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Risk Management of Islamic Microfinance (IMF) Product by Financial Institutions in Malaysia

Siti Khadijah Ab Manan[a]*, and Muhammad Hakimi Bin Mohd Shafiai[b]

[a]*Accounting Research Institute (ARI) & Academy of Contemporary Islamic Studies (ACIS), Universiti Teknologi MARA, Malaysia*
[b]*Faculty of Economics & Management, Universiti Kebangsaan Malaysia,Malaysia*

Abstract

Maintaining microfinance institutions' (MFIs) sustainability is extremely significant owing to the fact that it aims at alleviating poverty and improving the living standard of the poor at the same time. Hence, a sustainable Micro Finance Institution (MFI) is necessary in order to achieve the objective thereby realizing a just economic growth. Nevertheless, there are issues and challenges being faced by the institutions that could give impact towards their sustainability. Among others are moral hazards and adverse selection problems among participants that would ultimately give potential risks to the institutions. Hence, maintaining its sustainability by way of risk management is significant in ensuring financial inclusion of the poor and materializing the objective of poverty alleviation. This quantitative study was conducted to examine the practice of risk management in the specific context of Islamic microfinance (IMF) product offered by several Islamic financial institutions in Malaysia. Primary data were collected through the distribution of questionnaires to the selected officers of the bank. Findings of the study indicated that the institutions had taken the necessary steps in managing the risks.

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1. Introduction

Microfinance (MF) is a fast growing industry nowadays. The number of microfinance clients has reached more than one hundred million worldwide and about 90% of them were the poorest families living mainly in Asian countries (Fernando, 2008). With this huge number plus the expected increase in participation, sustaining the

* Corresponding author. Tel: -
E-mail address: sitik274@salam.uitm.edu.my

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industry and thereby maintaining microfinance institutions (MFIs) sustainability is extremely significant owing to the fact that MF aims at alleviating poverty and improving the living standard of the poor at the same time. Hence, a sustainable Micro Finance Institution (MFI) is necessary in order to achieve the objective thereby realizing a just economic growth. Sustainable MFI could be achieved directly by improving the risk management of the loan portfolio, and indirectly through supporting system of economic and social development.

Indirectly, Islam as a system that differs fundamentally from the prevailing conventional systems, has its Maqasid al-Shariah (goals of shariah) to be attained through the practice and implementation of Islamic law. This is important to realize falah or success of man's life in this world and the world hereafter. These maqasid or goals are the safeguarding of our al-daruriyyah al-khams (essential needs) comprising hifz al-deen (the safeguarding of faith), hifz al-nafs (the safeguarding of life), hifz al-aql (the safeguarding of intellect), hifz al-nasb (the safeguarding of progeny) and hifz al-mal (the safeguarding of wealth) (Chapra, 1992; Al-Omar & Abdel Haq, 1996; Bakar, 2007; Abozaid & Dusuki, 2007). The safeguarding of faith is the utmost ingredient of shariah as faith puts human beings to behave on a proper foundation (the straight path or sirat al-mustaqim). It also provides moral filter (Chapra, 1992) for the utilization, allocation and distribution of resources thereby the goals of Islamic financial system to have a broad-based economic well-being with full employment and optimum rate of economic growth, to attain socio-economic justice and equitable distribution of income and wealth, to have stability in the value of money, to have mobilization and investment of savings for economic development in an equitable manner, and to have effective rendering of services normally expected from the banking system can be materialized (Chapra, 1985). In the context of business conduct, this manifestation of faith may become a powerful mitigating system against all sorts of misconducts or moral hazards in contractual business relationship.

Apart from the supporting economic system, microfinance (MF) industry should be more resilient than the traditional banking sector. With sustainable source of income from the government and philanthropic institutions together with low percentage of non-performing loan (NPL), MFIs seemed fairly immuned to risks from financial crisis, making banking with the poor become successful business (Walter & Krauss, 2008)

Nevertheless, recent studies showed that MFIs are not completely insulated against shocks. Being part of the global financial system, MFIs were found to have similar fate with the traditional banking sector. A study by Gonzalez (2011) and Wagner (2012) showed that MFIs were less resilient during the late 2000s financial crisis. The sector experienced a severe decline in capital inflows, a severe contraction of credit and deterioration of loan portfolio quality. Funding capacity dried up when MFIs faced problem in attracting more funds due to lack of repayment capacity of counterparts as they are also affected by the crisis.

There are three types of risks commonly discussed in literature as far as banking and MFIs are concerned. The three are financial risks, operational risks and strategic risks (Fernando, 2008). This study is therefore conducted to examine one type of financial risk i.e. credit risk in the specific context of IMF product. Credit risk is chosen as the risk has negative repercussions on the sustainability of IMFIs. The study would first outline some credit risk management criteria in IMF that the IMFIs need to consider.

2. Risk Management in IMF Product

In Islamic finance, the concern over poverty reduction via microfinance initiative is of relevance to Islamic banks. As business entities are established within the ambit of Shariah, Islamic banks are expected to be guided by Islamic economic objectives, among others, to ensure that wealth is fairly circulated among as many hands as possible without causing any harm to those who acquire it lawfully (Tahir ibn Ashur & Tahir El Mesawi, 2006). This could be done by enabling the low income earners to have easy access to micro finance.

There are several reasons why many financial institutions are unwilling to give loan to microfinance, such as the real profitability of microfinance, the high risks posed by small and short-term lending operations and the widespread belief that the poor are often poor due to a lack of skills. Furthermore, it is extremely difficult for financial institutions, particularly in less developed countries, to overcome the social and cultural barriers in providing microfinance services (Ferro, 2005).

Risk is a common thing that has to be faced by all financial institutions and they cannot avoid it: however, they can take action to reduce it. Risk is the possibility that the outcome of an event could result in an adverse situation. More specifically in finance, risk refers to the probable loss of income and asset value. The term risk has a variety

of meanings in business and everyday life. At its most general level, risk is used to describe any situation where there is uncertainty about what will occur (Agnes Osei et al., 2010).

As financial institutions, IMFIs cannot avoid from getting problems related to risk. It is an inherent element and integral part of financial services in general and of microfinance in particular and indeed, profits are in part the reward for successful risk taking in business. On the other hand, excessive and poorly managed risk can lead to losses and thus endanger the safety and soundness of microfinance institutions and safety of microfinance institution's depositors. Consequently, microfinance institutions may fail to meet their social and financial objectives. This implies that proactive risk management is essential for long term sustainability of MFIs (National Bank of Ethiopia 2010).

Brau and Woller (2004) argued that institutional sustainability of MFIs is insufficient without maintaining their financial self-sufficiency as the latter is the necessary condition of the former. Good credit risk management is the determining factor in the financial sustainability of MFIs. A study on 217 MFIs in 101 countries confirmed that, irrespective of the legal status of MFIs, managing credit risk is significant in ensuring the long standing of MFIs in serving the objectives of poverty alleviation among poor household (Ayayi & Sene, 2010).

One may argue on the importance of credit risk management in IMFIs as Islam greatly emphasized on partnership and profit sharing in mobilizing IMFIs funds. Partnership could take the form of mudharabah (trustee profit sharing) and musharakah (joint-venture profit sharing) although muzaraah (joint sharing of agricultural produce) and musaqat (joint sharing of orchard preservation) are gaining more attention, especially in agricultural financing. Nevertheless, current practice shows that debt-based products overshadowing the former principles as IMF, just like the traditional counterparts, are more risk averse. Partnership is perceived more risky with the inherent problem of moral hazards and asymmetric information apart from the least or no experience that the MF clients have. Even though the same problem encircles the latter, the basic nature of fixed-return in debt-based products had caused them to be more favoured.

Credit risk is defined as the risk to earnings or capital due to borrowers' late or non-payment of loan obligation (Till Bruett, 2004; Kwagara, 2006; Fernando, 2008). In Islam, loan and any other form of deferred payment are considered as obligations that must be fulfilled by the obligor. The Qur'an clearly mentioned "...fulfil all your obligations..." (Q, 5: 1) to the effect that whoever promises anything to anyone must fulfil the promise, and failing to do so is considered sinful. Promise (or waad in Arabic) could be binding and nonbinding. A nonbinding promise, generally is a nonmonetary promise that the defaulter is answerable to God alone. A binding promise, as in the case of microfinance, is monetary obligation which the defaulter is not only answerable to God but also to the person he or she is indebted with. In this regard, the prophet had warned that "He who does not have honesty does not have faith, and he who does not keep his promise does not have religion (in his heart)." The prophet further warned that he who did not keep his promise is munafiq (hypocrite); "If he talks, he lies; if he promises, he does not keep his promise..." except when some major reasons prevent them to keep it i.e. death or bankruptcy of the promisor.

Most IMF products are debt-based products with underlying contracts consisting of bay' al-inah, murabahah, bai' bithaman ajil or tawarruq. Bai' al-inah and tawarruq are commonly applicable contracts for the offering of personal loan whereby the borrowers could take back cash money for entrepreneurial purposes. Murabahah and bai' bithaman ajil are advance delivery sales contracts that facilitate the financing of working capital and machinery. Payment of the purchase is deferred to a future specified date as agreed. Another underlying contract least favoured by IMFIs is qard hassan or benevolent loan. As the name connotes, the lender should expect no return from the lending as the borrowers are required to repay the principal.

The created debts arising from those contracts are payable to IMFIs and borrowers are expected to pay as agreed and on time. In microfinance, borrowers are perceived highly risky as the cash received could possibly be used to a much needed priority in life. That could explain for the necessity to have more stringent credit risk management.

Credit risk includes transaction risk and portfolio risk. Transaction risk is the risk in the individual loan, while portfolio risk is the risk in the composition of the overall loan portfolio (Fernando, N. 2008). In managing the risk, IMFIs should systematically identify, limit and monitor the risk faced by the institution. Incidence of credit risk could originate from the lender's side and the borrower's side (Kassim & Rahman, 2008). Risk could occur from the lender's side whenever the IMFI is weak in administering the funds. As borrowers are mainly very poor, loosely administered funds would give opportunity for the recipients to use the funds for other purposes besides the original aim.

On the other side of the coin, moral hazard problem on the part of the recipients has been identified as the main source of loan default. In managing the risk of information asymmetry and moral hazard, we need to investigate the previous track record of the enterprises. In other words, we look at the good performance of the small and medium enterprises. In this regard, IMFIs should consider assessing the risk profile of the borrowers. A previous study by Rahman and Hossain (1995) suggested assessing household vulnerability in the process of screening. Household vulnerability is measured by (i) structural factors in the economy (demand for the products and services of the poor), (ii) crisis factors (household shocks such as illness, theft of assets, natural disasters etc) and (iii) life cycle factor (the proportion of economically active to dependent household members, also in the context of marriage). Chen and Dunn (1996) suggested examining household economic portfolio. Household economic portfolio is defined as (i) the set of household resources, (ii) the set of household activities, and (iii) the circular flow of interaction between household resources and household activities.

Another important aspect on credit risk management in IMFIs is the portfolio of the loan. Studies had listed several criteria in ensuring an effective management of MFIs' loan portfolio. Among the main indicators are (Wellen and Mulder, 2008); (i) Loan tenure – often in microfinance practice, loan is extended at a typical maturity of not more than one year as funders are afraid they may not refund their own funding and because they are less sure of getting back their outstanding credit, (ii) Size of portfolio – Size of loan portfolio could provide an insight on MFIs' stability and future growth. MFIs generally have smaller size of loan portfolio with a bigger number of borrowers, (iii) Loan loss reserve - sufficient level of loan loss reserve is important in coping with the estimated loan losses. In other words, MFIs' loan loss reserve should ideally cover any anticipated loan losses.

3. Method

This study focused on the risk management of micro financing products in selected banks and financial institutions. The idea behind the study was to obtain a clear picture of how the bank managed risk, especially credit risk, and examine the real-situation. Primary data were collected through distribution of questionnaires among the selected bank officers who dealt directly with the product. They were qualified persons to answer all the questions and provide relevant information for this study. More than 50 questionnaires had been distributed to the selected samples. Nevertheless, only 34 sets were returned and usable for analysis of the study. All the collected data were processed using SPSS version 20 and then analyzed descriptively.

4. Results and Discussion

Discussion on risk management for IMF product is mainly centred on financial risk. The following sub-sections discuss the findings of this study.

4.1. Demographic Analysis

In the survey, a total of 34 respondents participated from Islamic Microfinance Institutions owned by commercial banks, non-commercial banks and cooperatives. The samples consisted of employees from commercial banks and noncommercial banks with a total of 19 male (55.9%) and 15 female (44.1%) employees. A large portion of the samples (22 employees or 64.7%) held a Bachelor's Degree, and quite a significant number of them (20 employees or 58.8%) had working experience of 3-5 years.

Table 2 shows information of the respondents' employers. Respondents of this study are mainly those who work with non-commercial banks (61.8%) and commercial banks (32.4%). Only two of them (5.8) are working with other institutions such as cooperatives or state-government owned institutions.

The designations of the respondents are displayed in Table 3. Slightly more than half (18 respondents or 52.9%) of the respondents are the executives of their respective institutions. The rest are managers, officers and assistants (14.7% respectively). Only a single assistant manager was available to fill in the questionnaire. These respondents were chosen mainly from microcredit and product management departments.

Table 1. Respondents' Gender, Education Level and Experience

	Number of Respondents	Percent	Valid Percent	Cumulative Percent
Male	19	55.9	55.9	55.9
Female	15	44.1	44.1	100.0
Total	34	100.0	100.0	
Highest Education Level				
	Number of Respondents	Percent	Valid Percent	Cumulative Percent
Primary School	1	2.9	2.9	2.9
Certificate/Diploma	9	26.5	26.5	29.4
Bachelor's Degree	22	64.7	64.7	94.1
Masters	2	5.9	5.9	100.0
Total	34	100.0	100.0	
Working Experience				
	Number of Respondents	Percent	Valid Percent	Cumulative Percent
less than 2 years	5	14.7	14.7	14.7
3-5 years	20	58.8	58.8	73.5
6-10 years	5	14.7	14.7	88.2
More than 10 years	4	11.8	11.8	100.0
Total	34	100.0	100.0	

Table 2. Respondents' Employers

	Number of Respondents	Percent	Valid Percent	Cumulative Percent
Commercial Bank	11	32.4	32.4	32.4
Non-Commercial Bank	21	61.8	61.8	94.1
Cooperatives	1	2.9	2.9	97.1
Others	1	2.9	2.9	100.0
Total	34	100.0	100.0	

Table 3. Respondents' Designation

	Number of Respondents	Percent	Valid Percent	Cumulative Percent
Manager	5	14.7	14.7	14.7
Assistant Manager	1	2.9	2.9	17.6
Executive	18	52.9	52.9	70.6
Officer	5	14.7	14.7	85.3
Assistants	5	14.6	14.6	100.0
Total	34	100.0	100.0	

4.2. The Availability of Micro Finance Products

Respondents were asked on the availability of micro finance products offered by their institutions. Products could be debt-based or equity-based or charity-based qard hassan. Of the total respondents who represented their institutions, 16 of them (47.1%) claim that they have debt-based micro finance products on the basis of debt-based contracts such as bai' bithaman ajil, murabahah or bai' al-inah. When asked on the age of products, the response given ranged from two to fifteen years or an average of five years.

Table 4. Availability of Debt-based Products (i.e. BBA)

	Number of Respondents	Percent	Valid Percent	Cumulative Percent
Yes	16	47.1	47.1	47.1
No	18	52.9	52.9	100.0
Total	34	100.0	100.0	

When the respondents were asked on the availability of equity-based product, a significant number of them (73.5% or 25 respondents) said that their institutions offer such product. It is quite surprising owing to the fact that such product is known to have inherent moral hazard problem. Indeed, 23.5% of the respondents claim that the product had already been on the shelf for eight years.

Table 5. Equity-based Products (i.e. Mudharabah) Availability

Number of Respondents	Percent	Valid Percent	Cumulative Percent
25	73.5	73.5	73.5
9	26.5	26.5	100.0
34	100.0	100.0	

In addition to debt-based and equity-based products, there are also institutions that offer qard hassan. As shown in Table 6, 11 respondents (or 32.4% of them) revealed that their institutions offer qard hassan for at least a year.

Table 6. Availability of Qard Hassan

Number of Respondents	Percent	Valid Percent	Cumulative Percent
11	32.4	32.4	32.4
23	67.6	67.6	100.0
34	100.0	100.0	

4.3. *Risk Management of the Products*

Respondents were asked to respond on several items relating to the risk management of micro finance products in their respective institutions by circling the Likert scales of 1=totally disagree to 5=totally agree. Table 7 below displays the outcome of the study.

Table 7: Descriptive Statistics on Risk Management

	N	Mean	Std. Deviation
Fraud Policy & Procedures Reside with Institution	34	3.8824	.64030
Mechanism Exists to Identify & React to Changes	34	3.5294	.82518

Loan Loss Reserve are Practised	34	3.7647	.78079
Risk Identification is Incorporated	34	3.7941	.80827
Practice Peer Lending to Reduce Credit Risk	34	3.5000	1.13485
Develop Expertise to Make Character Assessment	34	3.7353	.99419
Forced Saving Requirement is Practised	34	3.8824	.91336
Offers Small Loan to Reduce Risk	34	3.5882	1.07640
Offers Various Loan Terms to Reduce Risk	34	3.7059	.97014
Imposing Limits to Loan Size	34	3.7941	.91385
Mean		3.7157	

Data shown in Table 7 indicated that the institutions had taken the necessary steps in managing the possible risks that could happen in micro financing. Among the steps include, the residing of fraud policy and procedures in the institution (mean = 3.88; s.d = 0.64), requiring the borrowers to save (mean = 3.88; s.d = 0.91), imposing limit to loan size (mean = 3.79; s.d = 0.913); incorporating risk identification (mean = 3.79; s.d = 0.808), practising loan loss reserve (mean = 3.76; s.d = 0.78), developing expertise to make character assessment (mean = 3.73; s.d = 0.99) and offering various loan terms in order to reduce risk (mean = 3.705; s.d = 0.97). Other mechanisms of risk management are offering small amount of loans (mean = 3.58; s.d 1.07), having mechanism to identify and react to changes (mean = 5.53; s.d = 0.825) and practising peer lending (mean = 3.5; s.d = 1.13). The overall mean of 3.7157 indicates that the institutions had taken what is best to manage risks relating to micro finance products. Nevertheless, a lot more effort could be done in improving the management of risk by the institutions.

5. Conclusion

Microfinance products are not immuned against the risk of financial crisis and credit risk. Literatures in the field indicated that MF industry had experienced a decline in capital inflows, a severe contraction of credit and deterioriation of loan portfolio quality that led to the capacity being dried up. The presence of default risk among the borrowers due to the misuse of fund, health condition of the borowers, and also unfavourable turn-over of business ventures are other sources of risks. Thereby, the probable occurance of financial risks and credit risks in micro financing should not be taken lightly. In this study, we had examined how the bank address financial risk, conduct their risk management and the challenges behind the implementation of the product. Thus, MFIs may realize a just economic growth and maintain its sustainability.

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