Credit Risk Assessment and Management Practices in Islamic Banks of Pakistan: A Qualitative Approach

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Abstract
Purpose: The term "credit risk" has been widely explored individually, but the conceptual framework has not been formed up till now. The purpose of this conceptual paper is to find out the ways in which credit risk face by Islamic banks of Pakistan. Then to find out the ways through which Islamic banks of Pakistan can minimize the credit risk by using different approaches. This conceptual modal/paper can be useful to the managers of Islamic banks of Pakistan for the management of credit risk.Research Methodology: following research is of descriptive type and a conceptual framework has been developed to measure and manage the credit risk faced by Islamic banks on the basis of Crux of different studies conducted by researchers throughout the world.Findings: The conceptual framework is beneficial for the credit risk management in Islamic banks of Pakistan. Research found that Islamic banks in Pakistan facing different types of credit risk and suggestion are given that how can Islamic banks in Pakistan manage credit risk by using different approaches.Research Implications: The practical application of this research is to increase the credit risk management ability of the Islamic banks in Pakistan.
Keywords: Credit Risk,Credit risk Management Islamic Banks of Pakistan, issues in Islamic banks of Pakistan, ,loan loss Provision, portfolio mix.

1.INTRODUCTION

The first sketch of an Islamic banking system appeared in the early 1970s, Islamic banking develops broadly in Islamic countries such as Pakistan, Bangladesh, Iran and in Arab. In Saudi Arabia (Jeddah) with the development of the International Islamic Development Bank (IDB), the first Islamic bank came into being in the United Arab Emirates was the Dubai Islamic Bank (DIB). Then after 2005 numerous semi private and private commercial Islamic banks were formed in Bahrain, Kuwait, Sudan and Egypt (Iqbal and Molyneux, 2005). In 2005 numbers of Islamic banking have increased from 75 institutions to about 300 institutions and that Islamic banks were in constant growth stated by International Monetary Fund (2005). Islamic banking industry is growing faster than the traditional banking. The worth of Islamic banks assets were about US$882 billion and the assets of Islamic banks have increased by 29% Sharia Calling, (2009) during 2009. Roughly expected in 2015 that the assets in Islamic banks worldwide would be accomplishing $4 trillion (Said, 2013). According to the State Bank of Pakistan, total assets of Islamic banks reach to Rs, 424 billion at the opening of last quarter of 2010 while 31% yearly growth has been observed for Islamic banks of Pakistan (Ahmed, 2011).

There is no fixed rate of return in Islamic banking because Islamic banking is interest free banking. Islamic banking system is run according to the Shari a` board and Islamic laws that guides the institutions. These are Shari a` compliant or not this Shari a` board authorizes the products. Islamic banking is guided by Islamic economics and guided by is Islamic law (Shari a`) principles. In particular, Islamic law prohibits the collection and payment of interest, also commonly called Riba in Islamic conversation and usury". In Islamic banking all type of transactions are of risk sharing and interest free and also finds its roots in Islamic finance. The interest is prohibited from Quran and in Islamic customs of banking. In Quran, in Surah Al-Imran, Allah said that; "*O you who believe! Do not devour Riba multiplying it over and keep your duty to Allah that you may prosper*" (3:130) (Akram, Rafique, and Alam,2011).

First section discusses the history of Islamic banks. Second section discusses the risks and credit risk faced by the Islamic banks of Pakistan in different transactions. Third section describes the theoretical Modal for credit risk management.The Fourth section is the discussion and conclusion and fifth section gives the recommendation.

II. LITERATURE REVIEW

2.1 Islamic banking in Pakistan

The state bank of Pakistan plays a very important position in establishing the Islamic banking in accordance with the rules of Islamic laws. According to Ahmed et al., (2010) State Bank of Pakistan has framed rules regarding Islamic banking. For the proper functioning of Islamic banking in Pakistan the separate Islamic banking department has established by the state bank of Pakistan. For the proper establishment of Islamic banking while replacing the existing system 12 Islamic modes of financing introduced by SBP for the growth of Islamic banking. The SBP is dedicated to strengthening the Islamic banking in Pakistan. According to the SBP Report, (2002) the first full fledge Islamic bank established in Pakistan was the Meezan Bank Limited.SBP provides the reasonable opportunity to Islamic banking to develop along with the conventional banking. The total deposits of

Islamic banks increased to Rs. 245 billion and assets increased to Rs. 323 billion. Now in Pakistan in different cities there are 6 fully fledged banks and 12 conventional banks with 337 branches working (SBP annual reports, 2003-07).Islamic banks have to make investment decisions and take on different business transactions, which involve some degree of risk. Islamic banks face parallel risk to Western banks; however, there are variances within the level of the risks. Islamic banks are in front of a large number of risks such as market risk, interest rate risk, foreign-exchange risk, liquidity risk, and credit risk etc. (State Bank of Pakistan, 2007). As a result, risk factors and risk might threaten Islamic banking industry's survival and success.

2.2 What is risk?

If someone says that there is a risk in sure thing then it certainly means that conversation is on the situation where there is doubt about the desired results and the chance that the outcomes would be something that is not desirable. Moreover one writer says about risk that it's a situation that involves chance of variation from the trail that leads to the probable or usual result.

2.3 What is credit?

It is responsibility formed by banks for one who demands from it that he be permitted to use particular asset on account of the confidence reposed in him with respect to it.

2.4 What is credit risk?

Credit risk is explained as the possibility of opposite party which not succeed to meet its liability according to their contract. It can also be described as credit or opponent party risk is the probability that debtor of a financial tool, whether individual, an organization or a state will not pay back primary and other investment associated cash flows according to the particular provisions in a credit accord. Credit risk can be defined as the chances that a corresponding person of a contract will fail to fulfill its actions, either as a one-off or completely. Islamic banks face many risks, but the main one is credit risk. It is typically argued that Islamic banks have higher levels of credit risk than their counterparts in conventional finance, based on the fact that Islamic banks do not have the suitable risk management tools to manage the risk. A typical Islamic bank uses many tools in order to earn profits,. These tools can be divided into two groups: cost-plus tools (ijarah, murabahah, Salam, istisna', etc.) and investment tools (musharakah ,Mudarbah). Islamic banks take many risks but the major one is credit risks over the course of each contract underlying these tools, (in Mudarbah and musharakah this risk is called "capital impairment risk" (Islamic Financial Services Board, 2005a).

Mudarbah, Musharakah, Salam, istisna', murabahah and ijarah and are the main contracts used by Islamic banks to facilitate their customers. A second probable categorization for these contracts could be the difference between non-debt-creating Islamic modes of financing (Mudarbah and musharakah) and debt-creating modes (all others).A third probable categorization would be to distinguish original Islamic modes of Financing (Mudarbah, musharakah, Salam, istina') and from "reshaped" modes of financing (murabahah and ijarah).Banks made partnership agreement with one or more partners.Musharakah is resulting from a commercial relation in Fiqh called shirkat-ul- amwal.This agreement constitutes a part of a more general idea mostly known in Fiqh: that of shirkah.

Before commencing business a profit-sharing ratio must be defined. For each partner, profit is a portion of the real profit of the project. In case of failure bank can lose its capital that it provided the credit risk is called "capital impairment risk" Islamic banks merge their own capital with the amount of investment accounts and management is done by following PLS rule. Both parties know that they can lose the amount invested at any moment (Boumediene, 2011).In Murabaha contract the credit risk is that banks give assets to the customers and customers do not make payments in time. In Non-binding Murabaha dealings customers may turn down the delivery of the product purchase according to his right on the accord (Boumediene, 2011).

In case of Mudarbah investments there are two parties' banks as Rab-al mal (principle) and outsider party as Mudarib. Banks give an option to the Mudarib to utilize the capital for business purpose. If the Mudarib is convicted for carelessness or misbehavior, he is responsible to rabb-ul-mal for the loss caused by his actions. The risk is particularly in the markets where the transparency of Mudarib is low (Boumediene, 2011).

A Salam is a contract between two parties. One party agrees to make available specific goods at a future date while the other party agrees to pay its price in full at the end of the contract. Credit risk is present when there is avoidance on delivery of the commodity. The bank can wait until the commodity is available or break off the contract when there is any default (Boumediene, 2011).

In Istisnah agreement banks have risk of breakdown of supply on time or no supply at all. Such kinds of risks are because of failure to make payments and banks goes into loses. Istisna means "order to manufacture". A party orders another party to make a product that is not available in the market. The price of istisna' can be paid in advance. Credit risk in istisna' can be one of two kinds. It can be a failure to deliver, in which case the contract of istisna 'can contains a penalty to overcome counterparty risks. A second difficulty can arise if the purchaser in a parallel istisna defaults on paying the due installment or the price in full. In such a situation, the bank has the right to retain the title of the manufactured object (Boumediene,2011).

Ijarah is considered for sale of vehicles, equipment or property. Distinct from conventional banking anywhere the bank permit the client (purchaser) to rent commodities at predefined interest charges, the Islamic leasing has two sub agreements. Firstly, the bank signs a purchase agreement with the vendor for the product or service which the purchaser desires to lease. The bank makes the payment to vendor and then delivers the product or service to the purchaser from the vendor. Secondly, the bank signs a rental agreement with the purchaser in which product or service is lease to the client allow him the possession of the asset after making the payment of rent installment and remaining charges. The lease alternative is usually used for dealings in cars, real estate, computers, equipment and machinery (Siddiqui, 2008). Credit risk in ijarah occurs when defaults on payment of rent occur, either at individual times, or completely (Boumediene, 2011).

Islamic banks offer such a competency on a restricted degree to poorer sections of the general public such as needy student or small rural farmers. Such loan would have downbeat NPVs for the banks. Conventional banks do not have any such kind of loan structure. Any compassion is only manifesting through charity and grant or scholarship, but not through non-returnable zero interest loans (Siddiqui, 2008).

3. CONCEPTUAL FRAMEWORK

Following research is of descriptive type and a conceptual framework has been developed to measure and manage the credit risk faced by Islamic banks on the basis of Crux of different studies conducted by researchers throughout the world.

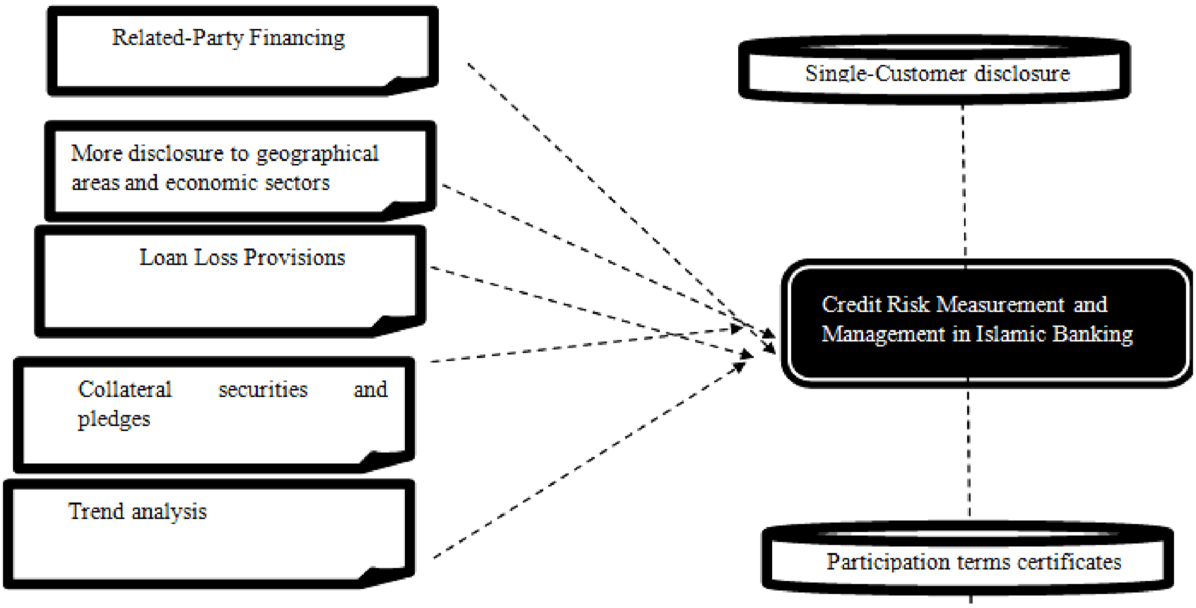

Fig: 3.1: Conceptual framework to measure and manage credit risk faced by Islamic banks

It is clear that credit risk is present in different transactions of Islamic banks. The above figure describes the various ways through which Islamic banks of Pakistan can minimize/eliminate the credit risk.

4. DISCUSSION AND CONCLUSION

Credit risk managing in Islamic banking is extremely hard as the banks are forbidden to charge interest and penalty. Customers' holds up the payments as they recognize that banks will not accuse any fine for that. Due to these delay banks' finances are stocked and banks don't make return or any profits. Difficulty can be abridged by some ways similar to look into Banks policy which previously exist and its methodologies of moving out policy of credit risk with an outline of the categorization of the assets of the bank.

4.1 Single-Customer disclosure

A Modern prudential set of laws generally demands that a bank avoid from invest in or extend credit to any individual body or associated group of entity in surplus of an amount representing a agreed proportion of the bank's capital and reserves. Most countries enforces a single-customer exposure limit of between 10 and 25 percent of capital. The upper limit at which reporting to supervisory authorities becomes necessary should normally be set somewhere below the maximum limit. Supervisors can then give particular consideration to exposure above the limit and need banks to take protective measures earlier than attention become very chancy (Iqbal, 2008)

4.2 Related-Party Financing

Dealing with connected parties is a particularly dangerous form of credit risk exposure. Related parties typically include a bank's parent, major shareholders, subsidiaries, affiliate companies, directors, and executive officers. Such parties are in a position to exert control over or influence a bank's policy and decision making, especially relating to credit decisions. A bank's aptitude to recognize and follow the extension of credit to insiders is important. The question is either credit decisions are made on a balanced basis and according to the bank's policies and procedures. An additional concern is whether credit is based on market terms or on terms that are more positive with regard to amount, adulthood, rate, and security than those provide to the general public. Most regulators set up limit for associated parties, typically stipulating that whole credit to associated parties cannot beat a certain profit of Tier 1 or total qualifying capital. If prudential regulations have not recognized such a limit, the bank should uphold one as a substance of board policy. Careful banking practices would need board authorization of all facilities extended to related parties. (Iqbal, 2008)

4.3 more disclosure to Geographic Areas or Economic Sectors

Another aspect of risk focus is the disclosure of a bank to a particular sector of the economy or a narrow geographic area. This makes a bank exposed to weakness in a particular industry or area and pose a risk that it will experience from immediate failure between several clients for related reasons. This distress is mostly related to regional and specialized banks or banks in small countries with weak economic profile such as those with mainly agricultural economies or exporters of a single commodity. It is hard to evaluate the exposure of a bank to various sectors of the economy, as most bank reporting systems do not generate such information. For example, a holding company of a big diversified group could be used to finance projects in different industries in which the companies operate. In any case, banks should have well-developed procedures to observe sector risks, evaluate the impact of unfavorable trend on the quality of their portfolio and income statements, and deal with increased risk. Banks engage in international lending face additional risks, the most important of which are country (or sovereign) and transfer risks. The country risks include the whole range of risks pose by the macroeconomic, political, and social environment of a country that may influence the performance of clients. Transfer risk may have the difficulty that a client may have in obtaining the foreign exchange required to service a bank's obligations. The categorization of global loans should usually include both country and transfer risks. A bank might be asked for provision for global loans on a loan-by-loan basis, whereby the level of required provisions is raised to accommodate added risk. Otherwise, a bank may decide collective exposure to country and move risks on a country-by-country basis and grant special reserves to accommodate risk exposure. (Iqbal ,2008)

4.4. LLP (loan loss provision)

LLP (loan loss provision) has been recognized in place of credit risk that it must have a optimistic and important association with NPL (non performing loan) high the LLP means boost in risk and decrease in loan worth. Contractually Islamic bank depositors agreed to losses or lower fee of interest when assets are under performing through which the bank deals with the risk. In mudharaba agreement clearness is provide on investment and motivate to them to agree to the connected risk(Ahmed, 2011).

4.5. Collateral securities and pledges

Now banks use collateral securities and pledge beside the credit risks. Banks can require added pledges or securities before the Mudarbah agreement due to weak lawful regulations. (Ahmed, 2011)

4.6Trend analysis

Consequentially any current problem which can have an effect on credit risk and cause of lose to the bank, tendency study is also in use from the past data to get result about loses. Current policy is reviewed and betterments are recommended for them (Ahmed, 2011).

4.7. Participation terms certificates

Lease financing tool direct to the risk division financing used by CII. Lease financing is a mixture among debt and equity if profit loss sharing is not appropriately hold to lying interest free economy then lease financing tool mainly used in general financing operations (council of Islamic ideology (CII, p. 13). The CII projected the participation terms certificates in its place of debenture (council of Islamic ideology (CII, 1980, p.36) as it has risk division features and offer lack of answer of problems for interest reluctant nature borrowers and organizations, low broad variety of risk distribution and secondary markets. There are also strategies to supervise the credit risk in Islamic banking. Similarly to administer the risk the credit exposures to individuals are decreased. Working with clients knowing their troubles of credit and finding answer to these problems. In case of failure to pay moving out legal procedures and calling on the guaranties and liquidating guarantee securities (Boumediene, 2011).

5. SUGGESTIONS AND RECOMMENDATIONS

5.1 Receivable efforts strength

The Credit recovery department should analysis the risk and work with clients in order to know the problem they are facing in the payment of the credit. In case of failure to make the payment of credit by client banks should take legal actions and sell out the collateral securities for the recovery of the credit.

5.2 Credit policies strict

Banks should make strict policy for the assessment of the clients and demand additional collateral securities in case risk is high are the transaction. The banks should try to quantify the risk that is involved in the transaction.

5.3 Financing portfolio mix changed

Islamic banks should change their portfolio and invest in those projects where the chances of loss are low.

5.4 Training forum For Credit Risk management Staff

Islamic banks should train their risk management staff so that they have complete knowledge about the Islamic mode of financing. So that they complete understanding about the Islamic mode of financing.

5.5. Courses for credit risk management

HEC should take steps to introduce the courses in higher educational institutes for credit risk management in Islamic banks. So that the business graduate knows that how to manage credit risk in Islamic banks.

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