

Credit Risk Management Practices in Islamic Banking: A Literature Review

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Abstract: *Credit risk management is a critical aspect of banking operations, aimed at identifying, assessing, and mitigating the risks associated with lending activities. In the context of Islamic banking, credit risk management holds particular significance as it involves adhering to Shariah principles while ensuring financial stability and profitability. Therefore, the objective of this study is to explore the credit risk management practices employed by both full-fledged Islamic banks and Islamic subsidiaries of conventional banks. The study adopted document analysis as a method of analysis. Expected findings of this study includes the reviews and discussion on understanding the credit risk management practices of both types of institutions as it is crucial for enhancing risk management effectiveness, ensuring financial stability, and maintaining investor confidence. This study will help to inform policymakers, regulators, and practitioners in formulating robust credit risk management frameworks tailored to the unique characteristics of full-fledged Islamic banks and Islamic subsidiaries of conventional banks.*

Keywords: credit risk, bank performance, risk management, Islamic banking

1. Introduction

In today's dynamic financial landscape, credit risk management has emerged as a fundamental pillar that underpins the stability (Ismail & Ahmed, 2023) and prosperity of financial institutions. As the principles of Islamic banking gain increasing recognition on the global stage, delving into the intricacies of credit risk management within this specific framework becomes an endeavour of profound relevance and significance. This literature review embarks on a comprehensive journey into the realm of "Credit Risk Management Practices in Islamic Banking," seeking to dissect, analyse, and illuminate the distinct strategies, challenges, and innovative approaches that characterize this unique field.

Islamic banking is rooted in ethical tenets, risk-sharing principles, and the steadfast prohibition of interest (*riba*). As a result, the credit risk management strategies employed by Islamic banks significantly diverge from their conventional counterparts, reflecting the Shariah-compliant nature of these financial institutions. This review casts a wide net, drawing upon an extensive array of scholarly articles, peer-reviewed research papers, and pertinent case studies. By doing so, it aims to not only comprehensively explore but also critically evaluate the methodologies utilized by Islamic financial institutions to assess (Xu et al., 2023), monitor (Yilmaz, 2023), and mitigate (Wang & Hou, 2023) credit risk.

It not only delves into conventional credit risk tools but also examines Sharia-compliant mechanisms, such as *musharakah* (partnership) and *mudharabah* (profit-sharing), that alter the dynamics of credit risk management. It delves deeper, unpacking the intricate challenges faced by Islamic banks in navigating the ever-evolving financial landscape while adhering to their faith-based principles (Minhajuddin & Ibrahim, 2022). This exploration showcases the delicate balance that Islamic banks must strike between ensuring profitability and upholding ethical considerations, revealing the remarkable adaptations and innovations that arise from this synthesis.

Through the meticulous synthesis of the existing literature, this review seeks to provide not only a comprehensive understanding but also a nuanced insight into the realm of credit risk management practices in Islamic banking. In a world where financial systems are progressively interconnecting, this endeavour adds valuable knowledge to the discourse surrounding the integration of Islamic finance (Aassouli, 2021) with conventional practices. By exploring the multifaceted dimensions that underlie credit risk management within Islamic banking, this review enriches the ongoing global conversation on this pivotal subject, contributing to the broader understanding of the symbiotic relationship between financial practices and faith-based principles.

2. Literature Review

Credit risk management is a crucial aspect of financial institutions' operations, ensuring their stability and safeguarding against potential losses arising from borrower defaults (Wahyudi et al., 2015). This section discusses some empirical and theoretical literature on the Islamic banking, risk mitigation and credit risk management.

2.1 Islamic Banking

Introduction to Islamic Banking provides an overview of the fundamental principles and concepts that underpin Islamic banking, encompassing its distinctive characteristics and adherence to Shariah principles. Islamic banking functions in accordance with Islamic values and is guided by Shariah law. In contrast to conventional banking, Islamic banking prohibits the charging or payment of interest (*riba*) and refrains from investing in activities that are deemed unethical or incompatible with Islamic principles (*haram*). Instead, Islamic banks engage in profit-sharing arrangements (*mudharabah*) and collaborative ventures (*musharakah*), employing various other Islamic financial contracts like leasing (*ijarah*), sale contracts (*murabahah*), and partnership (Wahyudi et al., 2015).

Islamic banking represents a form of financial service that operates based on the teachings, principles, and ethics of the Islamic faith, guided by the precepts of Shariah law. These banking practices revolve around financial activities aligned with Islamic principles, avoiding transactions that contravene the parameters of Islamic Shariah. The central foundation of Islamic banking lies in harmonizing its operations with the teachings and values of Islam, ensuring that all financial dealings uphold ethical and Shariah-compliant standards (ISRA, 2012).

Additionally, an Islamic bank is a financial institution specializing primarily in offering funding and services related to financial transactions and money circulation, all in accordance with Shariah principles (Rahmayati, 2021). According to the study, the adoption of a competitive strategy in the Islamic banking sector, focused on enhancing customer service through digital banking services, significantly impacts customer experience. As emphasized by

Khan and Bhatti (2008), the Islamic banking and finance sector has been making substantial strides, aiming to establish itself as a genuinely viable and competitive alternative on a global scale. Islamic banking and finance institutions have experienced remarkable growth and influence across regions including the Middle East, Southeast Asia, and South Asia.

Islamic banking is not confined to Muslims but is designed to serve everyone, aligning with Karim's (2012) assertion that the system's roots in an Islamic economic framework make it universally applicable and beneficial. The primary goal of this system is to promote the welfare of all humanity. Consequently, Islamic banking has the capability to cater to diverse interests, catering to both Muslim and non-Muslim individuals. In terms of interest rates, Ergec and Arslan (2013) found that Islamic banks in Turkey are affected by interest rates, which contradicts the foundational principles of Islamic banking. Similarly, research by Hassan and Aliyu (2018) reveals that the influence of interest rates on Islamic banking operations surpasses the impact of real economic activities. This also supported by research done by Li et al. (2023) found that there is a favourable correlation between the conventional overnight rate and the Islamic deposit rate. This relationship remains consistent across various maturity periods for Islamic deposits.

2.2 Risk Mitigation

Risk mitigation refers to the process of taking proactive actions and measures to minimize or reduce the potential negative impacts or consequences of risks. Risk mitigation strategies aim to identify, assess, and then implement steps that either prevent risks from occurring, lessen their severity, or provide contingency plans to effectively respond if they do materialize. The goal of risk mitigation is to increase the likelihood of achieving desired outcomes while minimizing potential losses or disruptions. According to research done by Yusoff et al., (2022), the bank must create risk management policies and procedures, which will encompass measures to counter the inherent risks associated with Islamic finance operations like *Ijarah* and *Murabahah* transactions. These policies and procedures will be applicable throughout the entire process, from the initial stages before a contract is established, through the contract's duration, and up to its termination or resolution. As the bank is obligated to possess the asset prior to its sale or lease to the customer, effective risk management for inventory becomes crucial even before the contract is formalized.

The proficiency of Islamic banks in handling their credit risks enhances their performance, leading to improved financing quality. This augmentation renders their financing offerings favourable and more appealing to customers (Al-Shaghdari et al., 2021). Furthermore, in a study conducted by Ben et al., in 2022, it was discovered that Islamic banks' credit risk moves in the opposite direction of economic cycles. The researchers propose that this contrasting connection indicates the presence of trade-offs in bank returns and credit risk. As a result, the historical profitability and risk mitigation of banks play a significant role in influencing the quality of their assets.

Risk mitigation in Islamic finance involves strategies and principles aimed at minimizing financial risks while adhering to Islamic ethical and legal guidelines. Here are some key approaches to risk mitigation in Islamic finance contract according to Wahyudi et al. (2015):

Table 1: Default Risk Factors in Islamic Finance Contracts and Their Mitigation Methods

Type of contract	Risk that emerges	Possible risk mitigation tactics that can be done
<i>Qardhul Hasan</i>	Debtor defaults	<ul style="list-style-type: none"> • Run simulations of debt restructuring or choose haircut policies. • Assess the expected value of a collateral asset as well as the return from the guarantor. • Build a list of failed debtors and their causes for future consideration and policy input.
<i>Salam</i>	Delayed delivery of commodity	<ul style="list-style-type: none"> • Improve the bank's relationship and communication process with the debtor to be able to detect any issues beforehand and find out the cause of a delay.
<i>Ijarah</i>	Bank purchases the asset chosen by the debtor, but the debtor rejects from choosing the asset as the leased asset.	<ul style="list-style-type: none"> • Take the debtor's promise (<i>wa'ad</i>). • If the debtor cannot adequately explain the reasons for the rejection, the bank can sell the asset in the market and then take some of the security deposit (<i>hamish jiddiyah</i>) previously given by the debtor to cover any occurring loss.

Source: Wahyudi et al., (2015)

The specific strategies employed depend on the nature of the risk, the context in which it arises, and the resources available to address it. In essence, risk mitigation is about being proactive and prepared, taking steps to reduce the impact of adverse events, and enhancing an individual's or organization's ability to navigate challenges and uncertainties successfully.

2.3 Credit Risk Management

Amidst the ever-changing dynamics of the global financial landscape, effective credit risk management holds paramount importance for banks and other lending institutions. This encompasses the recognition, evaluation, vigilance, and reduction of potential credit risks tied to lending operations. Through the implementation of robust credit risk management strategies, financial establishments can enhance their lending procedures, make well-informed choices, and uphold a healthy loan portfolio. Alshatti (2015) brought to light that, to formulate an efficient credit risk management system, banks must establish an environment conducive to credit risk management. This entails constructing a robust credit approval process, maintaining efficient credit oversight covering monitoring, processing, and executing adequate controls to mitigate credit risks.

The stability of banks hinges significantly on effective credit risk management, as it can either jeopardize or guarantee the continuity and expansion of the institution (Annor & Obeng, 2018). Leo et al. (2019) recognized that possessing research and models to anticipate or gauge the likelihood of default (PD), loss given default (LGD), exposure at default (EAD), and subsequently assess credit loss exposure would hold substantial significance for banks and their risk management endeavours. The tools or equations hold utility in framing this study, as illustrated by the research of Annor and Obeng (2018), wherein the study unveiled a notable correlation between credit risk management and banks' profitability. The study underscored that a higher capital adequacy ratio positively influenced a bank's profitability. Conversely, non-performing loans, the ratio of provisions for loan losses, and the loan-to-asset ratio exhibited statistically significant negative associations with bank profitability.

The structure and guiding principles of credit risk management differ among various banks. While certain banks have enacted all-encompassing systems and structures to gauge and supervise credit risk exposures, others concentrate on monitoring credit risk within specific business segments or legal entities. Moreover, certain banks employ separate models for

assessing credit risk in corporate and retail client portfolios (Gallati, 2022). To augment the effectiveness of the credit risk management process, Khairani and Diyanty (2022) suggest integrating five essential components. These components encompass governance and organizational culture, the formulation and determination of organizational strategy and objectives, performance assessment, review and revision, and the establishment of efficient information and communication channels.

Credit risk management strategies denote the measures undertaken by banks to prevent or alleviate the adverse consequences of credit risk. When a robust credit risk management framework is instituted, it not only safeguards against potential risks but also contributes to enhanced profitability and the long-term sustainability of banks (Aldayel & Fragouli, 2018). The study conducted by Aldayel and Fragouli (2018) illustrates that credit risk assessment, credit rating mechanisms, and credit analysis and evaluation serve as reliable indicators within the credit risk management model. Furthermore, these three indicators manifest a positive correlation with the financial performance of commercial banks in Saudi Arabia.

3. Research Method

The research employs a document analysis methodology, which involves the qualitative interpretation of documents to provide voice and significance to the subject being examined (Bowen, 2009). An integral aspect of document analysis is the categorization of content into primary themes and sub-themes. The primary sources utilized in this research consist of publicly accessible private records, including academic publications from SCOPUS and Google Scholars website. It is anticipated that this meticulously conducted literature review will establish a robust basis for my research, showcasing my grasp of the current domain knowledge and aiding in the identification of potential areas for my own study to make valuable contributions.

4. Findings

4.1 Credit Risk Management Practices in Islamic Banks

This section conducted a review of previous studies that were theoretical, conceptual, and library based. These studies laid the foundation for credit risk management practices within Islamic banks. Although only a limited number of relevant sources were available, some were outdated. This scarcity is attributed to the recent prevalence of empirical research in this field. Consequently, this study focused on examining a small selection of theoretical literature concerning credit risk management practices employed by banks.

Credit risk management is a critical facet of banking operations, aimed at identifying, evaluating, and mitigating the risks linked to lending activities. Particularly in Islamic banking, credit risk management holds special importance as it requires adhering to Shariah principles while ensuring financial stability and profitability. The prior research delves into exploring how both standalone Islamic banks and the Islamic arms of conventional banks manage credit risk.

Shah et al. (2023) conducted a study with the aim of assessing the influence of fintech on credit risks encountered by Islamic banks before and after financing. The research utilized primary data about fintech awareness and adoption, along with secondary data encompassing various financial and economic factors from 2009 to 2021. The findings highlighted variations in fintech awareness and adoption across Islamic countries. The Asia Pacific region, particularly

Indonesia, exhibited notable progress in fintech adoption, while Malaysia showcased effective integration for credit risk management.

Hameed et al. (2022) conducted a study examining the impact of entrepreneurial finance, market risk management (MRM), credit risk management (CRM), and operational risk management (ORM) on risk mitigation in both conventional and Islamic banks in Pakistan. The research distributed 500 questionnaires using cluster sampling among employees in these banks and employed Partial Least Squares (PLS) analysis to analyse the collected data. The findings indicated significant positive relationships between MRM, CRM, ORM, and risk mitigation.

Numerous empirical studies have focused on comparing credit risk management practices between conventional and Islamic banks. Akram and Ur Rahman (2018) conducted a study to investigate and compare CRM practices between Islamic banks (IBs) and conventional banks (CBs) in Pakistan. The research analysed data spanning from 2004 to 2016 and found that loan quality (LQ) had a positive impact on CRM for both IBs and CBs, while asset quality (AQ) had different associations with CRM in these two types of banks. Incekara and Çetinkaya (2019) explored factors influencing credit risk management in Islamic banks in Turkey from 2014 to 2017. The study used panel data regression and found a positive correlation between the capital adequacy ratio (CAR) and credit risk.

Basah et al. (2018) conducted a study that compared credit assessment practices for business financing between Islamic and conventional banks in Malaysia. The study used qualitative methods, including interviews with credit analysts, and highlighted distinct characteristics in risk assessment approaches between these two types of banks. This study emphasizes the importance of effective credit risk management in maintaining banking stability under Islamic principles. They also discuss challenges faced by Islamic banks in credit risk management while adhering to Shariah compliance. Additionally, there are theoretical studies such as that by Leo et al. (2019), which reviews machine learning techniques in banking risk management, and the study by Ali et al. (2020), which summarizes the relationship between the accounting information system and risk measurement.

There are lack of study comparing the credit risk management practices employed by both full-fledged Islamic banks and Islamic subsidiaries of conventional banks. Most of the study done are comparing between Islamic and conventional banks. The past research also revealed there a lack of study of comparing Islamic bank performance. Most of the past research are done between conventional banks and Islamic banks. This shown that the areas are not investigated from the past research reviewed. Some of the studies are focusing on investigate the risk involve in Islamic finance contract. Recent study was done by Misman et al. (2020) which investigates the impact of Islamic financing agreements on credit risk. Within the operations of Islamic banks, there exist three classifications of contracts. The research emphasizes that equity-based financing (EBF) constitutes a contract of profit and loss sharing, bearing elevated credit risk when contrasted with trading-based and supporting-based financing.

One of the studies done by Mohamad et al. (2015) which employed a qualitative approach to analyse data gathered through in-depth interviews involving five business financing officers from both full-fledged Islamic banks and the Islamic subsidiaries of conventional banks. The study revealed that not all these officers focused exclusively on the business financing products being provided, except in cases where fully-fledged Islamic banking practices were observed. They also discussed prevailing practices alongside the products offered during the interviews.

The research agrees with this observation to a certain degree; however, it posits that effective credit risk management can also impact the selection of business financing products incorporated into contracts, thereby influencing the customer evaluation phase.

In study conducted by Othman and Gabbori (2024) on the credit risk in Islamic banks, the researchers have employed panel data analysis to identify bank-specific and macroeconomic factors that influence non-performing loans (NPL) and explores the effects of the institutional environment, product development, and credit concentration on credit risk. They found that bank specific and macroeconomic factors significantly influence the credit risk. The higher return on asset (ROA) and liquidity ratio (LIQ) reduce the credit risk while higher net interest margin (NIM) and net charge-off ratio (NCOFF) increase the credit risk. Meanwhile, the macroeconomic factors such GDP growth and inflation, play a critical role in influencing non-performing loans (NPLs), where periods of economic contraction and elevated inflation exacerbate credit risk. While political stability contributes to reducing such risks, high credit concentration in sectors like real estate tends to increase the incidence of NPLs.

Another study conducted by Warninda et al. (2019) have analyzed whether Mudarabah and Musharakah financing impact the credit risk in Islamic bank. The findings show that Mudarabah financing demonstrates neither a significant linear nor non-linear effect on credit risk, whereas Musharakah financing exhibits a curvilinear (inverted U-shaped) relationship with Islamic banks' credit risk. The lack of significant impact from Mudarabah may be attributed to its relatively small share in the overall financing portfolio of Islamic banks.

This finding contributes valuable insights into the practices, strategies, and regulations governing credit risk management in Islamic banks. They shed light on the regulatory framework that influences credit risk management in both full-fledged Islamic banks and Islamic subsidiaries of conventional banks. This understanding is crucial for enhancing risk management efficacy, maintaining financial stability, and bolstering investor confidence. The insights from this research can inform policymakers, regulators, and practitioners in developing robust credit risk management frameworks tailored to the unique characteristics of both types of Islamic banking institutions.

5. Conclusion and Recommendations

In conclusion, this comprehensive literature review has provided a thorough exploration of credit risk management practices within the context of Islamic banking. Through an analysis of both theoretical and empirical studies, a holistic understanding of the strategies, challenges, and implications of credit risk management in Islamic banks has been attained.

The studies reviewed underscore the significance of effective credit risk management in Islamic banking operations. These practices are essential for maintaining financial stability, ensuring compliance with Shariah principles, and achieving sustainable profitability. The literature reveals that Islamic banks face unique challenges compared to conventional banks due to their adherence to ethical and Shariah-based principles. As a result, credit risk management strategies need to be carefully aligned with these principles while also conforming to regulatory requirements.

Practitioners in Islamic banks should take note of the findings from this literature review and consider adopting credit risk management strategies that align with Shariah principles while maintaining financial stability. Regulatory bodies should also collaborate with Islamic banks

to develop clear guidelines that facilitate effective risk management practices while ensuring adherence to ethical standards.

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Conflict of Interest Statement

The author declares no conflict of interest regarding the publication of this study.

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