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FAST School of Management Concludes First Islamic Finance and Business Conference

Advancements in Islamic finance and business in the 21st Century discussed in Islamabad, Pakistan.

DUBAI, DUBAI, UAE, April 27, 2015 /EINPresswire.com/ -- FAAIF CEO Camille Paldi participates in Islamic Finance and Business Conference at FAST School of Management in Islamabad, Pakistan. Paldi discussed the various risks in Islamic banking and whether or not this makes Islamic Banking too expensive. Paldi concluded that this is impossible to determine due to the fact that the majority of Islamic banks do not use IFSB and AAOIFI standards in financial reporting or for capital adequacy standards.

In murabahah, the IFI is exposed to credit risk in that the customer may default in payment and the bank is liable for any loss arising from damage of the goods prior to delivery. Also, the bank cannot charge anything in excess of the agreed upon price even due to late payment. Despite credit risk, murabahah has low liquidity and operational risk making it a preferred mode of short-term finance.

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> *Camille Silla Paldi*

In salam financing, the IFI is exposed to credit/counterparty risk in the event that goods are not delivered or delivered on time according to specification after payment is made. The IFI is exposed to market (price) risk on the goods in that the spot price on delivery may be lower than the amount paid. Furthermore, the commodities require inventories exposing the banks to storage costs and other price risk. In the event of default, the IFI may not be able to recover its capital from customers and/or the financial guarantee may not cover the full amount of salam capital. With regard to parallel salam, if the supplier under the salam defaults on delivery, the IFI may have to purchase the goods in the open market in order to meet its delivery obligation under parallel salam for a price higher than the original. However, parallel salam allows the IFI to sell the commodity for future delivery at a predetermined price, thus hedging the price risk on the original salam and protecting the IFI from having to take delivery of the commodity and warehousing it. Salam poses high credit, market, liquidity, and operational risk and has a high capital charge, however, the risks may be mitigated by use of parallel salam.

In istisna'a, the IFI faces market risks if the costs of production rises and credit risk if the buyer either declines to accept the goods or defaults on payments. The counterparty risks include failure to meet the quality and time of delivery terms of contract and not receiving the selling price of the asset from the customer either in pre-agreed stages of completion or upon full completion of the manufacturing or construction process. In parallel istisna'a, the IFI assumes the completion risk associated with the failure to complete the project, delay in completion, cost overruns, force majeure, and unavailability of qualified subcontractors. Istisna'a displays high credit, market, liquidity, and operational risk and has a high capital charge. Salam and istisna'a are expensive as they are risky and require Shari'ah mechanisms to hedge price risk, which are currently unavailable. However, these risks may be mitigated through use of parallel salam and istisna'a.

In operating ijarah and ijarah muntahia bittamleek (IMB), all risks pertaining to the leased asset are borne by the IFI, except for the residual value risk at the term of an IMB, which is borne by the lessee. The lessor is exposed to market (price) risk on the asset while it is in the lessor's possession prior to the signature of the lease contract, except where the asset is acquired following a binding promise to lease. The lessor is exposed to credit risk of the lessee as counterparty in servicing the lease rentals and market (price) risk attaching to the residual value of the leased asset at the end of the ijarah contract or at the time of repossession upon default. Ijarah has a high credit, market, and liquidity but low operational risk. However, off-balance sheet modes of finance such as ijarah may mitigate risks by nature of off-balance reporting requirements and ratios effect. Furthermore, leases do not require the same level of investigation and audit of the lessee's affairs as would an investment made in the lessee's enterprise, making it an attractive form of finance. In addition, financial ijarah actually produces financial leverage and operating leases can be used to gain capital structure leverage.

In musharakah, the IFI is exposed to credit risk in respect of the customer's purchase payments as well as to the risk attaching to the IFI's share of the underlying asset in the transaction. The IFI is further exposed to entrepreneurial risk of the managing partner and the risk that the manager may not report actual profits generated. The IFI may face a risk when a withdrawing partner owes money and if a venture enters bankruptcy, the IFI may be exposed to the risk of losing its entire invested capital, as this capital ranks lower than debt instruments upon liquidation. In the case of diminishing musharakah, the amounts due from the partner to purchase the agreed shares of the asset on the agreed dates are subject to credit risk in respect of the partner's ability and willingness to pay, with the shares of the partner in the asset providing credit risk mitigation as collateral. The capital invested by the IFI is also subject to risk that the amounts recoverable from the partner may be less than the amount invested because the value of the musharakah assets has decreased. Musharakah has high credit, market, liquidity, and operational risk and a high capital charge.

In mudharabah, the IFI is exposed to capital impairment risk if the venture incurs losses or if the mudarib defaults on payments due to the mudharabah. Furthermore, if a customer cancels the agreement to purchase, the IFI has to sell the goods in the open market at a possibly lower selling price than the purchase price. Alternatively, the IFI may have to hold the goods and incur storage costs. Mudharabah has a high credit and market risk, but low liquidity and operational risk. Camille Paldi can be reached at camille@faaif.com.

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