Transition to Islamic Banking

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Abstract
Risk management is the identification, assessment, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events or to maximize the realization of opportunities. The overriding aim of the research is to study the risk management practices in the transition from conventional to Islamic Banking. This study found that different forms of risks were faced by Islamic Banking in its transition from conventional banking. These risks were related to both micro and macro operations along with some general risks. The macro operations level risks faced by Islamic Banking related to liquidity, Asset’s Valuation, Creation of Credit and financial stability etc. The micro operations related risks faced by Islamic Banking ranged from increased cost of information to mark-up financing and from the financing of social concerns to the control over cost of funds etc. Apart from operational risks both at micro and macro levels, some general risk or problems were also faced by Islamic Banking in its transition from conventional banking and which related to the formation of Shariah Board, communicating Bank’s new Vision and the marketing of the new bank products.

Key words: Islamic Banking, Conventional Banking, Islamic
Shariah Board, Risk Management, Transition

1. Introduction

In an Islamic system, banks, although constrained by the rules of the Shari'a, essentially perform the same functions as those in conventional system; that is, they act as administrators of the economy's payments system and as financial intermediaries. They are needed in both systems for the same reason for the exploitation of imperfections in financial markets. This imperfection includes imperfect divisibility of financial claims, imperfect information, transaction costs of search and acquisition, diversification by the surplus and deficit units, and existence of expertise and economies of scale in monitoring transactions. Financial intermediaries in an Islamic system can reasonably be expected to exhibit economies of scale with respect to these costs, as do their counterparts in a conventional system. Just as in the latter system, the Islamic depository financial intermediaries transform the liabilities of business into a variety of obligations to suit the tastes and circumstances of the surplus units. Prohibition of interest and the fact that the banks have to rely primarily on profit sharing leads to a major difference between the two systems: Islamic banks have to offer their asset portfolio of primary securities in the form of risky open ended “mutual funds” type packages for sale to investor depositors, while banks in conventional system keep title to the assets portfolios they originate. Banks fund these assets by issuing deposit contracts, a practice that results in solvency and liquidity risks, because the asset portfolio entail risky payoffs and costs of liquidation prior to maturity, while deposit contracts are liabilities that are often put able instantaneously at par (Iqbal and Mirakhor, 1987).
Islamic finance has been expanding strongly all over the world during the past few years and shows significant product innovation and sophistication. Shariah-compliant products have proven to be attractive and offer many opportunities - even for non-Islamic institutions. This is due to the fact that up to 50% of the total savings of the Muslim population worldwide are projected to be invested in a Shariah-compliant way within the next five years, making it an extremely fast-growing business worldwide and offering significant potential to traditional Islamic institutions and new entrants. Risk management is getting more attention all over the world due to the sub-prime crisis and for most Islamic financial institutions, risk management presents specific challenges. The Islamic capital market is reaching an important peak of sophistication: almost all conventional products can be readily replicated in a Shariah-compliant way, even the most complex structured products, which is not always desirable according to many experts in the industry (Kumar 2009). Therefore it holds importance to carry out a detailed study of the risk management practices/processes being carried out by an Islamic bank.

This research study therefore relates to the study of the risk management system of the Islamic Banking. A comprehensive study of the risk management framework will be carried out in order to find out if it has helped the Bank in its transition from conventional to Islamic banking. Rest of this paper has been organized as follows. Literature review is presented in section 2. In section 3, data is analysed. Recommendations are detailed in section 4 whilst conclusion and future work are covered in section 5.

2. Literature Review
Islamic finance was practiced predominantly in the Muslim world throughout the middle ages. European financiers and businessmen later adopted many concepts, techniques, and instruments of Islamic finance. In contrast, the term “Islamic financial system” is relatively new, appearing only in the mid 1980s. In fact, all earlier references to commercial or mercantile activities conforming to Islamic principles were made under the umbrella of either “interest free” or “Islamic” banking. This, no doubt, prohibits the receipt or payment of interest as the nucleus of the system, but is supported by other principles of Islamic Doctrine advocating risk sharing, individuals’ rights and duties, property rights, and the sanctity of contracts. Similarly, the Islamic financial system is not limited to banking, but covers financial instruments, financial markets, and all types of financial intermediation (Khan and Mirakhor, 1990).

There is a debate among the Islamic community over the effectiveness of an interest based banking system. While it is acknowledged that banks play a pivotal role in the development of a country through their role as financial intermediaries, the question is how efficient an interest-based system is in performing this function. In fact, there is even some debate as to whether or not an interest based system actually contributes to cyclical fluctuations. A new system of banking has emerged known as Profit Loss Sharing PLS most likely in response to the interest based banking system debate, but more due to religious beliefs in the Islamic community. Currently, this banking system is integrated into over 60 countries throughout the world with over 250 Islamic financial institutions in operation (Al-Iqtisadiyah, 2005).
Aside from the economic debate, the main contributing factor in the emergence of a profit loss sharing (PLS) banking system is the prohibition of ‘riba’ (interest) in the holy Quran. The basic intention behind establishing Islamic banks was the desire of Muslims to reorganize their financial activities to complement the principles of the Shariah (or the Islamic Law) and enable them to conduct their financial transactions without indulging in ‘riba’. The term riba is used in the Shariah in two senses. First is riba al-nasiah, which is the fixing in advance of a positive return on a loan as a reward for waiting to be repaid. Second, riba al-fadl is encountered in a hand to hand purchase and sale of commodities. The Shariah prohibits both forms of ‘riba’ (Suleiman, 2000).

Risk management is the identification, assessment, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events or to maximize the realization of opportunities. Risks can come from uncertainty in financial markets, project failures, legal liabilities, credit risk, accidents, natural causes and disasters as well as deliberate attacks from an adversary. (Hubbard 2009) The process of risk management is a two (2) step process. The first is to identify the source of the risk, i.e. to identify the leading variables causing the risk. The second is to devise methods to quantify the risk using mathematical models, in order to understand the risk profile of the instrument. (Rozman, 2010)

Once a general framework of risk identification and management is developed, the techniques can be applied to different situations, products, instruments and institutions. It is crucial for Islamic banks (IBs) to have comprehensive
risk management framework as there is growing realization among IBs that sustainable growth critically depends on the development of a comprehensive risk management framework (Greuning and Iqbal, 2007). The four important aspects of risk management processes are: (1) understanding risk and risk management; (2) risk identification; (3) risk analysis and assessment; and (4) risk monitoring.

Thus, a robust risk management framework can help IBIs to reduce their exposure to risks, and enhance their ability to compete in the market (Iqbal and Mirakhor, 2007).

As this research is based on the transition of Bank of Khyber from conventional to Islamic banking therefore, it is necessary to discuss the risks faced by both the Conventional and Islamic Financial Institutions. Risk arises when there is a possibility of more than one outcome and the ultimate outcome is unknown. Risk can be defined as the variability or volatility of unexpected outcomes. It is usually measured by the standard deviation of historic outcomes. Though all businesses face uncertainty, financial institutions face some special kinds of risks given their nature of activities. The objective of financial institutions is to maximize profit and shareholder value-added by providing different financial services mainly by managing risks. There are different ways in which risks are classified. One way is to distinguish between business risk and financial risks. Business risk arises from the nature of a firm’s business. It relates to factors affecting the product market. Financial risk arises from possible losses in financial markets due to movements in financial variables (Jorion and Khoury 1996). It is usually associated with leverage with the risk that obligations and liabilities cannot be met with
current assets (Khan and Ahmed 2001).
The risks that Financial Institutions (banks) face can be divided into financial and non-financial ones. Financial risk can be further partitioned into market risk and credit risk. Non-financial risks, among others, include operational risk, regulatory risk, and legal risk. The study shows that the Islamic banks face two types of risks. The first type of risks they have in common with traditional banks as financial intermediaries, such as credit risk, market risk, liquidity risk and operational risk. However, due to Shariah compliance the nature of these risks changes. The second type is of new and unique risks that the Islamic banks face as a result of their unique asset and liability structures. Consequently the processes and techniques of risk identification and management available to the Islamic banks could be of two types - standard techniques which are not in conflict with the Islamic principles of finance and techniques which are new or adapted keeping in view their special requirements.
The different categories of risk involved in Islamic banking relates to Credit risk, Equity investment risk, market risk, liquidity risk, operational risk and rate of return risk. While making meaningful risk assessments, it is crucial for Islamic Banking Institutions to recognize and evaluate the overlapping nature and transformation of risks that exist between and among the categories of the above-mentioned risks. In addition, IBIs may face consequential business risks relating to developments in the external marketplace. Adverse changes in IBIs’ markets, counterparties, or products as well as changes in the economic and political environments in which IBI operate and the effects of different Shariah rulings are examples of business risk. These
changes may affect IBI’s business plans, supporting systems and financial position. IBIs are also exposed to reputational risk arising from failures in governance, business strategy and process. Negative publicity about the IBIs' business practices, particularly relating to Shariah non-compliance in their products and services, could have an impact upon their market position, profitability and liquidity.

3. Data Analysis

The different risks and problems faced by Bank in its transition to Islamic Bank, as identified through the interviews with the Bank officials can be categorized in three ways i.e. Macro Operations Risks, Micro Operations Risks and General Risks.

3.1. Macro Operation Risks

The macro operations level risks faced by Islamic Banking related to liquidity, Asset’s Valuation, Creation of Credit and financial stability etc.

3.1.1. Liquidity

The most important risk faced by Banking was related to the liquidity. Though conventional banks emphasize the need for maintaining liquidity and hence require an adequate amount of reserves but Islamic banking stands for the use of money as a medium of exchange. Being profit and Loss (PLS) based financial institution; Islamic Banking was exposed to greater risk i.e. it required higher reserves and liquidity.

As described by one of the interviewee, “This was because of its nature of investment in assets having lesser divisibility and reversibility. That means, reserve ratios for interest-free banking are to be calculated on the basis of risk calculation in various forms of investment.” (Interviewee 1)

In that case Islamic Banking had to depend on the Central Bank i.e. State Bank of Pakistan instead of its parent conventional Banking for the supply of cash while in case of
conventional banking, the liability management is replaced by asset management for funding their liquidity needs.

3.1.2. Valuation of Bank’s Assets

Like most of the Islamic banks, Islamic Banking also suffered a loss of value of its assets in the absence of a fixed positive rate of return. Theoretically, Islamic banks are likely to face a dual risk: (a) the ‘moral’ risk due to lack of honesty and integrity on the part of the borrower of funds in declaring a loss, (b) the ‘business’ risk arising from unexpected market behaviour. Without the provision of insurance, Islamic Banking also faced trouble in making its system stable and avoiding liquidity crises.

As described by an interviewee, “The deposits under a profit and loss sharing system are conceptually more akin to a mutual fund’s share certificate. These deposits would share in both the realised as well as unrealised gains and losses on the investment of Islamic banks.” (Interviewee 1)

The problem associated with proper valuation of assets at Islamic Banking had important implications from the point of view of bank safety and bank regulation i.e. how far the gains (losses) on banks’ investments were to be passed on to the depositors. If in the extreme case, these gains and losses are fully reflected in the value of the deposits, the banks probably would had to pass on all the risks to their depositors.

Another problem in determining the profit or loss to be distributed to the depositors of the Islamic Banking related to the periodic evaluation of its assets, especially in case of long term investments, such as Mudaraba, or Musharaka. Also identified by Hassan & Lewis (2007), the value of long-term investments would fluctuate with the changes in the expected cash flows as well as the opportunity cost of capital. In
the absence of an active market in these investments, the valuation process will be very imprecise and costly.

3.1.3. Creation of Credit

Another risk faced by Islamic Banking related to the creation of Credit. As the State Bank of Pakistan adjusts the money stock to keep pace with the secular growth of output, therefore the control of money supply is accomplished by regulating the high powered money at the source. In this way the credit is created by SBP by imposing a 100% reserve requirement on the commercial banks, which is then channelled through commercial banks on a Mudaraba basis. Alternatively, the banks are also allowed to create deposits. In the principle of Islamic banking private banks does not have the power to create money, as money creation is a power reserved for the government or to the SBP (Central Bank).

3.1.4. Financial Stability

As conventional banking system is based on the fractional reserve system, therefore has built-in instability which arises from the lack of synchronization between the decisions of commercial banks and the central bank thereby resulting in destabilizing forces. In the words of an interviewee, “Modern banking is based on interest issues fixed value liabilities to its depositors. In the absence of deposit insurance the value of assets can fall below its fixed liabilities, resulting in bankruptcies and instabilities in banking system.” (Interviewee 2)

In this way, the lack of lack of insurance coverage posed a risk for Islamic Banking. It was presumed that depositors in Islamic Banking, due to fair of capital and or profit losses in the event of having no insurance coverage, would not remain with the banks. But it is argued by Muslim economists that under Islamic banking, because there are no fixed liabilities, depositors feel
encouraged to remain in the bank when it suffers a decline in the value of its assets. As there is no externality created, therefore the provision of deposit insurance is not required (Hunt 2007). However, it was needed to have some provision of insurance against fraud and theft in Islamic banking.

3.2. Micro Operational Risks
The micro operations related risks faced by Islamic Banking ranged from increased cost of information to mark-up financing and from the financing of social concerns to the control over cost of funds etc.

3.2.1. Increased Cost of Information
At micro level the most important risk faced by Islamic Banking was related to the increased cost of Information. As the Islamic Banking had to finance the working capital of a business venture taking a quasi-equity position, therefore the monitoring cost as well as cost of writing and enforcing contracts is higher as compared to that of the conventional Banking or interest based system. As was described by an interviewee, "In financing, a management company is formed which floats a negotiable security, or the Islamic Banking may completely finance a project within the scope of its charter." (Interviewee 3)

Moreover, since the economy of Pakistan (while implementing Islamic banking) is generally characterized by market and informational imperfections, further persistence of these problems had increased the cost of information. This higher cost of information proved to be a major setback in effective implementation of the PLS system at Islamic Banking in its transition from conventional system.

3.2.2. Mark-up Financing
Another risk perceived to be tackled by Islamic Banking was related to the mark-up. It is still generally believed that there is little difference between mark-up
practiced by Islamic banks and conventional banks. Markup was seen by the banks as a tool to facilitate the transition to Islamic banking without disrupting the system. Because the ultimate objective of the establishment of Islamic Banking was toward investment-oriented long-term financing, the transition from markup to equity finance would also require a larger spread between rates of return to the banks and to their depositors.

As argued by one of the interviewee that real substitute of interest in an Islamic financial system is the mode of profit/loss sharing along with Qard Hasana. While the other techniques like Murabaha, Bai-Muajjal, Ijara and Ijara WA Iqtina cannot be of equal significance in achieving Islamic socio-economic objectives (Interviewee 1). The reasoning employed by Islamic Banking is that as Islam disallows the interest system because intrinsically it is a highly inequitable system. The feature that makes the interest based system inequitable is that the provider of capital funds is assured a fixed return while all the risk is borne by the user of these capital funds. Justice demands that the provider of capital funds should share the risk with the entrepreneurs if he wishes to earn profit. Financing techniques like Murabaha, Bai-Muajjal, Ijara and Ijara WA Iqtina, which involve a pre-determined return on capital, cannot be regarded as commendable substitutes for interest, and should only be used when absolutely needed.

3.2.3. Financing Social Concerns

In case of financing social aspects, Islamic Banking faced a risk of following in prints of the conventional bank as it was interested in extending credit facilities to well-established commercial establishments (like conventional bank), which often obtain credit facilities from both
conventional as well as Islamic banks without real commitment or attempt to free themselves from the prohibited means of finance. In this way, Islamic Banking might be undertaken as trading like other traditional banks. Also Islamic Banking did not have the necessary expertise and trained manpower to appraise, monitor, evaluate and audit the projects they are required to finance, therefore it could not expand despite having financial liquidity.

3.2.4. Control over Cost of Funds
Another most important risk faced by Banking related to the control over costs of funds. As conventionally, it maximizes its profit subject to cost of funds as it is in a position to know in advance, with a reasonable degree of certainty, the amount of profit it may earn in the short term. Through the use of hedging Banking was also able to determine the level of profits in the long run. Under the Islamic Banking or PLS system, as there is no such scope to know the cost of funds beforehand, the depositors of Islamic Banking were to paid a portion of bank's profits the volume of which is extremely uncertain. In this situation if profit rate expected by the depositors was not realized, the Islamic Banking could face greater uncertainty in their profit base.

Ideally, Islamic Banking is expected to calculate its rate of return on PLS deposits periodically. In the words of an interviewee, "the usual practice is that the deposits are weighted to reflect differences in their maturity. Islamic Banking prepare a six monthly summary account of its operations and send it to the central bank, which determines the individual PLS rate to be paid by each bank."(Interviewee 4). In spite of that individual banks are allowed to marginally deviate from the proposed rate of return. In sum, it
can be argued that Islamic Banking has no control over the cost funds.

3.3. General Risks
Apart from operational risks both at micro and macro levels, some general risk or problems were also faced by Islamic Banking in its transition from conventional banking. These were identified by the interviewees as follows:

3.3.1. Formation of Shariah Board
As Banking was making a transformation, it was in need to form a Shariah board that includes a group of prominent Shariah scholars. This Shariah board was to assume a key role in supporting the bank's operation to meet the Shariah requirements according to Islamic law. As described by an interviewee, "The new Islamic banking products and services will need to gain approval by Shariah scholars. During the transformation stage, the Shariah board's role is crucial because the entire scope of banking has to be approved" (Interviewee 1)

3.3.2. Communicating Bank's New Vision & Identity to Staff
Another problem was the non-availability of the necessary expertise and trained manpower. Also for the old staff which opted for joining the Islamic banking, it was critical to communicate the bank's new mission and identity to them. It was very important as it is crucial for the bank to educate its customers on the changes in banking processes so that they are compliant with Shariah law. The customers were needed to understand the changes in areas such as returns on investment deposits and the provision of interest-free deposits.

3.3.3. Marketing New Banking Products
Along with communicating the Bank's Vision, the marketing of its new Banking products was also important. In marketing its new banking products, Banking had two options. It may have develop its own
innovative approach by hiring specialized Islamic banking marketers or may have opt to train its own in-house marketing and sales people. Islamic Banking eliminated the barrier between those who save and those who invest, and has brought them closer to the real market. As with conventional banks, Islamic Banking also considers the credit worthiness of the person acquiring the loan. However, conventional banks have a tendency to focus more on the profitability of the transaction. The principle of justice governs Islamic Banking and under this principle, the actual output which refers to profit or loss of a project must be shared equally between the financier and the beneficiary.

3.4. Risk Management during Transition to Islamic Banking
The second objective of the research deals with the exploration of the risk management process and practices carried out in transitioning to Islamic Banking at Banking. At the time of transition to Islamic Banking, need for a comprehensive risk management framework was outlined as it was critical for a sustainable growth. Once a general framework of risk identification and management was developed, the techniques were then applied to different situations, products, instruments and institutions. First, it was important to identify the source of the risk, i.e. to identify the leading variables causing the risk and then methods were devised to quantify the risk using mathematical models, in order to understand the risk profile of the instrument. The four important aspects of the risk management processes that were carried out included: (1) understanding risk and risk management; (2) risk identification; (3) risk analysis and assessment; and (4) risk monitoring. This robust risk management framework helped
Islamic Banking to reduce its exposure to risks, and enhanced its ability to compete in the market. A number of categories of risk were identified during the interviews with the bank officials, which related to credit, equity investment, liquidity, market, operations and rate of return risk. Based on the principle Guidelines described by the State Bank of Pakistan, Islamic Banking made a meaningful risk assessment in order to recognize and evaluate the overlapping nature and transformation of risks that exist between and among these categories of risks. It was also identified by an interviewee, "Banking has a sound process for executing all elements of risk management, including risk identification, measurement, mitigation, monitoring, reporting and control, as this requires the implementation of appropriate policies, limits, procedures and effective management information systems (MIS) for internal risk reporting and decision making that are commensurate with the scope, complexity and nature of Banking's Islamic banking activities." (Interviewee 3) Islamic Banking had ensured that an adequate system of controls with appropriate checks and balances is in place. The controls (a) comply with the Shariah rules and principles; (b) comply with applicable regulatory and internal policies and procedures; and (c) take into account the integrity of risk management processes. The steps taken to manage the four major risks identified earlier during the transition stage are briefly described as follows:

3.4.1. Credit Risk

During and after transition stage, Islamic Bank of Khyber needed to manage credit risks inherent in their financings and investment portfolios relating to default, downgrading and concentration. Credit risk included
the risk arising in the settlement and clearing transactions. Islamic Banking designed a strategy for financing, using various instruments in compliance with Shariah, whereby it recognizes the potential credit exposures that may arise at different stages of the various financing agreements. Also it had in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument. As described by an interviewee, "We carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument." (Interviewee 1) Thus adopting appropriate Shariah-compliant credit risk mitigating techniques for each Islamic financing instrument helped Islamic Banking in countering the Credit Risk.

3.4.2. Market Risk

In transition to Islamic Bank, Banking also faced the risk of losses in on- and off-balance sheet positions arising from movements in market prices i.e. fluctuations in values in tradable, marketable or leasable assets (including sukuk) and in off-balance sheet individual portfolios (for example restricted investment accounts) and the risks relate to the current and future volatility of market values of specific assets including Foreign Exchange Rates. Through interviews it was identified that Islamic Banking adopted an appropriate framework for market risk management (including reporting) in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.

3.4.3. Equity Investment Risk

The equity investment instruments, available with Islamic Banking are based on the Mudarabah and Musharakah contracts. The
investments made via Mudarabah and Musharakah instruments may have contributed substantially to Bankings' earnings, they entail significant market, liquidity, credit and other risks, potentially giving rise to volatility in earnings and capital. During transition stage, Islamic Banking ensured that its valuation methodologies are appropriate and consistent, and assess the potential impacts of its methods on profit calculations and allocations. The methods are mutually agreed between the Bank and the Mudarib and/or Musharakah partners in order to minimize the equity investment risk. In the word of an interviewee, “Banking also defined and established the exit strategies in respect of their equity investment activities, including extension and redemption conditions for Mudarabah and Musharakah investments, subject to the approval of our Shariah Advisory Board.” (Interviewee 5)

3.4.4. Liquidity Risk

Islamic Banking also faced liquidity risk of potential loss arising from its inability either to meet its obligations or to fund increases in assets as it may fall due without incurring unacceptable costs or losses. In managing the liquidity during and after the transition stage, Islamic Bank ensured that the availability from the possible funding sources i.e. natural cash flows arising from its usual banking activities, the realisation of tradable invested assets, asset securitisation, and its capacity to access shareholders' and/or head office funds.

The liquidity management policies adopted by Islamic Banking included some form of contractually agreed orderly liquidation procedures, to avoid having to liquidate assets at unfavourable prices, resulting in the erosion of the PLS deposit holders'
capital and damage to the Islamic Bankings’ reputation and viability. Steps were also taken to manage other risks like those arising from rate of return and its operations.

3.5. Perception of Islamic Banking towards Risk Management
The third objective of the research relates to find out the perception of Islamic Banking towards the management of the risks faced. Taken in to account the potential risks and its effects on the depositors, the investors and the bank itself, it was identified through interviews that Islamic Banking takes the risk management an important issue and places much significance on an appropriate risk management system. Therefore it takes every possible step to minimize or level the effects of these risks. Such as

3.5.1. Timely Disclosure of Information
One risk minimizing step includes the making of appropriate and timely disclosure of information to depositors having deposits on Profit and Loss Sharing basis, minimum requirements of which are specified by SBP in its Guidelines for Shariah Compliance in Islamic Banking, so that the depositors are able to assess the potential risks and rewards of their deposits and to protect their own interests in their decision making process.

3.5.2. Emergency & Contingency Plan
Also the senior management regularly draw up an emergency and contingency plan, approved by the board of directors in order to be able to deal with risks and problems which may arise from unforeseen events.

3.5.3. Integration of Risk Management
While assessing and managing risk, the management at Islamic Banking has an overall view of risks the bank is exposed to. This also requires having a structure in place to look at
risk interrelationships across the organization. Such a setup has been established in the form of a separate Risk Management department which ensures effective monitoring and control over risks being taken.

3.5.4. Risk Measurement

For each category of risk, Islamic Banking has established a system/model that quantifies its risk profile. The results of these models are assessed by an independent risk review function. The Board of Directors approve limits on aggregate financing and investment exposures to avoid concentration of risk and ensure that Islamic Banking hold adequate capital against these exposures. The BOD also reviews the effectiveness of the risk management activities periodically and makes appropriate changes as and when necessary. All these different risk management measures are taken by Islamic Banking to avoid or minimize the risk that arises from its' failure to perform in accordance with explicit and implicit standards applicable to its fiduciary responsibilities. As a result of losses in investments, Islamic Banking may become insolvent and therefore unable to (a) meet the demands of current account holders for repayment of their funds; and (b) safeguard the interests of its PLS deposit holders.

4. Recommendations

Following are few of the recommendations for effectively tacking the risks arising and availing the opportunities available to the Islamic Banking.

4.1. Long-Term Investment Tools

One of the main selling points of Islamic banking, at least in theory, is that, unlike conventional banking, it is concerned about the viability of the project and the profitability of the operation but not the size of the collateral. Good projects which might be turned down by conventional banks for lack of
collateral would be financed by Islamic Banking on a profit-sharing basis. It is especially in this sense that Islamic Banking can play a catalytic role in stimulating economic development of the province. In many developing countries, of course, development banks are supposed to perform this function. Islamic banks are expected to be more enterprising than their conventional counterparts. In practice, however, Islamic banks have been concentrating on short-term trade finance which is the least risky (Ariff 2010). As about 95% of Shariah-compliant funds are invested on a short term basis, therefore there is about 40% more liquidity in Islamic Banking and Finance institutions than in traditional banking. This can be seen as an opportunity. Also, there is a serious dearth of long-term Shariah-compliant investment tools, therefore it recommended for Islamic Banking to introduce some long-term Shariah Compliant investment options which will not only increase its credibility but will also bring in use the excess liquidity, if any available with the bank.

4.2. E-Documentation
Like other Islamic financial institutes, Islamic Banking also tends to be document-intensive. This is because typically each transaction has multiple phases - contract, procurement, sale, financing and servicing. Various documents are required to be completed during the various stages of the deal. At the same time, adoption of e-documentation is recommended for Islamic Banking which can obviate the need for multiple physical meetings, track the time elapsed and also alleviate the need to maintain paper and related storage and retrieval costs (Tahir 2003). For this different nature of contracts, Islamic Banking will require new practices: The use of non-conventional contracts to offer products for financial services can
create a whole range of issues concerning corporate governance standards, sources of new risks and how to manage them, as well as how to make Islamic Banking conform to the market discipline already created for conventional banks.

4.3. Pool of Shariah Expertise

There is a shortage of qualified human capital in relation to the Islamic Banking and Shariah on financing not even in Peshawar but in overall Pakistan. Meanwhile, the strong growth in the global Islamic banking and finance sector means that the current shortage of personnel working in the sector will be exacerbated. There is a need for developing a substantial number of Shariah experts of high professional prudence and integrity. It is therefore recommended that Islamic Bank of Khyber can start a sponsorship programme with the local universities, imparting degree courses in Islamic Banking & Finance which will not help in fulfilling the demand for the qualified human capital but will also provide Islamic Banking, a pool of talent to choose from the best available talent for fulfilling its human resources requirements.

4.4. Knowledge Propagation of Islamic Products

Like many other Islamic Banks, the knowledge propagation for Islamic products is not done at the beginners' level by Islamic Banking. The backend chemistry of Islamic financial products formation is not made publically known hence has less impact upon society. Either Islamic Banking Seminars or Conferences are costly affairs or institutions imparting that know-how (or similar trainings) are charge higher than normal fees. All this has made Islamic Banking professional learning a costly affair for new comers or a lucrative career path for those who could afford that price (Nadeem, 2010). Therefore, it is recommended for
Islamic Banking to arrange for such seminars and conferences in order to make the public aware of their Islamic products.

4.5. E-Banking

Another aspect in today's technological world is e-banking i.e. banking at your own comfort of home. Branchless banking is taking ground where electronic channels such as phone, internet, or short messages or mobile phones are used heavily for banking - It is therefore recommended for Islamic Banking to start E-Banking in order to provide their customer the opportunity to do their banking at their own comfort.

5. Conclusions and Future Work

A number of risk management measures were taken by the bank during its transition stage. The robust risk management framework helped Islamic Banking to reduce its exposure to risks, and enhanced its ability to compete in the market. In order to manage credit risks, Islamic Banking designed a strategy for financing, using various instruments in compliance with Shariah, whereby it recognizes the potential credit exposures that may arise at different stages of the various financing agreements. Islamic Banking also adopted an appropriate framework for market risk management (including reporting) in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility. During transition stage, Islamic Banking ensured that its valuation methodologies are appropriate and consistent, and assess the potential impacts of its methods on profit calculations and allocations.

The report recommendations consist of an introduction of some long-term investment tools in order to bring in use the excess liquidity. An adoption of e-documentation is also recommended for Islamic Banking in order to prevent the intensive documentation involved in a single transaction. The report also
recommends sponsoring degree level courses in Islamic banking and finance at the local universities which will help in building a pool of talent for fulfilling the need for human capital in Shariah expertise.

An introduction of e-banking is also recommended along with the knowledge propagation of Islamic products of the bank.

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