



**RISK MANAGEMENT PRACTICE AND RISK
DISCLOSURE ON FINANCIAL PERFORMANCE IN
ISLAMIC AND CONVENTIONAL BANKS IN
GCC COUNTRIES**

BY

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ABSTRACT

Risk management is regarded as one of the most interesting and deeply researched areas over the past 15 years in the financial industry. Risk management in the financial sector is crucial as many banks argue that shareholder value is established through superior risk management. The global economic crisis broke out in the United States in 2008 as a result of the bankruptcy of the most well-established and prominent U.S. banks, followed by the bankruptcy of several banks all over the world. The spread of the crisis to almost the whole world has raised many questions about the effectiveness of risk management practice applied by those bankrupt banks. The findings reached by several studies have actually proved the failure of risk management departments to effectively perform their duties. Risk management experts, practitioners, academicians, and others acknowledge that the presence of effective risk management departments is the cornerstone for the management of economic and financial institutions, including banks, while the failure of effective risk management practice may lead to effect negatively on financial performance for institutions, including banks. As the GCC countries is an indispensable part of the world, the researcher embarked on this study with the aim of examining the risk management practice, risk disclosure, and financial performance (ROA and ROE) of both Islamic and conventional banks in the GCC countries. The researcher also investigated the impact of risk management practice and risk disclosure on the banks' financial performance (ROA and ROE). The study selected a sample of 30 out of 61 banks from five countries (14 Islamic banks and 16 conventional banks). The present study used a quantitative approach with primary data (questionnaires) and secondary data (the annual reports for 30 banks for the years 2008 to 2013). Data was analysed by using various statistical tests, such as descriptive, T-test, regression, the ANOVA test, and cross-sectional and panel data. The findings of the study indicated that there are statistically no differences in risk management practice and risk disclosure between Islamic and conventional banks. However, there is positively influence of risk management practice on the financial performance of the Islamic banks in the GCC countries. Meanwhile, it was found that risk disclosure has no influence on the both Islamic and conventional banks on financial performance in the GCC countries. Moreover, risk disclosure for Islamic and conventional banks in the GCC countries are almost the same. When statistically comparing between the two types of banks, the mean for risk disclosure for conventional banks is slightly higher than Islamic banks in the GCC countries. This study creates significant contribution from at least three perspectives; contribution to knowledge, contribution to practice and lastly contribution to policies and regulations. In term of knowledge, a few studies – to the best of the researcher's knowledge – were conducted in the GCC countries related only to risk management practice and the study adds interesting insight from the point of view of academics and practitioners. In term of practice, the study provides empirical analysis to practitioners and bank managers on the consequence of driving factors that may assist them extend the performance of the banking system and advance the excellence of services thereby adding value to the banking sector. In term of policies and regulations, Islamic banks need a special regulation to be established, where it regulates and supervises Islamic banks, and is responsible for regulating these banks in terms of Shari'ah compliance principles.

ملخص البحث

تعتبر إدارة المخاطر في مجال التمويل من المجالات الأكثر بحثاً واهتماماً على مدى السنوات الخمسة عشرة الماضية. إدارة المخاطر في مجال التمويل أمر جوهري حيث يؤكد الكثير من البنوك أن تحديد قيمة المساهم يتم من خلال الإدارة الجيدة للمخاطر. اندلعت الأزمة المالية العالمية في الولايات المتحدة في عام ٢٠٠٨ نتيجة إفلاس البنوك الأمريكية الأكثر شهرة ورسوخا، وعقب ذلك إفلاس العديد من البنوك حول العالم. أثار انتشار الأزمة في أغلب أرجاء العالم الكثير من التساؤلات حول مدى فعالية عملية إدارة المخاطر التي كانت تطبقها تلك البنوك التي أفلسنت. أثبتت النتائج التي توصلت إليها العديد من البحوث فشل أقسام إدارة المخاطر في قيامها بمهامها بشكل فعال. يقر خبراء إدارة المخاطر والمطبقون لها والأكاديميون وغيرهم بأن وجود أقسام إدارة مخاطر ذات دور فعال يعد حجر الأساس لإدارة المؤسسات المالية والاقتصادية – وتشمل ذلك البنوك – بينما الفشل في عملية إدارة المخاطر بشكل فعال قد يؤثر سلباً على الأداء المالي لتلك المؤسسات وتشمل ذلك البنوك. بما أن دول مجلس التعاون الخليجي جزء لا يتجزأ من هذا العالم فقد قام الباحث بالشروع في هذا البحث بهدف دراسة كل من عملية إدارة المخاطر والإفصاح عن المخاطر والأداء المالي (العائد على الأصول والعائد على الحقوق) لكل من البنوك الإسلامية والتقليدية في دول مجلس التعاون الخليجي. قام الباحث أيضاً بالنظر في أثر عملية إدارة المخاطر والإفصاح عن المخاطر على الأداء المالي لتلك البنوك (العائد على الأصول والعائد على الحقوق). قام البحث باختيار عينة مكونة من ٣٠ بنكا من أصل ٦١ في خمس دول (١٤ بنكا إسلاميا و١٦ بنكا تقليديا). اعتمد هذا البحث الطريقة الكمية لجمع البيانات الأولية مستخدماً (الاستبانة) والبيانات الثانوية (التقارير السنوية للبنوك الثلاثين التي تمثل العينة للأعوام من ٢٠٠٨ لغاية ٢٠١٣). تمت معالجة البيانات باستخدام العديد من الاختبارات الإحصائية مثل الوصف واختبار "تي" والانحدار واختبار تحليل التباين الأحادي والبيانات ذات المقطع المستعرض والبيانات المقطعية عبر الزمن. أشارت نتائج البحث إلى عدم وجود فروق ذات دلالة إحصائية بين عملية إدارة المخاطر والإفصاح عن المخاطر بين البنوك الإسلامية والتقليدية. علي حين وجدت علاقة تأثير لعملية إدارة المخاطر على الأداء المالي للبنوك الإسلامية في دول مجلس التعاون الخليجي. تم التوصل أيضاً إلى أنه لا أثر للإفصاح عن المخاطر في كل من البنوك الإسلامية والبنوك التقليدية في دول مجلس التعاون الخليجي على أدائها المالي. اسفرت نتائج البحث عن العديد من المخرجات، من ضمنها: بناء على معطيات عملية إدارة المخاطر فإن كلا من فهم إدارة المخاطر، واختبار المخاطر وتحليلها، ومراقبة المخاطر في البنوك التقليدية في دول مجلس التعاون الخليجي أعلى من تلك التي في البنوك الإسلامية في دول مجلس التعاون الخليجي، بينما تحديد المخاطر في البنوك الإسلامية في دول مجلس التعاون الخليجي أعلى من تلك التي في البنوك التقليدية في دول مجلس التعاون الخليجي. علاوة على ذلك فإن الإفصاح عن المخاطر في كل من البنوك الإسلامية والتقليدية في دول مجلس التعاون الخليجي متساوية تقريبا. اظهرت المقارنة إحصائياً بين النوعين من البنوك فإن متوسط الإفصاح عن المخاطر في البنوك التقليدية في دول مجلس التعاون الخليجي أعلى قليلاً من ذلك في البنوك الإسلامية في دول مجلس التعاون الخليجي. يسهم هذا البحث بشكل فعال في ثلاث مجالات: الإسهام في العلم، والإسهام في التطبيق، وأخيراً الإسهام في السياسات واللوائح. فيما يتعلق بالعلم فعلى حد علم الباحث لم يتم إجراء ايه دراسته سوى القليل من البحوث في دول مجلس التعاون الخليجي فيما يتعلق بعملية إدارة المخاطر على وجه التحديد، لذا فإن البحث مفيد بشكل مثير للاهتمام لكل من الأكاديميين والممارسين. فيما يتعلق بالتطبيق فإن هذا البحث يوفر تحليلاً علمياً للممارسين ومدبري البنوك فيما يخص تبعات العوامل المؤثرة مما يساعدهم في تحسين فعالية النظام المصرفي وتحسين جودة الخدمات مما يثري القطاع المصرفي و فيما يتعلق بالسياسات واللوائح فإن البنوك الإسلامية بحاجة إلى كيان مستقل ليتم تأسيسه حيث يقوم بإدارة ومتابعة البنوك الإسلامية فيكون مسؤولاً عن إدارة هذه البنوك من حيث ضرورة التزامها بالشريعة.

APPROVAL PAGE

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DECLARATION

I hereby declare that this dissertation is the result of my own investigation, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Hussain Al Ali

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My beloved mother, beloved sister (Ahlam), and all my teachers, especially, Assoc. Prof

Noraini Mohd Ariffin

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LIST OF ABBREVIATIONS

ANOVA	Analysis of Variance
Basel	Basel Committee on Banking Supervision
BP	Breusch-Pagan
GCC	Gulf Cooperation Council
Ibs	Islamic Banks
IFR	International Financial Reporting
IFSB	Islamic Financial Services Board
KFH	Kuwait Finance House
LM	Lagrange Multiplier
MASB	Malaysian Accounting Standard Board
OLS	Pooled Least Squared
RAA	Risk Assessment and Analysis
RD	Risk Disclosers
RI	Risk Identification
RM	Risk Monitoring
RMPs	Risk management practice
ROA	Return On Assets
ROE	Return On Equity
STATA	Statistics and Data
SPSS	Statistical Package for Social Sciences
UAE	United Arab Emirate
URM	Understanding Risk Management
US	United States
VIF	Variance Inflation Factor

CHAPTER ONE

INTRODUCTION

1.0 BACKGROUND OF THE STUDY

Risk management in the financial sector is crucial as shareholder value is established through superior risk management (Abu Hussain and Al-Ajmi, 2012). Understanding the most important risks facing the banking sector enables stakeholders, especially managers, and the regulatory authorities, to undertake the necessary measures to mitigate the adverse impact of these risks on the performance of the financial institutions. It is of greater importance to Islamic banks because of the additional risks such as Shari'ah non-compliance risk, reputation risk, and equity investment risk they face compared with conventional banks (Reyazat, 2012). Given its importance, it is necessary to expose the different risks that may face banks, methods for their assessment and management, and approaches to reduce such risks and the impacts thereof (Abu Hussain and Al-Ajmi, 2012).

The global economic crisis emerged from the United States in 2008 as a result of the bankruptcy of established and prominent U.S. banks, followed by the bankruptcy of several banks all over the world such as Lehman Brothers, Merrill Lynch, and National City Bank in United States (Angkinand, 2009). The spread of the crisis to almost the whole world has raised many questions about the effectiveness of risk management practice applied in such bankrupt banks. According to Khalid and Amjad (2012), they stated that risk management departments had failed to perform their duties effectively. Risk management experts, practitioners, academics, and others, acknowledge that the presence of effective risk management departments is the

cornerstone for the management of economic and financial institutions, including banks (Abu Hussain and Al-Ajmi, 2012).

An effective risk management practice in Islamic banks is more important than in conventional banks due to the increased risks they face. For instance, Shari'ah non-Compliance Risk which is Risk arises from the failure to comply with the Shari'ah rules and principles, Rate of Return Risk which is the potential impact on the returns caused by unexpected change in the rate of returns, and Equity Investment Risk which is risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk. This risk is relevant under *Mudharabah* and *Musharakah* contract (Reyazat, 2012). These risks pose a serious challenge to Islamic banks.

Improving financial or non-financial indicators in the banking sector requires adequate disclosure and effective risk management within the establishment since they improve liquidity, return on assets (ROA), return on equity (ROE), profitability, and others. Naturally, every business seeks to consolidate financial performance as it determines survival in a highly competitive global market (Mohd Ariffin and Kassim, 2011).

In GCC (Gulf Cooperation Council) countries, the development and growth of the GCC economy heavily rely upon the progress of the banking system, and in this endeavour, the banking establishments of the GCC countries have introduced unique tools and products to serve the specific needs of customers (Global Investment House, 2005). This includes company lending, individual banking, in addition to saturating the financial needs of the projects initiated in various sectors. It is worth noting that

the growth of the Islamic and conventional financial industry alike has been promoted due to many factors, chief of which is the rise of oil prices.

Given its importance, this researcher identifies risk management practice, risk disclosure, and their influence on financial performance in both Islamic and conventional banks in the GCC countries.

1.1 PROBLEM STATEMENT

The global economic crisis broke out in the United States (U.S.) in 2008 as a result of the bankruptcy of the most established and prominent U.S. banks, followed by the bankruptcy of several banks all over the world. The spread of the crisis across the globe has raised many questions about the effectiveness of risk management practice applied by such bankrupt banks. Several studies proved the failure of risk management departments to effectively perform their duties, such as the Lehman Brothers (Khalid and Amjad, 2012; Abu Hussain and Al-Ajmi, 2012; Reyazat, 2012). This occurred due to the failure in risk management practice.

Financial crises have long threatened the stability of the financial systems and the banking industry. These changes and developments have directly or indirectly influenced the banking sectors all over the world including the banking sector of the GCC countries. (Abu Hussain and Al-Ajmi, 2012). GCC countries also suffered from the global crisis, particularly its banking system. Many conventional banks reported massive losses during the economic crisis due to holding toxic assets. For example, the Gulf Bank (a Kuwaiti CB) incurred US\$1.4 billion losses mainly due to derivatives activities, with the bank's shareholders and the Kuwait Investment Authority (KIA) injecting an equivalent amount of capital (IMF, September 2010). Bahrain offshore banks also provide a good illustration of this point. For example, in

2007–08, the Gulf International Bank (GIB, a Bahraini wholesale CB) incurred US\$1.3 billion losses in securities investments in debt-based toxic assets (mortgage backed collateralised debt obligations). The Arab Banking Corporation (a Bahraini wholesale CB) incurred US\$1.2 billion losses due to similar investments and its shareholders injected US\$1 billion of new capital. The National Commercial Bank (NCB, the largest Saudi CB) lost more than SR 1 billion due to changes in the fair value of financial instruments in 2008 (IMF, September 2010). These events occurred due to the failure of the banks to identify or predict the possible risks associated with the banking transactions.

The global financial crisis has not only proved the poor level of risk management practice around the world, but it has also shown the importance and strength of Islamic banking. Once perceived as an impractical concept, Islamic banking has captured the attention and confidence of many people globally and has proven its worth and ability to operate successfully, having overcome financial and economic crises suffered by the world economy (Al-Suwaidi and Pun, 2012).

Although the central banks of the GCC countries issue instructions for applying risk management practice through internal controls, which both Islamic and conventional banks are expected to follow, banks may not apply such instructions, requirements, and regulations properly or optimally. This may be attributable to the lack of necessary resources, the difficulty of application and/or the lack risk management expertise.

Moreover, the banking industry has witnessed various important developments and risks over the last decade. To start with, the list of services provided by this sector is expanding, especially the services related to new products in both the Islamic and conventional banks. As for the conventional banks, their services are diverse as in

deposit schemes, various saving account types, and the conventional functions of current accounts. On the other hand, Islamic banks offer *Musharakah*, *Mudarabah*, *Murabahah* accounts and other accounts. Regarding both Islamic and conventional banks, risk increases because the menu of services and products for both types of banks have increased in the past decade, as stated by Khalid and Amjad (2012). With an increase in the list of services provided by banks, risks can be expected to increase in the banking sector. This necessitates following an effective risk management in the sector.

When looking at the issue of bank performance one notices that bank management sets it as their main objective to increase the shareholders' return (ROE) as this serves an indicator of bank performance, and as a result increases the assets of the bank (ROA), hence increasing the bank size. With this sought benefit comes the disadvantage of greater risk, as numerous risks surface in the banking sector, a few of which are technology and operational risk, credit risk, country risk, market risk, off-balance risk, insolvency risk, liquidity risk, foreign exchange risk, among others. Risks which cause bank underperformance are the most relevant to the bank's risk management endeavour.

There is also a correlation established between the issue of risk management in the banking sector and economic growth, as observed in the annual report of Thai Oil (2010), it was found in a study based on empirical evidence that the volatilities of aggregate stock markets and foreign exchange and their prices too are influenced by past return stock originating from the banking sector, hence establishing the fact that banks can be a major source of contagion during crises. Other studies found that risk exposure in the banking sector can be reduced through effective risk management Beretta and Bozzolan (2004) suggested that the effective implementation of the risk

management practice within banks give such banks more advantages, such as compliance with the principle of obedience towards the rule, which in return lifts the reputation of the bank, attracts a wider array of customers in building the banks' portfolio of fund resources, and as a result increases profitability.

Due to the importance of risk management in institutions' performance, especially in the banking sector, this research studies the relationship of risk management practice and risk disclosure (RD) by determining and comparing the level of risk management practice and the level of disclosure in Islamic and conventional banks in the GCC countries. It then studies the impact of risk management practice and risk disclosure on the performance of Islamic and conventional banks, while considering that the GCC countries are vital due to the many Islamic and conventional banks functioning in an environment faced with challenges and risks, and whose main characteristic is free competition.

1.2 MOTIVATION OF THE STUDY

The banking industry has witnessed various significant developments and risks over the last decade. To start with, the list of services provided by this sector is expanding, especially the services related to the new services and products, in both Islamic and conventional banks. This increase in the list of services provided by banks increases risks in the banking sector. Although Islamic and conventional banks face similar risks, Islamic banks are exposed to unique risks that conventional banks do not face such as *Shari'ah* non-compliance risk, the rate of return risk, reputational risk, and withdraw risk.

Another motivation behind the present study is the nature of the banking sector in the GCC economy. GCC banks are the second largest financial sector in the GCC

economy. Furthermore, both Islamic and conventional banks in the GCC countries are large financial intermediaries and constitute the largest portion of total financial institutions therein. As mentioned in the report of Standard and Poor (Oct 2014), GCC banking assets, inclusive of both Islamic and conventional banks, are expected to rise by US\$ 2 trillion by the end of 2015 compared to US\$ 1.7 trillion at the end of 2013. The Islamic banking industry is expected to grow faster than conventional banking in the next two years, particularly in Qatar and Saudi Arabia where domestic credit is projected to grow the most. Risk management practice have yet to reach maturity in GCC banks due to the paucity of studies on risk management practice in the GCC countries, especially for Bahrain (Abu Hussain and Al-Ajmi, 2012) and the UAE (Al-Suwaidi and Pun, 2012).

The present study compares between Islamic and conventional banks to reveal the practical differences, while also identifying the impact of risk management practice and risk disclosure on the financial performance of Islamic and conventional banks in the GCC countries.

Furthermore, this current study is expected to fill in the gap by exploring risk management practice in the banking system of the GCC countries, bearing in mind that only a few studies have been carried out in the GCC countries. These are Al-Ali and Naysary (2014) in Kuwait, Abu Hussain and Al Ajmi (2012) in Bahrain, Al-Tamimi and Mazrooei (2007) and AlTamimi (2002) in United Arab Emirate. According to Rosman (2009), only a few studies have been conducted for Islamic and conventional banks, especially in the field of Islamic banking. Therefore, the present study will fill in the gap by studying risk management practice in the banking system of five GCC countries.

Furthermore, this study will examine the influence of risk management practice on financial performance (ROA and ROE) which has not been examined in the banking system of the GCC countries. Moreover, the present study will examine risk disclosure issue in the banking system in the GCC countries, which also has not been done before in GCC banks.

Finally, the current study will examine the impact of risk disclosure on financial performance (ROA and ROE) in the GCC countries.

1.3 OBJECTIVES OF THE STUDY

This study empirically examines risk management practice (RMP) and risk disclosure (RD) in Islamic and conventional banks in the GCC countries and investigates the impact of RD and RMP on bank performance from the financial perspective of ROA and ROE. To achieve this goal, the study adopted a questionnaire from the studies of Al-Tamimi and Al- Mazroori (2007), Hassan (2009), Khalid and Amjed (2012), and Abu Hussain and Al-Ajmi (2012) in order to identify risk management practice and undertakes content analysis to identify and count risk disclosure in the annual reports of 30 Islamic and conventional banks listed on the GCC stock markets. To this end, the study examines the following:

1. To examine the difference between Islamic and conventional banks in risk management practice in the GCC countries.
2. To investigate the influence of the risk management practice of Islamic and conventional banks in the GCC countries on their financial performance (ROA and ROE).
3. To determine the difference between Islamic and conventional banks in terms of risk disclosure in the GCC countries.