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Title: ISSUES AND CHALLENGES OF RISK MANAGEMENT ISLAMIC FINANCIAL INDUSTRY: A CASE STUDY OF BAHRAIN

Abstract:

In this work, an attempt has been made to focus on various types of risks faced by the Islamic banks in their different modes of financing especially in the context of Bahrain, where Islamic banking is comparatively at the advanced stage than other Arabian countries. The main purpose behind this exercise is to understand the problems of survival of Islamic finance industry that is also expanding steadily despite facing the risks of different nature. How the scholars have dealt this issue in recent years is also one of the basic parts of this study, in order to understand the nature of theoretical and practical development in this important area of Islamic finance.

Aim of the study

The main objective of this study is to find out various risk management problems of the Islamic financial institutions operating in the Arab Gulf and more especially in Bahrain which is considered as the hub of Islamic finance. This will also lead to examine as what remedial measures can be taken to improve the risk management areas so that the regulatory authorities may be able to fine-tune the functioning of Islamic financial market in the region

Results

While exploring the concept of risk and various risks involved in contemporary Islamic banking and finance, this study argues as to the very need of risk management, especially in view of the cost implication. Without not managing costs the risk can, at times, be larger than that of managing it. Further, proper risk management. while enabling meaningful comparison or risk adjusted business performance across the entities and industries, also yields higher returns for the investors and other stakeholders, thus creating value for the shareholders. The practices of financial institutions are to take up activities in which risk can be efficiently managed and shared.

The field of risk management is undergoing monumental change. Risk management must understand financial markets and be able to effectively incorporate quantitative analysis and technology in their risk management programs. For example with the Risk Based Supervision (RBS), which is gaining ground now, merely the supervisors are expected to concentrate their efforts and optimize their resources to ensure that financial institutions, more particularly banks, use the process necessary to identify, measure, and control risk exposure. Whereas for Islamic Banks, effective regulation authorities must have extensive knowledge and experience in dealing with risk management issues.

The survey shows majority of the Islamic banks in Bahrain use RAROC, GAP Analysis and Value at Risk for risk measurement. However risk mitigation banks are normally dependent on derivatives followed by securitization, guarantees, and loan loss reserves. For example, credit risk is being mitigated by estimating and minimizing credit losses, and sufficient loan loss reserves are used at highest rate because they gives protection against expected credit losses. The banks are required to maintain the mandatory loan loss reserves subject to the regulatory requirements in different jurisdictions. This clearly indicates that Islamic banks are eager to face the competition in the global financial market as these institutions see seeking emerging opportunity and challenges in this area in the coming years.

Also reflected from the field study is the common practice of Western banking institutions of granting credit facilities to those clients who are able to offer sufficient tangible collateral security. *Urbun*, the down payment, serves as a kind of collateral or guarantee to the seller that the potential buyer has a serious intention to purchase the commodity. The down payment also serves as compensation to the seller in case the buyer withdraws from the purchase. Secondly, the down payment upon purchase of the commodity is counted towards the total price of the commodity, whereas in an option contract, premium is paid by the client as consideration for the possibility/entitlement to purchase underlying for an agreed price on an agreed term in the future.

Conclusion:

Islamic banking is flourishing in the same market where conventional system is prevailing. In many cases both Islamic and conventional banking also works together in various projects trade related financing. This obviously means that risk faced by the Islamic finance industry is basically inherited from the conventional system.

Further the definition and meaning of risk is similar in both industries except that the nature of loan and types of financing differs. However, the internationalization of banking environment has resulted in fierce competition and brought uncertainties and risks. In addition, lack of market discipline and corporate governance has also been responsible for banking risks. Broadly risks faced by banks can be attributed to their business, which is concerned with sourcing of funds through various channels and their profitable deployment, as also to their control functions.