Financial Risk and Islamic Banks’ Performance in the Gulf Cooperation Council (GCC)

Prof. Hussein Al- Tamimi
Dr. Hela Miniaoui
Dr. Walaa Wahid Elkelish
FINANCIAL RISK AND ISLAMIC BANKS’ PERFORMANCE IN THE GULF COOPERATION COUNCIL (GCC)

Hussein A. Hassan Al-Tamimi
Professor of Finance
Chairman, Department of Finance and Economics College of Business Administration University of Sharjah
P.O.Box 27272, Sharjah United Arab Emirates
E-mail: hussein@sharjah.ac.ae
Tel. +9716 5050539

Hela Miniaoui, PhD
Faculty of Finance and Accountancy University of Wollongong in Dubai Block 15, Knowledge Village P. O. Box 20183, Dubai, UAE Tel. +971 4 3900469

Walaa Wahid Elkelish,Ph.D.
Assistant Professor of Accounting Department of Accounting College of Business Administration University of Sharjah P.O.Box 27272, Sharjah United Arab Emirates
Email: welkelish@sharjah.ac.ae
Tel. +9716 5050521
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College of Business Administration, University of Sharjah
P.O. Box: 27272, Sharjah – United Arab Emirates ,
Tel: (9716) 5053-545
Fax: (9716) 5050-513
E-Mail: businessadministration@sharjah.ac.ae

SERIES EDITORS:

Dr. Abu Elias Sarker
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Abstract

Purpose – The purpose of this study is to examine the relationship between financial risk and performance of the GCC Islamic banks and the relative importance of the most common types of risk.

Design/methodology/approach – The study covers 11 of the 47 Islamic banks of the GCC region from 2000 to 2012 period, based on the availability of data. The data used in this study was obtained from the Bankscope database. For bank performance, the two most common measures, ROA and ROE, were alternatively used and for risk measures, four types of financial risk were used, namely credit risk, liquidity risk, operational risk, and capital risk. Regression analysis was used to test the three hypotheses of the study.

Findings – The results as expected indicate that there is a significant negative relationship between the GCC Islamic banks’ performance and two types of risk, namely capital risk and operational risk. The results also confirm that there is a significant negative relationship between the GCC Islamic banks’ performance. However, the positive relationship between risk and performance of the GCC Islamic banks was not confirmed. Furthermore, the results indicate that the most important type of risk is capital risk, followed by operational risk.

Originality/Value – The current study is considered the first of its kind conducted on the GCC Islamic banks' performance and risk. Therefore, it might add some value to the literature.

Key words: bank performance, financial risk, GCC Islamic banks
1. Introduction

Islamic banking has been experiencing significant growth worldwide during the last three decades. Currently, there are large number of Islamic banks and Islamic units spreading all over the world. The UK, for example, represents one of the leading centers for Islamic banking globally. The international giant banks such as HSBC (HSBC Amanah), Citi Bank (Citi Islamic), and Standard Chartered have established Islamic units. The Gulf Cooperation Council Countries (GCC) are operating under dual banking systems: conventional and Islamic banking. In 2012, the total assets of Islamic banking in the GCC region was 34% of assets of Islamic banks worldwide, while Iran's Islamic banking assets contributed 42.7% of the total global Islamic banking assets and Malaysia contributed 10.0% (Zawya, 2013). Islamic banking is gaining popularity after the 2007–2008 financial crisis, and the Islamic banking industry has witnessed a radical change in terms of the number of banks, branches, Islamic units, and Islamic financial instruments. For some experts the main reason for the financial crisis was the collapse in credit supply (e.g., the collapse of Lehman Brothers in September 2008). In the search for solutions there has been interest in the model of interest-free banking used in the Islamic banking industry since Islamic law prohibits usury, the collection and payment of interest.

The objective of this study is to examine the relationship between financial risk and performance of the GCC Islamic banks and the relative importance of the most common types of risk. As mentioned above, Islamic Banking has been growing significantly worldwide during the last three decades and has grown faster in the GCC region. In the UAE, for example, where the first Islamic bank (Dubai Islamic Bank) was established in 1975, there are now 8 Islamic banks with 283 branches constituting 34% of total number of bank branches in the country. The total assets of Islamic banks have increased from AED 182.6 billion (about US$ 49.6 billion) in 2008 to AED 358 billion (about US$ 97.3 billion) in 2012. The proportion of UAE Islamic banks’ assets has increased from 14.9% in 2008 of the UAE banking sector’s total assets to 20% in 2012. The structure of the paper is as follows. In the first section, a literature review of the most recent studies is provided. The second section deals with
the research questions and hypotheses, followed by an exposition of research methods and data collection. The fourth section is devoted to discussion of the empirical findings. In the final section a brief summary of the paper and conclusions concerning the main results are provided.

2. Literature Review

In this section there is an attempt to summarize the main findings of some selected empirical studies. It should be mentioned here that there is no such an empirical study, as far as the authors know, dealt with the same title for the GCC Islamic banks, or those working in other areas of the world. However, the majority of the available empirical studies dealt with only one type of risk such as liquidity risk or operational risk or credit risk or capital risk. The following is an attempt to highlight the results of some empirical studies that covered one or more of the four types of risk that are considered in the current study.

Wasiuzzaman and Gunasegavan(2013) in their study entitled “Comparative study of the performance of Islamic and conventional banks: The case of Malaysia”, concluded that liquidity and operational risks were found to be highly significant in affecting profitability( performance).

Febianto (2012) attempted in his study entitled “Adapting Risk Management for Profit and Loss Sharing Financing of Islamic Banks” to answer the question: Why are Islamic banks reluctant to indulge in mudharabah and musharakah financing? The main conclusion of the study was that risk management can give Islamic banks guidance on how to manage the risk attributed to profit and loss sharing arrangements through Mudharabah and Musharakah contracts. Febianto indicated in this regard that this guidance can motivate Islamic banks to be more participative in profit and loss sharing arrangements, especially on their asset side.

Hidayat et al. (2012) investigated the level of effectiveness of liquidity risk management of Islamic banks in Bahrain. They used a questionnaire which was distributed to a sample of 50 depositors who have active relationships with the Islamic banks. The 50 employees chosen were managers and supervisors of Islamic Banks in the Kingdom of Bahrain. The main finding of this study was the positive perception on the status of equity-based financing, which was believed to be an effective part of liquidity risk management. The findings also indicated that there is
no significant difference in perception between the employees and depositors on the level of effectiveness of liquidity risk management in terms of deposit portfolio and equity financing.

Liquidity risk and banking system performance in Pakistan were examined by Zulfiqar and Anees (2012). The period covered was 2004-2009 and the sample includes 22 banks, which constitute the main part of the Pakistani banking system. They found that liquidity risk significantly affects bank profitability. Kumaran (2012) examined risk management and mitigation techniques in Islamic finance. The study reveals that the Islamic financial institutions face the category of risk they have in common with conventional banks as financial intermediaries, namely credit risk, market risk, liquidity risk, and operational risk. However, due to Shari‘ah compliance the nature of these risks changes. Abu Hussein and Al-Ajmi (2012) examined risk management practices of conventional and Islamic banks in Bahrain and they found that credit, liquidity and operational risk are the most important risks facing both conventional and Islamic banks. They also found that the levels of risks faced by Islamic banks are significantly higher than those faced by conventional banks.

Ramadan (2011) indicates in his study on bank-specific determinants of Islamic banks’ profitability that well capitalized banks, efficient management, and higher credit risk lead to higher return on assets, which is a measure of bank performance. Another finding of this study is that the credit risk positively and significantly affects the profit margin of Jordanian Islamic banks, which is another measure of bank performance. Bank performance of Islamic banks compared with conventional banks in Indonesia has been investigated by Ilka et.al (2011) and they reached the conclusion that Islamic banks are generally more liquid as compared to conventional ones.

Boumediene (2011) attempted to answer the question: Is credit risk really higher in Islamic banks? The results indicate that credit risk is indeed higher in Islamic banks compared with conventional banks. Abdullah et al. (2011) investigated operational risk in Islamic banks. The main finding of their study is that risk measurement and risk management practices still need specific adaptations to Islamic banks’ operational characteristics. They also highlighted the unique characteristics of Islamic banks and raised serious concerns regarding the
applicability of the Basel II methodology for Islamic banks.

Rahman (2010) investigated the determinants of the three-factor capital asset pricing model (CAPM) of Malaysian commercial banks. The main findings of this study were: different types of risk exposure have different determinants; the market risk exposure for the Islamic bank is lower than for conventional banks; the merger program is fruitful because it reduces the interest rate risk exposure, total risk exposure, and unsystematic risk exposure; and the banks under study had higher total and unsystematic risk exposures during the 1997 Asian financial crisis.

Sensarma and Jayadev (2009) examined the relationship between returns on the banks’ stocks and risk management. They found that banks’ risk management capabilities have been improving over time and returns on the banks’ stocks appear to be sensitive to risk management capability of banks. Rahman (2010) examined the financing structure and insolvency risk exposure of Islamic banks. The main findings of this study were that an increase in real estate financing decreases insolvency risk, but increasing concentration of financing structure increases insolvency risk. Furthermore, increasing the stability of the financing structure reduces risk in the short term. The study recommended the regulatory bodies, policymakers, and market players in the Islamic banking industry should take appropriate action to manage the insolvency risk of Islamic banks.

Volatility of the returns and expected losses of Islamic bank financing has been investigated by Ismal (2010). He concluded that VaR computation on the volatility of returns and expected losses of bank financing finds that risk of investment and expected losses are well managed. This conclusion was mainly based on the assumption that equity and debt-based financing produce sustainable returns of bank financing. Marcellina (2011) examined credit scoring and risk assessment, and was able to confirm that financial ratios are good predictor variables of bank’s performance and can be used for classifying and evaluating the bank’s customers. Consequently, the bank can reduce its non-performing loans and its credit risk exposure.
Siddiqui (2008) investigated financial contracts, risk, and performance of Islamic banking. The results indicate a good performance of the Islamic banks covered, measured by returns on their assets and equity; these banks also demonstrated better risk management and maintained adequate liquidity.

Saiful and Mohammad (2008) examined the relationship between risk and return (i.e. a measure of performance) for Islamic banks’ investment deposits and shareholders’ fund. The findings indicate that deposit yields in conventional banks were lower than return on equity (ROE), as a result of the contractual differences between fixed deposit and bank capital. The findings also indicate that Islamic banks’ deposit yield and ROEs do not reflect their risk-taking properties.

Turk and Sarieddine (2007) highlighted some of the challenges facing Islamic banks in implementing capital adequacy guidelines. For instance, more complications arise when attempting to measure Shari’ah compliance risk; Islamic banks are exposed to a significant liquidity risk, as currently Islamic banks tend to rely on short-term Murabahat which is not enough for liquidity purposes. Therefore, more work is needed in order to better account for liquidity risk exposure and risk-weighted assets that do not include assets funded by profit-sharing investment accounts.

How et al. (2005) investigated whether Islamic financing can explain three important bank risks in a country (i.e., Malaysia) with a dual banking system: credit risk, interest-rate risk, and liquidity risk. They found that commercial banks with Islamic financing have significantly lower credit and liquidity risks but significantly higher interest-rate risk than banks without Islamic financing. Bank performance and risk has been investigated by John and Courington (1993). They examined the causes of variation in loan performance among banks located in the energy-producing states of Louisiana, Oklahoma, and Texas. The results indicate that a substantial portion of the variation in troubled assets can be attributed to differences in local economic conditions as well as to the unusually poor performance of particular industries like energy and agriculture. The results also indicate that excessive risk-taking played a critical role
in the loan problems experienced by many of the region's banks and was a contributing force to the diversity in loan performance throughout the region.

3. Research Hypotheses

Based on the purpose of the study which is to examine the relationship between risk and performance of the GCC Islamic banks and the relative importance of the most common types of risk, the following hypotheses are formulated:

\( H_1 \): There is a significant relationship between credit risk, liquidity risk, capital risk and operational risk and Islamic banks’ performance in the GCC.

\( H_2 \): There are significant differences in the magnitude of the impact of each type of financial risk on Islamic banks performance in the GCC.

The logic behind the first hypothesis may indicate a positive relationship based on the most common relationship between risk and return as the higher the risk, the more the profit (i.e., improvement in performance) and vice versa. However, another opposite relationship may be also logical if, for example, liquidity risk is increased, which means cash is not sufficient or not available for borrowers and depositors. This may negatively affect revenues or profit (i.e., performance is getting worse). The purpose of the second hypothesis is to test the relative importance of the influence of each type of risk and how it explains the behavior of Islamic banks’ performance.

4. Data and the Empirical Model

Based on the previous empirical studies mentioned above, the model used in this study includes some of the variables used in the literature. For example, in evaluating the overall bank performance, two ratios are commonly used: return on equity (ROE) and return on assets (ROA). In this study, ROE and ROA are used
Alternatively with four independent variables. The following are brief justifications for the use of independent variables.

The first independent variable is credit risk (CRK) measured by total loans/total assets or loan losses/total loans. It is well established in the literature that there is a positive relationship between credit risk and profit (see for example Alam et al., 2012). Alam et al. highlighted that banks which have higher loans to total asset ratio tend to take on lower risk. However, if for some reason banks face default or collection problems, the positive relationship between credit risk and profit might not exist.

The second independent variable is liquidity risk measured by total loans/total deposits. The UAE Central Bank determines this ratio as 1:1 and based on this the UAE commercial banks are not allowed to provide loans exceeding their total deposits. However, 1:1 means the maximum limit, as it is risky for banks to use all deposits for lending purposes because they need cash in order to meet their short-term commitments.

The third independent variable is capital risk (CAPR) measured by equity capital/total assets. As capital is used as a cushion, the higher this ratio, the better (less risk) and vice versa.

The fourth variable is operational risk (OPR) measured by the proxy measure cost/income. Ross (2012) explains operating risk as follows: “uncertainty regarding a financial firm’s earnings due to failures in computer systems, errors, misconduct by employees, floods, lightning strikes and similar events or risk of loss due to unexpected operating expenses.” Uncertainty regarding a financial firm’s earnings due to failures in computer systems, errors, misconduct by employees, floods, lightning strikes and similar events or risk of loss due to unexpected operating expenses (Rose and Hudgins, 2013). On the other hand, the European Commission, in line with the Basel II regulations, defines operational risk as “the risk of a change in value caused by the fact that actual losses, incurred for inadequate or failed internal processes, people and systems, or from external events (including legal risk), differ from the expected losses.”

However, as it is difficult to access one measure reflecting the causes of operating risk mentioned in the Ross’s explanation, cost/income is used as a proxy measure of operating risk.

It is worth mentioning here that there are other types of risk, but because of unavailability of data, the study used the above mentioned four types of risk. Examples of other types of risks that were not included are: market risk, interest rate risk, legal risk, foreign exchange risk, and off-balance sheet risk.

The data used in the study covered 11 Islamic banks out of the 47 in the GCC region for the period from 2000 to 2012. The data used in this study was obtained from the Bankscope database. The 11 banks consist of three banks from Kuwait, two banks from Bahrain, three banks from the United Arab Emirates, two banks from Qatar, and one bank from Saudi Arabia. The selection of banks was entirely based on the availability of data.

The name of the banks included were: Kuwait Finance House, Dubai Islamic Bank plc, Abu Dhabi Islamic Bank, Qatar Islamic Bank SAQ, Islamic Development Bank, Qatar International Islamic Bank, Sharjah Islamic Bank, Kuwait International Bank, Arcapita Bank B.S.C., Gulf Finance House BSC, and International Investor Company.

The regression model used in this study is as follows: PERFS = f (CRK, LIQR, CAPR, OPR)

Where:

- PERFS – represents two alternative performance measures for the GCC commercial banks. These two measures are ROA and ROE;
- CRK – is credit risk = Total loans/total assets or loan losses/total loans;
- LIQR – is liquidity risk = Total loans/total deposits;
- CAPR – is capital risk = Equity capital/total assets;
- OPR – is operational risk = Cost/income.

Control variables
Three control variables were used; the first one is inflation as there is an inverse relationship between inflation and performance. This relationship has been reported by N'cho-Oguie et al (2011), the second one is Bank size is measured by the natural logarithm of bank’s total assets. In this regard Shriever and Dahl (1992) and Hussain and Hassan(2004) indicated that size may have an impact on the bank’s level of portfolio risk. The third control variable is GDP growth rate, which is used as proxy for macroeconomic shocks( see Micco and Panizza ,2004 and Yanez, 2007). The macroeconomic shocks affect risk and return(performance).

5. Data Analysis and Results

Using more than one variable to examine the contribution of independent variables to the regression model may result in a multicollinearity problem among these variables. Before examining the contribution of independent variables to the regression model the potential for multicollinearity should be examined. A multicollinearity test was carried out to assess the degree of correlation among variables. Table (1) provides the correlation among the independent variables. The “rule of thumb” test proposed by Anderson et al. (1990) suggests that any correlation coefficient exceeding (.7) indicates a potential problem. An examination of the results of correlations is presented in Table 1. These results suggest that correlations among variables are not statistically high enough to indicate the existence of a serious multicollinearity problem.

Table 1. The Correlation Coefficients between Independent Variables

<table>
<thead>
<tr>
<th></th>
<th>CRK</th>
<th>LIQR</th>
<th>CAPR</th>
<th>OPR</th>
</tr>
</thead>
<tbody>
<tr>
<td>CRK</td>
<td>1.000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LIQR</td>
<td>.427</td>
<td>1.000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CAPR</td>
<td>-.605*</td>
<td>-0.228</td>
<td>1.000</td>
<td></td>
</tr>
<tr>
<td>OPR</td>
<td>-.526</td>
<td>-0.224</td>
<td>.352</td>
<td>1.000</td>
</tr>
</tbody>
</table>
* Correlation is significant at the 0.05 level (2-tailed)

** Correlation is significant at the 0.01 level.

For bank performance, two measures were alternatively used, namely ROA and ROE. In the first model, ROE was used as a measure of bank performance as better results were obtained.

Table II shows the results of the first regression model. It can be seen from the table that the adjusted R square is 64.4%. This indicates that the four independent variables explain 64.4% of the behavior of bank performance of the GCC Islamic banks, while the estimated coefficients of the four independent variables were, as expected, negative and statistically significant at the 5 percent level in the case of capital risk and at 10 percent in the case of operational risk which is consistent with the findings reached by Wasiuzzaman and Gunasegavan(2013). However, the estimated coefficient of the other two variables, credit risk (CRK) and liquidity risk (LIQR), were unexpectedly statistically insignificant.

**Table II. Summary of Regression Results – The First Model**

<table>
<thead>
<tr>
<th></th>
<th>Beta</th>
<th>T</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td></td>
<td>3.156</td>
</tr>
<tr>
<td>CRK</td>
<td>-.009</td>
<td>-.033</td>
</tr>
</tbody>
</table>
| OPR        | -.399| -1.883*
| CAPR       | -.703| -3.108**
| LIQR       | -.231| -1.162*
| R          |      | .879  |
| R Square   |      | .773  |
| Adjusted R Square | | .644  |
| Std. Error of the Estimates | | 5.296 |
The second model presented below was examined by considering the ROE as the dependent variable and the four independent variables used in the first model with one control variable which was the real GDP growth rate (GDPG). However, the other two control variables, were also included in the second model, but the results were meaningless. Table III reveals the results of the test. It can be seen that the adjusted R square is 59.5%. This indicates that the four independent variables explain 59.5% of the behavior of bank performance of the GCC Islamic banks. The estimated coefficient values are as expected negative except liquidity risk (LIQR), but statistically insignificant except capital risk (CAPR) which was statistically significant at the 1 percent level.

The results partially confirm the first hypothesis as there is a negative relationship between the GCC Islamic banks’ performance and risk, and statistically significant in the case of one type of risks namely the capital risk. This is consistent with the findings of Alam and Tang (2012), who

**Table III. Summary of Regression Results – The Second Model**

<table>
<thead>
<tr>
<th></th>
<th>Beta</th>
<th>t</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td></td>
<td>2.645</td>
</tr>
<tr>
<td>CRK</td>
<td>-.263</td>
<td>-1.164</td>
</tr>
<tr>
<td>OPR</td>
<td>-.472</td>
<td>-1.634</td>
</tr>
<tr>
<td>CAPR</td>
<td>-.718</td>
<td>-2.945*</td>
</tr>
<tr>
<td>LIQR</td>
<td>.035</td>
<td>.117</td>
</tr>
<tr>
<td>GDPG</td>
<td>-.131</td>
<td>-.406</td>
</tr>
<tr>
<td>R</td>
<td>.883</td>
<td></td>
</tr>
<tr>
<td>------------------</td>
<td>------</td>
<td></td>
</tr>
<tr>
<td>R Square</td>
<td>.779</td>
<td></td>
</tr>
<tr>
<td>Adjusted R Square</td>
<td>.595</td>
<td></td>
</tr>
<tr>
<td>Std. Error of the Estimate</td>
<td>5.644</td>
<td></td>
</tr>
</tbody>
</table>

Dependent Variable: ROE (net income/equity)

*Statistically significant at the 1 percent level

noted that banks which have a higher loans-to-total-asset ratio tend to take on lower risk (i.e., an inverse relationship between risk and performance). However, the results were not supported by the expected negative relationship between performance and liquidity risk as the value of the coefficient was statistically insignificant in the two models.

The results of the current study are consistent with the findings of Zulfiqar and Anees (2012) and Ramadan (2011). However, the results are inconsistent with those of Hayden et al. (2007) who attempted to answer the question: Does diversification indeed lead to increased performance? As diversification affects the level of risk, the more the diversification, the lower the risk and vice versa. They found little evidence of large performance benefits associated with diversification.

The second hypothesis proposes that “the magnitude of the impact of each type of risk on the GCC Islamic banks’ performance is significantly different” and the results confirmed this hypothesis. The results provided in Table II and III show that the estimated coefficients were statistically significant for two independent variables, with capital risk ranked first followed by, operational risk, and this is consistent with Rahman (2011).

6. Conclusions and Summary of Findings
The objective of this study was to examine the relationship between financial risk and performance of the GCC Islamic banks and the relative importance of the most common types of risk. The study covers 11 of the 47 Islamic banks in the GCC region for the period from 2000–2012. For bank performance the two most common measures, ROA and ROE, were alternatively used and for risk, four types of risk were used: credit risk, liquidity risk, operational risk and capital risk. The selection of these banks and these types of risk was determined by availability of data. By using two regression models, two performance measures were used. The results as expected indicate that there is a significant negative relationship between the GCC Islamic banks’ performance and two types risk, namely capital risk and operational risk, and also confirm that there is a significant negative relationship between the GCC Islamic banks’ performance. However, the positive relationship between risk and performance of the GCC Islamic banks was not confirmed. Furthermore, the results indicate that the most important type of risk is capital risk risk, followed by operational risk. For policy implementation, it is highly recommended that more attention be paid to capital risk, as this type of risk represents the main determinant of performance, either the equity or assets components. In addition, more attention should be given to operational risk which is mainly related to uncertainty regarding a financial firm’s earnings due to failures in computer systems, errors, misconduct by employees, or risk of loss due to unexpected operating expenses. Finally, more attention should also be paid to liquidity risk which represents a determinant of GCC Islamic banks’ performance.

References


