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Research paper

Risk and Islamic banks: a study on Malaysian Islamic banks

Faridah Najuna Misman [1] *, Wahida Ahmad [2], Noor Sufiawati Khairani [3]

[1] *Department of Finance, Faculty of Business and Management, University Technology MARA Johor*
[2] *Faculty of Business and Management, University Technology MARA Puncak Alam*
[3] *Faculty of Accountancy, University Technology MARA Johor*
**Corresponding author E-mail:*

Abstract

This study examines the major risk faced by Islamic banks specifically in Malaysia. Furthermore, this study also focuses on the risk profile of Islamic banks compared to conventional banks. To achieve the objectives, this study adopts a case study analysis by inverviewing and closely examines the annual reports of four major Islamic banks in Malaysia. The findings reveal that credit risk is the main risk faced by the Islamic banks in Malaysia. Moreover, consistent with the literature, the findings also suggest that specific features of Islamic banks pose an extra and unique risk compared to conventional banks.

Keywords: *Islamic Banks; Risk.*

1. Introduction

Islamic banking and finance (IBF) industry has witnessed several important events during the last decade. Since their inception in 1975, Islamic banks (IBs) have now become a global phenomenon in about 50 countries around the world. In certain countries like Malaysia and Bahrain, Islamic banking (IB) industry has evolved from a primarily domestic concern to one of international significance. This success for the IB industry is proven by its total assets value which grew from US$1.8 trillion at the end of 2013 and accumulated nearly to US$1.9 trillion by end 2015. During the last ten years the IB industry has witnessed changes in economic conditions and the onset of a financial crisis. It is reported that IBs remain strong and continue to grow globally.

The rapid growth of IB industry poses an attention to risk related issues. Risk exposure may cause a negative impact to the banks performance. Previous empirical studies suggest that credit risk is one of the main risks faced by the commercial banks around the globe. Mokni, Echchabi, and Rajhi (2015) claim that credit risk is considered as the most important risk for both conventional and Islamic banks followed by liquidity risk. Among early studies on Islamic banks also tried to identify the risk faced by IBs. For example, Habib Ahmed and Khan (2007) suggest that IBs faced similar risk group with conventional counterpart, however the characteristics and level of exposure is different due to the unique characteristics of IBs. Therefore, this study will closely examine this scenario in the context of Malaysia IBs (MIBs).

The main objective of this study is to examine the main risk faced by IBs in Malaysia. Apart from that, this study also aims to investigate either there are any difference in risk profile of IBs and conventional banks (CBs). The objective will be achieved by conducting an interview survey and examination of annual reports and related documents of sample banks.

2. Literature review

Risks exist in any business activity including the banking industry (Oldfield & Santomero, 1997). Both IBs and CBs will have to deal with risks in their daily operations. In general, risk is defined as uncertainty arising from the any transaction or activity. Jorion and Khoury (1996) define risk as variability or volatility of unexpected outcomes. An example is the volatility of interest rates having an impact on cost of funds and profits. Čihák and Hesse (2010) claim that risk is simply a measure of uncertainty, the chance that some events will have an impact on objectives. In the case of banking operations risk can result from the uncertainty of profit or loss in daily operations such as deposits and loans. Risk can be a major disaster for any financial institution including IBs. Therefore, it is critical for the banks to continuously define and identify risks involved in their business activities.

The concept of risk in financial institutions consists of two unique attributes that can be applied to both IBs and CBs (Zakaria & Ismail, 2008). Risk in financial institutions can be grouped into systematic and unsystematic risk. Systematic risk is naturally generated by the economic conditions, for example any risk arising from changes in policy and regulations or economic conditions that adversely affect business activities. Unsystematic risk results from the business activities such as lending and deposit-taking activities. Both types of risks will have a negative consequence for financial institutions' performance if they fail to manage operations well. Excessive risk exposure can affect not only the profitability of the banks but also the safety and soundness of banks in the future. The recent financial crisis known as global financial crisis (GFC) in 2008-2009 witnessed a few established commercial banks collapsing due to their excessive risk-taking activities.

2.1. Uniqueness of risk in Islamic banks

Previous discussion of categories of risk specifically in Islamic banks does not explain in detail on the types of risks that fall into systematic and unsystematic risk. For example Iqbal and Mirakhor (2007), they do not explain which one of the risks belongs to systematic and unsystematic risk. This study proposes a framework for the grouping of risk for IBs by making some changes to the previous discussions. Figure 1 illustrates the risk profile of IB by considering systematic and unsystematic risk classification. This framework divides risk into three main groups - systematic, unsystematic and a combination of them called SUR. Under this new framework, only business risk belongs to systematic risk. Governance risk which consists of operational, reputation and Shari`ah risk is classified under unsystematic risk. The other two groups of risks which are financial risk and treasury risk. There are classified under SUR and not under the traditional types of risk because systematic or unsystematic risks are due to their very nature.

Financial risk consists of credit, market and equity risk and cannot only be classified under systematic or unsystematic risk because the risk involved comes both from external and internal sources. For example credit risk is of a default payment by the borrower, but in the case of IBs, banks operating as an entrepreneur or buyer, in that IBs provide financing rather than just a normal loan. Therefore, credit risk in IBs may result from changes in economic or market conditions or from internal weaknesses of the banks. Referring, to the Shari`ah law an Islamic bank is either an investor or seller when it provides financing to its customers. Thus, it will be able to control risk exposure when making decisions about providing any finance. The failure to making the right decision will contribute to the possibility of credit risk in the future. Risk becomes a big challenge in IBs particularly in an age of globalisation. In order to ensure the survival of IBs in the finance market, any issues concerning risk and its management must be handled properly and not jeopardise Shari`ah prohibitions.

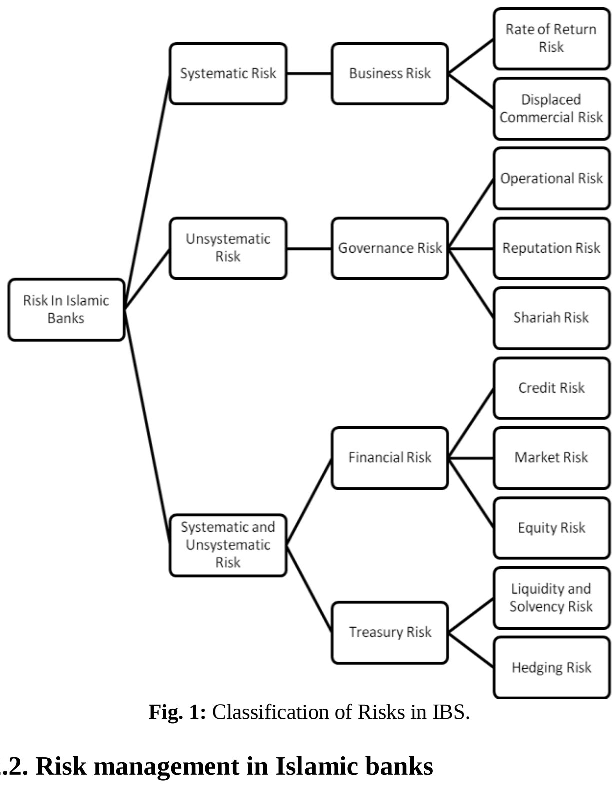

Fig. 1: Classification of Risks in IBS.

2.2. Risk management in Islamic banks

Risk management is a major cornerstone of bank operations. The effectiveness of risk management systems in banks will ensure their survival and will indirectly increase their profitability. After the GFC, risk management became even more important. The concern for risk management began prior to the crisis, but it was highlighted again in 2009. Rahman and Shahimi (2010) claim that risk management is more important in the financial services sector than any other part of the economic system. This is because a weak risk management system not only causes loss of profits; it will have a more severe impact and lead to bank collapse.

Risk management is a process that protects an organisation's assets and profits by reducing the potential for loss before it occurs, mitigating its impact when it occurs and executing a swift recovery after its occurrence (Coffin, 2009). According to Galai, Ruthenberg, Sarnat, and Schreiber (1999), financial risk management is the process by which managers need to identify the risk involved, understand and measure it, determine the factors and establish the procedures to reduce risk. Waring and Glendon (1998 as cited in Kalapodas and Thomson (2006), contend that risk management attempts to eradicate, reduce and manage risk, and to increase the benefits whilst avoiding harm from taking risk. In other words, risk management can be defined as avoiding risky activities or if the risk cannot be avoided, transferring the risk to a third party.

Risk management is a continuous process that depends directly on changes in the internal and external environment of banks (Hussain & Al-Ajmi, 2012). Therefore, it requires continuous attention and a comprehensive framework. In the case of IBs, risk management is more complicated because it cannot simply replicate what is practiced by the CBs. However, in terms of the risk management process, these are similar to those practised by CBs. Kayed and Hassan (2011) state that the risk management processes in IBs and CBs are similar, beginning with risk identification, mitigation and controlling the risk exposure in order to ensure it does not affect profits and losses. IBs differ in that they must ensure that as the framework develops, all the tools used are in line with the Shari`ah requirements. In IB principles, risk identification is a two-step process. The first is negative Shari`ah screening which excludes Riba, Gharar and Maysir-based transactions; this step reduces exposure of risk to some appropriate level. The second is positive screening which will emphasise justice, ethics and accountability issues. Every product offered by the IBs will undergo the first screening. All the proposed products will be evaluated by the bank's Shari`ah Committee.

Considering the fast and global growth of the IB industry, it is important for IBs to have appropriate risk management frameworks. Before the establishment of the IFSB in 2005, IBs did not have any specific risk management frameworks or guidelines. The risk management activities of IBs depended on the initiatives of the banks themselves or the regulatory bodies of particular countries or jurisdictions. For example in Malaysia following the establishment of IBs, all banks followed the framework used by their conventional counterparts especially in the context of capital adequacy. Awareness of the IB system requiring its own risk management framework led to the establishment of IFSB.

3. Methodology

This study employed a qualitative research methodology to address risk management issue of Malaysian Islamic banks more closely. Case study approach has been chosen because the researcher can explore a bounded system or multiple bounded system over time, through details and in-depth data collection employing multiple sources of information; for example observations, interviews, and documents and reports (Creswell, 2007). This study employs a multiple case study approach for exploring and explaining the risk and risk management scenarios of four sample IBs in Malaysia.

The qualitative data for this study is collected using an interview survey technique and closely examining the annual reports of four major MIBs. This qualitative case study will shed light on the processes of credit risk management not covered by other studies in earlier empirical analyses.

This study targeted the key personnel working in the risk management division of the sample IBs to explain the major risk faced by the IBs. The survey data consists of four interviews from four IBs in Malaysia. For reasons of confidentiality in information disclosure the sample banks will only be known as A, B, C and D. The interviews cover the important issues of risk management, and types of main risks faced by IBs in Malaysia.

4. Results and discussion

The analysis of four selected IBs in Malaysia reveals that they face two different types of risks. The first risk is similar to that occurring in the CBs and the second is concerned with Shari`ah jurisdiction. In both banking systems the four main risks are: i) credit risk, ii) market risk, iii) operational risk, and iv) liquidity risk (see Table 1). However, IBs are exposed differently to CBs due to the nature of IBs' products and services contracts. The respondents explain that all products and services offered by IBs are either Shari`ah-based or Shari`ah-compliant. These two conditions expose IBs to extra risk in addition to the existing risk that arises from normal banking operations. The risk managers in the survey claim that IBs' risks are more unique and different from those of CBs. This finding is in line with Makiyan (2008), who concluded that risks in IBs are unique due to the nature of their operations and some Shari`ah prohibitions. All risk managers in this case study agreed that the first and foremost risks faced by IBs are credit risks. This is evident in the studies by Arunkumar and Kotreshwar (2005), Boffey and Robson (1995), Khan (2003), Carey and Stulz (2005), and Saunders and Cornett (2006). Credit risk arises from all transactions that could lead to actual, contingent or potential claims against any party, borrower or obligor. Hussien (2017) examines the risk management of Islamic banks in Egypt claims that credit risk is one of the important risks to IBs and it appears due to lending and investment activities. Table 1 ranks major risks faced by MIBs.

From the perspective of surveyed IBs, all risk managers involved in this study agreed that credit risk is a serious issue and has received much attention by banks' risk management department (RMD). It is generally a dedicated team that specialises in credit risk and is used by IBs to manage credit risk better. Bank B's risk manager claims that the credit risk section is the largest division in their bank's RMD. According to him, the reason for this strategy is because credit risk cannot be avoided since financing is the main source of income.

"The main risk faced by our bank is credit risk, credit risk carry about 80% of the total risks faced by our bank".

(Risk Manager Bank C)

Credit risk has the biggest stake in total risks of IBs because financing is the main activity in the banking industry. On average financing contributes about 60% to 80% of total income. Therefore credit risk cannot be avoided by the banks. According to the risk manager of Bank D, credit risk is the main 'bug' to their banking operations and contributes the highest proportion of total risk. Further examinations with the sample IBs disclose that they handle four different kinds of credit risk: i) default risk, ii) country risk, iii) settlement risk, and iv) contingent financing risk. Each type of credit risks occurs in different financing scenarios.

Second objective of this study is to examine the risk profiles of IBs. Managers' interviews reveal two different opinions regarding the risks of IBs: i) IBs are exposed to similar risks like CBs, and ii) IBs perceived more risk than CBs. According to Bank B's risk manager, IBs risk is similar to CBs' risk because their activities are similar. Bank B's risk manager argues that in terms of credit risk exposure, the only difference between IBs and CBs is that of funding structures. However, all IBs' activities such as deposits and financing must meet Shari`ah requirements. Thus, Banks A and D claim that IBs perceive more risk than CBs. Habib Ahmed (2011) mentioned this issue, claiming that IBs face two types of risks: firstly, risks similar to those faced by CBs; and secondly, risks that are unique to IBs due to their compliance with Shari`ah.

Banks A and D's risk managers explain that there are a few reasons why IBs are exposed to more risks than their conventional counterparts. The first is compliance with Shari`ah. All products and services offered by IBs are not only bound to traditional banking laws but more importantly Shari`ah law, which varies over jurisdictions and various schools of thought to qualify for their own Fatawa by Mufti. This risk, which is known as Shari`ah risk, also known as reputational risk is included under the group of operational risk. There are two main consequences of the Shari`ah risk: first, the income from the business activities cannot be recognised as income if it does not comply with Shari`ah requirements; and second, it is possible that IBs will face a lawsuit due to non-Shari`ah-compliant products and services. Failure to address these situations will impact harshly on IBs' performance and reputation.

Second, IBs perceived more risks due to the lack of instruments that can mitigate risk; for example lack of hedging instrument and/or variety in Shari`ah-compliant securities. The managers' view is that such deficiencies increase their difficulty in managing risks. The Shari`ah prohibition of using contemporary hedging instruments like futures and options, and sale of debt, makes it more difficult for IBs to manage various risks like credit and market risk. The respondents in the case study suggested that both regulatory bodies and Shari`ah scholars should work together to resolve these issues. To this end, the International Shari`ah Research Academy for Islamic Finance (IS this view comes from Banks A and D

RA) is playing a significant role in overcoming this mismatch between finance and Shari`ah compliancy of hedging, options and future instruments. A few scholars have discussed this issue, for example Bacha (1999), Obaidullah (1998, 1999, 2002) and Jobst (2007).

Complexities of the products contract also differentiate the risk exposure faced by IBs and CBs. According to Bank A, IBs cannot avoid this extra risk arising due to compliance with Shari`ah law, but they can mitigate it through an effective risk management strategy. For example, in Mudharabah profit loss sharing (PLS) contracts these expose IBs to asymmetric information, which occurs when an entrepreneur does not report the actual profits and at the same time fails to repay back IBs equity shares when they are due (Khan & Ahmed, 2001). This type of credit risk is classified as capital impairment risk. Under this contract, the obligor has no contractual obligation to return the financier's capital intact (Ariffin, Archer, & Karim, 2009), and this situation is very costly to IBs' operations. Furthermore, all respondents agree that PLS financing exposes IBs to higher credit risk than non-PLS contracts. For this reason, a few IBs in Malaysia do not offer PLS financing to avoid higher credit risk exposure. In this survey, only Banks B and C offer PLS financing. Bank A started offering PLS in 2009 and Bank D still does not offer PLS financing.

Table 1: Major Risk Ranking by Four IBS

Risk Type\Banks	Bank A	Bank B	Bank C	Bank D	Mean	Median
Credit risk	1	1	1	1	1	1
Market risk	3	2	3	3	2.75	3
Liquidity risk	2	4	4	4	3.5	4
Operational risk	4	3	2	2	2.75	2.5

Note: The Scale 1 to 4 Shows the Ranking of Risks As Suggested by the Respondents

5. Conclusion

This study presented the findings from the interview survey of four major MIBs. This study reveals that credit risk is a main risk faced by MIBs followed by operational, market and liquidity risk. The study also concludes that MIBs are facing extra risk compared to CBs. There are three reasons that differentiate the risks of IBs from those in CBs: i) Shari`ah compliance, ii) lack of Shari`ah-compliant instruments, and iii) the complex nature of IBs' products. This study therefore suggests that the nature of products and services of IBs expose them to extra risk, IBs must ensure that all their strategies, policies and tools to manage risk also meet the Shari`ah requirements. Regulators and the relevant organisations working with IBs should provide more support and infrastructures so risk is better managed; for instance, Shari`ah-approved risk management tools and regulations or standards. This case study analysis provides valuable information to other researchers, IBs and regulators where they need to concentrate on Shari`ah compliance risk management framework using the right management strategies, policies, regulations and tools.

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