

CHAPTER I

INTRODUCTION

1.1 Introduction

In general, risks are among the most important elements in banking business. This is because risks are uncertain future events that influence the achievement of a bank's objectives – strategic, operational and financial – and thus will affect the profitability of a bank (Simons, 2009). Thus, in order to sustain in a stiff competitive market, banks must consider all dimensions of risk in their daily operation and business because the lack of management of risks will not only affect the banking business but will affect the whole performance of the bank. Good risk management comprises the process of identifying, assessing, monitoring and controlling the risks associated with a bank's activities (Corvellec, 2009). Different departments within a bank are generally responsible for monitoring and managing a given set of risks. For example, the operations department is responsible for the aspects of operational risk, while the credit department is accountable for credit risk.

In addition, Islamic banks, due to the requirements of *Shariah* are exposed to different types of risk compared to conventional banks because Islamic banks offer different types of contract that are in line with *Shariah* rules and principles (Khan & Ahmed, 2001). Hence, regarding the dissimilarities in nature between different types of banks approach, it will make this study particularly valuable to explore the practices of different types of banking system in credit evaluation process.

In general, different types of banks play important roles as financial intermediaries in providing credit to individuals and for business purposes due to the capital needs of the customers (Santha Vaithilingam et al., 2006; Rose & Hudgins, 2012). The capital needs have increased the rivalry among business entities in obtaining credit (loans), which has transformed the structure that financial institutions face today (Gomez & Ponce, 2013). For conventional banks approach, the reason for the rivalry for credit in the financial market is due to the concern about financial activities only, which means the relationship between the lender and borrower (Hullett, 2011). Thus, the funding costs increased so that the rivalry for credit purposes put downward pressure on the interest charges (*riba*) over the cost of bank funds (Hullett, 2011; Choudhry, 2012).

In contrast, the Islamic banks approach is more 'friendly' because it not only concerns the financial activities but also the social and Islamic ethic for *halal* economic contribution. This is because it offers interest-free financing as interest charges (*riba*) are prohibited in Islam. Moreover, it makes a profit using *Shariah*-compliant contracts in which the relationship between the Islamic banks and the business partner is such that they share the business risk in return for a share of the profits and any losses that are borne (El-Gamal, 2008). The reason for this is that there are different investment tools in investment accounts as the Islamic banking system includes the profit-and-loss sharing (PLS) principle in its business operation and offers cost-plus financing contracts (Boumediene, 2011).

In addition, the Islamic banks approach in a commercial financing activity when providing financing, they must ensure that there are no asymmetric information and moral hazard in evaluating their customer as they are practicing risks-sharing

contracts (Yahia Abdul Rahman, 2010). Therefore, the practices in Islamic banks must avoid any stipulation in credit evaluation process and any claim to additional amount (interest charges) if they wish to fulfil the customer's *daruriyyah* (necessity) and *hajiyyah* (wants) as part of credit risk management (Muhammad Farhan Akhtar & Khizer Ali, 2011). This makes the dual-banks approach are different in nature in terms of credit purposes because different practices of banks have different kind of moral dimension (Muhammad Hanif, 2010).

Notwithstanding the difference in nature in different practices of banks approach, Islamic banks approach are still developing their banking and financial products, and, hence, there are still developing standards for risk management and other activities (Akkizidis & Khandelwal, 2008; Muhammad Farhan Akhtar & Khizer Ali, 2011). Furthermore, the determinants of Islamic funds in Malaysia still underperform because of the higher operating cost and low returns from the commercial financing activities, which as a result affects all the risks associated and particularly credit risk (Mohd Rahimie Abd Karim et al., 2013).

To sustain as a credit provider, banks also need to consider the issue of default payments from their customers, as these may raise the issue of high credit risk and a tendency to bankruptcy. Therefore, they need to consider all the stages in the credit process – pre- and post-approval. Therefore, this study attempts to explore the current practices of the credit risk management in the credit evaluation process of commercial financing approval in dual-banking approach in Malaysia, and, in doing so, identify the differences between both banking approaches in the credit evaluation process. Then, the study explores what and how Islamic elements are used in credit risk management in the evaluation process, and then propose good parameters for the

credit evaluation process in the Islamic banks approach as a contribution to knowledge of study.

This chapter is divided into eight sections. Section two discusses the background of the study. Section three presents the problem statements. Section four states the research questions and objectives. Section five discusses the scope and limitations of the study. Section six presents the significance of the study. Section seven states the research questions, and, lastly, the structure of the study is discussed in section eight.

1.2 Background of the Study

In reality, humans have a continuous need to improve their daily life, which is true of business practices as well as in the management of credit risk. To ensure the objective is achieved, they should improve their knowledge and skills concerning how to manage the credit risk in banking business (Zamil Iqbal et al., 2012).

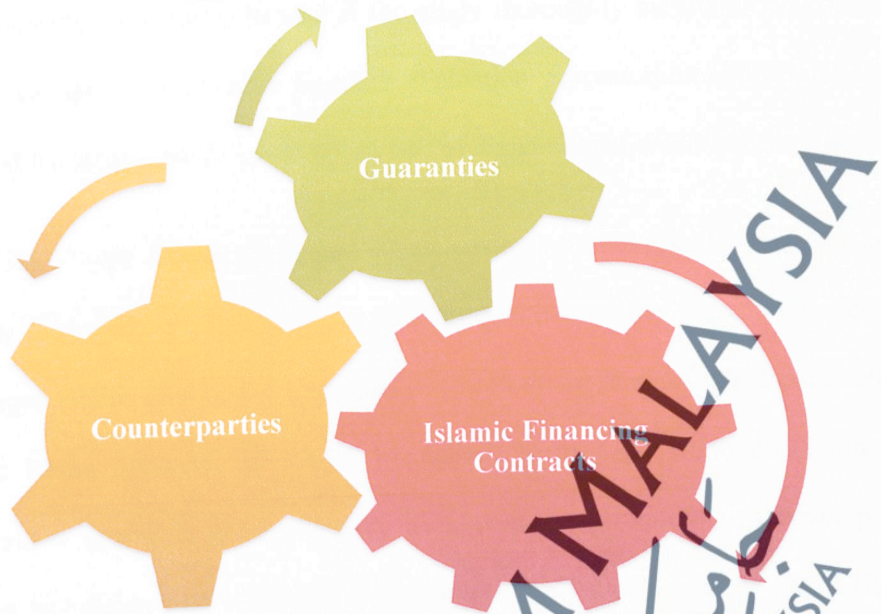
Good credit risk management comes from the practicing of the concept of *taqwa* (fear of Allah), which underlies how well the individual achieves in the context of their relationship with Allah the Almighty (*Hablum-minallah*) and the context of the relationship with participating humans in the business contract (*Hablum-minnanas*). This is why Islam is *syumul* (complete) life, not only in business but every aspect of one's life. The practicing of the concept of *taqwa* in business activity can be demonstrated from the success of people, such as Prophet Rasulullah s.a.w., Khalifah Uthman bin Affan, Zubair Ibn Marwan, Abdul Rahman bin Auf and Talhah Idn Affan. Reforming the practicing of Islamic business practices, as well as practicing a good way in financial activities, are a means to elevate the Muslim as a whole to ensure that

they are practicing the way of business based on *Al-Quran* and *Sunnah*.

Credit risk appears when banks expect a payment from customers and also appears when there is an underestimation in the strict evaluation of the customers such as asymmetric information and moral hazard (Sinkey, 2002; Shiller, 2008). As for conventional banks practices, they are exposed to credit risk because of high issues in asymmetric information plus the relationship between the lender and the borrower and the emphasis on the expectation of whether or not borrowers will pay the loan, or, in other words, default (Foster & Magdoff, 2009; McConnell, 2013).

In contrast, Islamic banks are highly exposed to credit risk as well because of the emphasis on the different types of contract offered in commercial financing, such as *Mudharabah*, *Musharakah*, *Murabahah*, *Ijarah*, *Bai' As-Salam* and *Bai' Al-Istisna* plus there are still high issues in asymmetric information which same with conventional banks practices and thus proclaim as no different strategies in credit evaluation process (Sudin Haron & Bala Sharmugam, 1997; Bouheni & Bellalah, 2012; Habib Ahmed, 2011; Bidabad, 2014). In regards of different types of contracts offered in Islamic banks practices, one of the uniqueness of Islamic banks, they have a tight relationship due to the unique relations of commercial financing contracts (*Mudharabah*, *Musharakah*, *Murabahah*, *Ijarah*, *Bai' As-Salam* and *Bai' Al-Istisna*). All the parties involved in the Islamic contract agreements are called counterparties, and the guaranties are used to cover the amounts of the potential losses in the case of default (Akkizidis & Khandelwal, 2008). The explanation of the relationship between the Islamic financing contracts, counterparties and guaranties in Islamic banking practices is shown in figure 1.1 below:

Figure 1.1: Relationship between Islamic Financing Contracts, Counterparties and Guaranties in Islamic Banking Practices

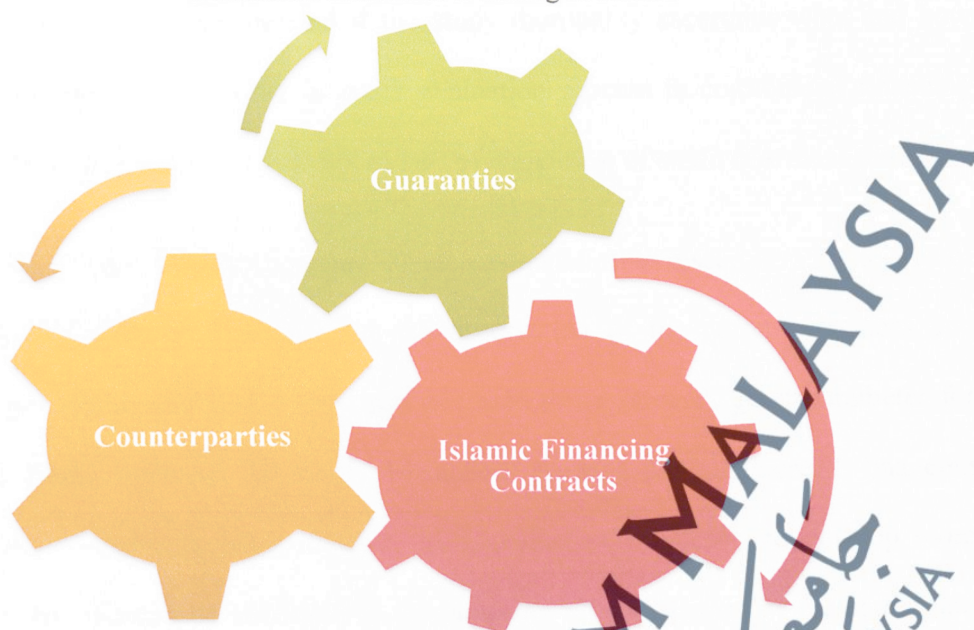


Source: Akkizidis & Khandelwal, 2008

Zamir Iqbal et al. (2012) viewed that giving financing to customers who run the business is a profit for Islamic banks as they offer cost-plus financing in the financial contracts and share the profit and loss with the counterparties in the agreed contract. In contrast, conventional banks approach, they give credit to customers also provides profit to them as in return, the customers pay interest (*riba*) on the amount borrowed (Oluitan, 2011; Bundala, 2012).

Despite these dissimilarities in practices, this activity also results in concerns concerning how good the current practices of credit risk management are in the evaluation process (pre-approval stage) for commercial financing approval with different types of banks approach. In considering that the Islamic banks need to be more proactive in undertaking permissible (*halal*) business activities and as they have the uniqueness of moral dimension uphold, hence, they should be more proactive and

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advanced credit evaluation process as part of credit risk management. Accordingly, this capability could be enhanced if the study thoroughly ascertains what and how Islamic elements can be used in credit evaluation process in commercial financing approval for Islamic banks approach as part of dimension of credit risk management.

By considering the above and the statements of other researchers in the area of interest, this study is motivated by the observation of the current practices and challenges within dual-banks approach as guide to implements good parameter for Islamic banks approach in credit evaluation process for commercial financing approval, as thus it is good platform for Islamic banks industry to develop more advance techniques and strategies in guaranteeing all dimensions of credit risk are mitigated. For that reason, these help the study to get some views and perceptions of those involved in the events of study.

1.3 Problem Statement

In the real world of the financial industry, when banks lend money to borrowers, it tend for compensation as banks itself comes along with strings attached, which become a credit risk which includes two (2) dimensions of credit risk (Amalendu Ghosh, 2012). The first dimension is the pre-approval of credit risk, which is to understand the reality of the soundness of the customers by evaluating them based on the credit element. The second dimension is the post-approval of credit risk after the credit (loans) is approved, as banks need to know whether the customer will settle-up the payments within the time agreed. Regarding this situation, an issue arises concerning the understanding of how well the current practices of credit risk management in the first dimension of credit risk (pre-approval stage) affect the credit

risk management in the second dimension of credit risk (post-approval stage). This is supported by Carey (2000), Avis (2008), Akkizidis and Khandelwal (2008).

On top of that, in regard issues on asymmetric information and moral hazard in credit evaluation process, the issues arise as how well dual-banks approach mitigate these situations in first dimension of credit risk (Avis, 2008).

In addition, concerning the situation in the conventional banks approach, the nature of the relationship in the evaluation process of the credit application consists of two counterparties – the lender and borrower. Therefore, the issue that arises pertaining to the nature of the relationship in commercial loans is that of a lender-borrower relationship, which is restricted to the financial activities only, and thus affects the high default case not only to the commercial borrower but also the bank's performance as they apply downward pressure on the interest charges over the cost of the bank's fund (Khan & Ahmed, 2001; Akkizidis & Khandelwal, 2008). The other situation concerns the use of interest-based lending in commercial loan contracts in the conventional banking approach. This leads to the issue arising from the misuse of the capital as a factor of production, and the application of uncertainty (*Gharar*) of business activities, which involve speculation. This statement is supported by Muhammad Hanif (2011).

Furthermore, pertaining to the situation in the Islamic banks approach, the nature of the relationship in the evaluation process of the commercial credit application comprises the unique nature of the contract compared to the conventional-based banking approach in that the assessment stage of the financing decision depends on the type of contract for the commercial financing offered, such as *Murabahah*, *Mudharabah*, *Musharakah*, *Ijarah*, *Bai' Al-Istisna'* and *Bai' Al-Salam*. Therefore, maximizing the profit is not their motive but more concerning the three dimensions of

upholding the social, economic and financial activities. The reason for this is that Islamic finance has a strong root in sustainable society with a focus on welfare, equality and justice (Akkizidis & Khandelwal, 2008).

Nevertheless, the issues that arise pertain to how deep or how well the Islamic banking approach evaluates their customers before approving the commercial financing application and choosing the appropriate type of contract (Mohamad Yazis Ali Basah & Mazlynda Md. Yusuf, 2013). The other part is in terms of the standardization of the commercial financial products in the Islamic banking approach. Consequently, issues arise concerning the lack of awareness of the customers in a variety of commercial financing contracts offered (misconception). This statement is supported by Aminah Zuhria (2010).

Moreover, one of the problems is the complexity of the commercial financial transaction, which can impact the degree of evaluation/assessment for the different types of contract offered. This is supported by Nuradli Ridzwan Shah Mohd Dali and Saned Ahmad (2005). The other situation concerns the misconception of Islamic banking by the commercial clients who apply for commercial financing, and, hence, the issue arises as to how the Islamic banks and commercial credit applicants understand that the degree or parameters in the evaluation stage for credit applicants differ from the credit evaluation in the conventional-based approach. This issue is supported by Irfan Shahid (2013).

After the issues and statement of the problem are identified and stated, Islamic banks approach should come out a different evaluation approach in commercial financing approval. Islamic banks are still developing the banking and financial products offered, as well as the standards for risk management and other activities (Akkizidis and Khandelwal, 2008; Muhammad Farhan Akhtar and Khizer Ali, 2011;

Mohd Rahimie Abd Karim et al., 2013).

The determinants of Islamic funds in Malaysia still result in underperformance because of the higher operating cost and low returns from the commercial financing contracts, which affect all the associated risks, especially credit risk (Mohd Rahimie Abd Karim et al., 2013). Based on these problems, this study explores on what and how Islamic elements can be used in the evaluation process of commercial financing approval in Islamic banks approach. By exploring this purpose, this study first identifies the current practices of the credit evaluation process for the conventional and Islamic banks approach and identifies any different practices in the evaluation parameters between the two different types of banks practices. It is imperative to develop good parameters for credit risk management in credit evaluation as aim to reduce the post-approval stage of the financing issues of credit risk.

All the above issues and the statement are based on the findings of various studies. However, before accepting or confirming the findings from the review of the literature, the researcher must first carry out this research.

1.4 Research Questions

In respect of the concerning to the research questions in this research study, the study first conducts preliminary study (phase I) before attend to the development of next two (2) of research questions (phase II). There are two (2) of research questions in phase I and two (2) of research questions in phase II. Table 1.1 below shows the research questions of the study:-

Table 1.1: Explanation of Research Questions

<u>Phase I</u>	<u>Phase II</u>
1. What are the current practices in different types of banks in credit evaluation process for commercial financing approval?	1. What and how Islamic elements can be used in credit evaluation process for commercial financing approval for Islamic banks approach?
2. Are there any differences between both banks approach in terms of credit evaluation process for commercial financing approval?	2. What is the best parameter for credit evaluation process in commercial financing approval for Islamic banks approach?

1.5 Research Objectives

As connected with research questions, the study first conducts preliminary study (phase I) before attend to the development of next two (2) of research objectives (phase II). There are two (2) of research objectives in phase I and two (2) of research questions in phase II. Table 1.2 below shows the research objectives of the study:-

The objectives of this study are as follows:-

Table 1.2: Explanation of Research Objectives

<u>Phase I</u>	<u>Phase II</u>
1. To explore the current practices in different types of banks in credit evaluation process for commercial financing approval.	1. To explore the Islamic elements that can be used in credit evaluation process for commercial financing approval for Islamic banks approach.
2. To identify any differences between both banks approach in terms of credit evaluation process for commercial financing approval.	2. To propose the best parameter for credit evaluation process in commercial financing approval for Islamic banks approach.

1.6 Scope and Limitations of the Study

The scope and limitations of the study are based on the area of credit risk management in the pre-approval (credit evaluation) stage before the financing approval. Duffie and Singleton (2003), and Hopkin (2012) stated that credit risk in the evaluation stage is one of the main risks that can arise from the credit activity in the banking industry. The reason being that poor credit risk management at the evaluation stage will increase the probability of loans becoming bad debt and affecting the financial performance of the banks (Zamir Iqbal et al., 2012).

Although there are many financial institutions in both the conventional banking and Islamic banking system in the world at large, and Malaysia in particular,

the study will be limited to those banks that offer an Islamic window of financing and full-fledged Islamic banks to identify the current practices and their experience in managing credit risk in the evaluation process of commercial loan approval, and to identify the differences between different types of practices in the credit evaluation process.

Although there are two (2) types of activity in financing – personal financing and commercial financing – the study will be limited to the commercial financing. Because the complexities in the evaluation process of financing are more difficult to analyze before the financing is approved, a bank will want to evaluate the fundamental characteristics in terms of the five C's of credit or CAMPARI analysis.

Thus, to validate the above scope of study that results from the face-to-face interviews with the business financing officers that handle commercial financing, this study used the same method to interview and discuss with *Shariah* advisers in financial institutions and explore on what and how the Islamic elements can be used in credit risk management in the credit evaluation process and the implementation of good parameters for the credit evaluation process for Islamic banks.

In addition, the tasks in this study were conducted using the Internet and journals. Therefore, the findings of the study depend entirely on the interviews responses.

1.7 Significance of Study

As the aims and objectives of the study demonstrate, the research presented contributes to the relevant literature. Therefore, the significance of the study is that it provides an academic research of credit risk management in the Islamic banking system in Malaysia, which has not been widely covered from the economic and financial perspective in terms of the evaluation process of credit applications.

In addition, the outcomes from this study are essential instruments to support, add or advise on certain techniques and strategies in respect of commercial financing approval, which can be supplementary to those already known to endorse an appropriate credit risk management in the pre-approval of credit for commercial financing in dual-banks approach.

Furthermore, the suggestions of the parameters provided by this study can be implemented to minimize the credit risk issues that arise related to the counterparties in the pre-approval stage that affect the banks in Malaysia. This study establishes that there is a bright future in the credit risk management, with the capacity of the financial industry to develop more Islamic principles and practices worldwide.

1.8 Structure of the Study

This thesis contains seven (7) chapters, the outline of which is provided below:-

Chapter two presents the credit risk management in the conventional banking approach. It provides a brief understanding of credit risk management in the banking system in general and the evaluation process in mitigating credit risk. The study proceeds to show how conventional banks handle the scene of striving to strike a good implementation of credit risk management in commercial loan approval based on the conventional approach perspectives. Finally, it presents an empirical study in the area of study and chapter summary.

Chapter three presents the credit risk management in the Islamic banking approach. The study proceeds to show how Islamic banks are able to implement good credit risk management based on Islamic perspectives. Finally, it presents the empirical study for the area of study and chapter summary.

Chapter four is devoted to the presentation and discussion of a suitable research methodology to perform this research and also describes how the data are collected and justifies the usage of the chosen strategy.

Chapter five discusses the analysis phase I pertaining to the analysis of business financing officer's perceptions and findings from the analysis.

Chapter six presents the analysis phase II pertaining to the analysis of *Shariah* adviser's perceptions and come out with findings from the analysis.

Chapter seven is devoted to the conclusion and theoretical contribution as well as the parameter will be recommended based on the findings, and, thus, ends with

recommendations and conclusions for future research in the area of study.

