Editor's Note

Basic financial contracts in both conventional and Islamic settings expose the issuing party to substantial risks. From the perspective of an individual financial contract, information asymmetries in the forms of adverse selection and moral hazard are the main risks faced by financial intermediaries looking to facilitate the transfer of capital for productive use. For example, banks are often unable to directly observe the conditions of those to which they lend capital and, thus, it is difficult for intermediaries to determine whether defaulting borrowers are under legitimate distress or behaving inappropriately. Information asymmetry is a key obstacle in Islamic financial contracts as well. In mudarabah and musharakah sharing agreements, there are incentives for the management company to mislead the lender with regards to the actual profits made from the venture. Information asymmetry can have the affect of raising the cost of capital of all borrowers, thus increasing market frictions and impeding the productive transfer of assets. As a result, financial institutions often engage in audits and other mechanisms aimed at mitigating the information asymmetry problem. Additionally, from an Islamic finance perspective, shared religious beliefs may act as a social pressure that deters exploitative behavior.

From the perspective of financial intermediaries as a whole, the financial institution's portfolio of financial contracts exposes the organization to another set of operational risks. Some of these risks can be mitigated though the actions of management, while others are macroeconomic in nature. Through the process of risk management, financial institutions identify and quantify their exposure to different types of risk and incorporate measures to reduce the institution's exposure. Through the process of risk management, there is an important distinction between risk sharing and risk shifting. In risk sharing, the parties in a financial transaction share in the risks associated with the cash flows stemming from the financial contract. Risk shifting occurs when one party is able to shift the risk associated with a financial contract to the other party or a third party. The distinction between risk sharing and risk shifting is important from an Islamic finance perspective. While risk sharing implies an equal stake in the financial contract among the parties involves, risk shifting may shift risk to another party in a way that is unjust or creates inequality. The later would be considered unacceptable in an Islamic financial transaction.

From an Islamic perspective, the idea behind risk shifting is similar to the distinction between hedging and speculation. Hedging activities attempt to reduce risks through holding portfolios of assets in such a manner that reduce the risk of the overall

portfolio or firm. Certain financial contracts like SWAPs and forwards may, in theory, be consistent with Islamic principles encouraging economic stability and the reduction of risk. However, many of the same products can be used for speculative purposes. Speculation does not necessarily have the effect of reducing risk and can often increase instability in the financial markets as a whole. The increase in volatility surrounding speculative activities is not compatible with Islamic principles, and, accordingly, many derivative contracts often used for speculative purposes, such as short sales, futures, options, and swaps have thus far been ruled as containing elements of gharar and are consequently prohibited in Islamic financial contracts.

In general, Islamic financial institutions face many of the same risk management challenges as their conventional counterparts. Credit, liquidity, operational, and foreign exchange risks are all areas in which both sets of financial institutions must engage in risk management strategies. Also, Islamic banks face rate of return risk in a similar fashion to that of interest rate risk faced by conventional banks.

Although many of the risks and the processes used to control them are similar across both conventional and Islamic banks, Islamic banks face some risks that are unique to the types of financial contracts used in the Islamic banking system. Significant operational risks occur in banks due to the nature of holding certain types of assets. In murabaha contracts, for example, the price risk of the underlying commodity can be mitigated, because it is immediately sold to the client at the time of purchase. Under a ijara contract, however, the price risk for the bank is substantially higher, because the financial institutions hold the underlying asset for a longer period of time. Another risk specific to Islamic banking contracts is the risk posed by mudarabah deposits. In the conventional banking systems, the banks' returns are guaranteed, fixed interest payments. However, mudarabah deposit returns are subject to the profits earned on the investment. Islamic banks often maintain a profit equalization reserve, which can be used to mitigate the risk of low profits or losses from mudarabah contracts. The opportunity costs of liquidity are also significantly higher for Islamic banks, because Islamic banks cannot hold treasuries or other interest bearing securities. Instead, Islamic banks maintain overnight murabaha deposits with other Islamic banks, which provide very low returns.

The Islamic Financial Services Board (IFSB) plays a role in guiding Islamic financial institutions' risk management guidelines. However, there is no singular scholarly set of Islamic risk management principles. In general, Muslims are satisfied by any set of principles that upholds Islamic principles governing contracts. From a financial contract perspective, Islamic principles are concerned with the appropriate use of resources to generate individual utility, but only in ways that avoid waste and damage. Waste and damage include macroeconomic considerations, such as

inequality, market stability, and fairness, and avoiding unjust or immoral behaviors, and these considerations take precedence in Islamic contracts over individual utility. As in other areas of Islamic life, financial contracts must conform to the Islamic principles of Shariah, and compliance with Shairiah, or Shariah risk, is another key risk faced by Islamic financial institutions.

Risk management from an Islamic banking perspective contains an additional set of requirements imposed by adherence to Shariah. The involvement of Shariah oversight in Islamic financial transactions is meant to ensure that unethical or damaging elements do not enter business contracts. Among the elements prohibited by Shariah are elements of usury and uncertainty. The process of evaluating and mitigating the potential for noncompliance with Shariah principles is called Shariah risk management. Shariah risk management can be divided into positive and negative Shariah screening. Negative Shariah screening involves excluding transactions that involve riba, gharar, and maisir. Firstly, Islamic contracts must focus on the asset markets, which naturally limits the scope of Islamic transactions and eliminates undue complexity in contracts. Secondly, the contracts used to mitigate financial risks must also correspond with the principles of Shariah, such as avoiding speculation. Positive Shariah screening, on the other hand, involves seeking out justice and moral behavior. Seif (2009) suggests a redesign of Islamic financial markets in a manner more consistent with positive screening. This strategy would involve revising the values, principles, objectives, and tools of risk management within the industry and gear it more toward the Islamic core principles by encouraging socially responsible investments, ethically viable socio-economic goals, growth-boosting venture capital financing of low income groups, and investing in employment-generating projects.

The goal of risk management processes within the financial services industry is to encourage the stability of the banking system and avoid financial crises. During the recent financial crisis, much of the instability seen in the conventional banking system was mitigated in the Islamic financial system. Many scholars point to the increased requirements of Shariah as being a major contributing factor to the relative stability of the Islamic financial system over its conventional counterpart during the financial crisis. The rejection of many conventional derivative products that drove the recent financial crisis helped to immunize the Islamic financial system from the negative effects of the crisis. Going forward, there is still much debate regarding whether or not some of the guidelines in place in the Islamic financial system would serve a valuable purpose in the conventional system as well.

The first paper, by Professor Bidabad, focuses on the Rastin Social Takaful mechanism as a means for socially beneficial investment. Social Takaful provides a means for depositors to participate in benevolent and interest free loans as a means to

greater social welfare, consistent with the charge of Islamic principles. Islam provides that Muslims should strive to help alleviate poverty and provide for the wellbeing of others. In addition, it is often asserted that the government plays a role in providing minimum standards of care for its citizens. Under the social takaful scheme, grants and loans are provided through Rastin PLS banking, through agreements whereby depositors agree to share their returns with those who are less fortunate. In addition, government authorities often provide a supervisory role to ensure the proper distribution of takaful payments. Rastin Social Takaful is a means to provide the less fortunate with benevolent grants and interest free loans in accordance with the social responsibility requirement of Islam. Further development of social takaful within the industry can be an important mechanism in making the Islamic financial system more compatible with the core beliefs of Islam.

In the second paper, Dr. Awad discusses the various monetary policy instruments available to central banks for the purposes of conducting successful monetary policy. The paper focuses on the central bank of Sudan and discusses the various policies available to conduct Islamic monetary policy. The paper also analyzes the impact of Islamic monetary policy in Sudan in achieving the goal of price stability. The development of Islamic monetary policy tools is an important area, because Islamic central banks are prohibited from using many of the conventional, interest bearing tools, such as treasury bills. Therefore, establishing successful monetary policy tools in the context of the Islamic financial system is of key importance for fostering a stable Islamic financial system. This paper expands the literature in this regard.

The third paper is by Professor Alam, and it discusses the development of new Islamic financial products in India. India is an important emerging market for Islamic finance and this paper proposes a system for the ordered development of new Islamic financial products within the country. The author concludes that customer interactions during the establishment process are of key importance in the development of a system to promote new products. The key contribution of this study is its exploration of the development process in establishing new Islamic financial products in emerging markets. This study contributes to the literature on the development of Islamic financial products in emerging markets.

In the fourth paper, Akbar and Barkely examine the characteristics of many major international stock indexes during the recent global financial crisis. The paper focuses on Islamic stock indexes as alternatives to conventional indexes during financial crises. The study examines the returns, volatility, and correlations of many major global stock indexes. The Dow Jones Islamic Market Index (DJIMI) is compared with the Wilshire 5000 (W5000), FTSE All Share Index (ASX), and the Shanghai Stock Exchange (SSECI). The analysis is conducted over the period of the financial crisis

from 2008 to 2011. The results show that the DJIMI exhibits lower levels of volatility than its conventional counterparts, while the returns were lower than the W5000, but comparable to those of the ASX and SSECI. In addition, the DJIMI does not appear to be highly related to the conventional indexes over the long run. The DJIMI also appears to be less susceptible to the contagion affects of financial crises. This paper presents evidence that Islamic stock indexes may provide lower risk alternatives to conventional indexes during financial crises.

The fifth paper is by Drs. Ahmad, Amran, Darus, Yusoff and Zain and examines the issue of Corporate Social Disclosure (CSD) in the Islamic financial system. This paper differs from the literature in that it focuses on the social reporting aspect of accountability, rather than the typical financial reporting perspective typically discussed in the literature. The study examines the concept of Maqasid Al Shariah in the context of accountability and reporting. The literature concludes that social reporting is an important component of the Shariah requirements of Islamic financial products. The study highlights the important need for developing a framework whereby corporate social reporting can be developed and implemented.

In the sixth paper, Dr. Pematasari and Nurul Huda examine several issues in the zakat market. Specifically, the study examines the impact of service quality of the zakat-collecting financial institutions on the loyalty of zakat payers. The study examines data collected from a survey of 150 zakat payers in Jakarta, Bogor, Depok, Tangerang, and Bekasi (Greater Jakarta). A structural equation model estimation results in a positive, but insignificant, direct affect of service quality on the loyalty of zakat payers. The study has implications that are of significant importance to providers of zakat management services as well as academics and other practitioners.

In the seventh paper, Prof. G.N. Khaki and Bilal Ahmad Malik examine the status and growth opportunities of Islamic finance in Central Asian states such as Kazakhstan. The collapse of the Soviet Union brought about the establishment of several Muslim nation states in the Central Asian region, and each has incorporated varying degrees of Islamic banking. Kazakhstan in particular has made strides to develop their Islamic financial markets, and there still remain many growth opportunities in Kazakhstan, as well as the Central Asian region in general. The study outlines several areas where the Islamic financial industry can improve market growth and saturation. For example, the industry needs to develop strategies to broaden customer awareness in the region. The development of awareness programs, seminars, social networking, and other mechanisms could help increase the literacy of the population with regards to Islamic financial products available in the region. In addition, microfinance products could be developed and encouraged in order to create outreach to poorer, rural communities and expand the reach of Islamic finance to the agricultural areas of the region. Finally, regional authorities may seek expertise from

the Islamic Development Bank (IDB) which can provide support and guidance regarding the expansion of the Islamic finance industry.
The eighth paper is by Siew Chun Hong and Shaikh Hamzah Abdul Razak and examines the financial performance of Islamic banks in Malaysia. The study uses ratios and other performance measures in a regression framework to examine the impact of macroeconomic variables on bank performance. Results of regression analysis using data from 2007 to 2011 show that GDP has a significant impact on many important banking ratios, such as ROA, liquidity, and equity capital. Additionally, results show that the inflation rate has an inverse relationship with banking profitability, as measured by ROA and ROE. The results of this paper are important for practitioners and researchers in the area of Islamic banking.

In the ninth paper, Muhammad Ridhwan Ab. Aziz and Asyraf Yusof examine issues surrounding cash waqf contributions in Islamic economies. Cash waqf is money designed to be used for a social goal and is a mechanism for wealthy Muslims to fulfill their Islamic duties of contributing to the wellbeing of others. This study focuses on issues surrounding the management of cash wajf. Specifically, the paper examines issues surrounding the methods in which the monies are donated as well the appointment of the financial institutions charged with managing the contribution. The study conducts a survey of 231 respondents and concludes that respondents have the strongest desire to contribute wajf funds using electronic methods. In addition, it is proposed that the use of specialized banking services such as the Islamic Wajf Bank will lead to the most efficient management of the donated funds. Developing efficient mechanisms for managing cash wajf contributions is important in fulfilling Islamic social justice goals, and this research contributes to the literature in this area.

I hope you will enjoy reading this issue of the Journal.

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