

Specifics of Risk Management in Islamic Finance and Banking, with Emphasis on Bosnia and Herzegovina

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Abstract

The ever increasing globalization of financial institutions' business activities and liberalization of capital markets inevitably lead to the increase in both diversity and intensity of the institutions' types of risk. Risk management is of the essential importance to the institutions, especially banks, because of the fact that their risky activities are the source of creating wealth for their stockholders.

In terms of Islamic banking, risk management is still not sufficiently developed. Certain specific qualities in risk management in Islamic banks emerge due to a special way in which they run the business. Nowadays, Islamic banks mainly use conventional products for risk management, adopting them to their business in accordance to the Shari'ah. Regarding the Islamic finance and banking in Bosnia and Herzegovina, it is still based on the activities of the bank that, although being a "hybrid" Islamic bank, is the only Islamic bank on the territory of South-Eastern Europe. This paper surveys the specifics of its risk management.

Keywords: Islamic Finance and Banking, Risk Management, Bosnia and Herzegovina (BiH).

JEL Classification Codes: G21, G32.

Bosna ve Hersek Özelinde İslami Bankacılık ve Finans'ta Risk Yönetiminin Özellikleri*

Öz

Artan küreselleşmiş finansal kurumların iş faaliyetleri ve kapitalist piyasaların liberalleşmesi kaçınılmaz olarak kurumların risk türlerinde hem çeşitlilik hem de yoğunluk bağlamında bir artışa yol açmıştır. Bankaların riskli faaliyetleri kendi hissedarlarının refahını oluşturmada kaynak teşkil ettiğinden özellikle de bankacılık sektörü başta olmak üzere kurumların risk yönetimi ciddi bir öneme sahiptir. İslami bankacılık bağlamında risk yönetimi henüz yeterince gelişmemiştir. İslami bankacılığın risk yönetiminde belli spesifik özellikleri iş dünyasının kendine has yönetim tarzıyla ilişkilidir. Günümüzde İslami bankalar çoğunlukla risk yönetimi için kendi iş dünyalarını Şeri'at kanunlarına göre adapte ederek konvansiyonel ürünleri kullanma yoluna gitmektedir. Bosna Hersek'teki İslami bankacılık ve finans sektörü her ne kadar melez bir İslami bankacılık olsa da Güneydoğu Avrupa bölgesindeki tek İslami bankacılık sektörünün faaliyetlerini oluşturmaktadır. Bu çalışma İslami bankacılığın risk yönetim özelliklerini incelemektedir.

Anahtar Kelimeler: İslami Bankacılık ve Finans, Risk Yönetimi, Bosna ve Hersek.

JEL Sınıflandırma Kodları: G21, G32.

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1. Introduction

Islamic (interest-free) banking is currently on the rise and there are numerous facts supporting the idea that this kind of financial institutions that operate under the *Shari'ah* principles (i.e. the legal framework which regulates the public and private lives of all members of Islam) shall in time become a serious competitor to all conventional financial institutions. Many countries all over the world use Islamic banking for their financial activities. Some countries, for example Sudan or Pakistan, completely accepted the business activities complied with the *Shari'ah*. On the other hand, there are countries where Islamic banks run their businesses along with the conventional banks. Those countries are Saudi Arabia, Jordan, Egypt, United Arab Emirates, Malaysia, Kuwait, Brunei, Indonesia, *etc.* Such situations are made either by opening Islamic financial institutions within the conventional institutions or by founding separate banks (subsidiaries) under the Islamic law that specialize in the Islamic financial business activities. Practical implementation of Islamic banking in the world started in the 1970s,¹ while as early as in the 1980s and 1990s these banks became a widely distributed way of bank's operations. Nowadays, Islamic banking covers over 350 different Islamic financial institutions that operate in over 75 countries on all five continents. The Islamic industry of financial institutions includes a lot of institutions such as commercial and investment banks, investment companies and mutual insurances. Nevertheless, banks are still the basic institutions for providing financial services in many Islamic countries.

The conventional financial system focuses primarily on economic or financial aspects of transactions, while the role of the Islamic financial system is to equally express ethical, social, and religious dimension aimed at creating equality in a society for the welfare of that society as a whole.

When Islamic banking is concerned, it is more or less known that the attempts are made to spread business risk between bank and user of the capital. Bank shall be directly interested in client's success and it will be actively involved in the future firm's management. By such placement of resources it can achieve higher profit in the form of return interest, but it is also exposed to greater risk. In the Islamic system, this interest rejection is replaced by the concept that creditor shall bear the risk of debtor's business activities and participate in the activity-related gains and losses, resulting in equal distribution of income.

Generally speaking, in terms of risk management most people use the term "risk" in both business and everyday life without knowing its true meaning. Risk can be easily defined as "uncertainty about the future outcome".² Under the modern conditions of business activities of financial institutions there are various risks, which is the reason why most financial institutions take certain measures to protect themselves against such risks. This kind of protection of financial institutions against risk can be only partial and in such cases banks themselves

define the acceptable risk limit which shall be used as the basis for defining the prices of banking services. Each financial institution, depending on the activities it performs, has a different system of risk management. All financial institutions have some process of risk management. That process needs to include some of the phases such as the establishment of the appropriate environment for managing all risks, finding the appropriate “risk mitigators” and measures, and appropriate internal controls (Khan & Ahmed, 2001).

2. Theoretical Background

The aim of every bank, including the Islamic ones, is to establish an optimum relation between risk and return that move in the same direction, meaning that the increase in one of these two elements results in the increase of another, and *vice versa*. Therefore, Islamic banks can avoid the risks which they believe shall not be able to cover, transfer certain types of risk redundant for the activities of Islamic bank and, finally, actively manage risks if they believe that they would create certain profit in such a way. Regardless of the ways for mitigating risks that Islamic bank uses, it primarily needs to assess all positive and negative aspects of each of the risks and choose the most favorable one on the one side and the one that is acceptable by the *Shari'ah* on the other. The reason for this is the fact that “an Islamic financial system provides a linkage between the surplus spending units (SSUs) and the spending deficit unit (SDUs) through an array of financial products and services that do not violate the norms of Islamic ethics” (Febianto, 2012).

The ways of mitigating risks in Islamic banks include the standardization of certain contracts that bear high risks and then the sale or cession of such contracts to other interested parties that are prepared to take such risks. In a similar way, conventional banks sell some of their financial instruments if they suppose that such instruments are too risky for them, thus decreasing the risks in their business activities, primarily the risk against the reduction of price of a certain financial instrument. The ways in which risk can be avoided in Islamic banks include contractual risk mitigation, two-step and parallel contracts, on-balance sheet netting, and immunization.

Since Islamic bank uses unique ways of funding, some risks in certain types of Islamic contracts can be avoided if the contractual terms are properly defined. Appropriate agreements between the contracting parties in that case may serve as the ways for risk control. The following examples of contractual risk avoidance are given as follows (Hassan & Lewis, 2007):

- Usual procedure with the *murabaha* (cost-plus or mark-up sale) contracts for controlling one part of risk by the contract party is the advance payment.

- In *istisna* (object deferred sale) contracts feasibility becomes a problem especially regarding the qualitative specifications of the contract. Therefore, Islamic banks in the case of failing to fulfill these specifications charge penalties.
- In some contracts Islamic bank gives discount on early payment in order to obtain financial resources as soon as possible and to decrease non-payment risk.
- Provided that Islamic bank operates in the environment in which several different policies exist that oppose to the activities by the *Shari'ah*, then the exact procedure and regulations can be determined with the client regarding the implementation of certain contract so that risks can be reduced to the least possible measure.

Risk in Islamic banks can emerge from different sources:

- a) unique activities connected with specific Islamic contracts,
- b) non-standardized and unknown nature of some Islamic products, and
- c) deficiency of efficient and fiduciary *Shari'ah* judicial system for implementing a financial contract.

The risk management system in Islamic banks involves five successive stages: risk identification, quantification of risk and capital, collecting or merging of similar risks, previous risk controls, and monitoring. Identical to conventional banks, the initial stage of Islamic banks in the process of risk management is identification of risk, which needs to provide the answer to the question of a possible loss that a bank may suffer on the basis of its exposure to all types of risk. However, Islamic banks face much more difficult tasks than the conventional banks since they are exposed to the specific types of risk as well, which are generated by their specific ways of financing. Therefore, Islamic banks intensively develop the systems by which they would be able to identify all types of risk at their very emergence, so as to prevent the increase in the intensity of their emergence because the elimination or management of these risks will be more difficult.

Apart from most of the risks that the conventional banks face (such as one part of credit, market, operational, and liquidity risk), Islamic banks also have special types of risk that are specific to their business operations in accordance to the *Shari'ah*. That is why most of the authors that deal with Islamic finance divide the risks of Islamic banks to those similar to the risks faced by conventional banks and those that are unique to Islamic banks. Understandably, Islamic banks, while performing their usual activities done in a way that is more or less similar for conventional banks, face the risks that conventional banks face. However, while doing business operations that are made in Islamic banking only, these banks face unique risks. Due to the fact that there are large numbers of both types of risk and

that they are intertwined and mutually connected, it is difficult to comprehensively divide the risks that exist in Islamic banks. One of the referential classifications of risk in Islamic banks divides all the risks of Islamic banks into one of the following types:

- financial risk,
- business risk,
- safety-deposit risk,
- management risk, and
- other types of Islamic banks' risk.

Therefore, Islamic banks have certain risks that are equal to the risks to which conventional banks are exposed. However, these banks face certain specific risks that emerge in these banks only. The ratio of certain types of shared and specific risks for Islamic banks is illustrated in Figure 1.

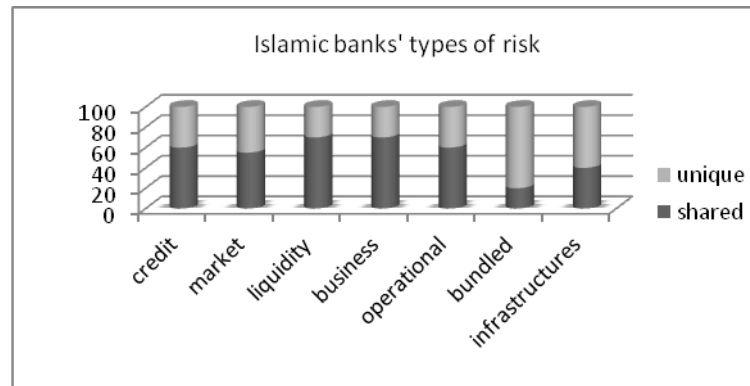


Figure 1: Shared and Unique Risks in Islamic and Conventional Banks

Source: Khan (2004)

After the identification of all types of risk, it is necessary to quantify them. This means that for every type of risk one needs to determine the highest possible loss that the risk can cause and use the data as the basis for the necessary reserves from the basic capital of a bank. This is necessary if one wants to determine the amount of capital that a bank may keep after it covers all types of risk that appear. Islamic banks have one facilitating fact that helps them in covering risk, namely they can sign contracts with their depositors that are based on the division of profit and loss so that one part of loss is borne by depositors and the remaining part by the banks.

The stage of collecting or merging similar risks in Islamic banks is extremely significant due to the fact that they are exposed to a wide spectrum of risks, so it is often necessary to divide them in certain groups that would contain the risks of the same or similar characteristics. Thus Islamic banks are enabled to perceive in a simpler way all the risks and potential losses caused by them. Without this stage

there would be too many similar risks that would be badly laid out and consequently cause confusion in their perception.

Previous controls are necessary for checking whether the conditions are set for the realization of each stage of the risk management process, failing of which would signal that certain measures must be taken so that the persons dealing with a particular stage of this process have the appropriate working conditions. In Islamic banks, the people dealing with individual stages of risk management are required to state whether they have at their disposal everything that is necessary for their work. In that way it is easier to obtain the information on what is missing so that the risk management process would be complete.

Since the process of risk management is a constant process that *per se* is repetitive, it is necessary to conduct permanent monitoring so as to ensure that all the process stages run without halts and difficulties. This step is necessary because it is possible for some halts to appear in individual stages so that the people in charge of that particular stage of the process are contacted.

The research conducted by Khan & Ahmed (2001) that included 15 largest Islamic banks in the world showed that, in terms of the risks that emerge both in Islamic and conventional banks, market risk, followed by operational and liquidity risk are most present in Islamic banks while credit risk is the least present. Such representation of certain types of risk in Islamic banks appears as a consequence of the products that these banks offer. This is showed in Figure 2 where the 1-5 scale is used whereby 1 marks the lowest and 5 marks the highest risk.

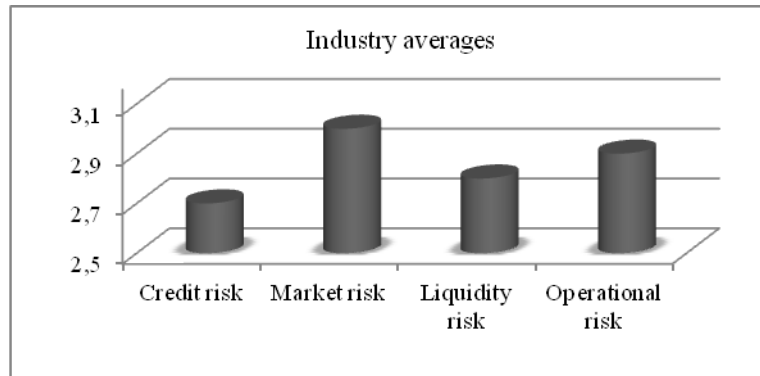


Figure 2: Average Risk in the Largest Islamic Banks in the World

Source: Khan (2004)

Besides the specific risks in Islamic banks, there are some general factors that can also make the work of Islamic banks more risky and/or less profitable than the work of conventional banks. They are the following:

- Lack of the instruments for protection against risk. Prohibition of interest means that many instruments of protection against risk such as options, futures, and forwards, are not allowed for Islamic banks.
- Insufficiently developed markets of money and state financial instruments on the basis of profit/loss division. It is difficult to manage liquidity due to aggravated harmonization of decrease of liquid assets and increase of liquid liabilities.³
- Limited availability of discount windows from the lender of last resort (LOLR). The lack of LOLR in compliance with the *Shari'ah* is connected to the prohibition of interest and consequently the prohibition of discount rate.
- Historically speaking, Islamic banks were forced to keep a large proportion of their assets on reserve accounts at central banks or the correspondent accounts at conventional banks. This significantly affects their profitability, as central banks give minimum or no return on such reserves, which affects their competitiveness and increases the potential for outer shocks.

Islamic banks' debts that are one of the basic reasons for the emergence of risk in these banks are different from the debts that exist in conventional banks. Some of the differences are given as follows (Ali Elgari, 2003):

- Inability to increase debt after the level of credit risk was defined. It is not possible to say that the addition of debt surplus shall necessarily lead to the increase in credit risk. Debt is increased due to reduced default and it is not an appropriate means for profit increase. The level of risk depends on the types of clients and the choice of credits. Concerning the circumstances under which most clients pay their debts to banks, banks impose penalties on them since otherwise clients will postpone the payments of debt. Imposition of penalties, later distributed to charities, on clients is sufficient for the level of risk in a *murabaha* contract to be at the same level as in the credits given by conventional banks.
- Prohibition of debt trading. It is forbidden to sell the debt prior to its maturity to anyone but its owner, under its nominal value. This “closes the door” to debt trading. Islamic banks can not therefore deal with discounted bills as it means that they support *riba* (interest). What is more important is that it is not possible for those banks to rely on the transfer of debts in their ledgers *via* selling them to third parties. The method of portfolio optimization enables bank to restructure its assets in the portfolio. Without doubt, this leads to the increased ability for risk management. However, this is not possible for the bank whose assets are comprised of massive debts in any way but by selling the debts. If debt trade is forbidden, as is the case with Islamic banks, these banks are required to show flexibility in managing liquidity risk.

- The influence of contract form on the level of risk. The basic difference between Islamic and conventional banks is the fact that the operations of conventional banks are based on credit. The relation between bank and its clients, regardless of the name of transaction, is the relation of creditor and debtor. In terms of Islamic bank, it operates through sale, partnership, and leasing. That is why it is assumed that the risk in Islamic banks is higher than in conventional banks. This is incorrect as it can be proved that the category of loans has a lower risk in relation to the categories of sale, partnership, and leasing. Thus, the attempts of Islamic banks to run their operations within the *murabaha* contract does not lead to decreased risk in relation to other risks that exist in a bank, just as giving loans does not mean the decrease in risk.
- Inability to increase the amount of debt. Banks' credits are of limited terms and debtor is obliged to pay them in the defined periods. Debtor is considered to be in default if the payment is postponed without bank's consent. If debtor is late with debt payment for a proportionally longer period of time, but still wants to keep good relations with bank and is prepared to bear higher interest rates, banks then rely on what is called debt reprogramming. In such cases client is not able to make payments for a certain period of time. The possibilities for such cooperation in Islamic banks do not exist since that is basically *riba* and *jahiliyyah*, meaning the arranged prohibition.⁴ If a debtor buys bank immovable and movable assets by the *murabaha* or *istisna* contract, the amount is fixed and it cannot be increased by imposing delay penalties. Some Islamic banks that impose delay penalties do that only as a way of intimidation and they later donate these amounts to its deponents. "Banks can voluntarily set aside a part of the profit made through investing the sources deposited on savings accounts and give that part to their deponents as a gift (*hiba*)".⁵ Islamic banks have other measures as well for reducing the influence of this problem on their incomes:⁶
 - a) Application of a higher mark-up rate (risk premium) for sales on credit, depending on the client's ability to pay the debt.
 - b) Making transactions that are based on the assumption that client is obliged to pay in time, which is made by calculating a higher price at a sale. There are two systems of payment formed. If buyer pays in accordance to the prompt payment system (first system), the increased sum is returned to him/her. In the second system, the client is obliged to pay the full price because bank in this system uses overdue.
- Prohibition of conditional discounting. Settling debts prior to their maturity is the target for many clients. Sometimes it can be the best solution for both client and bank. By doing so, they can rely on the provisions stipulated in the loan contract that define the amount of discount should clients decide to settle their debts prior to their maturity. However, conditional discounting

is forbidden for the *murabaha* contract. This contract does not allow such procedure, although nothing prevents early debt settlement and there is nothing wrong in giving discounts for early payment. It is considered that it sometimes may cause certain risks for bank, but that is not the case for most of the contracts.

One of the special risks that are present only in Islamic banks is the risk of financing the assets on the basis on profit-sharing investment accounts (PSIA). Some general rules for reducing the risk of financing the assets on the basis of PSIA are the following:

- assets financed by current accounts or capital should be completely separated from the PSIA financed assets;
- share the risk among PSIA shareholders and all the other shareholders, for example, *regulation capital for the PSIA financed assets = capital / 50 per cent of the PSIA financed assets*;
- implement the valid risk rules by Basel;
- determine investment risk reserves (IRR) and profit equalization reserves (PER).⁷

The non-existence of profit-and-loss-sharing (PLS) funding also bears certain specific risks that are present only in Islamic banks. Namely, a *salam* (pre-paid sale) contract exposes Islamic banks to credit risk and risk of a change of goods price as in this case Islamic banks agree to buy the goods on a future date without the present payment and keep the goods until they turn into cash. A similar risk is also included in the *ijara* (leasing or renting) contracts since these contracts do not provide Islamic banks with the ability to transfer lessee' significant risks and rewards on the rented property that needs to be included in banks' balances during the lease period.

On the liability side, a special risk inherent to the business operations of Islamic banks is a result of a specific nature of deposit investment. Namely, the value of the capital and return rate is not guaranteed. This is, along with the asymmetrical information, the result of unlimited PLS and non-PLS contracts where banks manage the population's money on their own responsibility.⁸ This increases the potential for moral hazards and creates the stimulus for taking risk for the operative Islamic financial institutions without the appropriate capital. The fact is that "Islamic banks should innovate or develop more tools which are *Shari'ah* compliant to cater for the sector's needs, but sufficient expertise in the relevant areas will be essential" (Tafri, Rahman, & Omar, (2011).

As previously stated, Islamic banks are not allowed to use some instruments for risk management that are used by conventional banks. It actually means that Islamic banks have limited abilities when they take credit or interest risks as well as the sources available to banks for balancing receivables and assets. The cause

to all this is in the usage of a *murabaha* contract as the form of financial brokerage.⁹ Since by a *murabaha* contract the financial property becomes debt, possibilities for Islamic banks that deal with debt, within the allowed restrictions specified by the *Shari'ah*, are limited. In a *murabaha* contract, it is possible to use the experience of conventional banks in the field of accounting and financial management on the basis of the property similar to the property generated by the conventional banking credits. This led those dealing with Islamic banks to compare the burden of financing by means of a *murabaha* contract with the burden that is the result of bank credits, since in both cases it is a matter of debt. They concluded that Islamic banks' business activities bear the burden that is heavier than bank credits. The most important reason for this is that Islamic banks operate on the same market as conventional banks and Islamic banks compete with them.

Islamic banks are subject to various forms of regulation that is partially equal to the regulation of conventional banks. However, Islamic banks have some specific qualities related to the regulation of this type of banks. Legal and regulatory practice of managing Islamic banks differs by individual countries.¹⁰ Chapra & Khan (2000) suggest four main reasons for the regulation of Islamic banks:

- a) keeping the regular system of payment;
- b) protection of the interest of clients that have demand deposits at an Islamic bank, which is the reason why Islamic banks need to have 100 per cent reserves for demand deposits;
- c) provision of the compliance with the *Shari'ah*, and
- d) support to the integration of Islamic banks in the international financial system.

One striking characteristic of modern Islamic banking institutions is the role of the *Shari'ah* supervisory board that is an integral part of Islamic bank. It monitors the business operations of Islamic bank and has the task to eliminate every transaction that is suspicious from the point of view of the *Shari'ah*. The attitudes and sanctions of these boards are expressed in the form of legal opinion called *fatwa*. Besides this the International Association of Islamic Banks (IAIB), the independent body, supervises the work of individual supervisory boards while their Supreme religious body examines the legal opinions proclaimed by bank members' supervisory boards in order to determine if they are in compliance to the *Shari'ah*. The Institute of Islamic Banking and Insurance (IIBI) operates in London. It provides training to all the people interested in becoming Islamic bankers. IIBI has its regular membership that includes both organizations and individuals. There is a fear that certain Islamic banks do not meet the provisions of the Bank for International Settlements (BIS). However, "if Islamic banks are accepted as a part of the regular financial structure and international trade, their harmonization with the BIS is absolutely necessary."¹¹

Under the conditions of the conventional economic system in Bosnia and Herzegovina (BiH), problems may appear in the relations between Islamic bank and state and supervisory institutions such as central bank, agency for banking, tax authorities, and others. The Central Bank has strictly specified rules of the obligatory reserve that commercial banks set aside and keep on its accounts. If the amount of the obligatory reserve exceeds “a certain equivalent”, the Central Bank charges compensation (interest) to commercial banks at a market rate. Also, provided that the obligation of keeping the obligatory reserves is not fulfilled, the Central Bank charges default interest. In both cases, Islamic bank needs to enter negotiations with the Central Bank aimed at defining the acceptable model which will replace the conventional means of collection or payment of interest.

3. Research Methodology

Although risk management has been present in most banks ever since they were founded, still there are many difficulties which all the banks in BiH face and which make their risk management more difficult. This is especially true for the Islamic bank for which no appropriate legal regulations have been created that would allow all the aspects of Islamic banking. The Islamic bank, *Bosna Bank International* (BBI), which is the only Islamic bank active in BiH,¹² is actually a “hybrid” or “semi-” Islamic bank since the existing entity laws on banks did not provide the possibility for the institutionalization of Islamic banking in BiH (the amendments to the existing federal Law on Banks are in the parliamentary procedure and one of them is related to the institutionalization of Islamic banking, more precisely, it needs to provide that banks “in their business activities use products based on partnership and buying/selling with a margin but only in order to crediting-financing their clients”). Therefore, the results obtained by this research take into account the fact that there are certain limitations, such as the limited application of Islamic banking and the comparison of the risk management by one bank to the average of the conventional banks.

The research in question, which was supposed to throw light on the specific aspects of risk management in the only Islamic bank in BiH (risk identification tools, intensity of emerging different kinds of risk, financial performance measuring, and risk controlling), was conducted by the survey method and the questionnaire technique. The questionnaire was delivered to all BiH banks to their e-mail addresses for the reason of further emphasis of specific points. The survey was conducted from the end of March to the beginning of July 2012. Out of twenty-nine BiH banks, nine banks filled in the questionnaires (one Islamic bank and eight conventional banks) which means that, if we exclude two banks that are under emergency administration (meanwhile one of them lost its license) and two entity development banks, the response rate was 36 per cent.

4. Results and Discussion

By analyzing the data on the ways of risk management in the Islamic bank and conventional banks in BiH we have identified certain differences, meaning certain details specific for the Islamic bank that will be presented in the following part.

The comparison of the ways for the identification of risk in the conventional banks and the Islamic bank would look as showed in Figure 3. It is evident that both, the Islamic bank and conventional banks use some identical methods for risk identification, such as analysis of financial statements, analysis of past experiences, and exchange of information among external partners and certain organization units. Among others, the Islamic bank regularly uses flow diagram and analysis of contract while only 14.29 per cent of the conventional banks use flow diagram and only 57.14 per cent of them use analysis of contract. Less than 30 per cent of the conventional banks use the methods for risk identification such as questionnaires, interviews, and hazard analysis while the Islamic bank does not use them at all.

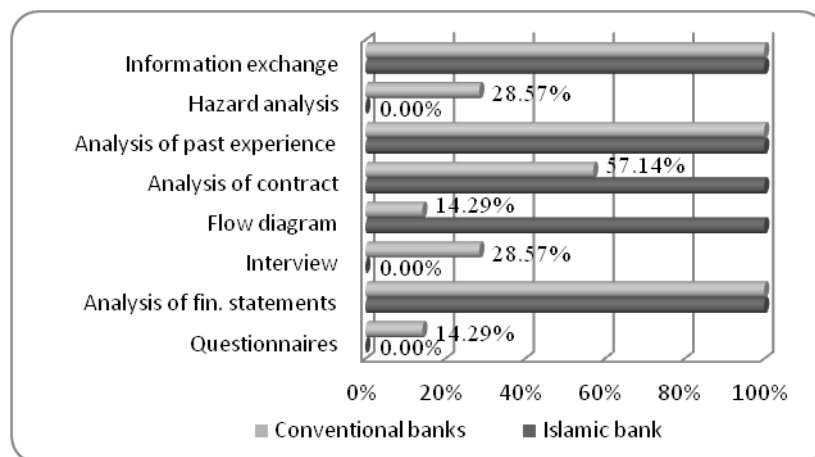


Figure 3: Comparison of Risk Identification Methods in Islamic and Conventional Banks

The effect intensity of certain types of risk is different in the Islamic and conventional banks. We can see that in Figure 4, which shows that the Islamic bank has higher intensity of emergence of all types of risk. The respondents confirmed that the Islamic bank in BiH has “high” credit risk, liquidity risk, and operational risk, while they stated that market risk in this bank has “medium” intensity of emergence. The conventional banks, in comparison to the Islamic bank, have smaller intensity of emergence of all risks. All the risks in conventional banks were rated with “medium” intensity of emergence. When reporting on other risks, the conventional banks also singled foreign currency risk stating that it has a “small” intensity of emergence but that it influences banks’ business operations.

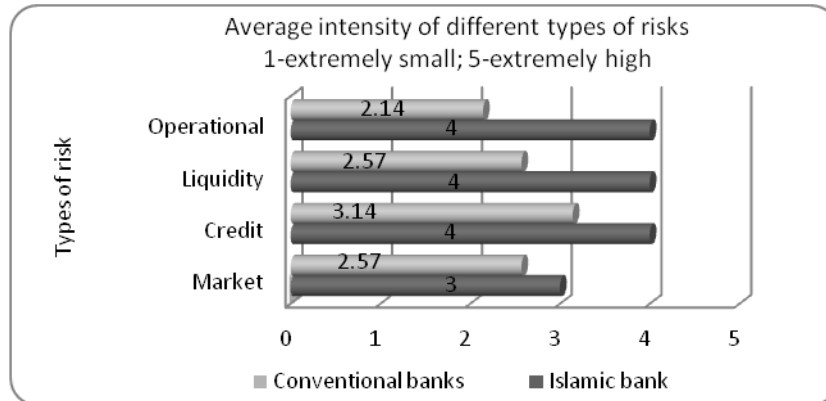


Figure 4: Intensity of the Emergence of Specific Risk Types in Islamic and Conventional Banks

The conventional and Islamic banks use different indicators for measuring their financial performance. It is noticeable that these two types of banks equally use indicators of interest earning assets and net interest margin indicators, while the Islamic bank uses liquidity indicators, indicators of financial structure, and profitability indicators more. On the other hand, while the Islamic bank does not use cash flow 1 and 2 and debtor income assessment, as well as other indicators, 28.57 per cent of the conventional banks use these indicators.

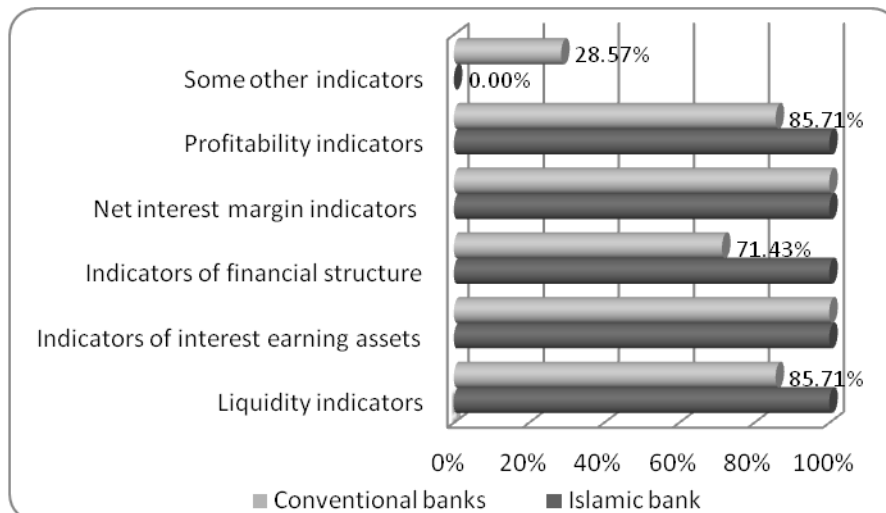


Figure 5: Differences in Financial Performance Indicators Usage by Islamic and Conventional Banks

Concerning the differences in terms of risk management in conventional banks and one Islamic bank in BiH, the Islamic bank is exposed to risks more than the conventional banks, mainly due to special products that the bank offers to its

client. Also, certain instruments of protection against risk are less available and mainly limited for the Islamic bank. The main reason lies in the regulation which has not completely allowed the business operations of Islamic banks in BiH. Therefore, the existing Islamic bank, as it has been emphasized, runs its operations only as a “hybrid” Islamic bank. If the advancement of the risk management process is to be achieved in BiH banking and consequently in the only Islamic bank in BiH, the especially important prerequisites are the following:

- to develop the financial market further (especially for Islamic banks) and inform the public in order to eliminate many prejudices that appeared mainly during the global financial crisis (for instance, one of the prejudices and wrong understanding of Islamic banking is that it is intended only for Muslims);
- to increase innovativeness in banks;
- to consistently follow all bank’s policies, especially those related to risk management;
- to work on the prevention of new risk emergence;
- to introduce the appropriate IT applications that is, the appropriate software for risk management, *etc.*

5. Conclusion and Recommendations

Based on the abovementioned considerations, in order to efficiently manage risks in Islamic banking, the strategies need to be considered that are based on the appropriate regulatory framework and institutional development. The regulation of banks in BiH should be additionally explained, especially regarding Islamic banks that still operate under the same legislative system used for conventional banks. The appropriate capital as well as the appropriate risk management are the key elements for ensuring proper work of Islamic banks. Only by active management of all risks, mutual and specific, can Islamic banks be competitive to conventional banks in future.

Some of the strategies for the appropriate risk management in Islamic banking can be:

- Bankers should have sufficient amount of capital to cover all risks in order to reduce the possibility for moral hazard in PLS contracts.
- Since unlimited contracts, such as *mudaraba* (sell at a profit, profit-sharing), include asymmetrical information for client and bank, the appropriate capital and reserves could be used to provide psychological help for depositors and retain their trust in banks.
- Constant efforts of banks to attract as many clients as possible who invest their money into PSIA. This is obligatory in case of losses where it can prevent gradual withdrawals of deposits. Withdrawals of deposits can lead

to the liquidity crisis for which Islamic banks are perhaps less prepared than conventional banks.

- In terms of financing by means of PLS it should be taken into account that they include several unique forms of risk that need to be considered and monitored, depending on specific contracts and the entire environment, *etc.*

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Notes

Note 1. The most significant impulse to the development of Islamic banking was the decision made by the Organization of Islamic Countries (OIC) in 1974 about the founding of the Islamic development Bank (IDB) whose goal is to sponsor Islamic banks worldwide, provide financial assistance to developing countries, and promote the principles of Islamic economy and finances.

Note 2. www.rizici.com/2/definicija (Accessed: March 2010)

Note 3. A significant improvement has been achieved in Iran by issuing state bonds and short-term instruments such as national participation certificates as well as the usage of the central bank assistance.

Note 4. This prohibition is marked by the well-known statement of the debtor to the creditor: "Prolong the period for me and I shall increase the debt amount for you", or the creditor's statement: "Shall you pay now or later but the increased amount".

Note 5. novihorizonti.ba/102/11.html (Accessed: February 2010)

Note 6. www.ibsintelligence.com/.../analysis-identifying-operational-risks.../114 (Accessed: May 2010)

Note 7. PER and IRR are "two mechanisms actively used by Islamic banking institutions to reduce the volatility of rates of return on investment deposits and consequently to smooth their returns" (Taktak, Zouari, & Boudriga, 2010).

Note 8. According to the unlimited quality of contracts, depositors agree for their resources to be used by banks at their discretionary right and they expect to share with the banks the total profit that a bank can earn.

Note 9. *Murabaha* contracts comprise more than 90 per cent of Islamic banks' business activities (www.ibsintelligence.com/.../analysis-identifying-operational-risks.../114, Accessed: May 2010).

Note 10. So far the laws on Islamic banking have been brought by the following countries: Indonesia, Lebanon, Malaysia, Pakistan, Sudan, Turkey, United Arab Emirates, and Yemen. In Saudi Arabia and Egypt, the laws are the same for Islamic and conventional banks.

Note 11. www.mm.co.ba/organizacija/47-zanimljivi-tekstovi/132-islamsko-bankarstvo (Accessed: October 2010)

Note 12. BBI was founded in the year 2000 by the Islamic Development Bank, Dubai Islamic Bank, and Abu Dhabi Islamic Bank with the aim to introduce Islamic banking on the territory of South-Eastern Europe.