Islamic Banking and Risk Management: Issues and Challenges

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Abstract
In view of the massive failure of banking institutions in response to the global financial crisis (2007-2009), there has been proliferation of writings on risk management as never before. Islamic banking is much less affected by the turmoil for a variety of reasons, especially because it is still a very tiny part of the global system and has yet to develop enough connectivity to catch the cold. The current wave of financial liberalization and globalization naturally prompts for examining the question of risk management in Islamic banking. This paper discusses on risk management in Islamic banking and focuses on the credit, operational and Shari’ah risks. The fact that Islamic banking is submerged in the global system makes the risk treatment not only urgent but also extra complicated. Their exposure to the risk of financial losses is enhanced and performance may be disrupted. Finally, the paper highlights the issues and challenges in risk management and provides suggestions for risk mitigation in Islamic banking.

Keywords: Risk; Islamic banks; Risk Management, Basel III

1.0 Introduction

Financial development is an important component of the overall development strategy. Growth in the finance industry reduces costs of financial intermediation and raises the overall return on investment. Islamic finance has entered a new stage of development, emerging after global financial crisis as a more equitable, efficient even sustainable form of financing. The stage has started due to the collapse of the conventional financial system that is based on interest. Islamic finance is more efficient and growth promoting, makes the economic system more stable, controls excessive credit creation and speculation and widens risk sharing and provides more sustainability to the financial industry (Al-Jarhi, 2005). In the recent decade, Islamic banking has experienced remarkable growth and transformation, demonstrating its potential as a competitive form of financial intermediation not only in Muslim countries but also outside the Muslim

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world. Currently, Islamic banking industry is offering a comprehensive range of products and services, serving a broad spectrum of consumers and businesses. It has been one of the fastest growing sectors of international financial markets and is expected to continue expanding at an even faster rate. Islamic banking has made commendable progress globally in recent decades spanning across 75 countries. It has witnessed significant growth achieving a compound annual growth rate (CAGR) of 17.4% between 2008 and 2013 with Islamic banking assets reaching USD1.427 trillion by end of 2013 (KFHR, 2014). Islam encourages trade activities that generate fair and legitimate profit. Fundamental feature of Islamic banking is the sharing of profit (loss) that entails risk-taking in the transactions which requires a high level of financial disclosure and transparency, especially in the case of Mudarabah or Musharakah contracts.

In insulating the Islamic banks from potential risks resulting from excessive leverage and speculative financial activities in the case of conventional banks, Shari’ah insists on the linkage of financial transactions with real economic activities. Still, effective risk management capabilities are important for Islamic banking in the face of challenging global financial environment of heightened uncertainties and increased financial vulnerabilities. These developments require gaining a higher standard of risk awareness and management. Regulatory concern has shifted towards a more risk sensitive capital adequacy framework and the assessment of risk management systems and processes in the financial institutions (Aziz, 2006).

This paper examines the issues and challenges that confront Islamic banking in the area of risk management. The structure of the paper proceeds as follows. Section 2 presents an overview of risk management, Section 3 elaborates the risk exposures in Islamic banking industry with reference to credit risk, operational risk and Shari’ah risk, Section 4 deals with the issues and the challenges faced by Islamic banking in the area, Section 5 discusses the risk mitigation strategies and the final Section 6 contains some concluding remarks.

2.0 Risk Management: An Overview

The Concise Oxford Dictionary defines risk to imply something bad, the chance of bad consequences, loss, etc. The definition of risk differs from one discipline to another. The definitions of risk that are typically found in the literature are as follows: (i) the chance of loss; (ii) the possibility of loss; (iii) the dispersion of actual from expected results; (iv) the probability of any outcome being different from the one expected; and (v) the significance of hazard in terms of the likelihood and severity of any possible adversity. Risk implies the randomness facing a decision maker that can be expressed in terms of specific numerical probabilities, whereas uncertainty means that no probabilities can be assigned to possible occurrences or that there is a lack of knowledge about what will or will not happen in the future. In general, risk can be measured in different ways as follows; measures of dispersion, value at risk and the probability, frequency and severity of loss (Moosa, 2007).

The definition of risk management takes various forms. Vaughan (1997) defines risk management as a scientific approach to dealing with pure risks by anticipating possible accidental losses and designing and implementing procedures that minimize the occurrence of loss or the financial impact of the losses that do occur. According to Tariqullah and Habib (2001), risk management is a comprehensive system that includes creating an appropriate risk management environment, maintaining an efficient risk measurement, mitigating and monitoring process and establishing an adequate internal
control arrangement. The management of Islamic banks needs to create a risk management environment by clearly identifying the risk objectives and strategies of an institution and by establishing systems that can identify, measure, monitor and manage various risk exposures. While Greuning and Iqbal (2008) stated that the central components of risk management are identification, quantification and monitoring of the risk profile including both banking and financial risks, the goal of risk management is controlling risks. Control is feasible when quantitative and qualitative assessments of risks exist. The organization and process of risk management should be bank-wide, across all business lines (Bessis, 2010).

Risk management process consists of the following steps; determining objectives, identifying risks, evaluating risk, considering the alternatives and selecting the risk treatment device, implementing the decision and finally evaluating and reviewing the process. In general, the concept of risk management is acceptable to contemporary Islamic scholars based on the following bases; the Quranic verse (Al-Baqarah:282) which requires Muslims to record debt or provide witnesses and supported by Hadith (Sunan al-Tirmidhi: 2517) on the requirement to tie the camel before leaving its fate to Allah (tawakal). Risk management is permissible in Islam and is in congruence with the objectives of Shari’ah (Maqasid as-Shari’ah) especially with respect to preservation of wealth (hifzulmaal). For example, in Mudarabah, it is permissible to specify investment project to reduce the risk of loss.

A sound risk management framework may help Islamic banks reduce their exposure to risks and enhance their ability to compete in the market. Extensive investment by Islamic banking required to have a place in a comprehensive and robust internal risk management infrastructure. The requirement to manage risks in Islamic banking becomes more important due to some special nature of the financial intermediation process that is guided by the Islamic Shari’ah. Islamic banking enters into diverse modes of Islamic financial contracts, each with its own peculiar risk characteristics.

3.0 Risk Exposure In Islamic Banking

The risk that Islamic banks face can be divided into financial and non-financial risks. Financial risks generally include credit, market and liquidity risk. The non-financial risks include operational risk, regulatory risk, business risk, legal risk, strategic risk and Shari’ah risk. The risk characteristics of Islamic banking differ from conventional banking. The risk’s Shari’ah attributes as financial assets, or non-financial assets, real estate, commodities or work in process inventories (Ijarah, Salam or Istisna’) or their results from financing made on profit sharing basis are exposed to losses (Mudarabah and Musyarakah). Realizing the significance of risk management, the Islamic Financial Services Board (IFSB) issued a comprehensive standards document on risk management in December 2005 that identifies different risks and provides guiding principles of risk management for Islamic financial institutions. This study is an attempt to understand three most common forms of risks that Islamic banks are exposed to namely, credit risk, operational risk and Shari’ah risk.

3.1 Credit risk: Credit risk is known as the potential risk attributed to delayed, deferred and default in payments by counterparties. It covers profit-sharing contracts (Mudarabah and Musharakah), receivables and lease (Murabahah, Diminishing Musharakah and Ijarah) and working capital financing (Salam, Istisna’ and Mudarabah). The techniques used by Islamic banks to mitigate risk are similar to conventional banks.
The importance of credit risk management becomes critical in the case of Islamic financial institutions where lending is replaced with investments and partnership.

In the case of Mudarabah investments, Islamic bank as a Rabbul–mal (principal) is exposed to an enhanced credit risk on the amounts advanced to the mudarib (agent), in addition to the typical principal-agent problems. The bank is not in the position to know and decide how the activities of mudarib can be monitored accurately, especially if claims of losses are made, since the nature of the Mudarabah contract does not give the bank appropriate rights to monitor the mudarib or to participate in the management of the project. Thus, it makes the assessment and management of credit risk difficult and the risk especially present in markets where information asymmetry is high and there is lack of transparency in financial disclosure by the mudarib.

In Murabahah transactions, Islamic banks are exposed to credit risks when the bank has already delivered the asset to the client but it does not receive payment from the client in time. Furthermore, in Salam and Istisna’ contracts, the bank is exposed to the risk of failure to supply goods on time or to supply at all, or failure to adhere to the quality of goods as contractually specified. Such failure can expose Islamic banks to financial losses of income as well as capital. The Islamic banks are exposed to the risk of losing entire invested capital in Musharakah, since such capital may not be recovered as it ranks lower than debt instruments upon liquidation (Akkizidis and Khandelwal, 2008).

3.2 Operational risk: Operational risk has been receiving increasingly attention as the trend toward greater dependence on technology, greater competition among banks and globalization have left the banking industry more exposed to operational risks now than ever before. The operational risk is defined as the risk of loss resulting from inadequacy or failure of internal processes, as related to people and systems or from external risks and includes the risk of failure of technology, systems and analytical models.

Operational risks are likely to be significant in the case of Islamic banks due to their specific contractual features and the general legal environment. Specific aspects of Islamic banking that could raise the operational risks in Islamic banks include the following: failure of the internal control systems to detect and manage potential problems in the operational processes and back office functions, difficulties in enforcing Islamic contracts in a broader legal environment, need to maintain and manage commodity inventories often in illiquid markets and involving costs and risks in monitoring equity type contracts and the associated legal risks. In addition, people risk is another type of operational risk arising from incompetence or fraud that exposes Islamic banks to potential losses. Operational risk is considered high risk exposures for Islamic banks. The asset-based nature of financing products in Islamic banking such as Murabahah, Salam, Istisna’ may give rise to forms of operational risk in contract drafting and execution that are specific to such products (Archer and Abdullah Haron, 2007).

3.3 Shari’ah Risk

Shari’ah risk is related to the structure and functioning of the Shari’ah boards at the institutional and systemic level. This risk consists of two types; the first is due to non-standard practices in respect of different contracts in different jurisdictions and second is due to failure to comply with Shari’ah rules. Different adoption of Shari’ah rules results in differences in financial reporting, auditing and accounting treatment by Islamic banks. For example, some Shari’ah scholars consider the terms of a Murabahah contract to be
binding on the buyer, others argue that the buyer has the option to decline even after placing an order and paying the commitment fee. While each practice is acceptable by different schools of thought, the bank’s risk is higher in non-binding cases and it may lead to potential litigation problems in case of unsettled transactions. Banks are exposed to the risk of non-compliance with the Shari’ah rules and principles determined by the Shari’ah board or the relevant body in the jurisdiction. The nature of relationship between the bank and investors/depositors is not only of an agent and principal, but it is also based on implicit trust to fully comply with the Shari’ah where this relationship distinguishes Islamic banking from conventional. In case where the bank is unable to maintain this trust and the bank’s actions lead to non-compliance with the Shari’ah, the bank is exposed to the risk of breaking the confidence of the investors/depositors. Breaching the trust and confidence of the depositors/investors will lead to serious consequences, including the withdrawal and insolvency risk. To some extent, a few Shari’ah scholars have suggested that if a bank fails to act in accordance with Shari’ah rules, the transaction should be considered null and void and any income derived from it should not be included in the profits to be distributed to the investors/depositors (Iqbal and Mirakhor, 2007).

4.0 Issues And Challenges

Risk management is widely developed in the conventional financial market frameworks. However, it is underdeveloped in the Islamic financial markets due to limited resources, high cost and lack of technological machinations to assess and monitor risk in time. Islamic banks face crucial challenges in improving their risk management strategies as they are exposed to various types of risks.

Conventional risk management techniques and tools are based on interest, gambling and speculation, which are prohibited by Shari’ah. Islamic finance is sorely lacking on product breadth, depth and sophistication. There are still only few risk-hedging instruments and techniques in Islamic finance despite its rapid growth. A number of risk management techniques are not available due to requirements for Shari’ah compliance. In particular, these are credit derivatives, swaps, derivatives for market risk management and money market instruments (Syed Alwi, 2008). Hence, the development of prudential regulations and systems related to risk management, capital adequacy and corporate governance of Islamic banking is all the more pertinent.

Financial engineering is another operational challenge for Islamic banks, which demands standardization of the process of introducing new products in the market. An Islamic bank currently has its own Shari’ah board examining and evaluating each new product, without having coordinated efforts with other banks. This process should be streamlined and standardized to minimize time, effort, cost and confusion. Cross border comparison of Islamic banking performances is difficult because the regulatory frameworks of Islamic banking jurisdictions are not standardized and remain highly divergent, ranging from frameworks that promote dual banking such as in Malaysia to frameworks that only recognized Islamic banking system such as in Iran.

Islamic banks may have higher operational risk; greater number of contracts, newer supporting system, evolving skill sets and lack of consistency of best practice. Islamic banking is perceived to be more exposed to operational risks associated with the failure of controls, procedures, information technology systems and analytical models. Operational risk goes beyond the mathematical models and capital adequacy; a cultural
change in the organization regarding the operational risk is needed in order to develop sound operational risk management practices (Akkizidis and Kumar, 2008).

The issue of capital framework and liquidity standards is central to adopting the Basel III. The banking institutions are required to raise minimum capital requirements and hold a capital buffer. However, Islamic banks are exposed to operational risk arising from compliance to Basel III requirements. Some of the principles of risk management as proposed in Basel III can be applicable to the Islamic financial industry with necessary modification and adaptations. Even so, Basel III could not answer all the risk management issues for Islamic financial institutions; hence there has been a need for alternative and supportive standards on risk management. Nevertheless, serious and sustained efforts are needed to find the applicability which is specific to countries and markets.

5.0 Risk Mitigation Strategies

Basel III has to a certain extent, enhanced risk coverage that can be assimilated by Islamic financial institutions. Even so, these accords are not considered much relevant to Islamic banks. They may rather burden them with uncalled for responsibilities (Hasan, 2014). Islamic banks need to be ahead in exploring other dimensions of risks in the Islamic financial contracts. The risk management infrastructure in Islamic banking must therefore be in place to identify, unbundle, measure, monitor and control all specific risks in Islamic financial transactions and instruments to provide for their effective quantification and management.

Islamic banking must be equipped with the required capacity and infrastructure to capture the respective risk weights and assign appropriate amount of regulatory capital at each of the different stages of Islamic financial transactions. Supervisory authorities need to be equipped with the specialized skills necessary to have the right assessments on the level of risks that the Islamic banks are exposed to and the effectiveness of the risk management infrastructure in Islamic banking. An effective regulation and supervision will ensure the soundness and the stability of the system. The bank should give high priority to ensuring transparency in compliance with the Shari’ah and take necessary actions to avoid non-compliance. A proper governance framework should be established to consider appropriate level of disclosure that will create an adequate level of transparency and effective prudential supervision.

Finally, the designing of a risk mitigation strategy calls for a closed collaboration between the management of Islamic banks and regulators that focus on harmonization in Shari’ah standards, pool resources among Islamic banks and training programs for human resource development.

6.0 Concluding Remarks

In developing economies, the turbulent market environment is prone to spread chaos without adequate and effective risk management framework in place as the magnitude of exposure to risk is indeed great in banking industry. Therefore, a well-developed risk management system to identify any potential deterioration in the asset quality of the Islamic banking portfolio is a temporal imperative. This is essential to allow Islamic banks to be in a position to maintain adequate provisioning in dynamic situations, ability to forecast future earnings and apply Shari’ah compliant risk mitigation techniques to manage volatility and be competitive. Islamic banking capacity for risk
management contributes significantly to the quality of its risk management practices. Efficient risk management capability is crucial to enable Islamic banks to strategically position themselves in the volatile global market.

References


