Managing credit risk in Islamic banking

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Islamic banking is a system based on the principle of Islamic moral act (shari’ah). Shari’ah guides Muslims in every field of their life which may be social, economical, political etc, with their rights and duties. This moral law (shari’ah) of Islamic sector is the way of promoting justice as well as welfare in the society as the order of Allah. Islamic banking is said to providing transparency and documentation is banking system. Islamic banking plays important role in economic regeneration and social justice (Siddique, 1995) Islamic banking is being adopted and popular all over the world in recent years, because it provides a transparent system of banking. Islamic banking is expected to have characteristics like Islamic and ethical behavior, Good governance with people, Maintain customer relationships, Fair dealing with everyone, Deduction and provision of zakah, Focus on safety and security of staff, balanced goals with environmental protective and friendly projects and Doing research and development (Hassan, S Harahap, 2010). As the Islamic Banking is being popular it also has many types of risks including credit risks also. Credit risk is defined as the potential of counter party which not succeeds to meet its responsibility toward their agreement. It can also be described as credit or counter party risk is the chance that debtor of a financial instrument, whether individual, a company or a country will not repay principal and other investment related cash flows according to the specified terms in a credit agreement.

The Islamic Banking System is an important component of Islamic finance. It has inimitable characteristics because its base is laid on the principles and rules of Islamic Law (Al-Shari’ah), which says that the whole thing is owned by Allah and man has only been allowed to use it (Chapra 2000). Risk and equity sharing are the main characteristics of Islamic banking. Another mainly crucial characteristic of Islamic banking is the ban of interest (riba). It did not charge and not give interest in a straight way where the imbursement of interest is put in advance and viewed as the fixed value of credit or the payment for capital invested. It invests capital and reward only on the base of profit and loss sharing. It also has the entrepreneurial features. It also spotlight not “only on financial growth but also on objective growth of economic manufacture and services” (Haiwad 2008, 12).
Islamic banks are also revenue making organizations just as conventional banks, but they run all their actions in according to Al-Shari’ah law. Islamic banking arises when Muslim intellectuals have to use conventional banking and another main reason was colonial rule in Islamic countries. In 1963 Egypt and Malaysia started this sector and later on many other Arab and Muslims countries also started it, such as Sudan, Pakistan, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates. Now Islamic banking institution is working out more than 53 countries and 70 countries have same kind of structure in their institutes. The volume of Islamic banks approximately around the globe was expected to be close to USD 850 billion at the end of 2008 and is estimated to develop by around 15 percent annually (Yilmaz 2009). According to a trustworthy estimate, the Islamic financial commerce now increased to over USD 1 trillion (Al Maraj 2010a). It is expected that the organization could double in amount within ten year if the past routine are sustained in the future (Mersch 2010). There were some organizations with a fixed rate on capital of more than 30 percent and in rare situation smooth more than 40 percent. They were also capable to make an average profit on assets approximately 10 percent (Al Maraj 2010a). The problem facing by the Islamic banking are the world financial disaster which makes a lot of problems for its continuous production. But in this disaster it was favored because According to a recent IMF study (Hasan, Dridi 2010[1]) Islamic banks carry out healthier than conventional ones in 2008 in word of profitability, credit and asset production. The Islamic banks’ profitability crisis was minimum 10 percent, while the conventional banks’ profitability drooping up to 35 percent in 2008 contrast with 2007.

For more than past few decades, Islamic banking and finance has been emerging from a thought and a term of Muslims’ individual distinctiveness to an established and fast-growing industry. From the most recent worldwide economic disaster, it became one of the mainly discussed issues around the globe. It is noteworthy that British usury laws were abolished during the nineteenth century. In the USA, however, these continued until 1980, whereby one of the last acts of President Carter was to allow lenders unfettered liberty in charging borrowers. A term collective imagination is used here which is the voice of 33 first-rate UK-based experts (gathered by the British Academy) and addressed to the British Queen. She asked
a flimsy question from the group of academics during her visit to London school of economics “why did no one see it (the crisis) coming?”

To attempt this apparently simple query, a memorandum was arranged by the group and co-authored by Peter Hennessy and Tim Besley. This explained that lower rates of interest rates made loan available to every person whether he was in a position to pay it or not. This credit crunch was brought about by the some widespread practices (fixed interest rate, corporate earnings, nature of the executive payment-bonus system). (Shubber, May 26th, 2011).

In Australia, Muslims are in the form of minorities and there is no Islamic banking there due to following reason the regulatory regime for Islamic banking in Australia and legal and regulatory challenges faced by it and lack of Islamic insurance and other Australian legal concern and also there is lack of compliance of Islamic banking with Australian rules but the Islamic banking is growing in Australia and Muslim population which is 2% of population they require a major institute of Islamic banking and finance.

Some Credit risks are specific to Islamic Banking, As in Murabaha transactions the credit risk is that banks deliver assets to the clients and clients do not give payments in time. In Non-binding Murabaha transactions clients may refuse the delivery of the product purchased according to his right on the agreement. In Istisnah contracts banks have risk of failure of supply on time or no supply at all. Such type of risk causes default of payments and banks goes into loses. In case of Mudarbah investments there are two parties’ banks as Rab-al mal (principle) and external agent or client as Mudarib. Banks gives a right to the Mudarib to use the capital business purpose. Bank does not have any influence in decision making and also not have any sufficient evidence in case of losses are claimed by the Mudarib. The risk is especially in the markets where the transparency of Mudarib is low. Credit risk is arising in Islamic banking when bank pays money under the Salam or istina contract and deliver goods under the murabaha contract before receiving its own asset or money. (Khan and Ahmed, 2001) Supply of credit is depend on the change in inflation rate, total deposit, time lags of the variables.
LLP (loan loss provision) has been identified in place of credit risk that it should have a positive and significant relationship with NPL (non performing loan) higher the LLP means increase in risk and reduction in loan quality. Contractually Islamic bank depositors accept losses or lower rate of interest when assets are under perform through which the bank manage the risk. In mudharaba contract clarity is provided on investment and stimulus to them to accept the associated risk. Islamic banks have enough concentration of long term asset and cash to set off their floating liabilities. Sector clear the nature of risk and better disclosure of risk to create the confidence in their stakeholders. Efficient operational risk measurement and better risk reporting criteria to sure that in case of any disputes event they are protected, different techniques are being used e.g. Derivative financial instrument being used to create the right and obligations between the parties, determine the risk management, foreign currency exchange and interest rate of exchange etc. The standard should deal with the disclosure of qualitative and quantitative data. All term and conditions must have mention on financial instrument which have significant effect on foreign exchange. The weighted average or range of interest rate for each class of instrument must be presented. In balance sheet the carrying amount (book value) should be including exposing the credit risk of financial asset. Credit risk management in Islamic banking is very difficult because the banks are prohibited to charged interest and penalties. Clients delay the payments because they know that banks will not charge any penalty for that. Due to these delays banks investments are stucked and banks don’t earn profit or any income. Organizations assessing the both qualitative and computable market risk due to structural nature and frequent changes in economic condition (Rag van and Li, 2006). In case of negligence proven from the side of Mudarib the contract is transformed into misconduct of Mudarib.

Now banks use collateral securities and pledges against the credit risks. Banks can demand additional pledges or securities before the Mudarbah contract due to weak legal rules. Difficulties can be reduced by some ways like looking into Banks policies which already exist and its methodologies of carrying out policies of credit risk with overview of the classification of the assets of the bank. Finding any current factor which can affect credit risk and cause lose to
the bank, Trend analysis is also taken from the historical data to get findings about loses. Current policies are reviewed and betterments are suggested for them.

Lease financing instrument directing to the risk sharing financing used by CII. Lease financing is a hybrid between debt and equity if profit loss sharing is not properly support to lying interest free economy then lease financing tool predominantly used in overall financing operations (council of Islamic ideology (CII), p. 13). The CII proposed the participation terms certificates instead of debenture (council of Islamic ideology (CII), 1980, p.36) because it has risk sharing features and provide lack of solution of hurdles for interest averse nature borrowers and institutions, low wide range of risk sharing and secondary markets. There are also strategies to manage the credit risk in Islamic banking. Likewise to manage the risk the credit exposures to individuals are reduced. Working with clients knowing there problems of credit and finding solution to these problems. In case of default carrying out legal actions and calling on the guaranties and liquidating collateral securities, (Greuning, Iqbal, 2008)

Interest free economy mark up reduced and permitted for special conditions, but in 1985 state bank of Pakistan(SBP) show willingness that banks invest their PLS finance in interest free government securities so that properly Islamic banking system revolved in Pakistan economy(zaidi, 1987). The SBP take active role in interest free economy reduced the interest based schemes like deposits, national certificates, saving monthly income, defense national finance certificates, higher rate against investment (Rahman, 1997). The SBP can use the fixed rate tool for avoiding from credit risk of banks, in which SBP fixed the rate that any banks can lend outside in this way limit of advance amount restricted. The SBP manage dual banking system interest free system inclined and interest based financing reduced and claimed that who reduced the risk factor in Islamic banking because bank face many difficulties in performing lending and advances functions so SBP maintain itself risk averse market environment.

In 1984 Islamic banking concept was introduced through which the interest free loan scheme was introduced. Its market share increase from 0.3%in 1984 and 9.4% in 2003. Standards (FRS) for Islamic banking being established in Malaysia and this standard trace the market risk being
face by all companies of Malaysia. Lease financing instrument directing to the risk sharing financing used by CII.

In Affin Islamic banks perform splendid management in credit risk. Affin Islamic is a part of Affin banking group of Malaysia developed in 2006 April completed Islamic commercial banking system. Affin distributed finance for diversification of sector of the economy and banks are in nature of exposure had very risk factor than other sector because these sector are vulnerable to economic and business cycle. The management team actively involve to pretending from credit risk which reduced profit in Affin Islamic. For this structure and operational changes require. Avoiding from risk established separate group not on branch level but on broad level so that risk factor can be manage. The authority and approvals of financing limit of that group had been cleared. In exacting, the study analyzes the significance of the Islamic banks’ financing and deposit in channeling the monetary policy special effects to the economy. Malaysia has a dual banking system; it is then appealing to notice whether the Islamic banks are also capable to respond in a parallel approach with the conventional banks once the central bank imposes a definite monetary policy. The study shows that there is displaced commercial risk in the Islamic banking in Malaysia which increases the importance of Islamic banking. We also found that Islamic deposit is a very central cause of financing for the Islamic banks. The results show that Islamic banking plays a vital duty in the diffusion process of monetary policy in Malaysia. Policy makers should take into consideration the role of Islamic banking in their design and implementation of monetary policy. Policymakers should remain vigilant to Islamic banking as they are with conventional banking. (Sukmana & Kassim, 2010)

5 steps involve in risk management functions; identify the risk first, measurement and assessment of risk, mitigation and control of risk, review and monitoring of risk, reporting the risk to Affin Islamic in same order as in conventional banking. In the annual report of Affin Islamic 2008, for risk management broad risk management committee established (BRMC). Other committee’s broad loan recovery committee (BLRC), management loan committee, Asset and Liability management committee (ALCO), operational risk management committee (BRMC) performed their functions in managing credit, liquidity and operational risk. Risk management
process based on the shariah advisory council (SAC). SAC deliver the report to board of director and then it is transfer from Affin Islamic to BRMC. Risk management committee taken some operational strategies to reduced the credit risk these are, financing problem transfer to holding company, uncollectible finance write off, securitization, financial structure reclassified and rehabilitate, receivable efforts strength, credit policies strict, financing portfolio mix changed.