Risk Management System of the Islamic Banking

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Abstract
Studying risk management issues of the Islamic bank is an important but complex subject. The present research discusses and analyzes a number of issues concerning the subject. This research has concluded that there are several risks which are associated with the way Islamic banking is conducted. Moreover, if the assets of all Islamic banks were pooled, they would still be less than those of any single bank in the top 50 banks in the world, and the assets of the largest Islamic bank are equal to only 1 percent of the assets of the largest bank in the world

1. Introduction
Thirty years ago, Islamic banking was unheard of. It was considered as, mentioned by the authors, as "wishful thinking". It is only in the early 1970s, and especially after the launch of the First International Conference on Islamic Economics organized by King Abdul Aziz University in Makkah, Saudi Arabia and the establishment of the first commercial Islamic Bank, Dubai Islamic Bank (DIB) in the United Arab Emirates followed by the establishment of the international Islamic Development Bank (IDB) in Jeddah, Saudi Arabia and the many private and semi-private commercial Islamic banks that were established after that in Egypt, Sudan, Kuwait, Bahrain, etc. that Islamic banking
established itself not only as a feasible and viable alternative of financial intermediation but also as an efficient and productive way of undertaking financial intermediation between surplus and deficit economic units (Iqbal and Molyneux, 2005).

Since then, Islamic banking has gained momentum and has been growing very fast at a double digit average annual rate of growth. Today, Islamic banking is not a negligible or merely temporary phenomenon but it is here to stay and there are signs that it will continue to grow and expand (Mohamed, 1988). At the moment, it is one of the fastest growing industries. Its size has grown tremendously from a mere few hundred thousand dollars in 1975 to reach hundreds of billions of dollars by 2005. The practice of Islamic banking is now not limited to only Arab and Muslim countries but has spread from East to West, all the way from Indonesia and Malaysia towards Europe and the Americas. Not only that, but the fact is that many conventional banks, including some major multinational Western banks have also started using Islamic banking techniques. Al-Iqtisadiyah (2005) reported that the world have been witnessing a widespread of Islamic banks all over the five continents. Today, there are 280 Islamic banks in 48 countries, whose total deposits have reached US$400 billion, in addition to 300 conventional banks, which opened branches, windows or provide Islamic financial products. The contribution of this work is to analyse the key risks to Islamic banking. Rest of this work is organized as follows. In section 2 literature review is presented. The focus of section 3 is to analyse risks to Islamic banking whilst conclusion and future work is covered in section 4.

2. Literature Review

A central tenet of an economic system based on Islamic principles is the absolute prohibition on the payment and receipt of interest. It is this
prohibition that makes Islamic banks and financial institutions differ in a fundamental sense from their Western counterparts. As the use of the interest rate in financial transactions is precluded, Islamic banks are expected to conduct operations only on the basis of profit-sharing arrangements or other modes of financing permissible under Islamic law. At present about 45 countries, encompassing most of the Muslim world has some type of Islamic banking or financial institutions. This development, which has gained momentum since the second half of the 1970s, has basically taken two forms. The first has been an attempt to establish Islamic financial institutions side by side with traditional banking. In such attempts, two types of institutions have evolved: Islamic banks, established mostly in Muslim countries, and Islamic investment and holding companies, operating in some Muslim but mostly in non-Muslim countries. In both cases, generally, the banking operations of Islamic banks are subject to specific regulations that apply to all banks. Examples of Islamic banks are the Faisal Islamic Banks in Egypt and the Sudan, the Dubai Islamic Bank, and the Jordan Islamic Bank. Examples of investment companies having either a national or an international mandate include the Darul Mal Al-Islami (Geneva), the Islamic Investment Company (Bahamas), and the Bah-rain Islamic Investment Bank. These institutions compete with conventional banks to attract deposits but without paying a predetermined interest rate and invest these funds wherever they find profitable investment opportunities. The majority of these institutions were established through private initiatives (Khan and Mirakhor, 1990).

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.

3. Analysis and Discussion

The nature of risks that Islamic banks face and risks inherent in different modes of financing are outlined below.

3.1. Credit Risk

Credit risk would take the form of settlement/payment risk arising when one party to a deal pays money (e.g. in a Salam or Istisna contract) or delivers assets (e.g., in a Murabahah contract) before receiving its own assets or cash, thereby, exposing it to potential loss. In case of profit-sharing modes of financing (like Mudarabah and Musharakah) the credit risk will be non-payment of the share of the bank by the entrepreneur when it is due. This problem may arise for banks in these cases due to the asymmetric information problem in which they do not have sufficient information on the actual profit of the firm. As Murabahah contracts are trading contracts, credit risk arises in the form of counterparty risk due to non performance of a trading partner (Greuning and Iqbal, 2008, Pp. 126-127). The non performance can be due to external systematic sources.

3.2. Benchmarking Risk
As Islamic banks do not deal with interest rate, it may appear that they do not have market risks arising from changes in the interest rate. Changes in the market interest rate, however, introduce some risks in the earnings of Islamic financial institutions. Financial institutions use a benchmark rate, to price different financial instruments. Specifically, in a Murabahah contract the mark-up is determined by adding the risk premium to the benchmark rate (usually the LIBOR). The nature of fixed income assets is such that the mark-up is fixed for the duration of the contract. As such if the benchmark rate changes, the mark-up rates on these fixed income contracts cannot be adjusted (Greuning and Iqbal, 2008, Pp. 126-127). As a result Islamic banks face risks arising from movements in market interest rate.

3.3. Liquidity Risk

As mentioned above, liquidity risk arises from either difficulties in obtaining cash at reasonable cost from borrowings or sale of assets. The liquidity risk arising from both sources is critical for Islamic banks. As interest based loans are prohibited by Shariah, Islamic banks cannot borrow funds to meet liquidity requirement in case of need. Furthermore, Shariah does not allow the sale of debt, other than its face value (Greuning and Iqbal, 2008). Thus, to raise funds by selling debt-based assets is not an option for Islamic financial institutions.

3.4. Operational Risk

Given the newness of Islamic banks, operational risk in terms of person risk can be acute in these institutions. Operational risk in this respect particularly arises as the banks may not have enough qualified professionals (capacity and capability) to conduct the Islamic financial operations. Given the different nature of business the computer software available in the market for conventional banks may not be appropriate for Islamic banks (Hunt 2007). This
gives rise to system risks of developing and using informational technologies in Islamic banks.

3.5. Legal Risk

Given the different nature of financial contracts, Islamic banks face risks related to their documentation and enforcement. As there are no standard forms of contracts for various financial instruments, Islamic banks prepare these according to their understanding of the Shariah, the local laws, and their needs and concerns (Hussain & Lewis 2007). Lack of standardized contracts along with the fact that there are no litigation systems to resolve problems associated with enforceability of contracts by the counterparty increases the legal risks associated with the Islamic contractual agreements.

3.6. Withdrawal Risk

A variable rate of return on saving/investment deposits introduces uncertainty regarding the real value of deposits. Asset preservation in terms of minimizing the risk of loss due to a lower rate of return may be an important factor in depositors' withdrawal decisions. From the bank's perspective, this introduces a 'withdrawal risk' that is linked to the lower rate of return relative to other financial institutions (Greuning and Iqbal, 2008).

3.7. Fiduciary Risk

A lower rate of return than the market rate also introduces fiduciary risk, when depositors/investors interpret a low rate of return as breaching of investment contract or mismanagement of funds by the bank (AAOIFI 1999). Fiduciary risk can be caused by breach of contract by the Islamic bank. For example, the bank may not be able to fully comply with the Shariah requirements of various contracts (Hunt 2007). While, the justification for the Islamic banks' business
is compliance with the Shariah, an inability to do so or not doing so will fully cause a serious confidence problem and deposit withdrawal.

3.8. Displaced Commercial Risk

This risk is the transfer of the risk associated with deposits to equity holders. This arises when under commercial pressure banks forgo a part of profit to pay the depositors to prevent withdrawals due to a lower return (AAOIFI 1999). Displaced commercial risk implies that the bank though may operate in full compliance with the Shariah requirements, yet may not be able to pay competitive rates of return as compared to its peer group Islamic banks and other competitors. Depositors will again have the incentive to seek withdrawal (Greuning and Iqbal, 2007). To prevent withdrawal, the owners of the bank will need to apportion part of their own share in profits to the investment depositors.

4. Conclusion and Future Work

The contribution of this work is to analyse some of the key risks associated with the Islamic banking. This research suggest to review the existing structure of Islamic banking in order to minimize the occurring probability of discussed risk to avoid any major loss in due course. Future research will analyse the risks related to conventional banking. We are committed to share future research findings with the ongoing research in this area.

References

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