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Risk Mitigation in an Interest Free and Non-Speculative Financial System: A Critical Review and Regulatory Framework for Shari'ah Compliant Risk Management

Abstract *This paper critically and systematically reviews previous literature on Risk Mitigation in an interest free banking system. The paper, through a study of literature, identifies different forms of risks that are general to all financial institutions and are largely systematic. The review highlights unique risks and unique risk management practices which are specific to Islamic Banking and Financial system. The review enables us by highlighting the importance of the Islamic financial system in the form of real economic activity it performs, unlike the conventional financial system. The Islamic banking system does not permit the use of conventional risk management practices and therefore require risk mitigation practices that are distinctive and particular to Islamic Financial Institutions. A conceptual framework is proposed based on the review of literature proposing three main regulatory variables comprising of Shari'ah Compliant Prudent investing, financing and transactions, Separate Advisory of Scholars and, Integrated Accounting, Auditing and Financial Systems. All these three variables, when implemented, results inadequate capital for absorbing risks, Shari'ah Compliant business practices and monitoring and, identification and controlling of risk factors. This leads to managing unique risks particular to Islamic Financial System through policies and regulations, resulting in sustained profits of the business by avoiding adverse effects on institutions, thus ensuring long term stability and growth. Furthermore, methodology and directions for future research are discussed.*

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Introduction

Islamic Financial System

All the financial activities or the financial system carried on the basis of Islamic Jurisprudence and Islamic Principles are referred to as Islamic banking or Islamic financial system (Mounira & Anas, 2008). The roots of the Islamic financial system and its activities stem from the era of Prophet MUHAMMAD (PBUH) and have been in

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operation since then. Islamic financial system as opposed to the conventional system of financing, promotes asset-based real transactions. The essence of all Islamic financial transactions is risk-sharing and creating real economic activities based on asset backing. Unlike conventional finance, it is not restricted to just financing of funds and earning promised return without any reference to the real asset-backed economic activity performed on those funds (febianto, 2011). All the financing activities in the Islamic mode of banking and finance, including Musharakah, Mudarabah, Ijarah, Salam, Istisnah and Murahabah, are required to deliver real assets and are necessitated with the element of risk-sharing amongst financer and fund seekers.

Interest

Interest is the rent for money used by someone where time is a consideration for this rent (Usmani, 2010). The whole conventional finance is based on interest. It does not take into consideration whether the person with funds has gained or made a loss, but a fixed rate of return is taken from him irrespective of sharing profit or loss with him. As per the Islamic school of thought, this gives rise to unequal distribution of wealth. Because the person making the biggest of profits doesn't share these profits with the financer but provides a fixed return, while on the other side, the person getting a fixed return demands it even in the case of loss. Islam prohibits this and promotes a justifiable right for both the financer and the one using those funds in the form of Musharakah and Mudarabah.

Speculation

When the business is done in such a fashion that the gain of one is due to the loss of the other and gain and loss is purely a matter of chance, such activities are termed as speculations and are forbidden in Islamic jurisprudence. These are pointed similar to gambling and are prohibited as they promote injustice, inequity, and instability in the financial system as well as society. It is such an act where the one who gains through his skills can not provide evidence as to how he has made this gain(Al-Saati, 2003).

Unique Risks of Islamic Financial System

Risk is the negative deviation of actual results from one's expected outcome (Horne & Wachowicz, 2000). So, while taking on the business activities, the business organizations are always faced with financial risks in the form of Market risk, Credit Risk, Liquidity Risk, and Operational Risk. The essence of asset backing and real activity create certain types of risks which are distinct from risks faced by the conventional financial system. As the whole globe is working based on the conventional system of finance, the risks faced by all the financial institutions are based on something underlying principles. The institutions working under Islamic financial systems thus face risks, which are unique due to their nature of asset backing as well as their inability to use instruments used by conventional systems for minimizing those risks (Chapra & Khan, 2000). Islamic Financial Institutions face risks that are faced by other conventional financial institutions; in addition, they are faced with other risks that are particular to their mode of financing (Rajhi & Hassairi, 2012). According to them, these risks can be categorized into the following:

Rate of Return Risk

Islamic finance demands real activity, while conventional finance requires a return in

the form of interest. Therefore the expected return in the two formats of financing is different. In Islamic finance, the return is based on the investment made and is not on some pre-determined rate of interest. Therefore these institutions face this unique competitive rate of return risk not prevailing in conventional banking.

Commodities Price Risk

As the Islamic mode of finance requires real activity and real assets, this requires the banks to hold assets in Murabahah and Ijarah Contracts. Due to the holding of these commodities and inventory, a unique risk specific to Islamic Financial Institutions is faced.

Equity Risk

Islamic Institutions are not allowed to invest in debt instruments. Investment in the debt instrument has far lesser risk than equity due to prior claim and security backing. In the form of Mudarabah and Musharakah contracts, the Islamic banks have to invest in equity and have to properly monitor these investments, therefore increasing the liability with regard to monitoring of these investments.

Legal Risk and Islamic Shari'ah Compliance

Being a new industry, Islamic Financial Institutions are faced with the lack of specific Islamic regulations and are regulated on the basis of legal requirements developed for a conventional system. As a result, the Islamic Financial Institutions, at one end, have to follow the government regulations and at the same time have to abide to the principles of Shari'ah. This has further enhanced risks for carrying out Shari'ah-compliant operations.

Withdrawal Risk

Being in a similar form of business, the Islamic financial institution is competitively enforced to provide a similar return, but in Islamic finance, the deposits offer variable-rate, and therefore, the institutions are uncertain about the real value of deposits. This forms another type of unique risk for Islamic Financial Institutions.

In addition to the above-mentioned unique risks, Islamic banks also face all other risks faced by conventional banks, but its exposure is more for the reason that it can not use risk-minimizing instruments of derivatives due to impermissibility by Islamic Jurisprudence.

Risk Mitigation

The words Risk mitigation and risk management are used interchangeably, which means the process of coping with your risk faced in such a way to remain in the normal business earning normal profits and enabling long term stability Khan & Ahmad (2001). Risk management for Islamic institutions is quite distinctive from conventional measures due to its unique forms of risks (Iqbal & Mirakhor, 2007).

Significance of Study

The purpose of the study is to identify the knowledge gaps pertaining to Shari'ah-compliant risk management techniques and propose a theoretical/ conceptual framework

of risk mitigation in an interest free non-speculative financial system.

The literature review was started using a methodology of developing a database of relevant research papers to make it systematic. A literature review table was developed and populated through research papers using relevant columns. Writing the review of the literature was initiated simultaneously at the time of studying research papers and populating the literature review table. The main focus initially was looking at the abstract, Purpose, Methodology, Finding, Conclusions, and gaps. But confining one's self to these areas in the research for Islamic Finance did not serve the purpose, the area being very subjective. The whole research papers were required to be studied to get a complete insight of the picture. This required an understanding of Fiqh, Islamic terminologies, the real problem, and suggested solutions, etc. Most of the research was descriptive and kind of Library researches. The literature was studied critically to identify different gaps, similarities and dissimilarities amongst different research works. Similar researches were brought together under the same sections, and consequently, different sections and subsections were formed for the literature review.

Literature Review

Islamic Finance as a Viable Alternative to Conventional Finance

Grigorian and Manole (2005) found in a study from 2000 to 2005 that Islamic banks are efficient on the basis of efficiency scores from conventional banks, though conventional banks comprise very large sizes in relation to Islamic banks. The Islamic banking and finance industry has sustained its growth at 15% to 20% despite economic recessions in the European countries, while the conventional counterpart banks have really suffered during this period (Iqbal & Molyneux, 2005). Islam strictly prohibits riba and is precisely mentioned in 12 verses of the Holy Quran. Islamic financial system doesn't operate on a fixed return basis rather provides profit and loss sharing operations. In order to avoid the evils of fixed returns and interest, Islamic institutions invest in Shari'ah-compliant business activities to provide the return to its shareholders. These financial transactions include Wadiah, Mudarabah, Musharakah, Murabahah, Bai Bisaman Ajil, Bai Salam, Ijarah, Bai Al-Tajiri, Ujrah, Wakalah, Al-Qardul Hasan, Bai Istisna, Ar-Rahnu and Kafala etc. All of these transactions are a viable alternative for interest-based financial transactions of conventional banks (Jalil & Rahman, 2010)

Islamic Financial System Prohibits Financial Derivatives

Forward futures and options are largely used for the purpose of risk management and speculation. Though options involve very high speculation, and futures create confusion amongst fiqhs during business transactions as a result of its complexity, steps are needed to make them fully shari'ah compliant. This can be done through the use of Gold Dinar, through which speculation and confusion from the hedging activities can be minimized in the use of derivatives (Dali & Ahmad, 2005). In Islamic financial jurisprudence, forward and futures contracts are not permissible for the reason of forbiddance of future sale and no clear intention of delivery. Options are not permissible in Islam due to the premium of promise, while Swaps are held impermissible for one transaction being a precondition for the second. Shares can be purchased unless the core business undertaken by a company is Halal (Usmani, 1999). The use of financially engineered derivatives has been a cause of the global crises of 2007. Islamic financial system has a strong defense against such crises, and its essence is that the risk must be

shared amongst all the participants in an Islamic financial system. This defence of the Islamic financial system is not accidental but exists because of a complete set of rules, procedures and policies laid down by Shari'ah. Islam prohibits the speculative activities of derivatives and credit creation without the creation of real assets, which is indeed in favour of few and against the welfare of billions. Islam does not prevent the management of risk but allows for risk management within certain guidelines of Shari'ah (Alaro & Hakeem, 2011). The Islamic financial system is based on no risk no gain policy. Derivatives are said to be parallel of gambling.

Financial Innovation and Financial Engineering are Necessities for Risk Management in Islamic Financial Institutions

Salehabadi & Aram (2002) highlighted some similarities of Future contracts with compromise contract SOLH and Jo-aleh, which are permissible in Islam. They compared the operations of options with Islamic insurance, financial right and Bia Ul Urban, which are permissible transactions in Islam, thereby providing Islamic justification for legality of options. They emphasized the use of financial derivatives for risk management of price fluctuations in international oil markets for Iranian oil contracts. The mechanism of Islamic financial instruments of Bai Salam and Istijrar contracts is similar to the mechanism of derivatives in conventional finance (Bacha, 1999*)*. The importance of derivatives should be considered on the basis of their need and welfare benefits to the financial markets.

Islamic banks are basically commercial banks working as financial intermediaries with Shari'ah-compliant products. There has been an annual growth of 15 to 20 percent in Islamic banking, which is very positive but the problem is that, there has been a lack of financial innovation, which is a necessity for unique services as well as risk management practices. The conventional instruments cannot be used by Islamic Financial Institutions because of many Islamic problems. Murabahah is one of the major innovations and is a basis of many Islamic Financial Services. With the development of specialization and human resource capital in Islamic Finance and institutions, conventional and existing products along with newly developed Islamic products can be further polished and made Shari'ah compliant. There are a lot of opportunities for Islamic banks in the untapped markets with huge Muslim populations. A true Islamic financial methodology is the need of time (Noman, 2002).

There are four types of Gharar (Risk and uncertainty) explained by Islamic jurisprudence, which are prohibited Gharar, permissible Gharar, acceptable Gharar and mandatory Gharar. Some types of risks are permitted by Islam, not all are prohibited. Through research and developing instruments based on permissible Gharar in Islamic Jurisprudence, Futures Options and Swaps can be modified for its operation in the Islamic system (Al-Saati, 2003).

Financial Derivatives can be Engineered to Make Them Shari'ah Compliant Islamic Risk Management Instruments

Dusuki & Mokhtar (2010) studied and analysed the working of Shari'ah-compliant Swaps introduced in Islamic Financial Institutions and compared them to conventional Swaps. They found that the outcome and economic results of Islamic Swaps are similar to conventional Swaps. But Islamic Swaps should have a structure and substance that is Shari'ah compliant and which can't be used abusively. These profit rate Swaps are yet

to be seen and rechecked by the jurists in order to make them totally compliant with the true principles of Shari'ah. These Swaps can only be used for hedging and not for speculation by any means, should avoid bilateral promises and avoid combining of contracts. Financial derivatives can be matched with Bai Salam and Arbun which are permissible contracts in Islam. By making the derivatives a win-win situation rather than a loser and winner, derivatives can be used in an Islamic Financial System provided Gharar rules are not violated. Looking at the profit rate Swaps and comparing it with interest rate Swaps, it can be concluded that the end result for both is the same, so interest rate Swaps should be considered Islamically (Yankson, 2011).

Risk Faced By Islamic Financial Institutions Is Unique and So Are Its Risk Mitigating Techniques

Makiyan (2008), discussed the special operating risks faced by Islamic Financial Institutions due to operational issues in the use of special Islamic instruments such as Mudarabah in PLS, Salam and Ijarah in Non PLS accounts. They analyzed the general risks faced as a result of regulatory issues, including Lack of Lender of Last Resort Option and prevailing market conditions of lack of Islamic money funds, as a result of limited favourable space for working of Islamic Institutions. Capital Adequacy, Assets, Management, Earnings, Liquidity, and Market risks are identified important risk areas faced, particularly by Islamic Financial Institutions. Islamic Financial Institutions face unique risks (Credit, Liquidity, Market, Price, Credit and Foreign Exchange Risks) with different financing operations, including Mudharabah, Musharakah, Murabahah and Salam etc. Kayed & Mohammed (2009), represented a conceptual model for scanning, identifying, and monitoring risks and then analyzing how to deal with the risks faced through Shari'ah-compliant risk mitigation techniques. These risks can be minimized by the true implementation of PLS and proper capital adequacy for Islamic contracts. (Rosman 2009) provided a conceptual framework for risk management practices and aspects of the risk management process and tried to identify the relationship between risk management practices and aspects of the risk management process. He put forward four hypotheses for factors influencing risk management practices. Through empirical literature, he identified that there is a positive relationship of risk management practices with understanding risk and risk management practices, identification of risk, analysis and assessment of risk and monitoring of risks faced by Islamic banks. The study proposed to identify the relationship between different factors mentioned in the model and recommended identifying further factors that influence risk management practices.

The deviation of Islamic banks from their unique mode of operations of profit and loss sharing in Mudarabah and Musharakah towards Murahabah, Ijarah, Salam and istisna has led to an increase in risk, particular to Islamic banks. The role of risk management provided by Musharakah and Mudarabah modes of financing provides a solution to the problems of risks faced by Islamic banks (Febianto, 2012). Unique types of risks faced by the Islamic banks can be mitigated through three important variables that are, policies for financing, investing, and lending activities to cope capital adequacy, the separation of Shari'ah Board from management for minimizing the non compliance with Shari'ah issues, and an efficient information system to update the IBs about the relevant risks faced by the institutions, its monitoring and control (Zaki, Sattar, & Manzoor, 2011).

Rahman (2011), in his study, found that the banking industry has shifted its dependency for credit forwarding from demanding collateral to more sophisticated risk analysis and measuring tools. This requires the establishment of a data bank, industry averages and the capability of preparing projected financial statements. He argued that Credit concentration should be based on common risk factors, there should be sound credit assessment, and validation and testing techniques. There should be proper credit review, client and collateral valuation, proper stress testing techniques for business and product life cycle assessment, and a risk sensitivity pricing model for pricing credits.

Liquidity Risk Management in an Interest Free Financial System as Opposed to Conventional Institutes

(Mounira & Anas, 2008) argues that Islamic Financial Institutions face four types of unique risks in addition to conventional banks, namely commodities and inventory risk, rate of return risk, legal and Islamic laws compliance risk, equity position risk in the banking book and withdrawal risk. Identifying, measuring, managing and monitoring various risk exposures are among the main elements of the risk management process. Risk management requires the development of the regulatory framework, the development of regulatory institutions, Islamic mutual investment funds and the need for Islamic capital markets that can lead to better risk management practices. Islamic bank cannot use other hedging derivatives, though Sukuk is an option but is held for maturity. Islamic Takaful is also a source of risk management. Liquidity Risks in Islamic banks is raised by problems of 100% reserve requirements, no lending by central banks and inability to invest in short-term riba instruments. Designing of instruments for short-term liquidity like commercial paper, call deposits, bankers Acceptances T-bills, Govt and municipal bonds, and modification of interest-based instruments can be used readily in Islamic financial environment. The development of Islamic Money Market instruments and enhancing Islamic banks to work in more specialized areas of banking such as Interest-Free Investment, retail, wholesale banks, Islamic brokerage institutions, Dealmaker and Direct investment banks in which conventional banks are currently operating is a necessity for minimizing risk (Abdul-Rahman, 1999).

Shaikh & Jalbani (2009) identified the presence of Reputation risk, exchange risk, price risk, concentration risk, default risk, liquidity risk, religious risk and exchange risks with distinct features from conventional banks. Through six years of ROE data using Islamic, private and public sector banks, the value of r =.731 expressed a strong relationship between ROE of Islamic and conventional banks. They argued that Islamic banks with equity-based investment are better at managing their risk to remain profitable. By analyzing the relationship of liquidity risk with size of firm, Net-working capital, return of equity, return on assets and capital adequacy ratio of 12 banks with six conventional and 6 Islamic banks Akhtar, Ali, & Sadaqat (2011) found a positive relationship for both conventional and Islamic banks with size of bank and networking capital. They found a positive relation for return on assets with liquidity risk in Islamic banks while capital adequacy showed a positive relationship with liquidity in conventional banks and these relationships were significant.

In a study of liquidity risk in six Pakistani Islamic banks for data taken from 2006 to 2009, results showed the value of adjusted R square .713 implying size, age, tangibility, profitability and leverage to be important determinants of liquidity risk

(Ahmed, Ahmed, & Naqvi, 2011). Leverage, age and tangibility were found to be powerful explanatory variables.

Islam & Chowdhury (2009), described the comparative liquidity position of Islamic and conventional banks in Bangladesh using Islamic bank Bangladesh limited and AB bank limited. The data of two banks on liquidity was taken for 2003-2006. Islamic bank showed better management in liquidity on average. The regression analysis revealed that performance indicators such as P/E ratio, EPS, ROE, and ROA had an impact on extent of liquidity of both the banks

The Role of Islamic Banks as True Financial Intermediaries

Islamic banks uses four types of contracts on liability and asset side i.e. Mudharba, Musharakah, Quasi contracts (Salam,Ijarah, Murahabah, Istisna) and Mustajrar. The Mudharabah combination on asset and liabilities side is considered as the most appropriate (Khalid & Hamdouni, 2011) for financial intermediation with the rest recommended for use on a secondary basis.

Exposure to Risks Arising From Market Factors, Operations and Its Implications

Conventional risk measuring tools including scenario analysis and VaR, both measuring the impact of market risk factors on portfolio, can be used as a part of risk management for measuring the risk faced by Islamic banks (Hassan & Antoniou, 2008).

Data using interest rate and rate of return along with total deposits of conventional and Islamic banks of Malaysia revealed that Islamic banks are exposed to rate of return risks in dual banking as there is a profit motive, i.e. increase in rate of return increases Islamic deposits. Rate of return showed a positive relationship with interest (Zanol & Kassim, 2010). In a study identifying the relationship between macroeconomic variables of monetary policy with the volatilities in stock returns of Islamic and conventional stocks showed that the interest rate volatility had more impact on conventional stocks and insignificant impact on Islamic stock. Exchange rate is found to be a factor of instability in the Islamic stock markets. Monetary policy variables cause less instability in Islamic stocks as against conventional stocks (Yusof & Majid, 2007).

(V.Sundararajan, 2008) in his study of risk to investment account holders in profit-sharing investment accounts discussed the importance of investment risk reserves to cover the losses and profit equalization reserve to smoothen the returns. He argued that some minimum amount of profit equalization reserve and investment risk reserve is needed for risk-return combination to investment Account Holders. Islamic Financial Institutions are required to design a yield ratio for a combination of these two reserves and risk-return combination between the equity holders of bank and Investment Account Holders. These reserves which are created in good times are necessary for usage in bad business cycles to cover losses and to smoothen returns.

Findings from the Review

Islamic financial system is a viable alternative to conventional system. It provides the investor as well as the entrepreneur equal share in the massive profits earned by the business. Since its inception the Islamic financial industry has shown efficiency and stability in comparison to conventional system even in the economic meltdown which is

majorly caused by interest, uncertainty and speculation based financial system. Islamic financial system has its inbuilt feature of financial intermediation in the form of Musharakah and Mudharabah basis of financing. Though much more stable and efficient Islamic financial system faces risks that are general to all the financial systems. In addition it faces risks that are unique to its operations. These general and unique risks can not be managed through conventionally used instruments such as derivatives and short term debt instruments due to its impermissibility. This calls for innovation and financial engineering in the area of Islamic banking and finance. One of the important considerations for risk management techniques in the Islamic Financial system is by developing policies and regulations to proactively manage these unique risks.

Theoretical/ Conceptual Framework

It has been analysed that Islamic Financial Institutions face unique risks that are distinctive from risks faced by institutions working on the underlying principles of conventional finance. Islamic Principles do not allow the use of debt instruments which are necessary for liquidity management, nor does it allow the use of financial derivatives, which has been the biggest source of financial risk management. Risk management practices are not performed to earn extraordinary profits rather to remain in business and earn normal profits. So theoretically risk management practices should be to secure your business from adverse effects not to use those adverse effects to earn abnormal profits. On the review of literature, it has been assessed that as much of the conventional risk management practices can not be used in Islamic Institutions, there is a need for regulatory policies that can help monitor the risk factors, analyse them, take preemptive actions to minimize the risks thus ensuring long term stability and ensure long term growth through sustained profits. Less analysis has taken place in the area of Islamic Banking and Finance. There are methodological, empirical, theoretical and variable gaps. On the basis of the literature reviewed, I am proposing a conceptual framework for risk mitigation Islamic Financial Institutions given in figure 3.1. The first variable in the model is Shari'ah compliant Prudent Investing, Financing and Transactions. It is very important for Islamic Institutions to keep their transactions compliant with legal as well as Shari'ah principles. This will help them minimize the unique risks inherent in the asset-backed investment and financing decision as well as carrying out transactions such as Murabahah and Ijarah involving holding of commodities. Most of the time, Islamic Institutions have suffered because of noncompliance to Shari'ah and Prudential. Adopting this policy will enable adequate capital to absorb all types of credit, liquidity, operational and market risk. Through compliance Islamic Financial Institutions will also eliminate the risks that arise in Islamic banking due to manipulation of transactions.

The second important variable is separate Shari'ah advisory that is keeping the Shari'ah Board separate from the rest of the Board of Directors. This will actually take the form of a monitoring body and will actually control the compliance of activities to Shari'ah as an independent authority. This Board having a separate part from the rest of the banking operations will guide the transactions towards Shari'ah principles, thus enabling true economic activity, which is the essence of Islamic finance and considered more productive, efficient, and ethical in terms of justified and equitable distribution of wealth.

The third important variable is the presence of an integrated Accounting, Auditing and financial information system. This information system will actually incorporate much need market, accounting and internal control information and disseminate it to responsible authorities for required actions. It will enable monitoring, identification and control of risk factors and will enable timely decisions to cope with the risk that these institutions are facing. The information system will actually incorporate information about liquidity risk, credit risk and market risk and will enable filling gap of information asymmetry.

All these three variable will result inadequate capital, prudent business transactions and monitoring of risk thus mitigating organisational risk proactively which will result in securing normal profits of business and help Islamic institutions equip itself against negative deviations. This will lead to long term growth and stability of businesses.

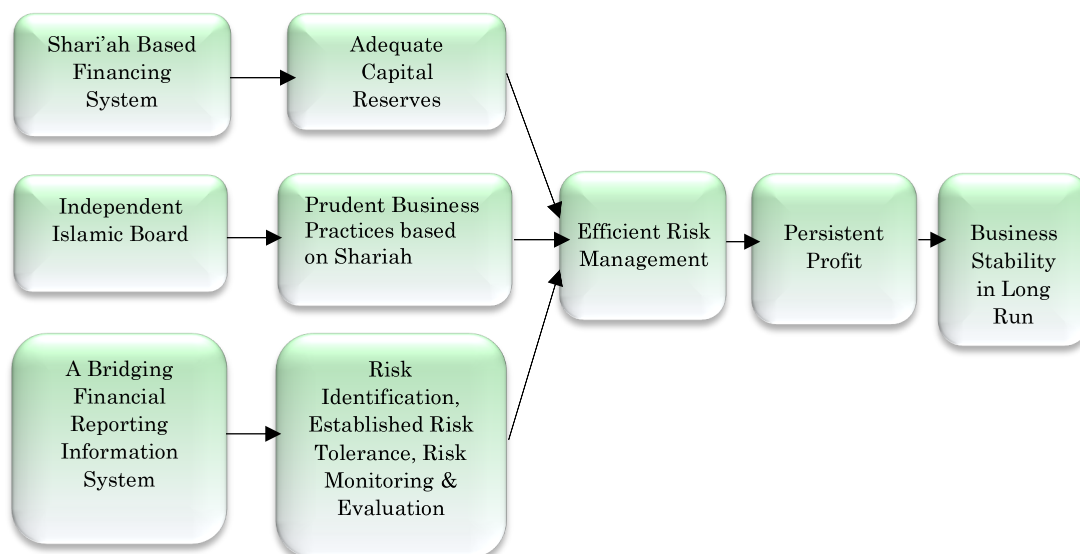

Figure 1: Conceptual Framework for Mitigating Risk through Policies and Regulations

Conclusions and Findings

Conclusion

The current economic crises prevailing throughout the world shows the requirement for a more suitable economic system. It has been witnessed that the financial system which has its roots in interest and which allows for speculation and uncertainty, as well as the creation of credit without asset backing, has resulted in injustice. Islamic financial system which eliminates all those activities and promotes asset-backed real economic activity promises equal and justified distribution of wealth. Islamic financial system, due to its unique mode of operations is faced with unique risks which must be countered in an efficient way in order to sustain the current stability of this interest free non speculative financial system. This review tried to address different options available to this Islamically justified financial system in the light of Islamic principles and jurisprudence, with a focus on avoiding any gambling, speculation and uncertain

transactions. It has been identified through an intensive study of literature on Islamic finance that Islamic principles in no way allow the use of derivative instruments such as futures, forwards and options. Additionally, it does not allow for the use of debt instruments to manage liquidity risk. It is further faced with risks like rate of return, commodity price, Shari'ah compliance, equity risk and withdrawal risk. The study identifies that given the current circumstances Islamic financial system being in its infancy with unique risks faced can be secured and stabilized through regulatory policies. These regulatory policies include adoption of Shari'ah-compliant prudential investing, financing and transactions resulting inadequate capital for countering risks , separate advisory Board of Islamic scholars for ensuring Shari'ah compliant business transactions and an effective accounting auditing and financial information system for monitoring, identifying and controlling risks. These measures result in risk mitigation which ensures sustained normal profits leading to long term institutional growth and stability. Further work needs to be done by applying a proper methodology to test the effectiveness of the proposed framework.

Knowledge Gaps and Directions for Future Research

Islamic Financial Institutions are facing problems of limited number of scholars giving rise to fatwa shopping due to overload of work. Easy fatwas for products and difference of opinions amongst scholars on many products due to sectarian issues are creating doubts in the investors' mind. There is a lack of centralized religious authority and Boards, a lack of qualified Islamic banking experts, lack of Islamic banking professionals who can better explain and innovate Islamic products. Islamic Financial Institutions are short of Islamic products and have artificially engineered products which don't truly comply with Shari'ah in spirit. Sukuk market is facing pricing and market sharing problems. Furthermore the use of LIBOR as a standard has raised questions for providing market competitive returns. There is a competitive issue of international markets making Islamic banks to follow other regulations along with Islamic regulations (Malik & Mustafa, 2011). Ultimately there is a need for product innovation rather than engineering conventional products. Obstacles of research in the area of Islamic finance are identified, including lack of study of Islamic history, absence of empirical findings, literature and studies, lack of cooperation at organisational level, plagiarism and proper vision of understanding the scenarios(Siddiqi, 2008). Not only in the area of derivatives and risk management but in the field of whole Islamic finance there is a completely open ground for research. Most of the researches done in the area of Islamic Banking and Finance have only elaborated the current practices of Islamic Financial Institutions and matched them with the literature available on Islamic Jurisprudence regarding permissibility or impermissibility of financial transactions. In addition, the research is mostly descriptive and lacks any existence of innovation, modelling, measurement and analysis. Shortly I can say there are only gaps and none empirical findings. A lot needs to be done for the future and success of Islamic Finance. Islamic finance is based on Profit and Loss as well as Risk Sharing. There are negligible financial instruments, products and techniques available for operations of Islamic Banks and for risk management practices. A researcher would wonder from where to take a start. There are issues of regulations, operations, instruments and products. Taking all the scenarios into consideration focus here is to propose a financially engineered model and product which can be used for operations as well as risk mitigation by Financial Institutions and investors.

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