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ISSUES AND CHALLENGES OF RISK MANAGEMENT IN ISLAMIC BANKS

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Abstract*:* *Islamic bank is a financial institution that is founded and administered according to Shari'ah principles and is universal in its actions to safeguard the wellbeing of mankind. At present, Islamic banking industry is quickly expanding and flourishing. Nonetheless, as time passes, the risks and issues encountered by the Islamic banks are becoming more sophisticated. Therefore, this paper aims at reviewing the literature review of issues and challenges of risk management in Islamic banks. Through literature review, it was found that Islamic banks needs to find initiatives in resolving all challenges that may bring risks to the institutions. To overcome weaknesses in the Islamic banking systems, they need to understand and apply risk management processes as well as maximize the use of efficient strategies. The challenges faced in terms of infrastructure, financial engineering, product offerings, and Shari'ah audit need to be seen from a positive perspective to produce effective risk management.*

Keywords*:* *Risk Management, Islamic Banks, Issues, Challenges*

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Introduction

Generally, risks can be classified as any unwelcome event or effect, as well as the likelihood or statistical expectation value of an event that may or may not occur. Banks must accept or deny risks based on the likelihood and consequences in their daily operations. Furthermore, due to the intricacy of the contracts offered, identifying risks in Islamic banks is more difficult. One of the most significant factors for Islamic banks in dealing with contract complexity is the identification, evaluation, and comprehension of risks; otherwise, Islamic banks may face consequences if risks are not appropriately managed (Ali Basah et al., 2018).

Undeniably, the Islamic banks survival are heavily dependent on their ability to predict financial changes. The banks must be able to effectively manage many risks that they face, without sacrificing performance, quality of service, operational systems, or goals set by the banks' shareholders. If the banks successfully manage their risks, they will be able to turn those risks into commercial opportunities that will generate profit for the banks (Wahyudi, Rosmanita, Prasetyo, & Putri, 2015). In this case, Islamic banks must face issues and challenges to compete effectively with conventional banking procedures. This scenario suggests that Islamic banks must use risk management strategies and approaches in facing of uncertain future events (Ali Basah et al., 2018). Therefore, this study aims at exploring the issues and challenges of risk management in Islamic banks. The structure of this paper is as follows: Section 2 explains the problem statement, Section 3 discusses literature review, Section 4 elaborates the issues and challenges; and Section 5 concludes the paper.

Problem Statement

The Islamic bank is a financial institution that is established and managed under the principles of Shari'ah and currrently, Islamic bank is growing rapidly. However, from time to time, the risk and challenges faced by the Islamic bank will become more complex and extensive. In a global world economy, Islamic banks have to face key challenges in order to effectively compete with conventional banks (Ariss & Sarieddine, 2007). Thus, the future of the Islamic bank is highly dependent on its capabilities to anticipate changes in the financial world, such as the effects of globalization, the chain reactions of effects that can take place when a crisis occurs, and the rapid development of information technology (Wahyudi et al., 2015).

In this light, the management of Islamic banks needs to create a risk management environment by clearly identifying the risk objectives and strategies of an institution and by establishing systems that can identify, measure, monitor and manage various risk exposures (Abdul Kader Malim, 2015). It can also be argued that some risks are much more serious in the Islamic banking than in the conventional banking system. Hence, prudent risk management in Islamic banking is needed to cope with the challenges of globalization and to survive the financial crisis (Rosman & Rahman, 2015). This is because the existence of a weak risk management system has implications that go far beyond the immediate losses borne by individual banks. Instead, extensive losses in the banking context can lead to the collapse of individual banks and even to the banking system more generally with serious implications for the economy in a broad sense (Al Rahahleh, Ishaq Bhatti, & Najuna Misman, 2019). Therefore, any issues and challenges faced by Islamic banks in managing risks need to be identified and overcome to ensure an effective risk management.

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Risks in Islamic Banks

The concept of risk in Islamic banking is similar to that of conventional banking because there is no such thing as a free risk in company, particularly in financial management. The bigger the risk, the larger the profit or loss potential. Financial, operational, business, and event risks may be encountered by both Islamic and conventional risks. Islamic banks may be exposed to additional risks that are exclusive to them, such as Shari'ah risk. (Ahmed & Khan, 2007).

According to (Hassan, 2016), the unique risk consists of Shari'ah non-compliance risk. It is a hazard that develops from disobedience to Shari'ah regulations and principles. For example, the inability to follow the terms and conditions of Shari'ah contracts in terms of contract parties, method of transactions and others basic Shari'ah contract rules. Zainol & Kassim, (2010) also stated other unique risk such as the risk regarding to rate of return which is the risk related to the influence on returns that an unexpected change in the rate of return could have. Rates of return are a concern for Islamic banks. Profit rate risk, benchmark risk, and mark-up risk are all terms used to describe the rate of return risk (RORR) idea. The RORR is seen as one of the primary risks that Islamic banks must address, just as it is for conventional banks. As a result, Islamic banks should be concerned with the RORR because they are expected to manage risk according to Shari'ah principles, which states that no element of interest rate should exist in their transactions (Zainol & Kassim, 2012).

The same writer mentioned about the unique risk above, mention another unique risk which is the displaced commercial risk (DCR), the possibility that the bank may face commercial pressure to give higher returns than those generated on assets financed by investment account holders. To keep its fund provider and discourage them from withdrawing their funds, the bank foregoes a portion or all of its earnings. Given the competition of fixed and higher returns from conventional banks, DCR could pose a threat to Islamic banks. DCR, on the other hand, would not be a danger to Islamic banks if their account users select Islamic banks because of religious need (Arshad, Zakaria, Sulaiman, & Irijanto, 2014). Next risk is about inventory risk, which is risk that associated with keeping products in inventory for resale under a *murabahah* contract or to lease under an *ijarah* contract. For example, in a *murabahah* contract, the client has the option to change his mind and opt out of the transaction. It is likely that the client would back out of the *murabahah* or *ijarah* contracts, which will add a layer of risk to the deal. Once this is discovered, the bank will be held liable for the charge. In an *ijarah* contract, the Islamic bank is exposed to the risk of the residual value of the leased asset at the end of the lease period or during the contract if the customer defaults on the lease (Yousfi, 2015).

Basically, the risks faced by Islamic banks are essentially the same as the risks in conventional banks. The only difference is the unique risks faced by Islamic banks as mentioned above. This difference exists due to the strictness of Islamic banks based on Shari'ah law itself. In Islam, risk is acceptable when it is required for the creation of value. When no value is added, however, it becomes a type of gambling. Additionally, the risk must be unavoidable and inextricably linked to real value-adding transactions. Due to unique criteria to conform with Islamic principles, Islamic banks confront risks that are distinct from those faced by their conventional counterparts (Yousfi, 2015).

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Issues and Challenges

One of the important aspects for Islamic banks in handling the complexity of contracts are identification, evaluation and understanding the risks. Therefore, Islamic banks may suffer consequences if risks are not appropriately managed (Wahyudi et al., 2015). Hence, Islamic banks have to face key challenges in order to compete with conventional banks practices very well (Ali Basah et al., 2018). There are four identified issues and challenges of risk management faced by Islamic banks i.e. infrastructure, financial engineering, product offering and Shari'ah audit.

Infrastructure

Infrastructure implies the fundamental, the basic structure, or the highlights of a framework (Oxford, 2007). As indicated by Rosman (2009), The concept of detecting, assessing, measuring, and defining the intended risk level through risk control and risk transfer is a basic risk management process that is widely acknowledged. Rosman (2009) also mentioned that financial risk management defined by Basel Committee on Banking Supervision (BCBS) is a series of four processes which are identifying events into one or more broad categories of market, credit, operational, and other risks into specific sub-categories, assessing risks using data and risk models, timely monitoring and reporting of risk assessments and senior management control of these risks. On risk management processes, it is requiring supervisors to be satisfied that banks and their banking groups have a thorough risk management process in place.

According to Iqbal (2007), research has revealed that Islamic banks have flaws and vulnerabilities in the areas of risk management and governance. Due to the harmonization and accounting framework problem associated to infrastructure concerns, many banks are permitted to acquire a worldwide or national accounting standard or to expand their own unique financial reporting regulations to fit varied bank conditions (Ilias, 2012). Thus, there is fierce competition between conventional and Islamic banks to fulfil their framework in order to ensure that risk management is carried out in accordance with consumer needs. There is demand in many countries where Islamic banks coexist with conventional banks to apply the same regulation to both types of banks, and a uniform legislative framework is being constructed. In this case, no separate regulatory laws have yet been set to govern the operations of Islamic banks (See Abdullah & Rahman, 2017; Alam, Islam, & Runy, 2021; Ariss & Sarieddine, 2007).

Underdeveloped risk management also can be the issues and challenges that Islamic Banks might face in developing the infrastructures of risk management. Factors that lead to the issues are due to the limited resources, high cost and lack of technological machinations to assess and monitor risk in time (Abdul Kader Malim, 2015). Furthermore, Islamic banks are frequently unable to afford high-cost management information systems, or the technology needed to assess and monitor risks in a timely manner due to their sometimes-limited resources such as to appropriately trained staff, but also suitable risk management software and procedures. Islamic banks' risk exposure is potentially higher due to allegedly inferior management and a lack of effective risk-monitoring mechanisms (Aldoseri & Worthington, 2016).

Therefore, the emphasis on the development of a strong framework as well as a framework that is tailored to the needs of each Islamic bank is really needed. This is so that issues related to the inability of the framework to function when risk management does not arise as well as issues of consumer confidence in the management capability of an Islamic bank on risk can be curbed. Moreover, government in Islamic country should focused more in helping Islamic banks

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development in counter their internal risk to establish believes in consumer especially to non-Muslims consumer heart to use Islamic banks products and services as their preference.

Financial Engineering

The definition of financial engineering according to Shaaibith (2020) is a process that covers various aspects such as design, solution formulation, and development by using innovative financial theories and instruments to solve complex financial problems. The financial engineering process is to redesign the existing financial profile to a more robust financial profile by adapting innovations in the creation of financing tools, renewal of financial instruments and others (Alhasadi & Ilhusadi, 2019). With the advancement of financial technology, it becomes a challenge in financial engineering as it is an important aspect to evolve the existing financial equipment towards a more robust economic efficiency to solve the problems that will occur especially in Islamic financial institutions. This challenge is important to measure the most effective risk management due to the high flexibility and great diversity to bring new consumer type financial instruments to corporate transactions (Iqbal, 2007; Shaaibith, 2020).

From the perspective of Islamic financial institutions, the main challenge for financial engineering that needs to be faced is to introduce new products in companies to be compatible with Islamic-based Shari'ah requirements. The concept of Shari'ah is meant not only in terms of human relationship with Allah SWT, but also in terms of human relationship among human beings who trade in daily financial transactions such as buying and selling. Although to pursue the evolution of economic efficiency, but according to the Shari'ah perspective, there are some economic activities that are prohibited in Islam such as banning usury, gharar, gambling and not allowed to involve in any industry that produces alcohol, pork sales, cigarettes, and entertainment centers. The compatibility of new products with Shari'ah requirements should be able to increase the liquidity of the company's assets or liabilities and portfolio diversification to meet demand from either investors, entrepreneurs or financial intermediaries (Alhasadi & Ilhusadi, 2019; Iqbal, 2007).

Basically, to overcome the challenge of using financial engineering methods in Islamic financial institutions, they must strive to provide a lot of commitments while attracting public trust to use Shari'ah-compliant institutions based on the risk return characteristics of the products offered, not relying on Islamic or non -Islamic product facts. Therefore, it is important to understand the risk return characteristics of each system building block so that the generated system is used effectively, in addition to offering new products with different risk return profiles to meet customer requirements (Iqbal, 2007).

Another challenge that needs to be faced in financial engineering for Islamic financial and banking institutions is the need to streamline all the production processes of new products in the market so that they can be standardized with all four the Islamic scholars used. In this case, to ensure the production of new Shari'ah-compliant products requires cooperation with Islamic legal scientists or muftis who are recognized to apply Islamic laws in Shari'ah-compliant bank. This challenge requires a very thorough procedure as it relates to Islamic law such as allowed or forbidden contracts. This process needs to consider the consent of the majority of fuqaha' for each contract introduced, and each Islamic contract and financial instrument must be analyzed first. The purpose of achieving uniformity is because the religious boards for each Islamic bank globally have different views and opinions. It is important to research and evaluate each new product offering in order to minimize confusion to customer (Alhasadi & Ilhusadi, 2019; Iqbal, 2007).

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In order to face the great challenge of finding the best mechanisms to mitigate risk, the field of financial engineering in Islamic banking institutions can take some benefits from Western or conventional institutions that are more experienced and more sophisticated in the financial markets. This is because sustainable development to produce new products is high risk as it requires high cost and uses effective resources. Conventional institutions can justify these costs because they have invested heavily in infrastructure to create new products. Therefore, Islamic financial institutions must reasonably consider making joint efforts in risk mitigation other than issuing product variants that differ from conventional ones in terms of risk profile and return without using interest (Iqbal, 2007).

Product Offering

Islamic banking faces several challenges that must be solved in order to ensure its development in the future. The industry's response to these challenges will determine whether it become a viable alternative to the conventional financial system in global markets. The industry's first and most pressing difficulty is establishing to its identity. The question of whether Islamic banking and finance (IBF) wants to maintain its place within conventional banking and finance or build a distinct market outside of it is crucial. Moreover, the Islamic banking industry is exposed to various risks such as lack of legal framework, qualified workforce and effective government support. Among the challenges that have a major impact on Islamic banking institutions is product offerings. This is because it plays an important role in gaining the trust of customers (Muhammad, Sairally, & Zada, 2016).

According to Bhuiyan, Ismail, Siwar, and Hassan (2019), offering new products with different risk-return profiles that meet security and liquidity demands among investors and entrepreneurs is a major challenge for Islamic banking. In addition, they also need to introduce new Shari'ah-compliant products based on an understanding of the risk-return characteristics of each system building block. This is because most of the products offered by Islamic banking are seen as imitating conventional banking products. In fact, Islamic banking uses the basic framework of sectoral governance and legislation from conventional banking as an effort to apply the muamalat system. Additionally, Islamic banking is also still tied to the conventional system in terms of risk measurement which involves certain reporting and standards. In conclusion, Islamic banking needs to be more innovative in producing products that can meet the needs of investors, entrepreneurs, consumers, and the Islamic community (Ab. Aziz, 2021).

Although Islamic and conventional banking products are similar but Islamic financial products are more complex in terms of structure. To meet the requirements of a product that is structured with Shari'ah standards, it requires substantial transaction costs. Furthermore, the Islamic banking industry lack of short-term investment products. In Malaysia, banking institutions have implemented product alternatives according to European countries where commodity *Murabahah* financing as a short-term financing instrument is widely used. However, Islamic banking in Malaysia is unable to generate assets to bear credit ratings and liquidity issues. Therefore, cooperation from financial experts and Shari'ah supervisory councils is very important in finding Shari'ah-based solutions to overcome this problem as it can provide high risk and require greater capital (Malik, Malik, & Mustafa, 2011).

Shari'ah Audit

Shariah audit is a monitoring tool for ensuring Shariah compliance proved to be an important component in the operations of Islamic financial institutions (IFIs) (Isa, Ariffin, & Abidin, 2020). Shari'ah audit is defined as "the regular assessment conducted on a regular basis to

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obtain an independent review and goal assurance in connection with the business operations of Islamic Financial Institutions (IFIs), with the main goal of ensuring a strong and effective internal control systems for Shari'ah compliance" (Omar, 2019). Shari'ah audit is a crucial job of IFIs since it provides an unbiased assessment of whether or not the institutions are Shari'ah compliant, which is their fundamental purpose. Shari'ah auditors often undertake the tasks of internal auditors at each IFI. However, the success of such duties will be determined by the obstacles that auditors face when executing Shari'ah audit practices (Mohamad Puad, Shafii, & Abdullah, 2020).

There are now a number of barriers in the way of IFI audits, particularly in terms of shariah compliance auditing. AAOIFI's attempts to promulgate auditing standards, the focus and breadth of auditing standards tend to concentrate on financial statements rather than the larger idea of shariah audit, which includes the audit of all IFI activities based on maqasid al-shariah. Furthermore, AAOIFI's usage of the phrase "shariah review" instead of "shariah audit" may imply a lower level of assurance in the former situation (Arwani, 2018). The same author also mentioned that the issues of External auditors, SSBs, internal shariah reviewers, and the Audit and Governance Committee are just a few of the bodies that perform shariah audits or reviews. While external auditors serve as an external method for monitoring compliance, their lack of expertise causes them to rely largely on the SSB's fatawa, when they should be making an independent decision on the matter.

Additionally, issues and challenges of the Shari'ah auditor's incompetence have been impeded by a lack of both Shari'ah and accounting understanding till now. Those who are familiar with accounting are unlikely to be familiar with Shari'ah, and vice versa. From the beginnings of modern Islamic finance in the 1970s, this has been a point of controversy. It should be noted that to understand and audit IFIs, a Shari'ah auditor must be well-versed in both accounting and Shari'ah. Education in Shari'ah, accounting, and auditing is vital for enhancing the knowledge and expertise of actors involved in Shari'ah auditing in particular, and IFIs in general (Yaacob, 2012).

Based on the difficulties raised in this point, it is closely tied to Shari'ah audit authorities' ability to carry out their duty in ensuring greater risk management implementation from time to time. Apart from that, there is still a scarcity of persons with both Shari'ah and accounting qualifications in the Islamic banking industry, which could be due to a lack of transparency in the hiring process. These certifications are crucial in ensuring that Islam's vision and goals are upheld within Islamic financial organisations. According to AAOIFI Auditing Standards (2010), the auditor must be aware about Islamic Shari'ah rules and concepts, according to Yaacob and Donglah (2012). However, because he or she will not have the same degree of understanding as Shari'ah supervisory board members, the auditor will not be expected to interpret these (Islamic) rules and concepts. The auditor evaluates whether the IFI has followed the Islamic Shari'ah laws and principles based on the fatwas, rulings, and guidance issued by the SSB. This will also be used by the auditor to determine whether the IFI's financial accounts have been prepared in compliance with Islamic Shari'ah norms and principles."

Conclusion

In conclusion, Islamic banking needs to find initiatives in resolving all challenges that may pose a risk to the institution. To overcome weaknesses in the Islamic banking system, they need to understand and apply risk management processes as well as maximize the use of efficient strategies. The challenges faced in terms of infrastructure, financial engineering, product

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offerings, and Shari'ah audit need to be viewed from a positive perspective to produce controlled and effective risk management. This is important in ensuring public confidence in Islamic banking as well as in maintaining the Islamic identity itself. The aim is for Islamic banking keep remain in the financial industry globally.

In fact, the financial industry needs to be aware the requirements of Shari'ah governance as well as product methodology reform is a real challenge. Therefore, they need to find a solution because it does not require ingenuity in identifying the problem. One of the most important factors for Islamic banks in dealing with the complexity of contracts is by conducting risk identification, assessment and understanding. This is to ensure that all risks and challenges can be managed in an appropriate manner. Shari'ah advisers' qualifications and experience are used to evaluate and help in the construction of Shari'ah-compliant financial services. If all of the risks are mitigated, the Islamic bank can turn the risk into a business opportunity that generates revenue.

Finally, with the passage of time, difficulties and hazards are continually changing. As a result, the Islamic bank's capacity to forecast financial shifts is critical to its existence. Islamic banking must also maintain its competitiveness by meeting or even exceeding conventional banking norms.

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