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Does One Size Fits All?

Applying Conventional Credit Risk Mitigation to Islamic Financial Institutions

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Abstract

The purpose of this paper is to examine the credit risk mitigation in Islamic Financial Institutions (IFIs). Currently, shariah compliant financing in Malaysia are still dominated by the concept of Bai' Bithaman Ajil (BBA), Ijarah Thumma Al Bai and Murabahah. These sale-based approaches allow conventional credit risk mitigation to be utilized by IFIs. However, with the emergence of equity-based approach products like Musharakah/Mudharabah business financing and Musharakah Mutanaqisah Home Financing means IFIs need to enhance their perspective of credit risk which means the conventional method is not enough. Thus, this paper illustrates the concept of credit risk and differentiates them with capital impairment risk in line with the risk sharing responsibility of IFIs. This paper suggests some credit risk mitigation techniques to help IFIs create a niche for themselves in the financial market.

Keywords: *Islamic Banking, Risk Management, Credit Risk, Capital Impairment Risk, Default Risk, Musharakah, Mudharabah, Risk Sharing*

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Introduction

Financial institutions are the lifeline of an economy. Undeniably, real sector generates economic growth; nonetheless it is the financial sector that supports the momentum of the fund-hungry real sector. Financial institutions are so important in an economy that if the banking system collapse, it will brings down an economy and ultimately, the country itself.

Financial institutions as financial intermediaries

In its basic form, financial institutions are the financial intermediaries between two parties. Banks channel the fund from one party (i.e. surplus group) to another party (i.e. deficit group). In other words, banks borrowed the depositors' money and lend it to the borrowers. This fund transferring activity is crucial in the modern world as mentioned by Siddiqi (1998) that the modern society cannot function without financial intermediation and that it is a must for any contemporary Islamic society.

Traditionally, lending activities was dominated by few people. During that period, everybody knew each other. In other words, the rich lenders were well aware about the credit-worthiness of their borrowers. This was not the case in the current world. In addition, it is not possible for an individual to give financing to the whole population. He will not have the financial capability to achieve such feat. Consequently, financial institutions replaced individual money lenders as financiers to household and businesses alike.

Financing in Islam

Financing is allowed in Islam although it was not encouraged. There is a saying that the giver is better than the receiver. There were also occasions whereby the Prophet refused to perform the final pray on indebted deceased until somebody agreed to settle the deceased's debt. However, if there is an urgent need for loan, Islam requires that it is *riba*-free. In the Quran, Allah declared war on people who engaged in *riba* (2:279). This is in line with the fairness and equity value of this religion.

Riba-based loans are nothing but nuisance to the economy. In the olden time, entrepreneurs wanting to venture into business may have to borrow money stipulated with *riba.* If they failed to pay on time, the loans will multiply. If the hopeful entrepreneurs were unable to settle their loans, they become slave to the lender. In short, *riba* crushed the spirit of entrepreneurship and is detrimental to economic growth.

Islamic Financial Institutions (IFIs)

It can be seen from the above that lending in Islam is benevolence in nature. Thus, financial institutions must have this value ingrained in themselves before offering Islamic financial products. When Islamic finance was revitalize after 1400 years in exile, scholars were quick to remind that apart from being free from *riba, gharar, maysir,* etc, Islamic financial products must have the risk sharing element. In other words, Islamic banking business should be more than just extending credit and earning profits.

The risk sharing way of doing business can be traced back to the *mudharabah* contract between the Prophet and Saidatina Khadijah. In a *mudharabah*, the financier or *rabb al mal* risks losing his capital while the entrepreneur or *mudarib* will only lose his time and effort if the business venture fails. Thus, it is expected that the financier will share his knowledge and experience with the entrepreneur to have successful business.

It is easy to see the good points of risk sharing. In contrast to the negative effect of *riba* on entrepreneurship, *mudharabah* fosters the development of venture capitalist. It also promotes brotherhood between the financier and entrepreneur in line with the spirit of Islam. Thus, scholars were hoping that the structure of Islamic financing will be based on *mudharabah* or *musharakah* contracts. Unfortunately, this was easier said than done.

Reality Bites

As mentioned earlier, risk sharing requires Islamic financial institutions (IFIs) to play greater role than just as financial intermediaries. In Malaysia, however, their liabilities side (bank deposits) normally involve risk sharing but not their asset side (financing business). Due to the similar intermediation role, IFIs inherit similar risk of

conventional financial institutions (CFIs) such as market risk, credit risk, liquidity risk, operational risk with additional risk of non-compliance to *Shariah* (ie. *Shariah* risk).

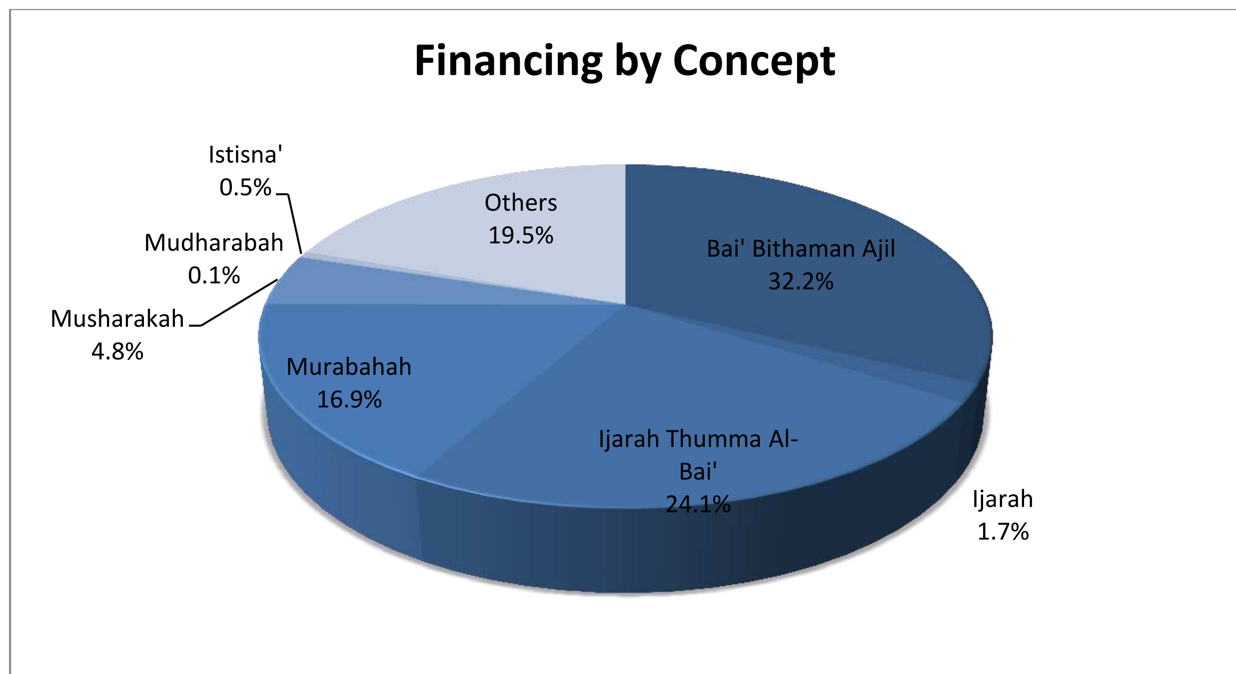

Figure 1: Financing by Concept by Malaysian Islamic Banks as at 31.8.2012 (Total financing of RM220,525.4 million)

Source: Bank Negara Malaysia (2012)

It can be clearly seen from Figure 1 that most Islamic financing concept in Malaysia is dominated by *bai' bithaman ajil* (BBA), *ijarah thumma al-bai* and *murabahah* contracts. Basically, these three financing concepts involve sale with deferred payment based approach rather than an equity-based approach in *mudharabah* and *musharakah*. What it means is that, most of the Islamic financial products are equivalent to its conventional counterpart.

Sale with deferred payment based or debt-based products like BBA, *murabahah* and to some extent *ijarah thumma al-bai* means that the bank will pay cash to the vendor and secure the assets on behalf of the customer. Then, the customer will have to purchase the assets from the bank at mark-up on deferred payment basis. Although the bank is not lending cash, the customer is indebted to the bank.

As a result, IFIs will be exposed to Non-Performing Financing (NPF) which is similar to Non-Performing Loan (NPL) in CFIs. Needless to say, NPF is one of the main measures of

bank's efficiency and credit resilient. In addition, credit evaluation is largely based on whether or not the customer is bankable, not on the trade fundamentals.

Although IFIs is free from interest, it is not free from the impact of interest rate movement due to the dual banking nature of Malaysia. Fluctuation in interest rate would positively or negatively impact depositors (flocking in or crowding out) and customers (refinancing). As an example, when the interest rate was low, depositors may put their money in IFIs to earn higher profit while customers will take loans from CFIs to settle their Islamic financing. It results in some matching problem for IFIs.

Credit risk

Credit risk is the single biggest risk for banking industry (Apostolik *et al,* 2009; Ho and Nurul Izza Yusoff, 2009; Mohamed Ali Elgari, 2003 and Dedek, 2001) due to its fundamental business is money lending and deposit taking. Islamic banks is also exposed to credit risk due to the fact that large amount of business conducted is in form of debt financing like BBA and *murabahah*.

If the customers are unable meet his obligations partly or entirely or on timely basis, the bank would be in trouble as they will be unable the bank to pay back the depositors. It is worth mentioning here that at the current moment, the regulators do not allow losses to pass-through to depositors even if they are *mudharabah* investment account holders. Another issue is where delinquency in the current period may affect a group of depositors while recovery in the future period may benefit another.

As mentioned earlier, IFIs should move away from their current business strategy to create a niche for themselves. There are call for banks to move towards *musharakah* financing which conducts true trading of goods and services instead of money intermediation (Zainal Azam Abd Rahman, 2005). In addition, innovation should triumph imitation – from purification of financial transactions to the serving of the *maqasid al-shariah*, where there should be decline in debt and rise in equity (Muhammad Nejatullah Siddiqi, 2007).

The lingering question is then whether this expected changes in portfolio, would it still be appropriate to apply CFI credit risk mitigation on the new portfolio. Thus, this paper intends to answer this pertinent question.

Objective

The objective of this paper is to analyse the appropriateness of applying CFIs credit risk mitigation on new portfolio i.e. equity based and *ijarah*. This paper will discuss the CFIs techniques of risk mitigation and seeks to answer whether they are applicable to IFIs. In addition, this paper is a humble attempt in identifying the appropriate risk category for more effective risk mitigation techniques for IFIs.

Literature Review

In 2001, Bank Negara Malaysia (BNM) or the Central Bank of Malaysia has laid down the best practice of credit risk management. The guidelines aims to improve the on credit risk management of conventional and Islamic banks alike. The following are the excerpt of the recommended best practices:

- Sound and well-defined credit granting criteria – credit evaluation which covers purpose of loan, source of repayment, current exposure, repayment history, susceptibility towards economic and market development, collateral value, and legal capacity of the borrower, that will address how much can be given, the need for collateral, and the credit terms and conditions;
- Comprehensive risk measurement and evaluation to assist the credit granting evaluation and to avoid non-bankable loans;
- Detailed structure of limits of risk taken – limitation on particular individual or portfolio;
- System to control, monitor and report risk in order to raise concerns or red flags on breach or near breach; and
- Management of problematic credits i.e. restructuring or recovering of bad loans.

Basically, the measures are tailored to assess whether individual borrower is able to pay back the loan. In this case, the risk is fully on the borrower to ensure prompt payment to the lender. The problem is whether this ruling should adequately apply to

musharakah and *mudharabah* financing since Islamic banks supposed to be partner of the business. Islamic banks have goal congruence with entrepreneurs or business partner to make the business successful. It is believed that rather than becoming just a financing affair, the emphasise should be more for the venture to be self-sustain and generate enough income to be distributed among the parties instead on the ability of the counterparty to pay back the financing.

According to Tariqullah Khan and Habib Ahmed (2001), the lack of *mudharabah* and *musharakah* instrument by IFIs is mainly due to its high credit risk. According to the authors, this is mainly due to the instrument of Islamic financing facility does not require any collateral. As a result, there will be some moral hazard by counterparty to remit the profit share of IFI. In addition, IFI may have information asymmetry on performance of the venture which may result in them not understanding the current business situation. Coupled with the lack of competencies of IFI in project evaluation may further jeopardize IFI share of profit. To add salt to the wound, regulations or institutional treatment on tax, accounting and regulatory framework caused *mudharabah* and *musharakah* not in favour of IFI.

The earlier finding by Tariqullah Khan and Habib Ahmed (2001) was contradicted by Boumediene (2011). According to Boumediene (2011), Islamic bank should have lower credit risk than conventional bank. In fact, he was adamant that there should not be any credit risk in *musharakah* and *mudharabah*. Rather than facing credit risk, IFI operating *musharakah* and *mudharabah* products may face capital impairment risk instead. As a result, IFI requires *shariah* compliant techniques of risk management instead of using the same technique like the conventional, which would be inconsistent because the contracts are different in nature.

This contradiction of opinion among the authors was probably just in terms of terminologies. As per our understanding, differences of opinions are perhaps due to categorisation of risk by both authors. Basically, the inability to recover investment in *mudharabah* and *musharakah* may be recognised as credit risk. However, it can only be recognised as a credit risk if it is due to moral hazard and information asymmetry of the business as mentioned above.

However, what if it is due to genuine loss of the investment venture? We believed it should be recognised separately, perhaps under the general category of capital impairment risk as categorised by Boumediene (2011) earlier. We are also in cohort with Boumediene (2011) who concluded that CFIs risk mitigation technique is inappropriate to be applied to IFIs equity financing instrument. Since both papers did not demonstrate the inappropriateness and outline suggested risk mitigation measure as raised as the objective of this paper, we will try to contribute to the existing literature by analysing the root cause of capital impairment risk and how to mitigate it.

Empirical Findings

As stated above, the current IFI Assets consists of debt based or equity based financing. Although debt based financing is not encouraged in Islam and it is hard for IFI to justify their earnings from this financing, debt based financing stills dominate IFI products. The debt based product in IFI is not through money lending but through delayed payment of asset purchase or long-term commitment of lease.

In the first instance, *the bai' bithaman ajil* (BBA) financing is very popular in Malaysia. In essence, BBA is about sale on deferred payment basis. There is no problem with this concept initially. In fact, scholars like Al-Kasani, Ibn Rushd, Ibn Taimiya and Ibn-Qudamah[3] allow premium pricing for deferred payment sale. Saiful Azhar Rosly (2011) illustrated about different sale scenarios that may occur from caravan trade during the Prophet period. Apart from cash sale, traders may have to engage in credit sale in particularly during the end of trading days.

Since the caravan trade involve long journey for the traders, it may not be cost effective for the traders to bring back their unsold stocks. The nature of caravan trade whereby traders will bring back stocks from faraway trading market to sell at their hometown may also make it impossible for the traders to bring back non-sale item.

As a result, traders may have to sell these goods on credit. Debts created from these sales may be collected during the next trade visit. In short, the fact that credit sale has

[3] Saiful Azhar Rosly (2011)

been approved by scholar and it has been practiced traditionally means that there is no issue in deferred payment sale even at higher prices.

Problem arises, however, when the concept of BBA is couple with enah sale which involve sale and buy back. It is well known that the concept of enah sale is not acceptable by most scholars except in Malaysia. In addition, the level of profit taken by the bank may sometimes be an objection because it is even more expensive than conventional financing. As a result, BBA looks like conventional financing in Islamic robe.

In terms of the long-term commitment of lease, it is based on *ijarah* contract in IFI. *Ijarah* is an established Islamic banking product with wide range of potential and acceptable worldwide. In Malaysia, the most prominent *ijarah* contract is the *ijarah thumma al-bai'* (ITAB) which are mainly used by IFI for vehicle financing. Unfortunately, ITAB may sometimes look like normal hire purchase agreement in substance. This is not help by the fact that ITAB is governed by Hire Purchase Act, 1967 similar to conventional hire purchase agreement.

One of the issues of ITAB occurs when the contract requires borrower to agree to purchase the asset at the end of the financing term. If the sale contract is made binding to the initial leasing contract, it may render the *ijarah* contract to be invalid because it is like having two agreement in one contract which is not permissible in Islam. This problem is worsened when the selling price is fixed upfront. This is because there is an element of *gharar* or uncertainty about the condition of the asset at the end of the financing term.

Fortunately, there are measures taken to settle the above issues (i.e. not allowing upfront selling price and having different rental and selling contracts). According to Ahcene Lahsasna (2010), it is permissible to combine more than one contract in one set, without imposing one contract as a condition in the other, and provided that each contract is permissible on its own.

As mentioned earlier, although *ijarah* and conventional hire purchase maybe similar in outcome, the financing nature or operations should be different. Another criticism is about asset ownership in ITAB. Theoretically, IFI is supposed to own the *ijarah* asset and assume risk and reward of the ownership which is not the case in an established practice by conventional hire purchase.

It is worth to note here that Islam imposed certain restriction on profit takings such as imposition of *al-kharaj bil dhaman* (entitlement to profit is linked to risk it bears) and *ribh ma lam yudman* (prohibition from taking profit without risk). Due to the potential of ITAB, we strongly suggest this contentious issue should be adequately addressed from risk management point of view to avoid this product from extinction because of *Shariah* non-compliant or it is just not profitable.

Currently, among the measures taken by CFI to mitigate credit risk on loans is evaluating credit worthiness of the debtors based on the 5Cs. 5Cs stand for (i) character or willingness to pay loans, (ii) capacity or adequate income to pay, (iii) collateral pledge for the loan, (iv) capital or down payment committed for the loan, and (v) condition of the borrowers environment and terms of the contract.

In order to judge "character", the bank will investigate the credit history of the borrower. If he has defaulting habit, he may be considered to have bad character in the bank assessment. Possibly, this is the most important factor in evaluating credit worthiness because a person may have all the money in the world but never pays his loans.

In terms of "capacity", the bank will look into the income of the individual or companies. In other words, this assessment is about the ability to settle the loans. For an employed individual, the bank may look at his monthly salary, his employment contract (permanent or contract basis) and also the reputation of his employer. For a businessman or company, bank may evaluate the profitability of the business from financial statement (preferably, an audited ones) and the sustainability of the business from financial forecast (i.e. 5-year or 10-year forecast).

If the bank found any potential problems from the "capacity" assessment, bank may require collateral or down payment for the loans. As an example, in property financing, bank will require a 10 percent down payment and the house will be pledged to the bank. In the event of default, the bank would auction off the property and recover amount due up to the date of settlement from the auction price. If the auction price falls short from the bank's outstanding amount, the borrower would need to make good of the difference. This evidence the fact that in whatever circumstances bank's loaned amount and its interest is protected, as compared to the spirit of risk sharing in Islamic finance.

"Condition" is where the bank will ensure whether the loan will be beneficial and not detrimental to the borrower. As opposed to "character" which deals with the inner part of the borrower, "condition" is about his external environment. As an example, gloomy business environment in the near future may render projects fail to take off as planned. A responsible banker may instead suggest for the loans requested to finance the project is deferred to future date. "Condition" also means the condition stipulated on the borrowing agreement to ensure strict compliance by the borrower. Borrower with stronger credit rating would have a more lenient condition as compared to a borrower with less strong credit rating.

It can be seen that the above credit worthiness evaluation of bank customer is still applicable to IFI. In fact, such approach fits very well for IFI's debt financing like *murabahah*, BBA, *enah*, or even *ijarah* to reduce the banks' exposure towards credit risk. In other words, by knowing the current situation and overall condition of potential customer, necessary *shariah* compliant measure can be taken to further reduce credit risk. Among the steps that can be taken is charging *ta'widh* on late payment, pledge of asset to the bank, clause on foreclosure of assets upon non-payment of financing after a certain point of time, call for guarantee by third party (*kafalah*) or other *shariah* compliant debt recovery measures.

As mentioned in the earlier section, equity financing remains a small portion of Islamic financing (i.e. *musharakah* 4.8% and *mudharabah* 0.1%). Nevertheless, as IFIs are moving towards equity based financing, there is a need to investigate whether current

CFI credit risk mitigation is still applicable to *musharakah* and *mudharabah* financing in IFI.

Questions may be asked about the differences between *musharakah* and *mudharabah* financing as compared to the existing financing model. What is the betterment brought by these financing? It may be best to answer these questions by explaining the financing method first.

In *mudharabah* financing, the bank acts as *rabb al mal* or the financier while the borrower acts as the *mudarib* or the entrepreneur. Both parties will enter into business as partners. As the *rabb al mal*, the bank is entitled to share of profits as agreed upfront. However, if the business fails, the bank will have to cover for the losses unless it can be proven that the losses are due to the entrepreneurs' negligence. In other words, the bank will not receive any payment from the financing.

It is easy to see that the bank is not really keen to offer *mudharabah* financing because of the high credit risk. In *musharakah* financing, however, any losses may be shared between the bank and the borrower. In addition, the bank has also some say in *musharakah* financing which makes it more appealing than *mudharabah*.

Still, *mudharabah* and *musharakah* financing is minimal in the Islamic banking industry in Malaysia. It can be said that IFIs have yet to embrace the joy of being more than financial intermediaries. Nevertheless, the pressure from international scholars and bank customers to have real Islamic financing may push Malaysian IFIs towards fully promoting these products in the near future.

Once *mudharabah* and *musharakah* financing have become the preferred financing mode, the next question is whether current credit risk mitigation technique is still applicable to IFIs. In our opinion, evaluation of the counter party as in 5C above is still relevant to avoid moral hazard, but it is not sufficient to fully address the fundamental issue in *mudharabah* and *musharakah* financing which is the risk sharing portion

If the bank imposes third party guarantee on return from *mudharabah* and *musharakah* venture as well as capital protection, it is actually defeating the spirit of sharing risk and reward of the venture. Similarly, imposing collateral on amount invested or collars on assets bought for the venture would also defeat the purpose of the partnership. Instead, the credit risk mitigation of IFIs dealing in *mudharabah* and *musharakah* financing should focus on the business fundamental of the contract whether it is for business or trade financing, home financing, or others.

Reiterating our earlier argument, IFIs are regarded as riskier than CFIs perhaps due to insufficient emphasise towards appropriate risks faced that would resulted in capital impairment of their investment. Rather than looking at risk with conventional eye, IFIs should segregate between credit risk (aka capital impairment risk) that derives from information asymmetry and negligence of the borrower and business risk which may not be avoidable by the borrowers. If not, IFIs will continue to shy away from the efforts to advance *musharakah* and *mudharabah* financing and taking the risk of asset ownership.

In the next chapter, we will illustrate some of the causation that would lead to losses in *musharakah*, *mudharabah* and *ijarah* financing as a basis for risk mitigation.

Root Cause Analysis

Undeniably, IFIs are profit making organizations and need to earn reasonable profits to continue in business. As business entity, IFIs are exposed to losses if they are unable to recover advances. This is made worse because IFIs are actually trading depositors' money apart from their shareholders' capital. In fact, the minimum capital requirement for IFIs (also for CFIs) under Pillar I of Basel II is only 8 percent which means 92 percent belongs to the depositors.

If there are any losses, it would hamper IFIs in paying return to depositors (IAH) which would reduce confidence towards Islamic banks. If the losses were too huge, it may erode depositors' money which in turn may result in a bank run. Consequently, it may collapse the whole Islamic finance structure.

IFIs capital amortisation risk does not occur in isolation. Normally, it is caused by some reasons and induced something else such as liquidity problem. Thus, we need to identify the cause and mitigate it. In illustrating the root cause, let us further focus on the following consumer and trade financing products:

- *Musharakah/Mudharabah* business financing;
- *Musharakah Mutanaqisah* Home Financing; and
- *Ijarah Thumma Al-Bai* Vehicle Financing.

As mentioned in the previous section, IFIs operating *musharakah* or *mudharabah* business financing would lose money when the business venture loses money. In analysing such losses, IFIs should differentiate between losses that occur intentionally and unintentionally. Obviously, it would require additional judgment and extra works for the IFIs.

If the borrower has been diligent in executing their responsibility as project manager, there should not be any reason for the IFIs to penalise them if the business was not successful. In this case, IFIs should give some leeway to the borrower by extending their repayment period without charging any penalties. This is in line with the Quran which states that when a borrower is in distress, the lender should not ask for repayment (2: 280).

However, business losses may be due to the entrepreneurs' wrongdoings instead. As an example, rather than investing into the business like buying new machineries or researching for new methods of production, the borrower may use the financing for their own enjoyment by purchasing expensive cars and engaging into entertainment. In this case, IFIs should curb such immoral action immediately by requiring the borrower to return the financing amount as soon as possible. This is based on the argument that this money may be better off given to genuine entrepreneurs.

In respect of the *Musharakah Mutanaqisah* Home Financing (MMP), IFIs and the borrower bought a completed property together as partners. Normally, the borrower's deposit or down payment is considered like his capital portion on the house. The bank

will then sell his share of the house to the borrower in stages. Once the borrower fully purchased the banks' share, the house will become his.

Until the borrower has fully paid for the house, it is jointly owned between him and the bank. If the borrower wants to stay in the house immediately, he will have to rent it from the bank until he fully paid the bank's share. It should be noted here that the rental amount in Malaysia is calculated based on the Base Financing Rate (BFR) of Malaysian bank. As a result, the rental amount paid is similar to the conventional financing amount. In contrast, LARIBA of American Finance House sets rental amount based on real rental rate in the vicinity.

This different methodology is covered in detailed by Ahamed Kameel Mydin Meera and Dzuljastri Abdul Razak (2009), a staunch supporter of rental payment for MMP based on market rental of the property. However, we believed that although this computation is welcomed by one party (either customer or banker), it will be undesirable by another.

The fallout is due to the mathematical calculation where empirically high value real estate does not command good rental (i.e. gives good Return on Investment or ROI) as compared to the market interest rate[4]. If market rental is used for these properties, banks may not able to recover good return to compensate their depositors. Eventually,

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[4] Empirically high value landed properties in the suburbs yield lower ROI as compared to strata properties in the city centre. As an illustration we apply figures as advertised via Mudah.my;
A Semi-D in Bandar Seri Putra Bangi valuing RM 790,000 earns monthly rental of RM 2,600 (4% ROI)
A low cost flat in Pantai Dalam Kuala Lumpur valuing RM 107,000 earns monthly rental of RM 800 (9%)

Comparatively, CFI charging annual interest at BLR(6.6%)-2% for a financing period of 30 years would charge the following monthly instalment to each borrower;
RM 4,089.29 to borrower whom purchase the Semi-D in Bandar Seri Putra Bangi
RM 553.87 to borrower whom purchase the low cost flat in Pantai Dalam Kuala Lumpur.

If IFI charges MMP rental rate based on market rental rate;
Borrower purchasing the Semi-D would be well off financing with MMP as he would pay RM 2,600 monthly (as compared to RM 4,089.29 instalment to CFI)
Borrower purchasing the low cost flat would pay less if they borrow from CFI

The contentious issue of using market rental rate for MMP would be;
Would it be enough for IFI's rental income at 4% to cover its operational cost, loss provisions, and to compensate depositors at fluctuated market rate?
Would IFI achieve the main objective of Islamic economics that is to provide basic needs for the people?

it may trigger the rate of return risk and displaced commercial risk which will be damaging to Islamic banks' reputation or credibility.

On the other hand, low cost property in city centre may command good ROI for bank when they used market rental but it would burden the poor people. Ultimately, it will defeat the objective of providing the basic needs for the people. As such, banks either use flat rental rate or the market interest rate (i.e. BFR $\pm$ spread) to price the rental (which is more popular) in Malaysia's MMP.

The credit risk issue in this financing type is the inability of customer to pay in the middle of the financing where balance of the principal financing higher than the market value of the house. A case in point is the housing project in Bukit Beruntung. Initially, the property price in that area was set quite high because it was tipped to home the new Kuala Lumpur International Airport (KLIA). Due to the news, speculative activities built up in that area, resulted increase of property price. Eventually when the Government announced that the new KLIA would be located in Sepang, all the excitement in Bukit Beruntung died off and speculators started fire sale on their properties. As a result, genuine homeowners lose out when their property value dropped and hope of getting better accessibility to the city centre lost. In this case, the bank customer is at a losing end. Thus, the house buyer may feel that it is better for them to default because they will not be able to gain anything if they proceed with this financing.

Another relevant issue is when the housing project was abandoned by developer. In this case, house buyer may have no choice but to purchase or rent another house. As a result, they will not be able to service the repayment of loans on these abandon properties. In fact, there is no incentive for them to do so.

IFIs should be more flexible in handling default cases relating to the above scenarios. It is clear from the above illustration that the bank customer should not be totally blamed for the defaults. In fact, IFIs are partly responsible because they did not properly review the whole situation when financing the property. If IFIs have acted beyond the role of money lenders, these situations may have been avoided taking into consideration the knowledge base available in the IFIs.

As mentioned above, the rental payment by customer (borrower) would be affected by fluctuation of interest rate.[5] Once the interest rate moves up, their rental payment would increase. In the case of MMP financing, if the customer fails to pay the rental (credit or counterparty risk), would the bank together with the customer (both partnering as landlord) evict the customer (as tenant) and find another tenant?

This is unlikely since banks are operating as financial intermediaries, not property investor. Banks would resort to business that they used to or familiar with, which is to auction the property. If the property value on the auction date is higher than the financing value, it would be sold off at a higher price, both partners would get a capital gain on their investment and everybody would be happy (presumably). If the value of the property gone down instead, both party would lose their capital invested. This is a possible case of capital impairment risk.

Another case in point is the *Ijarah Thumma Al-Bai* Vehicle Financing offered by IFIs. Similar to MMP case, bank customer may be unable to pay their vehicle *ijarah* payment because the principal balance is higher than the market value of the vehicle. Recalling the nature of *ijarah* contract, it is clear that IFIs are the owner of the vehicle during the rental period.

Following that, the bank is supposed to recover the vehicle from the defaulting lessee and find new ones. Obviously, IFIs are not keen on having a fleet of vehicles in their balance sheet. Nevertheless, it is the obligation of IFIs to follow this process if they are financing the vehicles using *ijarah* type of contract. We will discuss how IFIs can cover themselves from losses arising from the above risk in the following section.

Risk mitigation techniques

In the previous section, we have illustrated different credit risk scenarios based on three different types of Islamic financing products offered by banks in Malaysia. Among

[5] Basically, banks can either use flat rental rate (fixed) or fluctuated rental rate (based on BFR) to price the rental amount in MMP. In this illustration, we are referring to the later rental computation.

others, we have discussed capital impairment risk proposed by Boumediene (2011). Overall, we have recommended that Islamic bank should re-evaluate their perspective towards credit risk. Credit risk management in IFIs should be unique from CFIs by changing their focus of risk management on other risk. By doing so, IFIs will be able to break free from their cocoon as financial intermediaries and create a niche for themselves as investors or merchants.

In order for IFIs to mitigate losses from capital impairment risk arising from this new role, it requires extra work no doubt. As the saying goes, no pain no gain, IFIs should accept this new responsibility with open arm as the reward will be tremendous. It should be remembered that the growth in computerised industry and eventual emergence of current heavyweight companies like Microsoft and Apple, all started from venture capitalist project. In short, financing a winner will certainly be a rewarding experience for IFIs financially and knowledge-wise.

Thus, for *musharakah* or *mudharabah* business financing, IFIs should have a separate department to evaluate the business venture. This Business Development Department must be segregated from the Credit Department to avoid confused judgment. In *musharakah* business financing, the department should closely monitor the progress of the business. If there is any discrepancy between forecasted and actual performance, this department may called upon the directors of the company to get better information and suggest ways to overcome it.

On the other hand, the department may request performance report and audited report from businesses using *mudharabah* financing. Since *rabb al mal* is not allowed to interfere in business operation, IFIs may instead conduct regular training to share their knowledge about the business with the *mudarib.* As a result, IFIs will be able to stay close to the business and increase their knowledge base at the same time.

Since IFIs are exposed from default of *Musharakah Mutanaqisah* Home Financing from the burst of property bubble, it is important that they focus on good location. Good location does not mean it must be in the city centre only. In fact, there is a possibility

that some outskirt areas may be good location too depending on future development in that area.

A research by Weber, Bhatta and Merriman (2007) on Chicago's single-family home sales data that link tax increment financing (TIF) districts to housing price appreciation concluded that TIF influenced housing values but the influence varied positively and negatively for different type of TIF (commercial, mixed and industrial) districts. TIF reflects future commitment of municipalities to develop certain area and may improve property value in the vicinity. Thus, IFIs will have to be wary when deciding to finance properties in areas earmarked for future development as it may have adverse impact to prices instead.

In addition, IFIs should focus on reputable developers to avoid abandoned projects. IFIs may work along with government departments or agencies to identify errant developers. It is believed that the government sector will be more than willing to help because abandoned project eventually creates political and social issues. Once IFIs have managed to collate credible developers, they may venture further by financing the development of a township. IFIs may be able to cut development cost further by tendering the project among these developers.

In terms of *Ijarah Thumma Al-Bai* Vehicle Financing, IFIs should focus on vehicles with high resale value and avoid the risk of financing cars that have very low resale value. It is well known that certain brand or models of vehicles have high second hand price even after years of usage because of its quality and durability. IFIs should focus on these cars rather than just giving financing based on customers' request and their repayment ability. In addition, IFIs may have strategic alliance with the respective car dealers and request extra goodies (i.e. free maintenance, body kits) for the vehicle buyer.

If customers insist on buying cars that is not in the IFIs' preferred list, IFIs may have to set additional conditions to cover themselves. As an example, IFIs may request higher deposit, shorter tenure or higher monthly rental for cars that have low resale value. We believed that although IFI may see a drop in financing less favourable cars, the increase in income of financing the preferred ones along with the covering of losses from auction

cars will far outweigh the drop. This would in turn help the customers from falling into high debt trap.

In addition, IFIs may have separate funding account for each financing portfolio with risk rating on each fund/portfolio. For instance, separate Special Investment Account is created for home financing, vehicle financing, business financing and others, similar to what had been practiced by Macquarie Bank Australia. The investing public can expect different level of risk and reward for each fund and place their money based on their risk tolerance.

Although the recommendations made in this section may be a little tight, it will bring goodness in the long run. IFIs, assuming new role as partners to the bank customers, should be above their profit seeking motive and educates the public about good spending habit. Indirectly, it will remind the public to spend responsibly by choosing good products and avoid buying things that they cannot afford. In the long run, IFIs will benefit from lesser default risk and better client base.

Conclusion

In Islam, ownership comes with risk and there is no profit without ownership. In other words, Islam embraces risk sharing in line with the spirit of brotherhood. As a result, conventional credit risk mitigation focusing on counterparty may not be appropriate to financing portfolio which requires IFIs to share some of the borrowers' risk. In order for IFIs to excel in this new responsibility, they need to refocus their risk areas from credit risk to other factors that would impair investments (capital impairment risk). Consistently, risk mitigation plan should follow the same direction.

It is important that IFIs build the platform from now to support the move from debt-based financing to more equity-based risk-sharing financing. The shift will gradually build more confidence for customers (depositors) and hopefully, it will be the first step towards risk-sharing with depositors, and reduction if not abolishment of Profit Equalization Reserve (PER) and Investment Risk Reserve (IRR).

The problem from the bigger picture is to have adequate expertise in different field for the IFIs to be more aggressive towards the new portfolio with better risk management in particularly when risk management for *musharakah* and *mudharabah* is still at early stage of development (Mohamed Ali Elgari, 2003).

An area to be explored is for the banks to pool their resources together i.e. collaboration or forming a mega Islamic bank with subsidiaries in different sub areas like mortgage financing company, leasing, trade financing, etc with niche depositors acknowledging the risk so that the risk and reward of the business and be effectively pass through from investments to depositors, thus eliminating the need of PER and IRR.

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