

CHAPTER III

CREDIT RISK MANAGEMENT IN ISLAMIC BANKING APPROACH

3.1 Introduction

Banks have learned from the financial crises in 1997 and 2007, thus providing better strategies in credit risk management (Zubair Hasan, 2002; Anil & Zingales 2010; Kacperczyk et al., 2010; Friedman & Posner, 2010). The first banks launched were conventional banks but the increasing number of Muslims concerned about the Islamic principles of banking business led to the promotion of other types of banking system that complied with *Shariah* principles – Islamic banking system. Banks in Malaysia moved to consider the Islamic window of finance, such as Maybank, RHB bank and CIMB bank, which also provide Islamic modes of financing to the customers as a result of the features of Islamic financing system offered. However, conventional banks still differ from Islamic banks (Hassan & Lewis, 2009; Liaqat Ali et al., 2013).

The operating modes in conventional banks contrast from Islamic banks in that they are based on manmade principles, while Islamic banks are based on Islamic principles which are based on *Al-Quran* and *Sunnah*. The prohibition of *riba*, allowing the concept of equity participation, money as ‘potential capital’, the prohibition of *gharar*, the sanctity of contracts and permitting business activities that do not violate the rules of *Shariah* are the principles of the Islamic banking system.

In addition, in terms of business financing activities, they shared the risks among the counterparties included in the contract. In the case of lending, conventional banks lend money to the customers and charge compounding interest on the loan,

while Islamic banks use Islamic contracts as the bank itself participates in the partnership business. This is a fundamental function and the uniqueness of Islamic banks (Muhammad Ayub, 2007).

To extend this further, this chapter reviews the literature and explains some of the previous studies related to the scope of study, which enables this study to have a coherent standpoint on the understanding of this topic. Firstly, this chapter explains the differences between the Islamic banking system and conventional banking system in terms of the principles and how the differences affect the exposure to risk in general. Thus, the study explains the concept of management, risk, risk management and credit risk management from an Islamic perspective. Next, this chapter explains the credit risk management in Islamic modes of financing in major Islamic financing contracts. This helps to develop this chapter on credit risk management to show that the existing ideas in the previous literature that are relevant to forming a standpoint to see whether they are consistent or otherwise, and whether the previous studies have any impact on the research area.

Furthermore, the study will discuss the empirical studies on credit risk management in the Islamic banking system, which helps in developing a standpoint on the existing ideas on the concepts, theories and applications. Thus, this study will explore all the existing ideas and frameworks to see if there are any consistencies or gaps in the area of study.

3.2 Islamic Banking System versus Conventional Banking System

In general, a banking system is needed as its nature is to provide funds (borrower) to those in need (Arora, 1997; Saunders, 1999; Casu et al., 2006). As financial intermediaries between borrowers and lenders, banks attract deposits from

individuals and legal entities, and use the deposited money to give financing to those who need funds, which is called credit financing. Despite the nature of the banking business system, there are many differences between the Islamic banking system and conventional banking system. The key difference is in terms of the fundamentals of the *Shariah* ruling principles in the Islamic banking system, which consists of the laws governing human deeds called *Fiqh* (Muhammad Ayub, 2007; Iqbal & Mirakhor, 2011). The term *Fiqh* is based on the respective particular evidence, which comes from specific verses of *Al-Quran* and *Sunnah*. Therefore, these principles have led to significant differences between the Islamic banking system and conventional banking system. These include the business dealing transactions, product features and responsibility as a whole. The Islamic banking system adheres to the following principles:

1. Interest-free based transactions

Islam prohibits *riba* transactions as it is an excess or increase in transaction, such as the exchange of commodity that accrues to the lender or in a loan transaction without giving an equivalent counter-value (Abdus Samad et al., 2005).

يَا أَيُّهَا الَّذِينَ آمَنُوا اتَّقُوا اللَّهَ وَذَرُوا مَا بَقِيَ مِنَ الرِّبَا إِن كُنتُمْ مُؤْمِنِينَ

“O ye who believe! Fear Allah and leave the rest of the *riba* (which has not been collected), if you are believers.”

(Al-Quran. Al-Baqarah, 2:278)

“Abu Hurairah R.A. reported that the Prophet Muhammad S.A.W, said: A time will certainly come over the people when none will remain who will not devour usury. If he does not devour it, its vapour will overtake him.”

(Hadith. Ahmed, Abu Dawud, Nisai and Ibn Majah)

2. Free from oppression (*Zulm*) activities

Islam teaches Muslims to avoid oppression (*Zulm*), because the Prophet Muhammad s.a.w. reminded that among the dark things is oppression. It has been narrated by Hazrat Abu Huraira RA that Prophet Muhammad s.a.w. said:

“Whoever has oppressed another person concerning his reputation or anything else, he should beg him to forgive him before the Day of Resurrection when there will be no money (to compensate for wrong deeds), but if he has good deeds, those good deeds will be taken from him according to his oppression which he has done, and if he has no good deeds, the sins of the oppressed person will be loaded on him.”

(Hadith, Sahih Bukhari)

3. *Gharar*-free based activities

The term *gharar* refers to the uncertainty that it is prohibited in Islam and that it can be reduced simply by adding more information to a contract (Abdus Samad et al., 2005). On top of that, it is ignorance of the parties concerning the contract over the attributes of the object of sale and availability at the time of the contract.

وَلَا تَقْرَبُوا مَالَ الْيَتِيمِ إِلَّا بِالَّتِي هِيَ أَحْسَنُ حَتَّىٰ يَبْلُغَ أَشُدَّهُ وَأَوْفُوا بِالْعَهْدِ وَالْعَهْدُ الَّذِي بَيْنَ يَدَيْكُمْ عَهْدٌ عِنْدَ اللَّهِ وَالْعَهْدُ الَّذِي بَيْنَ يَدَيْكُمْ عَهْدٌ عِنْدَ اللَّهِ
وَلَا تَقْرَبُوا مَالَ الْيَتِيمِ إِلَّا بِالَّتِي هِيَ أَحْسَنُ حَتَّىٰ يَبْلُغَ أَشُدَّهُ وَأَوْفُوا بِالْعَهْدِ وَالْعَهْدُ الَّذِي بَيْنَ يَدَيْكُمْ عَهْدٌ عِنْدَ اللَّهِ وَالْعَهْدُ الَّذِي بَيْنَ يَدَيْكُمْ عَهْدٌ عِنْدَ اللَّهِ

“And do not approach the orphan's property except in a way that is best until he reaches maturity. And give full measure and weight in justice. We do not charge any soul except [with that within] its capacity. And when you testify, be just, even if [it concerns] a near relative. And the covenant of Allah fulfill. This has He instructed you that you may remember.”

(Al-Quran. Al-An'am, 6:152)

“Abu Hurairah R.A reported that the Prophet Muhammad s.a.w. forbade a transaction determined by throwing stones, and the type which involves some uncertainty.”

(Hadith, Sahih Muslim, Kitab No. 10: Hadith 3614)

4. The introduction of Islamic tax (*Zakat*)

يَا أَيُّهَا الَّذِينَ ءَامَنُوا أَنْفِقُوا مِنْ طَيِّبَاتِ مَا كَسَبْتُمْ وَمِمَّا أَخْرَجْنَا لَكُمْ مِنَ الْأَرْضِ طَيِّبَاتٍ وَلَا تَتَّبِعُوا الْخَبِيثَاتِ مِنْهُ تُنْفِقُونَ وَلَسْتُمْ بِأَخِيذِهِ إِلَّا أَنْ تُغْمِضُوا فِيهِ ۚ وَاعْلَمُوا أَنَّ اللَّهَ غَنِيٌّ حَمِيدٌ

"O you who believe, spend in Allah's way the best portion of the wealth you have lawfully earned and that which we have produced for you from the earth, and do not pick out for charity those worthless things that you yourselves would not accept but with closed eyes, bear in mind that Allah is Self-Sufficient, Praiseworthy."

(Al-Quran. Al-Baqarah, 2:267)

"Ibn Mas'ud reported that the Prophet Muhammad s.a.w. said, there is no envy except in two: a person whom Allah has given wealth and he spends it in the right way and a person whom Allah has given wisdom (knowledge) and he gives his decisions accordingly and teaches it to the others."

(Hadith. Sahih Bukhari. Volume 2, Kitab no. 24: Number 490)

5. Production of goods and services that are based on permissible full-fledged Islamic value (*Halal*).

يَا أَيُّهَا الَّذِينَ ءَامَنُوا إِنَّمَا الْخَمْرُ وَالْمَيْسِرُ وَالْأَنْصَابُ وَالْأَزْلُمُ رِجْسٌ مِّنْ عَمَلٍ الشَّيْطَانِ فَاجْتَنِبُوهُ لَعَلَّكُمْ تُفْلِحُونَ

"O you who believe! Intoxicants and gambling (dedication of) stones and (divination by) arrows are an abomination of Satan's handiwork, so avoid it in order that you may prosper."

(Al-Quran. Al-Maidah, 5:90)

"The Prophet (peace be on him) said, Surely, Allah and His Messenger have prohibited the sale of wine, the flesh of dead animals, swine and idols."

(Hadith. Reported by al-Bukhari and Muslim)

Based on the above explanation, on the fundamentals of Islamic principles in the Islamic banking system, the tenets of the Islamic banking system are based on *Shariah* laws as the nature of the contracts offered differ from the conventional banking system and are not exactly like-for-like in that the Islamic banking system applies asset-backed financing contracts. In contrast, the conventional banking system

is based on the debtor-creditor relationship and uses interest charges to price the loan besides dealing in money and monetary papers only.

Therefore, with the different nature of financing offered through the different types of banking system, the relationship in terms of financing is participatory in nature in the Islamic banking system, such as the use of contractual transactions and the relationship in terms of risk and rewards in Islamic financing is led by socio-economic principles of (Muhammad Taqi Usmani, 2002). Furthermore, the Islamic financing-based approach considers that the lender should not take advantage of the borrower and there should not be any reward without taking a risk. To sum up the above explanation, table 3.1 below shows the difference between the Islamic banking system and conventional banking system in financing activities:

Table 3.1: The Difference between the Islamic Banking System and Conventional Banking System in Financing Activities

No.	Islamic Financing (Islamic banking System)	Conventional Loan (Conventional Banking System)
1.	The operating modes of Islamic financing are based on the <i>Shariah</i> Principles.	The operating modes of conventional financing are based on fully manmade principles.
2.	Islamic financing upholds the risk-sharing concept between the provider of capital (investor) and the user of funds (entrepreneur).	The capital (investor) is assured of a predetermined rate of interest charges (<i>riba</i>).
3.	The core function of Islamic financing is based on the participation in partnership business.	The core function of conventional financing is based on compounding interest (<i>riba</i>).
4.	The default case in Islamic financing is that there is no provision to charge interest but that the borrower just charges the amount of compensation and the amount from compensation	Conventional financing charges an additional amount in the case of default, such as a penalty plus the charge of compounded interest.

	are then used for charity purposes.	
5.	Islamic financing pays more attention to the evaluations and to developing business appraisal since Islamic banks offer profit and loss sharing.	Conventional financing pays less importance to evaluations and to developing expertise in business appraisal since the income from the advances is fixed.
6.	Islamic financing aims to ensure the growth with equity as it is based on asset-backed financing because it gives due importance to public interest.	Conventional financing makes no effort to provide growth with equity as it is based on the debt-creditor relationship because the bank's own interests are dominant.
7.	The status of Islamic financing is based on the relation to clients, which is that of partners, investors and trader, buyer and seller.	The status of conventional financing is based on the relation to clients, which is that of creditor and debtors.
8.	There is greater emphasis on the viability of the projects (business) in Islamic financing.	There is greater emphasis on the credit-worthiness of the clients in conventional financing.
9.	Financing activity must be based on a <i>Shariah</i> approved underlying transaction.	Borrowing from the money market is relatively easy in conventional financing.

Source: Sudin Haron & Bala Shanmugam, 1997; Muhammad Hanif 2010

In addition, regarding the credit purposes, according to Akkizidis and Khandelwal (2008), some of the differences between the Islamic banking system and conventional banking system in terms of credit purposes, as shown in table 3.2 below:-

Table 3.2: Differences between the Islamic Banking System and Conventional Banking System in terms of Credit Purposes

Islamic banking system	Conventional banking system
Primarily prohibits the interest chargers	Interest rate is allowed
Concerns social, economic and financial activities	Concerns financial activities only
Focuses on three different types of efficiency – social, ethical and financial	Focuses on financial efficiency only
Has strong moral dimension	Moral dimension is restricted
Risk sharing	No risk sharing

Source: Akkizidis and Khandelwal, 2008

Even though there are differences between them, they still have the same purpose of gaining profits. The Islamic banking system, which operates on a parallel basis with the conventional system, is called a dual banking system. Malaysia is the only country to implement a dual banking system and also utilizes the same set of banking infrastructure (Nor Mohamed Yakeop, 2003; Awaydeh, 2011; Faisal Ansari, 2013). Therefore, the approach is to study the Malaysian dual banking system as it enables one to distinguish between the Islamic banking system and conventional banking system in the credit evaluation process. This is because the range of Islamic banking products in a dual banking approach tends to be wider, since in a dual system the Islamic banks have to provide all the services provided by the conventional banks.

3.3 Management from an Islamic Perspective

Management in general is the core of the concept instead of the risk in credit in business activity (Fontaine & Khaliq Ahmad, 2013). The concept and application of management comes from the success of management in the time-line of Islamic civilization over the past decade (Azman Che Omar, 2001; Fontaine & Khaliq Ahmad, 2013). It can be proven that the people during that time applied the concept of Islamic

management in a way of business activity. Instead, the practices of Islamic management are fully based on the use of the concept of moral, *akhlak* and '*adl* (equity distribution) as a whole.

The Islamic management system existed during the time-line of Prophet Rasulullah s.a.w. He taught the concept and application of the management system, which is based on *Al-Quran* and *Sunnah*. It can be well-defined as an ability to consume the natural resources, either in the sorts of things neither human being ethically. For instance, the need to protect the natural resources, such as how is individual managing it wisely from the occurrence of risks (hazard). The other perspective is that the management is one of the characteristics that consist of principles and rules that are essential in the wide scope of things. In addition, it can be explained as the art of the knowledge of planning (Azman Che Omar, 2001).

However, the practices of Islamic management have not been widely practiced since the *Uthmaniah* civilization in 1924 *Hijriyyah*. Thus, the conventional civilization arose after the recession of the Islamic civilization and introduced the concept of management, which was based on capitalism and socialism. This concept of management is to maximize the wealth and thus affects the pure management system in Islam as it practices the secular system that separates the concept of *tauhid* and management (Abbas Ali, 2005).

To transform the current practices of the secular system, Muhammad Syukri (2003) and Abbas Ali (2005) stated that the secular system of management practices can be eradicated by going back to the concept of *tauhid* – relationship between human and the Almighty Allah s.w.t. – and the concept of the relationship between human and human in business activity. To transform the current practices of

management one must not only look at the extrinsic and intrinsic issues but at the spiritual and ethical dimension (Zahid Parves & Pervaiz Ahmed, 2004).

3.4 The Concept of Risk and Risk Management from an Islamic Perspective

In general, the concept of risk can be described as the possibility of an undesired outcome occurrence, which is extensively used to describe the probability of undesired outcomes (Kahf, 2006). In addition, risk is viewed as something negative, which could lead to both developing a better awareness for controlling it or to ignoring opportunities. Taking risk, in many instances, is crucial to achieve progress. Thus, the culture of risk should be a balanced one that leads to rational and fair decisions. Thus, risk management generally concerns circumstances (Akkizidis & Khandelwal, 2008). Islamic law; *Al-Shariah*, neither denies risk nor prevents people from taking risk. The terms risk and risk management and their implications have been discussed and stated in the verse from Al-Quran. This includes the *Surah Taha* verses 115 to 119, *Surah Al-Syua'ra'* verses 60 to 63, *Surah Maryam* verses 22 to 25 and hadith narrated by Imam Tarmizi.

Surah Taha verses 115 to 119 basically convey that Allah s.w.t. created us in the environment of risk. Prophet Adam s.a.w. was created in heaven given a wife and everything he needed but Allah also gave him risk. Humans are made weak in nature and always susceptible to risk. Hence, verse 115 states:

وَلَقَدْ عَهِدْنَا إِلَىٰ آدَمَ مِنْ قَبْلُ فَنَسِيَ وَلَمْ نَجِدْ لَهُ عَزْمًا

"We had already, beforehand. Taken the covenant of Adam but he forgot: and We found on his part no resolve.

(Al-Quran. Taha, 20:115)

He was the first Man created by Allah and he showed the features of being forgetful and weak in nature. According to Azman Ismail and Muhammad Ali Jinnah Ahmad

(2010), this teaches us at least two (2) things:-

1. The environment of risk and exposure to risk is the natural state of humans to exist in, even in his first beginnings in the heavens of Allah. What more when he is thrown down to the earth where the quantity of his risks multiplied.
2. Humans are naturally forgetful and weak, two features that accentuate his exposure to risk.

Hence, verse 116 in *Surah Taha* states that:

وَإِذْ قُلْنَا لِلْمَلَائِكَةِ اسْجُدُوا لِآدَمَ فَسَجَدُوا إِلَّا إِبْلِيسَ أَبَى
 “When we said to the angels, “Prostrate to Adam” they prostrated themselves, but not Iblis: He refused.”
 (Al-Quran, Taha, 20:116)

Allah created an environment of risks that embody risk in the nature of Satan (*Iblis*) and made humans forgetful and weak, and thus very liable to risks. Allah teaches us about the existence of risk and how to manage it wisely. For humans, the wide core of risk management is nothing less than the Kingdom of Heaven (Allah s.w.t.). If humans do not have needs, they are less susceptible to risk. This teaches us that living in a society of other beings are also a natural state for humans. As humans, we have to admit that fact and recognize the increase in risk exposure and how well we manage it. Hence, verse 117 states:

فَقُلْنَا يَا آدَمُ إِنَّ هَذَا عَدُوٌّ لَكَ وَلِزَوْجِكَ فَلَا يُخْرِجَنَّكَمَا مِنَ الْجَنَّةِ فَتَشْقَى
 “Then we said: O Adam! Verily, this is an enemy to you and your wife: so let him not get you both out of the Garden, so you are landed in misery.”
 (Al-Quran, Taha, 20:117)

This verse explains that the greatest risk to Prophet Adam s.a.w and his wife was the risk of being thrown out of the Garden. Adam needed to manage this risk but his

forgetfulness and weakness as a human failed him. Hence, verse 118-119 states:

إِنَّ لَكَ أَلَّا تَجُوعَ فِيهَا وَلَا تَعْرَى (١١٨) وَأَنَّكَ لَا تَظْمَأُ فِيهَا وَلَا تَصْحَى (١١٩)

*“There is therein (enough provision) for you not to go hungry
or to go naked. Nor to suffer from thirst, nor from the sun’s
heat”*

(Al-Quran. Taha, 118-119)

The other basic needs Allah created for a human is the need to have food and water, to be clothed, and to be protected from the elements. If only they had identified the risk and managed the risk humans might have undergone a different story. However, thus has it been ordained for Man; Prophet Adam s.a.w and Eve known of the risks, they did not manage them and faced the consequences. This teaches us that no matter in what way humans have progressed in the world we find ourselves in; they have to manage the risks of not losing these basic needs. These basic terms in the verse warn humans of the danger they will face if they do not identify the risks they face and manage them early and effectively.

The concept of risk and risk management to the Islamic financial system that can be gleaned from the above verses are as follows:-

1. Islamic financial systems have to accept the fact that risks exist in business and have to be managed. There is no business that is riskless except perhaps *riba* banking. That is why *riba* banking is abhorred by *Shariah*. Saiful Azhar Rosly & Mohd Afandi Abu Bakar (2003) stated that the riskless nature of *riba* banking violates the laws of nature in Islam, since everything except Allah must depreciate and money is no exception. When money is not subjected to the law of depreciation, humans have placed money equal to Allah. In the Islamic law concept, this amounts to idolatry (*syirik*). For this reason, Allah

declared war on Muslims who consume *riba*. Once the study acknowledges there is risk in Islamic banking, it needs to identify them before addressing how to manage the risks. Islamic banking is a business, so there are risks assigned to various aspects of the business. The pure concept of Islamic banking itself is a business that applies the practices and principles of Islam, collecting monies from the public and investing those funds to give a return to the people who have extended the monies.

2. All dimensions of risks should be looked at from the point of view of the Islamic bank that is exposed to the risks. If the risks are not managed then the Islamic bank will suffer losses, or, in the worst case scenario, it will have to be closed. All these risks are measured in terms of monetary loss (Aktizidis & Khandelwal, 2008).

In addition, verses 60 to 63 from *surah Al-Syua'ra'* and *surah Maryam* verses 22 to 25 explain:

فَاتَّبَعُوهُمْ مُشْرِقِينَ (٦٠) فَلَمَّا تَرَاءَى الْجَمْعَانِ قَالَ أَصْحَابُ مُوسَى إِنَّا لَمُدْرَكُونَ
(٦١) قَالَ كَلَّا إِنَّ مَعِيَ رَبِّي سَيَهْدِينِ (٦٢) فَأَوْحَيْنَا إِلَى مُوسَى أَنْ اضْرِبْ بِعَصَاكَ
الْبَحْرَ فَانْفَلَقَ فَكَانَ كُلُّ فِرْقٍ كَالطَّوْدِ الْعَظِيمِ (٦٣)

"So they pursued them at sunrise. And when the two bodies saw each other, the people of Moses said: "We are sure to be overtaken."
(Moses) said: "By no means! my Lord is with me! Soon will He guide me!" Then We told Moses by inspiration: "Strike the sea with thy rod."
So it divided, and each separate part became like the huge, firm mass of a mountain."

(Al-Quran. Syua'ra', 26:60-63)

فَحَمَلَتْهُ فَانْتَبَدَّتْ بِهِ مَكَانًا قَاصِيًا (٢٢) فَأَجَاءَهَا الْمَخَاضُ إِلَى جِذْعِ النَّخْلَةِ قَالَتْ يَا
لَيْتَنِي مِتُّ قَبْلَ هَذَا وَكُنْتُ نَسِيًّا مَنْسِيًّا (٢٣) فَنَادَاهَا مِنْ تَحْتِهَا أَلَا تَحْزَنِي قَدْ جَعَلَ
رَبُّكَ تَحْتَكَ سَرِيًّا (٢٤) وَهَزِّي إِلَيْكِ بِجِذْعِ النَّخْلَةِ تُسَاقِطُ عَلَيْكَ رَطْبًا جَنِيًّا (٢٥)

"So she conceived him, and she retired with him to a remote place. And the pains of childbirth drove her to the trunk of a palm-tree: She cried (in her anguish): "Ah! would that I had died before this! would that I had been a thing forgotten and out of sight!" But (a voice) cried to her from beneath the (palm-tree): "Grieve not! for thy Lord hath provided a rivulet beneath thee; "And shake towards thyself the trunk of the palm-tree: It will let fall fresh ripe dates upon thee."

(Al-Quran, Maryam, 19:22-25)

These two *surah* above teach an element of risk and risk management that will never be taught in conventional knowledge; that is, risk management through complete obedience, submission and worship of Allah s.w.t. It teaches how two holy souls in the form of Prophet Musa s.a.w. and Maryam conducted their risk management by being the consummate servant of Allah. Musa is a revered Prophet of Islam showered with many favors and power (*mu'jizat*) of Allah s.w.t. Maryam in her earlier periods of total worship was served fruits that came direct from Allah s.w.t. This teaches another form of risk management to Islamic Financial Institutions, which is to be true to the teachings and requirements of *Shariah* in all its business and actions, and Allah s.w.t. will surely protect the institution. It needs to be said, however, that such institutions have to go beyond adhering to the literal legal rules of *Shariah* and achieve the higher platform of embodying *Maqasid Al-Shariah*.

Saiful Rosly & Mohd Afandi Abu Bakar (2003) stated that ethics again take a back seat making way for legal rules to dominate Islamic banking juristic opinions. As ethics (*akhlak*) and law (*fiqh*) do not seem to mix, the *Quranic* spirit of justice and mutual aid is compromised to pave way for financing techniques that may look Islamic on the outside only. Two Hadith (narrated by Tirmizi) state that:

A man asked the Prophet s.a.w. "Oh The Messenger of Allah! Should I leave my camel (without tying it) and put trust (depend) on Allah (tawakkal 'alAllah) or should I tie it then depend on Allah? He (the Messenger of Allah) said, "Rather tie it and then depend on Allah."

(Hadith. Narrated by Imam Tarmizi)

Umar r.a. said, "I heard the Messenger of Allah said, "If you depend on Allah (Tawakkal 'alAllah) truly, He will provide you with sustenance the way He provides to a bird, which flies out hungry in the morning, and comes back to nest in the evening with the stomach full."

(Hadith. Narrated by Imam Tarmizi)

There are various aspects of risk management indicated in these two hadith. One aspect is that in daily life one has to follow the rules of the world, for instance, *dua*, effort (*Al-Juhd/Muhawalah*) and allowing no deviation (*Istiqamah*) before placing *Tawakkal* on Allah. In other words, it is wrong to not do what is required in the hope and belief that Allah will take care of us. The way of the world, as set by Allah, must be followed before we place our *Tawakkal* on Allah.

In conventional discussions on risk management, it is recognized that there are certain risks that are highly unlikely and are acceptable for the bank not to provide for. This discussion usually arises in the context of determining economic capital and what risks can be ignored. The Islamic discussion will take it further by introducing the concept of *Tawakkal* where in such situation man still manages risk by placing his trust in Allah s.w.t. to protect him (Akkizidis & Khandelwal, 2008).

In addition, the second Hadith about the *rizq* of the birds extends the depth of belief further, such that deep beliefs take the being to a higher level of *Tawakkal*, bordering on the certainty that Allah will provide. This falls into the same category of Allah guaranteeing the *rizq* of all newborn lives. Thus, a further lesson of these two Hadiths is that an institution does not have to provide for every single risk. It is merely

expected to do its level best in terms of risk management and it is then valid as a strategy to place *tawakkal* 'alAllah.

3.5 Credit Risk and Credit Risk Management from an Islamic Perspective

Risk is the probability of an event or situation that may or may not occur (Muhammad Farhan & Khizer Ali, 2011). For example, in the banking system, it may occur when banks make decisions under conditions of known probabilities, which is called decision under risk. Similar to credit risk, it would occur when there is a probability of borrowers not meeting their obligation within the time agreed.

Therefore, for banks to continuously succeed in the financial industry, they must ensure that their profits are achieved with less default by business borrowers by implementing strategies to manage the credit risk. The conventional banking system uses some conventional strategies by charging interest to the borrowers that cause them to default or the bankruptcy of their business (Akkizidis and Khandelwal, 2008). While the Islamic banking system offers profit-and-loss sharing contracts that are based on asset-backed financing, which is called equity-based financing (Muhammad Taqi Usmani, 2002). Therefore, this section explains the credit risk in Islamic Financial Institutions (IFI) and Credit Risk Management in Islamic modes of financing in general.

3.5.1 Credit Risk in Islamic Financial Institutions (IFI)

Islam allows financing (lending) activities but does not encourage it as the Islamic teachings state that “a giver is good deed than a receiver” unless a person or business entity needs financing, Islam allows it to be free from *riba* activity:

فَإِنْ لَمْ تَفْعَلُوا فَأْذَنُوا بِحَرْبٍ مِنَ اللَّهِ وَرَسُولِهِ وَإِنْ تُبْتِغُوا رُءُوسُ أَمْوَالِكُمْ لَا تَظْلُمُونَ
وَلَا تُظْلَمُونَ (٢٧٩)

“And if you do not, then be informed of a war (against you) from Allah and His Messenger. But if you repent, you may have your principal – (thus) you do no wrong, nor are you wronged”.
(Al-Quran. Al-Baqarah, 2:279)

From the verse of Al-Quran above, Allah declared war on those who engaged in *riba* activity as Islam is committed to the concept of equity value and fairness (*‘adil*). Therefore, the lending principle in Islam is based on compassion in nature as narrated in Al-Quran and *Sunnah*.

In addition, Al-Quran in Surah *Al-Baqarah* stated the concept of the managing of risk:

يَا أَيُّهَا الَّذِينَ آمَنُوا إِذَا تَدَايَنْتُمْ بِدَيْنٍ إِلَى أَجَلٍ مُسَمًّى فَاكْتُبُوهُ وَلْيَكُنْ بَيْنَكُمْ كَاتِبٌ بِالْعَدْلِ وَلَا يَأْبَ كَاتِبٌ أَنْ يَكْتُبَ كَمَا عَلَّمَهُ اللَّهُ فَلْيَكْتُبْ وَلْيُمْلِلِ الَّذِي عَلَيْهِ الْحَقُّ وَلْيَتَّقِ اللَّهَ رَبَّهُ وَلَا يَبْخَسَ مِنْهُ شَيْئًا فَإِنْ كَانَ الَّذِي عَلَيْهِ الْحَقُّ سَفِيهًا أَوْ ضَعِيفًا أَوْ لَا يَسْتَطِيعُ أَنْ يَمْلِكَ لَهُ فَلْيُمْلِلْ وَلْيِهِ بِالْعَدْلِ وَاسْتَشْهِدُوا شَهِيدَيْنِ مِنْ رِجَالِكُمْ فَإِنْ لَمْ يَكُونَا رَجُلَيْنِ فَرَجُلٌ وَامْرَأَتَانِ مِمَّنْ تَرْضَوْنَ مِنَ الشُّهَدَاءِ أَنْ تَضِلَّ إِحْدَاهُمَا فَتُذَكَّرَ إِحْدَاهُمَا الْأُخْرَى وَلَا يَأْبَ الشُّهَدَاءُ إِذَا مَا دُعُوا وَلَا تَسْأَمُوا أَنْ تَكْتُبُوهُ صَغِيرًا أَوْ كَبِيرًا إِلَى أَجَلِهِ ذَلِكَمْ أَمْسَطَ عَنْهُ اللَّهُ وَاقِفًا لِلشَّهَادَةِ وَالَّذِي لَا تَرْتَابُوا إِلَّا أَنْ تَكُونَ تِجَارَةً حَاضِرَةً تُدِيرُونَهَا بَيْنَكُمْ فَلَيْسَ عَلَيْكُمْ جُنَاحٌ أَلَّا تَكْتُبُوهَا وَأَشْهِدُوا إِذَا تَبَايَعْتُمْ وَلَا يُضَارَّ كَاتِبٌ وَلَا شَهِيدٌ وَإِنْ تَفْعَلُوا فَإِنَّهُ فُسُوقٌ بِكُمْ وَاقِفُوا اللَّهَ وَيَعْلَمُكُمْ اللَّهُ وَاللَّهُ بِكُلِّ شَيْءٍ عَلِيمٌ

"O those who believe, when you make transaction on a debt payable within a specified of time, write it and let a scribe write it between you with fairness and no scribe should refuse to write as Allah has educated him.

He, therefore, should write. And the one who owes should give the dictation, but he must fear Allah, his Lord, and should not curtail anything from it. And if the one who owes is feeble-minded or weak or cannot as himself give the dictation, his guardian should dictate with fairness, and it must have two witnesses from among your men, and if

two men are not there, then one man and two women from those witnesses you are pleased with, so that if one of the two women errs the other woman may remind her, and the witnesses should not refuse when summoned, and, be not loath to write it down, as payable at its time, no matter how short or long. That is more equitable with Allah and more establishing for the evidence and nearer to that you fall not in doubt, unless it be a cash deal you carry out among yourselves. In

that case, there is no sin on you if you do not write it, and have witnesses when you transact a sale and neither scribe nor witness should be harmed, and if you do, it is certainly a sin on your part and fear Allah and Allah teaches you, and Allah is All-Knowing in respect of everything.

(Al-Quran. Al-Baqarah, 2:282)

وَإِنْ كُنْتُمْ عَلَى سَفَرٍ وَلَمْ تَجِدُوا كَاتِبًا فَرِهَانٌ مَّقْبُوضَةٌ فَإِنْ أَمِنَ بَعْضُكُم بَعْضًا فَلْيُؤَدِّ
الَّذِي أُؤْتِمِنَ أَمَانَتَهُ وَلْيَتَّقِ اللَّهَ رَبَّهُ وَلَا تَكْتُمُوا الشَّهَادَةَ وَمَنْ يَكْتُمْهَا فَإِنَّهُ آثِمٌ قَلْبُهُ
وَاللَّهُ بِمَا تَعْمَلُونَ عَلِيمٌ

And if you are in travel, and find no scribe, then (resort to) security taken in possession. However, if one of you trusts the other, then the one who has been trusted upon should fulfil his trust, and should fear

Allah, his Lord. And do not conceal the testimony. And whoever conceals it, his heart is, surely, a sinner. And Allah is All-Aware of what you do."

(Al-Quran. Al-Baqarah, 2:283)

Both of the verses from Surah Al-Baqarah in Al-Quran stated that it is important for documentation of the debt contract. Therefore, any financing transaction must be recorded and practice *Muamalat*, the transaction of financing must be clearly written, and state the rates and time, and the existence of witnesses are compulsory. Any risk matter must be considered and thus it is a lender's obligation to guarantee the occurrence of risk because the right of the borrower is to settle the debt within the time given. These verses of Surah teach that when entering into a financing transaction, the lender must provide collateral to the creditor. It is important to safeguard the creditor's obligation and the possibility of did not pay the financing is no longer.

Therefore, for Islamic Financial Institutions (IFI) striving to be in line with *Shariah* principles, they must first implement a positive value ingrained in credit risk management before giving financing to the clients, because of the customer's need for Islamic financing products. Such is the concept of how well the Islamic banks must evaluate their business partner, the implementation of the concept of '*adl* (equivalent) in the evaluation stage, the concept of effort (*ikhtiyar*) in doing business, the implementation of Islamic work ethics in commercial financing, the application of *Istiqamah* (continuously) in business activity, and adopting the concept of *syura*' in commercial financing.

Thus, each type of Islamic mode of financing must have a risk-sharing element, which contrasts with the principles in the conventional banking system. As a financial intermediary, Islamic Financial Institutions (IFIs) play an important role in risk-sharing modes as the deposits in a bank's balance sheet normally involve this mode, while the financing business activity does not involve the risk sharing mode in which the activity is more on the asset side stated in the balance sheet (Khan and Ahmed, 2001). Therefore, this financing business activity may impact on the bank itself in the occurrence of credit risk. This is because the biggest risk in banking activity is the credit risk (Ho & Nurul Izza Yusoff, 2009).

Islamic Financial Institutions (IFIs), in general, mostly conduct debt financing in their financing business activity and thus are exposed to credit risk. Abd El-rahman El-zahi Saaid Ali (2012) viewed that a high contribution to credit risk in the Islamic banking system is the nature of Islamic banks financing operations compared to conventional bank loans. To legitimize Islamic financing activities in line with *Shariah* principles, the effective way is that both parties should bear some risk

because both parties first need to understand and identify the risk in credit in order to avoid operational hazards.

Therefore, before giving financing and deciding on what type of financing to offer the client, banks should be concerned about the probability that their customers will fail to fulfill their obligations within the time given, which may expose the banks to credit risk. The way of managing the occurrence of risk is stated in the hadith:

The Prophet (s.a.w.) once asked a Bedouin who had left his camel untied, "Why don't you tie your camel?" The Bedouin answered, "I put my trust in God." The Prophet (s.a.w.) then said, "Tie up your camel first then put your trust in God"

(Hadith. Narrated by Imam Tarmizi)

According to the above hadith, Prophet Muhammad s.a.w advised Muslims to tie their camels before placing trust in Allah, a lesson that teaches them how to manage risks. To sum up from the above narrated hadith, it can be concluded that in terms of risk management in the banking system banks should first recognize their risks as it impacts on the nature of the banking activities and then risks should be controlled. The analogy from this hadith, is that the camel can be tied up either with the use of a metal chain or weak rope, thus in the context of risk, banks should ensure sound risk controls to mitigate the risks. To extend this further, they should place their trust in Allah. To manage the risk, no control is perfectly done. The hadith teaches to trust in Allah after making an effort and that we should make an effort before putting trust in Allah. Therefore, before giving financing to the clients of banks, they should put in place the concept of vigilance (*al-hitiyat*) as one's should conscientious and look at reasoning in order to avoid bad stipulation in their financing strategy.

It is important for the Islamic banking system, which differs from the conventional banking system, to move to a more niche business strategy in order to strive to be competitive in the Islamic financial industry. Zainal Azam Abd Rahman

(2005) suggested that the Profit-and-Loss Sharing (PLS) mode of financing is one type of Islamic financing product that is good to sustain in the industry, because it provides sound financing and maintains a good relationship with customers. On top of that, Muhammad Nejatullah Siddiqi (2007) stated that, before giving financing to the customers, purification in terms of transactions in financing must be in line with *Maqasid Al-Shariah*- as preservation of religion (*ad-din*), life (*nafs*), progeny (*nasl*), intellect (*'aql*) and wealth (*mal*). Therefore, this study, consistent with the research questions, concerns in what ways Islamic principles be used in the credit evaluation process. To achieve this, the study first stated whether the current practice of credit evaluation in the conventional banking system would differ from the current practice of credit evaluation in the Islamic banking system from the perspective of the Malaysian banking system, and would the outcome still be appropriate to apply credit risk management in the stage of the evaluation process before approving the financing to the customers.

3.6 Credit Risk Management for Major Islamic Financing Contracts

The Central Bank of Malaysia (BNM) laid down the best practice for credit risk management for the conventional banking system and Islamic banking system in 2001. The best practices are sound criteria in credit granting. Credit granting criteria is involved in the credit evaluation process, which includes the purpose of financing and the current exposure, client's source of repayment, client's repayment history and credit terms and conditions. In addition, BNM stated that an effective evaluation of credit risk is to avoid hazards in banking business and that it is important for a detailed structure of the limits of risk taken. In addition, a tried competitive banking business is

developed based on how a bank manages the problematic credits, such as restructuring of bad debt issues.

To extend this further, Kahf (2006) stated that there are two (2) main principles in Islamic financial contracts for Islamic modes of financing:

1. The principles of consent and legal permissibility, as these are accepted between all societies and the legal system.
2. The principles of moral commitment, *Shariah* permissibility and validity of contracts.

Therefore, before giving financing to the customers, banks should first implement these principles so that customers may know that the Islamic banking system in financing business activity is morally sound and socially responsible. As the dual banking system applies the five C elements of credit and the CAMPARI elements, Islamic banks should be more proactive in credit risk management so that banks look more at the criteria of the clients, especially for business clients that apply for credit from the business resources to support alcohol, drugs, gambling, porno industry, environmentally harmful products that are illegal in Islam, and any other business activity related to haram activity that does not comply with humanly acceptable Islamic ethical practices (Saiful Rosly & Mohd Afandi Abu Bakar, 2003). Therefore, the five C's elements can still be applicable to IFI by understanding the potential business clients, added to which the *Shariah* compliant measures are good to explore to further mitigate the credit risk (Akkizidis and Khandelwal, 2008).

To extend this further, before giving financing to the clients, banks should be concerned with the *Shariah* permissibility to the business clients, such as evaluating the credit application and whether the client runs a business activity that involves pork

and other swine products or other meat whose animals are not slaughtered in compliance with *Shariah* principles (Saiful Rosly & Mohd Afandi Abu Bakar, 2003).

In addition, before approving the credit applications, banks should analyze themselves and the client's performance to determine whether they are in line with the principle of balance and justice between the parties in the Islamic financial contracts, because each party is equivalent to the obligations of the other. For instance, conventional banks take interest or extra charges from the customers, and this principle is assumed that the opportunity cost of the other and this practice are unbalanced in the activity. To get a good bank customer relationship, banks should first evaluate to ensure that their systems are in line with *Shariah* principles.

Furthermore, before giving financing to the customers, banks should validate that all the Islamic financing products are founded on realism or validity in their financing business activity. The current practice in the Islamic banking system measures the probability that the borrower is able to pay back the debt, as it is a problem for banks to assume the payment from the borrowers, as the borrowers must ensure the prompt payment to the banks as a lender (akkizidis and Khandelwal, 2008). Later, the problem arising from the borrowers being unable to complete the tasks given in fulfilling the obligations is of less concern because banks must first evaluate their Islamic modes of financing, such as *Murabahah*, *Musharakah*, *Bai As-Salam*, *Bai Istisna*, *Ijarah* and *Mudharabah* financing, which are offered to business clients. The biggest question concerning the problems in credit risk management is whether Islamic modes of financing before giving financing to the business clients are adequately applied to mitigate the issues in credit risk (Febianto, 2011). Therefore, it is believed that the importance is for the venture to be self-sustained among the parties rather than whether the customers will pay back the debt. This is because *Musharakah*

and *Mudharabah* financing are the main causes of credit risk because these kinds of financing do not require collateral (Khan & Ahmed, 2001). Thus, business clients tend to moral hazard as they remit the profit-sharing ratios to IFI.

In addition, because of the issues that arise, banks may have some asymmetric information in terms of the venture's performance, which causes misunderstanding of the current business situation (Muhammad Farhan & Khizer Ali, 2011). To extend this further, Islamic banks need more proactive credit risk management strategies before disbursing the credit to the business clients instead of implementing the same strategies like the conventional banking system, which would be more inconsistent because the contracts offered by Islamic banks are different in nature.

Several Islamic financial instruments have been developed in the Islamic banking system to meet the demand in market needs. There are five (5) Islamic financial contracts in Islamic banking practices – *Murabahah* financing, *Mudharabah* financing, *Musharakah* financing, *Ijarah* financing, *Bai' As-salam* and *Bai' Al-Istisna'* financing. This chapter discusses several Islamic financial contracts in the Islamic banking system, which is related to the credit risk.

3.6.1 *Murabahah* Financing Contract

Murabahah financing is known as cost-plus financing contracts. This financing contract involves the party with buying and selling contracts in which the actual cost is declared by the seller (bank) and the buyer provides a specific profit margin agreed by both parties (Kantil Khir et al., 2008). The bank in the first contract buys the commodity from the supplier and thus possesses the commodity. Within the financial needs, customers that wish to buy the commodity enter into the contract by cost-plus financing with deferred payment. However, when the customers are unable

to pay the financing (loan) within the time agreed, the occurrence of credit risk will arise by both parties and there is a tendency to default.

Nevertheless, *Murabahah* financing is an Islamic credit sale that provides an interest-free bearing loan. The special feature in this type of financing is in terms of the fixed-set of payments after the profit over the cost is stated based on the percentage of the cost price to the seller, and there is no extra profit above the price agreed in the contract. However, in the case of the occurrence of credit risk, banks should bear it in order to achieve their value/returns. In the case of being unable to meet the obligation to make the payments, the bank may ask the customer to provide security and stipulate the penalty payments; however, there are no additional charges in the case of installments.

3.6.2 *Mudharabah* Financing Contract

Mudharabah is a special kind of partnership in which one partner provides the capital (*rabb-ul-maal*) to the other (*mudharib*) for investment in a commercial enterprise (Kamal Khir et al., 2008). The profit assigned to a party cannot be a percentage of the capital amount contributed, as that would be considered a fixed return. The profit assigned to either of the parties cannot be a lump sum amount either as this would also constitute interest. As such, the only determination of profit distribution that is permissible is based on the actual profit earned by the enterprise.

Further, *Mudharabah* financing raises the question concerning the importance or necessity of the contract, and there are also motives for financing directly linked to the contract mentioned by Islamic jurists, such as the motive for trade or exchange, which is indispensable for all societies and the human desire to make one's wealth grow. In addition, this type of financing was based on the profit and loss sharing

(PLS) modes of business transaction by the financier and the user of funds. This principle implies a sustainable relationship between counterparties in which the business transaction can only be known by the related parties. Moreover, in facing the credit risk in this type of financing, Islamic banks are also differently oriented toward the perception of risk and they have their own unique credit risk management challenges (Khan & Ahmed, 2001). Credit risk might happen when the counterparties default on the contract, which is directly related to the nature of the *mudharabah* contract and can be the determinant of the possibility for losses on the *mudarib* (agent) or the capital that may be lost due to business losses.

3.6.3 *Musharakah* Financing Contract

Musharakah financing is a form of partnership contract in which two or more persons combine either their capital, to share the profit, enjoying similar rights and liabilities (Kamal Khir et al., 2008). The practice of partnership-based contract is regulated by the business practices prevailing in the business community. This limits companies as the commercial activities are influenced by the business practices (*urf*), and in co-operative societies, the commercial activities are influenced by the practices prevailing in the business community. Thus, the profits are to be distributed among the partners in business on the basis of the proportions settled by them in advance. The share of every party in profit must be determined as a proportion or percentage and no fixed amount can be settled for any party.

Nevertheless, a loss shall be borne by the partners according to their invested capital. However, a party that has no capital invested in an enterprise does not have to share its loss. This is because of after investment of capital, to avoid the risk of loss in the enterprise. In modern commercial practices, the loss does not reduce the respective

capital of the partners or shareholders, but remains as it is in the account books of the *Musharakah* in order to be adjusted against the future profits. Furthermore, it would not be possible for anyone to earn profit without being willing to share in the risks of business. Thus, risks would become more widely distributed in an Islamic economy than is possible under capitalism.

In addition, credit risk is the loss of income arising as a result of the counterparty's delay in payment on time or in full as contractually agreed. In the case of *Musharakah* financing, the credit risk will be non-payment of the share of the bank by the entrepreneur when it is due. The problem may arise for banks in this case because of the asymmetric information problem in that they do not have sufficient information on the actual profit.

3.6.4 *Ijarah* Financing Contract

Ijarah financing is an Islamic leasing contract under which the bank leases equipment to their clients against a fixed charge as the ownership of the asset remains with the lessor (Kamal Khir et al., 2008). The purpose of Islamic leasing is to raise funds especially for industries where rapid technological innovation is either underway or desired and for top class firms that are quickly expanding their business, and firms that normally have insufficient assets and capital base to meet the normal collateral requirements of most other forms of long-term financing.

However, credit risk may arise if the lessee does not pay the lease amount. The banks can impose any monetary penalty on the lessee and use it as operating income, however, under the *Ijarah* financial contracts; the penalty amount is donated to society under Islamic banking. In addition, *Ijarah* offers the advantage of not requiring collateral and thus simpler repossession procedures. Furthermore, it has greater in-

built stability to contain inflationary pressure in the economy. The lessor is only exposed to a low-level credit risk from the lessee as the lease transaction is, by definition, asset-backed. *Ijarah* financing has also become popular due to the tax advantages, as the rental can be offset against corporate tax by the lessee.

3.6.5 *Bai' As-salam* Financing Contract

Bai' Al-salam financing is a contract for deferred delivery that was originally sanctioned during the time of Prophet Muhammad (peace be upon him) to facilitate the trading activities of farmers who were awaiting the harvest of crops. In more modern times, it has also been applied to the production of raw materials and fungible goods in general (Kamal Khir et al., 2008). The contract is valid when the goods sold need not be in existence at the time of contracting. The delivery date and location must be specified and full advance settlement of the agreed trade price is required at the time of contracting, otherwise the contract would sanction the trading of one debt for another, which is not deemed permissible in Islam. Further, this transaction is limited to products whose quality and quantity can be fully specified at the time the contract is made.

Credit risk in this type of contract may arise due to the customer or seller defaulting after taking the payment in advance (Akkizidis & Khandelwal, 2008). If at the time of delivery the seller can neither produce the goods nor obtain them elsewhere, the buyer has only two choices, either take back his price, without increase, or await the goods becoming available later, with no compensation permitted for the delay.

3.6.6 *Bai' Al-Istisna'* Financing Contract

The *Bai' Al-Istisna'* Financing Contract is a contract of exchange with deferred delivery, which is applied to specified made-to-order items (Kamal Khir et al., 2008). In this type of financing contract, the manufacturer must make a commitment to produce the item as described, and the quality of the item to be delivered must be specified. The payment can be made in one lump sum or in instalments and the sourcing of inputs to the production process is the responsibility of the manufacturer.

Credit risk in this type of financing may arise due to the failure to deliver the subject matter within the specified time period by the manufacturer. Thus, the purchaser has the right to liquidate damages as mutually agreed in the contract.

3.7 Islamic Elements in Managing Credit Risk in Credit Evaluation Process

According to Abbas J. Ali (2014), there are several Islamic elements in conducting a good practice in business as well as managing credit risk in credit evaluation process. It includes elements of *adl* (fair and justice), *ukhuwah* (continuous relationship), *Istiqamah* (allowing no deviation), *akhlak* (Islamic ethics), *syura'* (discussion) and *tawakkal* (put in trust to Allah).

3.7.1 *'Adl* (fair and justice)

According to Abbas J. Ali (2014), *'adl* is a concept of justice and it is one part of *tauhid-ilallah* or called as belief that Allah is just. To extent this further, Allah will reward or punish any person according to his deeds and thus the notion of

predestination (where all decisions are return back to Allah's hand and not any one's else) in one's deeds does not exist. Surah An-Nahl in verse 90 explained that:-

إِنَّ اللَّهَ يَأْمُرُ بِالْعَدْلِ وَالْإِحْسَانِ وَإِيتَاءِ ذِي الْقُرْبَىٰ وَيَنْهَىٰ عَنِ الْفَحْشَاءِ وَالْمُنْكَرِ
وَالْبَغْيِ يَعِظُكُمْ لَعَلَّكُمْ تَذَكَّرُونَ

"Verily, Allah commands 'Adl (fairness, equity, justice) Ihsan (excellence in servitude to Allaah, benevolence towards people, graciousness in dealings) and giving to those close to you, while He forbids Fahshaa (lewdness, indecency, licentiousness, immorality), Munkar (bad actions, undesirable activities, generally unacceptable behaviour, not fulfilling one's obligations), and Baghy (rebellion, transgressing limits, exploiting or violating others' rights, abuse of authority or freedom). He admonishes you so that you heed the advice."

(Al-Quran. An-Naht, 16:90)

Therefore, the concept of 'adl is very comprehensive and implies fairness and equity in the whole thing that person says or does (Sayyid Qutb, 2000). It covers the comments we make, the judgements we pass, the way we handle our responsibilities and obligations to others, the way we deal with people, the way we handle differences, the way we treat others whether they are members of our family, friends, relatives, strangers or enemies. Fairness, equity and justice must be a hallmark of our behavior in all of these areas. Similar with the financing decision, as one's make credit evaluation process, they should implements 'adl as one parts of elements in evaluating their clients.

3.7.2 Ukhuwah (Continuous Relationship)

According to Sayyid Said Akhtar Rizvi (1996), Rafik Issa Beekun (1997) and Abbas I. Ali (2014), practicing good relationship in making financing decision is vital for developing the long-term relationships as well as *ukhuwah* (continuous relationship with clients. This practice is one parts of credit evaluation process in

mitigating credit risks issues. Besides, this element is strategic for banks to have a better position in the market and thus also to secure continuous banking relationships.

To extent this further, there is a positive relationship between ethics and risk management because ethical principles constitute a precondition for creating the climate of collaboration necessary for successful risk management activities (Fauziah Hanim Tafri et.al, 2011). Islamic banking is created under Islamic law and is frequently considered ethical banking. To succeed in competition with conventional banks, Islamic banks should enhance Islamic elements in making financing decisions as well as in evaluating their clients differentiated by the implementation of Islamic business ethics.

3.7.3 *Istiqamah* (Allowing no Deviation)

The literal meaning of *istiqamah* is to go straight into the right direction, acting rightly, allowing no deviation (Imam Nawawi; Abbas J. Ali, 2014). It is derived from the stem *Qiyam*, which implies the continuity of doing something, following up with it and making sure that it is done in the right way and there is neither deviation nor swerving.

The term has been used by the Al-Quran in many verses. One of the verses from Surah Hud, Allah the Almighty says:

فَاسْتَقِمْ كَمَا أُمِرْتَ وَمَنْ تَابَ مَعَكَ وَلَا تَطْغَوْا ۚ إِنَّهُ بِمَا تَعْمَلُونَ بَصِيرٌ
 “Therefore, stand firm (on the Straight Path) as you are commanded
 and those who turn in repentance with you. And do not transgress, for
 He (Allāh) sees well all that you do.”

(Al-Quran. Surah Hud, 11: 112)

To simplify, *istiqamah* is to stand firm and steadfast to what we have been commanded by Allah, for instants to fulfill obligations and to avoid prohibitions. Correspondingly, we should not allow ourselves to follow or be misleading by desires (whether it is our desires or the desires of others) as it will cause deviation and lead us astray.

According to Ibn al-Qayyim (rahimahullāh), there are five (5) conditions to achieve *istiqamah* in performing required deeds:-

1. The act should be done for the sake of Allah alone (*ikhlas*).
2. It should be done on the basis of knowledge (*'ilm*).
3. Performing *'ibadah* should be in the same manner that they have been commanded.
4. To do it in the best way possible.
5. Restricting one to what is lawful while performing those deeds.

Therefore, to achieve *istiqamah* (allowing no deviation) in making financing decisions, banks must always being aware of the final destination (the Day of Judgement) and has to make a commitment that they will be steadfast and will do things in the right way and in the best way possible, and to adhere to conjunctions of Islam.

Besides that, banks should in-line with the financing decision; they have to make continuous efforts (*Mujahadah*) to bring that commitment to reality. Some Muslims dare to make the commitment, but dare not to make the effort to make the commitment a reality. The other ways is self-accountability (*Muhasabah*). This should

be done twice: Firstly, before banks start doing financing decisions, ensuring that it pleases Allah, that they do it for His sake only, realizing the right way it should be done. Secondly, after the financing decisions has been done, to check whether they have achieved what they aimed for, and to check for defects and shortcomings, and that they still could have done it better in mitigating credit risks.

3.7.4 *Akhlak* (Islamic Ethics)

Akhlak is an Arabic term referring to the practice of virtue, morality and good manners in Islamic theology and philosophy. It is most commonly translated in English as Islamic behavior, disposition, good conduct, nature, temper, ethics, morals or character (of a person).

To extent this further, *Akhlak* is the plural for the word *Khulq* which means disposition. Disposition is that faculty (*Malakah*) of the soul (*Nafs*) which is the source of all those actions that man performs spontaneously without thinking about them. *Malakah* is a property of the soul which comes into existence through exercise and repetitive practice and is not easily destroyed.

Likewise, a particular disposition (*Malakah*) may appear in human beings because of one of the following reasons:-

1. Natural and physical make up (*Fitrati*)

It is observed that some people are patient while others are touchy and nervous. Some are easily disturbed and saddened while others show greater resistance and resilience.

2. Habit (*Ada*)

It is formed because of continual repetition of certain acts and leads to the appearance of a certain disposition.

3. Practice and conscious effort

This means of which if continued long enough will ultimately lead to the formation of a disposition.

Based on the above explanations, the importance of *akhlak* is thus revealed. This is because of the reasons mentioned above that ethics is considered to be the most exalted and valuable of sciences. Moreover, we know that man is the noblest of creatures, the ultimate purpose of whose existence is to attain perfection; therefore, it follows that ethics is the noblest of all sciences which also includes in actions of financing decisions (Khan and Ahmed, 2001; Abbas J. Ali, 2014).

3.7.5 *Syura*' (Discussion)

Syura' is one of the basic fundamentals of the Islamic political system. It extended to include all the affairs of Muslims. Thus, the Islamic state might have preceded the modern democratic systems with regard to the necessity of unanimity over choosing the one who runs its affairs and cares for its interests, something which stresses the value and effectiveness of unanimity among Muslims.

Besides of the concerns on Islamic political system, Islamic banks likewise concern on *syura*' as one part of making decision in financing activities as well as in evaluation process. *Syura*', as a principle, is rooted in the Al-Quran itself. In addition, Al-Quran has stated that the application of *Syura*' as a norm and not as a system. The distinction is important to note, since the Al-Quran in this manner has left it to

successive generations of Muslims to continue to strive on the way to a more perfect realization of the *Syura*' practices in making financing decisions. To extent this further, verse 159 from Surah Al-Imran stated that:-

فَبِمَا رَحْمَةٍ مِنَ اللَّهِ لِنْتَ لَهُمْ وَلَوْ كُنْتَ فَظًا غَلِيظَ الْقَلْبِ لَانْفَضُّوا مِنْ حَوْلِكَ فَاعْفُ عَنْهُمْ وَاسْتَغْفِرْ لَهُمْ وَشَاوِرْهُمْ فِي الْأَمْرِ فَإِذَا عَزَمْتَ فَتَوَكَّلْ عَلَى اللَّهِ إِنَّ اللَّهَ يُحِبُّ الْمُتَوَكِّلِينَ

"It is part of the Mercy of Allah that thou dost deal gently with them. Werd thou severe or harsh-hearted, they would have broken away from about thee: so pass over (their faults), and ask for (Allah's) forgiveness for them; and consult them in affairs (of moment). Then, when thou hast taken a decision put thy trust in Allah. In place of Allah loves those who put their trust (in Him)."

(Al-Quran. Al-Imran, 3:159)

Based on the above discussion stated that, in the context in which the term has been used in the Al-Quran, *Syura*' is predicated on likeness among those consulting in order to arrive at a decision making. As mention earlier, this clear Quranic interpretation of the *Syura*' as principally a decision-making process among equals has to be distinguished from the notion that depicts *Syura*' as merely an optional in credit evaluation process in Islamic banks approach as one part to mitigate credit risks (Akkizidis and Khandelwal, 2008; Abbas J. Ali, 2014).

3.7.6 *Tawakkal* (Put in Trust to Allah)

Tawakkal refers to placing the trust in Allah Alone as well as to have faith in that he alone can award of the harms of this world, provide the blessings and sustenance, and to ease the challenges (Abbas J. Ali, 2014). Besides, *Tawakkal* is also about accepting the results that he decides regardless of how they may turn out to be.

To understand the concept of *Tawakkal*, it is important to consider how tense and worried that one's get at times about the challenges of this worldly life. Besides, *Tawakkal* should not be mistaken with giving up the efforts thinking that somehow the challenges will get resolved. Rather striving and working with the attitude that Allah s.w.t will take care of the affairs and will help in getting through the trials as part as one's have the *Tawakkal* in Allah.

Abbas J. Ali (2014) have stated that *Tawakkal* in reality does not deny actually working and striving for provision, for Allah s.w.t the almighty has decreed that we should work and it is from his ways that he gives people when they strive. In fact, Allah almighty ordered us to both depend on him, and to work, to take the necessary steps needed to achieve goals, and so the act of striving for the sustenance is an act of physical worship while trusting and depending upon Allah is faith in him.

To simplify, in making financing decisions as well as evaluating the clients in credit applications, Islamic banks should also combine *Tawakkal* with other means, whether they are acts of *Ibadah* (worship or supplication), *Solah* (Prayers), *Sadaqah* (voluntary charity) or maintaining the ties of kinship, or other material means which Allah has predestined (Abbas J. Ali, 2014).

After all of these have done in a good manners, of course both Islamic banks and the clients gets benefits from the practicing of *Tawakkal*, such as it can release from the unnecessary anxiety, worry, and resulting depression from the challenges that both of them may be facing. By believing that all their affairs are in Allah's hands and they can only do what is in their control, they leave the results to Allah and accept his decree whatever it maybe. Ibn Rajib Al hanbali said, "The fruit of *Tawakkal* is in acceptance of Allah's decree. Whoever leaves his affairs to Allah and then is accepting of what he is given has truly relied on Allah."

To sum up, it is important to understand the concept of *Tawakkal* and make it a part of Islamic banks belief systems in making financing decisions. Of course, they will then learn to appreciate that matters will get resolved without difficulty with the help of Allah and *Tawakkal* will also relieve them from the day-to-day concerns and worries supplementary with the challenges of this life in daily banking activities.

3.8 Empirical Study on Credit Risk Management in the Islamic Banking Approach

Makiyan (2003), in his research on the role of the rate of return on loans in the Islamic banking system of Iran, found that it is significantly dependent on the changes in total deposits, and the time lags of the variables and rate of inflation. This shows that they are not significantly dependent on the changes in the expected rate of return on debts.

Saiful Azhar Rosly and Mohd Afandi Abu Bakar (2003) showed that the performance of the Islamic banking system in Malaysia recorded a higher return on assets (ROA). However, it has been shown that business financing (loan) that offers Islamic financial products, such as *Murabahah* financing, *Mudarabah* financing, *Musharakah* financing, *Bai' As-Salam* and *Istisna'* and *Ijarah* financing, are less concerned with the efficiency terms as they lack ethical content. In addition, the Islamic financing offered is not expected to motivate them by practicing the Islamic elements in financing decision as to sustain in terms of business efficiency.

Greuning and Iqbal (2007) found that profit and loss sharing (PLS) modes of financing are reluctant to indulge in the Islamic banking system because of the factor of banks' depositors facing risks. It is shown that it is a reflection of the Islamic

banking system in the case of low level transparency and thus trust is eliminated between the customers and the banks.

To extend this further, Muhammad Hanif (2014) analyzed the practices of profit and loss sharing (PLS) modes of financing in the Islamic banking system. The study found that the profit and loss sharing (PLS) modes of financing are highly used for the purpose of financing contracts and deposits. However, this practice is limited (negligible) due to the non-conduciveness of the existing natural environment of business practices.

Abdus Samad et al. (2005) studied Islamic banking and finance in theory and practice, and found that there is an average level of *Mudharabah* financing with five percent and for *Musharakah* financing it is only four percent of total finance. The reason is that both these types of business financing have increased risk associated with them, and, thus, these Islamic modes of financing will increase in importance for further Islamic banking development and growth in the Islamic financial industry.

To extend this further, Iqbal (2008) found that *Murabahah* financing is also higher in credit risk followed by *Musharakah* financing. *Mudharabah* financing and *Ijarah* modes of finance with only ten percent. Thus, the occurrence of credit risk in different Islamic financial contracts tends to be more limited engagement in PLS modes of financing than with which the Islamic banking system needs to be content.

Chong and Liu (2009) further studied the Malaysian banking industry and stated that the current practice of Islamic banking systems is not too different from conventional banking. In their study, they used the causality test and the result showed that the Islamic banking system and conventional banking system are interrelated in terms of the rate of return.

Fauziah Hanim Tafri et al. (2011) further conducted a study on the empirical evidence concerning the risk management tools practiced in Islamic and conventional banks, and found that there is a significant difference in the strategies in credit risk mitigation and the other tools identified between the Islamic and conventional banking systems. Factors, such as the nature of Islamic banking itself, and the lack of tools in mitigating the occurrence of risk are stated. This suggests that the Islamic banking system needs adequate tools and systems to manage the critical financing hazard areas.

By reviewing the literature, Siddiqui (2008) examined the performance of the Islamic banking system in selected banks in Pakistan by identifying the risk profile and Islamic financial contracts. Islamic banks have a different risk profile to that of the conventional banking system because of the prohibition of interest, and because Islamic banks are conducted using the permissible financing contracts. There is little long-term project financing in the Islamic banking system in Pakistan, as evidenced by the results of the bank balance sheets and performance indicators. In contrast, the Islamic banking system has shown good performance in risk management with respect to the results of returns on equity (ROE) and returns on assets (ROA).

Muhammad Jaffar and Irfan Manarvi (2011) further studied the performance of two types of banking system in Pakistan and compared the banks performance by using the CAMEL (Capital Adequacy, Asset Quality, Earning Ability and Liquidity position) test standard factors analysis. This showed that the Islamic banking system performs better in terms of the capital adequacy and liquidity. The rest – quality and earning ability – is found to be better in the conventional banking system.

Further, to assess the conventional commercial banks and Islamic banks in Malaysia in terms of financial performance, Thim et al. (2014) used the financial ratio. Although the Islamic banks slowly peak in the financial performance, it is found that they have better insights in terms of the utilization of assets, expenditure control and effective management, and that the customers' trust and confidence in Islamic banks are rising.

Furthermore, Nazir et al. (2012) conducted a survey on risk management between conventional and Islamic banking systems in Pakistan. The finding shows that risk management practices in the dual banking system in Pakistan are significantly different. They suggested that the Islamic banking system should be more proactive in the analysis of credit risk and develop innovation in credit risk assessment to differentiate it from the conventional banking system.

Abedifar et al. (2013) viewed that the Islamic banking system has a lower credit risk compared to the conventional banking system, based on the results of the analysis, which were developed from examining the bank's risk and stability by selecting a sample of 500 banks from 24 countries. It was found that the financing quality of Islamic banks was less responsive compared to the other banking system.

Becka et al. (2013) viewed that Islamic banking was different to conventional banking in terms of the business orientation after the study controlled for time-variant country-fixed effects. This showed that Islamic banks, which correspond to high asset quality, were better in the capital and intermediation ratio but were less cost-effective.

Chusaini and Ismal (2013) viewed that the Islamic banking system in Indonesia showed that the index for credit risk management was a good criterion. The study suggested that for the Islamic banking system to become more proactive in the

banking industry, the authority that formulated the banking regulations should continue to improve the quality of credit risk management. In addition, the Islamic banking system should be more aggressive in providing the quality of credit risk management and be in line with *Shariah* principles and guidelines, and thus improve the aspects in risk management techniques, which have not been assessed adequately.

Abdul Wahab et al. (2014) conducted a study on the capital adequacy and risk taking behavior in the mixed banking system in Malaysia. By using the panel data of the banks from 2006 to 2013, he showed that the Capital Ratio (CAR) and Risk-Weighted Asset Ratio (RWA) resulted in a positive relationship. The study suggested that for banks to have a sustainable banking business, they should achieve high capital growth to pursue relatively riskier financing activities. However, towards risky assets, Islamic bank subsidiaries (IBS) and full-fledged Islamic banks (IB) should follow the conventional practice.

Faridah Najuna Misman (2012) found that the importance of credit risk in the Islamic banking system has affected the financial growth in the industry, as the findings of the study showed that there was a positive significant relationship between the financial structures and bank-specific variables related to the credit risk.

Khan (2010) viewed that the Islamic banking system provided more ethical transactions than the conventional banking system, as they provided interest free financing and prohibited gambling and *gharar* (uncertainty) activities. By sustaining the use of the Islamic principles and adapting the appropriate Islamic terminology, the Islamic banking system could survive in the competitive market through its full-fledged Islamic identity that contrasts with the conventional financial transactions.

Ebrahimi et al. (2011) used primary sources from *Al-Quran* and reviewed some literature in terms of the evaluation of Islamic principles and practices. It can be concluded that the ethics in evaluation should be looked at from the Islamic point of view, such as self-evaluation, plurality of evaluation tools, speed in evaluation, and consideration of individual differences. It is necessary for organizations to apply the usage of Islamic evaluation principles.

Nevertheless, Rashid Ameer et al. (2012) conducted interviews and a survey related to the asymmetric information in the Islamic banking system in Malaysia that was related to the profit sharing investment accounts (PSIAs), which showed that disclosure does not apply to PSIAs. This was because such disclosure was not mandatory. The reason for the shortcomings in the disclosure was because of the shortage of support and lack of expertise. The study suggested the need for expertise in the regulation and also that Islamic jurists should use *Istiqra'* – the deductive approach. This suggests that the techniques may reduce the information asymmetry and enhance the appropriateness of the Islamic banking system.

Further, Rudnycky (2014) found four dimensions of the afterlives of the development of the Islamic banking system in Malaysia in terms of Islamic finance projects. The dimensions include the wide range of networks regarding the economy of Malaysia, the assemblage of religious, the full-fledged Islamic economic practices and the responsibility of the managerial role in the area of interest.

Maswadeh S.N (2014) conducted a survey of the Jordanian business firms to examine the principles of Islamic finance with the compliance of Islamic banks. It was found that the banks were in line with the Islamic Law. The Jordanian Islamic Bank has not played a sufficient part to share the risk and sought to transfer most of the risk to the financier party by obtaining adequate guarantees. The study recommended that

banks pay attention to determining the exact mechanism by which profit and loss should be determined.

Therefore, to sum up from all the above empirical studies, several issues are identified for improvement. A few studies were conducted on the credit risk management in the evaluation stage, especially in the Islamic banking approach. This is because the current practices used the same practices as the conventional banking approach, since Islamic banks must be more proactive in evaluating the clients in commercial financing approval because they offer profit and loss sharing contracts and different types of contract, such as *Murabahah*, *Mudharabah*, *Musharakah*, *Bai' As-Salam*, *Bai' Al-Istisna'* and *Ijarah* financing contracts. Furthermore, there are still challenges for different types of banking system. Similar to the empirical study of the conventional banking approach, there are few studies in the Malaysian banking system in relation to the area of study. Therefore, this study further proposes to implement the Islamic principles in the credit risk management that can be applied in the credit evaluation process, since the techniques of credit risk management after the approval of the credit application have been widely discussed in the reviewed literature. By using the inductive approach, the study proposes the parameters for the credit evaluation process in the Islamic banking system.

3.9 Chapter Summary

Credit risk is deemed to be the most important type of risk faced by Islamic banks. It can be mitigated by the ability of a debtor to repay at the time appointed for repayment and in accordance with the mutual agreement by the counterparties. If not, it leads to a loss for the creditor, and, therefore, becomes a risk for the bank. Unlike the conventional banking system approach, Islamic banks handle the credit risk in terms of the different modes of Islamic financing due to the unique types of Islamic financing offered. Nevertheless, before giving financing to the clients/customers, the Islamic banking system should be more proactive in evaluating the credit application due to the different types of banking system.

The review of the literature and empirical study was to develop a standpoint, which is connected to the area of study from the in-depth interviews, which will be used to state the empirical findings in order to have a good presentation on the analysis, discussion and conclusion of the study. This chapter discussed the review of the literature to determine the credit risk management practices in the Islamic banking system.