Istisna` risk Management in Islamic Banks

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Abstract:
This study aimed to identify the policies and procedures applied in Islamic banks to manage the risks of the Istisna` model. To achieve this objective, a descriptive and a case study approach were applied to identify the risks that can arise from implementing this model, and the adequate plans to face them.

The study found that the Islamic bank faces many risks, when applying the Istisna` model, and by studying the case of Malaysia, it became clear that the country relies on several policies and procedures, such as using takaful insurance, guarantees, and adhering to the decisions and guidelines of the Basel Committee (BCBS) and Islamic Financial Services Board (IFSB).

Keywords: Islamic Banking, Istisna`, Risk Management, Basel Committee, IFSB.

(JEL) Classification: G21, G24, G28, G32

1. Introduction:

After a long series of banking crises that struck the international banks, the interest in the risk management department has increased until it has become one of the main departments in every bank. Risk management represents the main weapon for these institutions to maintain their activity and continuity by monitoring and identifying risks, appraising them and developing appropriate plans to confront them.

The banking business incorporates several risks such as credit risk, liquidity, operational and market risks. And the Islamic banks, in this regard, are not immune to the risks that surround this industry since they are a part of it, and with the great expansion they are witnessing in their activities along with the considerable development in their investment tools, Islamic banks are paying attention to risk management in order to preserve the renowned position they have attained as well as continuing to develop and grow to achieve their economic and social goals. And due to their distinctive nature, even if the risks they face may appear similar to those of conventional banks, they still differ greatly in terms of substance, how they occur, and how these risks are managed.

By analyzing the Istisna` model, we find that the Islamic bank applies this latter with the aim of achieving a return by manufacturing a commodity that it is received from the manufacturer, then resells it at a higher price to the final buyer (al-mustasni`). And as is the case in any investment, this return is accompanied by a certain level of basis risks, which arise from the final buyer or the actual manufacturer (al-sani`) or from the commodity itself.

1.1 Research Problematic:

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This study aims to answer the following question: **What are the policies and procedures taken to manage the risks of the Istisna` model in Islamic banks?**

1.2 Research importance:

The importance of this study stems from the developmental importance and the need for the Istisna` tool. This model is one of the contemporary tools that can be relied upon in financing major projects to achieve economic, social and environmental goals, and due to the size of these projects and the special nature of the contract, the risks deriving from them are of a high level, and this is what makes Islamic banks avoid this type of contracts and leans toward lower risk models such as murabahah. And on this account, it is important to know the type of these risks and how severe they are in term of impact. Along with figuring out the appropriate methods to confront them so that a starting base can be set in order to look for ways to develop this tool and reduce the risks surrounding it in accordance with Islamic Shari`ah, in order to increase the use of this tool in Islamic banks.

1.3 Research methodology:

This study relied on the descriptive and deductive approach to give a clear picture of the Istisna` contract, how to apply it in Islamic banks, the risks that accompany it, analyze their parts, and identify the appropriate plans to manage them. It also relied on the case study approach to shed light on Malaysia’s experience in managing this type of contract.

2. Literature review:

2.1 The conceptual framework for Islamic banks:

2.1.1 Definition of an Islamic bank:

The Islamic bank is a banking financial institution that collects funds and employs them in accordance with the rules of Islamic law in financial transactions. In which it does not deal with usury (Riba), and avoids in its investment and financing operations, activities that do not abide to the Islamic law, and works to direct its financial resources to the best possible uses (Al-Azazi, 2012, pp. 11-12).

Through this definition, it is noticed that the condition of not dealing with usury is not sufficient for the bank to be Islamic, because of the emergence of banks that do not deal with usury but are not Islamic ones. Rather, it must adhere to Islamic law in all its banking activities. In this context, Dr. Rafiq Al-Masry says: “These Islamic banks were not established only because RIBA is forbidden, but rather they were established in order to implement Islam with all its orders and prohibitions in their fields of work.” (Irshed, 2007, p. 14).

2.1.2 Models of financing in Islamic banks:

A. Salam:

A Salam contract is an agreement to purchase a particular commodity in a specific quantity, quality and price, to be delivered on a date that is determined in the future. And the price is paid the moment the contract is established, or in a period that does not exceed three days. On top of that, the Islamic bank can support the Salam contract with a parallel one to sell the purchased commodity on the first contract for a customer other than the original seller, in order to cover the price and storage risks associated with the first contract (Al-Azazi, 2012, p. 29).

B. Murabahah:

It is a sale contract between two parties; one of them sells a commodity to the other party in exchange for a specific price and a known profit margin, while the second party pays for the commodity either immediately or in pre-determined installments (Muhareb, 2016, p. 555).
C. Mudarabah and Musharakah:

Mudarabah is a model that combines financing on one side and work on the other side with the aim of making a profit. It is a contract between a party that has funds and wants to invest it and another party that has the ability and desire to engage in economic activity but does not have funds. In a mudarabah contract, the Mudarib does not bear the loss except in the case of infringement or inadequacy, and therefore the owner of the money bears it entirely, but in the case of profit, a certain percentage is determined for the Mudarib (Muhareb, 2016, p. 675).

In Musharakah, it can be defined as a contract between two or more parties to participate in creating a capital with the purpose of entering into specific projects in order to make profit. In this contract, the loss is according to the share of each partner in the capital. So Musharakah differs from Mudarabah in that it requires financing from all partners, but in mudarabah, the financing is provided by one party (Al-Ajlouni, 2008, pp. 223-224).

D. Ijarah (leasing):

Ijarah contract is a partial sale contract for a benefit that is derived from the rented asset in exchange for a specified price in a fixed period, and the contract does not include the sale of the asset itself (Al-Ajlouni, 2008, pp. 260-261).

E. Istisna:

It is a contract for the sale of a described commodity, in which the characteristics of the commodity to be manufactured are specified, and the seller who is called a manufacturer (al-sani”) is obliged to manufacture it with his own preliminary materials and delivers it at a specific date in the future, and the buyer who is called "al-mustasni" is obligated to pay the complete cost immediately or later, or even in installments (Ali, 2010, pp. 117-118).

2.2 Risk management in banks:

2.2.1 Definition of Banking Risks:

According to the Banking Regulatory Commission of the Banking Sector Authority in the United States of America, banking risk has been defined as: “The possibility of the loss occurring either directly through losses in businesses or in capital, or indirectly through the presence of restrictions that limit the bank’s ability to Achieve its goals and objectives” (Bourakba & Zerargui, 2015, p. 94).

Through this definition, the concept of risk in the bank relates to the possibility of facing adverse effects in the future that hinder the bank from achieving its objectives.

2.2.2 Risks facing Islamic banks:

A. General Risks:

- Credit risk: This risk is defined as those financial losses resulting from the customer’s inability to fulfill his obligations within specific deadlines (Hashad, 2005, p. 22).
- Market risk: It is the risk that arises from dealing in markets as a result of focusing on one segment of customers or focusing on one sector. Market risks also arise because of fluctuations in stock prices, exchange rates, and commodity prices. Islamic banks may also get indirectly affected by changes in Interest rates, although they do not deal with them, since they are sometimes used as a scale to determine the prices of their products (Mohammed, 2020, pp. 135-137).
- Operational risk: The Basel Committee on Banking Supervision defined this type of risk as “The risk of losses arising from inefficiency or failure of internal processes, people and systems, or arising as a result of external events. This definition includes legal risks, but excludes strategic risks and Reputational risk”
- Liquidity risk: defined by the Islamic Financial Services Board (IFSB) as: "The risk of potential loss to the institution arising from its inability either to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses." (IFSB, 2020).

B. Risks related to Islamic banks:

- Displaced Commercial Risk: In some cases the Islamic bank is unable to compete with the returns provided by competitors, and in order to avoid withdrawing its funds (Guendouz, 2012), the bank, as a Mudarib, donates a part of its profits 'share for the benefit of investment accounts holders in order to support their rightful profits (IFSB, 2020).

- Confidence risk: This type of risk issues when depositors think that the low return is due to infringement or inefficiency from the bank. Trust risks may also result from lack of full compliance in the application of contracts within Shari’ah rules, which leads to losing customers' confidence in the bank and thus the tendency to withdraw deposits (Guendouz, 2012).

2.2.3 Definition of risk management:

Risk management is an essential part of the strategic management of any organization, and it represents the procedures and policies applied in institutions on a regular basis in order to deal with the risks that accompany their business. These procedures are to provide appropriate tools to identify risks, assess them, estimate their effects along with developing feasible and effective plans to avoid, control and mitigate them or if possible, Eliminate their sources and at the lowest costs (Belazzouz, Guendouz, & Habar, 2013, pp. 44-46).

2.2.4 Risk Management Policies (Abu-Shahd, 2013, pp. 212-215):

Banks follow several preventive and remedial policies and methods to face banking risks, and they can be divided as follows:

- Avoidance of risk: This policy consists in taking decisions to limit or stop an activity that involves large intolerable potential losses.

- Transferring the risk: This method is one of the remedial or mitigating measures and is intended for another institution to bear the risk on behalf of the bank, such as insurance companies.

- Preserving the risk: it takes place when the company fails to prevent the risk from occurring or to put an end to it (if it does happen), and this can be a result of neglecting the risk or not discovering earlier. Or in other cases, preserving the risk can be decided by the manager after being sure of the company’s ability to withstand this risk.

- Diversification policy: This policy means that the investor diversifies his assets and applies the principle of "Do not put all eggs in one basket". Through diversification and investing money in multiple sectors, risks are greatly reduced.

2.3 Istisna’ risk management in Islamic banks:

2.3.1 Application of the Istisna’ model in Islamic banks:

An Islamic bank, when applying Istisna’ model, can be a manufacturer (al-sani’) or a buyer (al-mustasni’), it is a buyer when it requests industrial products with specific descriptions, and it is a manufacturer when companies or establishments request specific products from it and in this case, the bank can use its own companies and factories to produce these manufactures or contracts with another manufacturer (Irshed, 2007, p. 122).

There is also other situation where the bank can be a manufacturer and a buyer at the same time, by
applying the so-called parallel Istisna’, in which the bank concludes a contract of Istisna’ as a manufacturer with a client who requests a specific product, then the bank goes and concludes another one as a buyer and asks the manufacturer to make the commodity agreed upon in the first contract with the same Specifications. And for this process can be considered valid, the first contract ought to be separated from the second, so that Istisna’ is not a ruse for usury (Samhan & Mubarak, 2009, p. 206).

2.3.2 Practical procedures for implementing the Istisna’ contract in the bank (the popular method) (Ali, 2013, pp. 223-225):

The application of the Istisna’ model in Islamic banks goes through several practical procedures, which are as follows:

- Submitting the application: The first step of the Istisna’ contract begins with submitting a request from the customer to manufacture a commodity or build a property using the Istisna’ model, by filling out a form submitted by the bank that includes all the details related to the commodity, including specifications, quantity, price, date of delivery and payment.

- Collecting information: The bank requests a set of documents related to the source of income, its accounts, financial statements, the commercial registry and its dealers, and the bank can also make a field visit to the customer’s location.

- Study the request: At this stage, the bank studies the customer’s request from an economic and credit point of view by analyzing the market and studying the customer’s case to ensure his ability to fulfill his obligations. The bank also studies the nature of the process, the possibility of implementation, its profitability and its compatibility with the policy of the banking institution, in addition to the time of payment. On the other hand, the bank studies the manufacturer who performs the operation in terms of experience, efficiency and good reputation, and in terms of the conditions that have been reached regarding the price and delivery time, and in the end, a report is issued to be submitted to the decision-makers.

- After studying and discussing the report, the appropriate decision is taken, and in case of approval, the contract is drawn up and signed by the bank as the seller in the first Istisna’ contract, and as a buyer in the parallel one.

- After signing the contracts, there is an implementation and follow-up phase, and considering that the bank will not be the actual manufacturer of the commodity, its role at this stage is to follow up all steps of execution so that it can check their reliability and can use in this regard a consulting office. The process also includes receiving what was inspected; deposit the payments and collecting installments.

- In the end comes the liquidation and accounting stage, in which the works are approved by the consulting office, the bank and the client to finalize the delivery process of the commodity to the bank and then to the customer.

2.3.3 Risks of the Istisna’ model:

When an Islamic bank enters into an Istisna’ agreement, it may face a set of risks related to the customer, the manufacturer, the producer, and the duration of the contract. The risks that arise from this model can be classified into credit risks, operational risks, market risks and liquidity risks.

A. Operational risk:

This type of risk appears in the contracting and implementation phases, in which the contract is required to be clear in terms of rights and obligations, without any ambiguity in order to avoid deception and fraud. Operational risks may also stems from a difference in the interpretation of the information
available by the contractors, or disparity in information (Bourakba & Zerargui, 2015, pp. 104-105). Furthermore, these risks may arise if the customer, the contractor (actual manufacturer) and their credit study have not been queried thoroughly. This also applies for reviewing the contents of the customer’s request in terms of specifications and the nature of the customer’s activity (Suleiman, 2017, p. 80). And so, if the bank was not vigilant enough, it will be exposed to legal and credit risks or even liquidity ones.

**B. Credit risk:**

The bank's application of the Istisna’ model can make it even more exposed to credit risks since the Istisna’ model is characterized by postponing the commodity's delivery. And so the risks here stems from the possibility that the product will not be delivered within deadline and with the required quality due to an emergency such as the occurrence of natural disasters (Nazzal & Al-Wadi, 2010, pp. 236-237). In addition to the actual manufacturer, the bank can face a problem from the final buyer's inability or failure to fully stick to his obligations towards the Islamic bank on the date that was agreed upon (Eid, 2011, p. 276). And the bank may also face a problem with the buyer or the actual mustasni’ when the latter decides not to receive the commodity (manufactured) if the Istisna` contract is non-binding (Ali, 2014, p. 167).

**C. Market risk:**

Market risk arises due to inflation or fluctuations in prices at the stage of preparation of unfinished and non-billed products, and it may also arise when the contract provides for the possibility of adjusting the selling price to the bank (Guendouz, 2020, p. 60).

Moreover, the financial institution is exposed to market risk due to the price of the commodity or asset that may undergoes some changes at a later date and thus differentiate the specified nominal price with the market one (Akkizidis & Khandelwal, 2008, pp. 63-66).

Besides commodities, these risks also arise due to exchange rate fluctuations in the case the first purchase was dealt with a certain currency, then selling in another one within the parallel Istisna` framework (Al-feel, 2019).

**D. Liquidity risk:**

The bank falls into such predicament in case the manufacturer fails to deliver the product or when he does deliver it but beyond time limit and as a result the bank will not be able to sell it to the final buyer at the right time, which may expose it to liquidity risk as the bank expects a cash flow that will not be obtained at the date of the future sale, this may lead the bank into facing reputational risks by not committing to its obligations with the clients (Akkizidis & Khandelwal, 2008, pp. 63-66).

### 2.3.4 Istisna` risk management methods in Islamic banks:

An Islamic bank can implement several policies and plans to avoid and address the various risks it faces when applying the Istisna’ model, the most prominent of which are the following:

**A. Education, Development and Training:**

Leaning towards scientific research and training is a necessary and inevitable step for the Islamic bank in order to face various risks, especially operational risks, as the qualified and trained human factor is one of the most prominent problems facing the Islamic bank. And in light of this, Islamic banks organize internal and external training courses and activities that cover various job levels, and the training activity takes two dimensions: The first one concentrate on the Islamic behavior of the worker at both levels, and focus on the personal and professional behavioral side and on the job side.

In another context, Islamic banks attach a huge importance on banking research and studies that
help them develop new financial tools and enhance their employees’ skills. Some of these banks hold numerous conferences and seminars on Islamic banking, with the aim of finding a solution to the difficulties that face the Islamic banking business (Al-Jamal, 2016, pp. 272-277).

B. Create an Inquiry model:

In order to avoid operational risks, the bank must make two models to inquire about the buyer and the contractor. For the mustasni’, the model must include information to verify his reputation such as the type of his company, its legal form, customers and suppliers, and on top of that, his financial position and the efficiency of his capital to make sure of his ability to abide by contracts.

As for the contractor, the model must also include information related to his reputation, in addition to his previous projects and the extent of his commitment to the timetable for their execution (Suleiman, 2017).

C. Legal Advice:

The bank must review contracts with the help of the institution’s legal department and in case the bank got into some large projects, it must rely on an external legal advisory office that has the adequate experience in studying large contracts, and this is in order to reduce legal risks (Suleiman, 2017).

D. Choose the right item:

Assuming that the bank is a buyer, then when implementing the Istisna` model, the bank must take into account how in demand the commodity is and the number of markets that can be entered to sell it and the commodity must not be rapidly obsolete, so that the bank reduces costs and avoids the risks of preservation and storage. There are also cases where the commodity requires maintenance, so this must be kept in mind when choosing the manufacturer, as certified maintenance centers must be available (Ali, 2013, p. 221).

E. Make a technical study of the project:

Before the bank accepts the Istisna` project of a commodity, it must first ensure the availability of raw materials and the stability of their prices during the completion period, as well as guarantee the availability of efficient and productive manpower. Additionally, the bank must evaluate the project in terms of its compatibility with the environment and ensure that the project is not affected by it or have some adverse impact on it (Hammad, 2008, pp. 202-204), as these procedures are considered a way to avoid risks of price fluctuations or business interruption, as well as to avoid legal risks that may arise from lawsuits that may be filed against the bank in case the project had some harmful effects on the environment.

F. Risk insurance with Islamic insurance companies:

The Islamic bank can resort to insurance companies in order to mitigate the effects of risks for the sake of cooperating with others in bearing risks, in which a collective contract is signed where all participants are obligated to pay a specified amount of money as a donation to compensate those affected on the basis of solidarity when the risk takes place. And thus, the bank that belongs to these companies, benefits from the compensation for the loss or deficiency in profit (to a certain limit) with insurance funds (aldammagh, 2012, pp. 134-135).

The Islamic bank in the case of Istisna` will bear several risks, including the risk of storage, after the commodity is delivered by the manufacturer and before it is delivered to the final buyer. And to face this risk, the bank can benefit from Takaful of goods in order to cover the expected losses during the storage phase (UAC, 2020), and therefore the bank will handle part of the loss if it occurs, provided that
the Islamic insurance company bears the rest (Eid, 2011, p. 662).

G. Monitor the stages of completion:
To prevent the bank from not fulfilling the customers’ demands that were agreed upon, it can establish a separate engineering department or assign an external specialized expert to evaluate the completion process and monitor the technical aspects, or the bank can request the final buyer to personally perform the monitoring process from time to time. So that he can make sure that the specifications he demanded are being followed diligently (IFSB, Guiding Principles IFSB-1, 2005, p. 10).

H. Diversification policy:
The bank ought to implement a diversification policy that enables it to reduce risks without affecting the return. This policy can be applied by investing in several economic sectors to avoid shocks and entering global markets that may contribute to hedging against Exchange rate risk. This policy can also be applied by diversifying the entitlement dates, since this matter is important in facing the inflation risks that arise from long-term contracts (Ali, 2014, pp. 175-177).

I. Parallel Istisna` or Promise to Purchase:
The parallel Istisna` or obtaining a promise to buy can be used as a tool to reduce the risks of changing commodity prices, when the commodity price drops after the Islamic bank have already signed the contract for instant (UAC, 2020).

J. Securitization in sukuk:
Securitization in sukuk is considered one of the innovative financial tools for risk management in Islamic banks, where the bank issues securities based on assets from projects on the basis of investment contracts, then sells them to investors, and thus the risks of these projects are transferred to them instead of bearing the risks alone (Belazzouz, Guendouz, & Habar, 2013, p. 390), and the Islamic bank can rely on this strategy in order to manage the risks of the Istisna` contract, given that the bank assets, based on this contract, can be subjected to Securitizations (UAB, n. d).

K. Create entitlement tables and classify cash flows:
The bank can hedge against liquidity risk, using maturity ladders based on appropriate time bands (IFSB, 2005, p. 20), and cash flows can be divided according to predetermined cash flows in terms of entitlement date and quantity as is the case with murabahah and ijarah contracts, and it can also be classified according to conditional and expected cash flow such as flows arising from Istisna` contracts, which depend on the completion of obligations, work and fulfillment of terms and conditions within a specific time frame and as agreed upon with the counterparties. The bank can also classify cash flows into conditional, but unpredictable flows, these flows are related to participation in capital same as musharakah and mudarabah, in which , the recovery of the invested capital and the potential return depend on the activities’ financial results in which the investment was made (IFSB, 2012, p. 22).

L. Commitment to the capital adequacy ratio:
The capital adequacy ratio is an important indicator for assessing the financial wellbeing of the bank. Capital adequacy is a safety valve to protect depositors from risks arising from banking business (Eid, 2011, p. 467). In order to maximize the return, the bank will engage in activities with high returns and risks, and thus the bank needs strong capital in order to support those risks and maintain its stability, and based on this strong relationship between capital and risk, the Basel Committee issued a set of decisions related to the criterion of capital adequacy, in which it set the minimum coverage percentage for risk-weighted assets, which was 8%. After that, it issued an amendment in 1996 that includes calculating
capital to cover market risks, and in 2004 it added a new adjustment to the ratio, that deal with the importance of capital preservation in covering operational risks (Hashad, 2005, pp. 29-30).

Given the distinctive nature of Islamic banks and the need to adapt them to Basel standards, the IFSB provided capital adequacy criteria to complement the Basel guidelines and meet the characteristics of Islamic banks. And so the Board focused on developing a better framework for capital adequacy in which it addresses the risk profile of Islamic banks and determines their appropriate weights for each item of assets, which differ from the assets of interest-based banks (Hassan & Mollah, 2018, pp. 234-243).

As for the Istisna` contract, and in view of the many high risks that may accompany it, the bank may be forced to maintain high levels of capital (Paldi, 2014), and according to the IFSB, the weight of the Istisna` credit risk is determined in most cases according to the classification of the final buyer by the accredited external credit rating institution that is approved by the supervisory authority. And in case the buyer is not classified, a risk weight of 100% is determined. There are other situations where the supervisory selective classification criteria for specialized financing (project financing) is relied upon, whose risk weights range between 70% and 250%. With regard to market risks, a weight of 20% can be applied in order to face price risks when applying the Istisna` contract without the parallel Istisna` when the bank is a seller and the weight of 187% when the bank is a buyer (IFSB, 2013, pp. 80-83).

3. A case study of Malaysian Islamic banking:
3.1 The reality of applying Istisna` contracts in Islamic banks in Malaysia:

The Istisna` contract is considered one of the financing methods approved by Islamic banks in Malaysia, to the extent where the total financing at the end of the second quarter of 2022 reached an amount of 680 million Malaysian Ringgit, but despite that, and compared to the rest of the formulas, the amount of Istisna` financing is very small, as it did not exceed 0.1% of the total financing, which exceeded more than 748 billion RM. The reason for the lack of reliance on the Istisna` formula is due to the complexity of this formula, in addition to the bank’s exposure to various types of risks associated with the implementation of the contract in all its stages (IFSB, PSIFIs Data).

3.2 Istisna` contract’s risk management in Islamic banks in Malaysia:

The various and high risks that arise when executing the Istisna` contract prompted the Malaysian Central Bank (Bank Negara) to shed special light on this contract, in which the bank allocated a number of procedures that would reduce the risks of this contract and enhance the bank’s ability to absorb losses. If they occur, these procedures can be divided into preventive procedures and remedial procedures.

3.2.1 Procedures to prevent Istisna` risks:

In 2015, the Central Bank published a document containing a set of policies and procedures that help Islamic banks manage the risks of this contract, which became effective from July 2016. Among the procedures adopted by the bank, the document included the possibility of Islamic banks adopting, before executing the contract, a set of guarantees that may contribute to mitigating risks, we can mention: Guarantee ( kafalah), pledge ( rahn), earnest money ( orboune), security deposit (hamish jiddiyah), takaful coverage, parallel Istisna`.

Using takaful coverage, the Islamic bank is allowed as a seller (Sani`) to ask the purchaser to participate in Takaful coverage so that the bank guarantees that it will receive its dues in case the purchaser is unable to pay.
With the aim of paying the agreed price for the Istisna’ asset within the agreed time, or with the aim of delivering the Istisna’ asset by the seller (Sani’i) that meets the agreed specifications and within the agreed time, the Central Bank made it possible to arrange a guarantee contract as a third party along with the Istisna’ contract.

The bank can also link between the Istisna’ contract and the guarantee (Kafalah) by adding another contract called wakalah, in which the customer requests the property under manufacturing from the Islamic bank, and the latter authorizes a client who will be responsible for appointing the contractor who will complete the property under manufacturing, and in the third step, the client or the third party guarantees the contractor to perform the obligations agreed upon (Bank, 2015).

**Figure (01): The stages of implementing the Istisna’ contract with the wakalah and guarantee contract**

3.2.2 Implementation of Basel guidelines:
In order to cover the risks arising from the implementation of financing contracts in compliance with Islamic Shari’ah, the Bank issued in 2019 the latest document regarding the calculation of risk-weighted assets. This document is in accordance with Basel II guidelines regarding the denominator of the capital adequacy ratio.

This document included procedures for determining risk weights for Istisna` contracts, with the aim of calculating the risk-weighted assets of the credit risks resulting from the Istisna` contract, in which it is requested from the Islamic bank in accordance to the standard method, to allocate the appropriate risk weight for the asset associated with the Istisna’ contract according to the exposure category and the risk classification within each category, for example with regards to the bank’s exposures related to the Malaysian state and the Central Bank of Malaysia, the Islamic bank is allowed to allocate a preferential risk weight of 0%, considering this category as non-risky, and for exposures to other government agencies and central banks, it is considered low risk, and a weight ranging between 0% and 20% is determined, As for the rest of the categories, such as governments that do not meet the conditions of the first and second category, and other companies and banks, the risk weight ranges between 20% and 150%, where the weight is determined according to the customer’s credit rating within each category.
Regarding the operational and market risks arising from the Istisna’ contract, the Central Bank has identified several methods for calculating the capital requirements to cover these risks, where it defined the basic indicator approach, the standardized approach, and the alternative standardized approach for estimating operational risk, and it defined the standard method and the internal models approach for estimating market risks (Bank N., 2019).

Calculating the capital charges to cover these risks allows Islamic banks to estimate the size of the risks related to the operational and market risks arising from various contracts, including the Istisna’ contract, in which the value of the capital charge is multiplied by the reciprocal of the minimum capital adequacy i.e. 12.5, Then, the result is added to the credit risk-weighted assets, thus, obtaining the total value of risk weighted assets, which constitutes the denominator of the capital adequacy ratio (BIS, 2004), and here, the Central Bank requires Islamic banks to cover the total regulatory capital in accordance with Basel III, the total risks, by a rate of not less than 8%, along with an additional capital that consists of Common Equity Tier1 CET1 and it covers what is estimated with 2.5% from total risk weighted assets (Bank N., 2020) which is called capital conservation buffer (BIS, 2019).

**Figure (02): The reality of applying capital adequacy according to Basel 3 in Malaysian Islamic banks**

Looking to the reality of applying these preventive measures, figure (2) shows that Islamic banks in Malaysia have achieved high ratios in terms of total capital adequacy. In which it ranged between 17% and 19% in the period between 2017 and the second quarter of 2022. It is comfortably above the requirements of the Central Bank and the Basel Committee; this means that Islamic banks have the ability to cover up to 19% of the total credit, market and operational risks arising from Islamic financing contracts, including the Istisna’ contract.

4. Conclusion:

Islamic banking include various types of risks that conventional banks face, such as operational risks, credit risks, market risks and liquidity risks, however, these risks differ in terms of their nature, their source and how to confront them which stems from the distinguished nature of Islamic banks activities, When applying the Istisna contract in Islamic banks, the bank is exposed The four main risks mentioned above, these risks for that matter arise according to the nature of the contract from the buyer or the actual manufacturer or from the contracted commodity, because the bank may be a seller, a buyer or both at the
same time. In addition, the method of dealing with these risks differs from the traditional methods, as the nature of the contract and the Shari’ah controls that Islamic banks adhere to must be taken into account.

And well, this study aimed to identify the various methods and policies that Islamic banks rely on to confront and manage the risks arising from them. The study concluded the following results:

4.1. Results:
- When applying the Istisna` model, the Islamic bank faces the general banking risks associated with the final buyer, the actual manufacturer, or the commodity to be manufactured.
- To avoid risks, Islamic banks contract with legal and engineering offices and resort to information forms before entering into a project based on an Istisna' contract. And they can rely on entitlement tables and classification of cash flows in order to avoid liquidity risks.
- In addition, the bank resorts to strengthening contracts and securing them with guarantees and additional contracts. It also resorts to Securitization to transfer risks.
- The bank resorts to contracting with the Takaful insurance companies in order to mitigate the effects of the risks it faces, especially in the field of goods’ Takaful, to cover the potential losses that the bank is exposed to in storage or transportation stage.
- The Central Bank of Malaysia allows the possibility of resorting to the protection of contracts through contracting with Takaful insurance companies, or linking the Istisna` contract with wakalah and guarantee contracts.
- Islamic banks in Malaysia are committed to applying the decisions and guidelines of the Basel Committee and the Islamic Financial Services Board related to risk weights and the capital adequacy ratio to cover credit risks, operational risks and market risks, so that they rely on Basel 2 guidelines to estimate the size of the risks related to the Istisna contract, while they depend on Basel 3 guidelines in capital formation.

4.2. Recommendations:
- The expansion of Islamic sukuk will put Islamic banks in front of more risks. This matter requires more efforts from Islamic and central banks along with international Islamic financial bodies, in order to develop methods and solutions so that they can manage sukuk risks, especially in light of the lack of recognition by the Basel Committee of this type of financial tools.
- those working in the field of Islamic financial engineering are required to think outside the box and stop thinking about traditional hedging methods and trying to adapt them, in order to avoid falling into the cycle of usury, and moving away from the jurisprudential debate.
- It is incumbent upon Islamic countries to take serious steps to activate the Islamic financial market in order to provide the appropriate regulatory environment to enhance dealing in Islamic bonds, and thus increase the opportunities of Islamic banks to reduce their risks, especially with regard to liquidity.
- Islamic banks must exploit technological systems and take advantage of their many benefits that facilitate the process of risk management, as the information base and software are very important in the processes of inquiry and credit study, reducing human errors, implementing an effective diversification policy and achieving an optimal investment portfolio using artificial intelligence technology.

5. Bibliography List:


