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Islamic Banks Credit Risk: A Panel study

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Abstract

The purpose of this paper is to investigate the determinants of credit risk in the case of Malaysia Islamic banks. Using a yearly bank level data from 1995 to 2013, this paper utilizes the fixed effect model to provide empirical evidences on Islamic banks credit risk in Malaysia. The empirical results demonstrate that a few bank-specific variables do significantly influence credit risk of Malaysia Islamic banks. The findings show that financing quality and capital ratio demonstrate consistent results regardless of specification and estimation models. The inclusion of ownership status also suggests that there is a significant difference between the local and foreign ownership Islamic banks in this regard. The finding added important evidence to the existing literature on credit risk specifically Islamic banks credit risk.

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1. Introduction

The Islamic banking and finance (IBF) industry has witnessed several important events during the last decade. Since their inception in 1975, IBs have now become a global phenomenon, including the United Kingdom (UK), China (Hong Kong), Australia, Singapore and much of Europe. In certain countries like Malaysia and Bahrain, the Islamic banking (IB) industry has evolved from a primarily domestic concern to one of international significance. This success for the IB

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industry is proven by its total assets value which grew from US$1.8 trillion estimated at the end of 2013 and is expected to be more than US$2.0 trillion by the end of 2014 (see IFSB, 2014). During the last ten years the IB industry has witnessed changes in economic conditions and the onset of a financial crisis. It is reported that IBs still remain strong and continue to grow globally.

Early studies on credit risk determinants had primarily focused on conventional banking credit risk management particularly in developed countries (Berger & DeYoung, 1997; Berger & Udell, 1990, 1994). A few other relevant studies have attempted to address IBs' risk management. For example, Febianto (2012) conducted a library-based research analysis, and Abedifar, Molyneux, and Tarazi (2012) did an empirical analysis on 24 Organization of Islamic Cooperation (OIC) countries. This paper aims to examine the key determinants of credit risk of Islamic banks in Malaysia by introducing Islamic financing types (IFT) and ownership status (Status) variables. Malaysia has been chosen as the sample country because of its position in the global Islamic banking industry. The Malaysian IBs are ranked third in the global IB industry following Iran and Saudi Arabia. Malaysia established its first Islamic banks in 1983. Since then, the number of IB products and services has expanded with the implementation of Interest-free Banking Scheme (IFBS) in 1993. The IFBS allowed conventional banks (CBs) to offer *Shari`ah*-approved products and services through Islamic windows. The IB industry in Malaysia received strong support from the government, and as at the end of 2014 there were 16 fully-fledged IBs and 4 international IBs operating in the country.

2. Literature review

Credit risk management studies have attracted the attention of many parties, particularly in developed countries. Investigating the factors that drive the credit risk in the banking sector is not only important to the bank's management but also to regulatory authorities. Prior studies have measured the credit risk by using the ratio of non-performing loans (NPL). In banking studies, the loan is classified as NPL when the payment of interest and principal are overdue by 90 days or more. Higher NPL causes the banks to experience lower profit margins and if the problem becomes more serious, it can lead to a crisis. Potential influences on the NPL include the types of borrower, bank management and adverse changes in the economic situation. The importance of efficient credit risk management invites many parties especially researchers, regulators and banks' management to investigate the determinants of credit risk in banking. This will help them to understand and propose a comprehensive credit risk management framework.

Most studies suggest that there are two strands of literature on the factors that drive credit risk. The most popular strand suggests that credit risk is driven by several bank specific variables (BSV) and the second strand argues that macroeconomic factors greatly influence the credit risk of banks. A survey of the literature informs us that previous studies normally examined the determinants of credit risk either using BSV or macroeconomic factors as explanatory variables. However, a few studies used both BSV and macroeconomics variables to explain the NPL of banks. The examples include Louzis, Vouldis, and Metaxas (2012) who examine the determinants of credit risk in Greece's banking sector by using macroeconomic and BSV as explanatory variables. They used the NPL of different loan categories as the dependent variables and find that NPL of Greek banks are mainly explained by macroeconomic variables such as unemployment, gross domestic product (GDP) and interest rates.

Most empirical studies that investigate the effect of the BSV on NPL, uses loan growth, loan quality, management quality, size, loan concentrations, and capital as the variables. Demirguc-Kunt (1989) has reviewed empirical literature on deposit-institution failures. He compared and summarized the models and variables for banking failure studies. Demirguc-Kunt concludes that capital adequacy, assets quality, management competence and earnings are among the significant explanatory variables for bank failure. Berger and DeYoung (1997) focus on the BSV as an indicator for problem loans and efficiency of the banks. Using a US commercial banks dataset for the period 1985 to 1994, they examined the inter-temporal relationship between problem loans and cost efficiency. They developed four hypotheses related to: i) bad management (low cost efficiency signal for poor management); ii) bad luck referring to external events; iii) moral hazard; and iv) skimming issue. They find evidence that cost efficiency and capital are negatively associated with problem loans. Angbazo (1997) uses US Bank Call Report Data for 1989 to 1993 to examine the relationship between net interest margins (NIM) and interest rates risk, default risk and off-balance sheet activities. The author claims that there is a significant relationship between size, NIM and default risk. More recent studies focusing on the BSV as the main determinant of credit risk include Konishi and Yasuda (2004); Godlewski (2005); and Jiménez, Lopez, and Saurina (2007).