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RISK ASSOCIATED WITH ISLAMIC BANKING

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ABSTRACT

Islamic finance is one of the most rapidly growing segments of the global financial system. The emergence of Islamic finance can be traced back to 1963 in Egypt, while its importance comes to the global financial system only after the global financial crisis occurred in 2008. The use of financial services and products that comply with the Sharia principles cause special issues for supervision and risk management. Efficient risk management in Islamic banking has assumed particular importance as they try to cope with the challenges of globalization. This paper highlights the special and general risks surrounding Islamic banking. As the developing of managing risks tool becomes very essential especially in Islamic banking as most of the products is depending on PLS principle, so identifying and measuring each type of risk is highly important and critical in any Islamic financial based system.

Keywords: Islamic banking, Modes of Islamic, Risk in Islamic banking.

INTRODUCTION

Islamic banking is a finance management system that is based on the Islamic rules of Sharia. The main concept of the Islamic banking is the prohibition on collection of interest and its utilization for the business purposes. Banking in Islam is a saving money framework that depends on the standards of Islamic law, additionally known as Sharia law, and guided by Islamic financial matters. Two fundamental standards behind Islamic banking concepts are the sharing of benefit and misfortune. Gathering interest or Riga isn't allowed under Islamic law.

Islamic banking concepts have an indistinguishable reason from traditional managing an account aside from that it works as per the guidelines of Sharia, known as Fiqh al-Muamalat. Banking in Islam as an account exercises must be polished reliable with the Sharia

and its pragmatic application through the improvement of Islamic financial aspects. A significant number of these standards whereupon banking in Islam is based are regularly acknowledged everywhere throughout the world, for quite a long time as opposed to decades. These standards are not new but rather their unique state has been changed throughout the hundreds of years.

DEFINITION

Islamic banking refers to a system of banking or banking activity that is consistent with the principles of Islamic law (Sharia) and its practical application through the development of Islamic economics. Sharia prohibits the payment of fees for the renting of money (Riba, usury) for specific terms, as well as investing in businesses that provide goods or services considered contrary to its principles (Haram, forbidden). While these principles were used as the basis for a flourishing economy in earlier times, it is only in the late 20th century that a number of Islamic banks were formed to apply these principles to private or semi-private commercial institutions within the Muslim community.

According to Islamic Banking Act of Malaysia, an Islamic bank is a "company, which carries on Islamic banking business, Islamic banking business means banking business whose aims and operations don't involve any element which is not approved by the religion Islam."

It appears from the above definition that Islamic banking is systems of financial intermediation that avoids receipts and payments of interest in its transactions and conduct its operations in a way that it helps achieve the objectives of an Islamic economy. Alternatively, this is a banking system whose operation is based on Islamic principles of transactions of which profit and loss sharing is major feature, ensuring justice and equity in the economy. That is why Islamic banks are often known as profit and loss sharing banks.

MODES OF ISLAMIC FINANCE

Murabaha

It means a sale on mutually agreed profit. It is a contract of sale in which the seller declares his cost and profit. Islamic banks have adopted this as a mode of financing. As a financing technique, it involves a request by the client to the bank to purchase certain goods for him.

Ijara

Ijara is a contract of a known and proposed usufruct against a specified and lawful return or consideration for the service or return for the benefit proposed to be taken, or for the

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effort or work proposed to be expended. In other words, Ijara or leasing is the transfer of usufruct for a consideration which is rent in case of hiring of assets or things and wage in case of hiring of persons.

Istisna'a

It is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or a future payment and future delivery. A manufacturer or builder aggresses to produce.

Mudarabah

It is a type of partnership where one party has the right to invest in the business and the other has the right to manage it. Any profits earned are shared between the two parties as per the profit ratio agreed during the agreement, while the financial loss is only suffered by the investor.

Musharakah

Musharakah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. It is an agreement under which the Islamic bank provides funds, which are mixed with the funds of the business enterprise and others.

Bai al-Salam

This term refers to advance payment for goods which are to be delivered later. Normally, no sale can be affected unless the goods are in existence at the time of the bargain. But this type of sale forms an exception to the general rule provided the goods are defined and the date of delivery are fixed.

RISKS IN ISLAMIC BANKING

Islamic banks carry different types of risks, some of them exists only on any Islamic banking. And others are common between both Islamic and conventional banks.

Credit Risk

Credit risk is the loss of income arising as a result of the counterparty's delay in payment on time or in full as contractually agreed. Such an eventuality can underlie all Islamic modes of finance. For example, credit risk in murabaha contracts arises in the form of the counterparty defaulting in paying the debts in full and in time. The non-performance can be due to external systematic sources or to internal financial causes, or be a result of moral hazard (wilful default). Wilful default needs to be identified clearly as Islam does not allow debt restructuring based on compensations except in the case of wilful default. In the case of profit-sharing modes of financing (like mudaraba and musharaka) the credit risk will be non-

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payment of the share of the bank by the entrepreneur when it is due. This problem may arise for banks in these cases because of the asymmetric information problem where they do not have sufficient information on the actual profit of the firm.

Market Risk

Market risks can be systematic, arising from macro sources, or unsystematic, being assertor instrument-specific. For example, currency and equity price risks would fall under the systematic category and movement in prices of commodity or asset the bank is dealing with will fall under specific market risk.

Mark-up Risk

Islamic financial institutions use a benchmark rate to price different financial instruments. For example, in a murabaha contract the mark-up is determined by adding the risk premium to the benchmark rate (usually the LIBOR). The nature of a murabaha is such that the mark-up is fixed for the duration of the contract. Consequently, if the benchmark rate changes, the mark-up rates on these fixed income contracts cannot be adjusted. As a result Islamic banks face risks arising from movements in market interest rate. Markup risk can also appear in profit-sharing modes of financing like mudaraba and musharaka as the profit-sharing ratio depends on, among other things, a benchmark rate like LIBOR.

Commodity/Asset Price Risk

The murabaha price risk and commodity/asset price risk must be clearly distinguished. As pointed out, the basis of the mark-up price risk is changes in LIBOR. Furthermore, it arises as a result of the financing, not the trading process. In contrast to mark-up risk, commodity price risk arises as a result of the bank holding commodities or durable assets as in salam, ijara and mudaraba/musharaka. Note that both the mark-up risk and commodity/asset price risk can exist in a single contract. For example, under leasing, the equipment itself is exposed to commodity price risk and the fixed or overdue rentals are exposed to mark-up risks.

Liquidity Risk

Liquidity risk arises from either difficulties in obtaining cash at reasonable cost from borrowings (funding liquidity risk) or sale of assets (asset liquidity risk). The liquidity risk arising from both sources is critical for Islamic banks. For a number of reasons, Islamic banks are prone to facing serious liquidity risks. First, there is a fiqh restriction on the securitization of the existing assets of Islamic banks, which are predominantly debt in nature. Second, because of slow development of financial instruments, Islamic banks are also unable to raise funds quickly from the markets. This problem becomes more serious because there is no

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inter-Islamic bank money market. Third, the lender of last resort (LLR) provides emergency liquidity facility to banks whenever needed. The existing LLR facilities are based on interest, therefore Islamic banks cannot benefit from these

Operational Risk

Operational risk is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, and technology or from external events. Given the newness of Islamic banks, operational risk in terms of personal risk can be acute in these institutions. Operation 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. This gives rise to system risks of developing and using informational technologies in Islamic banks.

Legal Risk

Legal risks for Islamic banks are also significant and arise for various reasons. First, as most countries have adopted either the common law or civil law framework, their legal systems do not have specific laws/statutes that support the unique features of Islamic financial products. For example, whereas Islamic banks' main activity is in trading (murabaha) and investing in equities (musharaka and mudaraba), current banking law and regulations in most jurisdictions forbid commercial banks undertaking such activities. Second, non-standardization of contracts makes the whole process of negotiating different aspects of a transaction more difficult and costly. Financial institutions are not protected against risks that they cannot anticipate or that may not be enforceable. Use of standardized contracts can also make transactions easier to administer and monitor after the contract is signed. Finally, lack of Islamic courts that can enforce Islamic contracts increases the legal risks of using these contracts.

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.

Fiduciary Risk

Fiduciary risk can be caused by breach of contract by the Islamic bank. For example, the bank may not be able to comply fully with the shari'a requirements of various contracts.

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Inability to comply fully with Islamic shari'a either knowingly or unknowingly leads to a lack of confidence among the depositors or hence causes withdrawal of deposits. Similarly, a lower rate of return than the market can also introduce fiduciary risk, when depositors/investors interpret a low rate of return as breaching an investment contract or mismanagement of funds by the bank.

Displaced Commercial Risk

This is the transfer of the risk associated with deposits to equity holders. This arises when, under commercial pressure, banks forgo a part of their profit to pay the depositors to prevent withdrawals due to a lower return. Displaced commercial risk implies that the bank may operate in full compliance with the sharia 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. To prevent withdrawal, the owners of the bank will need to apportion part of their own share in profits to the investment depositors.

CONCLUSION

Islamic banks face various types of risks due to the nature of their balance sheet and sharia compliance. Non-availability of financial instruments to Islamic banks is a major hindrance in their way to manage market risks as compared to the conventional banks. This paper analyzes the various types risks related with Islamic banks. The obligations of Islamic banks towards depositors (investment account holders) are different from those of conventional banks and hence they face different risks. Islamic banks still may face extra risks because of the complexity of Islamic modes of finance and limitations in their funding, investment and risk management activities. On the other hand, customers of Islamic banks are expected to be more concerned about their religious beliefs.

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