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Sharia Risk, The Indicator of Sharia Governance on Islamic Banks

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Abstract: *Banking is a very vulnerable business to risk, so it takes good management to ensure itself as a healthy institutions. The governance of Islamic banking has a fundamental differences with the governance of conventional banking in terms of sharia compliance. The disobedience of the Islamic banking to the sharia compliance causes Islamic banks to be subject to sharia risk. The sharia risk is the possibility fot the operational of Islamic banks are not or will not be in compliance with established sharia principles and standards. Through a descriptive analysis by using library research, this study aims to map the flow of sharia risk in Islamic banks and categorizes its causes. This study notes the sharia risk arises from the purpose, politics, people, process, and systems.*

Keywords: *sharia governance, sharia risk, Islamic bank*

JEL Classification: G32, G34, O16

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INTRODUCTION

The banking crisis 1997 provided valuable lessons for national banking in Indonesia. This crisis caused the national banking became to slump so that the government carried out a series of programs to save banks from the crisis, including banking restructuring. This illustrates that banks are very vulnerable to risk, so that good corporate governance is needed to create a healthy national bank. The importance of risk management is reflected with the establishment of international risk setting standards in the form of Basel. Indonesia also has to be required to follow these standards.

However, crisis experience proven that Islamic banks have been more resilient to the financial crisis than their conventional counterparts, because all transactions have to be backed by a tangible asset, which means that Islamic banks tend to have more collateral than their conventional counterparts.[1] Van Greuning & Zamir[2] affirm that risk management in Islamic bank actually is not much different from conventional bank. But, specific differences lie in Islamic compliance. Hamza[3], Ismail & Razak[4] explain Islamic banks have the responsibility to ensure the compliance with the sharia rules of their products, instruments, operations, practices and management. The compliance with the sharia principles will be achieved by having a proper sharia governance framework. Clearly, sharia principles are the foundation of Islamic banking operations and the comprehensive compliance with the sharia principles differentiates Islamic financial institutions from conventional institutions. Therefore, countries practicing and promoting Islamic banking engaged in a sound and robust sharia governance framework with varied practices employed.

Furthermore, study of Idat[5] shows that there is a decrease in the compliance of Islamic banks to sharia principles. Based on a survey on community preferences conducted by Bank Indonesia in collaboration with university research institutions, there were doubts by publics about sharia compliance in Islamic banks. Complaints that often arise were aspects of compliance with sharia principles.

LITERATURE STUDY

Sharia Governance

One of the unique governance processes of Islamic Financial Institutions (IFIs) is sharia governance. Ismail & Razak[6] assure that sharia governance plays an undeniably important role in IFIs. There are various definitions of sharia governance recorded in

[1] N. P. Swartz, "Risk Management in Islamic Banking," *African Journal of Business Management*, Vol. 7 (37), October (2013), 3799-3809;

[2] Van Greuning H, and Z. Iqbal, *"Risk Analysis for Islamic Banks,"* (The World Bank: Washington, D.C., 2008)

[3] H. Hamza, "Sharia Governance in Islamic Banks: Effectiveness and Supervision Model," *International Journal of Islamic and Middle Eastern Finance and Management,* Vol. 6, No. 3 (2012), 226-237.

[4] N. A. Ismail & S. H. A. Razak, 2014. "Shariah Governance Framework Gaps and Issues," *International Journal of Financial Economics* Vol. 3, No. 1, 1-10.

[5] D. G. Idat, "Tren Bank Syariah: Penurunan Terhadap Kepatuhan Prinsip Syariah," *Media Akuntansi,* Edition 33, May, 2012.

[6] N. A. Ismail & S. H. A. Razak, 2014. Shariah Governance Framework Gaps and Issues. *International Journal of Financial Economics* Vol. 3, No. 1, 1-10.

previous studies. According to Bahari & Baharudin[7], Hidayat & Al Khalifa[8] mention sharia governance as a governance system that ensures all activities and business transactions by IFIs are free from non-allowable elements such as *riba, gharar, maisir* and other similar attributes. Sharia governance is a mechanism at the institutional, industrial and national levels that ensures the IFIs only take and use sharia-compliant activities, products and services. Hamza[9] affirms that the sharia governance which refers to all the elements about the active role of sharia board and compliance with sharia is strongly fundamental for Islamic banks.

Maradita[10] argues the application of *Good Corporate Governance* (GCG) principles is a necessity for an institution, including Islamic banking institutions becuse the existence of public accountability related to the bank's operational activities that are expected to fully comply the positive law. Chapra and Ahmed[11], Ginena[12] also remind the importance of GCG for Islamic banks. Without effective CG, it may not be possible to strengthen Islamic banks and to expand rapidly. It is a mistake to presume that Islamic banks do not need to organize prudent corporate governance just because the Islamic value system equitably shield the rights of stakeholders. Islamic banks are no less disposed than conventional banks to losses, or even failures, which can result from corporate governance breaches. Study of Rama & Novela[13] find that sharia governance ---which are measured by the number of sharia board members, doctoral qualification of shariah board, and frequency of shariah board meeting--- has a significant impact to the increase the quality of GCG in Islamic banks.

Further, Iqbal & Mirakhor[14] highlight there is no denying that good governance promotes economic growth and financial stability in the Islamic and conventional financial systems alike. However, the governance principles of Islam are much broader in recognizing and including stakeholders. The ultimate objective of the Islamic system is to enhance social justice and welfare. To this end, it expects the highest moral and ethical conduct from the business leadership as well as from policymakers, regulators, and industry participants. Then, the risk profile for operating an IFIs are grouped into four broad categories: financial, business, treasury, and governance risks. Governance risk refers to the risk arising from a failure in governing the institution, negligence in conducting business and meeting contractual obligations, and from a weak internal and external institutional environment, including legal risk, whereby banks are unable to

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[7] N. F. Bahari & N. A. Baharudin, "Shariah Governance Framework: the Roles of Shariah Review and Shariah Auditing," *Proceeding of the 3rd International Conference on Management & Muamalah 2016 (3rd ICoMM)*, (2016, October, 31 – November, 1), 377.

[8] S. E. Hidayat & A.K. Al Khalifa, "Sharia Governance Practices at Islamic Banks in Bahrain From Islamic Bankers' Perspective," *Al-Iqtishad: Jurnal Ilmu Ekonomi Syariah (Journal of Islamic Economics),* Vol. 10 (1) (2016), 54.

[9] H. Hamza, "Sharia Governance in Islamic Banks: Effectiveness and Supervision Model," *International Journal of Islamic and Middle Eastern Finance and Management,* Vol. 6, No. 3 (2012), 227.

[10] A. Maradita, "Karakteristik Good Corporate Governance Pada Bank Syariah dan Bank Konvensional," *Yuridika* Volume 29, No. 2, Mei-Agustus (2014), 193, 194.

[11] M. U. Chapra & H. Ahmed, "*Corporate Governance in Islamic Financial Institutions.*" (Jeddah: Islamic Development Bank (IDB), 2002), 6, 9, 10.

[12] K. Ginena, "Sharīʹah Risk and Corporate Governance of Islamic Banks," *Corporate Governance* Vol. 14, Issue 1 (2014), 87.

[13] A. Rama & Y. Novela, "Shariah Governance dan Kualitas Tata Kelola Perbankan Syariah," *Signifikan,* Vol. 4, No. 2, Oktober (2015), 124, 125.

[14] Z. Iqbal & A. Mirakhor, "*An Introduction to Islamic Finance: Theory and Practice,*. 2nd Edition," (Singapore: John Wiley & Sons (Asia) (2011)), 279, 291.

enforce their contracts. Banks are unable to enforce their contracts. One of, and the unique risk within, governance risks in IFIs is sharia risk.

Sharia Risk

In Islam, Noor, Ismail & Shafiai[15] argue that a set of evidence related to the origin of risk can be identified from the command of God in QS. Al-Baqarah [2]: 195, *"And spend in the way of God and do not throw [yourselves] with your [own] hands into destruction [by refraining]. And do good; indeed, God loves the doers of good."* This verse describes risk as unfavourable outcome. Therefore, risk in conventional practice slightly differs from Islamic practice in terms of this evidence.

There is also a Hadith describing the practice of risk management. It can be explained through the famous command from Prophet (p.b.u.h.) to a Bedouin. The Prophet (p.b.u.h.) asked the Bedouin why he left the camel untied. The Bedouin answered, "*I trust in God.*" Hence, the Prophet (p.b.u.h.) said, *"Tie your camel, then trust in God."* This Hadith is significant in declaring the Prophet's order to his people to practice the rules with diligence to reduce unpleasant future outcomes.

Further, Van Greuning & Iqbal[16] mention one aspect that is associated with the tremendous growth of the Islamic banking and finance is the risk factor where disputes are always anticipated. Whereas Islamic banks, as already mention, are different from conventional banks in their form of financial intermediation, financial instruments, and structure of financial statements. These institutions are nevertheless subject to a similar framework for analyzing their risk and exposures. As these principles and procedures for measuring and controlling risk are similar, so the analytical framework for assessing risk should be similar as well.

Beside having generic risks which are similar to the ones faced by conventional financial institutions, Noor, Ismail & Shafiai[17] claim IFIs also face additional risk which reflect the mix of risks by sharing arrangements. This risk arises from contractual design which ought to comply with sharia. Thus, risks faced by Islamic banks may differ either in terms of the risks' structure or severity compared with conventional banks. DeLorenzo[18] mentions sharia risk or sharia compliance risk is the possibility that a financial service or product is not or will not be in compliance with established sharia principles and standards. Refer to Swartz[19], sharia risk is of two types: the first is due to non-standard practices in respect of different contracts in different jurisdictions and the second is due to failure to comply with sharia rules. Different adoption of sharia rules sometimes result in differences in financial reporting. Chapra and Ahmed[20] assert risks are not a peculiarity of only the Islamic financial system. They are rather present in all financial systems – risk associated with fiduciary money, interest rate and exchange rate fluctuations, loan default, operational failures, natural calamities, and a range of other

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[15] N. S. M. Noor, A. G. Ismail, and M. H. M. Shafiai, "Shariah Risk: Its Origin, Definition, and Application in Islamic Finance," *Journal of SAGE Open*, April-June (2018), 7.
[16] H. V. Greuning & Z. Iqbal, *Risk Analysis for Islamic Banks (*Washington DC: The International Bank for Reconstruction and Development (IBRD)/World Bank, 2008), 73.
[17] N. S. M. Noor, A. G. Ismail & M. H. M. Shafiai, "Shariah Risk: Its Origin, Definition, and Application in Islamic Finance," *Journal of SAGE Open*, April-June (2018), 7-8.
[18] Y. T. DeLorenzo, "Shari`ah Compliance Risk," *Chicago Journal of International Law* Vol. 7: No. 2, Article 4 (2007), 397.
[19] N. P. Swartz, "Risk Management in Islamic Banking," *African Journal of Business Management* Vol. 7 (37), October (2013), 3803.
[20] M. U. Chapra & H. Ahmed, "*Corporate Governance in Islamic Financial Institutions*." (Jeddah: Islamic Development Bank (IDB), 2002), 6.

human, managerial and environmental weaknesses. The Islamic financial system is equally exposed to all these risks. The only risk that gets added to the Islamic financial system is that which arises from the introduction of the profit loss sharing (PLS).

RESEARCH METHOD

The governance of Islamic banks have a fundamental differences with the governance of conventional banks in terms of sharia compliance. The disobedience of the Islamic banking to the sharia compliance causes Islamic banks to be subject to sharia risk. This paper is intended to identify and understand about sharia governance as the distinctive of GCG between Islamic banking and conventional banking. One of important thing in sharia governance risk is sharia risk. As a conceptual paper, this paper will map the flow of sharia risk in Islamic banks and will explore a number of sharia risk causes by using library research through descriptive analysis.

RESULT AND DISCUSSION

Flow of Sharia Risk

According to Iqbal & Mirakhor[21], risks for operating in IFIs are grouped into four broad categories: financial, business, treasury, and governance risks. While these categories are also applicable to conventional finance, there are risks specific to Islamic banks and financial institutions arising from the different nature of the intermediation, products and constitution of the balance sheet. Then, one of the governance risk is sharia risk. Referring to Noor, Ismail & Shafiai[22], the issues related to risk management in IFIs requires significant attention because some risks arise due to the nature of Islamic financial institutions themselves. In fact, these additional risks are associated with specific Islamic contracts and business model arising from compliance with sharia.

The asset and liability sides of Islamic banks have unique risk characteristics.[23] Since sharia-compliant finance relies on the idea of profit and loss and thus risk-sharing, Radzi & Lonik[24] explain that on both the liability and asset side suggest clear differences in funding and activity structures of Islamic and conventional banks. Originating from the stylized balance sheet of conventional and Islamic banks, components of assets and liabilities reveal the extent of the different types of risk to which a bank exposed. The stylized balance sheet of conventional banks will flow debts-based and transfer of risks in operational model. While the stylized balance sheet of Islamic banks will produce asset-based and profit/loss sharing principle in operational model.

Then, both of them will have generic risks. Noor, Ismail & Shafiai[25] explain the generic name of risk from the perspective of economic science can also be seen from various dimensions. This is because there are various ways to classify risk until the derivation of its generic names. The classification of risk depends on the outcome (result),

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[21] Z. Iqbal & A. Mirakhor, *"An Introduction to Islamic Finance: Theory and Practice." (*Singapore: John Wiley & Sons (Asia), 2011), 278-280.

[22] N. S. M. Noor, A. G. Ismail & M. H. M. Shafiai, "Shariah Risk: Its Origin, Definition, and Application in Islamic Finance," *Journal of SAGE Open,* April-June (2018), 10.

[23] H. Ahmed & T. Khan, "Governance of Islamic Banks," in *Handbook of Islamic Banking,* Hassan, M. Kabir & Mervyn K. Lewis (Eds.)., (UK: Edward Elgar Publishing Limited, 2007), 144.

[24] R. M. Radzi & K. A. T. Lonik, "Islamic Banks' Risks: It's Rating Methodology and Shariah Assessment Solutions," *Journal of Islamic Banking and Finance* Vol. 4, No. 2, December (2016), 50.

[25] N. S. M. Noor, A. G. Ismail & M. H. M. Shafiai, "Shariah Risk: Its Origin, Definition, and Application in Islamic Finance," *Journal of SAGE Open,* April-June (2018), 6.

loss, or the nature of such risk and it also depends on contracts involved, facility, and hardship faced by an individual. In Islamic finance, instead of having a generic risk, institutions offering Islamic products and services face additional risks, namely, a unique risk. The unique risks come from the risks exposed by IFIs and risk sharing arrangements resulting from the contractual design of instruments.

The term to mention the unique risks in IFIs is sharia risk. Iqbal & Mirakhor[26] explain that sharia risk is related to the structure and functioning of the sharia boards at the institutional and systemic level. This risk is of two types: the first comes from non-standard practices in respect of different contracts in different jurisdictions; the second is the result of failure to comply with sharia rules. Figure 1 shows the flow of sharia risk in Islamic banks. Starting from the operational model, there are differences between conventional and Islamic banks. Both have generic risks. But, Islamic banks has additional risks also.

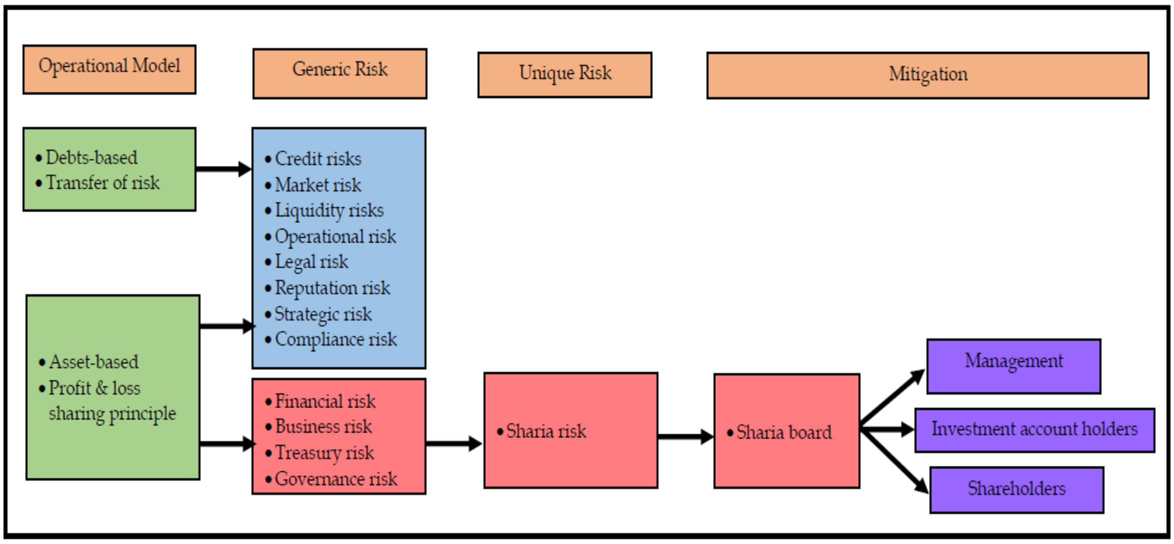

Figure 1: The Flow of Sharia Risk

Source: Developed from Noor, Ismail & Shafiai (2018), OJK (2016), Radzi & Lonik (2016), Ginena (2014), Iqbal & Mirakhor (2011), Nienhaus (2007)

In Islamic banks, Hassan and Lewis[27] claim there is an extra dimension arising from its religious charter, and an additional layer of governance stemming from the role of the Sharia Supervisory Board (SSB) that monitors its adherence to Islamic principles. Elfakhani, Zbib & Ahmed[28] mention SSB is made up of distinguished Islamic legal scholars who assume responsibility for auditing sharia compliance of a bank, including its marketing strategies, thereby functioning as a customer advocate representing the religious interest of investors.

[26] Z. Iqbal & A. Mirakhor, *"An Introduction to Islamic Finance: Theory and Practice." (*Singapore: John Wiley & Sons (Asia), 2011), 293.
[27] M. K. Hassan & M. K. Lewis (Eds.), *"Handbook of Islamic Banking."* (UK: Edward Elgar Publishing Limited, 2007), 5.
[28] S. M. Elfakhani, I. J. Zbib & Z. U. Ahmed, "Marketing of Islamic Financial Products," in *Handbook of Islamic Banking,* Hassan, M. Kabir & Mervyn K. Lewis (Eds.)., (UK: Edward Elgar Publishing Limited, 2007), 121.

The last but not the least, the risk mitigation. Ahmed & Khan[29] affirm that Islamic banks are constrained in using some of the risk mitigation instruments that their conventional counterparts use as these are not allowed under Islamic commercial law. The techniques of risk identification and management available to the Islamic banks could be of two types. The first type comprises standard techniques, such as risk reporting, internal and external audit, gap analysis, risk-adjusted return on capital (RAROC), internal rating and so on, which are consistent with the Islamic principles of finance. The second type consists of techniques that need to be developed or adapted, keeping in mind the requirements for sharia compliance.

The Causes of Sharia Risk

Ginena[30] prefer to define sharia risk, a form of operational risk, as the risk of financial losses that an IFI may experience as a result of non-compliance with sharia precepts in activities, as ascertained by the SSB or the pertinent authority in the relevant jurisdiction. After recognising the existing of sharia risk, it is necessary to map the possible causes of the sharia risk. According to the Basel Committee on Banking Supervision (BCBS), there are three internal causes of operational risk – people, internal processes, and systems, and one external cause – external events. The people is reaching who action, the process is reaching the action, so the system ia reaching how the action is performed.

According to Ahmed & Khan[31], the non-performance can be due to external systematic sources or to internal financial causes or be a result of moral hazard (wilful default). Wilful default needs to be identified clearly as Islam does not allow debt restructuring based on compensations except in the case of wilful default. In the case of profit-sharing modes of financing, the credit risk will be non-payment of the share of the bank by the entrepreneur when it is due. This problem may arise for banks in these cases because of the asymmetric information problem where they do not have sufficient information on the actual profit of the firm.

Furthermore, the development of Islamic economic and finance, including Islamic banks, will not be possible to be realized if it is not supported by a legal umbrella. Legal umbrella can be formed if there is a political support because the rule is a political product. According to the Islamic Helix Approach through Islamic Quintuple Helix Model by Musari[32], two of five institutions must exist in this circular to empower the Islamic instruments and institutions for becoming the engine of productive activities in real economy and for leading the economic growth to be higher and equitable are government institution and Islamic or sharia institution.

Then, one of the product of government institution is a policy. The policy will produce the rule. It means the development of Islamic economic and finance needs government institution through its political will (purpose). Moreover, the important

[29] H. Ahmed & T. Khan, "Governance of Islamic Banks," in *Handbook of Islamic Banking,* Hassan, M. Kabir & Mervyn K. Lewis (Eds.)., (UK: Edward Elgar Publishing Limited, 2007), 144, 149.

[30] K. Ginena, "Sharī'ah Risk and Corporate Governance of Islamic Banks," *Corporate Governance* Vol. 14, Issue 1 (2014), 90.

[31] H. Ahmed & T. Khan, "Governance of Islamic Banks," in *Handbook of Islamic Banking,* Hassan, M. Kabir & Mervyn K. Lewis (Eds.)., (UK: Edward Elgar Publishing Limited, 2007), 145.

[32] K. Musari, *Empowerment of ZIS for Entrepreneurship Innovation of MSMEs through Quadruple Helix Approach (Case Study in East Java Province, Indonesia).* A paper for The 12th International Conference for Islamic Economics and Finance (ICIEF) "Towards The Real Economy Challenges and Prospects" (2018).

elements of sharia compliance are fatwa, sharia rules and standards. They are the main keys to open the doors of the product of IFIs, and also Islamic bank, to market. It means the development of Islamic economic and finance also needs Islamic or sharia institution. This institution must issue fatwa and sharia rules and standards. The independence will be obtained through the political will (purpose) of the government institution. All of them need political will to be a political product. So, the political will (purpose) and politics may become the causes of sharia risk. Overall, Figure 2 shows the causes of sharia risk. The purpose, politics, people, process, and system are the causes of sharia risk.

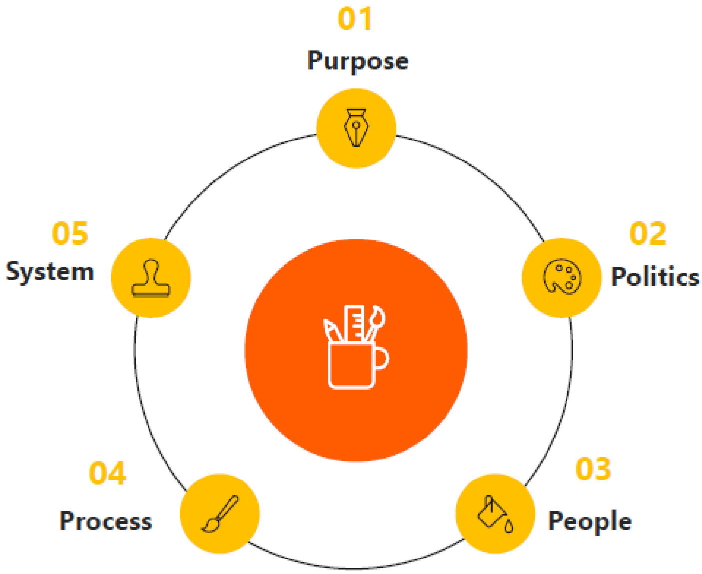

Figure 2: The Causes of Sharia Risk

Source: Developed from Musari (2018), Ginena (2014).

CONCLUSION

Banking is a very vulnerable business to risk, so it takes good management to ensure itself as a healthy institutions. A number of studies point to the stability and resilience of an Islamic banking system, but it must be understood that applying Islamic formalism in practice is neither a guarantee for commercial success nor a shield against an economic crisis.

Then, the governance of Islamic banking has a fundamental differences with the governance of conventional banking in terms of sharia compliance. The disobedience of the Islamic banking to the sharia compliance causes Islamic banks to be subject to sharia risk. The sharia risk is the possibility for the operational of Islamic banks are not or will not be in compliance with established sharia principles and standards. Following the flow of sharia risk in Islamic banks, starting from the operational model, there are differences between conventional and Islamic banks. Both have generic risks, ie risks that are similar to those faced by traditional financial intermediaries. But, Islamic banks has additional risks also. Islamic banks faced unique owing to their compliance with the sharia. This study also notes the sharia risk arises from the purpose, politics, people, process, and systems.

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