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NAVIGATING RISKS IN ISLAMIC MICROFINANCE: A COMPARATIVE STUDY OF OPERATIONAL, CREDIT, AND SHARIAH RISKS IN MALAYSIAN INSTITUTIONS

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Abstract

This study explores the complexities of Islamic microfinance in Malaysia, illuminating the significant risks that two different organizations, henceforth referred to as Institution A and Institution B, must deal with. The main goal of this research is to thoroughly comprehend the effects of operational, credit, and Shariah risks on these institutions within the rational framework of disbursement and repayment systems. This study examines the various issues surrounding Islamic microfinance using a qualitative research methodology that includes in-depth interviews and a careful comparison analysis. Despite having different operating approaches from one another, Institutions A and B are both susceptible to operational, credit, and Shariah risks. Despite adhering to Qard Hassan's ideas, Institution A has trouble managing resources effectively, which causes clients to misallocate and waste money. A significant operational risk exists, which is exacerbated by the possibility of fraud during cash collection. These difficulties are made more difficult by the institution's reliance on manual record-keeping. Using asset-based trade principles, Institution B, a business-focused organization, provides services and goods including Tawarruq and Murabahah. Despite having a strong market reputation, it is nonetheless vulnerable to reputational hazards, especially in a time of increased customer scrutiny. The organization also struggles with credit risk because its customers frequently overspend and take on debt that is beyond their means. This study emphasizes the interconnectedness of these risks and the fact that no one risk can have an independent impact on an institution. Risk management is an essential component of their operations because of the interdependence of credit, liquidity, operational, and reputational risks. This study's conclusion emphasizes the need for creative solutions to overcome the weaknesses and inequities seen in these organizations. This research helps to improve risk management systems in the field of Islamic microfinance by bringing these hazards to the fore. In order to provide a more thorough understanding of the hazards associated with Islamic microfinance, future research should take a wider range of case studies into account.

1. Introduction

Shariah, often known as Islamic law, is the basis for the financial system known as Islamic microfinance. Islamic microfinance is the provision of financial services in conformity with the tenets of Islamic finance, including loans, savings, and insurance. These principles prevent the charging or receiving of interest as well as any participation with things that are haram (forbidden) in Islam, like alcohol, pork, and gambling. Islamic microfinance attempts to meet the financial requirements of low-income people and communities, especially those who are shut out of traditional financial services (Ansari *et al*., 2021). According to reports, many microfinance institutions are in a condition of morbidity because they cannot manage risk. This is the result of a disregard for globalization. Budgets for microfinance institutions are frequently constrained. In Malaysia, a large number of microfinance institutions depend on government financing. Microfinance falls into two distinct areas. 1) Conventional 2) Muslim. Traditional microfinance operates mostly on the basis of loans. Islamic banks, on the other hand, are hesitant to rely on loans to support their operations. It is viewed as being prohibited (Rahman, 2007). Offering Muslim clients a choice is the primary objective of Islamic microfinance (Ali, Rahman, & Bakar, 2013; Karim & Naeem, 2022). Islamic microfinance focuses on Islamic goods including Salam, Qard Hassan, Bai Muajjal, Mudarabah, and Musharakah. These Islamic financial instruments are based on principles of risk sharing, equity, fairness, and social justice (Rahman *et al*., 2023). In the context of Islamic microfinance, risks can be categorized into three main types: operational risks, credit risks, and Shariah risks (Rohman *et al*., 2021). Operational risks refer to the potential losses or disruptions that can occur as a result of inadequate internal processes, systems, or human error. These risks can include issues such as fraud, mismanagement, and technological failures (Naibaho & Mayayogini, 2023). Credit risks, on the other hand, pertain to the possibility of borrowers defaulting on their loans or being unable to repay them in full (Silva & Gonçalves, 2022). Shariah risks revolve around non-compliance with the principles of Islamic law and can include activities or transactions that are considered haram. For instance, if an Islamic microfinance institution engages in transactions that involve interest or deals with prohibited industries, it would be considered a violation of Shariah (Hilmy & Hassan, 2019). It would be advantageous to lessen the risks associated with Islamic microfinance by combining, putting into practice, and integrating unheard-of innovations with the aid of cutting-edge technologies. The primary premise of the research topic is how risk affects Islamic microfinance in Malaysia within the framework of disbursement and repayment systems. In order to address this complicated topic, a qualitative study utilizing interview sessions and a comparison of the two different institutions has been developed. The paper's introduction is the first component, followed by the literature review. Then the techniques. The interviews that were performed for the findings section have already been thoroughly analyzed. The report's conclusion follows with an assessment and analysis of the results in light of managerial recommendations.

2. Literature Review

If companies want to succeed and keep their competitive advantage, they must implement cost-cutting measures. The financial services sector has significant obstacles since it is more exposed to dangers. Studies indicate that the financial services industry is more exposed to cybercrime (Clark, 2014). Numerous risks have already infiltrated enterprises as a result of globalization and technological advancements; consequently, risk management and risk assessment procedures must be taken into consideration in order to mitigate this expansion. One of the major threats to these institutions is credit risk. This results from the client's duty to pay back the money. Moreover, Loans and credit risk are closely associated (Churchill & Coster, 2001; Hoshen *et al*., 2017; Shah & Hussain, 2012; SCHNEIDER, Shaul, & LASCELLES, 2016). Additional research indicates that businesses cannot be impacted by just one risk. All risks are interlinked and linked to one another, including those that are associated with liquidity, market conditions, and transactions (Khan & Ashta, 2013). This is one of the things that makes the financial services sector, especially microfinance, susceptible to fraud. Both conventional and Islamic microfinance face the same levels and kinds of risks, but an Islamic bank has a higher level of risk due to its wide range of business activities. Institutions are susceptible to foreign exchange risks in addition to credit and liquidity problems (Bruett, 2004; Castellani & Cincinelli, 2015). Not to mention, it is not a goal to just identify these risks. The main objective is to confront and overcome these challenges. The majority of the time, microfinance organizations deal fairly and maintain a strong two-way communication with their clients. However, this usually becomes less of an issue once the institution is put in peril (SCHNEIDER, Shaul, & LASCELLES, 2016). Malaysia serves as a compelling case study for examining risks in Islamic microfinance institutions due to its well-developed Islamic finance industry (Alam *et al*., 2022). It has a diverse range of Islamic microfinance institutions, including both non-governmental organizations and commercial financial institutions, offering a variety of products and services (López-Sánchez & Grande, 2023). This diversity provides an opportunity to compare and contrast the risks faced by different types of institutions in order to identify common challenges and best practices for risk mitigation. Furthermore, Malaysia's strong regulatory framework for Islamic finance and its commitment to promoting financial inclusion make it an ideal setting for studying risk management in microfinance institutions. Hence, the comparative study of operational, credit, and Shariah risks in Malaysian Islamic microfinance institutions is crucial (Hashim *et al*., 2021).

3. Case Study

An evaluation of two Islamic entities that provide microloans was conducted. According to researchers, one advantage of comparison analysis is that the coded themes can be understood very clearly and are similar to one another (Sangers *et al*., 2019). The use of comparative analysis also shows how the execution of diverse phenomena in distinct institutions and contexts affects the issue. This has to do with two formal repayment and payout procedures in Islamic microfinance (Wahyuni, 2012). The first organization abides by Shariah. They do not rely on loans to run their firm. They seek to conduct business through reciprocal connections. They make loans in accordance with Qard Hassan, whereby the recipient donates money in the form of ujrah as repayment for the loan. After the institution closes, consumers are given access to a variety of benefits, such as training sessions, consulting services, managing finances, and company development. Meetings are consequently scheduled, usually on Tuesdays, to track the progress, and payments are made. However, the rise of mobile banking has made this relatively easier to carry out. The second institution is similar to the first in some aspects but is slightly different. For instance, it offers its consumers three basic and necessary things. 1) A mortgage 2) Personal loan 3). Withholding for retail. It has been considered, nonetheless, that by placing a strong emphasis on savings, this institution is ready to follow a blue ocean policy proposed by the Malaysian government. Tawarruq and Murabahah microfinance packages are offered. The delivery of trainings, leadership development programs, business establishment, and educating their clients about current and future trends so they can build their companies effectively are examples of this institution's exceptional offerings.

4. Research Approach

It was made easier to access qualitative and historical data, which gave the study the essential triangulation. The bulletins and brochures that institutions A and B prepared went to great lengths to assemble data from a range of sources. Qualitative research has three characteristics. It first shows the connection between induction theory and research. Second, simply studying the phenomena avoids interaction with those who are actually in charge of them, which is a limited and static condition. Contacts with others have also been introduced in order to help the approaches that supply social traits become more deeply ingrained. Finally, the interpretation of the world is informed by the participants' views of the world (Burrell & Morgan, 1979).

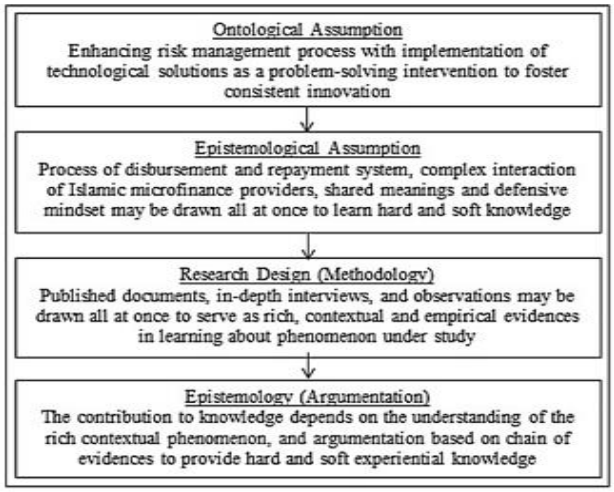

Figure 1: Research Approach

The qualitative research that has been conducted has focused on semi-structured interviews to give respondents a sense of independence. The interviews were conducted for the Risk Management Committee with their full cooperation. They were held in Bahasa, the language of Malaysia, to avoid any misunderstanding of the message. For clarity, these interviews, on the other hand, were further lucubrated into English. The length of one interview ranged from 20 to 60 minutes. A narrative analysis also oversaw the comparison of disbursement and repayment methods in terms of risk influence. Based on a social constructivist technique, the subsequent study closely scrutinizes the data to track the occurrence (Creswell & Tashakkori, 2007).

5. Findings and Discussion

Risks related to operations, sharia law, and credit are present for Institution A. The inability of customers who owe money to institution A or are bankrupt to do so causes improper cash allocation and visualization (Boumediene, 2011). Resource allocation is handled disproportionally because customers often put their own interests ahead of those of the business. They would spend it on pricey items rather than investing it in enterprises. Clients that are unable to meet the required payback amount are the outcome of bad financial management (Churchill & Coster, 2001). Due to the decreased pressure exerted by the microfinance companies, this commonly happens (Hassan, Nor, & Rom, 2012). Operational risk and fraud are closely connected concepts. There is always a potential of fraud and theft, regardless of how reliable the staff is. Due to meetings for disbursements and cash collection, the staff of the institution is more susceptible to robberies and break-ins. similar to what one of the managers said: “We're used to having our employees bring the money they receive from their centres all the way to this office. In all branches, we do that; occasionally, staff members have been threatened. After each centre meeting, they feel uneasy and need to check their surroundings to see if somebody is following them in their car. You see, they have a lot of money.” These dishonest practices are initially discovered by audit committees. They actively search for conduct that contravenes the corporate governance, laws, rules, regulations, standard operating procedures, and guiding principles of the institution. They've found that this institution engages in a lot of legerdemain, including improper sheet collecting, cash deposits, and incomplete, current fund accounts. This demonstrates that threats, fraud, and other subtle inconsistencies are present in Islamic microfinance. As a different manager puts it: “When dealing with significant sums of money, there is another group we are wary of. Fraudsters. It can be one of our own, or it might be fakes posing as one of us. A situation like this has happened before. It turned out that the man was acting; he was not even a staff. Of course, who could resist the temptation when they see us handling so much cash after the centre meeting? We can never trust someone when we have money. Even your family doesn't." A new method must be used because manually changing the items in Institution A is time-consuming and prone to human error. Institution B faces a similar range of risks to institution A, including operational, credit, and Shariah risk. In contrast to institution A, it does not work on the principle of Qard Hassan because it is a corporate and profit-oriented organization. They function by using asset-based trading platforms like Tawarruq and Murabahah. Failure to deliver items to clients and client nonpayment are risks. The concept of a ghost supplier also contributes to risk considerations since customers generate invoices from companies that do not actually exist. One of the other risks is that the customer will hesitate to purchase the things that the institution has already purchased, necessitating the customer's previous consent. "We must examine when the banks make a payment. Exists the questioned asset on the client's property or in their store? When staff members do an inspection, the machine abruptly disappears. Instead, he buys an automobile. Don't you think that should be wrong?" Another aspect of poor financial planning is credit risk. When clients are given more microcredit options, they frequently spend more money than they truly need and want, increasing their risk and debt. "For instance, the majority of the capital in a restaurant will only be spent on purchasing food and related utensils, correct? When we provide a client with a loan amount that is occasionally greater than what he needs, he may spend it extravagantly before deciding not to repay us when it is time to do so. So how can these entrepreneurs pay the bank if things happen that even we did not expect to happen and it turns out that their firms are not performing well? (Interview 4, Institution B, Manager, own translation). "As supply, a machine aids our customers in enhancing their productivity" The productivity of clients should rise if, in fact, everything is in order. Additionally, internal revenue should increase. The customer will then have no trouble paying the bank back. But where would he obtain the money to pay back if he takes the bank's money and uses it to buy other things? (Interview 3, Institution B, Manager, own translation) "Clients receive money" Yes, they misuse. This is why we continually draw attention to instances in which our funding has been misused. They discover that they do not have enough money to reimburse the bank after trying to recoup the sum they have misappropriated, so they choose not to pay. (Interview 5, Institution B, Manager, own translation). Consumers and individuals are tech savvy and have access to all available information as a result of the expansion of globalization. Despite having a solid reputation, a strong brand, and brand equity, institution B is nonetheless subject to reputational risks. This is because if business can't respond to client complaints, even one bad review might substantially damage its already-viable market reputation. "If money is lost, insurance will still cover it." However, if your reputation is damaged, clients will not want to bank with you. And it will be the loss the bank has to endure. (Interview 6, Institution B, Manager, own translation). Having said that, the staff's negligence in regards to accounting and operational chores puts this institution's operations at risk. Underserved clients receive compensation as a result of this neglect, which comes at the expense of deserving clients who would otherwise receive them. They behave carelessly when it comes to their duties. They give incorrect information about a customer, which could lead to the company paying different vendors different amounts and values."Except if staff made a mistake during payment, the client wants to pay to vendor A, but payment is instead made to vendor B which has no relation to the business, then there are some people who should have received 5,000 but suddenly receiving 30,000, then we have a problem there," the manager said (Interview 4, Institution B, Manager, own translation). Additionally, despite largely adhering to Shariah law, this firm nonetheless faces difficulties and risks. Bank Negara has succinctly described the challenges this bank faces when implementing Shariah Laws. "If you don't execute properly, all of a sudden a Shariah-compliant product has interest charged to it that bank charges interest." That is incorrect. Therefore, both the contract and the product are null and invalid. Customers may refuse to pay, claiming that the transaction is not kosher with Shariah since there is an element of interest (Interview 3, Institution B, Manager, own translation).

6. Conclusion

The study highlights the importance of coming up with innovative solutions to deal with the hazards that Islamic microfinance institutions in Malaysia confront. For these organizations to succeed and endure, effective risk management is crucial. By highlighting the risks involved and emphasizing the value of taking into account a wider range of case studies in future research to improve risk management systems, the study adds to the field of Islamic microfinance. The results show that, in terms of disbursement and repayment procedures, both institutions are similarly susceptible to operational, credit, and Shariah risk. By postponing payments, the clients exploit Institution A's shortcomings. Human error was also possible when tasks were completed by hand and on paper. Moreover, Institution B is in danger of having its reputation ruined. It is therefore anticipated that by highlighting the risks faced by two institutions, risk management systems will get access to creative ideas to resolve the problems and inequalities.

7. Limitations and Future Research

The study has certain limitations, including the narrow emphasis on just two institutions. A wider variety of case studies could be used in future study to provide a thorough knowledge of the dangers associated with Islamic microfinance. The study could also investigate novel risk-reduction techniques and the effects of technical improvements on risk management in Islamic microfinance.

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