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IMPACT OF RISK MANAGEMENT PRACTICES ON PERFORMANCE OF ISLAMIC WINDOW IN CONVENTIONAL BANKS IN SRI LANKA

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ABSTRACT

The objective of this study is to analyze the relationship between risk management practices and financial performance in the Islamic window in conventional banks in Sri Lanka. This study examined the present risk management practices of the Islamic window and the banks' financial performance. The study used both the primary data from survey questionnaires and secondary data from annual financial reports. For this purpose the present study selects risk environment, risk measurement, risk mitigation, risk monitoring and internal control as independent variables while return on assets is utilized as dependent variables for the period from year 2010 to year 2015. The study used descriptive, correlation, and multiple regression models. The results revealed that independent variable factors 83.5% impact on return on assets. This study further revealed that risk environment, risk monitoring and internal control system have positive significant impact on financial performance, however, the risk measurement and risk mitigation shown a negative significant impact on financial performance. The results of the study shed some lights on the present risk management practices of the Islamic banks in non-Muslim countries. By assessing their risk management practices and linking them with financial performance, the study contribute in terms of recommending strategies to strengthen the risk management practices of the Islamic windows in conventional banks, so as to increase the overall performance and competitiveness in the Islamic banking industry.

Keywords*: risk environment, risk measurement, risk monitoring, risk mitigation, internal control*

Introduction

The growing market demand and attention given to the Islamic banking and finance industry has escalated the research interest in this area as well. Due to the relatively recent nature of the Islamic banking industry compared to its conventional counterpart, many aspects of the industry are not well investigated. At the moment, topics of research interests

are mainly on product development and performance of the industry. In this regard, an area of concern which is highly relevant in ensuring healthy growth of the industry is the risk management aspects of the Islamic banking institutions.

Being involved in the intermediation process, risk management is as important to the Islamic banks as it is to the conventional banks. Banking is a risky business and several risk factors such as credit, liquidity, operational and market risks have been identified as critical to ensure that the banks position remain intact amid the intense competition in the industry. The survival and success of a financial organization depends critically on the efficiency of managing these risks (Khan & Ahmed, 2001). More importantly, good risk management is highly relevant in providing better returns to the shareholders (Akkizidis & Khandelwal, 2007, Al-Tamimi & Al-Mazrooei, 2007). In addition, prudent risk management by financial institutions is the hallmark to avoid financial distress that could lead to a full blown financial crisis. In view of this, the issue of risk management in the financial institutions is a topic of interest not only to the industry players, but also the policy makers.

In relating risk management practices and performance, several studies have documented negative effects of increased capital requirements on bank performance. This includes that of Furlong (1992) shows significant decline in the US bank lending due to the imposition of capital regulations. Similarly, Brinkman and Horvitz (1995) which documents a significant decline in bank loan supply by the US banks due to need to comply with the Basle I requirements. However, Peek and Rosengren (1995) and Berger and Gregory (1994) find contradictory findings

Therefore, Risk management in financial institutions has undoubtedly attracted more attention from the regulators, practitioners, and also academics over the last decade. One of the reasons is because of the huge losses incurred by a number of financial institutions due to the malfunctioning of their risks management.

Due to the importance of risk management to the growth, resilience and survival of the Islamic banking institutions, this study attempts to analyze this topic from a new perspective.

Very few relationship studies have been carried out on Risk Management and Financial performance in Islamic bank. Results are different from each researcher. In the study carried out by Adeusi et al. (2014) concludes a significant relationship between banks performance and risk management. Hence, the need for banks to practice prudent risks management in order to protect the interests of investors.

Another study carried out by Olusanmi et al. (2015) observed that there exist a negative non-significant relationship between risk management proxies and bank's performance as captured with return on equity. Yousfi (2014) concluded his research on Risk management practices and financial performance in Jordan that Liquidity, credit and operational risk management practices have a negative and significant statistical impact on Islamic banks' performance, and these banks failed at the same time in managing these risks. Bashir (2009) noted that the relationships between size and profitability measures are statistically significant, indicating that Islamic banks become more profitable as they grow in size.

As far as Islamic banking in Sri Lankan context is concerned, no any research have been carried out on the risk management area. Hence, findings forwarded by previous researchers from different country in their studies on the subject of risk management and financial performance may differ from findings which is going to be addressed at the end of this study.

Since Islamic banking in Sri Lanka is at introduction stage in product life cycle, much attention is being paid by industry players in order to build the industry so stronger. Hence, better risk management practices may lead the Islamic banking so healthier, which extremely reflect on financial performance of the bank. Based on the background of the study and research problem discussed above, the research objectives is formulated as to

assess the risk management practices in the selected Islamic window in conventional banks in Sri Lanka.

METHODOLOGY

Based on the literature review and the problem background following conceptual framework is developed.

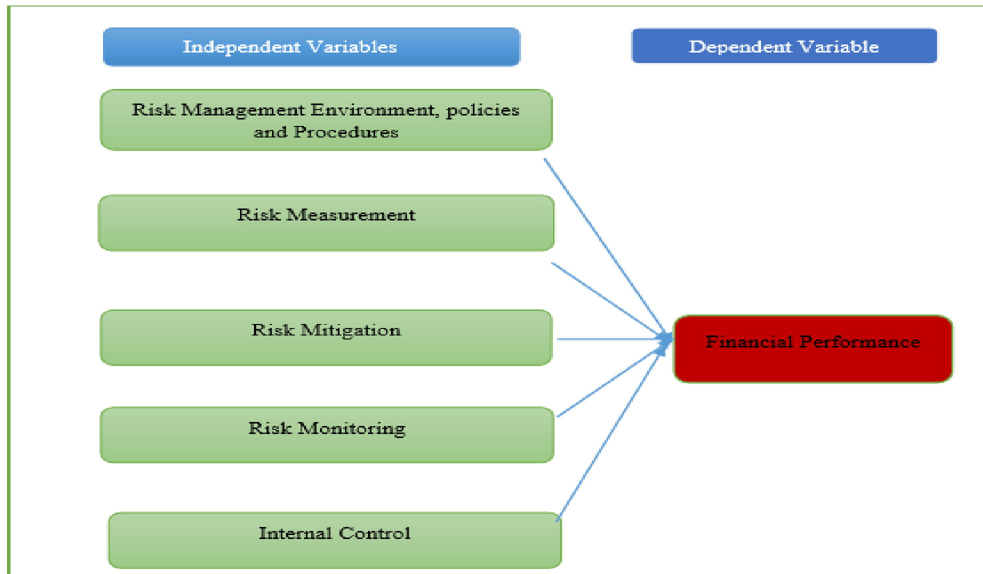

Figure: 1 Conceptual Frame Work
Source: Ariffin and Kassim (2009)

Risk environment, policies and Procedures: Here, it is confirmed that general risk management system is being followed by the financial institution. Hence top management or Board of Directors (BoD) outline the objectives of risk management and those objectives should be clearly communicated with relevant stakeholders specially employees of financial entity. When management understand gap between objective of Risk management and existing risk practices, the top management should take necessary action reduce the gap and try to manage risk into controllable.

Hence, best practice to better risk management is to have "Internal Guidelines" which gives direction of embarking any business or non-business activities. The bank must have a clear policy for Assets & Liability Management (ALM) as it is considered a core area in the banking. Risk can come from local business and from global business. Hence it is better to define business area.

Risk Measurement: The unique mix of risks in Islamic Finance and the potential role of investment account holders in sharing some of the risks, call for a strong emphasis on proper risk measurement (Sundarajan, 2007)

Sundarajan (2007) also noted that Effective risk management in the Islamic Financial Institutions requires that a high priority be given to proper measurement and disclosure of aggregate banking risks (to reflect the volatility of mudarabah profits accruing to Investment account holders), specific types of risks (to control effectively the extent of credit, market, operational and liquidity risks) and facility specific risks (to properly price individual facilities by measuring the full range of risks embedded in each facility).

Progress in risk measurement, disclosure, and risk management will, however, require a multipronged effort; to strengthen accounting standards and harmonize them with prudential standards, to initiate a systematic data compilation process to enable proper risk measurement, including through developing central credit and equity registries suitable for Islamic finance, to build a robust governance and creditor/investor rights infrastructure that would foster Islamic money and capital markets—based on innovative uses of asset securitization-- as a foundation for effective on balance sheet risk management, including through transparent apportioning of risks to investment account holders, to foster this transformation of investment accounts into an effective risk mitigant (in addition to collateral and guarantees) through product innovations supported by proper disclosure and reserving policies that makes transparent the extent of risk being borne by the counts, and the risk-return mix being offered, to provide supervisory incentives for effective risk sharing with profit Sharing Investment Account (PSIA), by linking the capital relief on account of PSIA to the extent of actual risks shared with PSIA, and by requiring adequate disclosure of these risks as a basis for capital relief. Progress in risk measurement, disclosure, and risk management will, however, require a multi-pronged effort.

Risk Mitigation: Credit risk is the most considerable risk in the banking industry in comparing with risk. Hence, most concentration is being given to mitigate those risks. In order to optimize the activity in the banking system, a series of proposals can be drafted,

to mitigate the risk according to some of the most important factors (Laura and Ileana, 2013). It illustrated in following table.

Risk Monitoring: It is very important for banks to have various monitoring procedures of the risk management process. To ensure the value and quality of assets, banks need to reappraise collateral and confirm a guarantor's intention to guarantee debt regularly. For institutions engaged in international investments, the country ratings and the frequency of assessing profit and loss positions need to be reviewed frequently (Ahmed, 2007)

The study carried by Rashidah et al (2014), It is found that Islamic Banks in Malaysia and Jordan are somewhat reasonably efficient in managing risk where risk assessment and analysis (RAA), and risk control and monitoring (RCM) are the most influencing variables in RMPs in Malaysia

Internal Control: Banks should have internal controls to ensure that all procedures and policies are adhered to. An effective system of internal control includes an adequate process for identifying and evaluating different kinds of risks and having sufficient information systems to support these. The system would also establish policies and procedures and their adherence are continually reviewed. These may include conducting periodic internal audits of different processes and producing regular independent reports and evaluations to identify areas of weakness. An important part of internal control is to ensure that the duties of those who measure, monitor, and control risks are separated (Habib Ahmed, 2007).

Return Assets (ROA): The return on assets ratio, often called the return on total assets, is a profitability ratio that measures the net income produced by total assets during a period by comparing net income to the average total assets. In other words, the return on assets ratio or ROA measures how efficiently a company can manage its assets to produce profits during a period. Since company assets' sole purpose is to generate revenues and produce profits, this ratio helps both management and investors see how well the company can convert its investments in assets into profits.

Ariffin and Kassim (2009) have taken the ROA as variable to identify financial performance of Islamic bank in relation to risk management practice. The study carried out on risk management practices and financial performance in Jordan by Yousfi (2014), the ROA has been taken as Independent variable to measure the financial performance.

ROA was used as independent variable to evaluate financial performance in the study carried by Rashidah et al (2014) and the conclusion was made that ROA (financial performance) has significant relationship with risk practices in the Islamic Banking.

Since the Islamic Industry is an introduction stage in the Sri Lankan context, very few players are in the industry. There are 25 licensed commercial bank in Sri Lanka (CBSL, 2015). Of which, Amana bank is only operating as a fully-fledged Islamic bank with *Shari'ah* principles. Remaining 24 other banks are functioning under conventional principle. As an Islamic window, six conventional banks (6) have introduced Islamic banking and finance in Sri Lanka. These six conventional banks consist of state and private banks. Hence, according to Convenience Sampling techniques, 6 banks were selected for this study, which comprises of 6 Islamic windows.

To achieve objective of evaluating the financial performance of Islamic window in Sri Lanka, Five (5) years of financial reports from 2010 to 2015 was gathered. Selection of years (2010 -2015) was purely made based easiness of accessing information from annual reports and relevant department. In addition to that questionnaire also used to gather primary data. Six banks mainly were selected in this study this six Islamic windows from State and private conventional bank. All Respondents are Male being Executive Level in the Bank having more than 5 years executive experience.

ANALYSIS AND FINDINGS

In this study descriptive analysis, correlation analysis and regression analysis were used.

Table 1 gives overall idea of each variable that are tested in this study. ROA of all banks stands for with mean value of 3.83 and standard deviation of 1.33. Minimum value of ROA

is 1.17 where maximum value is 5.91. Mean value of risk environment practices is 4.04 with standard deviation of 0.468 representing minimum, maximum of 3.39, 4.86 accordingly. Risk measurement points out the mean value of 3.13 with Standard deviation value of 0.236. Risk mitigation practices carry the mean value of 4.05 where standard deviation value of .0234. Risk monitoring, internal control stands for the mean value 4.12, 4.79 accordingly. The highest mean value belongs to internal control system of the bank representing 4.79 with standard deviation value of 0.324 meanwhile risk measurement practices points out lowest mean value of 3.84 with standard deviation of 0.236.

Table 1 Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
ROA	30	1.17	5.91	3.8347	1.33568
RE	30	3.39	4.86	4.0468	.46896
RMe	30	3.13	4.30	3.8413	.23641
RMi	30	3.66	4.25	4.0596	.23454
RMo	30	4.00	4.20	4.1267	.08277
INTc	30	4.25	5.13	4.7958	.32411
Valid N (listwise)	30				

Source: SPSS Results

In linking the risk management practices and financial performance, the mean scores of each risk management practices are correlated with the ROA. Risk management practices are explained by risk management environment, policies and procedures, risk measurement practices, risk mitigation practices, risk monitoring practices and internal control practices. Table 8 provides the correlation coefficients for all variables.

Table 2 illustrates the strength of relationship between independent and dependent variables. Risk environment and rate of return shown a fair positive relationship 0.468 at 99% confident level meanwhile risk measurement practices and ROA have shown again a fair positive 0.122 relationship with no significant level. This mean bank fairly different attention to risk environment and risk measurement practices. In case of risk mitigation practices, it has shown a moderate strong positive relationship with ROA at 99% confidence level. Risk monitoring practices had very strong positive relationship 0.866

with ROA at 99% confidence level meanwhile internal control system was correlated with ROA at 99% confidence level showing very strong positive relationship.

Table 2 Correlations Analysis

		ROA	RE	RMe	RMi	RMo	INTc
ROA	Pearson Correlation	1	.468**	.122	.527**	.866**	.859**
	Sig. (2-tailed)		.009	.522	.003	.000	.000
	N	30	30	30	30	30	30
RE	Pearson Correlation	.468**	1	-.168	.764**	.289	.631**
	Sig. (2-tailed)	.009		.374	.000	.121	.000
	N	30	30	30	30	30	30
RMe	Pearson Correlation	.122	-.168	1	.005	.439*	.282
	Sig. (2-tailed)	.522	.374		.979	.015	.132
	N	30	30	30	30	30	30
RMi	Pearson Correlation	.527**	.764**	.005	1	.499**	.787**
	Sig. (2-tailed)	.003	.000	.979		.005	.000
	N	30	30	30	30	30	30
RMo	Pearson Correlation	.866**	.289	.439*	.499**	1	.901**
	Sig. (2-tailed)	.000	.121	.015	.005		.000
	N	30	30	30	30	30	30
INTc	Pearson Correlation	.859**	.631**	.282	.787**	.901**	1
	Sig. (2-tailed)	.000	.000	.132	.000	.000	
	N	30	30	30	30	30	30

**. Correlation is significant at the 0.01 level (2-tailed).
*. Correlation is significant at the 0.05 level (2-tailed).

Source: SPSS Results

Table 3 explains overall results of the study. The survey had no auto data correlation. It is confirmed by the value of Durbin-Watson, 2.158. Table also explains that R value is 0.929 and R square is 0.864. The adjusted R value represents the value of 0.835. Adjusted R Square explains the relationship between ROA and risk components such as Risk environment, Risk measurement and Risk mitigation, Risk monitoring and Internal Control. According to the survey findings, 83.5% of study is explained by risk components that are taken as variables for this study. Each of the variables has various level of influence on ROA. Coefficients for all variables provide information about the goodness of fit of the regression model. Based on relationship between variables, the following model introduced in the research methodology is re written as follows;

$$ROA = -40.104 + 0.475\,RE + (-1.545)\,RMe + (-1.614)\,RMi + 11.140\,RMo + 1.779\,INTc + \mathcal{E}$$

Table 3 Coefficients table for all Variables

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-40.104	21.941		-1.828	.010
	RE	.475	.523	.167	.908	.003
	RMe	-1.545	.507	-.273	-3.050	.006
	RMi	-1.614	1.164	-.283	-1.386	.048
	RMo	11.140	6.917	.690	1.611	.020
	INTc	1.779	2.462	.432	.722	.047
	R	.929[a]				
	R Square	.864				
	Adjusted R Square	.835				
	F	30.430				.000[b]
	N = 30			Durbin-Watson = 2.158		

a. Dependent Variable: ROA

Source: SPSS Results

The Table 3 also illustrate that except risk mitigation, all other risk components are significant with ROA. Based on these findings, the study came to a conclusion whether to accept or reject an alternative hypothesis. Since significant value for risk environment is less than the Alpha value, Alternative hypotheses is accepted. Hence it is concluded the Risk environment, risk monitoring and internal control have significant relationship of financial performance of Islamic bank and Islamic window. However, a risk measurement and risk mitigation practice have negative significant relationship with financial performance. It is confirmed by the previous study carried out by Usmani (1996). However Ariffin and Kassim (2009) noted in his research that risk mitigation has significant relationship with financial performance.

CONCLUSION AND FINDINGS

This study was carried out with three objectives. Various analyses were statistically performed in order to achieve objective. The finding of the study concluded that all risk components except risk mitigation are having significant level of relationship with financial performance. This means that any changes on risk components will have certain level of impact on financial performance. More elaborately, risk environment, risk measurement, risk monitoring and internal control have significant level of relationship with financial performance. Only risk mitigation is significant with financial performance.

Based on the findings derived through study, it is concluded that better risk management practices has significant relationship with financial performance of Islamic bank and Islamic window in Sri Lankan context. However, strength of relationship (correlation) of each component of risk practices namely Risk environment, risk measurement, risk mitigation, risk monitoring, internal control vary from each other. Risk monitoring practices has high strength of relationship with financial performance. In other words, Islamic banks are very keen to monitor risks since Islamic banking system in Sri Lanka is at introductory stage and Top management of the bank pay more attention in order take industry to next higher level.

In case if the industry underperforms, stakeholders of the bank will not continue with Islamic Banking services. Hence, Board of Director (BoD) has huge responsibility to maintain performance of the bank on a stable level and keep the image of Islamic banking loyal among all stakeholders.

In case of risk environment, changes on environment should be treated as soon as possible. Because banks are dealing with public money. Hence BoDs are accountable for depositors and investors. Hence, research findings reveal that proper strategies should be formulated in order to mitigate the risk.

Based on the findings made through this study recommendation are proposed to introduce business process re –engineering and business continuity plan (BCP), fully –fledged computerized environment, set up a best in – house Shari'ah team to monitor Islamic banking operation.in order to make banks to better enjoy risk practices that would lead the banks financially viable.

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