

AL-ITQĀN

JOURNAL OF ISLAMIC SCIENCES AND COMPARATIVE STUDIES

Special Issue (1)

November 2018

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eISSN:26008432

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Tel: +603 6196 5558
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Published by:
IIUM Press, International Islamic University Malaysia
P.O. Box 10, 50728 Kuala Lumpur, Malaysia
Phone (+603) 6196-5014, Fax: (+603) 6196-6298
Website: <http://iiumpress.iium.edu.my/bookshop>

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Risk Management in Islamic Finance: What does Islam Say about *Mukhāṭarah*?

Syahiru Shafiai*
Engku Rabiah Adawiah Engku Ali*

Abstract

This article offers an observation on the concept of risk (*mukhāṭarah*) management in Islamic banking, based on the Islamic commercial laws (*fiqh al-mu'āmalat*). Beside the conventional system, the authors explore some issues of Islamic banking system such as *Sharī'ah* compliance, objectives of Islamic law (*maqāṣid al-Sharī'ah*) as well as other related issues. The study is based on a qualitative methodology, whereby critical and textual analyses and a comparative approach are applied on relevant written materials. Findings reveal that risk management issues such as contractual uncertainty (*gharar*), interest/usury (*ribā'*), and others are thoroughly deliberated and addressed in the discourses of Islamic commercial laws. This article attempts to shed light on some of the issues and to formulate some recommendations for enhancing and improving the current *Sharī'ah* risk management and *Sharī'ah* governance in Islamic banks.

Keywords: Risk management; *Sharī'ah* committees; *mukhāṭarah*; *Sharī'ah* non-compliance event; Bank Negara Malaysia.

Introduction

As Islamic finance has grown globally, the industry has shown great achievement over the past four decades with the establishment of the Islamic Development Bank (IDB) in 1975. After tremendous growth, it continues to expand and develop in size and complexity. Globally, the accumulation of assets from this industry is anticipated to hold more than USD 1.3 trillion and approximately 80 % of this figure is based in Malaysia, Qatar and the Kingdom of Saudi Arabia (KSA) (EY, 2015). Its economic and social impact are increasingly evident in societal

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sectors including savings, investments, wealth management, infrastructure, industry, philanthropy as well as trade.¹

Simultaneously, according to Global Islamic Finance Report (GIFR, 2017), Malaysia has always been an important player in the global Islamic financial system and also leading in the global *sukuk* issuance volume.² Malaysian government will continue to ensure that Malaysia will be a global leader in Islamic asset management.³ Therefore, *Sharī'ah* committees are central to Islamic financial structure and they play a significant role in the efficient functioning of the system besides sustaining Malaysia's pole position in Islamic finance within Asia countries.⁴ Financial transactions, services or products that claim to follow Islamic standards must be assessed according to a given set of *Sharī'ah* precepts. This is to ensure the Islamic financial contracts are align with *Maqāṣid al-Sharī'ah*, which is the goal of the Islamic financial system and guidance for Islamic finance procedures.⁵ The *Sharī'ah* committees must be committed to ensure that various policies and regulatory responsibilities are adhered to and that *fatwā* (pronouncements) issued by the *Sharī'ah* committees are always in the best interest of the banks and stakeholders.⁶ Hence, *Sharī'ah* committees must be equipped for a range of challenges – from anticipating the unpredictable to planning accordingly, to managing *mukhāṭarah* and the issues of *Sharī'ah* non-compliance events in the context of the Islamic financial institutions in Malaysia, whilst continuing to capture and exploit opportunities as they arise. These challenges come from within the industry and also from external factors. Abozaid, points out the legal challenges Islamic finance is facing which is a risk that may put its credibility at stake and pose a more serious threat to its long-term

¹ Mushtak Parker, 'Game-Changer for Global Islamic Finance', *New Straits Times* Kuala Lumpur, 2018.

<<<https://www.nst.com.my/opinion/columnists/2018/06/376749/game-changer-global-islamic-finance>>>, accessed 12 October 2018.

² GIFR, *Global Islamic Finance Report 2017*, Dubai Islamic Bank, 2017.

³ Ahmad Husni Hanadzlah, 'Powering the heart of Malaysia: Islamic banking's new frontier', in *Catalyzing For Change - A Financial Perspective*. Kuala Lumpur: MPH Publishing, 2012.

⁴ Ahmad Husni Hanadzlah, 'Malaysia as an Islamic Financial Hub', in *Catalyzing for Change: A Financial Perspective*. Kuala Lumpur: MPH Publishing, 2012.

⁵ Rusni Hassan, 'Shariah Non-Compliance Risk and Its Effect on Islamic Financial Institutions', *Al-Shajarah: Journal of the International Institute of Islamic Thought and Civilization (ISTAC)*, 21 (3), Special Issue, 2016, 21–25.

⁶ Fayaz Ahmad Lone and Siraj Ahmad, 'Islamic Finance: More Expectations and Less Disappointment', *Investment Management and Financial Innovations*, 14.1, 2017, pp. 134–41.

success and its very survival. As the author notes, Islamic banks should have a specific number of the most credible, experienced and qualified *Sharī'ah* scholars from various jurisdictions and school of thoughts.¹

***Sharī'ah* Precepts Governing the Islamic Banks**

Global Islamic financial systems used by the operation of Islamic finance in dual regulatory systems are driven by the need to fulfil both Islamic law and the multiple conventional governmental frameworks within which the industry operates around the world. An Islamic bank is an institution offering financial services which conforms to *Sharī'ah*. A set of *Sharī'ah* principles governing the operations of Islamic banks are (i) prohibition of dealing with interest/usury (*riba*); (ii) financial contracts must be cleared from contractual uncertainty (*gharar*); (iii) exclusion of gambling (*maysir*) in any financial activity; (iv) profit must not be originated from *haram* economic and financial activities (prohibited industries such as those related to pork products, pornography, or alcoholic beverages); (v) each financial transaction must refer to a tangible, identifiable underlying asset; and (vi) parties to a financial transaction must share the risks and rewards attached to it. The principles mentioned above must be conceptually inherent in Islamic banks in order to distinguish them from conventional banks.²

Islamic banking is ruled by the *Sharī'ah* and the interpretation of *fiqh al muamalat* (Islamic commercial law). *Fiqh al muamalat* comprises guidelines of business conduct, permissible forms of business and desirable and undesirable modes of transaction. Any product or services claiming to be *Sharī'ah* compliant, needs to conform to *Sharī'ah Islami'ah* (Islamic teachings) in all aspects of its operation including marketing, governance, accounting, management, and governance.³ It is important to understand that *Sharī'ah* complies based on what is known as the “principle of permissibility”, which means everything is

¹ Abdulazeem Abozaid, ‘The Internal Challenges Facing Islamic Finance Industry’, *International Journal of Islamic and Middle Eastern Finance and Management*, 9.2 2016, 222–235.

² Habib Ahmed, ‘Islamic Banking and Shariah Compliance: Product Development’, *Journal of Islamic Finance*, 3.2, 2014, pp. 15–29; Sabur Mollah and Mahbub Zaman, ‘Shari’ah Supervision , Corporate Governance and Performance: Conventional vs . Islamic Banks’, *Journal of Banking & Finance*, 58, 2015, 418–35.; Siti Mashitoh Mahamood and Asmak Ab Rahman, ‘Financing Universities through Waqf, Pious Endowment: Is It Possible?’, *Humanomics*, 31.3, 2015, 354–71.

³ NBS, ‘Risk Management in Banking’, *National Bank of Serbia*, 2001.

permitted unless it is specifically prohibited. A key principle of Islamic banking is the avoidance of interest, whether paid or received.

Risk Management from Conventional Outlook

Risk management failures in big companies have caught the industry's attention for many years, especially in the financial services sector,¹ which has led to shaking shareholders' and stock market participants' confidence in the effectiveness of bank risk management.² The Basel Committee on Banking Supervision (BCBS) estimates that its member countries alone lost output worth more than USD 76 trillion because of the crisis.³

Bernstein explained in 'Against the Gods', the theory that "the idea of risk management emerges only when people believe they are to some degree a free agent," has developed the concept of risk and opportunity. People are thus able to use both previous history and facts to analyse the probabilities and so forecast what should happen in the future.⁴ Looking at the banking context, financial institutions are invariably faced with different types of risks that may have a potential adverse effect on their daily operations. Banks are obliged to form a comprehensive and reliable risk management system which is integrated with all business activities and ensure the bank's risk profile to always be in line with the established risk propensity.⁵

Biblical view

In the biblical view on risk, the word '*risk*' leads people to think negatively, but there are times when captivating risks can be good. A more biblical way of talking about good risk is using the phrase "*to step out in faith*" and Lord is greater than any problem or risk.⁶ Hence the other religion also noticed that risk is something we cannot avoid but we must have options on how to manage it in order to minimize the impact.

¹ OECD, *Risk Management and Corporate Governance*, Corporate Governance. OECD Publishing, 2014.

² Adonis Antoniadis, *Liquidity Risk and the Credit Crunch of 2007-2009*, BIS Working Papers, 2014.

³ Viral V. Acharya, Hyun Song Shin and Tanju Yorulmazer, 'Crisis Resolution and Bank Liquidity', *Review of Financial Studies*, 24.6, 2010, 2166–2205.

⁴ Peter L. Bernstein, *Against The Gods: The Remarkable Story of Risk*. John Wiley & Sons, Inc., 1996.

⁵ NBS, 'Risk Management in Banking', *National Bank of Serbia*, 2001.

⁶ Fritz Chery, '25 Important Bible Verses About Taking Risks', *Bible Reasons*, 2018, pp. 1–14 <<https://biblereasons.com/taking-risks/>> [accessed 11 October 2018].; David Peach, '22 Bible Scriptures About Risk Taking', *Telling Ministries LLC.*, 2015, pp. 4–6 <<https://www.whatchristianswanttoknow.com/22-bible-scriptures-about-risk-taking/>> accessed 8 September 2018.

***Mukhāṭarah* from Islamic View**

Islamic banks face unique risks. Given that there was no well-defined risk management framework for Islamic banks, they mostly dealt with the risks they face in accordance with conventional guidelines. However, it is important that risk managers identify the risks faced by Islamic banks correctly by measuring them accordingly, mitigate and control them in accordance with *Sharī'ah* requirements and report them to all the stakeholders honestly and accurately.

The concept of risk is found to be practiced since the earliest civilizations (B.C) until the existence of a distinct terminology to explain that concept.¹ Consequently, it is also broadly applied in the Islamic financial system today. Trimpop discovered that the concept of risk has been a concern for humanity since the ancient days of recorded history.² On the other hand, Al-Suwailem focused on risks that are specifically discussed as being controlled risks and how to manage them in a way that will minimize “bad impact” in decision making.³

However, Shawamreh is more concerned about who defines Islamic law and discusses the function and responsibilities of *Sharī'ah* scholars in modern Islamic finance and their effort towards the industry's standardization.⁴

From Islamic jurisprudence, Muslim jurists used the word *khāṭar* and *mukhāṭarah* for business risk. *Mukhāṭarah* is defined as “possibility of unexpected outcomes”.⁵ In contrast to Al-Sharbasi, *khāṭar* and *mukhāṭarah* are interchangeably used with *gharar*.⁶ Likewise, Muhammad concluded that the concept of risk according to Muslim jurists is almost similar to what is defined by conventional economists.¹ In addition, Hassan noted that “risk that entails excessive uncertainty and elements of gambling is undoubtedly

¹ Nurul Syazwani Mohd Noor, Abdul Ghafar Ismail and Muhammad Hakimi Mohd. Shafiai, ‘Shariah Risk : Its Origin, Definition , and Application in Islamic Finance’, *SAGE Journals*, 2018, pp. 1–12.

² Rüdiger M. Trimpop, ‘The Psychology of Risk Taking Behavior - Chapter 1 : What Is Risk Taking Behavior’, in *The Psychology of Risk Taking Behavior*, 1994, CVII, pp. 1–14.

³ Sami Al-Suwailem, *Risk in a Turbulent World: Insights from Islamic Finance, Islamic Finance: The New Regulatory Challenge*, 2012.

⁴ Cynthia Shawamreh, ‘The Legal Framework of Islamic Finance’, in *Contemporary Islamic Finance: Innovations, Applications, and Best Practices*, ed. by Karen Hunt-Ahmed, 1st edn, United States of America: John Wiley & Sons, Inc., 2013, pp. 39–62.

⁵ Aḥmad Al-Sharbasi, *Al-Mu'jam Al-Iqtiṣādī Al-Islāmī*. Beirut: Dar Al-Jail, 1981.

⁶ Adnan Abdullah Muhammad Uwaidah, *Nazariyyah Al-Mukhatarah Fi Al-Iqtisad Al-Islami (Risk Theory in Islamic Economics)* (Herdon: International Institute of Islamic Thought, 2010).

¹ Fadel Abdul Karim Muhammad, ‘Idarah Al-Mukhatarah Fi Al-Iqtisad Al-Islami’, *Idarah Al-Mukhatarah Fi Al-Iqtisad Al-Islami*, 2008.

prohibited under Islamic law”.¹ From various definitions of risk in the world, Syed Ehsan Ullah Agha and Sabirzyanov held the view on risk and its management are embodied in the purpose of *Sharī'ah* which is to protect the wellbeing of society.²

Qura'nic view

The existence of immoderate risk in financial institutions is not a good practice and can be considered as *gharar*. This argument has been supported by Sakti.³ Hence, the initiative by the company to mitigate and control the risks is very important and it also complies with the pillars of *maqasid Sharī'ah*. Additionally, the concept of risk mitigation is already practiced in Islam. It can be traced back during the time of Prophet Yusuf A.S, highlighting the history of risk mitigation in Islam. Prophet Yusuf has managed to mitigate the risk for seven years.

*“Yusof then instructed them what to do. (He said: Ye shall sow seven years as usual) each year continuously, (but that which ye reap) of crops, (leave it in the ear) and do not thresh it, this is better for its preservation, (all save a little which ye eat) all save the quantity which you need for your sustenance.”*⁴

*“(Then after that) after the seven years of soil fertility (will come seven hard years) seven years of drought (which will devour all that ye have prepared for them) all that you have saved during the seven years of soil fertility, (save a little of that which ye have stored) kept aside.”*¹

¹ Rusni Hassan, ‘Shariah Non-Compliance Risk and Its Effect on Islamic Financial Institutions’, *Al-Shajarah: Journal of the International Institute of Islamic Thought and Civilization (ISTAC)*, 21 (3).Special Issue (2016), 21–25.

² Syed Ehsan Ullah Agha and Ruslan Sabirzyanov, ‘Risk Management in Islamic Finance: An Analysis from Objectives of Shari’ah Perspective’, *International Journal of Business, Economics and Law*, 7.3 (2015), 46–52.

² Rüdiger M. Trimpop, ‘The Psychology of Risk Taking Behavior - Chapter 1 : What Is Risk Taking Behavior’, in *The Psychology of Risk Taking Behavior*, 1994, CVII, 1–14.

³ Muhammad Rizky Prima Sakti and others, ‘Shari’ah Issues, Challenges, and Prospects for Islamic Derivatives: A Qualitative Study’, *Qualitative Research in Financial Markets*, 8.2 (2016), 168–90

⁴ *Al-Qurān*, 12:47.

¹ *Al-Qurān*, 12:48.

According to the verses, Prophet Yusuf A.S interpreted the dream of the King of Egypt that Egyptian would experience seven years of drought after seven years of wealth. Hence, Prophet Yusuf A.S advised the king to be prepared for the phenomena. Egyptians had to implement the recommendation (by Prophet Yusuf A.S) by planting crops during the first seven years and store as much food as possible, as a preparation to face the seven years of drought in order to avoid disruptions of food. The advice of Prophet Yusuf A.S were followed and the Egyptians managed to endure the seven years of drought.¹

Risks in Islamic Finance Contract

In order to evaluate the risks faced by an Islamic bank properly, the applicable conventional bank risks need to be taken into consideration, and complemented by additional risk types that cater specifically for the risks undertaken by Islamic banks such as the following:²

Table 1: Risk in Islamic Finance Products

Types of risk	Descriptions
Fiduciary risk	<ul style="list-style-type: none"> Specifically, risk related to the nature of the <i>muḍarabah</i> contract, which places liability for losses on the <i>muḍarib</i> (or agent) in the case of malfeasance, negligence or breach of contract on the part of the management of the <i>muḍarabah</i>.
Displaced commercial risk	<ul style="list-style-type: none"> This risk type is related to the common practice among Islamic banks of “smoothing” the financial returns to investment account holders by varying the percentage of profit taken as the <i>muḍarib</i> share, which can be compared to an arrangement or agency fee.
Rate of return risk	<ul style="list-style-type: none"> The risk of a mismatch between yields on assets and the expected rates of both restricted and unrestricted investment accounts, which may in turn lead to displaced commercial risk

Table 1 depicts the potential risks that may arise in the Islamic finance agreement between the bank and customers. In contrast with conventional risk which only depends on the laws that are applied in the contracts; Islamic finance products must follow the interpretation and fatwa released by *Sharīʿah* committee or scholars. The decisions made by the *Sharīʿah* board will be used as reference and legally recognized.

¹ *Tafsīr Ibn Kathīr*

² Simon Archer and Rifaat Ahmed Abdel Karim, ‘On Capital Structure, Risk Sharing and Capital Adequacy in Islamic Banking’, *International Journal of Theoretical & Applied Finance*, 9.3 (2006), 269–80.

In addition to the development of Islamic finance, the main gap between conventional finance and *Shari'ah* compliant finance is the risk management and how the risk is divided among the parties involved in the contract. For instance, the two main forms of Islamic finance are bank finance and issuing Islamic securities (*sukuk*). In conventional terminology, debt is involved— bank loans and bond issues, but that is false accusation. Those categories cannot be suited to pure Islamic finance. Fundamentally, Islamic finance interest is *haram* (prohibited). If a business is financed by debt with an obligation to pay interest, the risk of the business is not being shared fairly. Instead, Islamic finance requires that finance is provided on the principle of profit and loss sharing. Under Islamic principle finance can be offered through numerous contracts.

There is a need for that kind of transaction which includes land, ownership, money, property, rights that should be well-documented in the form of a contract and acknowledged by all parties in the presence of witnesses. In financial transactions, there is always a probability of opinion disputes over the commercial deals.¹ A documented contract eradicates the risk of default and ensures to protect the rights of all parties. Since a contract and a witness is important to demonstrate justice and fairness, Allah asks humans to not decline to be a witness when needed:

“The witnesses must not refuse when they are called upon to do so. You must not be averse to writing (your contract) for a future period, whether it is a small matter or big. This action is more just for you in the sight of Allah, because facilitates the establishment of evidence and is the best way to remove all doubts; but if it is a common commercial transaction concluded on the spot among yourselves, there is no blame on you if you do not put it in writing. You should have witnesses when you make commercial transactions.”²

Each agreement specifies how risk is shared between the business and the supplier of fund. One such contract is a *muḍārabah*. This specifies in advance on how profits and losses are to be shared between the financier and the business owner. Islamic banks and *sukuk* are currently based on contracts that are in accordance with the *Shari'ah* law. But many scholars argue that the way they operate is not based on

¹ Syed Ehsan Ullah Agha and Ruslan Sabirzyanov, ‘Risk Management in Islamic Finance: An Analysis from Objectives of Shari’ah Perspective’, *International Journal of Business, Economics and Law*, 7.3 (2015), 46–52.

² Al-Qurān, 2:282.

Islamic profit and loss sharing.¹ A buyer of a *sukuk*, for example, expects to receive an assured yield comparable to an interest-bearing bond.

Conversely, Hasan reported from *Sharī'ah* Committee's angle, the IFIs should allow a full assessment to the *Sharī'ah* Committee to access all documents, information and records for *Sharī'ah* compliance purposes.² As part of Islamic banks, *Sharī'ah* Committee has a responsibility "to ensure the internal and privileged information obtained in the course of their duties shall be kept confidential at all times and shall not be misused".³ Although some IFIs do not include the term of reference of *Sharī'ah* Committee upon appointment, the members are aware of the concealment of the information because Islam itself commands them to do so.⁴ Obligation of confidentiality depends on the sensitivity and the importance of the topic under review. *Sharī'ah* Committee must have the integrity to keep the internal issues to themselves without spreading the information to other parties especially to irresponsible individuals.⁵ On the other hand, the significance of this restriction is to avoid conflict of interest and preserve the confidentiality of IFIs.⁶

In view of all that has been discussed so far, it shows that the criteria to appoint a *Sharī'ah* Committee are not easy. There are a lot of criteria that the IFIs should be aware in order to maximize the effectiveness of the *Sharī'ah* Committee in delivering their task. Furthermore, there is no complete standard by Bank Negara Malaysia (BNM) to be implemented by IFIs. BNM gave full authority to IFIs in determining the 'fit and proper criteria' before nominating the *Sharī'ah*

¹ SOAS, 'Risk Management in the Global Economy: How Does Islamic Finance Differ from Conventional Finance?', *School of Oriental and African Studies (SOAS), University of London*, 2018, pp. 9–12

² Zulkifli Hasan, 'In Search of the Perceptions of the Shari'ah Scholars on Shari'ah Governance System', *International Journal of Islamic and Middle Eastern Finance and Management*, 7.1, 2014, 22–36.

³ BNM-SGF, *Shariah Governance Framework for Islamic Financial Institutions 2011* Malaysia: Bank Negara Malaysia, 2010, pp. 1–48.

⁴ Zulkifli Hasan, 'In Search of the Perceptions of the Shari'ah Scholars on Shari'ah Governance System', *International Journal of Islamic and Middle Eastern Finance and Management*, 7.1, 2014, pp. 22–36.

⁵ Don L. Arnwine, 'Effective Governance: The Roles and Responsibilities of Board Members.', in *Proceedings, Baylor University. Medical Center*, 2002, xv, 19–22.

⁶ IFSB-3, *Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)*, Islamic Financial Service Board, 2006, pp. 1–33.

Committee.¹ It is a good idea because Islamic financial institutions believe that the administration of the organisations should not be over-regulated by the government. On the other hand, as a central bank, BNM must improve their *Sharī'ah* governance to minimize the *Sharī'ah* non-compliance events. Along with the growth in this issue, in the author's analysis of the importance of transparency and disclosure, Elfeky identifies the big four accounting firm auditors gravitate to reveal more information voluntarily since a big four auditor attempts to maintain its status and supports the stakeholder through superfluous disclosure.²

Risk Identification

Risk identification is the basis of risk management in any financial institution. According to Basel Committee on Banking Supervision, risk identification is “paramount for the subsequent development of a viable operational risk monitoring and control system”.³ Effective risk identification does not only depend on the internal factors, but we must also consider the external factors such as the industrial revolution and technological advances in today's digital economic era. Internal factors normally involve the bank's structure, the activities of the bank, the talent acquisition and employee turnover. These factors could affect the performance of the bank. Risk identification processes are conventionally focused on the key risk types of credit, market, operational and liquidity risk. Effective risk identification will help the financial institution to mitigate the risk; hence will boost up the public confidence towards their operation. In their review, Haselkorn, Khaykin and Eaton identified that the current practices of risk identification at the banks were incomprehensive, insufficient and not deep enough.¹ The financial institutions failed to emphasize the underlying key factors of risks. This, in turn, leads to critical gaps in risk management.

¹ Sudin Haron and Bala Shanmugam, *Islamic Banking System: Concepts and Applications*. Kuala Lumpur: Pelanduk Publications, 1997.

² Mostafa I. Elfeky, ‘The Extent of Voluntary Disclosure and Its Determinants in Emerging Markets: Evidence from Egypt’, *The Journal of Finance and Data Science*, 3.1–4, 2017, 45–59.

³ BCBS96, *Basel Committee on Banking Supervision: Sound Practices for the Management and Supervision of Operational Risk (Superseded)*, Basel Committee on Banking Supervision, 2003, p. 20.

¹ Dov Haselkorn, Ilya Khaykin and Ross Eaton, *Risk Identification: What Have Banks Been Missing*, 2015.

<<http://www.oliverwyman.com/content/dam/oliverwyman/global/en/2015/may/Oliver_Wyman_Risk_Identification.pdf>> accessed 30 September 2018.

a. Risk Assessment

In addition, the bank should also assess their threat to these risks. Effective risk assessment is very important to financial institutions to evaluate their risk profiles better and as a proper investment asset allocation for a portfolio and most effectively target risk management resources.¹ According to Basel II in Sound Practices for the Management and Supervision of Operational Risk, there are methods applied by financial institutions in evaluating operational risk, namely:

i. Self- or risk assessment

A bank will assess its operations and activities against a list of potential operational risk vulnerabilities faced by the institutions.

ii. Risk mapping

This method can disclose parts of the weakness and help prioritise subsequent bank action in order to mitigate the potential risk.

iii. Risk indicator

These indicators tend to be reviewed on a periodic basis (for example, monthly or quarterly) to alert the financial institutions to changes that may be indicative of risk concerns. Such indicators may include the number of failed trades, human resource turnover rates and the frequency and/or severity of errors and omissions.

iv. Measurement

Data on a bank's historical loss experience could provide valuable sign for assessing the bank's exposure to operational risk and emerging a policy to control the potential risk.

b. Risk Monitoring

An effective monitoring process is crucial to adequately manage operational risk. Continuous monitoring events can give the advantage of risk detection and correcting deficiencies in the policies, processes and procedures for managing operational risk and the banks should

¹ BCBS96, *Basel Committee on Banking Supervision: Sound Practices for the Management and Supervision of Operational Risk (Superseded)*, Basel Committee on Banking Supervision, 2003, p. 20.

continue for the life of the contract as part of bank's activities.¹ The risk monitoring would not only lower the event or failures due to insufficient assess diversification and fluctuations in the business cycle, but also would diminish the high incidence of the bank's fiasco due to misconduct and fraud.

Hence, according to Mohammed, such monitoring can be applied to make sure that risk management implementation in the banks are in line with desired practices.² As investors, they also want to know the risk condition of the bank in mitigating the risk. Risk monitoring will help them to evaluate the company's performance and put it as assessment in their investment portfolio.³

c. Risk Mitigation and Control Implementation

Oldfield and Santomero suggested three generic risk-mitigation strategies: i) eliminate or avoid risks by simple business practices; ii) transfer risks to other participants; and; iii) actively manage risks at the bank level (acceptance of risk).⁴

Conclusion

This article focuses on the Islamic perspective about risk or *mukhāṭarah* in Islamic financial institutions. Ultimately, this study offers and formulates some recommendations for enhancing and improving current *Sharī'ah* non-compliance event management and *Sharī'ah* governance in Islamic banks. Hence, future researchers may want to explore on the responsibilities taken by *Sharī'ah* Committee in mitigating the operational risk. In order to achieve a good governance practice, the financial institutions should invest funds in the bank's *Sharī'ah* risk management as a long-term investment in order to obtain high level of confidence from their depositors or shareholders.

The bank's risk management officials should encourage the *Sharī'ah* Committee to attend trainings, conferences, meetings and forums across

¹ BCBS96, *Basel Committee on Banking Supervision: Sound Practices for the Management and Supervision of Operational Risk (Superseded)*, Basel Committee on Banking Supervision, 2003, p. 20.

² Faris Mohammed Al-Mazrooei and Hussein A. Hassan Al-Tamimi, 'Banks' Risk Management: A Comparison Study of UAE National and Foreign Banks', *The Journal of Risk Finance*, 8.4, 2007, 394–409.

³ C. N. V. Krishnan, P. H. Ritchken and J. B. Thomson, 'Monitoring and Controlling Bank Risk: Does Risky Debt Help?', *The Journal of Finance*, 60.1 (2005), 343–378

⁴ George S. Oldfield and Anthony M. Santomero, 'Risk Management in Financial Institutions', *Sloan Management Review*, 39.1, 1997, 33–46.

the globe as a method for them to be exposed to the market developments and issues in the industry. Despite Bank Negara Malaysia's expectation that the *Sharī'ah* committee must ensure compliance with Islamic rules at all times, they must also play their part as an advisor. They had to rely on moral persuasion which is inadequate to ensure compliance as lined up by the central bank. The effectiveness of *Sharī'ah* governance in Islamic finance in Malaysia has been proven when the Malaysian government has introduced a special High Court in the Commercial Division or the *mu'āmalat* (economic transaction) bench and the amendment of section 16B of the Bank Negara Malaysia Act, BNM 2003.¹ The *mu'āmalat* bench in the High Court is emphasised by the respective judges on the disputes on Islamic finance system. It also can be considered as an approach in coordinating Islamic law and conventional law in Malaysia. *Sharī'ah* governance is the soul to Islamic banking system of financial ecosystem and it can be considered as an essence of corporate governance for Islamic banks.

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¹ Rusni Hassan, 'The Establishment of Muamalah Court in Malaysia: An Overview of Issues and Challenges', *IIUM Law Journal*, Special Ed. December, 2011.

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JOURNAL OF ISLAMIC SCIENCES AND COMPARATIVE STUDIES

Special Issue

November 2018

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