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COMPARATIVE EXAMINATION OF RISK IN ISLAMIC AND CONVENTIONAL BANKS: AN EXTENSIVE REVIEW OF THE LITERATURE

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Abstract

Islamic and conventional banks perform similar functions throughout the financial intermediation process. However, the products offered by Islamic banks differ significantly from those of the conventional banks. Due to the differences that exist in its products and contracts, it may be exposed to different levels and types of risks. Therefore, the primary goal of this paper is set to evaluate the risk difference across Islamic and conventional banks (CBs). Islamic Banks (IBs) have a special contractual and operational structure that complies with Shari'ah, the nature and degree of risks differ between the two types of banks. Furthermore, as a result of this distinction between IBs and CBs, IBs are anticipated to bear risks beyond those encountered by conventional banks, such as equity investment risk, rate of return risk, displacement commercial risk, and Shari'ah compliance risk. This study provides a clear understanding of the risk profile of both types of banks to academicians, policymakers, and investors.

Keywords: Islamic banks, conventional banks, risk exposure, risk categorization

1. Introduction

Islamic banking follows Shari'ah law, which is based on the Sunnah of the prophet Muhammad (Peace Be Upon Him) and the holy Qur'an (Allah's revelation). Islamic banking has the following qualities: it is derived from the Divine law, adheres to Shari'ah, is rich in financial principles, does not charge interest or other forms of uncertainty (garar), does not tolerate injustice, and fosters kindness in all of its dealings. In addition, because of its greater operational efficiency, ability to stabilize the economy, lack of moral hazard, and ease in reducing poverty, Islamic banking is also superior to conventional banking. Because Islamic banking differs from conventional banking in that it places a greater emphasis on risk sharing and offers collateral-free loans for some products, it can better meet the needs of the underprivileged and micro-entrepreneurs (Abasimel, 2023). Further, Islamic law supports the idea that financial transactions ought to be based on a profit-and-loss-sharing concept (Uppal & Mangla, 2014).

Moreover, in Islamic banking, every transaction is backed by real asset (Beck et al., 2013). The sharing of risk among involved parties (bank, investor, and borrower) discourages speculation and promotes the creation of low-risk financial instruments (Arouri et al., 2013). Like this, Islamic law prohibited IBs from making investments in unlawful industries, buying and selling debt contracts with the intention of earning interest, engaging in derivative goods, and making profits devoid of actual economic activity or asset transfers. These special guidelines recommend the formation of new bonds between debt holders, shareholders, and management, the need for tangible assets, the availability of financial instruments tailored specifically for IBs, and value creation from an inclusive perspective (Jawadi et al., 2016; Mollah et al., 2017).

CBs largely rely on debt and risk transfer for their intermediation function, whereas IBs base theirs on asset and risk sharing. Hence, there are differences in risk exposure of both types of banks (Mejia et al., 2014). Furthermore, aside from the standard risks that CBs encounter, Khan and Ahmed (2001), Hassan and Bashir (2003), and Srairi (2009) found that IBs are subject to a number of extra specific risks. The extra risks could result from their unique asset and liability structure, adherence to Shari'ah regulations, and the ban on return or deposit insurance. Other reasons could include limited access to collateral, difficulties with recovery, unfamiliarity and inexperience with various financial tools, and the prohibition on using derivatives for hedging (Kabir et al., 2015; Sorwar et al., 2016). The other main reason is the failure of IBs to access interbank market liquidity instruments (having interest-bearing features) in times of distress which is prohibited in Shari'ah (Alqahtani at al., 2017).

There are divergent opinions in the literature regarding the risks Islamic and conventional banks face. Due to distinctive attributes, IBs are subject to particular, unique risks in addition to the credit, liquidity, operational, transparency, and regulatory risks that are similar to those of CBs (displaced commercial risk, Shari'ah non-compliant risk, rate of return risk, and equity investment risk). However, because IBs are special, the ramifications of these risks are different. Overall, it looks that IBs may possibly be subjected to more risk compared to CBs (Mejia et al., 2014). Boumediene and Caby (2009) reported that IBs and CBs were not subject to the same risks during subprime crises. IBs were partially safe, whereas, CBs were highly volatile during the subprime crisis. The levels of risks confronted by IBs are substantially greater than those encountered by CBs in Bahrain (Abu Hussain & Al-Ajmi, 2012), while Faye et al. (2013) reported that IBs are exposed to lower risk as compared to CBs in African countries.

Other researchers like Kabir et al. (2015) and Ferhi (2018) concluded that CBs have higher credit risk than IBs. Furthermore, Safiullah and Shamsuddin (2018) found that IBs face greater liquidity risk, but lower insolvency and credit risk, in comparison to commercial banks (CBs). According to Hassan et al. (2019), IBs are vulnerable to liquidity risk differently than CBs. IBs take deposits under the premise of sharing profits, but because there are not many opportunities for investments, they cannot always pay the profit, which raises the danger of liquidity problems.

Concerning the literature mentioned above, it is crucial to conduct a thorough study of the numerous risks that conventional and Islamic banks confront. It is also critical to ascertain whether Islamic banks face higher levels of risk than conventional banks.

2. Methodology

The present study utilizes a qualitative methodology by adopting a literature review approach. More precisely, this paper consists of a theoretical examination and evaluation of prior research findings about the risks and their classification in Islamic and conventional banks. The literature collected for this article was carefully curated from recorded research findings in scientific publications in various research databases.

3. Risk Exposure of Banks

Risk has no standard and consistent definition but most financial literature focuses on two definitions that are acceptable to investors: probability of unfavorable outcome; and uncertainty of future outcome (Brown & Caylor, 2006). According to Dimitriu and Opera (2009), banking risk is a phenomena that arises during banking operations and has a negative impact on these activities by deteriorating business, reducing earnings or losses, and impairing the bank's functionality. Hassan and Dridi (2011) defined risk as a chance of adverse conditions and the chance of losses incurred and the probability or threats of damage usually caused certain loss levels of any asset. Ghosh (2012) defined bank risk as “a potential loss that may occur due to some antagonistic events such as economic downturns, adverse changes in fiscal and trade policy, unfavorable movements in interest rates or foreign exchange rates, or declining equity prices”.

Risk has different definitions based on the point of view of certain disciplines. In the field of finance, risk is the “possibility that actual return on an investment is lower than the expected return” In a workplace, risk is “the product of the consequence and probability of a hazardous event or phenomenon” (Noor & Mohamed, 2018). In the field of economics, risk refers to “the existence of uncertainty about the future outcomes whereas the possibility of more than one outcome and the ultimate outcome is unknown or unclear” (Bouslama & Lahrichi, 2017).

Risks in economics and finance are categorized in different ways. For example, Jorion and Khoury (1996) classified risk into two categories: financial risk and business risk. Financial risk arises from the probable losses in financial markets caused by the movements of financial market variables, such as uncertainty of stock price, commodity price, interest, and exchange rates. Business risk arises from the business nature of a firm and is mostly concerned with the factors affecting the product market. For example, uncertainty about the future sale or cost of inputs. Santomero (1997) classified risk based on its treatment and stated that there are three basic types of risks faced by most organizations: the risk, which is avoided or eliminated by the simple practices of business, the risk which is transferred to other participants, and the risk, that is managed actively at the level of firm.

Financial institutions do not take up activities that enforce certain risks on them. They take up such activities where they effectively manage or shift the risk. The most common approaches to avoid risk include; standardization of business-related methods, developing diversified portfolios, and implementation of different reward schemes under strict monitoring. Moreover, selling or shifting of a bank’s risk in a well-organized financial market may be a good option to minimize risk exposure. Further, the practices of risk transferring includes selling or buying of financial claims, use of derivative tools for hedging, and changing the terms and conditions of borrowing. However, there are various risks that should be taken or assumed by the financial intermediaries. These risks cannot be mitigated or transferred by the mitigation practices. Because these risks are complex in nature and central to their business, and thus difficult to separate them from assets (Khan & Ahmed, 2001).

Gleason (2000) divided the bank's risk into financial and non-financial risk. Financial risk can be further classified into credit risk and market risk, while non-financial risk includes legal risk, operation risk, and regulatory risk. Al-Saati (2003) and Dusuki and Smolo (2009) categorized risk into primary and secondary risk. The primary risk is the risk that is naturally interconnected with every business and cannot be evaded, while the secondary risk is the one that can be reduced or eliminated by using derivative techniques. Risk can also be broadly divided into unsystematic and systematic risk. Systematic risk is inherent and associated to the entire economic system or market. It generally arises from adverse movements in macroeconomic factors like movement in interest rate, inflation rate, etc. Systematic risk is undiversifiable because it cannot be avoided through the practice of diversification. On the other side, unsystematic risk is associated with a specific individual firm or asset. This type of risk can be diversifiable through diversification because it exists only in a specific industry or company. The factors contributing to unsystematic risk are financial position, earnings, and poor management (Khan & Ahmed, 2001; Razif & Mohamad, 2011).

Considering the banking sector, Dardac and Vascu (2001) asserted that a bank can be exposed to two kinds of risks: bank-specific risk and general risk. Bank-specific risks include financial risks i.e. liquidity risk, variable income securities risk, interest rate risk, and counterparty risks (interbank risk, customers risk, country risk). On the other side, general risks refer to commercial risks i.e. the risk of a commercial image, the risk of accidents, market risk, customer/product risk, operational and technical risks, and internal risk management (technologic dependency risk, ethics risk, regulations risk, strategic risk and communication risk). Bessis (2002) reported that mainly banks exposed to interest rate risk, foreign exchange risk, operational risk, market risk, solvency risk, liquidity risk, credit risk, performance risk, country risk, and settlement risks are the main types of risks

The State Bank of Pakistan (2003) documented that commercial banks in Pakistan are exposed to liquidity risk, market risk, credit risk, operational risk, regulatory risk, reputation risk, and legal risk. Crouhy et al. (2006) categorized bank risks into business risk, operational risk, credit risk, liquidity risk, market risk, strategic risk, legal risk, and reputation risk. Abu Hussain and Al-Ajmi (2012) summarized that typically banks are exposed to solvency risk, liquidity risk, operational risk, credit risk, interest rate risk, rate of return risk, foreign-exchange risk, strategic risk, reputation risk, settlement risk, regulatory risk, legal risk, concentration risk, country (political) risk, and price (equity) risk with varying degrees of exposures. Moreover, Dimitriu and Oprea, (2009) classified banking risk into six types.

1) Credit risk refers to the failure of a customer to repay the interest or principal amount of loans and advances in the agreed time period.
2) Liquidity risk is the bank's incompetence to satisfy or fulfil the liquidity requirement of customers.
3) Market risk emerges as financial loss is generated due to the unexpected variations in exchange rate, interest rate, and market prices of assets, liabilities, and derivative instruments.

4) Operational risk is defined as the possibility of loss arising from poor internal processes, inefficient people, systems, or any external adverse event.
5) Legal risk, which refers to the loss that arises as unexpected changes in regulations.
6) Strategic risk, which refers to the risk that stems from the competition in the banking market.

Apatachioae (2015) categorized banking risk into two main categories: one is specific to financial and banking activities, while the other is systematic risk which affects the activities of an organization irrespective of their field of activity. Systematic risk emerges from macroeconomic indicators like GDP, inflation, interest rate, and currency exchange, etc., and arises from other characteristics like political situations, natural disasters, and the risk of the country, etc.

4. Risk Involved in Islamic Banking

The operational nature of IBs varies from that of CBs due to the feature of profit-sharing and mode of financing. For example, on the liability side IBs accept usually two types of deposits: deposits in the current account based on Amanah (trust) or Qard Hassana (interest-free loan), and deposits in saving and investment accounts which is based on profit and loss sharing mode of financing. On the assets side, IBs transform their deposits into various investment projects through fixed-income modes of financing like murabahah (cost-plus sale), profit-sharing mode of financing (musharakah and mudarabah), Salam and Istisna (prepaid sale or object differed sale), and Ijarah (leasing).

The profit and loss sharing mode of investment essentially requires the sharing of business risk with depositors. Hence, these characteristics of IBs differ like the risk faced by them (Khan & Ahmed, 2001). There is a disagreement among scholars about the nature of risk faced by Islamic banks. One group of researchers argued that Islamic banks are exposed to more risk as compared to conventional banks due to the unique nature of Islamic banks. For example, SBP (2008) risk management guidelines asserted that IBs exposed to certain types of unique risks (displaced commercial risks, rate of return risk, fiduciary risk, and Shari'ah non-compliance risk) as compared to CBs. Similarly, Khan and Ahmed (2001) revealed that certain kinds of risks (liquidity risk, market risk, operational risk, credit risk) are common to both IBs and CBS. Yet, there is some risks like equity investment risk, displaced commercial risk, rate of return risk, and Shari'ah non-compliance risk, which are unique to Islamic banking on the basis of their nature of activities.

In Islamic banking and finance, all financial institutions offering Islamic products are exposed to some additional (unique) risks along with generic risks. The unique risk imitates the mix of risks that arises from the risk-sharing arrangement and contractual design of instruments. Furthermore, the risks confronted by IBs may vary in terms of both structure and severity rather than CBs. For instance, the home financing product offered by IBs under musharakah contract generates two additional risks (Shari'ah non-compliance risk and equity risk arising from the ownership of equity) for IBs as compared to CBs (Sundararajan, 2007).

Ariffin and Kassim (2009) stated that Islamic and conventional banking are exposed to the same types of risk but on different levels. Other researchers have the opinion that Islamic banks are less risky because of the restriction of interest-based transactions, and the financial instruments of Islamic banks are mostly based on trade financing instruments (Fiennes, 2007). The risks associated with Islamic financial institutions can be broadly classified into four categories by Iqbal and Mirakhor (2007):

financial, business, treasury, and governance risks. Market, equity, and credit concerns are all included in financial risk. Business risk includes both solvency and rate of return hazards. Operational, reputational, Shari'ah, transparency, and fiduciary risks are all included in the category of governance risks. According to the empirical study of Khan and Ahmed (2001), Islamic financial institutions mostly face benchmarking risk, credit risk, operational risk, liquidity risk, withdrawal risk, legal risk, displaced commercial risk, and fiduciary risk.

5. Conclusion

It is concluded from the literature discussion that Islamic banks and conventional banks are exposed to a variety of risks like capital risk, liquidity risk, operational risk, credit risk, reputational risk, foreign exchange rate risk, interest rate risk, inflation rate risk, legal and fiduciary risk. However, the nature and level of risks are different across both types of banks because IBs have a unique contractual and operational structure compliance to Shari'ah. Moreover, because of such differentiation between IBs and CBs, IBs are expected to face additional risks like equity investment risk, rate of return risk, displace commercial risk, and Shari'ah compliance risk, along with the risks faced by conventional banks. Such as Shari'ah non-compliance risk arises due to the failure to fulfill Shari'ah injunctions and principles as drafted by the bank' Shari'ah board of directors.

This risk leads to Shari'ah non-compliance income which reduces the profitability of IBs. Because banks are required by Islamic law to deduct Shari'ah non-compliance income from net income. Similarly, displaced commercial or withdrawal risk arose at the time when IBs offered lower rates of profit to their depositors. In the case of a lower rate of return to depositors, the depositors will withdraw their funds from banks and deposit in some other banks where a high rate of return is offered. Further, IBs are exposed to rate of return risk due to volatile rate of return on investment. The rate of return is different from that of interest rate risk. As the nature of IBs activities is different as compared to CBs. CBs perform their activities based on a fixed interest rate on financial assets, hence they are exposed to less rate of return risk.

On the other hand, IBs deal in financial assets whose returns are accurate and cannot be pre-determined and disclosed at the end of maturity. In addition, IBs are restricted from investing their equity on a fixed-interest basis and making investments in various financial assets like private equity funds and shares of the stock market. These equities are exposed to serval risks. In such a situation, IBs may be exposed to instability in their financial earnings, which leads to a loss of capital invested in those equities. The study enlightens suggestions for policymakers and bank management to devise separate risk management strategies for both types of banks to encounter various kinds of risks. In addition, IBs may focus on the management of additional risks. Particularly, IBs ensure they operate in compliance with Islam to avoid Shari'ah non-compliance risk. To further reduce its rate of return and offset commercial risk, IBs engage in high-yielding assets that adhere to Shari'ah. Future studies can be conducted to evaluate the effects of IBs' specific risks on the performance and stability of IBs.

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