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Challenges Facing Bank in Financing International Trade: From an Islamic Perspective

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Abstract:

Risk has always existed in business and it is even predominant when business transactions are done across borders. With the intensification of industrialization, it has resulted in risks that are unknown before. In the competitive business environment today, for business firms to compete, they must not only be able to minimize their risks in doing business, but also be able to take advantage of the growth opportunities presented by doing business in other countries. Hence understanding what risk is and what the perception of business firm towards risk is very important to any bank especially Islamic bank.

This study investigates the risks that Islamic banks face in particular when dealing with the Islamic bank mode of financing. There are some inherent risks involved when Islamic bank uses the Islamic principle of financing. Managing risk management is a complex discipline even in a very simple commercial transaction. Nevertheless, risk is a core element of business (particularly international business) which is closely related to return. Financing international trade inevitably is complex and involves risks, irrespective of the markets in which business firms chose to conduct their business transactions.

Hence, it is pertinent that an analysis on issues of risk management in the Islamic Financial system is undertaken as well. A Sharia' compliant risk management is analysed and some alternatives to risk management is proposed for Islamic banks in mitigating their risks in financing international trade.

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Introduction

Uncertainties in many aspects of commercial transaction have made it synonymous with risk. According to Baldwin (2002), risk is uncertainty about matters that affect the welfare of people. Commercial transactions normally occur at two different levels, namely; (i) domestic and (ii) international, whereby domestic transactions they do not entail much risk compared with internationals. However, the reward that comes with doing business abroad is very high; hence, it is worth the risk that comes with it. Nevertheless, firms that would like to venture into international market should be aware of the risks as well the opportunities and facilities available to facilitate their business transaction.

Risk has always existed in business, especially with the intensification of industrialization, where it has resulted in risks which are not known before. Production activities normally involve long periods of time .The longer the period of production the more the uncertainty. In the competitive business environment today, for business entity's to compete, they must be able to take advantage of the growth opportunities presented by doing business with customers and suppliers in other countries. However, making paying and getting paid for the goods and services from their trading partners can pose a lot of challenges when they cross-borders. Hence, it is inevitable not to have risks, so they must prepare to face the problems in the future.

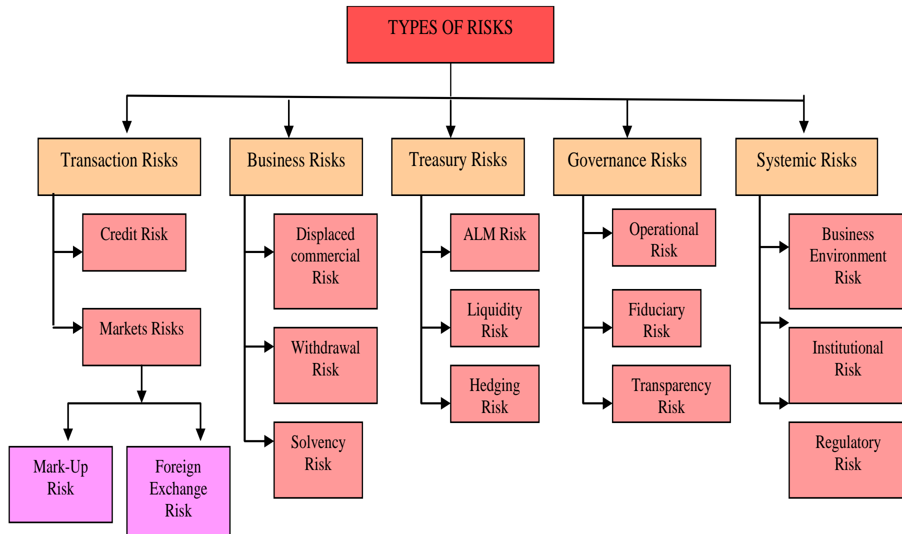
Understanding what is risk and the perception of business organisation towards risk is very important to Islamic bank. This is because Islamic bank take funds from several sources, (i) depositors and (ii) shareholders which forms the assets of the banks. Islamic Banks then channel these assets to productive activity that would yield a return enough to cover the cost of using the funds and its operation costs. However, the IB is structured upon the Islamic principle of risk sharing, hence they are tied in their management of their liquidity.

Islamic Banks were in the past active in short term financing (1 to 12 months), through financing the export and import of basic goods or commodities such as crude oil, cotton, rice and so on, on a Murabahah trade based on Murabahah principle. Using this principle, the transaction undertaken by IB carry different commercial, foreign exchange and other associated financing risks (Archer and Abdul Karim eds; Suryanto, 2014; Thalassinos *et al.,* 2015). Managing risk management is a complex discipline even in a very simple commercial transaction. Nevertheless, risk is a core element of business (particularly international business) which is closely related to return. Financing international trade inevitably is complex and involves risks, irrespective of the markets in which business firms chose to conduct their business transactions.

This study is structured in the following manner, the preceding section reviews the literatures on risk involved in financing international trade, section 3 analyses the

various forms of risks faced by Islamic banks, while section 4 expounded the management of risk for Islamic Banks and the last section concludes the study.

Literature Reviews



El-Hawary *et.al.* (2007) have discussed in length the profile of risk that affects the Islamic banks in financing business transaction. However, in financing international trade there are certain inherent risks that affect both bank and business firm. For the purpose of discussion of the paper Table 1 below detailed out the risks that would affect Islamic banks in financing international trade activity.

Table 1: *Profile of Risks*

Types of Risks	Definition	Islamic bank	Business firm
Transaction risks			
1.Credit risk	Failure of the counter-party to meet his or he obligations timely and on the agreed terms of the contract.	The bank faces counter-party risks in the various forms of contracts such as, Mudarabah, Musyarakah, and Murabahah.	
2. Market risk	Risk associated with change in the market value of held assets. a. Mark-up risk is risk of divergence between the	The bank may incur losses if the benchmark rate changes adversely. This exposes the bank to risks associated with their	The firm may incur losses if the benchmark rate

	Murabahah contract mark-up and the market benchmark rate. b. Foreign Exchange risk is the risk of the impact of exchange rate movements on transactions denominated in foreign currency. i. Transactional risk which occurs in cross border trade and where there are hazards and uncertainties created by fluctuation foreign exchange rate. ii. Translation risk which occurs when assets and earnings of the banks are consolidated into a single balance sheet and profit and loss account. iii. Competitive risk which occurs when the competitiveness of the business firm is adversely affected by foreign exchange fluctuation. iv. Strategic risk which occurs when business firms transfer foreign exchange risk to the trading partner and they then find alternative partner to do business with.	deferred-trading transactions as the value of the currency in which receivables are due may depreciate or the currency in which payables are due may appreciate.	changes adversely. This exposes the firm to risks associated with their deferred-trading transactions as the value of the currency in which receivables are due may depreciate or the currency in which payables are due may appreciate. Both exporter and importer of goods will be affected.

Table 1: *Profile of Risks (cont)*

Types of Risks	Definition	Islamic bank	Business firm
Business risks			
1. Displaced commercial risk	Displaced Commercial risk is the risk of divergence between assets' performance and expectations for returns on liabilities.	Displaced commercial risk may adversely affect the value of the bank's capital. Returns on equity go down.	
2. Withdrawal	Withdrawal risk where the	Withdrawal risk exposes	

risk	banks is exposed to the risk of withdrawal of deposits as a result of the lower rate of return depositors get compared to what the bank's competitors pay.	the bank to liquidity problems and erosion of its franchise value.	
3. Solvency risk	Solvency risk is the risk of a bank having insufficient capital to continue operations.	Solvency risk may expose the bank to a loss of reputation.	
Treasury risks			
1. Asset &Liability Management (ALM) risk	Balance sheet mismatches risk resulting from the difference in terms and conditions of a bank's portfolio on its assets and liability sides.	This may adversely affect the bank's capital.	
2. Liquidity risk	The risk that arises due to the inability of the bank to access liquid funds to meet its obligations.	The bank is exposed to risk of failure to honour requests for withdrawals from its depositors.	The firm may not get the financing that is needed to pay the foreign seller.
3. Hedging risk	Failure to mitigate and manage the different types of risks.	This increase the bank's overall risk exposure.	
Governance risks			
1. Operational risk	Failure of internal processes as related to people or systems.	This risk adversely affects profits.	This risk adversely affects profits.
2. Fiduciary risk	Risk of facing legal recourse action in case the bank breaches its fiduciary responsibility towards depositors and shareholders.	This risk adversely affects return.	This risk adversely affects return.
3. Transparency risk	Risk of consequences of decisions based on inaccurate or incomplete information which is the outcome of poor disclosure.		
Systemic risks			
1. Business	Risk of poor broad		

Environment risk	institutional environment including legal risk whereby banks are unable to enforce their contracts.		
2. Institutional risk	Risk of divergence between product definition and practices.		
3. Regulatory risk	Risk of non-compliance with regulations due to confusion, bad management or mistakes.		
Country risks			
1. Political risk	Risk arises due to war, civil war and insurrection, contract cancellation, cancellation and restriction on import and export license. i. Transfer risk occurs when a foreign country freeze the assets and bank accounts that the bank has in that Country.		
2. Private risk	Risk that involve private entity i. Customer risk which occurs when the credit worthiness of the buyer is at stake. ii. Commercial risk which relate to the insolvency of the purchaser, default on payment by a buyer following an unforeseeable event, non-acceptance of goods delivered to the purchased, where such goods comply with any contracts in existence.		
3. Natural risk	Risk which involves natural disaster and calamities that cannot be avoided.		

Source: *D. El-Hawary et.al. (2007)*

Analyses of the Risk Faced by Islamic Banks in Financing International Trade

From a trade financing perspectives, there are various forms of risk. There are various types of risks inherent in international trade financing, namely; (i) liquidity

risk, (ii) foreign exchange risk (iii) market risk, (iv) indirect risk, (v) credit risk, and (vi) Islamic financing related risk.

Liquidity Risk

Liquidity risk is the risk that arises from the inability of Islamic banks to access liquid funds to meet its obligations. Since IB provide financing which is normally on long term basis while the funds come from depositors which is very short-term in term of the withdrawal period, hence they are faced with liquidity risk. It is the risk to a bank's earnings and capital which arises from its inability to timely meet obligations such as meeting depositors demand when they come due without incurring unacceptable losses.

Foreign Currency Risk

Foreign exchange risk refers to the loss that resulted from exchange rates fluctuations. It relates to the potential losses that can result when the exchange rate of a currency to be received falls in value against home currency or a foreign currency in which a payment is to be made appreciates against home currency. Hence, both importer and exporter are vulnerable to foreign currency risk. Fluctuation in exchange rates can affect all aspects of international business.

For Islamic Banks, financing trade internationally they are dealing with more than one currency, therefore exposes them to the foreign exchange risk. For the firm engaged in international trade, irrespective if they are Muslim or not they will face currency risk, this is because when a firm sells or buys in foreign currency there receivables or payables are expos to currency exchange rate fluctuation and that can considerably increase (or decrease as a meter of facts) the firms liability's. Foreign exchange risk can be further divided into namely;

Transactional Risk

It occurs in cross border trade and where there are hazards and uncertainties created by fluctuating foreign exchange rate.

Translation Risk

If Islamic Banks own overseas assets, joint ventures or partnership, IB may be exposed to transaction risks when these assets and earning are consolidated into single balance sheet and profit and loss account.

Competitive Risk

Whether, a business undertakes transaction only in domestic market, or are buying and selling internationally but in Malaysian currency, the exchange movements will directly have an impact on their relative competitiveness.

Strategic Risk

However, if business firms undertake commercial transactions overseas in local currency and transfer the foreign exchange risk to the trading partner, they will

become less attractive to do business with. The trading partner will find alternative partners from other countries.

Indirect Risk

In addition to these types of exposures or risks that may arise directly from having undertaken a transaction, one could also face indirect risks. For example, a bank with solely domestic activities may not have direct foreign exchange exposure but could have extensive indirect foreign exchange exposure through its clients.

Market Risk

Market/price risk, which refers to changes in returns caused by changes in market prices of the asset. Market risk (arises from a change in commodity prices, in the mark-up price of deferred sale and the lease-based transactions).

Credit Risk

Credit risk or default risk arises when a debtor is unable to meet its obligations timely. It is related to the risk involve in financing the credit term. What is the impact if buyer delays payment or do not pay at all. It could arise from the possibility of defaults arising from the lack of complete agreement of the liability of *Murabaha* contract – i.e. the risk of IBs ownership of the assets being financed,

Islamic Financing Related Risk

Risk arising from non-standardized nature of some Islamic Banks products (*Ijara* – in some Islamic rules –) is not allowed to be ended with ownership. Moreover, some financial instruments could not be used simultaneously as risk management instruments), *Fiqh*-related risks (e.g. *Murabaha* contract – according to *Fiqh* rules, is not binding to the buyer).

Country Risk

As a buyer or customer, the country can pose separate risk that the Islamic Banks need to manage. Country risk comprises of various types of risks: political risk, private (customer) and natural.

Political Risk

War or civil war and insurrection, contract cancellation, and or restriction of export and import license, Cancellation or non-renewal of an insured's export license after a contract has been entered into War and other such disturbances in the purchaser's country of domicile which affect the fulfillment of the contract. Transfer risks, where one country can freeze the assets and bank accounts of another country held locally. Any action of a foreign government which hinders the enactment of the contract; including, import and export restrictions, the confiscation or expropriation of goods, and the nationalization of corporations and industries.

Private Risk

This risk comes in two forms namely; customer risk and commercial risk. Customer risk involves the credit worthiness of the buyer. There is a need to ensure that the buyer company really exist as a legally established business entity the country of import, the trading history of the buyer such as whether they are prompt payer, can they pay the bill. Is the company facing any potential insolvency in the near future? This will lead to the pre credit risk whereby losses can occur if the customer leaves insolvent during the manufacturing process or at any time before or after the despatch of the export consignment. When buyer refuses to buy the good, Islamic Banks have to collect the money in the buyer's country which can be expensive.
Commercial risks relate to the insolvency of the purchaser, the default on payment by a buyer following an unforeseeable event, non-acceptance of goods delivered to the purchaser, where such goods comply with any contracts in existence.

Natural Risk

This risk involve natural disaster and calamities that cannot be avoided, however, they still have an impact on Islamic Banks if customers or suppliers in that country are not able to fulfil their obligations. This will delay payment.

Analyses Expounding the Management of Risk for Islamic Banks

Prophet Muhammad peace be upon him once asked a Bedouin who had left his camel untied, "Why do not tie your camel?" the Bedouin answered, " I put my trust in God" the prophet then said, "tie up your camel first then put your trust in God". This conversation depicts not only how should Muslims accept their fate but it also indicates how do Muslims reduce the risk of loss and calamities.

According to Baldwin (2002), there are two crucial steps that must be considered before a robust risk management capabilities can be developed, namely; (i) proper identification of risks and (ii) accurate measurement of risks.

According to him, IB is exposed to a risk similar to the conventional banks such as the interest risk, even though they do not directly pay or receive interest. For an IB, financing was commonly done on the basis of measurable transaction whereby it involve the purchase of a commodity by the bank and sale to the end-user on a deferred payment basis at cost plus mark-up, where the mark-up is usually indexed to a suitable primary benchmark such as the market interest rate. The interest rate risks arise when the rate at which assets reprise in a given period is different from th rate at which liabilities reprise in the same period, lading to greater potential for volatile current period earnings. Securitisation of assets provides a mean by IB to manage their risks. Securitisation also brings other benefits by holding marketable asset-backed securities since IB would have access to a ready source of cash, namely enhancing liquidity.

One method in order to manage risk for IB is securitisation. Securitisation involves the transformation of a non-traded financial instrument into a traded security. The bank pools illiquid receivables and units the pool to an agency. The agency then converts the pools into marketable securities with the agency's credit rating and the securities are then sold to investors. Shari'a law prohibits the trading of debt or any security represents only debt as such instruments are not negotiable. However, trading in the ownership rights to real assets is permissible.

Conclusion

With globalisation requiring free movement of trade, services and people coupled with the liberalisation process which eliminates barriers and create a borderless world, has not only made each country dependent upon each other for goods and services, but also made us dependent on each other for foreign exchange earnings. This has further increase the business transactions across borders, hence demand for goods and services increases and this further increase the needs of financing resources to facilitate production activities. Hence the role of banks not only in the form of an intermediation but also as a partner in the business venture has increase.

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