Financing risk management to anticipate financial distress in Islamic banks

Riana Afliha Eka Kurnia1 \*
1 Graduate School, Airlangga University
Email: afliha.21@gmail.com

Tjiptohadi Sawarjuwono2
2 Faculty of Economics and Business, Airlangga University

Sri Herianingrum
1 Graduate School, Airlangga University

**Abstract**Uncertainty was not only found in conventional banks but also in Islamic banks. Financing risks in Islamic banks can occur because Islamic banks have made some modifications to sharia contracts used for financing to adjust general business of banks environments. Thus Islamic banks, like conventional ones, face risks and business issues. This study discusses how risk management at Bank Islam poses a risk to financial difficulties probability. This study will explain that Islamic banks should establish a risk management system by its functionality and complexity of the banks, and the system provides bank's risk management organization that suits with sharia principle to at least be able to avoid financial distress conditions.

**Keyword: Financing Risk Management, Financial Distress, Islamic banks**

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**Introduction**

Risks can occur in various segments of human life, including in the business activities undertaken by humans, and banking business is one of the many business activities developed by humans today, including in Indonesia. The emergence of new Islamic banks is legally supported in Indonesia after the issuance of Banking Act Number 10 of 1998 which states that the operational types of banks are divided into two conventional banks and Islamic banks. The law also guides conventional banks to open sharia branches or even totally transform into Islamic banks. The emergence of the Banking Act was immediately anticipated by Bank of Indonesia (BI) by conducting training for Bank of Indonesia officials such as the Directorate of Banking Research and Regulation, credit, supervision, accounting, research and monetary (Antonio, 2015, p. 26). Then, for the operation of the next Islamic bank is regulated in Law Number 21 the Year 2008.

In both legislations, there is, in fact, a very basic difference between Islamic banks and conventional banks. One of which is that the conventional bank use interest, while in Islamic banks apply profit sharing. In financing activities, Islamic banks have a different concept with conventional banks. It happens because Islamic banks have a principle of obedience to sharia (Islamic Law), then the concept of financing also uses “Akad syariah” (sharia contract) which is contained in the teachings of Islam.

But unlike in classical times, sharia contracts applied by Islamic banks have undergone many modifications and adjustments so that they may face the same financing risks as conventional banks practice. Also, due to the Islamic banks are relatively young but it has given a lot of responsible, expectations, and high hopes in its business activities, it finally makes risk management at the bank as another challenge for Islamic banks. Another factor that makes bank risk management as a problem is that conventional banks as competitors of Islamic banks are far more experienced regarding risk. Conventional banks have also been more accustomed to various management techniques and instruments and risk mitigation tools. Moreover, since some dangers in Islamic banks are unique and relatively more diverse than conventional banks, they require completely different, new, and specialized risk management and mitigation tools (Wahyudi et al., 2013).

 Today's Islamic banks, in fact, are not only exposed to traditional risks in financial matters but are also challenged to risks which are arising from the unique characteristics of the contract. This, in turn, will make the Islamic bank has many weaknesses, because some sharia instruments are quite complex which cause Islamic banks has lack of risk mitigation tool by the characteristics of Islamic banks. These failings and shortcomings may lead to Islamic banks to face higher risk impacts than conventional banks (Wahyudi et al., 2013).

 The weaknesses occur in risk management of Islamic bank financing can be seen when distributing funds to the community in the form of funding (working capital or capital purchase of goods). Generally, in the viewpoint of Islamic banks, the risk of financing can be understood as a risk of failure or inability of the customer (entrepreneurs) to return the loan/financing they have received from the bank is based on the given period. If this problem does not address or resolve, it can continuously affect the financial health of Islamic banks, resulting in financial distress and bankruptcy to the banks.

The term financial distress (Chen, Weston, & Altman, 1995; Glaessner & Mas, 1995; Supardi & Mastuti, 2003) is defined as bankruptcy or economic distress, which means the company loses money or income which results in the failure to cover its own cost because the profit rate is less than the cost of its capital. The failure occurs when the company's cash flow is far below the expected cash flow or the return on investment is less than the cost of the company's capital spent on an investment; the second term is Financial Distress, which means the difficulty to cover fund of corporate liabilities or liquidity difficulties that begin with mild problem up to more serious challenges, i.e. if the debt is greater than the asset. The definitive definition of financial distress is still difficult to formulate up to date, but it is understood as a mild to the severe difficulty faced by banks.

Suroso (2006) argues that financial distress is a condition in which the results of the company's operations are not sufficient to meet the corporate obligations or insolvency. Insolvency can be divided into two categories: Technical Insolvency which is temporary which appear because the company has to lack cash to fulfil short-term obligations; and Bankruptcy insolvency which is more serious that occurs when the total value of the debt exceeds the total value of the company's assets or negative corporate value. Many factors cause the company to face financial distress which are the increased operating costs, excessive expansion, technological losses, competitive conditions, economic conditions, weaknesses of corporate management, and a decline in industrial trade activities (Whitaker, 1999). This management weakness factor is one of the factors that should be avoided by Islamic banks, especially weakness in the risk management of financing.

 Based on described reasons above, every bank should build a risk management system by the function and complexity, and provide a method of risk management organization at the banks according to their own needs to avoid the potential of bankruptcy conditions or financial distress which results in the death of productivity of Islamic banks.

**Method**

The study of risk management is mostly done with a critical review (Saunders, Lewis, & Thornhill, 2012, pp. 73-74). The study was conducted on the existing data in the library, such as journals, magazines, newspapers, or websites because these are believed to be the sufficient sources that enable the writer to explore something more widely and still can provide answers to research problems. Also, this study is a conceptual research (Botha, 1989, Depree, 1989) because it is conducted on the plain of the concept of an object of study, in this case, the risk management of financing. The study with this kind of research approach is done because the idea of risk management of finance in Islamic banks is still developing a theme which has not had a clear and definite thought.

**Results and Discussion**

 **Financial Distress at Business Institutions**

Indicators of experiencing a financial distress are mentioned by Whitaker (1999) which marked by a halt of employment or dividend loss, as well as less cash flow than long-term debt, or if for two years experiencing negative net operating income and for more than one year did not pay dividends (Whitaker, 1999). While Geng, Bose, & Chen (2015) evaluated the predictive capabilities of all financial indicators according to their rankings using the score and frequency of occurrences and obtained ten fiscal management indicators with the highest predictive ability to predict economic distress. The strength of management can be found in the company that can return total assets, net profits to total assets, earnings per share, and cash flow per share. While studies conducted by Richardson, Lanis, & Taylor (2015) show that financial difficulties are also related to taxes. Their study also found that there is a definite relationship between financial distress and taxes.

Furthermore, Koh, Durand, Dai, & Chang (2015) state that the life cycle of a company consists of birth, growth, maturity, and a setback. The strategy that businesses use when facing financial distress is affected by this life cycle. The most prominent influence in facing financial distress is to make choices of financial restructuring strategies, for example by reducing dividends or changing the company's capital structure. Koh, Durand, Dai, & Chang (2015) have also tested the method of companies to face financial difficulties, and the result is that it reduces the investments and corporate dividends is related with recovering the financials distress conditions for all companies.

In addition to the above conditions, the conditions described by Amendola, Restaino, & Sensini (2015) may also cause financial distress risks. Amendola, Restaino, & Sensini (2015) mentioned the factors that can lead to the occurrence of financial distress is the competition between large companies and the difficulty of liquidation. However, the element that most affects the company's financial distress is separation from the dependence of international trade.

Manzaneque, Priego, & Merino (2016) discuss some corporate governance mechanisms (ownership and characteristics) of the company. His study states that the ownership factor of the company does not have a significant impact on financial distress and that large shareholders are passive regarding improving management and do not have enough role to withstand the occurrence of financial distress.

**Islamic bank Financing Risk**

Risks can be interpreted as possible events or circumstances that can threaten the achievement of organizational goals and objectives (Rivai & Ismal, 2013, p 57). However, the definition of risk in Islamic banks may vary, depending on the application or discipline that discusses it. The risk in Islamic banks can also have different connotations and suggest different meanings for various fields. For example, in microeconomics, the risk refers to the uncertainty of the consequences (positive or negative) of a decision. Meanwhile, for the field of financial economics, risk connotation is negative, as it refers to potential losses. While there is ambiguity surrounding the definition of the word risk, the definition can still be used to consider the possibility of a risky situation in the Islamic bank, to identify or predict future situations in the Islamic bank's business activities, and the ability to specify each of the probabilities of the occurrence of risk in Islamic banks. In Islam, there has distinguished two different forms of risk in business activities. The two types of risk are (Bouslama & Lahrichi, 2017):

1. Risks that are associated with transactions or in economic activities aimed to create added value or wealth;

2. The risk associated with gambling (eating wealth for nothing).

So, it is apparently still difficult to define the risks in Islamic banks specifically. However, from the literature found in this study, there is a specific discussion of the dangers in shariah contracts which is applied to Islamic banking. Since Islamic banks ask sharia contracts in their business activities, the modern risks of financing contracts in Islamic banks depend on the characteristics of their financing products (Rivai & Ismal, 2013, p 240):

Risks that arise in *Ijarah* contract may be the cause is if the property owned by the bank arises the risk of non-productive assets of *ijarah* due to the absence of customers; if the goods do not belong to the bank, there is a risk of damage to the goods by the customer due to abnormal usage; in the case of leased labor services of the bank then leased to the customer, the risk of qualified service providers may be not as competent as expected. While the risk on *Ijarah* contract development, *Ijarah* *Muntahiya Bit Tamlik* (IMBT) financing is about the inability of customers to pay large instalments at the end of the given period if the payment is made with the system of instalment payment in the large amount at the end of the period.

If banks use a *Salam* contract which is typically used to fund the purchase of agricultural goods, then the risks it faces may be at the time when sellers cannot fulfil the commitment as already agreed. For example, they do not ship some or all the items of the order. Another risk could be the possibility of a decline in the value of goods orders or decline in the amount of inventory stored. The decline could happen due to damages or decrease in market price. The risk of using *Istishna* contract is the same risk as*-Salam*.

*Istishna* according to some *fuqaha* (the experts of Islamic law) is a special kind of Salam, but it is widely applied if the banks that are engaged in business activities in the field of manufacturing and construction with a relatively extended period. However, in this case, the bank may face risks in the form of default implementation that is not suitable for the contract. It could be due to the late execution of the contract or maybe missed match of quality of the ordered goods.

In the *Mudharabah* / *Musyarakah* contract, the risk assessment of the bank usually includes the business risk being financed or the risk of reduced *mudharabah* / *musyarakah* financing, as well as the character risks of the *mudharib* / *musyarik* / customer. It is further illustrated that in the *Mudharabah*, clients as a fund manager do not have an obligation to bear the risk of loss arising. *Mudharib* is also not required to provide collateral to the bank. The loss that can be charged to the customers is the loss due to their negligence and fraud.

To face the possibility of risk of fraud or negligence of customers in this *Mudharabah* contract, the bank can conduct active supervision and conduct the direct examination of business operations, as well as customer files. However, in the type of Mudharabah *Mutlaqah* contract, the bank usually does not intervene in the management of the business, so the existence of this provision causes the bank may be facing high risks because all losses will address to the bank as the owner of capital. However, this study has approved the explanation written by Rivai & Ismal (2013), that the very high risk to *Mudharabah* *Mutlaqah* can be overcome by requesting a guarantee to the customer, even though the original *Mudharabah* contract is not required any collateral.

While *Musyarakah* contract applied to the bank, it is used for long-term investment of entrepreneurs, banks as investors who provide capital to carry out the business, and agree to share profit and loss (risk). These gains and losses are by the ratio agreed upon in the agreement. The risk of loss that can be faced by the banks may be the risk of loss from the proceeds of the business/project financed or the dishonesty of the business partners. However, *Musyarakah* financing risk may be relatively smaller than the risk with the *Mudharabah* financing contract, since in the *Musyarakah* the bank can manage to run the joint business and conduct a closer supervision of the company undertaken together. However, other problems that arise of this contract is the limited quality and quantity of human resources (HR) that perform the management and supervision of the business.

Another agreement that can be applied by the banks is *Murabahah*. The risk facing by the Islamic bank using this contract without modification is the same as *Mudharabah*, i.e. the absence of collateral for the bank in case the buyer cancels the transaction. Furthermore, the bank will also experience a risk of loss due to declining value of the goods or damages during the storage period.

Although it has been mentioned that the Islamic bank contracts used for financing have specific risks according to the type of contracts, but the risk management still has not found a definite form by the type of risk faced by Islamic banks. Overview of current risk management of Islamic banks can be seen from Ernest and Young (2000) explanation that the process and implementation steps of risk management applicable to all banks, both conventional and Islamic banks. Then the explanation by Herlianto (2002) that the implementation of risk management for all banks should pay close attention to risk management of life cycle, i.e. understanding cycle, identification cycle, assessment cycle, measuring cycle, managing cycle, and monitoring cycle. Based on the two opinions, the process of applying risk management to the bank is a process that must be run even though the implementation of each bank may be different depending on the type of bank (Rosly & Mohd Zaini, 2008).

The explanation in other literature also says that the essence of risk management is the process of conducting the adequacy of risk management procedures and methodologies so that the bank's business operations can be manageable to acceptable limits, and can provide benefits for banks according to the level of acceptable risk. In addition to the differences in market conditions, the structure, size and complexity of the bank's business, there is no single universal risk management system for all banks (*Ikatan* *Bankir* *Indonesia*, 2014, p.347). The literature further discusses that to anticipate a risk can be done by assessing inherent risks and assessing the quality of risk management implementation which includes the risk control system. While the type of risk is the risk inherent in every business activity of the banks, therefore the banks must submit bank risk profile reports individually or consolidated. Thus, risk management is an activity undertaken to respond to known risks to minimize consequences. Risk management is also said to be a structured approach or methodology to manage uncertainty related to threats to bank business (Indonesian Bankers Association, 2014, pp. 347-353; Rivai & Ismal, 2013, p 65).

Another opinion says that risk management in Islam is how to control losses arising from the possibility of risk and speculation. In the *fiqh* (Islamic law) literature, term *gharar* is indeed associated with the risks and uncertainties contained in the agreement. However, it is inappropriate to say that risk management in Islam is about controlling the occurrence of *gharar* possibilities, since *gharar* in Islam is not necessarily to be controlled or reduced, but is to be avoided altogether (Hassan & Lewis, 2007; Kettell, 2011, p. 106; Rosly, 2005). So, if there is *gharar* in the form of uncertainty or uncertainty in Islamic bank business, especially the quality of customers who need financing, Islamic banks should not channel their capital. Therefore, customer segmentation is essentials in this regard.

 This study agrees with the Association of Bankers of Indonesia (2014) that the determination of customer segmentation is essential in mapping the needs of banking products/services, regarding assets/financing and liabilities/funds from each group of customers to improve the quality of service or financing products. The purpose of this segmentation is to anticipate risks; business management can be done in a focused, efficient, and targeted according to the size of the business and business characteristics. The financing segmentation will affect the treatment and policy of the banks in determining the pricing, the adequacy of the collateral, the financing structure, and the authority to disconnect the financing. Meanwhile, financing customers can be grouped into five segments: corporate, commercial, business banking / small banking, micro, and consumer. The segmentation of each bank is different based on the size of the bank, but in principle is almost similar. Therefore, customer segmentation of cash loan and non-cash loan financing can be determined based on the following criteria: customer class, private business entity, Gross Annual Sales (GAS), financing limit, and financing purpose (consumptive or productive) (*Ikatan* *Bankir* Indonesia, 2014).

Based on the previous explanations, it can be seen the difference in the flow of risks between conventional banks and Islamic banks. In the conventional bank as shown in Figure 1:

Financial Distress

Liquidity risk

Credit risk

Figure. 1

In Fig.1 above, as explained by Whitaker (1999), Suroso (2006), Richardson et al. (2015), Amendola et al. (2015), and Geng et al. (2015) that start from the beginning credit risk has been determined to the bank. However, although it has been established since the beginning, credit risk could be the cause of other risks such as liquidity risk which can end up being a financial distress. At that time, the financial distress condition can affect more widely to the cessation of the bank's business. If the bank's business is stalled, then there will be a risk of losses either from the side of the bank's shareholders, bank employees because there will be a massive layoff of employees, and customers who feel the loss of confidence in the ability of banks. As mentioned above, if financial distress occurs in the bank, it will lose money to cover its expenses. At the same time, the bank will even have difficulty to cover corporate liabilities or liquidity difficulties that begins with a small challenge to more severe difficulties, i.e. if the debt is greater than the asset.

This condition is similar to what happened to Indonesia during the monetary crisis of 1998, where many banks collapsed because they could not be responsible for their customers' funds. Depositors also obviously feel aggrieved because they feel insecurity and loss of confidence in the bank.

Meanwhile, in Figure 2 shows the risk flow in the Islamic bank. Because Islamic banks apply contracts that contain sharia principles, the risk of financing that occurs in Islamic banks may start from the risk of human resources which is called operational risk in this study because the human resources in a Islamic bank run or operates a bank business.

Operational Risk: Quality of human resources

Financing Risk

Risk of Sharia Obedience

*Financial Distress*

Figure.2
This study says that the risk of Islamic bank financing can start from operational risk, because in the explanation of sharia contract that has been explained previously the most apparent characteristics of the Islamic banks are the behaviour and moral quality of the perpetrators of these contracts especially on *Mudharabah* and *Musyarakah* contracts. Although sharia contracts applied in Islamic banks may be modified to suit the business environment of the bank, the meaning and essence of the sharia contracts still contain the existence of the trust or even high trust. Trust is the basis of all the activities of banks, including conventional banks.

In addition to trust, the characteristics seen from these Islamic bank contracts are the concept of partnership or cooperation and more to the practice of *ta'awun* (to help each other) to fellow businessmen. Thus, in the contracts used by the Islamic bank between the owner of the capital (bank) and the manager of the capital (the customer) should have an equal position, no one has a higher or lower place only because of the financing distribution activities. This is different with a conventional bank in which the bank always positions itself as a creditor and a customer as a debtor.

 It can also be seen that the essence of sharia contracts contains the meaning that in conducting business activities should be based on high trust between business partners (the ability to maintain the trust), honesty, knowledge, and human quality in Islamic bank activities should be more prominent compared with conventional banks.If the behavior and moral quality of human resources in Islamic banks are not first managed properly, then it will cause failure on the implementation of sharia-based contracts that is suitable to the principles of sharia. As a result, in Islamic banks, the impact is much more substantial than conventional banks, because Islamic banks can suffer not only from financial distress but also are burdened with inconsistencies with sharia principles.

**The Concept of Sharia Risk Management**

In some financing contracts, risks may arise due to inadequate quality of business actors such as negligence, fraud, dishonesty, and the inability of customers to perform business activities with Islamic banks. Such risks can be self-anticipated by the Islamic banks by beginning to develop and improve the quality of human resources in the Islamic banks themselves, especially in the management and supervision of financing to form a management culture by the character of Islamic banks.

A well-implemented finance management culture is reflected in the attitudes of the skilled staffs, which have a clear understanding of the nature of Islamic banks and the risk of financing of Islamic banks. Bank management should also care about the development of a culture of financing management to ensure that the business generated is in line with sharia policy and successfully protects not only banks but also customers from financing risks.

All the necessary qualities within the human resources of Islamic banks are inseparable from the attitude of the leader and the support of senior management for the implementation of the financing process and the culture of financing management by the character of the Islamic bank (*Ikatan* *Bankir* *Indonesia*, 2014, p.64). However, it should not rely solely on the leadership, supervisors, or senior employees to control but also foster the attitude of administration and self-control of every employee of Islamic banks. Thus, in the day-to-day activities, there will be a leadership attitude regarding Islamic bank financing management oriented to the formation of bankers who has (*akhlakul* *karimah)* shariaattitudes (Rivai & Ismal, 2013, p 559).

*Akhlakul* *karimah* meant here is someone who has faith and piety to Allah SWT which is recognized with good intentions in beginning all activities, because the intention distinguishes something with a custom case with worship. However, such faith and piety can not only be proved by words alone but must also be done and proven by concrete actions (Booth, 2016).

Based on Al-Ghazali's thought, it can be seen that someone in a Islamic bank should be able to be a role model for oth members including its customers, by having *akhlakul* *karimah*, soled Islamic worldview, and the most important avoid *takabbur* (being proud of our ability) (Ash-Shallabi, 2014). Based on the concept of Al-Ghazal, human should not put themselves to feel the highest or most capable, or feel entitled to get more top returns and profits than they should receive or with other words *takabbur* here adjacent properties also with the nature of greed (Ash-Shallabi, 2014).

 Avoiding the nature of *takabbur* also means that the staffs being able to be humble and disrespectful of their power in the presence of their employees, fellow employees, as well as to the financing customers, and can distinguish between being assertive and coercive. Al-Ghazali explains about *Amar* *ma'ruf* *Nahi* *munkar* (doing good things, avoid lousy attitude), that can be concluded if someone does have authority in Islamic banks, he should not stand idly by noticing a problem, or irregularity, or harmful actions from both the banks and the customers (Ash-Shallabi, 2014).

Al-Ghazali's ideas about the enforcement of *Amar* *ma'ruf* *Nahi* *munkar* can also be applied in performance management within the company. Performance of management is a process to create a working environment that can encourage employees to show their best ability so that their attitudes and behaviour towards financing customers are also by the reflection of the characteristics of Islamic bank employees.

This understanding implies that the performance of management of Islamic banks not only discusses the company performances, work unit performances, and individual employee performances. It is more broadly that performance of management at Islamic banks is an effort to create a high performing culture throughout the work unit of Islamic banks. This process is also a process that examines the functions of work units and duties of employees and set employment goals for employees. In the performance of management, monitoring is also done as continuous communication activity between employer and employees to support various efforts undertaken by employees in achieving the targets of solving and preventing of financing risks. After that, the bank can conduct an evaluation. Evaluation can be done to the work unit, employees, and customers. In the process of evaluating the employee, the performance of employees will be measured during the period of work, ensuring that the achievement of employee meets the target. The evaluation becomes the media to provide feedback to employees about the lack and strength to improve future performance, ensuring the availability of indicators to be used as one of consideration in the decision making of financing distribution (*Ikatan* *Bankir* Indonesia, 2014).

The policy in financing risk management is also fundamental to be considered, as it aims to select/define financing sectors such as policies for the determination of debtor class, usage, priority scale of financing, and financing sectors. Financing policies in Islamic banks should be jointly applied by both the Board of Commissioners, the Board of Directors, and the Sharia Supervisory Board. Meanwhile, the step to secure Islamic banks can be done before disbursing financing funds to customers by initiating customer segmentation, then making an approval from customers of insurance closing and collateral binding. After that, financing can be disbursed. In the initial stages of disbursement of funds, banks direct financing based on customers proposals, the bank does not necessarily disregard the use of it and still do coaching and control actively and passively on the use of funds (Muhammad, 2014).

**Akad Syariah as a tool for Sharia Risk Mitigation**

 Despite many contracts used in Islamic banks, the study tends to focus on the importance of fund managing by *Mudharabah* and *Musyarakah* for risk mitigation of Islamic banks, as they are assessed in accordance with the objectives and definitions of Islamic banks proposed by the *UU* *Perbankan* 1998 (Banking Act of 1998) and *UU* *Operational* *Perbankan* *Syariah* 2008 (the Islamic banking Operational Law of 2008), namely Islamic banks are banks that use the principle of profit sharing in banking practices. Also, contract of *Mudaharabah* and *Musyarakah* are the most apparent contracts that show the characteristics of Islamic banks which are high confidence, the principle of profit sharing, cooperation (partnership), equality in business, and *ta'awun* (helping each other).

 In the science of classical *Fiqih* (Islamic law), the study did not find the *Musyarakah* contract to be applied to modern Islamic banks. The explanation of *Musyarakah* contract before it is applied by Islamic banks is *Musyarakah* explanation that is done on business in general. This statement can be seen in the study written by Ath-Thayyar (2015, p.226) which uses *syirkah* or sharia to describe etymologically the partnership activities between several partners or corporations. The character of a party or company conceptually in *syirkah* is to have a special liability and a formal legal jurisdiction which means it has rights and obligations. *The* problem of *Shirkah* arises in modern times because of economic and trade activities require the concept. *Ath*-*Thayyar* explains that based to *Hanafiyyah* madhhabs (the rule of Islam based on the leader namely Hanafi) argue that the pillars of *Shirkah* only one which is *shighah* (*ijab* and *qabul*), that means there is an offer and acceptance because *shigah* embodies the transaction of *syirkah*. While most scholars argue that the pillars of *shirkah* are, *shighah*, the existence of two people who do the transaction (*'aqidain*), and the transacted object (' *al*-*ma'qud* *'alaih*) (Ath-Thayyar, 2015).

 The legal requirements of *syirkah* from the scholars of *fiqh* (Islamic law), are two skilled (*ahliyah*) parties to represent and receive representatives who make *tra*nsactions, they have *syirkah* capital that is present at the same time. Both know the amount of profit applied, a total, half, and so on.

Legal requirements of *syirkah* which are still in the debate by scholars is according to *Shafi'iyah* *syirkah* capital derived from goods that exist on it, that is goods that can be measured or weighed. Also, goods should be able to be traded with *Salam* contracts, such as gold and silver, but other scholars do not require the same way. *Shafi'iyah* also requires the validity of *shirkah*, two treasures must be mixed, but the *fuqaha* (the expert of Islamic law) do not socialize this theory. *Malikiyyah* and *Syafi'iyah* require the distribution of profitability through the percentage of a partner's capital invested from the total capital *syirkah*. However, this is different from *Hanafiyyah* and *Hanabilah* who argue that the profit sharing may be based on partner agreement.

The applications of *Mudharabah* and *Musyarakah* contracts in modern Islamic banks are explained by Antonio (2015). In *Musyarakah* contract, Antonio explains that *Musyarakah* contract that is applied in Islamic banks consists of two types, namely: *Musyarakah* Ownership and *Musyarakah* *Akad* (Contract). *Musharakah* Ownership comes from the existence of inheritance, will, or other conditions that result in the ownership of an asset by two people or more. In this *Musharakah*, the purchase of two persons or more people shares in a tangible asset and the profits generated by the asset. On the other hand, *Musharakah* *Akad* (contract) is created by way of agreement where two or more people agree that each of them provides *Musyarakah* capital. The parties also agreed to share the advantages and disadvantages of the contract.

*Musharaka* *Akad* is further divided into *Al*-*'Inan* and, *Al*-*Muwafadah*, *Al*-*A'maal*, *Al*-*Wujuh*, and *Al*-*Mudharabah*. According to Antonio, many scholars disagreeon *Mudharabah*, whether it is included in the type of *Musharaka* or not. Some scholars consider *Mudharabah* to be a part *Musharaka* category because it satisfies the terms and conditions of a *Musyarakah* contract. However, some others assume that *Al*-*Mudharabah* is not part of *Musharakah*.

The explanation of *Shirkah* *'Inan* is a contract between two or more persons who give a portion of the entire fund and participate in the work. Both parties are divided into the advantages and the disadvantages that they have agreed. However, the portion of each party, whether in funding or in employment or for-profit sharing, should not be identical by their agreement. According to Antonio, most scholars allow this type of *Musharakah*.

At *Syirkah* *Muwafadah* contract, the cooperation is done between two or more people

where each party provides a portion of the entire fund and participates in the work. Each party shares the same advantages and disadvantages. Thus, the main requirement of this type of *Musharaka* is the similarity of funding provided, work, responsibility, and the debt burden that is shared together.

*Syirkah* *A'maal* is a two-person cooperation contract to receive work together and share profits of the job. This type of *syirkah* is sometimes also referred to *Shirkah* *Abdan* or *Shirkah* *Sanaa'i*. While *Syirkah* *Wujuh* is defined as a contract between two or more people who have good reputation and prestige as well as experts in business. For example, they buy goods on credit from a company and sell the goods in cash, they share the profits and the losses under warranty to suppliers which is provided by each partner. This type of *Musharakah* does not require capital because the purchase on credit based on the guarantee, therefore this contract is also commonly referred to as *Musyarakah* credit. The application in banking practices regarding *Musyarakah* type contracts is usually applied to project financing where customers and banks provide funds to the project. After the project is completed, the customer returns the funds with the agreed sharing for the bank.

 Another application of *Musyarakah* is to a special financial institution that is allowed to invest in the company's ownership, i.e. *Musyarakah* applied in the venture capital scheme. The investment is made for a specified period and after that the bank divests or sells its share of shares, either briefly or gradually.

The benefit of Musyarakah contract is that the bank will receive a certain amount of increase from increased customer profit. The banks have no obligation to pay a fixed amount to customer on a regular basis. The payment is adjusted to the bank's income/results so that the bank will never experience a negative spread. The repayment of the principal is fixed to the cash flow of the customer, so there is no burden to the customer. Furthermore, banks will be more selective and prudent looking for a genuinely halal, safe, and profitable business. This is because the real and actual gains are shared; the profit-sharing principle in *Mudharabah* / *Musyarakah* is different from the fixed interest principle in which the bank will collect the borrower (a customer) a fixed interest amount regardless of profit generated by the customer, even in the economic crisis.

While the *Mudharabah* deal is explained that the contract is divided into two namely *Mudharabah* *Mutlaqah*, a contract in which the form of cooperation between *shahibul* *maal* and *mudharib* whose scope is very wide and not limited by the specification of business type, time, and business area. In the discussion of the *fiqh* of the *salafus* shaleh is often exemplified by the expression *if'al* *ma* *syi'ta* (do as you wish) from *shahibul* *maal* to *mudharib* which gives great freedom. The second type is *Mudharabah* *Muqayyadah* or also called restircted *mudharabah* or specified *mudarabah*, which is the opposite of *Mudharabah* *Mutlaqah*. *Mudharib* is limited by business, time, or place of business. The existence of these restrictions often reflects the general tendency of *shahibul* *maal* in choosing the type of business.

In the practice of financing, *Mudharabah* is applied for working capital financings such as working capital of trade and services, and on special investment (*Mudharabah* *Muqayyadah*) where the special funding sources with special channelling on terms is established by *shahibul* *maal*.

Top of Form

**Sharia Contract as Tools to Anticipate Financial Distress**

In the classical Jurisprudence, it has not explained the *Mudharabah* and *Musyarakah* contracts on the bank's business activities that can be done as a risk mitigation tool. This agreement can be interpreted in any business activity to establish cooperation; to be honest in delivering financial statements, to help each other; to be careful in transactions and to record transactions; to consider having a witness in doing business (*muamalah*) is essential, and to not complicate the partner.

Therefore, many previous studies have attempted to modify *Mudharabah* and *Musyarakah* concepts which are derived from the teachings of Islamic law and state regulations adopted from the teachings of Islam in the Qur'an, hadith, and jurisprudence. In Indonesia, *Mudharabah* and *Musyarakah* contracts are contained in regulations such as the *Fatwa* of the *National* *Sharia* Council of the Indonesian *Ulama* (Islamic Expert) Council (*Fatwa* *DSN* *MUI*) and the Compilation of Islamic Economic Law (KHES) which is issued by the Supreme Court. These two regulations when viewed based on Lex Superior Derogat Legi Inferior's legal principle, are higher regulatory provisions, and have higher degrees and take precedence over their use/reference than the lower (laws) provisions. In the conflict situation, the higher rule is applied. So, on the practical level, the influence of *fatwa* of DSN MUI and KHES is still vague for Islamic bank business journey in Indonesia.

 However, the studies from Rosly & Moh. Zaini (2008); Djojosugito (2008); Kayed & Mohammed (2009); Lewis & Algoud (2001); Toumi, Viviani, & Belkacem (2011); Ismal (2012); and (Haron, Ramli, Injas & 2015) have strengthened this research to prioritize *Mudharabah* and *Musyarakah* contracts on Islamic banks. The study by Djojosugito (2008) reveals that some Islamic scholars propose a bank financing model based on PLS (Profit and Loss Sharing) which is more suitable and more beneficial between banks and customers, although in the practice of Islamic banking, this is substantially similar to conventional banks. However, this similarity is more since most of the internal regulatory frameworks related to Islamic banking have not been directed based on this *Mudharabah.* Even the regulatory framework for the PLS model to be applied to the bankings are not enough based on law (Djojosugito, 2008).

While Toumi et al. (2011) explain that currently Islamic banks practically, have equity based on capital structure, which is dominated by equity shareholder and deposit investment based on PLS principle (Profit and Loss Sharing). However, in individual institutions, it can differ significantly that they usually mobilize funds not based on interest on deposits, but by the form of Profit-Sharing Investments Accounts (PSIA).

Furthermore, there is an essential difference between *Mudharabah* and *Musyarakah*, which lies in the magnitude of contributions to the management and finances or one of them. In *Mudharabah*, the capital comes only from one party, whereas in *Musyarakah* the capital comes from two or more parties (Karim, 2008, p 103). Lewis & Algoud (2001) who took the opinion of Khan (1985, 1987) explains about the *Musyarakah* concept by comparing the 'fixed return scheme' (FRS-fixed profit scheme) in debt contracts with 'variable return scheme' (VRS-profit scheme in a *Mudharabah* system. The overall comparison between the two schemes involves the exchange between lower monitoring costs under the terms of FRS and better risk-sharing under the VRS scheme. However, there may also be an inverse situation which provides a theoretical reason for conducting Islamic banking practices on a project that allows for easy monitoring and evaluation. To realize this theoretical reason, it is advisable to develop *Musyarakah*. The *Musyarakah* model allows banks to provide technical assistance in the form of preparing feasibility studies, planning, coordinating and managing project development (Lewis & Algaoud, 2001).

**Conceptual Framework of Islamic bank Risk Management**

Based on the result of this study it can be drawn the conceptual framework of Islamic bank risk management to anticipate the emergence of financial distress as follows:

Sharia Bank

Risk Management of Finance Sharia Banks:

1. Akhlakul Karimah/Panutan (Good attitude/ behaviour)
2. Performance management
3. Customer Segmentation
4. The finance regulation is ruled by the board of commissioners, directors and supervisory board board of Commissioners, the Board of Directors, and the Sharia Supervisory Board. Ard of Commissioners, the Board of Directors, and the Sharia Supervisory Board. s Syariah.

Sharia risk mitigation tools:

To prioritize Mudharabah and Musyarakah contract upon the others.

Picture. 3

The explanation of this conceptual framework is that the condition of financial distress, especially described by Suroso (2006) about the condition of Technical Insolvency and Bankruptcy Insolvency can be anticipated by Islamic banks in several ways in accordance with the principle of sharia. Although, in any business including our Islamic bank, we never expect any risk or negative condition like financial distress. However, business activity especially Islamic bank business is an activity that cannot be stable or good condition forever; it has been explained by the Word of Allah SWT in Qur'an Surat Luqman (31) verse 34 that no one can know exactly what he will do tomorrow.

Therefore, to anticipate the condition of financial distress in the Islamic banks, they should start to manage the financing scheme to the contract which shows the characteristics of the Islamic banks, namely *Mudharabah* and *Musyarakah*. In addition, this agreement shows the true character of Islamic banks, as well as serves as a tool of risk mitigation due to the concept of sharing and partnership. In the concept of sharia contracts, banks and customers should not only share the profits but also share the risks so that no one will bear the risk alone.

Although the application in modern Islamic banking may be the risk that occurred was borne by one party, it can be anticipated by the Islamic banks by managing the management within the Islamic bank itself. Islamic banks should strengthen the risk management system by empowering and improving the quality of morals of Islamic bankers. They should apply the concept of performance management based on Islamic values, in this study the contribution of Islam in the performance management used is the thought of Al-Ghazali. Then, they should do prudence by first establishing segmentation of financing customers before the distribution of financing funds. The purpose of customer segmentation is to disburse funding on target based on the needs of customers. Lastly, it is a very important to have cooperation between the Board of Commissioners, Board of Directors, and Sharia Supervisory Board in regulating the financing policy so that the policy can provide *maslahah* (good and benefit) both for Islamic banks and financing customers.

**Conclusion**

To conclude, in conducting business, Islamic bank cannot be separated from risk. Where sharia principles applied to modern Islamic banks may have undergone many modifications in practice and experienced similarities with conventional banks practice. So, as conventional banks facing a lot of financial pressure including risks in lending, Islamic banks can also experience the same thing, namely the risk of financing on sharia contracts of financing.

In conventional banks, there are also various pressures such as the imperative of capital adequacy, the appropriateness of management, maintaining trust, taxation problems, competition between large companies, the difficulty of liquidation, and the dependence on international trade. These could be the cause of risks and financial distress which resulted in the dismissal of labour, the loss of dividends and bankruptcy in the bank. The existence of Islamic bank business that is still minimal in experience is considered to cause various pressures and risks to be faced by Islamic banks which can get worse without proper anticipation and solution.

In Islamic banks, anticipating the condition of financial distress must be done in ways of principles of sharia, because the principles of sharia are the character of Islamic bank contracts. Therefore, financing risk management in sharia contracts is very important because financing is a bank activity to continue the business cycle of banks and customers. Poor risk management can result in worsening business activities of Islamic banks and cause loss and bankruptcy, not only for Islamic banks, but also on customers.

Furthermore, Islamic banks should prioritize the application of *Mudharabah* and *Musyarakah* practices in business activities. These contracts are considered the most suitable contract for Islamic banks and customers. Although, this study does not prove any evidence in the form of data that *Mudharabah* and *Musyarakah* will generate a definite profit for banks and customers regarding financing, it concludes that only the two *Mudharabah* and *Musyarakah* is right applied to the bank. The conclusion of this study is reinforced by the explanation in the Qur'an Surat Luqman (31) verse 34 that the real man cannot be sure what he is trying because in fact, only Allah knows everything.

 Therefore, even if Islamic banks want to apply *Mudharabah* and *Musyarakah* in their financing activities, the profit earned may not be as significant as expected by the banks and customers. However, the two contracts can be used as risk mitigation tool for anticipating financial distress condition. Improving and developing financing risk management within the Islamic banks continuously by improving the quality of morals and capabilities of their human resources; applying business concepts containing Islamic values; sorting out and selecting potential business partners; as well as the cooperation and ability of the Islamic bank officials and supervisors of Islamic banks. Sharia regulators understand the meaning and purpose of *Mudharabah* and *Musyarakah* contracts as sharia principles.

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