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Risk Management in Islamic Banks

Dr. Ismail Younes Yamin
Finance Associate Professor
Department of Banking and Financial Sciences, Faculty of Economics and Administrative Sciences

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Abstract
In the last few years, several significant developments have been witnessed in the banking and financial processes. In the meantime, both the risk and competition faced by banks in stock markets have risen. As a result, the investment mechanisms and approaches of Islamic banks need to be found, bearing in mind that these banks encounter relatively higher risk that traditional institutions. Due to their commitment to the Shari'a rules of financial transactions, they have limited choice about risk and, thus, it becomes necessary to analyze, manage and control risk.To reduce and resist current and future risk, Islamic banks, in particular, should investigate its types and how to manage them. Upon the great success of such institutions in the banking and financial milieus throughout the world, they are urged to develop their risk management methods. The present study analyzes the risk facing all banks, especially those facing Islamic Banks, and the means to manage and control such risk.
Keywords: Islamic Banking Risk, Risk Management, Financial Risk

Significance of the Study

The present study explores the types of risk facing banks, in general, and Islamic banks, in particular. Special attention is drawn to those causing the loss of confidence in Islamic banking and finance forms, so that effective means can be identified to counter risk and better procedures can be taken to improve performance.

Objective of the Study

The present study sheds light on the definition and types of risk facing Islamic banks due to their considerable progress. The management of the specific types encountering all Islamic finance forms is addressed by making suggestions with regard to risk prevention and solution.

Methodology of the Study

To come up with a good conclusion, the descriptive-analytical and inductive methods are adopted. Facts and data on the risk phenomenon and management in Islamic banks are gathered from relevant previous references and papers. Risk is defined and classified in Islamic and other banks, in order to know how to manage it.

Introduction

Banking is one of the industries highly exposed to risk. In the last few decades, significant developments related to liberation policies, in particular, have constituted a major reason for financial and banking crises. Further risk has also been seen with the many rapid banking advancements as well as the competition between financial institutions in stock markets. Thus, it is important to develop the risk management techniques in different organizations.

In addition, clients and companies tend to depend on banks and similar institutions as a source of finance. On the other hand, banks themselves establish asset structures which would open more markets and produce more profit.

All these new investment mechanisms and approaches require better risk analysis and management.

In the last few years, Islamic banks has made great achievements and distinguished growth in the banking and financial sectors, extending to 500 institutions around the globe and making over a trillion US dollars.

However, such institutions have not been away from risk associated with the Islamic and other transactions. They have some challenges of dealing with risk, mainly with reference to investment and the implementation of the global Basel Committee. Therefore, Islamic banks need to carefully consider and develop a risk management system.

Risk Definition, Types and Management

Risk is defined as a future possibility which would subject the bank to unplanned losses which affect the achievement of the institution's targets, and if it is not controlled, it could lead to the bankruptcy of the bank (Sa'id: 2015).

Risk management is defined as a system which creates a suitable efficient atmosphere to set an efficient risk measurement, control processes and provide appropriate internal audit (Nurhafiza: 2015).

The elements of risk management are believed to be the definition, identity, determination and different forms of control, including banking and financial risk so that the aim is the risk supervision and control (Greuning & lqbod, 2008).

Risk is also defined as a probability of loss which is direct in the outcomes of business or in capital, or indirect through constrictions to the bank's ability to achieve its targets. Such constrictions weaken the institution in providing services and practicing activities, on the one hand, and seizing available chances in the banking context, on the other (Banking Regulation Committee, US Banks Sector Commission).

It is also defined as phenomena and events threatening the accomplishment of targets and negatively affecting the continuity of an organization in attempting to carry out its mission (Wahba: 2010).

For others (Leqleiti and Gharbi: 2015), it is believed to be the avoidance of what is expected, by uncertainty of occurrence, while risk management is the determination, analysis and control of the risk which threatens the organization's assets or revenue-making capability.

Risk management refers to procedures and policies adopted by the banking administration to protect the bank from the various surrounding forms of risk, by means of assigning the risk spots, measurements and management in order to avoid it, control it or convert it within an inclusive system (Saleh: 2009).

Further interest in Islamic Banking risk is attributed to the following factors:

- Accelerated growth of Islamic financial products
- Advancement of the global infrastructure of Islamic financial institutions
- Economic shifts seen in the banking market competition and new financial tools congruent with the Islamic Shari'a
- Considerable success of Islamic financial transactions during the global crisis (Abdul-Hadi: 2015).

Risk Types in Banking Institutions

There are various taxonomies for the risk faced by banking institutions, among which is that of Gleason (2000):

1. Financial risk: divided into sub-types:

a. Credit Risk: the probability of the failure of the clients to fulfill their commitments to the bank when or after they are due or by not paying off according to the agreed upon conditions (Hussein: 2015).
Another definition is about not paying off fully at the specified time, causing financial loss (Al-Zubeidi: 2000).
As a result, the risk is a possible loss due to the debtor's inability to pay off the debt and the interest on the date of liability. Risk also includes items in the budget such as debts and bonds, as well as beyond the budget such as security letters and document accreditations (Saleh: 2009).

b. Liquidity Risk: the type based on the bank's inability to fulfill its commitments when they are due by providing the money necessary without bearing unacceptable loss (Al-Duroobi: 2007). This type emerges when the liquidity available is not sufficient for the regular operation requirements, weakening the bank's capability to pay off its short-term commitments when they are due (Sophie Brana: 2003). As they never borrow from the central or other banks with interest, Islamic banks are likely to suffer much more from this type (Saleh: 2004).

c. Market Risk: the exposure to loss because of changes in the market conditions (Sa'id: 2015), whether they are economic, political, social or about security. This type was witnessed in Egypt in the 1960's and 1970's as well as in the US, in particular, and the entire world, in general, in the wake of the 2001 September 11th attacks (Hindi: 2004). Sub-types here could be as follows:
   - Risk of interest rates in traditional banks and profit margin in Islamic banks
   - Risk of stock prices
   - Risk of exchange rates, which are high for Islamic banks for they cannot deal with derivatives to cover risk
   - Risk of product prices

2. Non-financial risk, divided into different sub-types:

a. Operational risk: defined by the Basel Committee as "the risk of a change in value caused by the fact that actual losses, incurred for inadequate or failed internal processes, people and systems, or from external events" (Al-Manna'i: 2004). Interest in this type has risen due to the considerable dependence on technology, globalization and competition between banks (Nurhafiza: 2015).
It is also defined as the risk caused by human, professional or technical mistakes, whether intentional or unintentional. Due to the standards of the Shari'a, it could be higher in Islamic banks, comprising legal risk (Thorsten: 2010). Among the forms of operational risk are the following: (Basel 11 Encyclopaedia: 2005).
   - Fraud, embezzlement and other crimes caused by the employees' corrupt conscience
   - Unintentional human mistakes due to negligence and lack of experience

- Risk of forgery and counterfeiting of money
- Theft and robbery
- Risk based on using cash machines
- Insufficient devices and technical software used in banks
- Online crimes: internet, mobile phones and credit cards.

b. Political risk: caused by political events, such as globalization, boycott, public turmoil and nationalization, leading to the freeze or confiscation of the money of the bank (Saleh: 2009)

c. Legal risk: caused by mistakes in the phrasing of the contract, delay in the implementation of legal procedures or breach of some international laws (Saleh: 2009). It is sometimes attributed to incongruity between the laws issued by the monetary authorities or when contracts do not explicitly state rights and obligations (Sa'id: 2015).

d. Reputation risk: caused by a negative impression about the bank, leading to losses in the finance sources or shift of clients to rival institutions. It could also be based on some employees' or officials' behaviours or the bank's weak secrecy systems (Sa'id: 2015)

The above addresses risk to all banks, but there are types only threatening Islamic banks as follows (Mohammad: 2008):

Risk only associated with Islamic banks:

1- Risk of missing confidence in Islamic Banking: caused by the misunderstanding of the Islamic banking message and basics such as 'benefit for damage' and 'duty by guarantee'. Consequently, some people would not deal with these institutions as confidence is lacking in their significance and role.

2- Risk related to Islamic finance forms: a future possibility to subject the bank to unplanned losses affect the efficient achievement of the institution's targets, and if it is not controlled, it could lead to the bankruptcy of the bank (Abdul-Salam: 2012) such as:

i. Risk related to Al-Murabaha finance:

This is the main investment activity in Islamic banking, including loans and debts (Nurhafiza: 2015). Al-Murabaha finance could lead to the following (Al-Rifa'i: 2007):

- The bank's money is threatened if the client cannot pay if there are no sufficient guarantees even when a case is filed and a mortgage loan provided. The bank would lose some return over the legal process until the amount is paid off.
- The bank profits are the same throughout Al-Murabaha period.
- The bank bears responsibility for the commodity by owning it before selling it to the client. Therefore, any problem before completion of the sale process would affect the bank.

ii. Risk related to speculation:

Speculation finance is far away from the suspicion of usury, leading to great expectations. Such a process provides both parties with much profit and helps the bank to develop the community by means of building small- and medium-sized organizations. However, as it entails a great deal of risk, mainly that of liquidity deficiency and activity depression, it is not a common choice for Islamic banks. On the other hand, among the advantages of speculation are the following:

- Integration between production elements
- Efficiency of allocating economic resources
- Fairness of revenue distribution and higher number of owners
- Greater investment and employment opportunities (Iftikhar et al: 2012).

iii. Risk related to partnership finance (Abdul-Hamid: 2005)

Partnership finance is accompanied by a number of risk types:

- The capital itself may be lost, for an Islamic bank which finances a project is considered a partner in the capital. As it is subject to profit and loss, the finance amount is called the risk capital. Thus, the institution should guarantee that the business would achieve a good return. Such a long experience and high cost needed does not encourage this kind of involvement.
- Partnership investment is a sort of permanent investment, which may be converted to liquidity only by selling shares. As a result, Islamic banks do not prefer to take a risk in long-term investments, bearing in mind the permanent possibility that an emergency could make depositors withdraw their deposits.
- The law in many countries requires the organizations' capitals on their soil to use their national currencies. That makes the Islamic banks involved in that finance subject to the exchange rate fluctuations and difficulty of transferring their investment abroad. Thus, the invested amount and its returns are threatened, along with the permanent probability of government legislative changes

which would turn a likely profit to a certain loss.

vi. Risk related to tooling finance:

An Islamic bank employing this kind of finance is subject to several types of risk, such as the other party's failure to deliver the sold commodity in time or when it is bad.

Another risk is the buyer's inability to pay off the entire amount on the date of liability. A third has to do with some Fiqh opinions which consider it a permissible, rather than binding, contract. Here, the other party may quit the deal whenever they wish (Tarequllah: 2003).

V. Risk related to tenancy (Al-Rifa'i: 2007):

One type here is about marketing. When the bank intends to sell certain devices, it should hold a marketing campaign to draw the clients' attention, taking into consideration the market needs and demand for these commodities. Otherwise, the capital will be frozen. A second one is the failure to pay the rent regularly, halting the bank's working capital. A third is the rapid technological development, which requires the careful choice of the rented materials so that no losses would be borne by the bank.

Risk Management Tasks in Islamic Banks (Laqleeti: 2015)

1- Setting standards and limitations to control all the activities
2- Setting financial indicators and analyses to assess the validity of the adopted policy and its ability to achieve the targets of the bank, in addition to measuring the general performance
3- Conducting the technical studies related to the policies set by the top administration
4- Preparing the data required by the committee of assets and rivals management
5- Gathering and analyzing data about risk
6- Providing the top administration with regular reports on the risk – among other issues – which could face the institution
7- Follow-up on the actual applications of the Basel 11 requirements. This agreement is specialized in the new capital, aimed at maintaining a good level of capitalization, spreading security to the entire organization and developing the banking control activities so they would adopt risk assessment and ways to cover it. The above committee proposed a new criterion for the capital sufficiency in order to:

- Enhance the validity and durability of the financial and banking system
- Promoting competition between the departments of the institution
- Covering more of the faced risk
- Developing methods to measure risk types which are highly sensitive.

To apply the Basel 11 agreement is a great challenge to Islamic banks, as it necessitates a minimum average of the capital sufficiency, policies to manage banking risk and a strategy to make the assigned capital consistent with the actual risk faced by the institution (Nabeel: 2006). Moreover, the accord includes a new way to calculate the capital sufficiency as well as guarantee an efficient method for review and control and financial transparency for banks and market system (Tarequllah: 2003).

In addition, the Islamic Financial Services Board set special criteria and regulations for risk management, such as those related to the capital sufficiency in Islamic banks and its guidelines (2008), disclosures on enhancing transparency and market discipline (2007), guidelines on the basics of supervisory control procedures (2007) and major guidelines for risk management (2005) (Abdul-Hayy: 2010). The IFSB set such global standards in cooperation with the Basel Committee to stress the durability and stability of Islamic financial services, including banks, capital tools and insurance. It acts as a regulatory body responsible for international accounting standards in a way that goes in line with the rules of the Shari'a.

To guarantee good risk management in Islamic banks, four major stages need to be passed (Wahba: 2010):

1. identification of the risk faced by Islamic banking
3. Ability to continuously measure the risk through an appropriate information system
4. Choice of the risk which the bank wishes to go through and can be borne by the capital
5. The administration's control and measurement of such risk according to appropriate criteria, as well as right decisions in the right time to maximize returns while reducing the risk impacts.

Managing the Risk Faced by Islamic Banks:

Among the main and efficient methods of risk management faced by Islamic banks are the following (Al-Ajlooni: 2008):

1- Keeping promises: as mainstream high scholars argue that it is obligatory to keep a promise. It encompasses an benefit and, thus, relieves the parties of the process of loss and causing loss to others and consolidates confidence in transactions. This point may be applied in all types of contracts.
2- Issuing Sukuk and founding investment funds, mainly achieving the following:

- Reducing investment risk and distributing it through various channels
- Reducing the great attention to short-term finance, which controls the Islamic banking activities

3- Diversifying and distributing investment: in order to alleviate the harshness of risk in Islamic banks by means of diversifying the portfolio and distributing investments to different sectors and clients
4- Imposing delay fines: fining the debtor who procrastinates paying as much time as they delay – which constitutes a good means of deterrence
5- Developing and passing the methods of managing mistakes: such as solidarity insurance, securitization of stock property rights and the Assalam and tooling contracts
6- Taking real guarantees: in order to counter special cases while observing the Shari'a rules in this context
7- Providing an efficient system for information, assessment, balance and risk measurement (Hussein: 2015): whereby offering data about clients not only for assessment prior to granting facilitations, but also permanently updating them throughout the use of the finance period
8- Applying governance: which emerged upon the major collapses of global banks, cases of cheating and abuse, and its role in reducing systematic bank risk. Governance, which is common in Islamic banks, is aimed at encouraging them to exploit their resources in an efficient manner that complies with the Shari'a (Al-Tayyib: 2013).
9- Founding satellite companies: whereby banks establish corporations to carry out projects of production, distribution, letting or supply, which would reduce risk through various means, including:
   - The companies' possession of expertise and competence for the management and follow-up in a way better than the bank would do
   - Further control efficiency
   - The bank's treatment of such bodies as independent units from its activities, while they do not have credit priority
   - The bank's diversification and leverage, which would solve the problem of deposit guarantee (Saleh: 2009).

Among the procedures required to face risk and improve the performance of Islamic banks are the following (Abdul-Salam: 2012):

1- Developing a financial system which combines expertise, flexibility and competitive capability
2- Improving performance by employing ideas, technology and expertise
3- Using telecommunication technology and the internet to share the thoughts, studies and Shari'a rulings associated with Islamic banking
4- Further cooperation between the monetary authorities, controlling bodies and financial institutions in the market
5- Developing financial products which are acceptable by the Shari'a to compete with traditional products
6- The Islamic financial institutions' issuing of all the required financial reports to achieve transparency
7- Completely heading to integration between Islamic institutions in order to create a wider banking ground at the national and global levels.

Moreover, good risk management by banks necessitates commitment to the following fundamentals (Bal'jooz: 2005):

- The bank should have an independent Risk Management Committee concerned with setting the general policy. On the other hand, a specialized administration to manage risk would assume implementing these policies as well as regularly control and measure risk.
- The bank should assign an officer for each major risk type
- Each bank should set a specific system to measure and control risk.
- Each bank should evaluate its assets as a basis for measuring risk and profit.
- The bank should use up-to-date information systems for risk management and set appropriate standards to reduce it.

Conclusion

The significant advancement in the size of Islamic banks requires their safety and durability in order to maintain their financial stability. One of the forms of interest in Islamic banks is the presence of relevant global bodies. For instance, the IFSB set international accounting criteria which go in line with the Shari'a. It is noteworthy that Islamic banks are subject to further risk than traditional banks such as in the different forms of Islamic finance.

Islamic banks have proven capable to resist crises for they depend on assets and real sector finance. However, they could go through dilemmas and, thus, need to care for managing the types of risk shared by traditional institutions as well as exclusive ones, especially those related to Islamic finance. Therefore, a great deal of effort should be exerted and challenges faced to develop action systems, employ modern technological methods, devise national and international financial tools to meet the clients' increasing requirements and compete in the national and international banking markets. Among these requirements are:

- Employing qualified, competent individuals to carry out the Islamic banking message
- Providing an efficient system for information, assessment and risk measurement
- Developing and passing means of managing risk
- Founding an independent entity in each bank called Risk Management Committee.

Among the suggestions made to counter the risk before Islamic banks are the following:

- Setting sound, straightforward basics to separate between sources of the various Islamic finance forms in Islamic banks
- Attempting to found independent risk management departments to comprehend, determine, measure and treat different risk types
- Distributing credit and diversifying portfolios
- Setting sound criteria to grant and approve credit
- Carefully choosing partners, follow-up and supervision
- Checking the soundness of the received guarantees and their acceptability by the Shari'a
- Maintaining an appropriate, balanced level of liquidity
- Diversifying the sources and employment of money
- Clearly separating responsibilities and setting emergency plans.

It can be safely said that the Islamic banks in all countries need to agree and strive to establish economic criteria which counter any possible challenges as well as integrate with each other to create a broad banking base at the national and international levels.

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