

**Risk Management in Mudarabah and Musharakah Financing of Islamic Banks- A**

**Proposal**

[Name of Institution]

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## Table of Contents

Introduction.....	2
Aims and Objectives .....	3
Rationale of the Research .....	3
Literature Review.....	4
Methodology.....	6
Conclusion .....	7

## Risk Management in Mudarabah and Musharakah Financing of Islamic Banks- A Proposal

### *Introduction*

During global financial crisis, the entire financial market of the world was shaken but it was only Islamic banking industry that was affected slightly and majority of them kept flourishing and expanding. The current scenario of financial crisis provided Islamic institutions or banks an opportunity and a chance to clearly express themselves in the serious and challenging system of finance. This outstanding and considerable amount of performance has triggered the attentions of financial institutions of world wide, investors and financial analysts for researching and investigating this unique and new industry (Alam, and Masukujjaman, 2011).

For keeping this financial industry prospering and growing, authenticate and unique procedures for risk management should be adopted in order to minimize the chances and likeliness of encountering downside turns. Islamic financial banks and institutions observe and deal with the risks which are commonly present in conventional institutions of financing along with unique kind of risks because of their compliance nature with Shariah (Alam 2013). Islamic financial institutions seek continuously stability and profitability with safe and comfortable environment to the investments and deposits. In this regards, it is the need of Islamic banks to set-up a sound system of risk management for offering profitability, stability, banking operations as well as maintenance of the business (Hussain and Al-Ajmi, 2012).

Apart of riba (interest), the related risk concept is of Gharar. Gharar is an Arabic word that implies risks and uncertainty. In Islamic banking, it is any transaction of which the results are unclear. It is linked with the various levels of uncertainty about attainment of high losses or high returns. It is mandatory to concede that without risk, there is no progress in any dimension.

The risk is managed by this system in alignment with Shariah compliance and regulations (El Moussawi, & Obeid, 2011).

### *Aims and Objectives*

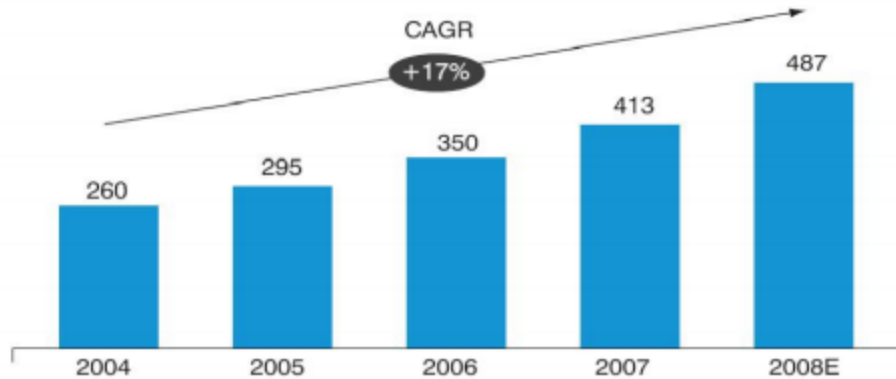
The main objectives of this in-depth research are:

- To identify major financial risks pertinent to Mudarabaha and Musharakah transactions in Islamic mode of financing;
- To adopt a mechanism to monitor those identified risks in timely manner;
- To develop a mechanism to assess those risks accurately;
- To establish a line of actions in order to minimize those risks

### *Rationale of the Research*

Islamic banks work as financial institutions which completely depend on their Shariah compliant operations which prohibit uncertainty, interest and gambling. Islamic banking has observed a substantial amount of growth since its inception. It has been reported by McKinsey (El Moussawi, & Obeid, 2011) that more than 700 Islamic institutions have been established since its inception in the whole world where average growth in asset is 15 to 18% (Haneef et al. 2012). This makes it the industry of fastest growing in the sector of finance. The industry of Islamic banking is assumed by the investors very attractive and the researchers from all over the world research make conclusive and inclusive research in order to make robust the financial industry and to strengthen the entire financial market by adopting the relevant rules and regulations and the reasons of success (Grassa 2012).

Figure 1. Growth of the Islamic Banking Industry in Billions of U.S. dollars.



Source: Booz and Company Analysis

Major innovations have been brought up by this sector. The main rationale of conducting this research is the boom of this industry along with its innovative nature. This research will take into account the mudarabah and musharakah aspects of Islamic financial system by making a demonstration that financial business can expand in contemporary markets in the absence of interest (Haneef et al. 2012).

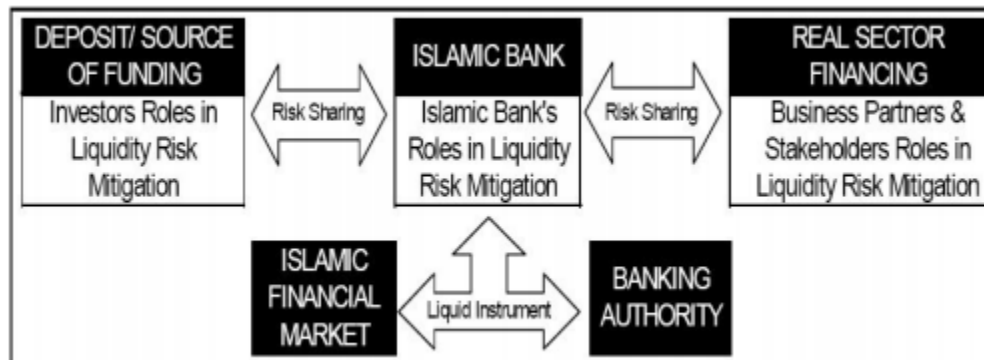
### ***Literature Review***

Mubarakah and Musharakah are the basic instruments of Islamic banking. Murabaha model has been used successfully in Islamic banking at the level of retailing (Hussain and Al-Ajmi, 2012). This instrument is assumed as a financial tool that is applied more rapidly and it is assumed as the most profitable instrument (El Moussawi, & Obeid, 2011). This happens because Islamic financing is capable in satisfying the needs of its clients along with keeping compliance with the rules and regulations of Shariah. Murabaha is deemed to be the main source for the generation of the debt in liability portion of balance sheet. This is the methodology of financing

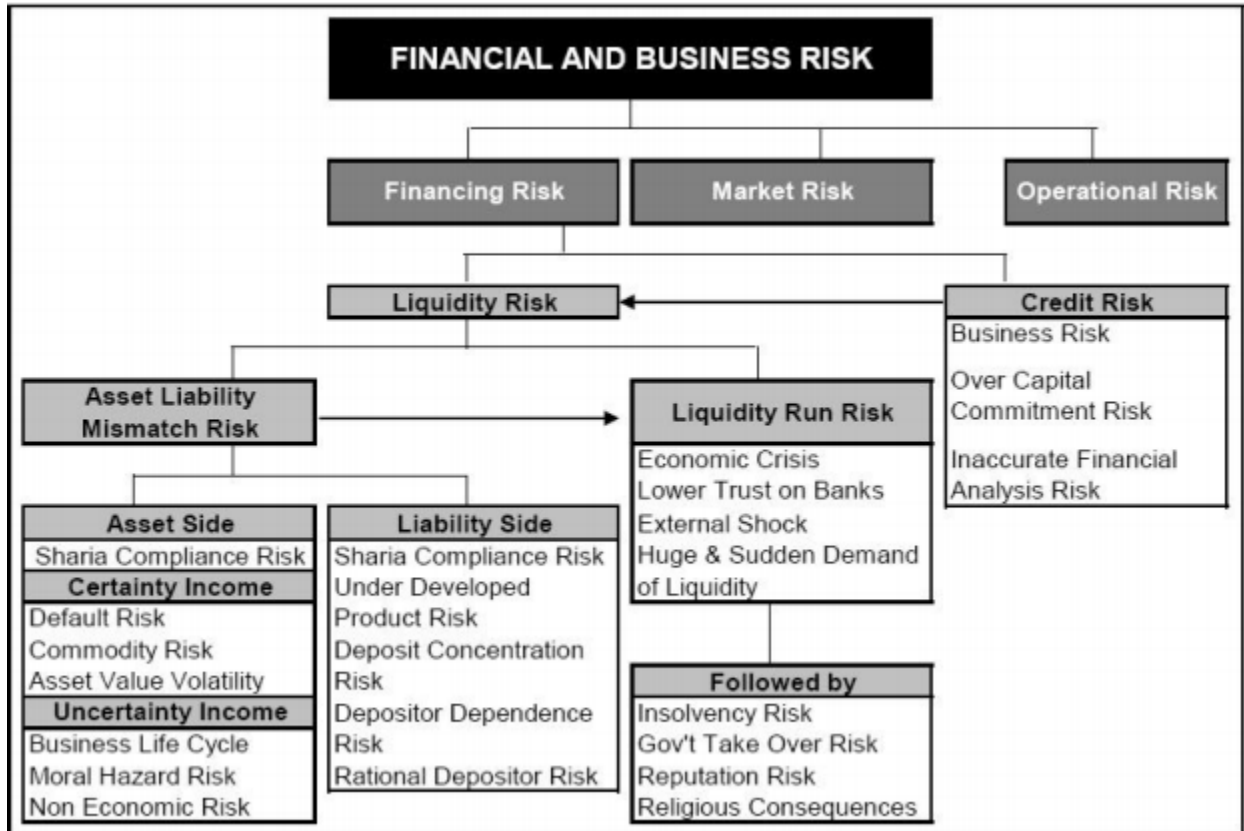
in which Islamic bank buy an asset where it works as an agent for its client and then it sells that asset with deferred payment and immediate delivery with known and pre-informed profit margin (Hussain and Al-Ajmi, 2012).

On the other hand, Mudarabah model of Islamic financing is assumed as an alternative way of riba or interest in the system of profit sharing (Haneef et al. 2012). It is basically a contract between two individuals or parties where an experienced agent is on one side of the agreement while investors are on the other side of the agreement. This model is similar as of partnership that is applicable in conventional system of financing (Institute of International Finance, 2013).

Risk management in financial institution is a process by which risks are measured and assessed and accordingly many strategies are developed for managing them. For mitigating the risk and its various levels, the context of human behaviours is brought into consideration, for instance, trust (A-Rahman, 2010). Two important steps are required to be followed which are deemed critical and must be preceded in terms of development of the strong system of risk management. In this regards, the initial step is correct recognition of the risks while the next step is aptly making measurement of all risks which are present with Mudarabah and Musharakah modes of Islamic financing. This can be clarified more as below (Alam, and Masukujjaman, 2011):



The main techniques for the mitigation of the risks by Islamic banks are risk retention, risk adaptation, risk avoidance, risk reduction and risk transferring. The main financial risks of Mudarabaha and Musharakah banking are shown below (Alaro, and Hakeem, 2011):



**Methodology**

The research gaps are meant to be identified by implication of the analysis that is used for assessing, measuring and then controlling the risk. In this regards, the semi-structured interviews are planned to be conducted for identifying the research gaps in order to proceed with the computation of risk management and performance (Iqbal and Mirakhor, 2011).

For the purpose of conducting research and analysis, a sample size of 10 managers of Islamic banks will be taken who will be selected on random basis for continuing with qualitative research. This implies 10 managers from two banks for the purpose of semi-structured

interviews. The descriptive research design has been adopted that is applied for acquiring the information that is based on current status for explaining the conditions and variables in connection to their environment without violating the ethical practices.

### ***Conclusion***

This research will be a unique contribution in the domain of research on Islamic banking and institutions where it will reveal the various uncovered aspects of risk management. This research will provide a stance to conventional banks for developing similar products and to enable themselves for reaping stroke less profit of high margins.

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