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A Qualitative Enquiry into the Risk Management and Reporting Practices of Islamic Banks in Malaysia[1]

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ABSTRACT

This study explores the risk management practices, reporting and performance of selected Islamic bank in Malaysia using single case study. Under the broad paradigm of mixed methods, one in depth interview, content analysis and ratio analysis were conducted. The result evidences a clear gap between Shariah and practice of Islamic risk management, difference in Shariah and legal remedy, and availability of credible internal control mechanism that are responsible for effective risk analysis and management. The top priority risk is the operational risk followed by market and credit risks. Risk management activities are mostly reported using annual reports. The declining return ratios with respect to the decreasing risk ratios indicate evidence of existence of conventional mean variance frontier in Islamic finance. However, this low risk low return and credit to asset ratios exhibit low risk taking tendency of the bank. As a result liquidity ratio is increasing but profitability ratio is going down. Bank has to build an internal risk management culture by training the employees and building up the internal control system more effectively.

Keywords: risk management, Islamic finance, Islamic bank and Malaysia

1. INTRODUCTION

Risk is erroneously considered to be an outcome rather it is an integral part of the overall process in a business. Due to this reactive mechanism, the recent global financial crisis has experienced the massive use of derivative financial instruments such as Credit Default Swaps (CDS), which provides evidences of risk transferring instead of sharing. Banks are in the business of transferring fund from surplus to deficit units. Islamic banks have to follow the *Shariah* guidelines under the broader spectrum of Profit and Loss Sharing (PLS) to share the risk among participants instead of transferring the risk. Banks, either conventional or Islamic, characteristically have common risk attributes such as credit risk for

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possibility of default on the loan amount given to the borrower, liquidity risk for potential inability from the part of the bank to satisfy withdrawal request against any customer payment request, interest rate risk is the possibility that change in rate of interest may adversely affect the deposit and loan portfolio of banks and operational risk raises from the sudden breakdown in the system, manpower and technology (Khan & Ahmed 2001).

In contrast to the conventional practices, Islamic banks have unique risk characteristics. Risk in Islamic banks includes credit, equity investment, market, liquidity, rate or return and operational risks (IFSB 2005). During the last decade, the incentive for imprudent lending practices among banks globally has been due to the false mind mapping that "banks are too big and sensitive to fail". Banking community has seen a lot of governmental initiative to rescue banks from crises. Finally, large banks had been transferring their risks by engaging them into various derivative instruments. These are examples of some reactive attitude towards risk management and overall governance mechanism that leads to one of the most uncommon global crises in the history of human kind (Krugman 2009). Consequently, the global economy is now witnessing the once-in-a-lifetime economic crisis. Banks have stopped lending to large borrowers, production has been the slowest and unemployment has been rising. Central banks and securities commissions across the globe are taking initiative to form new regulations and framework to come over the crisis. This study is an attempt to learn the root cause of this crisis from an Islamic banking perspective.

Risk and imprudent practices are the two hands of growth. Islamic financial industry has been growing at over fifteen percent rate every year globally (IFSB 2008), which includes the acceptance by non-Muslim customers (Metawa & Almossawi 1998). A growing system like this would face problems of risk management system, governance and overall supervision (Caruana 2005). Islamic banks should operate in accordance with the Islamic *shariah*. Among many, the basic principles that are guiding Islamic financial transaction include prohibition of Riba (interest), Gharar (uncertain information), Mysir (gambling), production of harmful products (alcohol etc.), distribution of Zakah (alms giving) and charity, creation of jobs and eradication of poverty, and establishment of overall human rights (Farook & Lanis 2005; Haniffa & Hudaib 2007; Chapra 1985). The peculiarity of the financial processing system of any Islamic bank raises the question of further enquiry into the risk management system (Khan & Ahmed 2001). Moreover, extant literatures on risk management of Islamic banks include mostly suggestions (IFSB 2005) and the role of risk management in Islamic banks (Iqbal & Mirakhor 2007). The complete study on learning various aspects of risk management, assessment and reporting was done by Khan& Ahmed in 2001. This study is undertaken to update the knowledge base in this area, especially on the assimilation of theory and perception, practice and reporting in the post-global financial crisis arena.

2. RESEARCH QUESTIONS

Risk management in Islamic bank is still at the embryonic stage. Regulatory and *shariah* experts on this issue are still facing troubles on giving clear cut directions. Additionally, every bank has their own portfolio of deposit and loans. Therefore, standardization is difficult. This study is undertaken to capture the case by case needs of risk management issues in Islamic banks. Risk managers responsible for handling risk management issues of Islamic bank are the right person to give ideas on the risk management practices of their banks. The primary objective therefore is to explore the practices and reporting standards of risk management among successful bank. This study is going to answer the following research questions:

1. What is the risk management process frequently practiced in the bank?
2. What is a possible ranking of risks from most to least important risks?
3. What are the prerequisites for effective risk management process?
4. What are the chief components in Risk Analysis and Management frequently discussed in today's banking arena?
    a. Risk Analysis and Management Committee
    b. Hedging and Risk Management
    c. Islamic capital market and liquidity risk
5. What is the risk reporting standard in the bank?
6. How well the bank risk performance in terms of risk ratios?

3. LITERATURE REVIEW

Risk is the uncertainty that actual outcome will be different than expected outcome. Banks intermediate between surplus and deficit units. Banks are also called risk management institutions because they reduce the risk of size, maturity and liquidity for their clients. Various types of risk for Islamic institutions have been discussed widely in literatures. IFSB (2005) suggested a set of guiding principles in line with Basel II requirements for Islamic banks. According to these risk management principles; all the Islamic financial institutions (IFI) must establish a comprehensive risk management reporting process (IFSB 2005:7). Apart from *shariah* compliance and integrate reporting standards; a comprehensive risk management framework is suggested to include apposite board and senior management oversight, to identify, measure, monitor, report, and control pertinent type of risk with appropriate adjustment in capital. Therefore, the holistic risk management approach should start with adequately identifying the exposure level individually and at the portfolio level, and followed by quantifying the exposure and taking sufficient action to reduce or control the level of risk (IFSB 2005; Rosman 2009). However, the approach must be proactive from the beginning, meaning the control mechanism should start right with the risk identification process (Khan & Ahmed 2001; Rosman 2009).

Among various types of risks, IFSB (2005) gave details about seven types of risk significant for Islamic banks. Credit risk is the most important among these seven, which represents the inability from the part of the borrower in paying the loan amount to the bank. However, each financing product is unique in Islamic banks and the risk associated with these must be separately dealt with. For instance: the Mudarabah that is used for project financing offers bridge financing to mudarib on a profit sharing basis whereas the mudarib is supposed to receive the progress payment from the ultimate customer. In another example regarding the mudaraba or musharakah contracts where the risk will be converted from market to credit risk. In a Salam contract, Islamic banks have to consider external macro-economic factors that may affect the performance commodity prices in the market place and eventually increasing the likelihood of default. Due to uniqueness of the riskiness, IFSB (2005) suggested to initiate a holistic approach in identifying, managing and reporting credit risk for Islamic financial institutions.

IFIs are exposed to equity investment risk especially when they are holding equity instruments under musharaka and mudaraba principles for investment purposes. Holding equity for trading or managing liquidity may create market risk on one hand, and may expose the bank to credit risk if invested under musharaka or mudaraba principles at others (Khan & Ahmed 2001; IFSB 2005; Rosman 2009). Under equity investment category, IFIs are suggested to understand the risk pattern of each investment type, concentrate more on the valuation methodologies and prepare an appropriate exit strategy (IFSB 2005). Performance in equity investment might also be affected by the existence of proper liquidity market framework. Islamic capital market and short-term money markets are still absent or at the very beginning stage in different countries. Therefore, banks are left with no or little option to embark on the effective equity investment.

IFIs are adversely affected by sudden changes in the benchmark rate (i.e. LIBOR – London Interbank Offer Rate), commodity prices, equity prices and foreign exchange rates. These changes expose the banks to market risk. For instance: there might be changes in the current and future prices of Salam asset or changes in the market value of *sukuk* contracts. In operating *Ijārah*, a lessor is exposed to market risk on the residual value of the leased asset at the term of the lease or if the lessee terminates the lease earlier (by defaulting), during the contract (IFSB 2005). IFIs are suggested to build a comprehensive information management system to mitigate the market risk (Khan & Ahmed 2001). For various reasons that are common to conventional system, IFIs are also exposed to liquidity risk. However, the solution has to come from a *shariah* compliant way. In case of any withdrawal request by current account or unrestricted account holders; IFIs may find themselves in liquidity shortage. Liquidity problem can be even severe for IFIs due to the absence of *shariah* compliant secondary market for inter-bank transfer in many countries. Bankers are suggested to have clear and details understanding on the supply and demand side of the fund from and by various account holders for certain time period (IFSB 2005; Rosman 2009).

Rate of return risk is another major issue for IFIs, which is associated with the overall balance sheet exposure. For instance: an increase in the benchmark rate will also increase the opportunity cost to investment account holders. IFIs will be forced to adjust their return, which is calculated at the end of investment holding period, according to the benchmark rate. Investors' reaction might be pessimistic regarding the adjustment of return with benchmark rate. IFIs are suggested to keep a Profit Equalization Reserve and Investment Risk Reserve for the safety from this risk. One of the highlighted risks in the post-2008 financial crisis era is the operational risks. Increasing importance on the regulatory supervision, corporate governance regulation and financial disclosure requirement indicate banks' effort for reducing the operational risk (Khan & Ahmed 2001; BCBS 2001). However, the problems with processes, people and system may not be sourced only from internal problems; some external factors may affect the internal system and can cause operational risk (IFSB 2005). IFIs are also suggested to comply with Shariah compliant products and services. IFIs are not free from the fiduciary risk of non-compliance to other local and internal laws pertinent to the industry or product. Therefore, an overall guidelines and supervision mechanism must be established and followed.

In this rapidly changing global atmosphere, Islamic Financial Institutions (IFIs) must be proactively planning for risk management and adjust the past learning with the policy so that future risky decisions can be avoided (Khan & Ahmed 2001). To understand the common and unique risk faced by IFIs compared to their conventional counterparts; Khan & Ahmed (2001) conducted a survey for Islamic Development Bank (IDB). The survey on the risk managers of different IFIs concluded that IFIs must (1) establish a risk-management environment, (2) risk reporting system, (3) internal rating system, (4) risk based information system, (5) establishment of supporting institutes that includes among many Islamic deposit protection plan, liquidity management system, and Islamic capital market, (6) setting up standards in line with the international standards and laws, and (7) research and training on risk management and mitigation.

Later on various studies were initiated a conceptual explanation of the risk management processes in IFIs (Rosman 2009), relationship between risk management and performance of Islamic banks (Rosman 2008), conceptualization of risk and prudential regulations in Islamic banks (Errico & Farahbaksh 1998), Basel II and regulatory framework for Islamic banks (Hassan & Dicle 2005; Schoon 2008), conceptualization of Capital Asset Pricing Model and systematic risk in Islamic system (Selim 2008), relationship between contracts, risk and performance of Islamic banks (Siddiqui 2008), transparency and market discipline in Islamic financial institutions (IFSB 2007), financial crisis after math for Islamic finance (Mirakhor & Krichene 2009) and risk management practices in Islamic banks in Brunei (Hassan 2009). The extant literatures show a clear trend of analyzing the risk management perception and practices in Islamic banks undertaken very recently. Other studies on Islamic banks' risk management, supervision and regulatory framework started to develop in year 2000.

Hassan (2009) reports risk management practices in Islamic banks of Brunei Darussalam using survey questionnaire. The study finds that IFIs in Brunei have been facing three major type of risks namely foreign exchange risk, credit risk and operational risk. This finding is similar to the study done by Al-Tamimi and Al-Mazrooei (2007) among foreign banks in UAE. From the survey, the study reports that Risk Assessment and Analysis (RAA) and Risk Identification (RI) have been chosen as most influential variables in risk management process in Islamic banks in Brunei. However, in the earlier study by Khan and Ahmed (2001) concluded that 17 IFIs from 10 countries ranked markup (interest rate) risk as the most influential risk followed by operational risk and liquidity risk. Credit risk and market risk are ranked as "not very serious" in the study. Khan and Ahmed (2001) also have explored that IFIs believe that they do not have sufficient knowledge in identifying and managing risk in Islamic banks. More importantly, many studies after Khan and Ahmed (2001) conducted on the same subject have forgotten about compliance risk, which is very important for the overall survival of IFIs.

There is still lack in research on risk reporting for IFIs. Even though the risk management process has been given much importance, Khan and Ahmed (2001) report that 70% banks report credit risk, only 30% report market risk, 24% report interest rate risk, 41% report foreign risk, 18% report operational risk and 35% report country risk status. Risk reporting works as a valuable input to decision making at the stakeholder level (Rosman 2009). Hassan (2009) report that around 90% of the bankers from the survey on risk management processes in Brunei put importance on risk reporting system. However, risk reporting has not been practiced at a large scale. Around 60% of the banks from Khan and Ahmed (2001) reports that they follow a combination of international and AAOIFI standard for risk assessment and monitoring policy. The study also concludes that around 35% bank does not have any standby procedure to handle emerging risk issues. Above discussions direct towards deeper study on risk management processes for Islamic banks. Two major studies on risk management processes and practices of Islamic banks used survey method (see Khan & Ahmed 2001; Hassan 2009). Since risk management process is a highly professional and context dependent (Hassan 2009; Khan & Ahmed 2001; IFSB 2005; Hassan & Dicle 2005), the practice of survey method is still highly questionable.

4. METHODOLOGY

4.1 Study Setting

Earlier studies take a survey approach in analyzing the risk management practices among Islamic banks in various countries. However, since risk management is a complex decision and highly context bound, this study undertakes an interpretivist approach of explain the risk management practices and reporting of the Islamic bank in Malaysia. There are two purely domestic Islamic banks available in Malaysia, Bank Islam Malaysia and Bank Muamalat (BNM 2009). This study excludes foreign Islamic banks and locally owned Islamic banking window system due to two assumptions that:

1. Islamic bank working as a separate window of any conventional bank still does not have the rigor of pure Islamic risk management.
2. Foreign Islamic banks are dominated by the risk management guidelines offered by the Headquarter.

These two assumptions are somewhat similar in essence with Hassan (2009). In the recent study, Hassan (2009) analyzed the risk management practices among only locally owned Islamic banks in Brunei Darussalam. Since risk management and risk reporting in Islamic banks are still at the conceptualization stage (Rosman 2008; 2009), the best approach to bring a thick description to these embryonic phenomena is to use a case study approach (Yin 1984; Merriam 1988). Merriam (1988) explain the case study as "the complete literal description of the incident or entity being investigated". At the conceptualization stage of any phenomenon, research questions include mostly why and how type of questions, which can be easily answered by case study approach (Yin 1984:20). Therefore a single case study in an economic setting has been planned to fulfill objective of the study. The study follows purposive sampling.

Reporting of risk management issues is as yet a fairly emerging topic. IFSB (2005) in their guidelines to IFIs added reporting of risk management issues for intra-banking arena. These reporting issues are meant for the process of integrating risk reporting for top level decision making inside the bank. However, both risk management and risk reporting have greater stakeholder orientation (Rosman 2008; 2009). The extent and category of risk undertaken by IFIs should be reported in annual report. This study uses content analysis to code the risk management issues from the annual report of the selected bank following Weber's (1988) content analysis methodology.

4.2 Data and Analysis

A single case methodology with multiple sources of has been adopted for this study. Data analysis strategy has been planned in three steps. An in-depth inter view on the risk management processes is followed by risk reporting system of the targeted case using risk reporting index and measuring the risk performance of the bank using risk ratios from the financial data. Most of the Islamic banks have their risk management division. The head of that division is chosen for the interview. The interview was guided by a semi-structured questionnaire following the questionnaire of Khan and Ahmed (2001). The procedure and questionnaire in Khan and Ahmed (2001) is rigorous and cover the basic objectives of this study. It was not permitted by the interviewee to tape record the interview. Therefore, important instructions were all handwritten. A person related to the researcher assisted in taking notes of the data. The interview took place in a private restaurant near to interviewee's office and it was last for 2 hours. The language of interview was English.

For fulfilling the second objective of the study, the risk reporting standard, at the second stage, content analysis method was followed. By using this methodology, based on archival study procedure, important risk reporting issues can be extracted and coded for further analysis and inference. To code the presence and absence of specific risk related items in the annual report, the study analyzed annual reports of the year 2007, 2008 and 2009. The risk measures have been adopted from Khan and Ahmed (2001). To prepare the coding, '1' refers to presence of the risk measures and '0' is for the absence of the risk measures (Weber 1988). The average score of the scores are taken as the risk reporting index for further analysis and interpretations. Beside case study and content analysis, some risk related ratios are also highlighted to get an overview of the risk performance of the bank. Risk ratios are taken from OSIRIS Database. These data were taken as on January 11, 2010. Table 4 gives the highlights of these data in the next section. After furnishing the data, a draft version of the report was sent to the interviewee, from which no further comment was added. Finally, triangulation technique is used to explain the data from various sources.

4.3 Brief Overview of the Bank

With a vision to be "the global leader in Islamic Banking", Bank A (actual name kept hidden due to the request of the interviewee) started its operation in 1983. Since its inception, bank's paid up capital swelled up to RM1.73 billion from only RM80 million, which is an indication of bank's continuous commitment towards fulfilling the vision. As a pioneering Islamic Financial Institution in Malaysia, apart from its economic role, Bank A plays a crucial role at the retail consumer level. To a greater extent, the innovation in product offering, effective customer management and convenient branch and ATM locations contributed to its becoming "Most Trusted Islamic Bank in Malaysia". Core values of Bank A include being leader with dynamism, professionalism, caring and trustworthy services to clients. Bank A is the first IFI in Malaysia to be listed in Bursa Malaysia. It is noted with the introducer of chip based ATM card. In the year 2001, Bank A becomes the first lead arranger for world's first Islamic corporate *sukuk*. In the same year, it received the "excellence" award from Association of Islamic Banking Institution Malaysia (AIBIM) and was also rate "A" by Malaysian Rating Corporation (MRC). However, after the introduction of bank's website in 1997, it took 6 years to introduce the internet banking in 2003.

Table 1: Key Financial Indicators

Items	2007	2008	2009
Return on Asset	1.40%	1.45%	0.91%
Return on Equity	23.33%	26.54%	16.48%
Capital Adequacy Ratio	12.01%	12.93%	13.61%
Net Non-performing Financing	11.35%	7.82%	4.90%
Earnings Per Share (in MYR)	0.16	0.22	0.09

Source: Annual Report of Bank A, Various Editions

In the year 2003, Bank A got into its first cross currency swap agreement. In the year 2008, bank celebrates its 25th anniversary with recorded highest profit of RM308.27 Million in 25 years. A brief financial overview is illustrated in table 1. Amid global financial crisis, Bank A maintains a higher capital adequacy ratio, which covers for credit, market and operational risk of the bank suggested by Basel II agreement. The minimum requirement is 8%. Bank's net non-performing finance has reduced substantially from 11.35% to 4.90%, which indicates successful credit management. However, the profitability ratios are lower in the year of 2009 compared to the continuous increase during 2007 to 2008 years. This represents a severe impact of financial crisis on the profitability of the bank. The study will be interesting to observe how the bank maintained the risk ratios at a higher level when the profitability ratios are going down. Finally, table 2 provides a list of top 20 IFIs list by asset size. Bank A is number 7th largest bank in the world and number 1 in Malaysia. Other Malaysian banks following Bank A are CIMB Islamic, Public Islamic Bank, RHB Islamic Bank respectively having been placed in 10, 11 and 19 in the list.

Table 2: Top 20 Islamic Institutions by Assets Size (end of 2008)

	Bank Name	Total Assets (Mil USD)
1.	Bank Markazi Jomhouri Islami Iran-Central Bank of the Islamic Republic of Iran	82,304
2.	Dubai Islamic Bank plc	23,153
3.	Abu Dhabi Islamic Bank - Public Limited Co.	13,944
4.	Islamic Development Bank	11,521
5.	Abu Dhabi Islamic Bank - Public Limited Co.	9,882
6.	Qatar Islamic Bank SAQ	9,215
7.	**BANK A**	**7,804**

8.	Emirates Islamic Bank PJSC	7,189
9.	Noor Islamic Bank	5,929
10.	CIMB Islamic Bank Berhad	5,385
11.	Public Islamic Bank Berhad	4,749
12.	Arcapita Bank B.S.C.	4,372
13.	Faisal Islamic Bank of Egypt	4,327
14.	Sharjah Islamic Bank	4,230
15.	Qatar International Islamic Bank	3,528
16.	Islami Bank Bangladesh Limited	3,350
17.	Bank Islam Brunei Darussalam Berhad	3,303
18.	Shamil Bank of Bahrain B.S.C.	2,885
19.	RHB Islamic Bank Berhad	2,705
20.	Jordan Islamic Bank	2,606

Source: Bankscope

5. RESULTS

5.1 Risk Management Practices: the Interview

5.1.1 Risk Management Process

The interview started with the question on how overall risk management and risk environment works. The interviewee responded with a new learning which is not available in any extant literature. He drew a relation between five major principles of Muslims' prayer (salat) and risk management in Islamic Banks. His statement goes below:

> *"Five pillars of salat directs towards effective risk management in Islamic banks are: Intention (Niyat), Process (Tartib), (Organizational) Structure, Tools, and Knowledge (Elmu)"*

The above quote says how Islamic principles can be applied in economic setting. The interviewee added that naturally Islamic banks do not need any risk management framework; it's already in there. By principles, Islamic contracts should be promoting profit and loss sharing (Farook & Lanis 2005). The basic form of PLS entails that the asset is owned by Islamic banks, where as the entrepreneurs are providing the knowledge. Therefore, Islamic bank knows well where they should invest to reduce their risk. A large part of counterparty risk can be easily reduced by applying PLS principles. As a result, risk management principles are already built in with Islamic Economic System. The most important matter here is that the intention of the bank governing body and planning committee must be in line with Shariah.

5.1.2 Ranking of the Relevant Risk

One of the most cited questions from risk practice studies is regarding the ranking of the relevant risk for Islamic banks. Normally under a conventional framework credit risk is the most important risk. However, for Islamic banks due to their PLS arrangement, a different result is expected. As the interviewee was quoting,

> *"the most important risk for IFIs is the operational risk followed by the market risk and finally the credit risk. However, the displaced commercial risk is another crucial issue for IFIs."*

These findings are similar partially to both Khan and Ahmed (2001) and Hassan (2009). Market up risk, operational risk and liquidity risk (Khan & Ahmed 2001), and foreign exchange risk, credit and operational risk (Hassan 2009) are respectively the first three most influential risks in IFIs. As it was argued by the interviewee that liquidity risk, rate of return risk and foreign exchange risks are special circumstances of market risk, the most relevant risk therefore is operational risk. The displaced commercial risk is caused due to the differences in the rates offered by the conventional banks and the IFIs. To minimize the gap the suggestion offered by the interviewee is to maintain a profit equalization reserve (PER), which is a normal practice now among all IFIs (Greuning & Iqbal 2008; AAOIFI 1999). Since, operational risk is the most important risk; governance mechanism in Islamic banks must be dealt with much care. The interviewee argued that:

> *"Still there is a clash present between the legal and Islamic shariah practice in many countries. Judges and lawyer in court do not have complete shariah knowledge and Islamic shariah expert does not have legal knowledge. However, the reality is that the legal and the shariah issues cannot be decoupled. So, more work is still to come in the form of regulatory and policy initiative."*

5.1.3 Knowledge of Islamic Banking and Legal Framework

Similar to earlier findings by Khan and Ahmed (2001), a holistic learning experience is still missing in many banks. Colleagues sitting next to the interviewee are all from conventional banks. At maximum they earned a diploma on Islamic banking. The logical argument below by the interviewee shows the gap between theory and practice in Islamic banking:

> *"However, it is not yet difficult to work even though the knowledge base is very weak because we are practicing Islamic compliant banking rather than Shariah based Islamic Banking.*

> *So, many of the things you may not need to know. Additionally, due to a "business types" banking mechanism, in Islamic banks we need people with diverse background such as real estate expert, oil and gas expert (engineers) and so on. So, the pure practice of Islamic banking is still in the hand of regulators and in the pages of books."*

5.1.4 Islamic Money Market and Liquidity Risk

Islamic interbank market is still less competitive. None of the Islamic banks in Malaysia has cash liquidity problem. However, cash does not only reserves for paying deposit. Islamic banks must be given the framework to lend in interbank market more widely like the conventional bank does.

> *"To do that, market should be more open. Instead of merger, there are more Islamic banks needed in the market. The competitiveness created by more Islamic banks is far deeper in rigor than the size effect of competition by few Islamic banks."*

Even though outright selling of security is prohibited in Islamic system, but there can be securitization of fixed asset investment. Khan and Ahmed (2001) study shows that a very few (17%) of the respondent banks were using securitization. The interviewee argued that:

> *"Competition is driving securitization currently; however, shariah issues are very important in this respect "*

Recently various academic studies are highlighting the importance of deposit insurance to compete with already establish conventional thrift framework. Deposit insurance can work as one of the weapons to handle the liquidity and withdrawal risks (Hassan & Dicle 2005). However, there are regulatory and religious concerns behind the use of deposit insurance program, where deposit insurance program is a macro economic tool as well.

5.1.5 Risk Analysis and Management Committee

An efficient system of risk management, monitoring and reporting is necessary to maintain a good risk rating (Greuning & Iqbal 2008). Most of the banks in Malaysia have already established such committees. According to the interviewee:

> *However, the practices of committees are just similar to the conventional practice. For example, you want to monitor credit, the same conventional principle applies. All the banks follow a sort of quasi-Islamic framework for monitoring and reporting*

> *risk. Internally a through monitoring principle is applied. There is a regular practice of reporting everywhere; either daily, monthly or quarterly basis, based on the requirement of the problem.*

These findings are similar to Khan and Ahmed (2001). Reporting standard is still very poor at IFIs (Wilson 2002). Hassan (2009) argued that all IFIs have necessary framework, computerized technology and internal operating practices are in place; what is needed is just a complete shariah framework to guide these processes. Even in risk analysis, Islamic banks use a comprehensive range of tools. From his experience, interviewee shared:

> *"Beside regular computer analyses and updates, risk managers and officials are responsible to run simulations and sensitivity analyses. Different categories of VAR (value at risk) approaches are being used. There is a specific committee only look into the application process for credits. No single person has dominance in sanctioning certain amount of credit limit."*

5.1.6 Hedging and Risk Management

Hedging has become an integral part of risk management. Since risk is about the uncertainty, no framework can completely eliminate risk. Therefore, certain reactive and end of tool is to hedge for the probable risk on any instrument.

> *"Sudden price change in the market can cause market risk and can drive into other severe form of risks. Therefore, hedging is necessary. However, hedging is still reactive. The best hedging of risk is effective management, which can be ensured through prudential governance mechanism, effective training program and vigilant monitoring."*

Since operational risk is found to be highly significant for IFIs, the best way to save the banks is to put more emphasis on the *shariah* governance mechanism. One of the major causes of the financial crisis of 2007-2008 is poor economic governance framework (Krugman 2009). Therefore, Islamic financial system should put more importance on *shariah* and financial governance mechanism.

5.2 Risk Reporting in Islamic Bank

During the interview, the interviewee was asked with the risk reporting system in the bank. Firstly, he replied that they do not follow any international standards such as the Accounting and Auditing Organization for Islamic Financial Institions (AAOIFI) and Islamic Financial Services Board (IFSB). They report the changes in collateral value, credit and market status report. Collateral and credit evaluation is done by the relationship manager once in a month. For large loan, a more checking is done and reported to the responsible authority for necessary action. Foreign exchange department carries out the market monitoring for FOREX operation and report it daily basis for immediate action. These findings are mostly similar to Khan and Ahmed (2001). However, in Khan and Ahmed (2001) study 65% of the banks reported that they were using AAOIFI guidelines. These differences in opinions drive for a content analysis on risk items from the annual report. Table 3 provides a brief view of the content analysis.

Except for few issues such as complete computerized risk management and processing system, standard for setting up the credit limit, maturity ladder chart and investment risk reserve; most other things were reported in annual reports. Average score has been included in table 3 in the name of risk reporting index. The average score for risk reporting is gradually increasing every year, which is a good sign and a good lesson for other players in the industry. To calculate the risk reporting index, all tick mark (which represents the presence of the measure) was coded as 1 and cross mark (which represents the absence of the measure) was coded as 0. The total score was then used to calculate the mean risk reporting index.

Table 3: Risk Reporting Index for Bank A

Particulars of Risk	**Y 7**	**Y 8**	**Y 9**
Formal system/ division/ committee solely responsible for identification and management of risk.	1	1	1
Presence of Internal Guidelines/ rules and/ or operating procedure for risk management purpose.	1	1	1
Any step taken to improve the asset quality.	1	1	1
Any approved loan approval system.	1	1	1
Presence of any computerized system for estimating the exposure of risk	0	0	0
Adopted a standard for setting up credit limit for individuals and corporations.	0	0	0
Diversification of loans and deposits country wise	1	1	1
Diversification of loans and deposits industry wise	1	1	1
Diversification of loans and deposits product wise	1	1	1
Any specific committee for handling problem loans	1	1	1
Bank regularly compiles a maturity ladder chart	0	0	0
Bank reports various statistical analysis (i.e. simulation and sensitivity analysis) for better risk identification and management	0	0	0
Bank has active reporting system in the management level regarding	1	1	1

the risk management issues.			
Banks reports the adjusted value of collateral against financing	0	1	1
Bank reports the country risk rating of their portfolio	0	0	0
Bank reports the extension of the large loans.	1	1	1
Bank reports the accounting standards for different portfolios	1	1	1
Bank has in place the internal audit for risk auditing	1	1	1
Bank establishes a strong data backup and recovery system	0	1	1
Bank has active research division for risk research	1	1	1
Bank organizes training frequently to learn about emerging risk issues	1	1	1
Bank reports profit equalization reserve	0	0	0
Bank reports investment risk reserve	0	0	1
Bank reports detail report on capital adequacy standard suggested by Basel II	1	1	1
Bank reports separate risk reporting for investment depositors and current account holders	1	1	1
Average Score (Risk Reporting Index)	0.61	0.65	0.72
Coding style: [1 = Presence of the measure, 0 = absence of the measure]			
Y7 = 2007, Y8 = 2008, Y9 = 2009			

5.3 Risk Ratios of Bank 'A'

Table 4 highlights some of the important ratios that can be related to riskiness of the bank. A lower loan loss reserve indicates two things; firstly, it had less amount of loan loss so it had to reserve less and secondly, it did not fulfill the regulatory requirement of reserving adequate amount of loan loss reserve. Loan loss reserve is mainly kept due to the increasing amount of non-performing loan becoming bad. Since the net non-performing loan is decreasing, lower loan loss ratio indicates a positive sign. Tier 1 and capital adequacy ratio covers the credit, capital and market risk. According to Basel II, every bank must reserve at least 8% of their risk weighted asset as capital reserve, out of which minimum 4% should be as primary capital or Tier 1. Tier 1 capital and capital adequacy ratio of Bank A are far above the expected level. A reduction in net non-performance financing represents greater collection of credit from the borrowers and therefore larger amount of profit.

Table 4: Risk Ratios

Items	30/06/2007	30/06/2008	30/06/2009
Loan Loss Res / Gross Loans	14.09	13.36	9.8
Tier 1 Ratio	10.4	11.3	12.3
Capital Adequacy Ratio	12.01	12.93	13.61
Net Non-performing Financing	11.35	7.82	4.9
Cost To Income Ratio	NA	59.58	56.85
Net Loans / Total Assets	44.28	38.47	35.15
Net Loans / Deposit & ST Funding	47.99	43.54	38.32
Liquid Assets / Total Deposit & Borrowing	39.03	50.73	35.19

Source: Bankscope

Cost of Income Ratio shows the operating efficiency in the form of input to output ratio. A reduction from 2008 to 2009 represents better operating efficiency therefore less risk. Higher net loans to total assets represents firstly higher credit risk and secondly higher profit. However, a lower ratio does not mean low credit risk always. A decreasing net loan to total asset ratio indicates future reduction in profitability and non-cash liquidity shortage. Bank should ideally pay deposit cost from the earnings of the credit. However, if the net loan or net credit is very low compared to total asset, profitability reduces as well as the bank's ability to successfully generate profit to pay for deposit cost. A reduction in net loans to deposit and short term funding refers to marketing inefficiency of the bank and indicates future low profitability. An average of 30% liquid asset to total deposit and borrowing indicates low liquidity risk and also low investment in high earning asset. This ratio indicates the trade off between liquidity and profitability, which is very low in this case.

6. CONCLUSIONS

Risk management is an integrated phenomenon (Nocco & Stulz 2006). It must go hand in hand with the overall banking policy. Under a typical risk-return theory, banks must espouse effective risk management framework to maximize the return to the business. Moreover, studies found relationship between risk management and performance of Islamic banks (Al-Tamimi & Al-Mazrooei 2007; Rosman 2008). Therefore, it is crucial for Islamic banks to continuously analyze and take corrective actions as to maintain the effectiveness of the risk management system. Risk management is unique to every Islamic institution (IFSB 2005) due to the uniqueness in the portfolio setting. Based on this statement, this study approaches for a cases study to analyze a practical Islamic banking risk management practices and their risk reporting. Bank A (hypothetical name) is one of the most successful banks in Malaysia. The risk manager of this bank was interviewed. The reporting of risk items suggested by Khan and Ahmed

(2001) was content analyzed from the annual report for recent three years (2007 – 2009) and the risk performance of this bank was analyzed (2007 - 2009). Few interesting issues came out while analyzing and matching the multiple data sources. Except for the regulatory and *shariah* mismatch, every bank in Malaysia has built the internal control system, established monitoring authority and risk management committee to look after the risk management issues. Therefore, the primary focus for a sustainable risk management is **a meaningful synthesis of legal and *shariah* framework**, which is a political decision in the long run.

As argued by the interviewee, Islamic banks are mostly practicing trade finance areas in a dual banking system. A major part of the portfolio is covered by *Murabahah* (cost plus mark up) (Hassan & Dicle 2005). It was also found from the balance sheet that portfolios are diversified into products and sectors very well already. Dual banking system is not a threat rather it is an opportunity to competitively position IFIs into customers' mind (Rashid et al. 2009). However, "**a hidden hand**" must work to monitor the mixing of the two banking system and will ensure a swift progress of the Islamic Financial System. It is not easy to fight with 200 years old conventional banks easily by the 30 year old IFIs. It is the reality that to survive in fierce competition in this dual banking system, IFIs are following more "*Shariah* Compliant" system instead of "*Shariah* based" banking system. The risk ratios are giving some additional input to the existing risk management framework. When it was asked to the interviewee; *why the profitability ratio is going down when the risk ratio is going up even though bank has fulfilled most of the risk management issues effectively?*

The answer given by interviewee is quiet normal however missing in organizational setting. As this study started with the statement that risk has been erroneously related to reactive action, the true argument is that risk has to be put inside the organizational policy. Risk is nothing separate from the operation and therefore **every department should have separate risk analysis department** instead of a centralized risk analysis department. Under "Shariah based" Islamic system, risk management, both proactive management and risk hedging, is already built in to the system. Therefore, firstly, Islamic banks are facing various risk issues because the **operation is quasi-Islamic** (*Shariah* Compliant) and secondly, **larger understanding on the business process is needed** (Rosman 2008; 2009; Khan & Ahmed 2001; Hassan 2009; Hassan & Dicle 2005; IFSB 2005; Greuning & Iqbal 2008; AAOIFI 1999).

Finally, it is the integrity and belief of the IFIs that counts end of the day. IFIs are not social organizations but they have responsibility towards larger community. To save them from the risks, if IFIs do not invest, this may reduce the liquidity risk, however, may reduce the future growth opportunity as well. Recently, the corporate governance has been the most important issue in banking supervision. AAOIFI, IFSB, BASEL (BCBS) are bringing in new rules every morning to strengthen the market supervisory power. However, it is always true that market is one step ahead of the regulators. Recently AAOIFI advised the IFIs to put more emphasis on the Shariah Governance, which is expected to integrate the work efficiency with job integrity and belief (AAOIFI 2010). Hypothetically, the best Islamic system works when **work efficiency comes with continuous knowledge building, job integrity and belief** (Beekun & Badawi 2005; Brown & Skully 2007; Dusuki 2007).

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