Journal of Engineering and Applied Sciences 13 (8): 2081-2085, 2018
ISSN: 1816-949X

Risks in Islamic Banks: Challenges and Management

Mohamad Yazis Ali Basah, Siti Nor Amira Mohamad, Muhammad Ridhwan Ab. Aziz,
Khairil Faizal Khairi, Nur Hidayah Laili, Hisham Sabri and Mazlynda Md Yusuf
Faculty of Economics and Muamalat,
Universiti Sains Islam Malaysia (USIM) Nilai Negeri Sembilan, Nilai, Malaysia

Abstract: Risks are significant and become more complicated in Islamic banks compared to conventional banks, since, the uniqueness of contractual features and general legal environment. The complexity of contracts could raise the risks of Islamic banks. Different types of risks in Islamic banks have attracted more attention from the regulators, practitioners and also academics over the last decade. This study will assess key challenges and management of risks in Malaysian Islamic banks. Analysis used in this study is regarding to previous studies as to deliberate the challenges of different types of risks in Islamic banks. The empirical studies in this study will fill the gap to the existing literature of risks in Islamic banks by showing the needs of specific adaption of risk measurement and risk management practices due to the nature of Islamic banks.

Key words: Risks, risk management, Islamic banks, Islamic financial contracts, Islamic finance, environment

INTRODUCTION

In general, risks are defined as unwanted event or cause or probability or statistical expectation value of event which may or may not occur (Hull, 2015). For banks especially, they have to accept or decline risks depends on the probability and consequence in their daily operation. Also, risks are more complicated to identify in Islamic banks, since, the complexity of contracts offered (Akkizidis and Khandelwal, 2008; Pritchard, 2014). One of the important aspects for Islamic banks in handling the complexity of contracts are identification, evaluation and understanding the risks as such Islamic banks may suffer consequences if risks are not appropriately managed (Wahyudi *et al*., 2015).

Hence, Islamic banks have to face key challenges in order to compete with conventional banks practices very well. These indicate that Islamic banks need to put up with the strategies and techniques in managing risks as well in terms of uncertain future events (Wahyudi *et al*., 2015). Failure of a borrower to repay a financing, fraud, incomplete security documentations, non-compliance with Shariah law and principles and other events that may result in a loss to the bank.

Thus, this study will access key challenges risks in Islamic banks by identifying the types of risks with complying the contracts. Then, this study also will address the management of risks for Islamic banks as well.

LITERATURE REVIEW ON RISKS IN ISLAMIC BANKS

The necessities of risk management aspect in Islamic banks have become one of the necessities in banking business activities. Its needs would enhance the value and performance of Islamic banks and make them resilient to crisis. Conversely, the nature of uniqueness of types of risks raises difficulties in effectiveness of contributions in terms of complexities of contracts in attaining comprehension of Islamic banks remains to be debatable now a days.

To date, review on literatures failed to convince that the fact that risks in Islamic banks which are approaching to ineffectiveness of daily operation of Islamic banks. This is because the nature of specific risks facing Islamic banks raises a host of issues in risk measurement, analysis and monitoring. Previous researches claimed that credit risk, market risk and operational risk are one of the major risk impacts towards Islamic banks. Lack of management practices in risk-hedging, underdeveloped money market and government securities, problems of transparency and hold large proportion of assets in reserve accounts in central banks or in correspondent accounts from Islamic banks are the reasons for slow growth of financial activities in Islamic banks and high risks occurs.

Furthermore, lack of knowledge in risk management among Islamic bank's staff influence the continuous

Corresponding Author: Mohamad Yazis Ali Basah, Faculty of Economics and Muamalat,
Universiti Sains Islam Malaysia (USIM) Nilai Negeri Sembilan, Nilai, Malaysia

relationship (Ukhwah) among Islamic banks and customers. One of the reasons given is that many risk management designed for process of risk management are limited to attracting customer's attention but not to active their minds to understanding the theory or concept.

Besides that, high credit, operational and market risk gives negative impact to financial conditions. Ahmed *et al*. (2011) and Mohamad *et al*. (2015a) advocate that a good asset management establishes a positive and significant relationship with those types of risks and inability of maintaining asset management will impact high risks as well. Buchory (2015) agreed with the previous study from Ahmed *et al*. (2011), however, the Shariah risk and Rate of Return (ROR) risk gives negatives impact to Risk Management Practices (RMPs) as well.

On top of that, high risks in financial activities has exposed to bankruptcy and inefficiency of Islamic banks. Capital adequacy, credit risk, size of bank and overheads of management are the contributing factors that have emotional impact the performance of financial activities in Islamic banks (Nodeh *et al*., 2016).

Additionally, the complexities of contracts have their own unique risk characteristics as it needs to be taken into account in curtailing moral hazard and adverse selection issues. The problem in moral hazard and adverse selection is resulted from the bad relationship among Islamic banks and customers as impact to the operational, credit and market performance in Islamic banks (Mohamad *et al*., 2015b). Thus, the complexities of contracts in Islamic banks are somewhat complicated as compared to conventional contracts as in the latter Islamic banks tend to have different natures of risks and exposures compared to conventional banks.

Moreover, level of transparency and public disclosure raised attention towards risk perception among Islamic banker's across nature of contracts. In relation to these matters, lack of transparency and public disclosure will results the inaccurate assessment of Islamic bank's financial conditions and performance in terms to business activities, risk profile and risk management (Mokni *et al*., 2014).

Even though there were researches examining factors that impact the risk management in complexity of contracts in Malaysia, the studies were not comprehensive. This study which is one part of a bigger research which corroborate with the previous study in area of interest attempts to identify the key challenges and management of risks in order to strengthen the performance of Islamic banking system.

For the past 15 years in Islamic banking industry, most research examine comparative analysis between conventional and Islamic banks in terms of risk management, particularly investigations on conceptual understanding and misconceptions held of risk management concepts. However, in more recent years, attention has been paid on the examining factors that impact the risk management in financial activities. So, this study further to fil the gap of the previous researches as contribution to the knowledge as to identify the key challenges of risks in Islamic banks and management of risks, emphasis on different types of contracts.

RISKS IN ISLAMIC FINANCIAL CONTRACTS

To enhance the efficiency of banks, risks need to be managed, since, it is crucial aspects in providing comprehensive earnings to the shareholders. The three major risks occurs in Islamic banks as appointed by Akkizidis and Khandelwal (2008) credit, market and operational risks which these occupy the maximum attention of the financial community in different types of contracts such as Musharakah, Mudharabah, Murabahah, Salam, Istisna and Ijarah.

Credit risks: The term of credit risk is defined as the probability of loss due to counterparty's failure to make payments in accordance with agreed terms (Akkizidis and Khandelwal, 2008; Joseph, 2013). The Basel Committee on Banking Supervision (BCBS) outlines credit risk as the potential that counterparty fails to meet its obligations regarding the terms agreed.

To extent this further, there are three characteristics that define credit risk (Witzany, 2017). First, exposure as well as to counterparties that has change possibly default in its ability to perform. Second, the possibility that counterparties will default on its obligations. Lastly, the recovery rate on how much can be recovered if a default takes place. It is noted that, the larger the first two elements, the greater the exposure and the higher the amount that can be recovered, the lower the risk will happen.

Furthermore, financing under Musharakah, Mudharabah and Murabahah are exposed to credit risk in Islamic banks, since, the have unique characteristics as it is more qualitative in nature (Akkizidis and Khandelwal, 2008; Amira *et al*., 2014). Hence, as a result of transactions of various varieties, credit risk its management are key issues for most Islamic banks.

Market risks: Market risk is simply defined as the possibility for an investor to experience losses due to factors that affect the overall performance of the financial markets in which he is involved (Alexander, 2009). It is also called systematic risk which cannot be eliminated through diversification, though it can be hedged against (Allen, 2012).

Furthermore, market risk is risk that is associated to the current and future unpredictability of market values from specific assets such as the commodity price under Salam and Istisna assets, market value of Ijarah agreements and Murabahah assets purchased to be delivered over a specific period and of foreign exchange rates (Akkizidis and Khandelwal, 2008).

Operational risks: The term of operational risk can be defined as risk that is remaining after determining financing and systematic risk and includes risks resulting from breakdowns in internal procedures, people and systems. Also, it is the risk of a change in value caused by the fact that actual losses, incurred for inadequate internal processes, people and systems or from external events (including legal risk), differ from the expected losses.

According to Pakhchanyan (2016), operational risk as one of the key risks that Islamic banks faced is reflected in the Basel II framework which expects banks to identify measure and manage this risk. Moreover, the Basel Committee requires banks to hold capital against operational risk as well.

IDENTIFICATION OF RISKS FACTORS

Ensuring that sufficient risks identification factors are implemented is the obligation of the Islamic banks as the owner is the first participant in the financial activities. The faster risks are identified, the earlier plans can be made to mitigate or manage those kinds of risks (Arora and Sharma, 2014). Hence, allocating the risk identification process is rarely successful and may be considered a way to achieve the appearance of risk identification without actually doing it.

Analytically, the counterparty of Islamic banks has interrelation with one or more contracts either wise it also linked with credit risk coverage. So, the problem of identify the risks are most complicated process.

Furthermore, there are four market risk factors which includes Rate of Return (ROR) risk, commodity price risk, FX rate and equity price risk (Akkizidis and Khandelwal, 2008; Allen, 2012). So, sensitivity is the vital part in market risk as it imitates the correlation between the sources from a financial risk factor. Its opposing impact is such for Islamic bank's earnings from the contracts. To extent this further, the sensitivity factor is depend on the degree of significant as it turn out to be higher when the features of the contracts involved in the quantification of market risk in non-linear condition (Chakroun *et al*., 2014).

For operational risk factors, the identification is includes of internal and external operational risks and must refer for the inadequate compliance with Shariah rules and principles (Akkizidis and Khandelwal, 2008). It is because the identification is needed for ensuing the development of practical operational risk control system.

MEASURING RISKS ASSESSMENT MODEL

Credit risk assessment has two different kinds of methods qualitative and quantitative (Akkizidis and Khandelwal, 2008). For qualitative assessment, Islamic banks will access the credibility of the customers that agrees on the contracts financing. As such they applied expert system (judgment of experts) in the timeline of credit approval. So, it is depend on the accuracy of subjective experience from them and this as how they called quality of empirical models of expert system (Kessey, 2015).

The other kind for credit risk assessment model is quantitative method. It is the method of assessment of credit risks that banks exposed to using quantitative statistical-based models. It includes of facts that bring up to the past and current behavior of the counterparty and losses of risks. As such, the assessment includes of identifying historical data, simulating data used for risk analysis, determining the model methodology, assessing the parameter and validating the qualitative and quantitative aspects.

Furthermore, market risk assessment also has two different types of methods static and dynamic (Akkizidis and Khandelwal, 2008). For static assessment, it has no change in positions related to financial contracts is taken into account, however, the only element that might vary is the market conditions.

For dynamic assessment, it is a forward-looking analysis based on defined market price situations and customer behaviors. Also, it is so called a strong tool for planning the future business in regards to what and how the banks should provide its contracts, so that, they can be profitable to the banks and beneficial to customers.

On top of that, for operational risk assessment there is one indicator called Key Risk Indicators (KRIs) as it to ensure the escalation of significant risk issues to appropriate management levels (Akkizidis and Khandelwal, 2008). The application of the indicator required being well-defined and their variations should be measure quantitatively. To assess the information used for KRIs, Islamic banks need consider three assessment which includes of on-gong process that need to be monitored in real-time or near-real-time or at least many times within a short period, periodic access as it should be

Table 1: Principles of credit risk management stated in IFSB

Numbers	Principles
2.1	It is good to have in place systems for financing, using various instruments within Shariah compliance whereby it identifies the potential credit exposures that may arise at different stages of the various financing agreements
2.2	IIFS shall convey out a due thoroughness review in respect of counterparties prior to determining on the choice of a suitable Islamic financing instrument
2.3	It is good to have in place suitable procedures for assessing and reporting the credit risk arising under each Islamic financing instrument
2.4	It is good to have in place Shariah compliant credit risk alleviating methods appropriate for each Islamic financing instrument

Islamic Financial Services Board

monitored on a periodical basis and lastly is access as on demand which risks must be tracked and recorded in terms of the time of appearance and its value.

RISK MANAGEMENT IN ISLAMIC BANKS

Islamic Banks faced unique kind of risks. If there was no risk management framework for Islamic banks, they will deal with the risks they faced in accordance with conventional practices. So, it is important that risk managers identified the risks faced by Islamic banks correctly, measured them accordingly, mitigated and controlled them in accordance with Shariah requirements and reported them accurately. The three major risk management areas were in place in Islamic banks to cover credit, market and operational risk management.

Credit risk management: In terms of the guiding principles of managing credit risk, the process of risk assessment and measurement shall be applicable to contracts. There are four principles stated as shown in Table 1.

Carrying out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument was part of the credit risk management process. Furthermore, appropriate methodologies for measuring and reporting the credit risk is important in managing credit risk. Also, Islamic banks should have in place Shariah compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.

Market risk management: In terms of the market risk management, it refer to the management of prospective impact of adverse price movements such as benchmark rates and equity and commodity prices on the economic value of an asset. Market risk exposures may occur at certain times or throughout the contracts. There is one principle stated as shown in Table 2.

Operational risk management: Converting these risks into quantifiable values enabled the risk management department of the bank to measure these operational risks.

Table 2: Principles of market risk management stated in IFSB

Number	Principle
4.1	It is good to have a suitable framework for management of market risk (as well as reporting)

Table 3: Principles of operational risk management stated in IFSB

Number	Principles
7.1	It is good to have in place comprehensive systems including Shariah board as to ensure the Shariah rules compliance and principles
7.2	It is good to have in place comprehensive instruments to maintain the interests of all fund providers. Where the IAH funds are commingled with the IIFS's own funds, the IIFS shall ensure that the bases for asset, revenue, expense and profit allocations are developed, applied and reported in a way of consistent with the IIFS's fiduciary responsibilities

Islamic Financial Services Board

An important tool was to create KRI's which most Islamic banks applied as it extensively to clearly identify and measure operational risks. Delay in offer and acceptance of the sale contracts to clients may have resulted in losses. Such requirements in KRIs are to ensure that no oversight happened on the part of employees.

Till then, IIFS are exposed to risks arising from disasters in their internal controls. The controls should provide reasonable assurance of the dependability of operations and consistency of reporting. There are 2 principles stated as shown in Table 3.

CONCLUSION

There are several limitations of this study that should be focus to work on in future studies. This study only uses empirical studies as a sample. For future study, collecting primary data will also add value to the study. Within a study of empirical studies in area of interests in this study, it is a good contribution to knowledge as well as this study further to fil the gap of the previous researches as to identify the key challenges of risks in Islamic banks and management of risks, emphasis on different types of contracts. Future study may include identifying the risk management model and practices as the strategies for risks in Islamic banks contracts.

By doing, so, it will cover the Shariah, operational and legal aspects in a way of managing risks in the Islamic financial contracts and the exploration on the possibility of the model development of risk management aspects are expected to give more insight on the risk management of Islamic banks.

ACKNOWLEDGEMENT

Financial support for this study was provided by a grant from the Ministry of Education Malaysia under the Grant No.: USIM/FRGS/FEM/32/52314.

REFERENCES

Ahmed, N., M.F. Akhtar and M. Usman, 2011. Risk management practices and Islamic banks: An empirical investigation from Pakistan. Interdiscip. J. Res. Bus., 1: 50-57.

Akkizidis, I. and S.K. Khandelwal, 2008. Financial Risk Management for Islamic Banking and Finance. Palgrave Macmillan, Basingstoke, England, UK.,.

Alexander, C., 2009. Market Risk Analysis: Value at Risk Models. Vol. 4, John Wiley and Sons, New York, USA.

Allen, S.L., 2012. Financial Risk Management: A Practitioner's Guide to Managing Market and Credit Risk. 2nd Edn., John Wiley & Sons, Hoboken, New Jersey, USA., ISBN:978-1-118-17545-3, Pages: 608.

Amira M.S.N., M.Y.A. Basah, M.R.A. Aziz, K.F. Khairi and M.M. Yusuf *et al*., 2014. Islamic credit risk management in murabahah financing-the study of Islamic banking in Malaysia. Aust. J. Basic Appl. Sci., 8: 318-323.

Arora, S. and R.K. Sharma, 2014. Risk identification system in Indian commercial banks: An empirical study. Intl. J. Econ. Manage., 8: 90-103.

Buchory, H.A., 2015. Banking intermediation, operational efficiency and credit risk in the banking profitability. Intl. J. Bus. Econ. Law, 7: 57-63.

Chakroun, M.A., S. Sebai and M.I. Gallali, 2014. Market risk in Islamic and conventional banks. Intl. J. Busi. Commerce, 5: 66-93.

Hull, J.C., 2015. Risk Management and Financial Institutions. 4th Edn., John Wiley and Sons, USA., ISBN:978-1-118-95595-6, Pages: 136.

Joseph, C., 2013. Advanced Credit Risk Analysis and Management. John Wiley and Sons, UK., Pages: 207.

Kessey, K.D., 2015. Assessing credit risk management practices in the banking industry of Ghana: Processes and challenges. Global J. Manage. Busi. Res., 15: 1-10.

Mohamad, M.T., M.H. Hasbulah and M.I. Razali, 2015a. Risk taking behavior and macroeconomic indicators of Islamic banks profitability in Malaysia. Intl. J. Res. GRANTHAALAYAH, 3: 1-12.

Mohamad, S.N.A., M.Y.A. Basah, M.R.A. Aziz, M.K.F. Khairi and M.M. Yusof *et al*., 2015b. Credit evaluation perspective of dual-banking and full-fledge of Islamic banking approach in Malaysia: Current practices and issues. Intl. J. Bus. Soc. Sci., 6: 169-185.

Mokni, R.B.S., A. Echchabi, D. Azouzi and H. Rachdi, 2014. Risk management tools practiced in Islamic banks: Evidence in MENA region. J. Islamic Account. Bus. Res., 5: 77-97.

Nodeh, F.M., M.A. Anuar, S. Ramakrishnan and A.A. Raftnia, 2016. The effect of board structure on banks financial performance by moderating firm size. Mediterr. J. Soc. Sci., 7: 258-263.

Pakhchanyan, S., 2016. Operational risk management in financial institutions: A literature review. Intl. J. Financial Stud., Vol. 4, 10.3390/ijfs4040020.

Pritchard, C.L., 2014. Risk Management: Concepts and Guidance. 5th Edn., CRC Press, London England, UK., Pages: 443.

Wahyudi, I., F. Rosmanita and M.B. Prasetyo, 2015. Risk Management for Islamic Banks: Recent Developments from Asia and the Middle East. Wiley, Singapore, ISBN:978-1-118-73442, Pages: 403.

Witzany, J., 2017. Credit Risk Management: Pricing, Measurement and Modeling. Springer, Berlin, Germany, ISBN:978-3-319-49800-3, Pages: 255.