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A Review of Risk Management Theory in Commercial and Islamic Banks

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ABSTRACT: *An attempt has been made in this paper to review six papers relating to the risk management practices in Islamic and conventional/commercial banks. The same methodology/approach is used in Islamic and conventional banks. In Islamic bank they develop a questionnaire. This covers six points about the risk management process. To understand what type of risk and manage that risk, assess risk and examine, identify risk, observe risk, credit risk and risk management practices. Islamic banks are more professional in managing risk as compared to conventional banks. But Islamic and conventional banks both have a positive impact on profitability after managing risk.*

K**eywords:** *Islamic Banking, commercial banks, conventional banks, risk*.

Uncertainty exists when one does not know what will happen in future. Risk is uncertainty that has the chance of loss in future. Uncertainty is a necessary but not sufficient condition for risk. Sometime uncertainty has no possibility of loss and there is no risk.

Why take risk?

- Because you have to take it.
- Because it brings more rewards.
- Risk aversion.

Classifications of Risk:

- Production risk
- Price risk of inputs / outputs
- Reputational risk
- Project risk
- Environmental risk (weather)
- Political risk
- Economic conditions risk

But from the point of view of banks there are some more types of risk that are as follow.

- Credit risk.
- Exchange risk.
- Operating risk.
- Interest rate risk

Risks are also classified into two more categories. One is systematic risk and unsystematic risk. Systematic risk is related to the market and economic conditions. While unsystematic is risk associated with assets and firms. Sometimes some systematic risks can be reduced by the use of risk mitigation technique.

For this Oldfied and Santomero (1997) prefer three risk mitigation strategies:

(1) Eliminate risk by business practice:
(2) Transfer risk to others.
(3) Actively manage risk (acceptance of risk).

- Risk Management Process:
- Risk Identification / Exposure
- Risk Assessment
- Selection of risk management techniques
- Implementation
- Review

This is the risk management process which Islamic and conventional banks adopt in risk management practices.

Concept of Islamic and Conventional Banking

The Islamic banking started in Pakistan in 1980.It is then very difficult in Pakistan to convert a conventional banking system to an Islamic (riba) free banking system. In 1963 Ahmad El Najjar led the pioneering effort in Mit Ghamr (Egyptian town) by introducing savings bank that was based on profit and loss sharing principles of Sha’ria(Ariff, 1988). Despite the purpose and function of finance and Finance Cost (Rate of interest) at which finance cost (rate of interest) is charged Islam does not allow Muslims to take or give interest (Riƅa).A Few so called Muslim scholars, imbued with the ideas of western Civilization argued that Islam does not prohibit Interest (Riƅa), what Islam prohibits is Usury.

So, efforts have been made to make a distinction between interest and usury and between the issuance of finance for productive purpose and the issuance of finance for consumption. Moreover, some of the so called Muslim scholars argued that usury is the (Riƅa) that was initially practiced by Moneylenders and Qur'an prohibits usury not Interest which is the key element of modern conventional banks. They argued that if Finance is issued for productive purposes, interest charged on that finance is not Riƅa, but their arguments were all in vain and have no place in Islam because it is generally accepted by all Muslim scholars (except some unorthodox views) that interest or Riƅa are same and the only difference between these two words is the difference of spelling not in the meaning.

On the other hand productive loan and so called unproductive loan only differs in degree not in kind. So, whatever name one may use for interest ether usury or Riƅa its characteristics will not change as it’s only the addition of money through unfair means that is against the Islamic jurisprudence and Qur'an. In saying of Holy Prophet (S.A.W) (Hadith) interest (Riƅa) is also quoted in definite terms. Prophet (S.A.W) held all alike in guilt, those who charge/take interest (Riƅa) and those who give/pay (Riƅa) and also those who record/ witnessed the transaction. Islamic banking system is defined as the banking system with culture and on the Islamic structure.

Methodology

The hypothesis developed and tested in risk management process.
H1. Positive relation exists between risk management process and risk identification, credit risk analysis, and risk assessment. This hypothesis is tested through standardized questionnaire. The questionnaires include risk management process as dependent variable and include aspects of RM as independent variable. In all the

papers we reviewed a standardized questionnaire methodology is used to find the relationship between the depended and independent variables.

Literature Review

There is a large number of papers published on risk management in general. But the number of empirical studies on RMP's in financial institutions found very little. This paper is an attempt to summarize the main conclusions of some selected papers.

According to O'Brien information system did not support the specific objectives accurately. In which the management and business operations basic requirements are involved. This system damages the actual success and existence of the banking business. Scoot, in 2000 suggests that the computer system gives such importance to Banks that Banks can compete to the impermanent atmosphere of business. In 1996, West is of the opinion that the institutions should get benefit of technology so that they should remain side by side with the economic rate of market. According to Froot Etal in 1993, he tells that in pure Capital maket, Modigliani Miller presents some important suggestions to settle the orders which have been identified.

The firms should be motived about the risks and should manage it like, the costs of Taxes and insolvency and agencies cost and all that. When the causes of Risk management in the actions of firms are connected with mutual understanding, they can give even one consequence. When all the risks become perceptive, this thing becomes the cause, in increasing the value of share holders. root and stein in 1998 made a frame work which examines the essential capital collection, capital budgeting and the affairs and decisions of risk management(W.Baller and Ryser 2004).

A public service based bank did not reduce the value of its shareholders in perfect market, and did not reduce the possibilities of risk. According to Miller 1992, in recent literature the risk management attracts our attention towards the methods and types of risk while risk too depends upon other things.

Mongiardino and Plath (2010) see that Risk Governance in big Banks using their limited resources increases their work pressure and eliminates the credit crisis. According to Erknes Etal in literary activities, mutual Governance of these banks between CEO and Management has been included. Further he probes that the relation between corporate governance and firm's efficiency becomes cause of credit crisis.

According to A.Hassan and Faris Risk management is a basic store among Banks activities. In recent condition without any doubt all banks face large number of risks as well as credit risk, liquidity risk, forgive exchange risk and the percentage of interest risk. That is why the perceptive risk management is very necessary. Linbo Fan in 2004 observes the efficiency of big banks of USA and risk as well. He discovers that in matter of credit risk and bankrupt, the sense of profit is rare, but not for liquidity risk and mix of loan. According to Wilson in 2001 Islamic banks have been introduced not only in the Muslim world but also in the west in recent years. Haniffa and Hudaiba in 2007 suggest that the Islamic banks will be integrated with the standardized approaches of the risk management.

In 2012 Sania.K and Shehla say that naturally risk is a part of a business and common life as well. According to them Risk is a state which enhances the chances of loss and indicates towards the unconscious incidents to whom we can sort out and increase the chances of advancement. Zaheer and Hassan in 2001 are of the opinion that from the very beginning the making of Islamic banks was a dream, in the mind of few people. As it was clear to very few people but with the passage of time and with hardest work, Islamic Banking was made the part of people's perception.

Meyer in 2000 and Khan and Ahmad in 2001, are of the opinion that the unperceptive incidents of Future which cause disappointed to any debtor that how he will pay back his debt. The fluctuation of forgive currency incomplete, paperwork, cheating and the disobedience of the principles of Shariat and many other actions which add fuel to that work, which becomes the cause of failure of Banks.

The management of risk literature tells the risk management situation as "the procedure along with which decisions are established (Forsdkk 1997).

There are two methods of risk management first of all we will discover the place of risk and secondly make the framework to develop the methods to Judge the risk by statistical or mathematical tools to understand the risk. (Rosman 2009).The Islamic banks not only recognize the new and uncertain risks but they also face the various types of risks that common banks faced. (Khan and Ahmad 2007).Wetmore (2004) observe the relationship among loans-to-core and liquidity risk Investment ratio of large commercial bank. Wang and sheng-yong (2004) He reviewed the foreign risk, world chain of production from beginning to end Talwanese American depository Invoices. Credit risks in Spanish saving bank and commercial the outcomes of the loan problems of Spanish commercial and thrift bank in the

tenure of 1985-1997 sales and Saving (2002) oldfield and santomero (1997) Examines the R.M in financial organizations. In this literature, they advised four methods for risk management practical methodology,
These are

1. Standardized and reports establishment
2. Set the guidelines for strategic creation of self-investment.
3. The balance of compensation contracts and incentive should be parallel.
4. Disorder of the position of rules, regulations and limits.

Khan and Bhatti (2008) Islamic base banks deals with another important challenge to enhancing their Risk management plan of action and corporate governance.
Abul Hassan (2009) the unmistakable involvement of some these arguments are that Islamic banks in Bornie need to hire sizzling risk management methods and techniques.

There are also current literary studies which give special importance to the fact that faults in bank governance played an Important part in the deficit of efficiency of banks throughout the fiscal crisis of (2007 to 2008) (Diamond and Ranjan, 2009).

Fraud situation and its probability within a bank lead to result from an unhandled control. This is frequently the outcome of Power to effect somebody being maintain by senior staff of banks cover more junior employees (Richorad dedman and simon Robert-Tissot 2001)
A writeable successfulness of risk management in the Islamic banks of Burnel Dorussalam, viewed the workers capability to cover with material or reward their way towards successful risk management (Hassan 2009).

Conclusion

Risk management process; risk identification, risk assessment, selection of risk management technique, implementation, review; we follow these steps in risk management process. But if the banks and other financial institutions fail in managing risk it means they are not following these steps. Banks mostly follow these techniques to manage risks like financial risk debt security risk and other risks.

Risk management technique: risk avoidance, risk prevention and control, risk retention, risk transfer. Risk avoidance: in this technique banks normally try to avoid taking risk risks; they follow defensive policies. The debt security of banks is very important in this technique.
Without the debt security banks do not give loans to any institute .In this technique banks totally avoid risks.
Risk prevention and control: in this method of risk management banks take risk and then try to control and prevent of risk. They give loans without any hard securities and then they spend money to recover and to control their risk of no recovery of debt.

Risk retention: in this technique banks retain risk with themselves to take extra advantage of profit. Because high risk means high profit. They follow the policy of high risk and high profit.

Risk transfer: In this technique banks transfer their risk to its subsidiaries and other branches which are running in high profit .so through these banks manage their risk.

Findings and suggestions

From all these papers that we read we found that the risk management is very crucial for the financial institutions to compete in the market .Most commercial and Islamic banks are insolvent due to the inefficient risk management policies. We found in all these papers that there is a positive relationship between the profitability and risk management. Those commercial and Islamic banks who manage their risk in proper way they have high profitability ratios. Analysis shows that all over the world those financial institutes who manage their risk in proper way their financial position is stronger than those who do not manage risk in proper way.
So our findings in these papers are that; risk management and profitability has positive relation; the banks who manage risk their financial position are more stronger than others; most financial institution fail in managing risk and they are insolvent; these papers show that risk management is very crucial factor in improvement of financial position of banks like commercial and Islamic banks.

After reading the literature on the risk management and all these papers we conclude that risk management process must be followed by every organization. We suggest that every organization must follow these steps to manage their risk to improve their financial performance. Every bank or other organization first of all identifies their risk factors. Then assess the risk quantity and type of risk financial risk or any other risk.
After the assessment of risk companies select the technique to control their risk.

There are four techniques that are used to manage risk; risk avoidance, risk prevention and control, risk retention, risk transfer, and implementation

After the selection of the technique companies implement it for risk management. After all the above steps are followed companies must review their risk management process. Is it effective or not if it is not effective than companies change their technique of risk management and then next process will be started again. We strongly recommend that companies like financial institutes like commercial and Islamic banks must follow the risk management process this will definitely improve their financial position.

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