Advances in Environmental Biology, 8(9) Special 2014, Pages: 402-405

AENSI Journals
Advances in Environmental Biology
ISSN-1995-0756 EISSN-1998-1066

Journal home page: http://www.aensiweb.com/aeb.html

Risks Management in Islamic Financial Instruments

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ARTICLE INFO

Article history:
Received 25 January 2014
Received in revised form
2 June April 2014
Accepted 6 June 2014
Available online 15 June 2014

Key words:
Islamic financial Institutions, instruments, Risk, Shariah.

ABSTRACT

Islamic financial Instruments have recently emerged as one of the most important tools for the Islamic financing and investment. They have the most influential and effective impact in various banking, finance and economic transactions whereby they have got a foothold in the international money and stock markets. Today, Islamic financial Instrument is among the most successful financial product in the financial industry and be one of the fastest-growing sectors in the global financial landscape. The primary objectives of this research is to determine the risks which facing the Islamic Financial instruments. The application and mechanics of Islamic financial tools is discussed in relation to Islamic financing and investment.

To Cite This Article: Essia Ries Ahmed, Md. Aminul Islam, Ahmad Zuqibeh, Tariq Tawfeeq Yousif Alabdullah., Risks Management in Islamic Financial Instruments. ***Adv. Environ. Biol., 8(9),*** *402-405, 2014*

INTRODUCTION

Islamic financial studies in literature have focused on the Islamic financial funding methods and its ability to solve efficiently the financial difficulties associated with loans and interests. Thus, it provides the necessary support for people and business projects without interrupting the international banking rules. However, there is a lack in studies on risk management in the Islamic finance.

Although the contract between the bank and costumers includes the share in both financial gain and losses, the bank is responsible for the safety of customer's deposits. Moreover, the risk of any commercial deals has to be studied carefully since it includes the usage of customers saving deposits [6].

Studying the risk management in banking is critical to understand the technical requirements for financial auditing in the Islamic bank, thus, setting fundamental measurements for the inspection and observation department. Moreover, this study disproves the claims of the higher risk probability in Islamic banking compared to the conventional banking.

Risk presents the uncertainty in achieving goals and the high probability of facing an unpleasant consequence of one's action. This definition is totally applicable for the risk in financial studies that includes two probabilities (i.e. fail or success), whereas the safe finance presents the case with only one consequence [5].

Risk has been defined by Vaughan [13] as "the case with a deviation off the safety road" whereas William [12]. has defined it simply as the lost probability.

Wide range of risk sources faces the Islamic banking concerning the customer, internal divisions of bank, political, economical and environmental effects on the bank. Risks cost the Islamic banks a considerable amount of money additional to the bank's credibility.

Some of these sources can be controlled and contained by the bank, while other sources are external and difficult to control. Thus, certain procedures have to be set in the Islamic bank to achieve a good risk management element that includes: definition, measurement, alleviation, observation, control and report the risks. A suitable risk management policy has to include a completer information system and good management to reach the decisions and write internal risk reports that suits the size and activities of the institution.

This paper will touch on some of the risks which facing Islamic financial instruments such as market risk, credit risk, *Shariah* compliance risk, operational risk, and institutional rigidity.

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2. The general advantages of Islamic Financial Institutions:

In general, Islamic financial services include the Islamic commercial banking, financial services and cooperation with the conventional banks, mutual savings, rental and investment companies and Islamic insurance companies. The industry of Islamic financial has seen a significant growth and development since the seventies of the last centaury where some countries have even included Islamic services side by side with conventional banking services. Pakistan and Sudan have decided to make a major modification on its financial system to be compatible with Islamic financial rules. As reported by the international community of Islamic banking, 176 Islamic financial institutions were reported by the end of 1997 [7] with total capital of 7.3 billion dollars. In 1997, circulated currency in these Islamic institutions was 112.6 billion dollars with net revenue of 1.2 billion dollars. Table 1.1 shows the financial status of Islamic institution.

Table 1-1: Size of Islamic financial institutions some financial status (MillionsofDollars).

Years	Number of banks	Consolidated capital	Consolidated assets	Money collected under management	Consolidated net profit
1993	100	2309,3	53815,3	41587,3	Not available
1994	133	4954.0	154566,9	70044,2	809,1
1995	144	6307,8	166053,2	77515,8	1245,5
1996	166	7271,0	137132,5	101162,9	1683,6
1997	176	7333,1	147685,0	112589,8	1218,2

Source: Directory of banks and Islamic financial institutions, 1997. International Federation of Islamic Banks, Jeddah.

The Islamic Finance has showed a promising success. A recent study has shown that Islamic banks has achieved stability and gained a wide recognition with considerable revenue [8]. Moreover, these gains were not inclusive on the fast growth side by side with conventional banking, but also have exceeded some of its counterpart banks in some departments as mentioned in the same study. In general, Islamic banks have higher capitals and have the advantage of the better resources utilization with higher revenue average compared to the conventional banks.

From table 1-1 it can be observed that Islamic financial institutions had a high growth rate in a globalized pattern in the last few years. One the indicators on these institutions success is the cooperation between some of the major financial institutions such as ANZ Morgan Stanley Dean Writter & Co, HSBC, Commerzbank Citicorp, Chase Manhattan, Grindlays with the Islamic banks. Moreover, the inclusion of Islamic sukuk such as bonds in the international bursa is another indication to the success.

3. Risks which facing Islamic Financial Instruments:

The usages of Islamic financial tools, which conform to the Islamic principles, pose special risks and challenges. Consequently, efficient risk management in Islamic financial institutions has assumed particular importance as they try to cope with the challenges of globalization. This, however, requires the development of a suitable regulatory framework and new financial instruments to provide an enabling operational environment for Islamic finance. This section briefly highlights some of these risks which are particularly associated with Islamic Financial Institutions. Therefore, the innovation of financial tools essentially involves a higher exposure to certain market and financial risks. These risks are market risk, credit risk, *Shariah* compliance risk, operational risk, and institutional rigidity.

3.1 Market Risks:

It is important that is defined as the risk on instruments traded in well-defined markets. Moreover, there are two categories of market risks are identified: general (systematic) and firm specific (unsystematic). Furthermore, systematic risks can arise due to governmental and economic policy shifts, whereas unsystematic risk arises because different firm specific instruments are priced out of correlation with other firms' instruments. Market risk is composed of profit rate risks, foreign exchange risks, equity price risks, and commodity risks [3].

The profit rate risk is rate of return risk upon which financial instruments is based on fixed rates that are exposed to this risk in the same manner as fixed rate bonds are exposed to the profit rate risk. Moreover, an increase in market profit rates leads to a decrease in the fixed-income instruments values. However, all fixed return assets either from Ijarah, Istisna, Salam or any other origin will face this risk. This also involves reinvestment risk and an opportunity cost of investing at the new rates, particularly if the asset is not liquid as in case of the zero-coupon non-tradable instruments. Also, undesirable changes in market rates will also unfavorably affect the credit worthiness of the issues and will lead to the increase in the credit risk of the issue. Furthermore, Islamic financial instruments certificates are exposed indirectly to profit rate fluctuations through the widespread benchmarking with LIBOR in their financing operations [1,2]. While the foreign exchange risk is a currency risk arises from unfavorable exchange rate fluctuations which will have an effect on foreign exchange positions. The challenge for Islamic financial instruments issuing corporate entities and sovereigns

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becomes to devise an effective exchange risk management strategy congruent to *Shariah* principles (Ali Tariq, 2004).

3.2 Credit Risk:

The Credit risk is the probability that an asset or loan becomes irrecoverable due to a default or delay in settlements, while the counterparty risk is the probability that the counterparty retracts on the conditions of the contract if the relationship involves a contractual arrangement. The consequences can be severe with a decline in the value of a bank's assets. The credit and counterparty risks inbuilt in Islamic finance are unique owing to the nature of Islamic financial instruments that become the foundation of the instruments asset pools. Unlike conventional financial institutions, Islamic banks do not have access to derivative instruments and other credit risk management mechanisms due to *Shariah* considerations [2,3].

3.3 Shariah Compliance Risk:

The *Shariah* compliance risk is the loss of asset value as a result of the issuers' breach of its fiduciary responsibilities with respect to compliance with *Shariah*. For example, if Islamic Financial tool is based on a hybrid of Ijarah and Istisna assets, Ijarah must always be more than *Istisna* in the pool; otherwise Islamic Financial tool deed will dissolve. Thus, generally speaking *Shariah* compliance risk must be defined as a rate of return foregone in comparison to the market rates as a result of complying with the *Shariah* principles [3]. Moreover, fixed rate Islamic Financial tool faces serious market risks. So, to match the market requirements of Islamic Financial instrument to be floating rate, and the *Shariah* requirements of rents to be fixed rate, the Ijarah contracts are based on a Master *Ijarah* Agreement with several subordinate Ijarah agreements. However, the investors could still face profit rate risk to a certain extent and since the originator can only guarantee the fixed return on the underlying asset pools, the issue of floating rate returns still remains contentious, particularly in pooled/hybrid instruments. Therefore, the association of *Shariah* supervisors with Islamic Financial tools issues will ensure investor confidence [3,2].

3.4 Operational Risk:

The operational risk is in the sense that is inherent to the structure of the issuances rather than the underlying Islamic principles. Furthermore, the risks related specific to the operation are mirror to those existent in conventional bond markets these risks are Default Risk, Coupon Payment Risk, Asset Redemption Risk, Investor Specific Risks, and Risks Related to the Asset (AL-Maghlouth, 2009 & Ali Tariq, 2004).

First, Default Risk is when each party has provisions for the termination of the certificate in the event of a default by the obligor. Second, Coupon Payment Risk is when the obligor may fail to pay the required coupons on time. Third, Asset Redemption Risk is when the originator has to buy back the underlying assets from the certificate holder. Fourth, Investor Specific Risks is when the certificate holder is rendered to several risks relevant to Islamic financial instruments structures such as liquidity management issues in Islamic finance. Fives, Risks Related to the Asset is when the underlying assets of the Islamic financial instruments certificates are subject to numerous risks such that the risk of loss of the assets [3].

3.5 Institutional Rigidity:

The financial infrastructure is weak in most of the emerging economies of the countries, but the financial infrastructure in some of these countries such as Bahrain and Malaysia are well-developed. However, Islamic financial instruments requires unique *Shariah* compliant structures which create a state that can be termed as one of institutional rigidity and that cannot be removed in the short run and always increasing the risks of Islamic financial instruments (AL-Maghlouth, 2009). Furthermore, the features of this state are lack of hedging and financial engineering processes, nonexistence of inter-bank money markets, lack of best practice uniform regulatory standards and regimes, weaknesses in litigation and legal framework support, particularly, in the treatment of default, non-uniform accounting, auditing and income and loss recognition systems, non-robust investment appraisal, promotion and monitoring infrastructure, ineffective external credit assessment systems, rudimentary state of financial markets, and weak inter-segmental support and linkages [3].

Conclusion:

Islamic Financial Institutions now has become the strongest segment in Islamic finance, are involved in the international market and generate significant cross-border flow of funds as may be achieved beyond domestic markets. Along with hard work, growth and balanced development agenda, all countries have the potential to expand the role of Islamic finance is increasing in contributing to global growth and financial stability.

There are some risks and challenges that need prompt solutions in order to sustain the development of Islamic capital market. This requires a close cooperation among Top Management, financial experts *Shariah* scholars on one hand, and more interaction among *Shariah* boards on the other. The focus of the Islamic Capital market and be acceptable to international financial institutions, although these are valid and well needed objectives, but to be *Shariah* compliant first and foremost. This will also help in the growth of real economy and socio-economic development of the society.

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