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Risk Assessment of Islamic Banking Products: Special Focus on Mudarabah and Musharakah

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Abstract

The banking industry is widely regarded as one of the sectors vulnerable to the effects of hazardous trade. To shape the banking industry, many international organizations, such as the BASEL Committee on Bank Supervision and the IFSB (Islamic Financial Services Board), as well as many developed countries and developing countries, have implemented risk management guidelines. The liquidity risk, credit risk, operational risk, and market risk that banks are exposed to are the most significant risks. According to the researchers, all risks must be managed concurrently; otherwise, mitigating one risk might result in additional risk. The objective of this paper is to analyze the risks that are associated with the contracts that are being made available by the Islamic banking institutions. The article concentrates on the two Shariah contract types: Mudarabah and Musharakah. This paper has been written after an extensive review of the relevant past studies. The findings of this paper show that each transaction in Islamic banks possesses its own set of one-of-a-kind characteristics. Because of this, the contracts governing each transaction are also unique. Consequently, Islamic banks are exposed to more significant risks, including equity investment risk, return on equity risk, etc. Some contracts may be exposed to the same risks; however, how these risks affect each might be unique. All contracts, including those of Mudarabah and Musharakah, are sensitive to market, credit, liquidity, and operations risks. However, the approach that should be taken toward each contract is distinct. As a result, Islamic banks need an effective risk management method. This study provides bankers, investors, and regulators with new insights

Keywords: Islamic banking, Risk, Risk Management, Mudarabah and Musharakah

1. Introduction

The proportion of the global economy that is devoted to Islamic finance is expanding at a rapid rate (Imam & Kpodar, 2013; 2016; Nalan, 2018; Bakhtar Chouri et al., 2022). It is not limited to Islamic countries and is spreading to locations worldwide with a sizeable Muslim population (Saiti et al., 2019). In more recent times, it has also attracted the attention of traditional financial markets.

In all aspects of their business, Islamic banks must conduct themselves by the precepts of Shariah (Htay & Salman, 2013; Alwi et al., 2021; Farooqui, 2022). According to the principles of Shariah, it is forbidden to have a fixed rate of return predetermined on loans and deposits. As a result, the Islamic banking system bases its resource mobilization and financing on distributing profits and risks. While uncertainty (gharar) is not permitted in Islamic business, risk is an essential business component in this context (Rusni, 2016; Omar & Rusni, 2019). Therefore, contrary to the practices of conventional banks, Islamic banks are not permitted to provide financing for speculative purposes.

The area of risks and the management of those risks is one in which Islamic and conventional banks can be distinguished more clearly.

Risk is the possibility of something terrible happening to an organization, typically in the form of something that stops it from accomplishing its goals (Htay et al., 2014; Salman, 2018). The activities and steps an organization takes, beginning with identifying risks and continuing through communicating those risks to the organization's upper management and the risk managers, makeup risk management (Salman, 2015). To effectively manage risk, one must consider restricting one's exposure to potential harm, expanding one's exposure to potential gain, and making adequate plans to deal with unknown outcomes (Commonwealth of Australia, 2008). According to Bank for International Settlements (2009) and Htay and Salman (2015), the global financial crisis that occurred in 2007 and 2008 brought to light the inability of financial institutions to shield themselves from the exposures and dangers posed by risk.

According to Dermine (2003), there are at least 15 risks to which the banking system is susceptible. These risks can be broken down into four primary categories of risks. The first category of potential risks is known as credit risk, and Dermine describes it as the possibility that the debt will not be repaid on time by the borrower or that losses may result from credit. Risks such as retail and corporate credit risk, counterparty risk, settlement risk, environmental risk, and country risk are all included in this category. The second group is known as the market risk group. Its definition is the loss of return or a decline in recovery due to an unfavorable movement in the market. The risks associated with the market consist of interest rate risk, currency exchange risk, equity risk, and commodity risk. The third type of risk is liquidity risk, which refers to a cash shortage defined by Dermine. Various factors, including the loss of deposits at the bank or an unexpected bank run, can cause this shortage. Last is the operational risk category, which encompasses the "risk of inadequate or failed internal processes, people, and systems" (Dermine, 2003). This category of risks features the likes of execution, model, fraud, legal, and regulatory risks (Dermine, 2003; Rusni, 2016).

Risks commonly associated with financial institutions include credit, market, liquidity, and operational risks (Meera et al., 2012). It is generally accepted that virtually all financial institutions are exposed to the associated risks because they are considered generic (Iqbal & Mirakhor, 2012).

Risks may never be eliminated, but careful, organized, and skillful risk management can help create opportunities to benefit from the dangers we face in the long run. Banks are vulnerable to various risks, some of which can lead to financial losses and even a potential liquidity shortage. Conventional and Islamic banks are often exposed to the same dangers. However, Islamic banks are susceptible to several unique risks because of how they conduct their business. The risks associated with Islamic banks are those connected to specific business strategies and contracts. This article focuses on two types of Shariah contracts, Mudarabah and Musharakah, which is considered the most basic mode of finance in Islamic banking operations and Islamic finance generally (Rashid et al., 2023). These two contracts share similar features of profit and loss-sharing, and that will expose the financial institution to the same risks. These risks include credit, operational, and market risks and liquidity risks.

2. Mudarabah

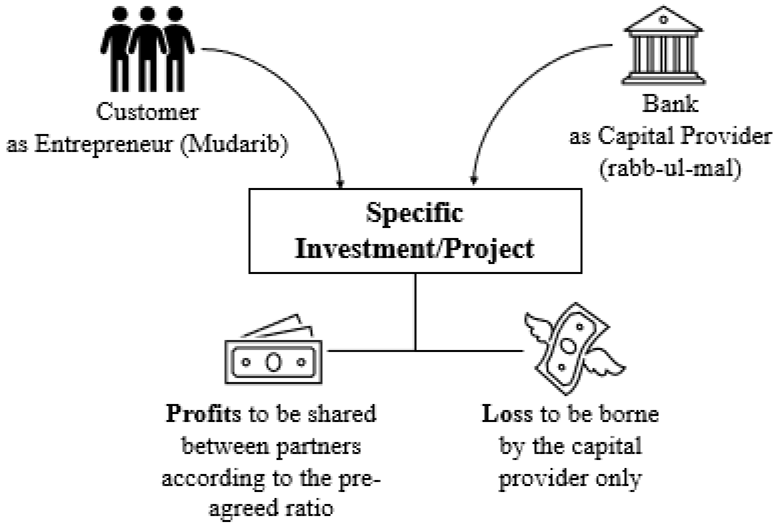
When the parties agree to a Mudarabah contract, the contract's validity is determined by whether or not the parties' profit ratio is selected. Before deciding, the parties must agree on a precise percentage of profit. However, as long as both parties agree on the share amount, Shariah is mute. The rabb-ul-mal and the Mudarib could decide to split the profits equally or break the earnings in a set ratio ((Rammal et al., 2003; Usmani, 2021; Ryandono et al., 2021)

Another important consideration is that the profit must be expressed as a percentage rather than a fixed number (Hassan, 2009; Hassan & Bello, 2014; Jais et al., 2020; Bacha,1997). Aside from that, no party's share can be tied to the capital at a fixed interest rate. The parties cannot agree to provide the Mudarib with the allocation of RM20,000/- out of the profits, for example, when the capital amount is RM2,000,000/-. The rabb-ul-mal can also receive up to 20 percent of the capital, which they cannot agree to. Profit can be split proportionally; for example, 60:40 percent between the rabb-ul-mal and the Mudarib or vice versa can be arranged.

The rabb-ul-mal may also specify different rates of profit based on the nature of the enterprise being conducted. For example, if the Mudarib trades in wheat, the rabb-ul-mal can offer him 50 percent of the profit, whereas if he deals in flour, the rabb-ul-mal can offer him 33 percent of the profit. Furthermore, depending on the location of the Mudarib, the rabb-ul-mal could agree to varying amounts of profit from the Mudarib. If he works from his hometown, he will be paid 30% of his salary, whereas he will be paid 50% if he works from another town.

2.1 Structure of Mudarabah

Diagram 1: Structure of Mudarabah Financing



The Mudarabah is a type of partnership agreement when it comes to Islam. Mudarabah is a verb that translates as "to travel" and comes from the Arabic phrase "*al-darb fi al-ard*." In the past, people had to travel a great deal to conduct their companies, which connects to that. A Mudarabah contract is a partnership agreement between at least two parties in which one party provides capital (rabb-ul-mal). In contrast, the other party is responsible for the firm's day-to-day operations. Unlike conventional banks, Islamic banks can act as both a source of financing and an entrepreneur. Investors who put their money into an Islamic bank's investment account operate as entrepreneurs, allowing it to expand its operations and grow its profits. The funds will be invested in the financial activities of the banks by the banks themselves.

When Islamic banks give Mudarabah finance to their customers, they act as capital suppliers. As depicted in Diagram 1, banks will offer cash to their customers, using the capital for a specific venture or project after conducting due diligence. The consumers will employ their knowledge and competence to create a return on investment. Profit-sharing under the Mudarabah principle will be divided between the capital provider and the entrepreneur by the predetermined ratio agreed upon at the outset of the contract, as explained above. On the other hand, the capital supplier will be responsible for financial losses.[1]

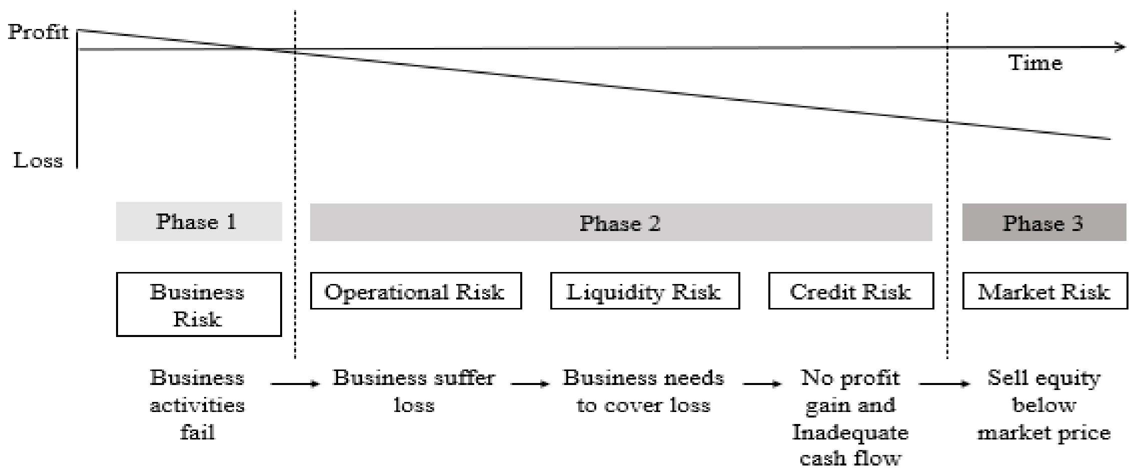
2.2 Risk Identification in Mudarabah

As previously noted, Islamic banks can act as capital suppliers and entrepreneurs. Both of these responsibilities expose Islamic banks to hazards. For this study, the risks associated with Mudarabah financing, in which banks operate as capital providers and the banks' clients or customers act as entrepreneurs, will be examined.

[1] The financial losses in Mudarabah are borne by the rabb-ul- mal except in the case where such losses caused by misconduct (*ta`addi)*, negligence (*taqsir)* or breach of specified terms (*mukhalafah al-shurut*) by the mudarib (BNM, 2015).

The failure of corporate operations serves as the trigger for the risks associated with Mudarabah financing. Diagram 2 illustrates the risks that Mudarabah ventures may face. This type of failure can be identified when the profit from the investment does not produce the desired results. The diagram shows that the investment risks losing its value when the profit drops. When a business or investment is in jeopardy, this is a clear indication that something is wrong with the company's running. In other words, it indicates that the business operation is exposed to a risk related to its operations. Internal problems such as inexperienced investment managers, outdated technology, and other factors could contribute to the risks. External circumstances such as natural disasters and the global financial crisis could also threaten the organization.

Diagram 2: Risks in Mudarabah



When a firm suffers losses, the capital provider, the banks, must supply additional capital to secure the continuation of the business operation. In addition, because the money could be used for other purposes, such as meeting financial obligations and providing finance for additional Mudarabah contracts, the banks will be exposed to liquidity issues. As the number of losses rises, the banks are exposed to increased liquidity and credit risk. As such, the company cannot generate the anticipated cash flow, so no profit may be distributed. In reality, the banks are required to fund additional losses. Partners can decide to close their firm or sell their investment shares if they cannot continue operating the business or investing their money. However, another risk must be considered, which is the market risk. When the market price of the shares is lower than the initial nominal price, the investor incurs the risk.

2.3 Risks Mitigations in Mudarabah

2.3.1 Operational Risk

As previously noted, operational risks arose due to the failure of the Islamic bank's business operations. Internal reasons, such as people and processes, and external variables, such as the current economic crisis, could be to blame for the failure. For this reason, to mitigate this risk in the Mudarabah contract, the following are some of the risk mitigation strategies:

a. Islamic banks should put a robust and comprehensive framework for controlling the internal and external elements that can result in operational risk. Islamic banks must write a precise and complete contract to avoid ambiguities between financial institutions and their consumers. Also required is that only qualified and skilled human resources be appointed to ensure that Islamic banks are adequately represented when dealing with clients.

b. Islamic banks should develop a regular or frequent evaluation of their business operations so that any difficulties in fulfilling those contracts can be recognized earlier. It can be accomplished through auditing by the internal control department of financial institutions. The assessment procedure is much more critical in the case of a Mudarabah contract because Islamic banks, as the capital provider, cannot participate in the firm's operation.
c. Islamic banks must also have sufficient structure and controls to ensure that their business activities comply with Islamic rules and principles. If a Mudarabah contract deviates from Shariah principles, the contract is automatically declared invalid, and all business activity must be halted until the deviation is corrected.
d. For Mudarabah contracts, an extensive evaluation procedure to select the Mudarib must be constructed because Islamic banks are not permitted to participate in business management. Only qualified consumers or customers are provided the Mudarabah funding opportunity.

2.3.2 Credit Risk

Credit risk occurs in the Mudarabah contract when one or more partners or clients fail to generate the desired company profit. As a result, solutions for reducing the likelihood of this occurrence must be created.

First, Islamic banks should have a tracking mechanism for business profits and losses. They must guarantee that the firm delivers the income the lender has forecasted. As for the Mudarabah contract, where Islamic banks do not have the authority to manage the business, they can serve as a reporting mechanism for business income and losses.

Second, in addition to maintaining accurate accounting records, Islamic banks must have well-established credit management systems and administrative procedures to take appropriate action if their clients experience financial issues. It is valid for both Musharakah and Mudarabah contracts, respectively. For example, the banks may propose rescheduling or restructuring the funding payment. It alleviates the financial strain on clients while ensuring the continued receipt of earnings by the banks.

2.3.3 Liquidity Risk

The liquidity risk in the Mudarabah contract arises when the Islamic banks do not get the expected income or profits. It will put them in the situation of having insufficient liquidity to carry out their other financial obligations. The Islamic banks should have anticipated this problem before signing such contracts. As a result, they should have a proper liquidity management system (i.e., before engaging in those contracts). Suppose there is a problem with the receipt of cash from those contracts. In that case, the banks have a plan for handling available funds for other financial operations and deposit withdrawals in the event of a cash flow crisis. The liquidity management system should include, among other things, the following components:

a. A competent Board of Directors and senior management to assess the liquidity management system is essential.
b. Islamic banks should have a system for regularly monitoring and measuring their liquidity risk exposures.

c. Islamic banking institutions should ensure enough financial capacity, particularly in the case of the Mudarabah project. It demonstrates the amount of cash they are willing and able to provide if required to supplement the capital in the Mudarabah contracts.

A practical method of measuring and monitoring liquidity exposures must be effective after implementing the liquidity management system. Several approaches can be used, as detailed below.

i. Establish a monthly cash flow study tailored to the changing market conditions.
ii. Islamic banks must have control over the liquidity of their funds. Because the funds are used in various ways, the banks should ensure that the money is exclusively used for profitable Mudarabah projects. The effect would be to avoid reduced cash obtained due to unsuccessful investments.
iii. At every stage of a liquidity crisis, Islamic banking institutions should have a liability contingency plan in place. For example, in a Mudarabah contract, the banks should establish what level of capital they can add to the agreement/projects to cover any losses.

2.3.4 Market Risk

Regarding Mudarabah projects where Islamic banks provide funding/financing, banks would prefer to profit from selling their equity to third parties. As long as the project operations continue to incur losses, the banks will almost certainly be unable to retain control of the company. However, the question arises regarding ensuring that the equities are sold at a higher price than or at least equal to their nominal value. In normal conditions, it may not be advantageous for other parties to purchase the stock of a company whose operations do not generate profits. For the banks to be influential, they must develop techniques for selling equities so that, even if the stock is sold below its nominal value, the amount of loss is still manageable and acceptable. A selling point must also be determined by the banks, at which time the banks are no longer capable of incurring losses due to the company's operations.

2.4 Risk Mitigation in Mudarabah from Regulator's Perspective

According to the regulator, any bank entering a Mudarabah contract must implement an integrated risk management system that effectively identifies, measures, monitors, and controls risks throughout the contract's life cycle. Before embarking on a project of this nature, the bank must design and build an appropriate evaluation technique to determine the suitability of the company type. It would entail properly establishing an internal process to evaluate the trustworthiness, talents, and expertise of the entrepreneur and or partner, as this would add to the magnitude of the equity risk that the bank will be required to expose in the first place. In addition, the bank will be asked to identify risk control mechanisms to ensure they are kept informed or alerted on the project's progress rather than acting as a sleeping partner. As a result, the bank may consider appointing a representative to serve on the Board of Directors of the venture firm as part of its risk mitigation strategy to reduce the likelihood of equity and project failure. Additionally, the bank will be expected to have a good review and monitoring system to monitor the project and issue an early warning notice if the project is not viable.

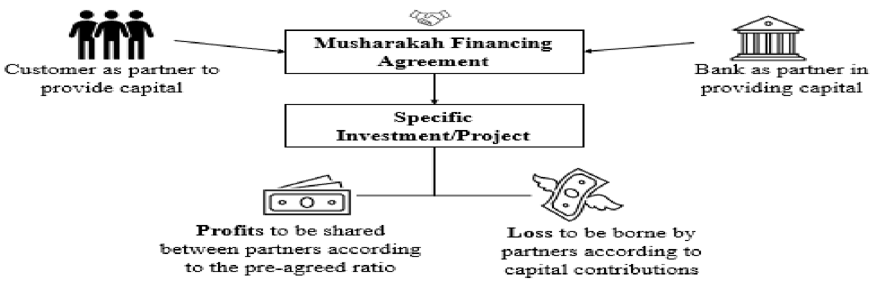
3. Musharakah

Musharakah is a partnership or contract between two or more persons to pool resources, labor, and liabilities (Tuan, 2019; Dinc, 2017; Khan, 2019 & Hussain et al., 2016). The agreement provides a mutually agreed-upon ratio to distribute joint venture profits among participants. On the other hand, the loss is distributed in proportion to each individual's capital input. The Musharakah agreement provides all partners equitable participation in the enterprise's management. However, they may waive their request if they prefer a specific relationship or individual. It is a common finance approach employed by Islamic banks in which two or more financiers pool their resources to fund a project and split the profits and losses.

3.1 Structure of Musharakah

Musharakah is a partnership agreement in which two or more parties agree to collaborate on an investment or project, similar to a joint venture. A Musharakah contract is one in which all parties to the agreement contribute funds to the operation of the venture. Profits will be divided among the parties concerned following a predetermined ratio. Even in the event of a loss, the burden will be shared; however, the distribution will be based on the amount of capital each party gives.

Diagram 3: The Structure of Musharakah



Musharakah can be divided into numerous categories, which can be further subdivided. According to the findings of this study, Musharakah may be divided into Pure Musharakah and Diminishing Musharakah or Musharakah Mutanaqisah.

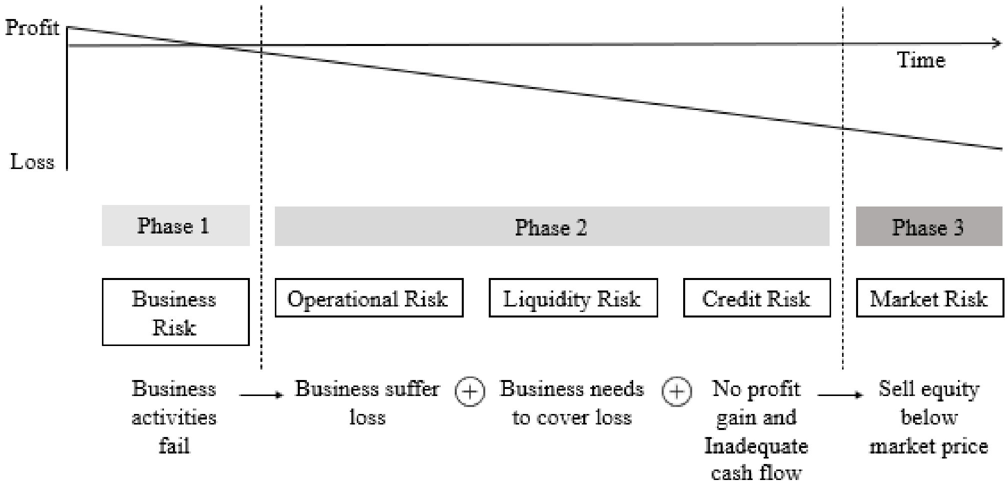
3.2 Pure Musharakah

In this case, the investment or project will continue indefinitely until the Musharakah is completely disbanded. Banks invest in the equity of the asset or project they are financing to receive a portion of the annual earnings and losses. The banks may engage in investment management or delegate control to the partner, with the banks just monitoring the performance of the acquisition on an ad hoc basis, depending on the circumstances.

3.3 Risk Identification in Pure Musharakah

Under Pure Musharakah contracts, the investment is also exposed to risks related to operations, credit, liquidity, and the market, among other things (Diagram 4). These hazards impact the permanent Musharakah contract similarly to how they affect the Mudarabah contract. The failure of company operations resulted in the agreement being exposed to business risk, which was the starting point for the chance. It can be identified when the earnings of a commercial entity begin to diminish over time. Once a company is exposed to business risk, it will also be subject to operational risk due to that exposure. As a result, the number of losses will climb even more significantly.

Diagram 4: Risks in Pure Musharakah

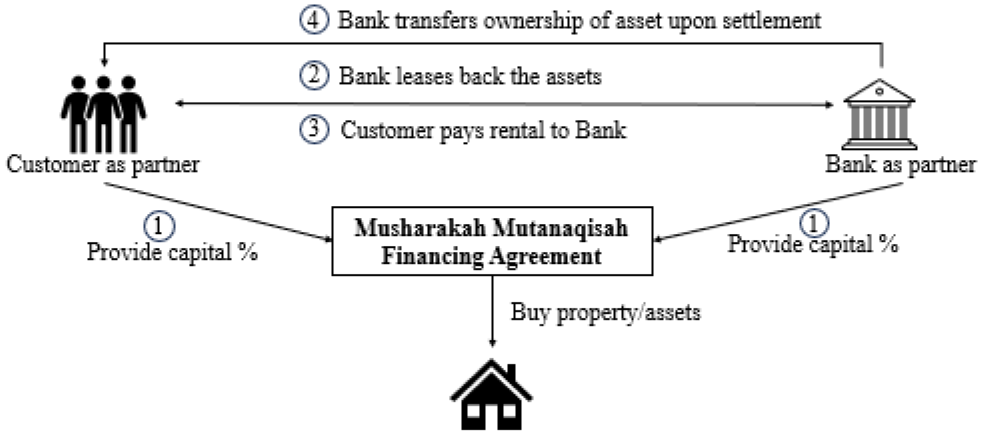


In contrast to the Mudarabah contract, profit and loss are shared equally between the banks and the customers. As a result, the banks need better business performance. Because of the impact of operational risks, the business may be unable to provide the planned cash flow. This situation is referred to as credit risk. If a firm needs more cash, it will be exposed to liquidity concerns, leading to the business needing more money for further investments. As soon as the partners conclude that the company cannot be sustained due to the massive losses suffered, they must sell their equities to the market, exposing themselves to market risk, in which there is a possibility that the market price of the equity will be lower than the nominal price.

4. Diminishing Musharakah

The relationship of Musharakah partners will only exist briefly under a contract with declining or Diminishing Musharakah. It is a contract that allows the parties to exit the Musharakah venture by virtue of an agreed redemption method throughout the tenure of the contract (BNM, 2015). Commonly, this contract is utilized when the consumers require finance to purchase a particular piece of real estate. Following is a diagram that depicts the process of diminishing Musharakah. A Musharakah contract between the bank and the customer will be entered, where both parties give capital. This portion of the capital symbolizes both parties' equity in the property. Compared to the bank's equity, the customer's equity is very little at the start of the transaction. As a result, the bank holds title to the property. To obtain property ownership, the client must purchase the bank's equity. It is accomplished through the bank leasing the asset back to the consumer, with the customer responsible for the rental payments. In other words, the customer purchases the equity through monthly payments. When the bank's equity has been purchased, the property will become the customer's property.

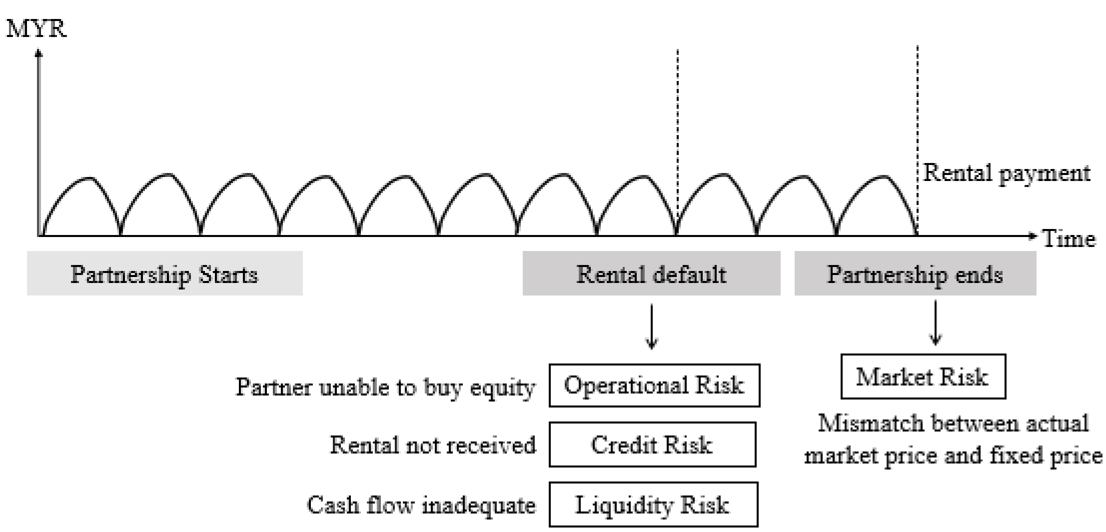
Diagram 5: Structure of Diminishing Musharakah



4.1 Risk Identification in Diminishing Musharakah

When comparing the impact of risks under a Diminishing Musharakah contract with a Pure Musharakah contract, it is clear that the former has a more significant effect. However, the agreement is subject to the same risks as any other contract, including operation, credit, liquidity, and market risk.

Diagram 6: Risk in Diminishing Musharakah



When a consumer cannot pay monthly rent payments to the bank, the trouble accrues. Operations risk is what this is referred to as. If the customer does not pay his rent for the following period, the bank is exposed to credit risk, resulting in financial losses in the long run. Due to this, the bank's cash flow is reduced, rendering it unable to make further investments to expand its operations. At the end of the partnership period, the bank may be exposed to market risk, which occurs when the actual market price of the asset does not match the fixed price, causing the bank to lose the potential profit it had made.

4.2 Risks Mitigations in Musharakah and Diminishing Musharakah

4.2.1 Operational Risk

As previously noted, operational risks arose due to the failure of the Islamic banks business operations. Internal reasons, such as people and processes, and external variables, such as the current economic crisis, could be to blame for the failure. As a result, to mitigate the risk associated with a Musharakah contract, the following are some of the risk mitigation strategies:

a. Islamic banks should put a robust and comprehensive framework for controlling the internal and external elements that can lead to operational risks. They must write a precise and complete contract to minimize ambiguities between financial institutions and their consumers. In addition, the banks must ensure that only qualified and skilled human resources are appointed so that they are capable of representing the institutions in their dealings with clients.
b. A robust system and controls are also required for Islamic banking institutions to verify that their business activities comply with Shariah norms and guidelines. Any contract deviating from Shariah principles is instantly declared invalid, and all business activity must be halted until the matter is resolved.
c. Regarding Musharakah, the Islamic banks may intervene in its management to defend their interests. It will prohibit the partner or customer from running the business for their financial gain and benefit.

4.2.2 Credit Risk

Credit risk occurs in a Musharakah contract when one or more partners or clients fail to generate the desired company profit. As a result, solutions for reducing the likelihood of this occurrence must be created.

i. Islamic banks should have a tracking mechanism for business profits and losses. They must guarantee that the firm delivers the income the lender has forecasted. Suppose an Islamic bank enters into a Musharakah contract; it may engage a financial expert to analyze and approve the firm's financial status as needed or periodically.
ii. Regarding Musharakah contracts, because the banks can engage in business management, they can ensure that the clients or customers maintain correct accounting records. If all accounts are correctly recorded, any inadequacies in cash management can be identified.
iii. Besides maintaining accurate accounting records, Islamic banks must have well-established credit management systems and administrative procedures to take appropriate action if their clients experience financial issues. It applies to contracts, including Musharakah. For example, an Islamic bank may propose rescheduling or restructuring the financing payment. It alleviates the financial strain on clients while ensuring the continued receipt of earnings by the bank.
iv. Regarding Diminishing Musharakah, if it is determined that the customer cannot continue making the rental payments, the banks can transfer the assets to a third party.

4.2.3 Liquidity Risk

The liquidity risk in a Musharakah contract arises when the Islamic banks do not receive the expected income or profits. It will put them in the situation of having insufficient liquidity to carry out their other financial obligations. The banks should have anticipated this problem before signing such contracts. As a result, they should have a proper liquidity management system (i.e., before engaging in those contracts). Suppose there is a problem with the receipt of cash from those contracts. In that case, the banks have a plan for handling available funds for other financial operations and deposit withdrawals in the event of a cash flow crisis. The liquidity management system should include, among other things, the following components (BNM, 2011):

a. Islamic banks must have robust policies and procedures to manage liquidity mismatches from Musharakah financing. The Board of Directors and senior management must develop an adequate liquidity management system for the institution.
b. Islamic banks must strengthen the process, regularly monitoring and measuring their liquidity risk exposures, especially on Musharakah projects and cash flow effects.
c. Islamic banks must institutionalize risk governance structures, improved control, and risk mitigation mechanisms, stable and diversified funding composition, and robust contingency funding, especially in a liquidity crisis.

A practical method of measuring and monitoring liquidity exposures must be effective after implementing the liquidity management system. Several approaches can be used, as detailed below:

i. Determine whether or not there may be a future decrease in liquidity. In comparison to other contracts, some of them carry a higher risk. As an illustration, the cash flow from Pure Musharakah is more uncertain than Diminishing Musharakah's. Therefore, a Pure Musharakah contract may expose Islamic banks to greater liquidity risk than they would otherwise incur.
ii. Establish a monthly cash flow study tailored to the changing market conditions.
iii. Islamic banking institutions should have control over the liquidity of their funds. Because the funds are used in various ways, the banks should ensure that the monies are exclusively utilized for profitable Musharakah contracts. The effect would be reduced cash obtained due to unsuccessful investments.

4.2.4 Market Risk

Concerning Pure Musharakah, there is little doubt that banks would like to profit from selling their equity to third parties. As long as the commercial operations continue to incur losses, the banks will almost certainly be unable to retain control of the company. However, the question arises regarding ensuring that the equities are sold at a higher price than or at least equal to their nominal value. In normal conditions, it may not be advantageous for other parties to purchase the stock of a company whose operations do not generate profits. For the banks to be influential, they must develop techniques for selling equities so that, even if the stock is sold below its nominal value, the amount of loss is still manageable and acceptable. A selling point must also be determined by the banks, at which time the banks are no longer capable of incurring losses due to the company's operations.

To diminish Musharakah and avoid losses resulting from customers' incapacity to pay monthly installments, banks should design a payment plan from the beginning of the contract so that the customers would pay according to the amount scheduled. However, because the asset's original price fluctuates with the market price throughout the contract's duration, the banks must consider this when computing the monthly amount the clients must pay. For example, banks may do static and dynamic analyses to evaluate the current and future Value at Risk (VaR). Based on this study, the banks can determine how significant their market risk exposure is. This risk will be taken into account when establishing the asset's price.

4.3 Risk Mitigation in Musharakah from Regulator's Perspective

According to the regulator, any bank entering a Musharakah contract must implement an integrated risk management system that effectively identifies, measures, monitors, and controls risks throughout the contract's life cycle. Before embarking on a project of this nature, the bank must design and build an appropriate evaluation technique to determine the suitability of the company type. It would entail properly establishing an internal process to evaluate the trustworthiness, talents, and expertise of the entrepreneur and or partner, as this would add to the magnitude of the equity risk that the bank will be required to expose in the first place. In addition, the bank will be asked to identify risk control mechanisms to ensure they are kept informed or alerted on the project's progress rather than acting as a sleeper partner. As a result, the bank may consider appointing a representative to serve on the board of directors of the venture firm as part of its risk mitigation strategy to reduce the likelihood of equity and project failure. Additionally, the bank will be expected to have a good review and monitoring system to monitor the project and issue an early warning notice if the project is not viable.

5. Conclusion

Both Islamic banks and conventional banks are susceptible to risk. Islamic banks are, however, riskier than traditional banks. Risks cannot be eradicated, but their competent, efficient, and effective management may provide possibilities for profit. There are unique risks associated with banks, some of which may result in losses or a liquidity shortage. Risks linked with Islamic Financial Institutions are related to particular business structures and contracts. Muslim academics have recommended Islamic banking due to the non-Shari'ah-compliant character of traditional financial activities. Modern banking is built on interest, which is one of the aspects banned from an Islamic standpoint. Shari'ah compliance is the foundation and top priority of Islamic financial operations. Shari'ah non-compliance risk in Islamic banks refers to failing to comply with Shari'ah when conducting banking business activities and functions. Shari'ah compliance is distinctive and regarded as the foundation of Islamic Banking and Finance. In the event of non-compliance, the reputation of Islamic banks and the confidence of market participants, especially depositors and investors, may suffer. Therefore, Islamic banks must ensure that this unique, non-Shari'ah-compliant risk is appropriately monitored and managed; otherwise, there will be no distinction between Islamic and conventional banks. The research aimed to evaluate risks associated with the contracts offered by Islamic banking and financial institutions, focusing on two Shariah contracts, namely Mudarabah and Musharakah. The equity-based contracts (Mudarabah and Musharakah) expose Islamic banks to risks irrelevant to conventional banks because the nature and idea of equity or profit and loss sharing do not exist in conventional banks. In certain situations, Islamic banks are exposed to a greater degree of hazards than conventional banks; nevertheless, there are techniques to limit and minimize these risks, as it is acknowledged that risks cannot be avoided.

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