic banks, results from the mobilization of funds by the Islamic bank in the form of participative investment accounts. In other words, this risk specifically sends to the behaviour of the holders of these accounts who, dissatisfied with the remuneration offered by their bank can withdraw their funds by running the bank at a serious risk of liquidity; it derives more specifically from the behaviour.

Islamic banks found under commercial or regulatory pressure are forced to resort to revenue smoothing techniques on participatory investment accounts which may put the Islamic bank in a delicate situation of non-compliance with the principle of sharing profits as stipulated by the principles of Shari'ah. Existing arrangements, including those of the IFSB, is not yet effective despite the efforts that have been made in view of their arbitrary and undifferentiated contribution to the determination of the displaced commercial risk.

To summarize, it must be said that Islamic banks, like other banking institutions, are required to respect certain financial recommendations to ensure their survival and continue to operate. However, unlike conventional finance, Islamic finance has defined a set of extra-financial criteria that must be met in order to be in full compliance. In such a situation, Islamic banks are in an emblematic position to adopt a particular strategy in order to compete with their rivals or to find themselves in a situation of non-compliance with the principles of Shari'ah.

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