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Research Article

Unique Characteristics of Risks in Islamic Financial Institutions (IFIs)

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Abstract

For financial institutions, whether it is Islamic financial institutions (IFIs) or conventional financial institutions, making a right decision to finance is often a difficult task to do and crucial as well. A through and strict risk appraisal of the business must be performed and if they are uncomfortable in taking a certain business risk, normally they will then insist on certain terms and conditions with protection in the form of security and guarantees to overcome the risk identified. The objectives of this study are to understand the unique characteristics of risks facing the Islamic financial institutions due to their compliance with Shari'ah rules and principles.

Keywords: *Risk, Islamic Financial Institutions, Shari'ah rules, Shari'ah principles, Risk management*

Introduction

Islamic financial institutions need to address the risks arising from compliance with Shari'ah rules and principles and to include it in their assessment of risk management system (Mirakhor, 2012 and Lahsasna, 2014). To understand the risks that arise in Islamic financial institutions, we therefore examine the risks faced by Islamic financial institutions at two levels. First level, we examine the nature of risks faced by the Islamic financial institutions; and at the second level, the risks arising in individual modes of financing are examined.

The Risks Faced by Islamic Financial Institutions (IFIs)

The following Figure 1 represents the types of risk facing the Islamic financial institutions (IFIs). Follow by describing the nature of each type of risk faced by the IFIs.

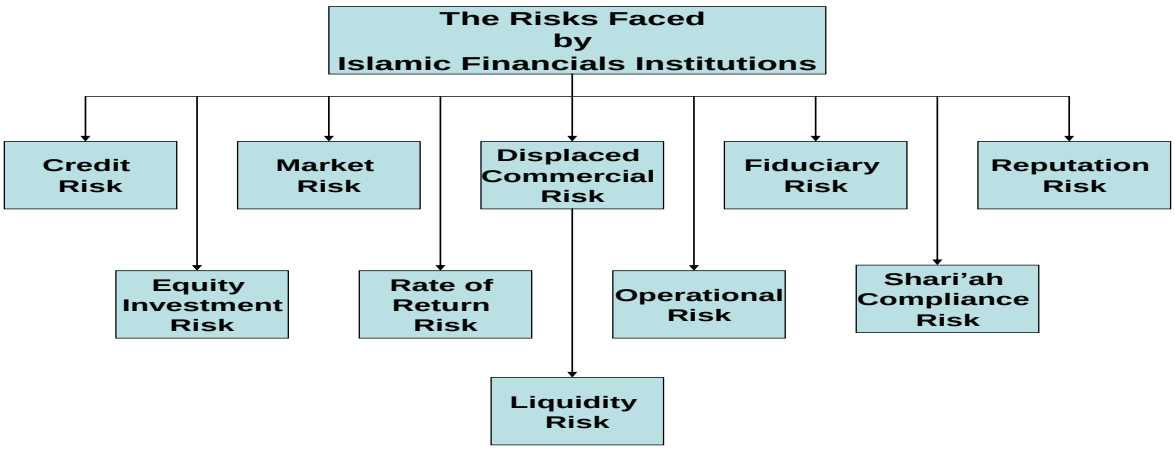

Figure 1. The Risks Facing the Islamic Financial Institutions (IFIs)

Credit Risk (CR) Characteristics

Credit risk is defined as the risk that counter-party fails to meet its obligations in accordance with agreed terms and conditions. Therefore, exposing IFIs to potential loss, for example, murabahah contracts are trading contract, risk due to non-performance of trading partner. Second, example, mudarabah and musharakah contracts are profit-sharing modes of financing, occur when the entrepreneur defaults in his payment of the share of the bank when it is due (Noraini and Salina, 2011 and Saiful Azhar & Mohd-Pisal, 2014/2009).

Equity Investment Risk (EIR) Characteristics

Is the "risk arising from entering into a partnership of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares the business risk". The loss may arise due to partner behavior or the business activity itself. How to minimize the risks? It is important to do due diligence on both the prospective partner and the venture prior to the investment decision and close monitoring process after the investments are made (Ayub, 2007; Ebrahim, 2011 and Lahsasna, 2014).

Market Risk (MR) Characteristics

Basically, market risk originating from instruments and assets traded in markets. Resulted from macro and micro sources for example, systematic market risk and unsystematic market risk. Systematic market risk refers to as a movement of prices and economic policy at macro level (monetary and fiscal policy). On the other hand, unsystematic market risk refers to as when the price of the specific asset/instrument changes due to events linked to the instrument/ asset. In addition, market risk can also be classified as equity price risk, interest rate risk, currency risk, and commodity price risk. Market risk can happen in both banking and trading books of banks (Ayub, 2007; Damak & Emmanuel, 2008 and Al-Amine & Al-Bashir, 2008).

Rate of Return Risk (RORR) Characteristics

Is a type of market risk linked to the balance sheet of Islamic financial institutions (IFIs). Changes in the market benchmark rate introduce some risks in the earnings of IFIs. For example, when the benchmark rate increases, the investment account holders (IAHs) would expect an increase in their rates of return. Since IFIs use a benchmark rate to price different instruments and the rates of return on fixed-income assets such as murabahah contracts cannot be changed, the IFIs may not be able to give the IAHs the higher rates of return. Therefore, results in "withdrawal risk" due to lower rates of return relative to market rates of return (Acharya, 2009 and Ahmed, 2009).

Displaced Commercial Risk (DCR) Characteristics

Arises when under commercial pressure, banks forgo a part of their profit to pay the depositors to prevent withdrawals due to a lower rates of return. Due to IFIs unable to compete with its peer group of Islamic banks and other competitors. In order to prevent withdrawals, IFIs may pay the Investment Account Holders (IAHs) a return that is higher than their due returns, IFIs will need to apportion part of the profit of shareholders to the IAHs (Iqbal & Abbas, 2011 and Chartered Islamic Finance Professional, 2010).

Liquidity Risk (LR) Characteristics

Is the potential loss to IFIs arising from their inability to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses. The risk arising from both sources (cash/sale of assets) is critical for IFIs. IFIs cannot borrow funds to meet liquidity requirement furthermore, Shari'ah does not allow the sale of debt, other than its face value. Therefore, to raise funds by selling debt-based assets is not an option for IFIs (Ayub, 2007; El-Tiby, 2011 and Bhatti & Faridah Najuna, 2010).

Operational Risk (OR) Characteristics

The risk arising from inadequate or failure of internal processes, people, and systems or from external events. For example, lacking of professional staffs, computer and technology systems that are not suitable for IFIs operations, legal system framework that do not have specific laws/statutes that support the unique features of Islamic financial products and lacking of Islamic courts to enforce Islamic contracts (Saiful Azhar & Mohd-Pisal, 2014/2009; Loader, 2007 and Hermanto, Sigit Sulistyo, & Imam Wahyudi, 2007).

Fiduciary Risk (FR) Characteristics

This risk can be caused by a breach of contract by the IFIs. Demand deposits (qard hasan contracts) and investment deposits (mudarabah contracts). The objective is to avoid the transfer of risk from investment deposits to demand deposits. If not manage willfully will cause serious confidence problem and deposits withdrawals. For example, lower rates of return than the market rates will cause depositors/investors to interpret a lower rate of return as a breach of investment contracts or mismanagement of funds by the funds managers (Shaikh & Amanat, 2009 and Greuning & Zamir, 2008).

Shari'ah Compliance Risk (SCR) Characteristics

IFIs must ensure that all their businesses/financial activities conform to the principles and values of Islam or Shari'ah compliance. For example, contracts documentations, supporting documents including legal paper, forms, procedures, guidelines and processes to be Shari'ah compliance. On operational issues including treatment of interest-based calculations, discounting, early and late payments defaults, etc., must follow the guidelines provided by the Shari'ah supervisory board (Ayub, 2007 and Saiful Azhar & Mohd-Pisal 2014/2009).

Reputation Risk (RR) Characteristics

This risk arising from "failure of governance, business strategy and process". The reputation of an IFIs and its profitability and market position could be at stake if there is negative publicity about its "business practices, relating to Shari'ah non-compliance in their products and services". End results will trigger bank failure and cause systemic risk and instability (Akkizidis & Sunil Kumar, 2008 and Ahmed & Khan, 2007).

Risks in Islamic Modes of Financing

The ultimate goal of financing and investment of Islamic financial institutions is to finance trade or invest in assets or equity to earn a good return. For example, holds cash in the current time involves no risk however, holding assets and needs to dispose of it, thus, subject to market risks as market price change. In addition, financing any transactions for future income is subject to credit risk or default risk. For example, hire purchase financing involve both risks, asset market value decline and not able to collect payment from borrower (Abdul Sattar et. al. 2007; Venardos, 2010 and Lahsasna, 2014).

This section will discuss in details the risks arising in individual modes of financing especially the credit risk and market risk. Figure 2 portrays Islamic modes of financing and to better understand the scenario we will look at the status of a transaction at three stages:

Stage 1: The beginning of the transactions,

Stage 2: The transaction period, and

Stage 3: The end of the transactions.

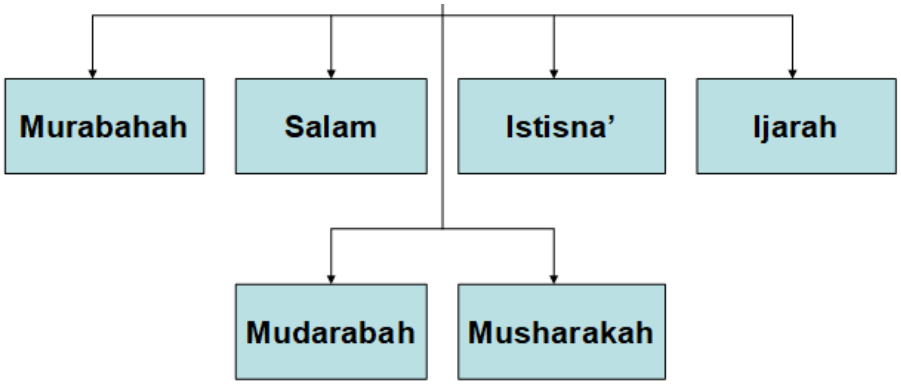

Figure 2. Islamic Modes of Financing

Murabahah

- *Beginning of Transaction*: Islamic Financial Institution (IFI) exposed to market risk if the promise is not binding.
- *Transaction Period:* IFI exposed to credit risk in case the debtor default on payments. Mitigate the risk through guarantors and/or collateral requirement.
- *Conclusion of Transaction:* no other risk if the payment is made without failure.

Salam

- *Beginning of Transaction:* As the IFI disburse the cash at the beginning of the transaction, there is no risk involved in the case of a stand alone salam.
- *Transaction Period:* Market risk involves under the condition of uncontrollable elements (natural disaster) if the price of the goods during the period increases considering that the price of the goods has been fixed from the beginning. In addition, counter-party risk exist when the supplier fails to deliver the quality of goods as contractually agreed or does not deliver it on time or may not be able to deliver at all.
- *Conclusion of Transaction:* If IFI does not have a ready buyer to buy the goods, market risk and storage costs related to the commodities will incurred.

Istisna'

- *Beginning of Transaction:* After the IFI commits to the contract, it has to select sub-contractors who can manufacture/construct the goods/assets.
- *Transaction Period:* Istisna' involves manufacturing and instalments payment thus, IFI faces both market risk and counter-party and/or credit risk. The former cause by increases in the costs of production and the later, buyer declines to accept the asset or default on payments.
- *Conclusion of Transaction:* no other risk involved if the asset is delivered and payment is received.

Ijarah

- *Beginning of Transaction*: If the client refuses to lease it (in a non-binding contract) then IFI faces market risk of disposing the asset.
- *Transaction Period:* IFI faces credit risk if lessee default in paying rental.
- *Conclusion of Transaction:* Market risk related to the residual value of the asset.

Ijarah wa Iqtina (Hire Purchase)

- *Beginning of Transaction:* If the client refuses to lease it (in a non-binding contract) then IFI faces market risk of disposing the asset.
- *Transaction Period:* IFI faces credit risk if lessee default in paying rental.

- *Conclusion of Transaction:* As the asset is transferred to the lessee, the IFI is no longer exposed to market risk.

Mudarabah

- *Beginning of Transaction:* Adverse selection and an IFI's existing competencies in project evaluation and related techniques are limited.
- *Transaction Period:* The counter-party risk arising from information asymmetry problem includes mis-reporting of profit by the manager.
- *Conclusion of Transaction:* The counter-party risk of untruthful reporting of profit exists.

Musharakah

- *Beginning of Transaction:* Adverse selection and an IFI's existing competencies in project evaluation and related techniques are limited.
- *Transaction Period:* Counter-party risk due to moral hazards and information asymmetry problems. For example, in the form of the manager not reporting the actual profit generated.
- *Conclusion of Transaction:* The risk of counter-party and market risk may exist. For example, investment is in physical assets, then the bank will face asset price risk and/or counter-party risks.

Conclusion

For Islamic Financial Institutions (IFIs) making a right decision to finance is often a difficult task to do and crucial as well. Therefore, a complete and strict risk appraisal of the business must be performed. If the IFIs are uncomfortable in taking a certain business risk, they will normally insist on certain terms and conditions. Usually, with protection in the form of security and guarantees to overcome the risk identified. In order to understand the unique characteristics of risks facing the IFIs due to their compliance with Shari'ah rules and principles, this study examines the nature of risks faced by the IFIs and the risks arising in individual modes of financing.

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