

# **COVID-19 AND RISK MANAGEMENT FOR ISLAMIC BANKS:**

## **Proposal for the New Normal Scenario**

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## Segment-1: Introductory Note

The Islamic banking industry is fighting Covid-19 related risks and strategizing to sustain in the new normal situation. The complex multi-crises situation<sup>1</sup> caused huge challenges for the banking and financial industry, and Islamic banking and finance is no exception (AAOIFI, 2020a). The Islamic banking industry is passing through a struggling phase to turn around from a very risky environment of acute business and financial interruptions; fears and lack of confidence amongst entrepreneurs and clients; and skepticisms with legal liabilities. Shaping the right approach and adopting the right kind of risk management framework is critical to the Islamic banking industry for transforming and sustaining in this new normal situation. Also, the root cause of this corona crisis must be part of the risk management approach of the Islamic banks for protecting the natural order by upholding their ethical commitment and Shariah compliance.<sup>2</sup>

‘Risk management’- a dynamic field that receives special attention and consideration following any big challenge and banking crisis. The risk management approach changed remarkably following the last global financial crisis of 2007-09 and is duly receiving concern and attention in this on-going devastation of Covid-19. The global banking industry covering both conventional and Islamic banks is very much within this classical banking rule. To a great extent, the risk management framework installed by the conventional banking industries has similarities with that of the Islamic banking counterparts as they commonly confront several banking-related risks.<sup>3</sup> However, there should be notable differences in terms of risks and their management in transaction and Shariah issues. Especially, the Islamic banks’ differential method of operations and ethical value-based approach require certain Shariah laws to duly comply. And thus Islamic banks’ risk management framework must be wider in scope having greater categories of risks. There is no logical basis to accept a complete replication of the risk management framework of the conventional bank by the Islamic banks.<sup>4</sup> Both conventional and Islamic banks are engaged in transforming and streamlining their risk management frameworks to sustain and flourish in the new normal situation<sup>5</sup>, and logically Islamic banks need greater efforts to accomplish their jobs.

The paper is an attempt to facilitate discussion on risk management approaches and frameworks in the context of the Covid-19 situation. Based on the published information and opinions, the paper puts forward certain proposals as part of the risk management framework of Islamic banks for the new normal.

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<sup>1</sup> Published recently in the Harvard Business Review, an article placed the existing and upcoming situation as a combination of Real Recession; Policy Recession and Financial Crisis (Carlsson-Szlezak et. al, 2020).

<sup>2</sup> Environmental protection is an important aspect of Islam, and the concept of environment is distinct enough with given values to unity, balance, order, and harmony in The Holy Qur’an (Shah, 2020).

<sup>3</sup> “Islamic banks are confronted with two categories of risk: common risks, which are similar to the risks faced by conventional banks and risks specific to Islamic banks” (Salma and Khalid, 2019).

<sup>4</sup> “The components of the conventional and Islamic banks are the same, and there is little argument on their applicability under Shariah law; however, the risk management framework for Islamic Banking institutions must be inherently different and bigger scope. It cannot just be seen as a replica of the conventional business; the foundation of Islamic banking is definitely different” (Alfatakh, 2018).

<sup>5</sup> A new normal is a state to which an economy, society, etc. settles following a crisis, when this differs from the situation that prevailed prior to the start of the crisis (Wikipedia.org).

## Segment-2: Covid-19 Devastations, Risks, and Reshaping Need Associated with Islamic Banking

Covid-19 resulted in an environment of unprecedented risks for the global banking arena. The uncertain business surroundings and wide-spread uncertainties intensified almost all types of risks associated with both the conventional and Islamic banking industry. Islamic banks are exposed to even higher risks because of their differential business models.<sup>6</sup> Credit risk<sup>7</sup>, liquidity risk<sup>8</sup>, market risk<sup>9</sup>, and operational risk<sup>10</sup> are common to both conventional and Islamic banks. Transaction risk, valuation or equity risk<sup>11</sup>, and displaced commercial risk<sup>12</sup> are connected with the specified way of transactions of the Islamic banking products. Shariah risks are other additional types of risks of the Islamic banks that are associated with non-compliance with Shariah decisions and instructions that include Shariah compliance risk<sup>13</sup>, fiduciary risk,<sup>14</sup> regulatory risk, and reputational risks. Shariah risks are also considered as the subset of the operational risks of the Islamic banks. However, the risk structure of the Islamic banks heavily depends upon their asset structures: debt-based where risks are transferred to the customers or equity-based where fund providers also undertake investment risks. On the asset side, equity-based financing (Musharakah and Mudarabah) comprises around 5 percent of the total global Islamic banking assets.<sup>15</sup> As significant Islamic banking products are debt-based, in reality, risk environments are similar both for conventional and Islamic banks excepting Shariah risks<sup>16</sup>. The global Islamic banking product structure points to the fact that the risks for the global banking industry fueled by the Covid-19 have notable implications for the Islamic banks as well.

The Covid-19 pandemic led to a major change in terms of growth, pricing, and products in the global financial and banking sectors (FSB, 2020). Liquidity challenge and cash crunch became strongly visible throughout the globe immediately after the spread of the Covid-19 as market liquidity deteriorated considerably including in markets traditionally seen as very deep (IMF, 2020a). In the global context, the economic slowdown led to a rise in

<sup>6</sup> “Islamic banks share many characteristics with their conventional peers but are also exposed to additional risks due to the specific nature of their business models” (Chattha, 2020).

<sup>7</sup> “The risk that a counterparty will not meet its obligations in accordance with the agreed upon terms” (Helmy, 2012). □

<sup>8</sup> “The bank’s potential loss resulting from its inability to fund an obligation on time without incurring unacceptable losses” (De Coussergues and Bourdeaux, 2010). □

<sup>9</sup> “This risk arises from an unfavorable change in the price of an asset that is generally traded on the market” (De Coussergues and Bourdeaux, 2010).

<sup>10</sup> “Due to inadequate control of internal processes and operational practices, the risks may result in real loss of income and potentially reputation.” (Islamic Banker, 2018).

<sup>11</sup> Due to the nature of some Islamic banking contracts, especially equity based structures, there are challenges in valuation of the portfolio.

<sup>12</sup> “Displaced Commercial Risk refer to the risk of mismatch between the fixed/contracted obligation to the depositors vs the uncertain returns on the financing (income) which may result in the income is insufficient to meet the obligations to the depositors” (Reyazat, 2012).

<sup>13</sup> Inability to comply with Shariah requirements puts the operations of the Islamic bank at risk and may be regarded as non-Shariah compliant business.

<sup>14</sup> Risk of loss arising from the Islamic bank’s negligence, fault or violation of their investment mandate.

<sup>15</sup> As of Quarter 4, 2018, Musharakah, Diminishing Mushrakh, and Mudarabah comprised 5.5% of the total (IFSB Bulletin, 2019).

<sup>16</sup> “In general, for an Islamic bank operating based on debt-structures, the risk management is the same as a conventional bank’s risk management, except on the Shariah risks” (Alfatakh, 2018).

nonperforming loans (NPL), especially NPL arose from loans issued to SMEs, airlines, hotels, tour operators, restaurants, retail, construction, and real estate businesses (Ozili and Thankom, 2020). As a consequence, the demands on the financial systems' capital and liquidity have risen (FSB, 2020). There is no doubt that today banks are better positioned with higher capital and liquidity than in the past in response to the stringent compliance requirements of the central banks. Regarding certain policy interventions to address this emergency, changes and flexibility on capital treatment have duly been recognized recently by the Basel Committee on Banking Supervision (BCBS). Still, exiting capital base and risk management approaches would be crucial to handle the situation.

Financial crime risk became particularly visible in the Covid-19 situation. Especially, cybercrimes<sup>17</sup>, money laundering associated with international trade and electronic payment systems<sup>18</sup>, and risks associated with willful default due to potential moral hazards appear to be particularly critical for the financial and banking sector. Moral hazard is a common challenge during a crisis which means that certain unethical groups of borrowers take advantage of the situation and do not pay back banks' liabilities willfully. Moral hazard in the context of Covid-19 might be a critical source of financial crime and credit risk if not handled properly.

The outbreak of Covid-19 is having major impacts on Islamic institutions, just as it has on conventional banks. Lower financing demand, reduced fee income, and additional subsidized financing would hit revenues; nonperforming facilities are forecasted to rise (Global Finance, 2020). Over USD 2.4 trillion Islamic finance industry with some 1,400 institutions, spread across 80 countries, is confronting unprecedented challenges driven by the global Covid-19 pandemic (Domat, 2020). Given the downturn posed by the Covid-19 pandemic, the volatility in oil prices, and the uncertain macroeconomic environment, the Islamic finance industry faces an unprecedented challenge to its development (Brown, 2020). According to Al-Natoor (2020), other than the contamination risks which is common, Islamic banks' risk factors and mitigations vary from country to country. In Indonesia, while Islamic banks are likely to be affected to a similar degree as conventional banks, those with significant exposure to the tourism sector are likely to be more affected. In Malaysia, Islamic banks' credit profiles are expected to remain broadly steady with adequate loss-absorption buffers, though asset quality and profitability might be affected should the Covid-19 outbreak be prolonged. In Turkey, asset quality pressures faced by Islamic banks are significant, as for conventional banks, due to seasoning risks following rapid financing growth, exposure to risky segments, and above-average foreign-currency financing, given potential lira depreciation (Al-Natoor, 2020).

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<sup>17</sup> The dangers of cyber-crime have been there for many years; however, the increase in the population connected to the Internet and the time spent online, combined with the sense of anxiety and fear generated from the lockdown, have provided greater opportunities for cybercriminals to take advantage of the situation and has prompted a proliferation of e-crimes (UNICRI, 2020).

<sup>18</sup> Even in normal times, there has been a growing recognition and concern of the threat that illicit financial flows pose to the integrity and stability of the global financial system; there are increasing evidences that the problem is growing and scopes are enhancing in the context of the Covid-19 situation (FATF, 2020a).

In the Gulf Cooperation Council (GCC) countries, Islamic banking is an integral part of the banking system, and unlike their Asian or African counterparts, Islamic banks in the Arab world depend largely on government spending which means the unprecedented drop in energy prices has serious implications for them (Domat, 2020). In many Asian and African countries, Islamic finance has a large market share in microfinance, small and medium enterprises (SME), and retail lending (Domat, 2020). The pandemic has a more severe and deeper impact on Islamic finance markets, as the current crisis is affecting SMEs as well as low income and minimum wage individuals particularly hard; and compared to conventional banking, Islamic finance has a larger exposure to SMEs, microfinance, and retail lending, especially in Asia (Brown, 2020).

Regarding Bangladesh, the Islamic banking industry, a very important segment of the banking industry of Bangladesh, has also been facing turbulent situations in most business areas and operations. The implication of the Covid-19 situation for both Islamic and conventional banks remains similar because of the extensive dominance of the debt-based investment modes in the Islamic banks in the country. Regarding performances, situations improved in the deposit and credit fronts, however, banks, in general, have been in conscious mode, which is logical. Deposit growth came back to the normal, however, small depositors are struggling (Habib, et al, 2020). Credit delivery to the big enterprises improved remarkably, however, CMSMEs are still confronting several challenges.<sup>19</sup> Not liquidity crunch, rather a liquidity surplus became a concern for certain banks in an environment of business uncertainty. Despite the improvement, banks are underperforming in their customer services, and there are fears of the erosion of customers' confidence. There are claims that with the reduction of cash flows, business firms are struggling to pay their suppliers, their employees, and ultimately their bankers. In the context of international trade services, payment-related risks became a matter of concern. In Bangladesh, banks-both Islamic and conventional, have significant involvement in trade transactions and may even face greater liabilities as a result of international trade disruptions. If not handled properly, back-to-back LC might be a source of challenge for the country's banks. As a whole, the situation points toward notable contraction of both financing/investment and fee income of banks and financial institutions. If the unfavorable business environments and the longer corona war result in a rise in non-performing loans to a reasonably high extent, banks may confront the capital and solvency risks- very critical indicators of financial stability.

Regarding the existing risk management structures, environmental risk received inadequate focus both in the conventional and Islamic banks' risk management frameworks. Covid-19 points to the necessity of handling environmental risks at all economic and business activities including banking.<sup>20</sup> Shariah has strong instruction to handle environmental risks and protect

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<sup>19</sup> Big borrowers are better positioned, the loan disbursements for the CMSME sector have been running on a slow track from the beginning, and till 15 September, all the banks could distribute only Tk3,330 crore from the Tk20,000 crore bailout package, which is 16.65% of the total fund (<https://tbsnews.net/economy/banking>).

<sup>20</sup> The pandemic is a reminder of the intimate and delicate relationship between people and the planet (WHO, 2020). To help prevent the next pandemic, it is essential to transform human's relationships with nature (WWF, 2020b).

the natural order. Being stewards of the Earth, it is the responsibility of Muslims to care for the environment proactively; Muslims are encouraged (in The Holy Qur'an<sup>21</sup>) to reflect on the relationship between living organisms and their environment and to maintain the ecological balance created by Allah (Al-Banna, 2020). Unfortunately, the Covid-19 scenario brought in even more environmental disruption in certain fronts<sup>22</sup> that points to the necessity of addressing the risk very intensely. Another unpleasant truth is that the corona crisis is interrupting the ongoing green and sustainable development agenda like the implementation efforts of the UN (United Nations) Sustainable Development Goals or SDGs.<sup>23</sup> The Islamic attitude towards the environment and natural resource conservation is not only based on the prohibition of over-exploitation but also sustainable development (Al-Banna, 2020).<sup>24</sup>

Covid-19 is shifting the dynamics in the banking industry and the outbreak has created new opportunities for Islamic finance markets by accelerating trends such as socially responsible investing, sustainability, and digitalization (Brown, 2020). The aftermath of Covid-19 may also create new opportunities for Islamic banking, particularly with the rise of socially responsible investing and the growing popularity of ESG.<sup>25</sup> Country or area-specific surveys and activities also came up with strong opinions in favour of green and sustainable recovery measures. According to Usher and Daouda (2020), Islam's promotion of social trust, cooperation and solidarity mean that Islamic banking products are well suited to SDG impact (box -3.2).

<b>Box 3.2: Aligning Islamic Banking and Finance with SDGs</b>
Policymakers and Islamic banks should come together to ensure SDG impact metrics and reporting are agreed upon that are both sharia compliant and in line with international standards
To better support the SDGs, leaders must develop a range of Shariah-compliant impact investing tools and instruments that are attractive to large investors. <sup>26</sup>
Make SDG-compliant Zakat investments the norm to channel funds to the local SDG projects. These include renewable energy projects in underserved communities. <sup>27</sup>
Create pro-poor and environmentally sustainable initiatives to attract investment from the public and private sector stakeholders with success indicators that can be and measured
Islamic finance institutions could not only provide a range of products to vulnerable communities but might also ensure these communities are adequately empowered by strengthening technical and managerial capacities, addressing climate risks, accessing markets, and building partnerships.
<b>Note: Authors' compilation based on Usher and Daouda, 2020.</b>

<sup>21</sup> "Allah surely loves not those who transgress the bounds of what is right. Do not cause any disruption on earth after it has been so well ordered." (The Holy Qur'an 7:55-56).

<sup>22</sup> For example, poaching and deforestation have increased since Covid-19 restrictions went into effect; bushmeat and ivory poaching incidents have become more frequent in Africa; Amazonian deforestation in Brazil has reached a nine-year high since the pandemic began (Price, 2020b).

<sup>23</sup> There are evidences that SDG-2: Zero Hunger; SDG-3: Good Health and Well Being; SDG-6: Clean water and Sanitation; SDG-7: Affordable and Clean Energy; SDG-13: Climate Action; SDG-17: Partnership for the goals are getting affected (UNIDES, 2020).

<sup>24</sup> Environmental awareness and protection of natural resources is an integral part of Islamic beliefs; as humans, people are keepers of all creation, including soil, air, water, animals and trees; a major objective of Islamic teachings and traditions is to build and maintain a healthy and clean environment (Al-Banna, 2020).

<sup>25</sup> Environmental, Social, and Governance (ESG) refers to the three central factors in measuring the sustainability and societal impact of an investment in a company or business.

<sup>26</sup> Under the Youth Employment Support (YES) program, IsDB pioneered venture capital financing (Restricted Mudaraba) for micro and small businesses operated by youth.

<sup>27</sup> In Palestine, Zakat funds support SMEs through Islamic microfinance structures.

One of the many issues this pandemic has shown to the globe is that survival depends heavily on investment in science, technology, and innovation (Bicer, 2020). Beyond its immediate economic implications, Covid-19 is also forcing the Islamic finance industry to adapt to the rapidly evolving market conditions and speeding up the pace of emerging trends such as digitalization to mitigate the impact of the outbreak (Brown, 2020). The global Islamic banking software market size is expected to grow by USD 460 million during 2020-2024, and the report<sup>28</sup> noted that as a whole the new opportunities are created due to the Covid-19 pandemic (Technavio, 2020).

### **Segment-3: Crisis Responses and the Challenges of the Islamic Banks in the Context of Covid-19**

In response to the widespread virus contamination and economic, monetary, and financial sector implications, the policymakers are providing unprecedented support to households, firms, and financial markets around the globe. These measures introduced by the policymakers may be categorized into public health measures; human control measures; fiscal measures, and monetary measures (Ozili and Thnakom, 2020). As noted by the UNDP (2020), Islamic finance can be part of the Covid-19 response through a range of financing instruments well-suited for various stages: emergency and short term, medium-term and long term. Zakat<sup>29</sup> can be an important component of national emergency support programs.<sup>30</sup> The financing of equipment, vehicles, and other sources of livelihood and trade finance are key mechanisms by which Islamic banks and financial institutions can support recovery in the medium term. Aligning their financing activities with the SDGs is a significant opportunity for Islamic banks.<sup>31</sup> Sukuk especially that are SDG linked<sup>32</sup> can be an important source of long-term capital for governments and companies engaged in the Covid-19 response and recovery; Waqf endowments can, in many contexts, be important contributors to long-term resilience which can be an important way for stakeholders to contribute to social infrastructure (Rehman, 2020).

Many of these policy interventions, undertaken over the globe, are directly and indirectly associated with financial sector stability- more specifically, the soundness of the banking

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<sup>28</sup> According to Technavio (2020) the Middle East (MEA) region led the Islamic banking software market share with application in different segments (retail, corporate and others) in 2019, followed by APAC, Europe, North America, and South America respectively.

<sup>29</sup> Zakat, which is effectively a Muslim ‘wealth tax’, is a sacrifice of wealth; this is not just charity - it is a core duty and one that ‘purifies’ the rest of our wealth (Iqbal, 2020).

<sup>30</sup> UNDP’s partnership BAZNAS, Indonesia’s national Zakat collection agency, has been in place since 2017. This collaboration is an example of how Zakat stakeholders can systematically link their projects with the Sustainable Development Goals, including in response to crises. UNDP’s recently-announced partnership with the Dubai Islamic Economy Development Center is a reflection of how UNDP can support private-sector companies on social impact.

<sup>31</sup> In 2018, the Al Baraka Banking Group launched a collaboration with UNDP that seeks to align over USD600 million of its financing portfolio with the SDGs in the Middle East, Asia, Africa, and Europe. The coronavirus pandemic makes such initiatives all the more urgent.

<sup>32</sup> Government of Indonesia’s Green Sukuk of 2018, is a prime example of how the venture may have great SDG impact (Rehman, 2020).



industry. FSB (2020) perceives the arrangement into three levels: System-Level; Supervisory-Level; and Firm-Level. At the system-wide level, central banks are engaged in maintaining stability in the financial and banking system by using policy tools and by ensuring due support from the fiscal policy authority. The central bank and the relevant authorities are monitoring and reviewing banks' pandemic plans, delaying certain activities; and scrutinizing existing services. At the individual firm or bank-level, the measures target to strengthen operational readiness and contingency planning; and maintaining the continuity of financial services (FSB, 2020). Other international bodies like The Basel Committee on Banking Supervision (BCBS) of the Bank for International Settlements (BIS), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and The Islamic Financial Services Board (IFSB) also came up with supportive measures.

The government of Bangladesh initiated preventive measures actively from early February 2020 i.e. even before identifying any confirmed Covid-19 case. Responding quickly, the government of the country came up with economic stimulus packages, and by mid-September, a total number of 19 stimulus packages have been announced worth 3.7% of the country's GDP.<sup>33</sup> Bangladesh Bank (BB) initiated several market intervention measures and refinancing schemes to complement the government's initiatives. Promotion of payment, especially online, has been rightly encouraged from the initial stages of response by the BB by raising monthly and daily transaction limits, and also by waiving of charges in certain online payments.<sup>34</sup> As the monetary policy authority of the country, BB responded to the market needs with several efforts of liquidity injection that includes buying-back of government securities; reduction in repo rates; and very importantly, reduction of Cash Reserve Requirement (CRR) and increasing Investment-Deposit Ratio (IDR) of banks.<sup>35</sup>

The economic stimulus packages declared by the government are being primarily channeled and enforced by the banking industry to support the core economic sectors affected by Covid-19. To that end, BB is engaged in facilitating the process by issuing complementary guidelines, directives, and incentives. As an initial response to support affected businesses, BB announced on March 19 moratorium on loan payments until 30 June 2020 (later extended up to December 2020), which is also benefiting bankers by relieving them in meeting loan classification and provisioning requirements at least temporarily. In another circular, the central bank relaxed several provisions related to international trade transactions and unveiled several policy support for the country's exporters and importers amid a slowdown in external trade in the wake of the coronavirus pandemic. The central bank offered extended time for realizing export proceeds, submission of import bills of entry, back-to-back letter of credits and payment of export development fund loans, and repatriation of export bills. Several

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<sup>33</sup> <https://link.springer.com/article/10.1007/>

<sup>34</sup> <https://home.kpmg/xx/en>

<sup>35</sup> CRR of the banks reduced from 5.5% to 5% on bi-weekly average basis and 5% to 4% on a daily basis on April 01; CRR is further reduced to 4% on bi-weekly average basis and 3.5% on daily basis effective from 15 April; IDR for Islamic banking increased to 92% from existing 90% on April 12 (BB BRPD Circulars: <https://www.bb.org.bd/mediaroom/circulars/circulars.php>).



complementary circulars were issued to support banks and their clients for easy availing of economic stimulus packages targeted to MSME and agricultural sectors.<sup>36</sup>

Economic stimulus packages are working capital support to the affected industries, traders, enterprises, and individuals. Both Islamic and conventional banks are to disburse or facilitate the investment based on the bank-customer relationship, which means banks are to bear the associated credit or investment risk. From banks' perspectives, alongside contributing to economic turnaround, the packages are expected to contribute to regaining the economic and financial strength of the banks' customers.

At the response stage, Islamic banks confronted several risks and challenges. During Covid-19, BB advised banks for blocking all interest charged/accrued for April-May 2020 and not to realize the same from the clients. In this situation, Islamic banks faced a problem in distributing profit to the Mudarabah depositors for these particular months. These challenges can be handled by the Islamic banks using profit equalization reserve (PER) and investment risk reserve (IRR),<sup>37</sup> however, Islamic banks of Bangladesh generally do not maintain such reserves. Like other jurisdictions, BB has instructed Islamic banks to extend the time for payment installments of the customers. However, roll-over is strictly prohibited in the Bai-transactions, the common mode of Islamic banks in Bangladesh. Therefore, Islamic banks could not charge any profit or re-fix their sale value of Murabahah/Muajjal goods against the extended time. Islamic banks also faced challenges in using refinance funds due to Shariah issues, and the quick adoption of digital technology.

Now, what should be the broad response approach on the part of Islamic banks? How the existing and upcoming risks should be handled? As recovery measures, and for future effective Islamic banking, what should be the right kind of approaches to risk management that the Islamic banks should adopt?

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<sup>36</sup> The paragraph is based on a number of BRPD, DFIM, MPD, FE, SMESPD, ACD, DMD, FID and DOS circulars of BB issued during March, April and May, 2020 in response to handle the Covid-19 situation (<https://www.bb.org.bd/mediaroom/circulars/circulars.php>)

<sup>37</sup> According to the AAOIFI (Shariah Standard No. 40), Islamic banks can maintain profit equalization reserve (PER) for smoothing profit and investment risk reserve (IRR) for off-setting loss.

## **Segment-4: Reshaping Proposals for the Risk Management Approach of Islamic Banks in the New Normal**

### **Risk Management Approach as Recovery Measures by the Islamic Banks**

**D**uring this period of on-going banking and business disruption, Islamic banks need to reflect the utmost patience and sacrifice. The crisis management process must be an integrated approach in line with the 'Enterprise Risk Management' fundamentals and within Shariah laws and principles. Top management, departments, branches, and regions need to be integrated with the ongoing risk management process of the banks. Boards need to revisit their strategies for existing and post Covid-19, and risk management frameworks must be revised concurrently. It is time when banks' boards and risk committees should be interacting more frequently and focus more on consequences and less on the causes of risks. Boards and senior management of banks should be concentrating on risk appetite metrics and install contingency arrangements if needed. Islamic banks need to update their newer form of credit risk, cybersecurity, crime, and other operational risks to mitigate the evolving risk exposures in line with their risk appetite. Board and senior management must be satisfied with the reliability of the information on the risk issues and reports that identify the prioritization of risks. This is the time when honesty and strong moral principles amongst the boards, bank management, and the key stakeholders would play the strongest roles to handle the banking challenges. This reflection is particularly desirable from the banking practices that founded on the Shariah laws mainly derived from the Holy Qur'an and the Hadith. This is time for survival during this catastrophe and works for the revival of the Islamic banking businesses with a reshaped form of the risk management framework.

**F**or handling the macro risks associated with Covid-19, Islamic banks must work on strategizing investment to support the policymakers in this critical moment. As a crisis response strategy, policymakers around the globe are following almost a common approach of injecting money in the economy by ensuring greater liquidity with the banks. However, if banks do not respond with proactive approaches and invest, national policy goals cannot be attained. An Islamic bank must have an internal strategy for approaching stimulus packages so that its clients and the bank itself might optimally benefit from these being within Shariah law. Clients having financial strength and who are unaffected should not be facilitated with these scarce packages for the sake of the quick economic recovery of the country.

**I**rrational profit targets would destroy the risk management framework at this critical time. Rather, Islamic banks must be very careful about reputational risk at this moment. It is particularly essential for the Islamic banks to let their customers know that Islamic banks are truly sensitive about their depositors, investors, the common people, and the factors responsible for the ongoing global disruption- 'Environmental and natural destruction'. Covid-19 is offering an opportunity to support clients and affected communities, thus improve the reputation and image of Islamic banks. Meeting additional funding requirements are challenging. Considering fund necessity during recession and crisis, Islamic banks may think to create a profit equalization reserve (PER) and investment risk reserve (IRR) in near future. Meeting commitment and liabilities in operations by banks is crucial for reputation

during this crisis period. Especially, international payment liabilities must be met for long term benefits and reputation. Trade service providers must not resort to unethical acts for the short-term gain of the bank. It is important to take care of the reputational risk and country risk for sustainable operation by banks in the post-Covid-19 situation. IT and Fin-tech service platforms and crime-prone activities must also be under extensive monitoring to handle any cyber risk and financial crimes.

In a crisis, moral hazard might be a critical source of credit risk. It is the problem when the borrower may not have the right incentive to pay back the loan, and bankers may not have adequate incentive to devote sufficiently for loan recovery. Thus, moral hazard might result in additional loan defaults and banks with inadequate capital might be in trouble. Strategic communications are critical for addressing moral hazard problems that would help to handle the investment quality of Islamic banks. Supporting and knocking might work as fruitful incentive tools for exiting investors to handle moral hazard. This is also critical for the retention of clients as well. Common people are consuming more digital marketing and are also observing how businesses are reacting to the current environment. Thus it might be a great time to continue with digital marketing by a bank for improving trust and confidence of the banks' clients. Business recovery would be difficult for banking institutions in the presence of the erosion of trust and confidence.

### **Risk Management Approach of the Islamic Banks for Industry Consolidation**

Covid-19 reiterates that environmental risk must receive due emphasis in Islamic banking operation, and must also be a core component of Shariah compliance risk. As the situation demands, the recovery efforts and upcoming investment by the economic agents like Islamic banks should be integrating 'environmental concerns and natural order' in their operations and functional areas in the context of addressing the root cause of the Covid-19 crisis. It is not about allocating additional efforts and resources on 'green banking' activities as a separate branch of banking, rather it is about incorporating environmental risks in all banking actions. And very importantly, investment without honoring the environment and nature is not approved in the Shariah law.

Guided by their boards and Shariah principles, Islamic banks are expected to play leading roles in the country's upcoming green banking and the green growth movements in the post-Covid-19 situation; and for that, the recovery approach of the Islamic banks needs to be 'green and environmentally sustainable'. Moreover, economically and environmentally desirable activities should be particularly addressed and supported by Islamic banks. Sustainable banking ventures related to financial inclusion, small and micro-enterprise financing and agricultural financing are particularly desirable. These have proven advantages of offering high economic, social, and environmental long term returns. Certain innovative Islamic financing modes to invest in projects aligned with SDGs might help the economy and community remarkably. These are associated with Islamic banks' reputational risks and ethical approach.

**A**doption of modern technology and Fintech is an efficient banking and risk management tool in the new normal. This is particularly crucial for the future business strategy of Islamic banks. Digitization might be an immediate strategy, however, digitalization should be the ultimate target. Digitalization may help to transform the financial crime and efficiency dynamics of Islamic banks. Adoption of technology might be the source of several financial crime risks like cyber frauds, money laundering in new payment systems; however, embracing the technology can beget the best solution for handling financial crime by the Islamic banks.

**O**n the way to reshape the risk management framework, the Islamic banks should work on portfolio reallocation and product distribution. A balancing composition of both debt-based and equity-based Islamic banking products itself is a fundamental risk management tool for the Islamic banks. Moreover, there should be an alignment of the debt-based and equity-based product compositions both at the asset and liability side. Equity-based investment products (Mudarabah and Musharakah) might be very effective in a crisis like Covid-19 when banks are skeptical about the efficient use of the investment funds by the clients of the Islamic banks. These products have inherent strength of addressing moral hazard challenges and thus might be very effective in addressing credit risk if executed diligently. Moreover, the investment need of the innovation associated with the on-going business process reengineering can be addressed with these signature products of the Islamic banks. This would also draw a clear distinctive line between Islamic and conventional banks in terms of transaction-related risks in addition to the Shariah risks. Practically, the presence of equity-based products is the true indicators of the Islamic banks' approach of sharing risks and are the real inbuilt risk absorbers for the Islamic banks in the crisis. Adding Sukuk in Islamic banking in near future would add value to the risk management approach of the Islamic banks of the country.

**A** supportive regulatory and governance framework is crucial for installing effective risk management in banks. The risk management activities of Islamic banks require more engaged and independent oversight by the Shariah supervisory committees for ascertaining risk management associated with Shariah compliance including environmental risk. There are a common demand and expectation of the key stakeholders for having a separate act on Islamic banking in the country. With similar debt-based financing products to that of the conventional banks, the necessity for a separate act may not be strongly defensible. Rather, a differential product basket of Islamic banks with debt and equity-based product composition might strongly bid for a separate act to govern a distinct nature of Islamic banking operation in the country.

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