Risks Facing the Profit-loss Sharing Banking System Within The Global Financial Crisis

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ABSTRACT:

While conventional banks are facing challenges to resolve problems emanating from the worst financial crisis in living memory, the Islamic banking sector is flourishing and remains in relative prosperity.

However, dynamic changes occurring in the global financial world pose various risks to banking institutions. Islamic banks are not immune to such risks. Their relative continuous prosperity depends on how well they manage such risks. Identifying these risks sheds light on challenging these risks. Unlike conventional banks, Islamic banks share business risks with investors and borrowers. The difference lies in the nature of risk sharing. This paper examines the different types of risks associated with different schemes of financial contracts that Islamic banks are facing. The paper also addresses several policy implications to promote risk management in terms of globalization and culture changes within profit-loss sharing banking industry.

Keywords: banking institutions, credit risk, Islamic banking.

INTRODUCTION:

Islamic banks have a unique risk profile because of the need to make their products Shariah (jurisprudence)-compliant. The future of Islamic financial Islamic institutions depends to a large extent on how they well manage their risks. This paper examines risks associated with the most common practice schemes of Islamic banks. Part (I), exposes the nature of Islamic economics with reference to the main issues of usury denial and prohibition of credit trading which are at the source of providing different schemes of financial investment by Islamic financial institutions. Some relevant macroeconomic issues are enumerated along two main types of financing pertaining to Islamic financial system. Part (II) and (III) identify systematically most critical risks formation in Islamic banking operations.

I -Issues facing Islamic financial system:

Islamic economics is loaded with normative values, unlike economics which is often emphasized to be a positive science. The injection against interest bearing and the prohibition of

credit trading are taken axiomatically unchanged by Muslim scholars. The emergence of interest-free financial institution in Muslim countries as well as in other parts of the world, came into existence to satisfy financial needs and banking services of devout Muslims (1.6 billion) who wish to abide to Islamic jurisprudence laws.

In contemporary economies, banking industry is the industry which is most vulnerable to risks. The ever changing nature of risks is emanating from the development of financial liberation, novelty in banking operations as well as development of new financial devices supported by the advancement of the ITC sector in the banking industry.

Risk management is gaining primordial importance in the banking sector. Basel committee considers risk management as one of the most important factor in determining bank capital adequacy.

Traditional as well as Islamic banking sector developed a specialized management department to manage different risks facing the banks.

The distinguished features which characterize Islamic financial system are the introduction of the profit-loss sharing instrument and the denial of credit trading, instead of the rate of interest rate and the permissibility of credit trading as mechanisms for resources allocation. The Islamic banking system operates on a fully equity-based system. This implies some changes on both the deposits side of the banking industry and the investment financing schemes. On the liabilities side there are two types of deposits:

a. Transaction deposits: This corresponds to current account where their nominal value is guaranteed with a 100 percent reserve requirement against them and bear no interest rate payment.

b. Investment deposits: Holders of these investment deposits accounts are not entitled to a fixed return but the holders receive pre-agreed shares of the banks' profits. The funds of these investment deposits are channeled to finance investment ventures on risk-sharing basis.

There are many types of partnerships. The most common operating forms are:

a. Mudarabah financing: Under such a form the bank provides financial capital to the entrepreneur for a pre-agreed share in the profit. In case of financial losses, the bank bears the capital loss while the entrepreneur loses time and effort.

b. Musharaka financing: in such venture, there are many contributors of funds with each sharing profits and loses in proportion to their capital contribution.

Within this setting there are some important macroeconomic implications, at least in the short-run. By eliminating fixed *interest* **payment, the transactions and precautionary motives would still hold for the demand for cash, as would the effects of inflationary and deflationary expectations. This leads to a real demand for money function containing as arguments rate of returns on the spectrum of permissible Islamic financial and physical assets (shares' ownership, land, etc.) along with a measure of real wealth and permanent income.**

With respect to the supply of money, there exit two accounts: transaction account and investment deposits. The issue is whether these two accounts should be separated or integrated? According to Fama (1980), a system in which checks can be written against all types of *deposits*, including investment deposits is workable. Thus funds in the investment account in an Islamic bank could circulate as money which gives rise to certain expansion or contraction of the money supply.

With respect to monetary policy, there exist two points of views: first, under fractional reserve system, the effectiveness of monetary policy is whether profit-sharing ratios should be legislated by government or left to be determined by market forces.

Secondly, there are those who advance the view of adopting a model requiring 100% reserve requirement on demand deposits a (transaction accounts). The presumption is that such deposits are placed as safekeeping and therefore must be fully backed by reserve. Khan (1985) argues that the model requiring 100% reserve requirement makes the system more efficient because:

a. Whereas any switch from high-powered money to deposit money and vice versa in the traditional reserve system creates an inherent instability; such a switch in the 100 percent reserve system would only change the composition of money, thus leaving the total supply constant .

b. By eliminating any differences between the monetary base and the money supply, thus making the money multiplier equal to unity, the 100% reserve system forces the banking system to be fully liquid. This model would preclude the central bank from using variation in the reserve ratios as policy instrument.[1]

To this extent, monetary policy would be attenuated and stabilization would have to be realized through control of the monetary base rather than credit.

II -Notorious Risks facing Islamic Banks:

The implementation of Islamic financial institutions came into existence as a response to the resentment of a segment of the Muslim population towards the usurious practice of traditional banks. These new institutions offer alternative ways to wealth holders in conformity to Islamic dictates concerning the issue of usury. Such institutions are changing the saving behavior of the traditional segment of the population and integrating this segment in the process of capital formation by transforming their real asset saving into financial saving.

However the new financial system has many issues to be resolved that can be enumerated as follows:

1. The absence of fully observed Islamic ethics and the lack of a well developed legal framework, witnesses the emergence of a risk of moral hazard along with the risk arising from market forces outcomes, which may lead banks to concentrate their asset portfolios in the real estate sector or in short term trade financing, thus constraining capital formation.

2. **One may expect an increase in information costs with respect to investment deposits. Depositors would have to evaluate different performance records of banks. Thus highly integrated information sharing capital market is needed.**
3. **With respect to the types of Islamic financial ventures, banks also face a rise in their information costs by placing more emphasis on the profitability and viability of specific projects. Such a task requires heavy costs to monitor, supervise and audit various project. Thus a call to industry experts is dearly needed and very costly.**
4. **The elimination of interest rates weakens the effectiveness of monetary policy unless suitable substitutes, such as variation in the profit-sharing ratios, are developed.**
5. **With respect to financing a government budget deficit, difficulties also arise in search for appropriate non-interest based instrument.**

Islamic banks evaluate the risks attached to their investment financing more rigorously than their *counterpart* **traditional banks. Both banks are exposed to risks associated with borrowing agents, political and economic risks and exchange rate risks. However Islamic banks carry extra burden for the fact that they share an extra risk associated with the outcomes of the projects they finance. Unlike traditional banks, Islamic banks share capital risk. There is somehow a misconception concerning this issue that Islamic Banks are more exposed to risks. Islamic jurisprudence which is the source of supervising the working of Islamic banks, has spelled out rules and boundaries that governs Islamic banks' activities. Any operation that yields a return with guaranteed associated capital is not permissible for the absence of the element of risk facing the financial provider. On the other side, gambling activity which yields a positive or negative return is not permissible for the fact that there is 100% risk facing.**

Within an interval boundaries of 100% guaranty and 100% risk sharing lays the space of permissible activities of Islamic banks.

The management of profit-loss sharing mode by Islamic banks is more complex than conventional financing in traditional banks. Such a mode of profit-loss sharing imply the determination of profit-*loss* **sharing ratios on investment ventures across various sectors of the economy, as well as the ongoing auditing of financed projects to guarantee proper governance and appropriate valuation.**

According to Tlemsani (2009), Islamic banks have no legal means to control he agent-entrepreneur who manage the business venture which is financed through Mudarabah scheme. This individual has complete freedom to manage the enterprise according to his/her best judgment and expertise. Banks are contractually entitled only to share with the entrepreneur the profits or losses of the venture according to the agreed-upon shares. In case of Musharaka financing scheme, banks have better opportunities to monitor the business they finance because, in these arrangements, partners may influence the management of the enterprise and exercise voting rights.

III- Challenging Risks

Risk management has not been the prime focus of Islamic banking sector until recent years. The concern of Islamic banking was concentrated on growth and creation of innovative instruments in compliance with Islamic jurisprudence and on conducting a fierce competition in an increasingly competitive market. Shariah-compliant assets worldwide are approaching $600 billion and have been growing at more than 10% per year over the past decade.

Standard & Poor's has estimated that the market has a potential size of $4 trillion.[2]

To consolidate their role in the financial system, Islamic banks need to get to grips with risks which are not currently well understood or well managed.

Islamic bank depositors and investment account holders are obliged by contract to accept lower rates of return and absorb losses when there is an under-performance of bank assets. Thus Islamic banks are more prone to provide their clients full information concerning the performance of their investments, especially with respect to Modarabah contracts which should be presented as an asset management business.

The Islamic banking sector is well known with its relatively high concentration of real estate exposure which exposes the bank to counterparty risk. Better reporting and disclosure would help improve more confidence in the sector, especially when the bank is involved in a venture by sub-contracting out the work. In case of under-performing sub-contractor work, the bank is subject to awkward legal risks.

Islamic bank real estate portfolios seem like a potent mixture of high risk and awkward moral hazard.

Another key issue roams in the coulisse of Islamic banks is whether the products and services provided by these institutions are compliant with Islamic jurisprudence (Shariah). There is an ample evidence of divergence in issues pertaining to their normative aspect as well as to lack of uniformity of Shariah standards. Islamic banking products and services are getting more complex and tricky and there is a real risk of future compliance dispute among different Islamic schools of thought. Such disputes based on nuances and complexities may obscure the real risks that Islamic banks are facing at both the transactional level and the portfolio level. Some living raised issues have inflicted devastating reputational damage to some banks.

CONCLUSION:

Within the realm of actual financial crisis, risk management practices within the conventional banking system are under intense scrutiny. The lessons are still under digestion. The risks discussed in this paper are pertinent to the unique features of Islamic banking.

The sector is in dear need to focus on strong risk management, robust governance and clear transparency in their activities. The issues of displaced commercial risk, real estate concentration

and reputational risk all emanate from the complex nature of Islamic banking relationships and products and the tensions between shariah laws interpretations. A need for uniformity in Shariah interpretation would enable banks to act more confidently and seize opportunities and integration into the international financial system within the living financial crisis.

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