The Nature of Risk Management Practice of Islamic Banks

Dr. Romzie Rosman
Researcher, ISRA

Introduction

The lack of risk management practices causing firms' failures can be traced to the 1980s, and the recent global financial crisis has brought more attention to the importance of risk management. Moreover, after the financial crisis, the proponents of Islamic finance proposed the Islamic banking system as an alternative to conventional banking. However, significant concerns have been raised regarding the practice of risk management in Islamic banks, due to the unique nature of the risks and because the risks are not well understood. Hence, understanding the unique risks and prudent risk management practices for Islamic banks is critical for their sustainability.

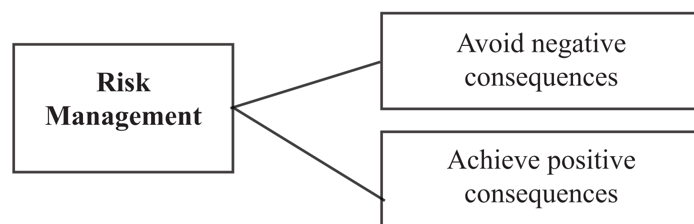
Definition of Risk

There is a variety of definitions of the term risk (Ritchie and Marshall, 1993). Banks as financial intermediaries face many types of risks. Risk can be defined as uncertainty, that is, the deviation from an unexpected outcome (Schroeck, 2002). However, Knight (1921) has made a distinction between risk and uncertainty. According to him, when the randomness facing an individual can be expressed in terms of numerical probabilities, whether these are objective or reflect the individual's subjective beliefs, the situation is said to involve risk. Contrary, when probabilities cannot be assigned to alternative outcomes, then the situation is said to involve uncertainty.

According to Bhimani (2009), the conceptual economic idealism demarcates risk as being a separable category from uncertainty – a distinction which subsequently shapes and influences operational strategies for the management and regulation of risk in organization. The term risk is usually used synonymously with specific uncertainty, because it can be quantified by using measures of dispersion. The variability around the expected or average value is usually measured by calculating the variance or the standard deviation. In business context, risk usually expresses only the negative deviations from expected or "aimed at" values and is therefore associated with the potential for loss (e.g. Schroeck, 2002), whereas positive deviations are considered to represent opportunities.

Objectives of Risk Management

The risk management theory has evolved since Knight (1921) made a distinction between risk and uncertainty. Many of the work on risk management theories are related to corporate risk management that explain the use of derivatives in the context of risk management for value creation, and why firms involve in corporate risk management. From many risk management studies (e.g. Scholtens and van Wensveen, 2000, Schroeck, 2002), it can be argued that firms have two main objectives for risk management; either to avoid negative consequences (i.e. risk associated to negative outcomes) or to achieve positive consequences (i.e. risk associated to opportunity) as in Figure 1.



In the context of banking, avoiding negative consequences are much related to compliance purposes. In this case, the banks practice risk management to avoid financial distress by having stable earnings. On the other hand, in achieving positive consequences, risk is treated as opportunity, hence, by exploiting the opportunities, banks can meet their objective to improve performance and finally increase the value of shareholders. In addition to that, risk management is much related to financial intermediation theory. Financial intermediation, theoretically, has a function only because financial markets are not perfect (Scholtens and van Wensveen, 2000). They argued that risk as the root of financial intermediation and as its main raison d'être where the origins of banking and insurance lie in their risk transforming and risk managing functions. For instance, the traditional role of banks in the process of risk transfer, taking deposits from savers and extending credit to borrowers is a risky business. Also, by dealing in financial assets, intermediaries are by definition in the financial risk business (Allen and Santomero, 1998). The views of Scholtens and van Wensveen (2000) explained that theory of financial intermediation should include the risk/reward optimization and risk management in their function; and financial intermediary is an entrepreneur provider of financial services. Also, risk management has made a prominent function of financial intermediation (Allen and Santomero, 1998).

Nature and Type of Risks in Islamic Banking

The nature of financial intermediation, including the function of banking, is different in the case of Islamic banks compared to conventional banks and this difference in intermediation is the key to understanding the different nature of risk in Islamic banking (Greuning and Iqbal, 2007). Risk exists in every contract that matures in future, and there is no doubt this was known to them (Elgari, 2003). The contract of Sharikah (partnership), Mudarabah, Salam, and so on, as each of these contracts involve a transfer or sharing of risk (Elgari, 2003). Undertaking business transaction or an investment decisions that involves some degree of risk taking that is based on educated analysis and understanding of the risks that are necessarily present is needed for Islamic banks. Hence, taking entrepreneurial risk and profiting from it is allowed (Hayat and Kraeussl, 2011).

The essential feature of Islamic financial institutions is the requirement to comply with Shari'ah rules and principles especially the prohibitions of generating profits without bearing risks (IFSB, 2005). Hence, it is Islamic bank's fiduciary duty as financial intermediary to apply Shari'ah compliant risk mitigation techniques in their operations. The Islamic Financial Services Board (IFSB) has issued a comprehensive guideline on Risk Management in December 2005. The guidelines, apart from the general requirement, are in the form of fifteen (15) principles on risk management, which are clustered into six categories of major risk areas,: 1) credit risk, 2) equity investment risk, 3) market risk, 4) liquidity risk, 5) rate of return risk/displaced commercial risk, 6) and operational risk that includes Shari'ah non-compliance risk. The central characteristic of Islamic banks' activities, is the requirement to abide by the Shari`ah rules and principles, especially the prohibitions of generating revenues without bearing any risks.

Conclusion

The nature of risk in Islamic banking is different from risk in conventional banking. Hence, the specific risk management practice of these unique risks is very crucial. It is found that the foundation of Islamic banking operations is in compliant with Shari'ah, which has an immediate impact on how they manage their operational risk especially the Shari'ah non-compliance risk. Both the fiduciary duty of Islamic banks and risk management practice are related to the theory of financial intermediation whereby financial intermediary is an entrepreneurial provider of financial services; and focus on the risk/rewards optimisation and risk management. Because of this, all businesses and transactions of Islamic banks must be associated with risks to justify their earnings. This shows that the Islamic banks have to uphold their fiduciary duty by conducting proper and prudent risk management. This fiduciary duty of Islamic banks is particularly essential for the protection of investment account holders, shareholders and other stakeholders including publics.

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