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Investigating the Relationship between the Volume of Funding Grant and Banking Risk Allocations in Islamic Banks: The Case Study of Al Salam Bank-Algeria During 2014-2019

دراسة العلاقة بين حجم التمويل الممنوح ومخصصات المخاطر المصرفية في البنوك الإسلامية دراسة حالة بنك السلام الجزائر للفترة من (2014–2019)

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Abstract:

This paper highlights the role of Islamic banks and their important funding services and diversified products dovetailing with the Sharia principles. Indeed, Islamic banks are witnessing such a high demand that they expanded their credit granting work. However, doing so led to higher banking risks.

This research points out Islamic funding formulae and risks encountered and ways to overcome them. Besides, it investigates the nature of the relationship between the expansion of Islamic banks in granting credit and allocations for banking risks. Such an objective is achieved by reviewing Al Salam Bank Algeria, being a distinguished successful sample in Islamic banking since 2008. Main factors to success are found out, and the financial services provided to different sectors in society are emphasized. At the end, a case study of the bank during 2014-2019 is carried out through the descriptive and analytical approach of monetary indicators.

Keywords: Islamic Banks ; Funding Formulae ; Al Salam Bank Algeria; Risk Management.

الملخص:

تسلط هذه الورقة الضوء على دور البنوك الإسلامية وأهمية خدماتها التمويلية ومنتجاتها المتنوعة التي تقدمها والمتوافقة مع أحكام الشريعة، حيث تشهد إقبالا واسعا ممّا جعلها تتوسع في منح الائتمان؛ ولكن هذا زاد من تعرّضها لمخاطر بنكية عالية النسبة مقارنة مع غيرها من البنوك التقليدية؛

وفي بحثنا هذا نبين صيغ التمويل الإسلامي والمخاطر التي تواجهها هذه البنوك وأساليب التعامل معها كما ندرس طبيعة العلاقة بين توسع البنوك الإسلامية في منح الائتمان مع مخصصات مواجهة المخاطر البنكية، بإسقاط الدراسة على بنك السلام الجزائر كتجربة متميزة في مجال الصيرفة الإسلامية والذي ينشط فيها منذ 2008 محققا نجاحا ملفتا، حيث نحاول معرفة العوامل الأساسية لنجاحه وتوليفة الخدمات البنكية والتمويلية التي يقدمها لمختلف فئات وقطاعات المجتمع، ونختم بدراسة حالة للبنك خلال الفترة 2014-2019. معتمدين على كل من المنهجين الوصفي والتحليلي هذا مع الاستعانة ببعض الجداول والمؤشرات المالية للبنك إلى جانب المنحنيات البيانية التوضيحية للفترة المدروسة.

الكلمات المفتاحية: البنوك الإسلامية؛ صيغ التمويل؛ بنك السلام الجزائري؛ إدارة المخاطر.

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1. INTRODUCTION

Islamic Banks have achieved considerable success in their field by providing banking services and financing formulae complying with the Sharia principles. The Islamic nature of these banks gave the general public, including non-Muslims, a

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Volume: 13 / Number: 05 Year 2021 p 01-20

satisfying impression owing to fusing the bank's special objectives with the society's general social and economic objectives, mainly investing in areas having no negative effects.

Islamic Banks highly contributed to fulfilling customers' needs, but this increase in the volume of funding heightens their banking risks compared to other counterparts from conventional banks, which affects the value of risk reserves faced by these banks.

1.1 The problematique:

According to what has been stated, this paper examines the nature of the relationship between the volume of funding granted and the allocations of banking risks in Islamic banks, particularly Al Salam Bank Algeria as a model, by answering the following research question:

How does the expansion of Islamic financing affect the bank risk allocations at Al Salam Bank Algeria?

1.2 Sub-questions:

1.What does Islamic finance mean? And what are its characteristics?

2.What are the tools and mechanisms used to manage risks in Islamic Banks?

3. At Al Salam Bank Algeria, what are the financing modalities available? And what is the relationship between the expansion of financing and the bank's risk management allocations?

1.3 Hypotheses:

Hypothesis 01: The diversity of Islamic finance formulae allows customers to choose the right one.

Hypothesis 02: Bank Risk Management reflects the set of instruments adopted by the bank's administrators to reduce banking risks and to predict them in the future.

Hypothesis 03: The volume of Islamic funding granted at Al Salam Bank Algeria is related to determining the size of Bank Risk Allocations.

2. Islamic Banks and the Concept of Islamic Finance:

In the first part of this paper, some of the key aspects of Islamic banking institutions and the financing they provide are addressed.

2.1 Defining Islamic Banks and their Objectives

Islamic banks are defined as financial institutions that provide banking services under Islamic law, and that rely on legitimate outlets to obtain and invest funds through legitimate means of speculation, profitability, sale of goods, leasing, etc. an Islamic bank is defined as a financial banking institution that collects and employs funds in accordance with Islamic law whose main principles are solidarity and usury-free societies[1].

The objectives of Islamic banks are numerous, but they fall within the framework of the purposes of Islamic law, as they seek to achieve their mission and to accomplish a number of objectives in several areas (Table 1)[2].

Table 1: *Islamic Banks Objectives*

Financial Goals	Customer Goals	Internal Goals	Innovative Goals	Social Goals

Afak Ilmia Journal ISSN: 1112-9336
Volume: 13 / Number: 05 Year 2021 p 01-20

Attracting deposits	Providing Financial services	Resource development	Creating financing formulae	Solidarity
Investing money	Providing funding	Growth	Development of banking services	Setting up social projects
Making profits	Providing Security	Spreading		

Source. Meriem ZAYDI, 2015, p. 347

2.2 The Definition of Islamic Finance

Financing means the provision of money that is based on a contractual relationship between two parties, one with a surplus of funds and the other with a deficit.

One major regulation is Islamic finance, which is a polymorphous term. For instance, Al Sartaoui (1999) perceives Islamic finance as the provision of an asset to another party for cooperation purposes. Such a kind of finance aims to "to invest in the asset and get profits divided between concerned investors according to a preset percentage, specified according to each party's work, contribution to the capital, and administrative and investment decision-making".[3]

2.3 Islamic Finance Characteristics:

Islamic Finance is characterized by features highlighted in the following points:

• Not using the advance interest and guarantee to finance institutions, this is the most important characteristic that distinguishes Islamic finance from traditional finance.

• The diversity and multiplicity of mechanisms and formulas of Islamic finance, which allows customers to choose the right formula according to their economic needs and nature, with the orientation of financing towards real investment.

• Linking Islamic finance to investment projects to the real needs of society pursuant to the priorities of investing in Sharia

• Focusing on directing the behavior of the individual towards virtuous morality, one of the characteristics of this funding is to educate the spirit of the individual on good manners, in which it promotes honesty, self-confidence, sincerity and mastery of work, which provides greater ways for success of the institution.[4]

2.4 The Importance of Islamic Finance:

Islamic finance, as a source of the tolerant principles of Islam, is not only a means to meet individuals' material needs, but it also accurately balances material and moral needs. Indeed, Islamic finance is able to meet material needs as much as it can teach Muslim individuals the various morals of honest performance, self-confidence, mastery of work, and sincerity; it can develop the character of self-censorship, and it can, most importantly, instill fear of Almighty Allah into individuals.

Islamic finance is also an ideal method in balancing the needs of the individual and those of the society

2. Concepts on Risk Management in Islamic banks:

The banking risk is defined as the likelihood to lose either directly or indirectly. Some forms of direct and indirect losses are identifie as: "directly through losses in business outcomes and capital or indirectly through restrictions of the bank's ability to conduct its activities on the one hand, and to exploit opportunities in the banking business environment on the other side[5].

2.1 Types of risks facing Islamic banks:

Islamic and traditional banks alike face many risks including the nature of their work and other risks related to their financing formulae.

2.1.1 **Risks Related to the Nature of Islamic Banks' Work:**

Credit risk: takes the form of settlement risks or payments that may arise from what a transaction party has to pay. This problem may arise from differing information stemming from insufficient data about the real profits of businesses financed on the basis of speculative rules. Credit risk can be created by the other party (the beneficiary) whose trade performances have been hampered, possibly by general external factors rather than its/his/her own [6].

Liquidity Risks: result from difficulties in obtaining affordable cash either by borrowing or selling assets.

Benchmark Price Risk: It may appear that Islamic banks are not exposed to market risks arising from interest rate variables that cause some risks in financial institutions' revenues. These institutions use a reference rate to determine the prices of their various financial instruments, which is usually the Libor index. Therefore, Islamic banks face risks arising from interest rate movements in the banking market.

Operating Risks & Legal Risks: Operating risks take place when an Islamic bank does not have sufficient trained human resources to carry out Islamic financial operations. Legal risks face Islamic banks in the field of documenting and implementing Islamic financial contracts because their nature is different from those of conventional banks.

Withdrawal & Confidence Risk: The variable return system on saving and investment deposits leads to uncertainty about their true value.

Commercial Displacement Risk: This type of risk stands for the transfer of deposit risk to shareholders. In other words, operating in accordance with Islamic law controls may not be able to give a competitive return on deposits compared to rival Islamic or traditional banks.

2.1.2 Risks Related to Islamic Financing Formulae:

Islamic banks face many risks associated with their financing formulae, which are classified into risks arising from (a) debt-based financing formulae and (b) proprietary financing formulae including both sharing-related risks and speculative risks.

a. The risks of debt-based financing formulae:

• **The risks of the Murabaha formula:** to which the bank is exposed as a result of using Murabaha with the client in Islamic finance. Such a risk is attributed to several reasons such as the non-compliance with the contract including the promise of purchase or the failure of the customer to pay or the damage of the item …etc.

•**The risks of the Ijara formula:** A party, either a bank or a beneficiary, is in risk of Ijara formula when sale of the benefits of a particular service or commodity is the final product of an investment project due to natural factors of the market or technological progress.

• **The risks of the Istisna'a formula:** are the risks the bank is exposed to as a result of financing the object funded in the form of facilities in accordance with the agreement with the client.

• **The risks of Salam:** result from financing goods, especially in the agricultural sector, in agreement with debtors. This is a rarely-applied beleaguered formula as it is unguaranteed in terms of loans returnability.

b. The risks of proprietary financing formulae:

The risks of proprietary financing formulae include: Musharaka Risks and Speculative Risks. The Islamic bank falls in such risks when it contracts a contributor or a speculator to pay capital in financing formulae by sharing profit and loss. These formulae are based on the bank's confidence in its secretary and on its ability to perform the profit-producing work, which are two high-risk contracts of trust that do not require mortgage or guarantees[7].

2.2 Reasons for the High Level of Risks in Islamic Banks:

The main reasons for the high level of risks in Islamic banks are related to a number of factors, which are:

- Effects of the surrounding environment: Some components of the surrounding environment create obstacles that endanger Islamic banks. Besides, they can be subjected to monetary policies approved by central banks when they—are not commensurate with their nature.
- Prevailing social misconceptions: Islamic banks are seen as non-profit charities or as banks that deal with usury, like traditional banks.
- Effects of the self-structure of Islamic banks: Islamic banks are self-structured as they use the simulation approach of

traditional banks in some areas, both in terms of attracting and employing resources, such as the financial services they provide.

- The absence of an active Islamic financial market which contributes to the development and activation of Islamic banks.

3. Definition of Risk Management

Risk management is defined as: “This process through which risk is monitored, identified, measured, and controlled, with the aim of ensuring a full understanding of it and the assurance that it is within acceptable limits, and the framework approved by the Bank's Board of Directors for risk”[8].

Methods of dealing with Risks: There are many ways of dealing with the risks faced by Islamic banks:

Risk avoidance: The individual or institution sometimes refuses to accept a particular risk arising from the unwillingness to face a particular loss.

Risk Reduction: refers to actions performed by financial institutions in observing “loans behaviours in an attempt to identify warning indications of early stop-payment problems, and to reduce interest rate risks using the asset and liability management policy designed for that purpose”[9].

Risk transfer: refers to its transferability to another party, in return for payment, but ownership of the object is retained by its owner in the original danger. Insurance is one of the most important and widespread means of transferring risks.

Fragmentation and risk diversification: aims to segment the at-risk object so that its constituents are not simultaneously exposed to risk-causing verification and diversification. This way allows achieving financial or geographical risk prevalence, provided that the endangered unit is viable.

Hedging: "Hedging differs from insurance in being a risk transfer with a waiver of profit ability"[10].

Participation in risk tolerance: Generally, risk management refers to a capital economy based on the transfer of risk from one party to another. However, risk management in the Islamic economy is based on the principle of profit-sharing and loss, whereby risks are shared among the various parties contributing to the process.

4. The Case Study of Al Salam Bank Algeria:

Al Salam Bank Algeria and its objectives are introduced in this section through the combination of banking and financing services provided to different sectors of society.

4.1 Introducing the Bank and its Objectives:

Al Salam Bank Algeria is one of the banking units of The Bahrain Al Salam Bank. It is a totalitarian bank that operates in accordance with the Algerian and Islamic laws in all its dealings. It is the result of Algerian-Gulf cooperation, adopted by the Bank of Algeria in September 2008. It started its activities aiming at providing innovative banking services at the level of its branches, which reached 17 branches in 2019. The bank's financial position in 2019 is estimated at 131 billion DA compared to 110 billion DA in 2018[11] with a growth rate of 19%. The Bank seeks to provide modern services that stem from Algerians' principles and values in order to meet the needs of the market, customers, and investors. The bank's dealings are controlled by a legitimate body made up of leading scholars in Sharia and economics. Table 2 overviews the main indicators of

Bank Al Salam Algeria during 2014-2019.

Table 2: Development of the main financial indicators of Bank Al Salam Algeria During (2014-2019)

Financial indicators	2014	2015	2016	2017	2018	2019
Total budget	36 309 089	40 575 207	53 103 919	77 585 329	110 109 059	131 018 967
Growth rate	-	11.7%	30.87%	61.5%	41.92 %	19 %
Net result	1 383	301	1 080	1 181	2 418	4 007
Growth rate	-	- 78.32 %	258.8 %	9.35 %	104.74 %	65.71 %

Note. Unit: thousands of Algerian dinars

Source. Prepared by researchers based on annual reports of Bank Al Salam Algeria (2014-2019)

The above table represents the development of the main financial indicators of the Algerian Al Salam Bank during 2014-2019. According to the table, the bank recorded a total net result of more than 13 billion dinars during the year 2019, which is an increase of nearly 60% compared to 2017. However, the lowest net profit was recorded in 2015, which recorded 301 million dinars only; The year 2015 is considered exceptional due to administrative matters specific to the bank and to the nation's economic conditions attributed to the decline in oil prices and their consequences at the level of the volume of economic banking transactions, laws, and regulations.

The total budget rose about 3 times during 2014 and 2019, especially in the last two years, due to the expansion of the Bank's activities through diversification of finance as well as the introduction of consumer loans.

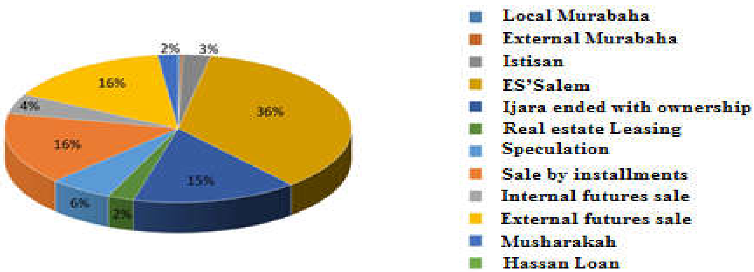
4.2 The Bank's Key Success Factors:

The Bank has identified its key success factors among several elements, including:
-Using modern systems and techniques to achieve efficient performance and speed.
-Selecting qualified employees and adopting a map for their promotion with knowledge, skill, stability, and loyalty.
-Attracting Resources: Capital and Deposits.
-Developing & diversifying the forms of banking services with excellence, also scrutinizing the implementation of Sharia.
-Implementing an active Credit Policy that accommodates customer requirements, and that attracts new customers.

4.3 Formulae of Financing Approved in the Algerian Al Salam Bank:

As Al Salam Bank Algeria provides financing to its customers through many formulae, the volume of funds provided during the year 2019 reached more than 98 billion DZD, recording an increase of 107% compared to the year 2017. Several factors contributed to such an inflation including mainly the expansion of the customer base, the diversification of products, and the opening of new branches. Figure 1 shows the distribution of funds in the bank according to Islamic financing formulae.

Figure 1. Details of Direct Financing 2018/2019



Source. Bank Al Salam Algeria 2019

Bank Al Salam Algeria offers a set of financing formulae; Table 3 shows some values of these offered formulae.

Table 3 : The Value of some financing formulae at Bank Al Salam Algeria During (2014-2019)

Years	2014	2015	2016	2017	2018	2019
Al-Murabaha	15 066 234	16 567 805	20 169 054	27 143 656	42 244 302	53 168 392
Speculation	8 649 378	6 403 485	7 866 447	8 171 368	10 487 621	11 333 094
Leasing	-	-	1 383 005	3 154 795	4 030 784	5 081 941

Note. Unit: thousands of Algerian dinars

Source. Prepared by researchers based on annual reports of Bank Al Salam Algeria (2014-2019)

These formulae are divided into two parts: (a) funds directed to individuals and (b) others to institutions. The total value of the funds provided has clearly increased due to the bank's strategy. Table 4 displays data of the total volume of funds and a breakdown of their distribution to individuals and institutions.

Table 4: The Value of the financing provided at Bank Al Salam Algeria During (2014-2019)

Years	2014	2015	2016	2017	2018	2019
Size of funding	23 939 475	23 130 277	30 845 987	47 439 033	77 827 992	98 585 758
Growth rate	-	- 0.03 %	33.3 %	53.8 %	64 %	27 %
Individuals	143 348	92 031	541 526	5 030 143	13 834 845	19 772 448
Institutions	28 352 633	23 038 246	30 304 461	42 408 880	63 993 147	78 813 310

Source. Prepared by researchers based on annual reports of Bank Al Salam Algeria (2014-2019)

From the table, the great development in the volume of financing provided is noticeable, especially in the last three years, as there was an increase in 2019 estimated at 27% compared to 2018. Such a rise stems from the new formulae at the bank level, such as leasing, and from the increase in the number of funding requests.

4.4 Banking Risk Management in the Algerian Al Salam Bank:

4.4.1 Organizational Structure of Risk Management

Managing risks encountered by the bank consists in establishing an internal system to frame and evaluate the negative impact of the bank's activity-related internal and external factors on its properties and its results at any time.

Risk management at Al Salam Bank Algeria is carried out through a set of central structures: (a) Operational structures, (b) Internal Committees, and (c) Committees of the Board of Directors

4.4.2 Risk Management System

The main risks to which the bank is exposed are classified into credit risk, liquidity risk, and operational risks.

During the year 2017, Al Salam Bank Algeria adopted a set of policies that regulate and frame risk management, and that define the relevant structures and tasks assigned to it.

In addition, for the purpose of disclosure to the Board of Directors, every three months, the bank prepares a risk matrix, which summarizes the most important risks to which the bank is exposed, while measuring exposure indicators and comparing them with the internal standards set by the bank.

4.4.3 The Relationship between the Volume of Granted Funds with Allocations of Banking Risks:

In order to cover possible general banking risks, Al Salam Bank Algeria depends on the formation of an allocated subsidy according to Article 09 of Regulation No. 03/14, which stipulates the classification of dues and signed obligations and allocations of financial banks and institutions. Such allocations are calculated at 1-3% of the capital dedicated to funding per year.

Table 5 : The value of the funds provided and bank risk allocations at Bank Al Salam Algeria During (2014-2019)

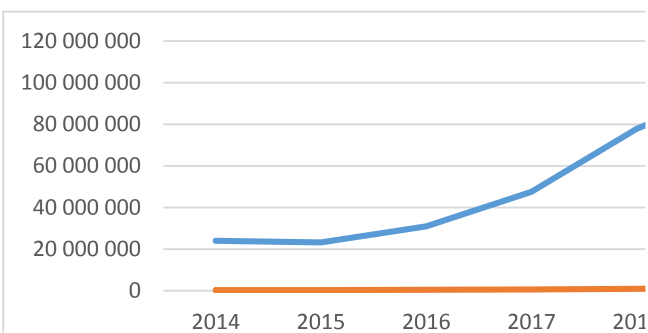
Years	2014	2015	2016	2017	2018	2019
Size of funding	23 939 475	23 130 277	30 845 987	47 439 033	77 827 992	98 585 758
Allocations	328 749	304 268	372 485	551 105	945 502	1 322 918
Percentage	-	-7 %	22 %	48 %	72 %	40 %

Note. Unit: thousands of Algerian dinars

Source. Prepared by researchers based on annual reports of Bank Al Salam Algeria (2014-2019)

Data in Table 5 show annual increases in the volume of funding provided. The latter reached 98 billion DZD in 2019, which when compared to the bank's risk allocations, we notice a positive proportional relationship as their value exceeded one billion DZD, recording an increase of 40% over that of 2018. Figure 2: illustrates this relationship.

Figure 2. The value of Bank Risk Allocations Changes in terms of the Amount of Funding Granted (DA)



Source: Researchers' achievement based on entries in Table 5.

Although Al Salam Bank's practices in Algeria are quite recent, it has proved to cater for successful activities through the annual expansion of its network and high-value provisions of funds, and the increase in its assets. Indeed, such activities commensurate with the banking risk allocations put forth by the bank in order to meet imbalances and to maintain its capital and the customers' confidence.

5. Conclusion

5.1 Results of the Study:

Islamic finance has witnessed rapid growth because it provides various financing formulae that contribute to achieving economic and development objectives. It is necessary to benefit from successful banking experiences in order to activate the Islamic banking industry in Algeria, especially with the scarcity of financial resources in our country due to the decline in revenues from rents. This study highlights a number of findings:

• Islamic banking finance is so important that Islamic banks are safe destinations because they provide financing services on affordable terms and at lower costs.

• Al Salam Bank Algeria offers legitimate banking products in line with current financing requirements that have helped it build great trust with its customers.

• The success of Al Salam Bank Algeria in achieving its objectives and in increasing the amount of funding provided has contributed to increasing banking risk.

• Al Salam Bank Algeria is keen to apply the Bank of Algeria's regulations on setting precautionary rules for the management of banks and financial institutions, in addition to respecting international management standards. Thus, Al Salam Bank Algeria has established a classification and appropriation committee whose main task is to re-evaluate the facility portfolio in accordance with the Bank of Algeria's instructions and to determine the appropriate level of allocations.

• Al Salam Bank Algeria relies on Risks & Controls Self Assessments (RCSA), allowing it to identify and assess possible risks and to develop proactive solutions.

5.2 Recommandations:

Some recommendations are drawn from these findings:

• Establishing Islamic banks can be facilitated by means of considering pioneering experiences and activating their work in all legitimate banking transactions. Indeed, financing real investments leads to support the pace of economic growth, to contribute to economic diversification, and to improve the standards of living.

• Training and qualifying employees in Islamic banks regularly help develop their performance. Moreover, it is highly recommended to nurture their knowledge aspect of Islamic banking technically & legitimately, to anticipate risks, and to periodically distribute a guide to other employees and pioneers of Islamic banks.

• Cooperation between Islamic banks and the Monetary Authority is encouraged to mitigate the legal risks faced by Islamic banks in Algeria, and to develop new risk reduction tools for Islamic banks, such as the use of Sukuk instruments and Takaful insurance.

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