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The role of Islamic finance in reducing financial risks

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Abstract

The study aimed to test the relationship between Islamic finance and financial risks, identify and explain the regulatory framework of Islamic finance, and clarify the financial risks resulting from financing operations. The importance of the study is that it represents a vision that allows the development of Islamic financing services and also diagnoses the characteristics of Islamic financing to combat financial risks. The problem of the study was how Islamic financing works to reduce financial risks.

The study adopted the descriptive and analytical methods. It reached that Islamic financing formulas are based on the provisions of Islamic law and There is a strong inverse relationship, where the more Islamic financing is used, the lower the degree of financial risk.

The study also made the following recommendations: Islamic banks should work to exchange experiences in risk management at the internal and external levels.,There should be sound and correct supervision of financial transactions through the adoption of a financial Shariah supervisory approach.,It is essential to adopt a diversification approach in Islamic financing formulas and not to be limited to a specific formula

✓ **Keywords :** financial, Islamic finance, risk, financial risks

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1. Introduction

It is well known that Islamic finance derives its origins, principles, and rules from Islamic law, which is a comprehensive and integrated approach that encompasses all aspects of human life and addresses them.

The concept of Islamic finance includes characteristics that can improve market discipline and support financial stability. Islamic financial institutions have emerged in the past four decades, primarily focused on providing financing, investment, and commercial opportunities that are in line with Islamic teachings.

These Islamic banks work to promote Islamic finance and help eliminate traditional finance by providing the appropriate Islamic alternative, which includes various types, instruments, and formulas of Islamic finance that are suitable for all diverse economic sectors.

One of the virtues of Islamic law is that whenever it closes a door that leads to evil, it opens a thousand doors to good. The prohibition of usury by the Almighty saying, "And He has forbidden usury," was accompanied by the allowance of trade by the Almighty saying, "And He has allowed trade."

The status of Islamic finance has been confirmed and Islamic banks have spread widely, with an increase in the volume of their financing activities.

Although the methods and activities of Islamic banks are based on real assets and not fictitious ones, and despite the distinctive principles and foundations of Islamic finance, this does not prevent them from participating with conventional banks in a number of financial risks, which, whether they are specific or general, have an impact on the activity of banks and obstruct Islamic financing operations.

The risks in institutions operating in the Islamic finance system differ from other institutions, as they face ordinary risks (inflation risks, exchange rate risks, liquidity risks, etc.), in addition to the risks specific to each Islamic financing formula. It can be said that there is no financing without risks.

Given that Islamic banks operate according to their rules and branches derived from the distinctive principles of Islamic law, they have the ability to identify the risks that appear with the application of Islamic financing formulas and to work to activate the process of managing multiple and diverse financial risks.

The research problem is: How can Islamic finance reduce or mitigate financial risks?

Hypothesis:

1. There are Sharia-compliant controls in Islamic finance that help to reduce the severity of financial risks.
2. Islamic finance has a positive impact on financial risks.
3. Islamic finance has no impact on financial risks, as it is similar to conventional finance.

Research objectives:

- To define Islamic finance products.
- To highlight the financial risks that banks face.
- To demonstrate the importance of Islamic finance in reducing the severity of financial risks.

Research methodology:

In our study, we used a descriptive approach to provide a descriptive picture of both Islamic finance products and financial risks. We also used an analytical approach in the applied study, using the SPSS program. We also used the Excel program to analyze the various numbers and ratios that we obtained.

2. **The concept of finance**

In Arabic, the word "تمويل" (finance) is derived from the word "مال" (money). It can mean "to give money to someone" or "to support someone financially" (Al-Sartaw'i, 1999)**.**

In financial terms, finance is the process of providing money or other financial resources to a person or organization. This can be done through a donation, an investment, or a loan.

3. **Definition of Islamic finance:**

Islamic finance can be defined from several perspectives, depending on the purpose of the presentation or writing. It may be based on the principles and ethics of Islamic finance or the objective of this activity. There are several definitions, including:

First definition: "Islamic finance aims to develop banking services and financial products to be compatible with the teachings of Islamic law" (Saba Fatima Al-Zahra, Economic Issue 32).

Second definition: Islamic finance means "providing tangible or monetary wealth, with the intention of profit for its owner, to a person who manages it and disposes of it in return for an income that is permitted by Islamic rulings."

Third definition: Islamic finance in the contemporary sense, can be said to be "a relationship between financial institutions in its comprehensive sense or institutions or individuals, to provide money to those who benefit from it, whether for personal needs or for investment purposes, by providing financial instruments compatible with Islamic law, such as murabaha contracts, participation, lease, istisna, salam or loan."

Fourth definition: Abdul Aziz Heikal defined it as "a set of actions and transactions that provide us with means of payment at any time there is a need for them, and this financing can be short-term, medium-term, or long-term (Farhan M. A.) .

Based on the above, it can be said that Islamic finance is a process of providing those in financial need with various financial instruments that are based on and comply with Islamic law and regulations, whether they are tangible or monetary, in return for a return that is permitted by Islamic law.

4. **Islamic financing forms:**

Islamic financing forms are multiple and can be divided into several different categories, some of which are based on the nature of the investment formula, that is, whether this formula is based on debt or profit and loss sharing. Some of them also depend on the terms of application of the formula from short, medium and long term.

4.1. Murabahah:

It is an agreement to sell at a price equal to the original capital, that is, the cost price plus profit with a specific fixed amount or a certain percentage In another definition of financing by Murabahah, it is known as a short-term financing tool, which is selling something at its price plus a certain increase(www.alriyadh.com_13-02-2023_11:43).

4.2.Salam

Definition of salam: A sale in which a buyer pays the seller a price immediately and in return the seller agrees to deliver the goods at a future date. The word "salam" or "salf" means providing capital (Al-Balouj, 2013).

The permissibility of salam is established in the Quran in Surah Al-Baqarah, in the verse 282, and in the saying of the Prophet Muhammad, "Whoever sells on credit, let him sell on credit with a known measure and weight and at a specified time."

4.3. Mudarabah : Mudarabah is a partnership in financing a specific operation, transaction, or project between two parties, one of whom provides the capital and the other provides the labor, with the profits divided according to the agreement and the capital owner bearing the losses in the event of no negligence on the part of the Mudarib (Abla Al-Maslaf, 2005/2006).

Mudarabah is very effective in mobilizing cash assets, integrating them into the economic cycle, and then converting them into productive investment through a joint company or institution (Islamic Financing Schemes as an Alternative to Traditional Finance, 2013)**.**

4.4. Istisna : Istisna' is defined as a contract between the client and the manufacturer, where the first party (the client) requests the second party (the manufacturer) to build or construct a project to which a profit is added, which is paid in advance in installments or on credit (Boukari Naima, 2020).

The contract of istisna' combines two characteristics:

1. The characteristic of salam, in terms of the possibility and occurrence of a sale that does not exist at the time of the contract.
2. The characteristic of ordinary absolute sale, in terms of the possibility of the price being an installment that does not have to be paid in full at the time of delivery, as in salam, because there is work in addition to the sale of materials, so it became similar to a lease, and it is permissible to delay the rent in a lease.

It is also possible for three parties to participate, in addition to the bank, the project owner, and the contractor, in a framework of a double istisna' in this format.

Istisna' is similar to the salam format, with the difference that the subject of the transaction is delivery, not the purchase of a commodity as it is, but manufactured materials that have been subjected to several conversion stages.

4.5. Musharaka : Musharaka is an agreement between two or more parties to combine their capital, work, or obligations for the purpose of profit.

In another definition, Musharaka is a contribution between two or more parties in the capital of an institution, project, or operation, with the distribution of the results (loss or profit) according to the agreed-upon ratios (www.albaraka_bank.dz consulté(14/02/2023))**.**

4.6. Lease:

In Islamic law, lease is a known benefit for a known period of time. It is the rent or leasing as it is known today. It means that a person rents something specific that he cannot obtain or does not want for certain reasons, and that is in return for a known wage that he gives to its owner (Boujlal, 1990)**.**

5. **Definition of financial risk:**

The financial risk dictionary of castineu defines it as "the loss that can be incurred as a result of uncertain changes (Ibrahim, 2021/2020)

Young and Smith see that risk is a local concept that can be quantitatively measured and that it creates potential losses.

It can be said that financial risk is the increase in exploitation risks due to borrowing, or it is the potential losses in the financial market due to the inability of current assets to cover the obligations of the institution, and it is a relative measure of the volatility of returns.

6. Types of Financial Risks

Financial institutions and businesses face a variety of financial risks, which can be classified into three main categories: credit risk, currency risk, and interest rate risk (Naoulou, 2022).

6.1.Credit Risk

Credit risk is the risk that a borrower will default on a loan or other financial obligation. This can lead to losses for the lender, such as the inability to collect the full amount of the loan.

6.2.Currency Risk

Currency risk is the risk that changes in exchange rates will lead to losses on foreign currency transactions. For example, if a company exports goods to a country with a weaker currency, it may receive less money for its exports when it converts the currency back to its own.

6.3.Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will lead to losses on financial instruments with variable interest rates. For example, if a company has a variable-rate loan, an increase in interest rates will increase the company's monthly payments.

7. Results and discussion:

In our study, we adopted the descriptive approach to provide a descriptive picture of Islamic finance in its forms and financial risks. We also adopted the analytical approach in the applied study using the SPSS program. We also used the Excel program to analyze the various numbers and percentages we obtained. The questionnaires were distributed randomly, and 30 valid questionnaires were recovered for analysis. Through the SPSS version 23 program, these data were analyzed in order to reach answers to the sub-questions and to deny or confirm the study hypotheses.

Reliability and validity of statistical tools for data collection (questionnaire)

Variables under test	**Number of items**	**Cronbach's alpha coefficient**	**Reliability of the questionnaire**
Questionnaire	27	0.786	0.886

Source: SPSS output version 23

The coefficient of variation

Since a five-point Likert scale was used, the range between the means in the table above was calculated by subtracting the smallest weight from the largest weight (5 - 1 = 4) and then dividing the result by the largest weight (4 / 5 = 0.8).

Based on the analysis of the questionnaire's axes, we obtained the results below. Through the weighted arithmetic mean for each paragraph, which was calculated by adding all the answers to this paragraph and dividing it by the number of questionnaires, we find that for each paragraph, it shows us the average answer for each question, which represents the general direction of the answer to this paragraph.

As for the variance, it is a "dispersion" tool. The variance value represents how far the answers are from the weighted arithmetic mean. The larger the variance value, the greater the difference in the answers. If the variance value is small, there is no significant difference between the weighted arithmetic mean and the rest of the answers.

correlation study

Using Pearson's correlation test at a significance level of 5%, the relationship between the variables (study hypotheses) was studied

the test hypotheses

Null hypothesis (H0): There is no statistically significant relationship between Islamic finance and financial risk at a significance level of 5%.

Alternative hypothesis (H1): There is a statistically significant relationship between Islamic finance and financial risk at a significance level of 5%.

Financial risks		
0,684	Pearson correlation test	**Islamic finance**
0,000	P-value	
30	Number of respondents	

Source: SPSS version 23

Based on the above test, the statistical decision is to reject the null hypothesis and accept the alternative hypothesis that there is a statistically significant correlation between Islamic finance and financial risk at the 5% significance level.

Since the correlation is significant, it is also a statistically significant and strong negative correlation. This means that as Islamic finance increases, financial risk decreases, according to the opinion of the respondents who were selected as a research sample.

To answer the main hypothesis, IBM SPSS version 23 was used, by performing a simple linear regression test on each of the variables

Fisher's test to determine the significance of the impact of Islamic finance and financial risk at a significance level of 5%

| Decision	P-value	Fisher's Test Value	Mean Squares	Degrees of Freedom	Sum of Squares	Model	Variables
Significant	0,000	24,674	1,644	1	1,644	Intercept	**Impact of Islamic Finance on Financial Risks**
			0,067	28	1,866	Residuals	
				29	3,510	Total	

Source: Output from IBM SPSS version 23.

According to the table, the p-value is equal to 0.000, which is less than 0.05. This means that we must reject the null hypothesis and accept the alternative hypothesis that there is a statistically significant effect between Islamic finance and financial risk at a 5% significance level.

Simple linear regression coefficients during the impact of Islamic finance and financial risk.

Coefficients Beta	coefficients	Model
(-) 0,684	1,552	**Constant**
	,6100 -	**Independent variable**

Source: Output from IBM SPSS version 23

Through simple linear regression analysis, a simple linear regression model was built.

By substituting Islamic financing with X and financial risks with Y, we have the following:

Y = 1,522 - 0.610 X

If Islamic financing increases by one unit, financial risk decreases by 0.610. However, if Islamic financing is equal to 0, financial risk is equal to 1,522.

The results of hypothesis testing:

Hypothesis 1: There are Sharia-compliant regulations in Islamic finance that help reduce the severity of financial risks. (Hypothesis confirmed)

Based on our research, there are rules and regulations based on Islamic law that govern Islamic finance in all its forms. These regulations, which rely on the principles of Islamic finance, help reduce the severity of various financial risks by adopting different methods for each form of Islamic finance. Therefore, the hypothesis is confirmed.

Hypothesis 2: Islamic finance has a positive impact on financial risks. (Hypothesis confirmed)

According to the analytical study of the questionnaire, a relationship was found between Islamic finance and financial risks. As the application of Islamic finance and the use of it increases, the degree and percentage of financial risks to which banks are exposed decreases. This is considered a positive impact of Islamic finance on financial risks. Therefore, the hypothesis is confirmed.

Hypothesis 3: There is no effect of Islamic finance on financial risks, as it is like conventional finance. (Unfulfilled hypothesis)

According to our research study, we have concluded that there is a fundamental difference between the Islamic finance system and conventional finance. It has been concluded that the financial risks resulting from conventional finance are much greater than the financial risks associated with Islamic financing. Therefore, the hypothesis is not fulfilled.

Through the analytical study, the researcher found that there is an effect of Islamic finance on financial risks. These risks decrease with the increase in the use of Islamic finance and increase when it is abandoned. Therefore, Islamic finance is not the same as traditional conventional finance in its impact on financial risks.

8. **Results:**

1. Islamic financing products are based on Shariah principles and are characterized by their flexibility, which allows them to meet a variety of financing needs.
2. The Pearson correlation test for the study of the relationship between Islamic financing and financial risk showed a statistically significant correlation between Islamic financing and financial risk at the 5% level.
3. The ANOVA test for the study of the effect of Islamic financing on financial risk showed a significant effect, meaning that there is an inverse and strong relationship, where the more Islamic financing is used, the lower the level of financial risk.

9. **Recommendations:**

1. Interest-based banking transactions should be avoided and replaced with legitimate transactions.
2. It is essential to adopt a diversification approach in Islamic financing formulas and not to be limited to a specific formula.
3. Increase the number of Islamic banks and financial institutions, while employing qualified and experts in Islamic finance.
4. Islamic banks should work to exchange experiences in risk management at both the internal and external levels, with sound and correct control of financial transactions through the implementation of financial Shariah supervision.

10. **Conclusion:**

Islamic banks and financial institutions are the most important financial institutions in the economic field, due to their extremely vital position in the country's economy and their modernity and modernity compared to conventional banks. Their activities and products are based on the provisions and regulations of Islamic law, which is in line with the Islamic community.

What distinguishes the Islamic financing system from the traditional usury system is its reliance on fundamentally different financing principles and methods. All Islamic financing formulas are compatible with the characteristics of Islamic banks, which gives them the ability to address financing problems by regulating the relationship between those with financial deficits and those with financial surpluses.

Banking operations are always accompanied by risks, especially financial risks, due to the nature of their work. Any changes and developments that occur in the banking system increase the degree of risk. This requires banks to pay more attention to the issue of financial risk and give it greater attention and keep it under their control because it is one of the things that most threatens the survival of banks and the continuation of their work.

This requires bank management to work to manage financial risks according to a specific model and to seek to identify those risks and contain them to maximize their returns, which is considered a measure of the success of Islamic banks that aim to make a legitimate profit in accordance with the provisions of Islamic law.

After our study of the topic of Islamic finance and its role in reducing financial risk, which may have some shortcomings, we propose the following topics as avenues for further study: the challenges of the Islamic financial system in the context of globalization or ways to activate Shariah supervisory bodies in Islamic banks.

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