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# Credit Risk Management Practices: A Study on Islamic Banking vs. Conventional Banking in Malaysia

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**Abstract:** This study is conducted in order to identify on how Islamic bank and conventional bank are difference in term of pre-approval financing. This study is concentrating on the evaluation of credit assessment for business financing by applying qualitative method by interviewing 5 credit analysts in banking institution. Interviews conducted is divided into two main parts: first, the current practices of credit assessment in pre-approval stage and post-approval stage. Second, the study on how Islamic elements being utilised in making financing decision, thus, managing credit risk. In the first part, it was found that there were no differences between Islamic and conventional bank in term of credit assessment. However, most of the respondents advise that, Islamic banks should come out with more proactive credit assessment rather than depending on conventional practices. For the second part, all of the respondents held similar views and opinions that the Islamic elements such as Adl (fair and justice), Istiqamah (Continous), Akhlak, Syura and Tawakal should be implementaed in Islamic credit assessment. However, there is still lack framework on how these issues could be implemented.

**Key words:** Islamic risk management, Islamic banking and finance, credit, advise, justice, views

## INTRODUCTION

Credit risk may come out with negative consequences for banks performance and this may leads for banks to get extra funds to cover the financial losses. To have a good credit risk management in line with the regulation, banks must assist good evaluation of its capacity, supervise, guarantees and know how to recover loans (Beck *et al*., 2003; Mohamad *et al*., 2014). While reviewing practices and policies of credit risk management, banks need first understanding how to recover loans from their customers (Mohamad *et al*., 2015).

Therefore, the study is conducted in order to identify on how credit assessment is difference between Islamic banks and conventional banks. This is due difference characteristic in Islamic banks that further expose different risk compare to conventional bank. At the same, the study also explore on the opinion on how Islamic elements can be implemented in credit assessment.

**Literature review:** Greuning and Iqbal found that Profit and Loss Sharing (PLS) modes of financing are reluctant to indulge in Islamic banking system because of the factor of bank's depositors to faced risks. It is showed that it is a reflection for Islamic banking system in case of low level of the transparency and thus, trust is eliminated between the customers and the banks.

To extent this further, Mohamad *et al*. (2014) analyze the practices of Profit and Loss Sharing (PLS) modes of financing in Islamic banking system. This are highly used in financing contracts and deposits purposed. However, this practice is not widely concerned due to non-conduciveness of the existing natural environment of business practices.

Chong and Liu (2009) further study on the Malaysian banking industry and stated that the current practice of Islamic banking systems are not too different from conventional banking. In their study, they use causality test and the result shows that there are inter-related between Islamic banking system and conventional banking system in terms of the rate of returns.

Tafri *et al*. (2011) further found that there are significant different in strategies in credit risk mitigation and the other tools identified between Islamic and conventional banking system. The factors such as the nature of Islamic banking itself lack of tools in mitigating the occurrence of risk are stated.

Further, to assess the conventional commercial banks and Islamic banks in Malaysia in terms of the financial performance, Thim *et al*. (2014) analyze by using the financial ratio. Although, the Islamic banks shows slowly peak in the financial performance, it is found that Islamic banks have better insights in the improvements in

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utilization of assets and effective management whose the customer's trust and confidence towards Islamic banks are rising.

Abedifar *et al*. (2013) viewed that Islamic banking system has lower credit risk compared to conventional banking system as it is found that there are less responsive in terms of financing quality of Islamic banks compared to the other one of banking system.

Abdul Wahab *et al*. (2017) suggests that for banks to have a sustainable banking business, they should achieve high capital growth to pursue relatively riskier financing activities. However, towards risky assets especially for Islamic bank subsidiaries and full-fledge Islamic banks to follow the conventional practice.

Misman (2012) found that there is significant relationship between the financial structures and bank-specific variables related to the credit risk.

Khan (2010) viewed that Islamic banking system can be further stand in the competitive market to have full-fledge of Islamic identity that contrast from the conventional financial transactions.

Ebrahimi *et al*. (2011) concluded that the ethic in evaluation would be looked from Islam point of view such as self-evaluation, plurality of evaluation tools, speed in evaluation, consideration to individual differences. It is necessary to organizations to applying the usage of Islamic evaluation principles.

Therefore, to sum up from all above of the empirical study, there are several issues identified for improvement. There is few studies conduct the credit risk management in evaluation stage especially in Islamic banking approach because the current practices used the practices same as conventional banking approach, since, Islamic banks must tend to be more proactive in evaluating the clients in commercial financing approval because they offered profit and loss sharing contracts and offered different types of contracts.

Therefore, this study further proposed to implement the Islamic principles in credit risk management that can be applied in credit evaluation process, since, the techniques of credit risk management after the approval of the credit application has been widely discussed in the reviewed literature. By using the inductive approach, the study is then proposed the parameter for credit evaluation process in Islamic banking system.

## MATERIALS AND METHODS

Qualitative method is used to explore the current practices of credit assessment in pre-approval stage and post-approval stage and how Islamic elements being utilised in making financing decision, thus, managing credit risk. The sample of banks consists of three Islamic banks and two conventional banks. In terms of analysis, this study uses NVivo Software to analyse the coding.

## RESULTS AND DISCUSSION

**Current practices:** Elements used in credit evaluation process conjure up different views and perceptions to the different types of banks approach. For some it was a normal part used as well as their current practices of credit evaluation process whereas for others it was unacceptable because of some reasons. As seen in the interview questions in appendix, business financing officers were asked questions of what are the current practices in credit evaluation process.

> "The first most important elements that we used to evaluate our credit applicant is character. It includes of the personality, reputation of the company and history. The reason is the character comes first beforehand" (Respondent C)

> "Being prepared for credit evaluation process, to me is that the purpose (niat) is come first and have the intention to pay back the financing. It is about all the things that our clients need to do to first before the financing is approved then. Besides, purpose of financing must be Shariah compliant. Business financing for the purchase of alcoholic drink from the main supplier to be distributed to retail outlets is prohibited in Islamic banks as the goods are considered as illegal (Haram) and thus, I have to be accountable to them" (Respondent E)

To simplify, Fig. 1 stated categories elements used by different types of banks approach.

**Islamic elements:** Islamic elements are important in making financing decision process. For Islamic banks for sure they need implements and practices Islamic elements as a tools/strategies in mitigating credit risk in pre-approval stage. There are different views and perceptions to the different types of banks approach pertaining to the lists of Islamic elements and how these elements can be used in credit evaluation process. Business financing officers were asked questions based on their opinions of what are Islamic elements in credit evaluation process for business financing

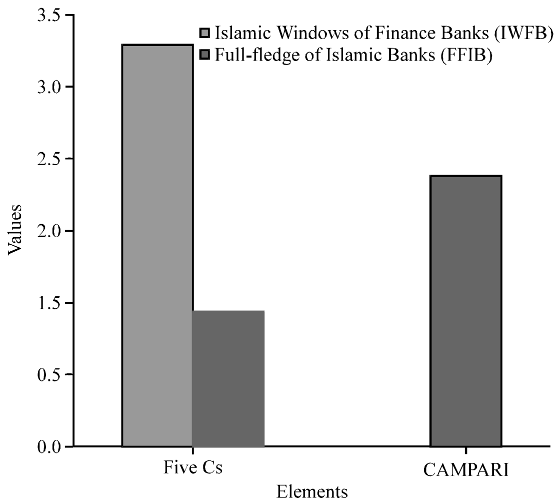


Fig. 1: Categories elements used by different types of banks approach

approval in addition five C's and CAMPARI elements and how the elements can be used in Islamic banks approach.

The current practices (five C's and CAMPARI) in credit evaluation process cannot be totally ignored. Therefore, Islamic elements can be used as a guide to assess the applicant from all angles which is necessary in identifying the strength and weakness of the applicants and the viability of the financing application. To simplify, Fig. 2 shows the Islamic elements that can be used in credit evaluation process.

> "In addition of using five C's and CAMPARI elements, Adl', Ukhuwah, Istiqamah, Akhlak, Syura and Tawakkal Elements will add value to credit evaluation process. For instance, the transparency is good for us and our customers because of practicing these elements. Besides, the customers need to also practicing these in disclosing the information needed by us, so that, the credit evaluation process can be effectively performed" (Respondent A)

> "My view is that Adl', Ukhuwah, Istiqamah, Akhlak, Syura and Tawakkal Elements are fruitful to be fulfilled as the customer discloses the information to us under the latter's Know-Your-Customer (KYC) policy. These can be achieved by practicing continuous customer-banker relationship (ukuwah)" (Respondent D)

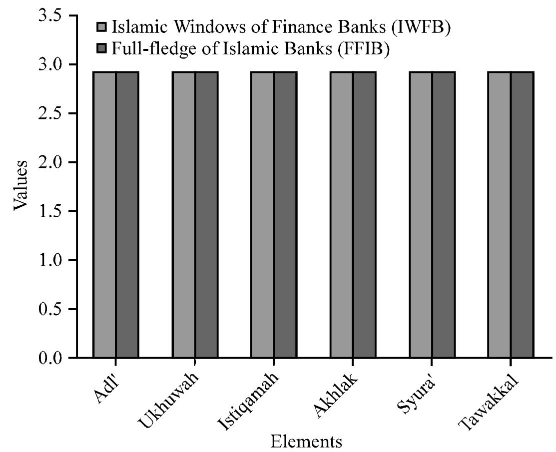


Fig. 2: Islamic elements that can be used in credit evaluation process

> "My belief is that Adl', Ukhuwah, Istiqamah, Akhlak, Syura and Tawakkal Elements are needed in credit evaluation process by constantly performing transparency in risk-sharing financing. We are borne as business partners and therefore, all these elements will helps us disclose all of the information to each other and maintain the ukhuwah throughout the financing lifetime (tenor)" (Respondent F)

**Findings of analysis:** There are several main themes found. It includes of the current practices in credit evaluation process (five C's and CAMPARI elements) and the Islamic elements that can be applied in credit evaluation process as parts of credit risk management.

All of the respondents answered the research questions as to achieve the goals of research study. Likewise, all of the respondents positively associated credit evaluation process with the proposed of the Islamic elements that can be used in addition to five C's and CAMPARI. Some of these perceptions were linked to the positive values of credit risk management in first dimension (pre-approval) stage for Islamic banks approach.

This research also found that a positive responses pertaining to the Islamic elements used in credit evaluation process, especially for Islamic banks approach, since, they are practicing Shariah-compliant financing and risks-sharing activities.

## CONCLUSION

From the study, it is found that Islamic banks and conventional banks have clear distinctive characteristic. The differences lead to different risk exposure between these two types of banks. Islamic banks are supposed to have more proactive and comprehensive in term of credit risk management compare to conventional counterparts.

Most of the respondents advised, despite on what have been implemented there should be a proactive evaluation for credit risk assessment. The relationship of Islamic bank also different as conventional banks. Thus, this high commitment should be followed with more proactive assessment and monitoring.

## IMPLICATIONS

For Islamic elements, Islamic banks are advised to develop comprehensive framework on how it can be implemented in credit risk assessment and monitoring. As general, the study is very important for better development and mechanism of credit risk management in Islamic banks. It is advisable for future research to explore on how quantitative method use in credit risk management for Islamic banks.

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