



# Journal of Economics and Business

**Kisman, Zainul. (2020), Risk Management: Comparative Study between Islamic Banks and Conventional Banks. In: *Journal of Economics and Business*, Vol.3, No.1, 232-237.**

ISSN 2615-3726

DOI: 10.31014/aior.1992.03.01.192

The online version of this article can be found at:  
<https://www.asianinstituteofresearch.org/>

Published by:  
The Asian Institute of Research

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# Risk Management: Comparative Study between Islamic Banks and Conventional Banks

Zainul Kisman<sup>1</sup>

<sup>1</sup>Universitas Trilogi. Email: zainulkisman@trilogi.ac.id

## Abstract

In the future the role of Islamic Banking / Sharia should be developed as an alternative source of corporate financing in addition to conventional bank financing. The role of this institution is increasing because based on survey Islamic Development Bank for certain types of risks attached to Islamic Bank is relatively easier to manage it compared with conventional banks. Easier risk management results in lower financing risks, making it easy to compete because it is profitable for banks, corporations and the economy. The survey results show that in Islamic Bank: Capital is quite good, Capital and Liquidity risk is low. Credit, market and operating risk moderate. More concerned about credit and liquidity risk. The most commonly used risk management techniques are Credit rating.

**Keywords:** Risk Management, Islamic Bank, Conventional Bank

## I. Introduction

Banks in accordance with Islamic law have long been present as alternatives to conventional financial institutions. The presence of this institution is, among others, providing services relating to investment or financing based on Sharia (Dahlan, 2005; Dendawidjaya, 2000)). The increasingly globalized and increasing world trade results in increasingly large competition and risks faced by the business world. Increased risk results in banks, both conventional and sharia being demanded to be able to compete in serving the business world so that the transaction risks they face can be minimized (IDB, 2001). In order to provide financial services (financial services) with low costs, conventional and Islamic banks are required to be able to issue contracts and instruments that can minimize financial risk.

The extent to which Sharia Banks can compete compared to its competitors in the future depends on how the institution manages its operational and other inherent risks.

### The purpose of this paper is as follows:

- In the first part, it is a preliminary background that explains how important the role of Islamic banks is in supporting business world financing as an alternative to financial institutions conventional.
- The second part discusses the unique characteristics of the risk of Islamic banks compared to conventional banks.

- In the third part, explain the results of a research survey from the Islamic Development Bank on the risk management practices of the Islamic Bank.

## II. Unique Characteristics of Sharia Bank Risk.

In its activities, banks face risks that have the potential to cause losses. According to Kisman and Shintabelle (2015) along with Kisman (2016), there are risks that can be avoided or minimized (unsystematic risk) and some that cannot be avoided (systematic risk). For this unavoidable risk, banks are required to be able to manage it without reducing the expected return. In order to achieve this goal, bank management is required to understand risk and how to manage it.

According to the Islamic Development Bank (2001), Olsson (2002), Jorion (2002) and William et al (2009) risk is the probability of an event occurring that can cause a loss. When an undesirable event occurs, it will cause a loss if not anticipated and managed properly.

For banks, these risks are events or events that can be either anticipated or not, which can harm the bank both for its income and its capital today or for the future or for the future. In overcoming this problem banks must continuously observe developments in both their internal and external conditions (Robock et al, 1983).

Not only conventional banks face this risk problem but also Sharia banks are also demanded to be able to manage risk, starting from identifying it, measuring it up to controlling it.

Viewed from the environment that affects banks, the risk is divided into two:

- (1) Systematic Risk, which is the risk that comes from macro situations: political situation, government economic policy, changes in market conditions, recession.
- (2) Unsystematic Risk, namely risks originating from within the company itself, micro risk and this type of risk can be minimized by diversification.

Judging from the bank's business activities, the risks in this bank can be grouped as follows:

- (1) Credit Risk (Financing Risk or Financing risk in Sharia banks)
- (2) Market Risk
- (3) Liquidity Risk
- (4) Operational Risk
- (5) Legal Risk
- (6) Reputation Risk
- (7) Strategic Risk
- (8) Compliance Risk

### (1) Credit Risk

Risk, which is a loss experienced by banks because the debtor is unable to pay the loan principal or interest on the loan. The risk of default is due to banks being too aggressive so that they ignore the prudential banking principle. And aggressiveness occurs because of the possibility of banks experiencing overvalued conditions so that they are overshadowed by fears of rising cost of loanable funds.

Credit risk also arises due to conditions in the real sector that are sluggish or not conducive. The features decreased and the cash flow was not sufficient to pay the interest and principal of the loan. Rising interest rates that result in increased lending rates or base lending rates also contribute to non-performing loans. Credit risk is increasing for banks because the collateral is inadequate and even worse the legal status is unclear. All these problems will make it difficult for the bank when it is going to restructure credit or when it is carried out.

Conventional banks that most of their income comes from loan interest income, conventional banks are required to pay considerable attention to this credit problem and its distribution. An increase in bad loans means that banks

must increase their capital. If the owner is unable to make additions, the bank's permission will be revoked. So credit risk here raises capital risk.

For a Sharia bank, this credit risk (or it is called in a Sharia Bank as Financing Risk ) is a specific problem. For example:

- (a) The bank has delivered the goods but the payment was not made according to the agreement. (Murabahah)
- (b) The bank failed to provide goods according to the agreement (both time, quality and specifications).
- (c) Banks run the risk of damage to goods rented/leased (Ijarah).

## **(2) Market Risk**

Losses experienced by bank portfolios due to changes in market variables such as interest rates, inflation, and exchange rates.

## **(3) Liquidity Risk**

Liquidity shows the ability of banks to meet their obligations which will soon mature in the short term. The bank is liquid if it can meet its funding needs immediately to meet the needs of its depositors. The not liquid bank will cause a decrease in bank credibility which will ultimately cause the bank to be rushed and bankrupt.

In Indonesia, this liquidity risk problem for conventional banks is easier to overcome compared to Islamic banks. Because conventional banks can easily overcome it by entering the interbank call money market. As with Islamic banks, although there are sharia interbank money market but participants is still limited as well as its volume.

## **(4) Operational Risk**

These risks include human errors, system failures, and inadequate procedures and controls that will affect bank operations. Included in this risk are errors in information systems, internal controls, human errors, system failures, and inadequate procedures and controls.

## **(5) Legal Risk**

The loss of a bank due to bank for lawsuits, weaknesses in legal or juridical aspects. Lack of regulations, legislation and weak contracts.

## **(6) Reputation Risk**

Risk due to the bank's declining reputation or the existence of negative publications or wrong perceptions about banks.

## **(7) Strategic Risk**

Risk experienced by banks because the bank fails to implement its strategy. For example, it failed in achieving the target set. The failure occurred due to a lack of sensitivity of banks to changes that occur in their environment.

## **(8) Compliance Risk**

Risk of losses that occur because banks do not comply with the provisions or regulations in force. Both internal provisions (from company management) and external (central banks).

**Based on Bank Indonesia Report, Islamic banking is unique risks, for example:**

- Potential for investment risk (income risk/equity investment risk)
- Specific liquidity risks associated with differences in return (rate of return risk)
- Specific market risks from changes in inventory prices
- Specific legal risks associated with transactions using sharia principles
- Reputational risk is also associated with compliance with sharia principles in bank operations.

**III. PROFILE OF RISK MANAGEMENT BANK SYARIAH:****Interpretation of Survey Results of Islamic Development Bank.**

This section will explain the results of a survey of several Islamic banks (28 countries). This survey wants to see the practice of risk management in these financial institutions. The results are as follows:

Table 3.1: Basic Balance Sheet Data

	Number of Observation	Average
Assets (Million \$)	15	494.2
Capital (Million \$)	15	73.4
Cap./Asset ratio (%)	15	32.5
Maturity of Assets		
<1 Years	12	68.8%
1 - 3 Years	12	9.8
> 3 Years	12	21.4

Source: Islamic Development Bank (IDB, 2001).

From table 3.1 above it can be seen that the average of the 15 institutions observed is the average total assets of \$ 494.2 Million with an average Capital of \$ 73.4 Million. The amount of Capital / Asset ratio is 32.5%. This figure for bank size is quite large. This shows that Islamic banks viewed from the capital are quite safe.

At the bottom, it is seen that the structure of Islamic bank assets is dominated by assets with a short-term lifespan of 68.8%. This shows the high liquidity of Islamic banks. High liquidity will usually have an impact on the low profitability of banks.

Table 3.2: Risk Perception - Overall Risk Faced by Islamic Financial Institution

	Average Rank
Credit risk	2.71
Liquidity risk	2.81
Market risk	2.50
Operational risk	2.92

Source: IDB (2001); 1 = not serious 5 = Critically serious

From table 3.2 above it can be seen that in the sharia banks, the highest risk is found in operational risk and lowest in market risk. The high operational risk is due to the fact that banks that have studied the system and procedures are incomplete, so this operational risk often arises. Low market risk indicates the low sensitivity of Islamic banks to changes in the market. Liquidity risk is included in the high category indicating less aggressive Islamic banks in lending.

Table 3.3: Maintaining an Appropriate Risk Measuring, Mitigating, and Monitoring Process Risk Report

Capital at Risk Report	64.7%
Credit Risk Report	70.6
Market Risk Report	29.4
Interest rate Risk Report	23.5
Liquidity Risk Report	76.5
Foreign Exchange Rate Risk Report	41.2
Operational Risk Report	17.6
Country Risk Report	35.3

Source: IDB (2001)

From table 3.3 above, it can be seen that the sharia banks that were studied mostly reported or monitored Liquidity risk and Credit risk. The lowest operational risk is only 17.6%.

Table 3.4: Maintaining an Appropriate Risk Measuring, Mitigating, and Monitoring Process Measuring and Management Techniques

	Percentage of Total
The credit rating of Prospective Investors	76.5%
Gap Analysis	29.4
Duration Analysis	47.1
Maturity Matching Analysis	58.8
Earning at Risk	41.2
Value at Risk	41.2
Simulation Techniques	29.4
Estimates of worst-case scenarios	52.9
Risk-Adjusted Rate of Return on Capital	47.1

Source: IDB (2001)

From table 3.4 it appears that Islamic banks in managing their risks more often use Credit rating in assessing debtors and the second technique in minimizing the risks. do Maturity Matching Analysis. While Gap Analysis and Simulation Techniques are rarely used.

#### IV. Conclusion

Based on the discussion above, it can be concluded as follows:

1. In the future, the role of Islamic banks needs to be developed as an alternative source of corporate financing besides conventional bank financing.
2. For certain types of risks inherent in Islamic banks, it is relatively easier to manage compared to conventional banks. The low risk of financing has made this bank easy to compete.
3. The survey results show that in Islamic banks:
  - Capital is quite good: Capital risk is low.
  - Low liquidity risk resulting in a low profitability rate.
  - Credit, Liquidity, Market and Operational risk are neither high nor too low (moderate).
  - Of the several types of risk, more concerned with Credit and Liquidity risk.
  - The risk management technique that is often used is Credit Rating.

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