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Risk Management in Islamic Banking

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Abstract: The financial services industry of Islam consists of an increasingly vast number of institutions, such as investment and commercial banks, investment companies and mutual insurance companies. In Islamic banks effective risk management deserves special attention. However, it has numerous drawbacks that are required to be understood better. Risk management is about the attitude towards paying off and the strategies in dealing with them and the risks associated with it in relation to modern banking. As an operational problem, risk management is about the classification and identification of methods, processes and risks in banks to supervise, monitor and measure them. In comparison to conventional banks, Islamic banks face big difficulties in identifying and managing risks due to bigger complexities emerging from the profit loss sharing concept and nature of particular risks of Islamic financing. This research investigates in detail the need for risk management in Islamic banks. This study has been conducted with specific reference to two famous Islamic banks in Malaysia by names Bank Muamalat and Al-Rajhi Bank , respectively. In addition to analyzing the effectivene of risk management strategies adapted by them at present, this research also has suggested strategies for improving risk management process of Islamic banks in future.

Keywords: Risk Management, Islamic Banking, Risk, Management.

1. Introduction

Islamic banking organizations use different types of contracts of Islamic finance to satisfy the needs of customers for financing amenities [1] . Every product has its own distinct risks that reveals the bank to important return losses for expected returns [2]. With every single product the risks associated can be broken down further into non major and major risks. Major risks refers the risks that prevail the used product. The major risks faced by the products of Islamic banking products are shown in the below table:

Table 1: Major risks faced by the products of Islamic Banking

Product based on	Major risks	Risk Classification
Murabahah	Credit risk	Unsystematic
Musharakah	Market and agency risk	Systematic
Mudarabah	Market and agency risk	Systematic
Ijarah thumma al-bay"	Credit risk	Unsystematic
Ijara wa iktina	Operational and payment risk	Unsystematic
Salam	Delivery risk	Systematic
Istisna'	Delivery risk	Systematic
*Bay' al-ena*h	Credit risk	Unsystematic
Tawarruq	Credit risk	Unsystematic
Commodity murabahah	Credit risk	Unsystematic

Source: Allen and Santomero (1997), "The Theory of Financial Intermediation," Journal of Banking and Finance, UK

[3] has mentioned that some of the risks faced by the Islamic bank shareholders can be eliminated and even reduced while some of the risks cannot. For instance, the credit risk linked to murabahah can be

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reduced by tightening up the valuation of credit or it can be ignored simply by not providing the facility at all. Unsystematic risks, such as in murabahah financing credit risk as obvious can use possible strategies of risk mitigation such as greater collaterals, stringent enhancers of credit and higher down-payments. Conversely in mudarabah and musharakah the products on market risk can neither be transferred nor ignored to a third party by way of claims, recourse and undertakings. Thus creative solutions and a proper adoption of possible risk management are required to reflect the special features of Islamic financial services and products. This research therefore attempts to attain the following objectives:

- To investigate the need for risk management in Islamic banks.
- Specifically, it intends:
- To identify the types of risks encountered by Islamic financial institutions.
- To analyze and propose the risk management strategies for efficient risk management in Islamic banks

2. Literature Review

Many studies have been made on risk management and its need with specific reference to Islamic banks. [4] found that the three most important types of risk that the Islamic banks in Brunei Darussalam facing are foreign-exchange risk, followed by credit risk and then operating risk. Furthermore, [5] stated that general risk faces by the Islamic Banks changes due to Shariah compliance. [6] has mentioned that a risk management is the practice or act of dealing with risk. It consists of scheduling for risk, recognizing risks, identifying risks, monitoring and controlling risks and developing strategies for risk response to decide how they have modified. Risk management is not an isolated activity of project office assigned to a risk management department but rather is one sound project management aspect. [7] have made an extensive description of risk management in Islamic banking by covering views of risk management problems in Islamic financial contracts, Islamic Financial Services Board and Basel II for the financial risk of Islam, and observing the market, operational and credit risk management for Islamic Banks. They also describe the distinct risk or mixes for every financial contract in Islamic banks. Moreover, [8] has described that the risk management context in Islamic banks covering the views of the requirements for risk management, controls and measurement in Islamic Banks and highlight the comprehensive structure of risk management for every distinct risk with the Islamic Financial Services Board standard references. [9] have similarly explained about the three major changes of Islamic banks theoretical balance sheet that has involvement on the overall risk of the banking surrounding. The contractual role of different stakeholders in relation to risk has also been highlighted apart from that. [10] has referred that as a banking organization Islamic bank behavior admitted banking tasks together with lending and borrowing without interest. [11] studied that the business of banking performed severe competition with financial instituitions and with banks to grab the attention of likely customers. [12] predicted financial institutions regarding the principle areas of Islamic Shariah of policy importance and modern academics. It is also considered that due to enhances service quality and superior customer satisfaction levels, Islamic banking is more pleasing and attractive than conventional banking [13]. All these studies make it clear that risk management is essential especially for Islamic banks.

3. Research Methodology

This study has undertaken a qualitative research. The research design adapted in this study is descriptive research design. The descriptive research is used to acquire the information based on the current phenomena status to explain what occurs with respect to variables or conditions in a condition. Similarly this study has adapted quota sampling. When researchers use this method of sampling they are always interested in the subgroups that occurs in a population and draw their sample so that it consists similar subgroups proportion. The sampling units are the following two Islamic banks from Malaysia (i) The Al-Rajhi Bank (ii) Bank Muamalat. The sample size for the qualitative study is six Bank Managers, three bank managers from each bank. The researcher has gathered data from six bank managers by conducting interviews to the respondents using open ended questionnaires at their corresponding work place without violating research ethics.

4. Findings and Analysis

Based on this research, it can be inferred that the Islamic banking industry is developing vastly and acquiring importance in the scenario of global finance. Risk management is regarded as an essential factor for Islamic banks as it is to the conventional banks. Banking is a risky business and numerous factors of risk such as liquidity, credit, market and operational risks have been recognized as difficult to ensure that the position of the banks remains impaired among the intense competition in the industry. Thus the success and survival of a financial organization rely critically on the effectiveness of handling these risks. Next the respondents were asked about the types of risks encountered by their bank. It can be found that the types of risks encountered in Islamic bank are Sharia non compliance risks, displaced commercial risk, equity investment risk and rate of return risk. The interview reveals that one of the most essential practices to be used in banks is the risk management, for getting assurance about the operations reliability and the processes being followed. in today's dynamic surroundings Islamic banks are exposed to numerous number of risks such as credit risk, foreign exchange risk, liquidity risk, interest rate risk and market risk. Efficient risk management is needed due to such exposure to different types of risks. Thus handling risk is one of the basic activities to be performed, once it has been known and recognized. Thus risk management is more essential to be undertaken in banks and it makes more sense to maximize revenues and provide maximum value to shareholders by enhancing them with different financial services by ruling risks. It can be found from the study that the challenges faced by these banks in relation to risk management are:

- **Reputational risk:** Banks face essential reputational risk specifically during crisis times and the reputational damage to banks takes several decades to repair. Reputation risk may be the most critical risk to handle compared with other kinds of risks.

- **Harmonization and accounting framework challenges:** Numerous banks are allowed to acquire a global or national accounting standard or to enhance their own particular financial reporting norms to accommodate distinct situations of the banks.

- **Valuation Challenges**: Valuation challenges became one of the most critical problems for banks to deal with following and during the financial crisis. Not only have the markets made it critical to price transactions, but many auditing and accounting guidance statement have been provided in an attempt to offer clarity

Finally, it is found that the bank's risk management process can be improved by: (i) delineating the risk management responsibilities of middle and senior management and Board of Directors clearly with respect to both credit risk and operational risk governance functions (ii) employing statistical processes too much clearly refers drivers of capital parameters and risk ratings (iii) ensuring and setting up periodic independent risk models validation, comprehensive verification of risk mitigation and risk model strategies and reviewing all risk systems (iv) setting up a governance framework that assures the management of information and data and last but not the least (vi) automating and re-engineering business processes of risk system.

5. Conclusion

Generally it can be concluded from the study that risk management plays an important role in Islamic banks. Islamic banks have a better risk monitoring system followed by internal control and risk mitigation strategies as compared to risk environment processes and policies and risk measurement policies. The types of risk undertaken by Islamic banks are rate of return risk, non compliance risk, equity investment risk and displaced commercial risk. The challenges faced by Islamic banks are reputation risk, valuation challenges and harmonization and accounting framework challenges. Thus it can be inferred that managing risk tool becomes very important in Islamic banking as several products are depending on the PLS principle and so measuring and recognizing every kind of risk is critically essential in Islamic banks.

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