Assessing the Risk Management Practices of Islamic Banks in Malaysia And Jordan

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Islamic Banking is a financial sector with aims, principles, and practices that comply with Islamic Law (Saleh & Zeitun, 2007). *The underlying principles that govern Islamic Banking are mutual risk and profit sharing between parties, the assurance of fairness for all and that transactions are based on an underlying business activity or asset* (BNM, 2007). Islamic Banking Institutions (IBs) in Malaysia and in Jordan emerged due to the growing awareness and increasing demand from Muslims for financial services and products that are managed in accordance with Islamic principles. The IBs have become one of the most important players in the economy of the two countries. Islamic funds are mobilized more effectively in the market due to the assurance that the business activities are free from *Riba*, gambling and elements of uncertainty; borrowers and financiers share risks and profits equally; and transactions are based on underlying business activities or assets.

Islamic banking has become one of the vital sources of economic growth, particularly in countries where a significant number of Muslims refuse to deal with *Riba* (interest) transactions. These countries include Malaysia and Arab countries, such as Jordan and Egypt. Jordan started to practice Islamic banking in 1978 with the opening of the Jordanian Islamic and financing bank while Malaysia started its first Islamic Banks in 1983. In general, banking business is exposed to an inherent number of risks, namely, credit risks, market risks, operational risks, and liquidity risks. However, since Islamic banks should only be involved with activities that comply with the religious and ethical underpinning, and due to the nature of their balance sheet these exceptional requirements expose the institutions to special or unique risks, namely, *Shariah* non-compliance risk, rate of return risk, displaced commercial risk, *murabahah* price risk, and equity investment risk to name a few.

Recently, the Islamic banking institutions of Malaysia and Jordan suffered several challenges, such as misconceptions about Islamic banking, lack of uniformity between *Shariah* review, inadequate pool of *Shariah* scholars with the right combination in respect of Islamic law and modern finance, documentary complexity, heightened competition, and the aggressive launch of innovation, lack of risk-hedging instruments, and the sophisticated products of other financial institutions (Makiyan, 2008; Khan & Ahmed, 2001). Despite all the challenges, it can be seen that the Islamic banking institutions have grown tremendously. However, the rapid growth of these institutions, coupled with the economic uncertainties demand that sound risk management practices are executed by them. This is vital for the survival of the banks, to help them in achieving their operational, financial, compliance and strategic business objectives, and, subsequently, create value for their stakeholders. Additionally, it could help the Islamic banking institutions stay competitive with their counterparts.

Further these two countries follow two different types of *Madhab* (religious jurisprudence) or schools of thought. Hence, would different countries with different environments and different schools of thought have practiced different approaches in managing risks in their Islamic banking institutions? This article focuses on examining the level of Risk Management Practices of Islamic banking institutions (IBs) in Malaysia and Jordan. Due to the different environments, various variables suggested by previous researchers (namely, Risk Management Practices, Understanding Risk Management and Techniques used in Risk Management, Risk Identification, Risk Assessment and Analysis, and Risk Control and Monitoring) are subject to further review. The main aim is to provide evidence and an enhanced understanding of the current risk management practices of the institutions in question. Research in this area would be a significant contribution to the development of knowledge and would also be beneficial to the practices of risk management for Islamic banking institutions.

Since the research setting of this study is looking at the level of risk management practices (RMP) of Islamic banking institutions in Malaysia and Jordan, only five risk management practice variables are examined. The intention is to capture several characteristics that can differentiate the level of RMP in both countries. The variables used in this study are Risk Management Practices (RMP), Understanding Risk Management (URM), Risk Identification (RI), Risk Assessment and Risk Analysis (RAA), and Risk Control and Monitoring (RCM).

RMP is the process by which various risk exposures are recognized, identified, analysed, assessed, quantified, mitigated, prioritized, exploited, monitored and reviewed (CAS, 2003).

Mohd Ariffin assessed the current risk management practices of eight Islamic banks in Malaysia and found that all banks in the study practice good risk management. However, those banks need a few improvements in the area of the techniques or approaches used to mitigate risks. To understand the background of risks associated with Islamic banks, suitable risk management practices and appropriate techniques are crucial as it helps stakeholders to determine the elements of risk and develop their risk framework (Khan & Ahmed, 2001). Since Islamic banks have a unique risk structure, this stage is crucial for the regulators, management team and the *Shariah* experts to accumulate all preliminary inputs before establishing comprehensive risk management practices and procedures; and, thereafter, help them to achieve their objectives (Khan & Ahmed, 2001). Once the management team identifies the related risks, they will then assess each identified risk in several different ways – they can choose to reduce the likelihood and impact of risk by implementing effective internal controls, accept the likelihood and impact of the risks, share or transfer the risks, or they can also avoid the risks of not engaging in the activity that produces such risk (Romney & Steinbart, 2012:213). On the other hand, risk analysis is normally the stage where the impact of specific risks and the consequent impact on the institutions are calculated (Hamilton, Qasrawi & Al-Jarrah, (2010). Further, the on-going RCM function should be considered of great importance nowadays to ensure that Islamic banks could cope with the current global economic challenges and uncertainties in the industry. With proper control and continuous monitoring, Islamic banks can deter problems before they arise, discover problems that are not prevented and also identify and correct the problems (Romney & Steinbart, 2012).

Since this study extends the current literature by examining the level of risk management practices (RMP) of Islamic banking institutions between the two countries, the relevant hypotheses that have been developed are as follows:

H1: There is a significant difference between the level of risk management practices (RMP) of Islamic banks in Malaysia and Jordan.

H2: There is a significant difference between the level of understanding and the techniques (URM) employed in assessing the risks of Islamic banks in Malaysia and Jordan.

H3: There is a significant difference between the level of risk identification (RI) of Islamic banks in Malaysia and Jordan

H4: There is a significant difference between the level of risk assessment and risk analysis (RAA) of Islamic banks in Malaysia and Jordan.

H5: There is a significant difference between the level of risk control and risk monitoring (RCM) of Islamic banks in Malaysia and Jordan.

H6. There is a significant positive relationship between risk management practices and understanding risk management, risk identification, risk assessment and analysis, and risk monitoring

The questionnaire used in the current study was segregated into five main parts: the respondent's profile; the company's profile; the risk management process – understanding risk management, risk identification, risk assessment and analysis, and risk monitoring; general risk management practices; and governance on risk management practices. Respondents were asked to indicate, on a 7-point Likert scale (ranging from 1= strongly disagree" to 7="strongly agree", their perceptions concerning a total of 40 closed-ended questions relating to the risk management process (11 questions) and risk management practices (29 questions).

Questionnaires were distributed to each of 17 Islamic banks (IBs) in Malaysia and 4 Islamic banks in Jordan. The usable data for Malaysia comprises 136 questionnaires and for Jordan 70, which gives a total sample of 206.

The study reveals that the countries differ in some dimensional aspects of risk management practices and share some practices to an equal degree. The similarities and differences in the risk management practices in Islamic banking between Malaysia and Jordan could be due to numerous factors, such as historical issues, level of development of Islamic banking in the two countries, and Islamic norms and values. As shown in Table 1, the findings imply relative competition between Malaysia and Jordan in risk management in Islamic banking, with Malaysia leading in terms of understanding risk management, risk assessment and analysis, and risk control and monitoring, while Jordan leads in the area of risk management practices. There is no significant difference between the two countries in terms of risk identification. Hence, the results reject H3 and accept H1, H2, H4, and H5. Overall, the results provide evidence of efficiency in risk management practices within the Islamic banking industry in Malaysia and Jordan.

Table 1: The Level of Risk Management Aspects in Malaysia and Jordan

	Risk Management Aspects	*Malaysia mean*	*Jordan mean*	*Significant Difference*
1	Risk management practices	5.83	6.22	.016
2	Understanding risk management	6.11	5.88	.011
3	Risk identification	5.4	5.57	.171
4	Risk assessment and analysis	5.95	5.84	0.029
5	Risk control and monitoring	6.04	5.92	0.04

In addition, the regression analysis in Table 2 depicts that two significant predictors were found in both countries, risk assessment and analysis (RAA) and risk control and monitoring (RCM) in Malaysia, and understanding risk management (URM) and risk control and monitoring (RCM) in Jordan; this indicates that risk control and monitoring (RCM) is a good predictor in both countries.

Table 2: Regression Analysis Results

Variables		*Malaysia*		*Jordan*				*Overall*	
	Coef-ficient		*Sig.*	*Coef-ficient*	*Sig.*		*Coef-ficient*		*Sig.*
Constant	-0.17		.978	3.304	.000		1.408		.009
Understanding risk management (URM)	.057		.608	.336	.002		.075		.384
Risk iden-tification (RI)	0.92		.382	-.178	.149		.153		.002
Risk assessment and analysis (RAA)	.254		.007	.136	.226		.179		.029
Risk control and moni-toring (RCM)	.526		.000	.275	.005		.369		.000
Adj. R^2		.516				.408		.367	
F-value		22.34				9.901		20.22	
Sig.		.000				.000		.000	
N		121				79		220	

The introduction of the "Basel II" provided an opportunity for sound RMPs in the Islamic banking system for both countries in that they responded to this challenge by undertaking a significant upgrading of their risk management system. Future research may want to focus on identifying the proper risk mitigation strategies for Islamic Banks.

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