RISK MANAGEMENT: A TOOL FOR ENHANCING ORGANIZATIONAL PERFORMANCE

(A Comparative Study between Conventional and Islamic Banks)

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Abstract

The purpose of this comparative study is to examine the risk management system of banks and its impact on their performance. For this study, the primary data was collected using closed - ended questionnaire and analyzed through independent sample T- Test and correlation. The secondary data was collected from financial statements of the banks and analyzed through financial ratios. The finding of research showed that Conventional Banks have more effective risk management process as compared to the Islamic Banks. The findings also showed that risk management has a negative non significant relation with operational performance where as it has positive relation with financial performance.

Keywords: Risk Management, Performance, Conventional Banks, Islamic Banks

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Introduction

Risk is inevitable and inborn in each and every economic activity. According to Brain (2001) risk occurs when outcome is uncertain. Risk exists as a part of an environment in which various organizations operate (Shafiq and Nasr, 2010) so each and every business has to face risk. Without taking risk, growth of business is like a nightmare (Asim et al., 2012). Banks like all businesses face various types of risk which arise due to the nature of their activities. The major aim of banks is to maximize profit by managing risk and by providing various financial services (Alimshan, 2011). In Practice we have two banking systems. One which follows normal interest based practices called conventional banking and second which follows Islamic law and perform interest free activities which is known as Islamic banking (Khattak et al., 2013). Both these banking systems are distinguished as conventional banks follow the SOPs prepared by their higher authority; their income is interest which is earned by lending money and they transfer the entire risk to others. While Islamic banks follow policies made by Sharia'h that prohibits interest that's why Islamic banks do not deal in interest and are trade-oriented banks, their income is profit which is earned by trading. They share risk with both lenders and borrowers (Ashfaq, 2009).

Risks faced by both Islamic and Conventional banks can be separated in two categories: financial risks and non-financial risks. Financial risk is further divided into credit risk, liquidity risk and market risk where as non-financial risks are divided into legal risk, operational risk and regulatory risk (Gleason, 2000). Other specific risks faced by Islamic banks include lack of riba free risk-hedging instruments, profit-loss sharing based government securities are under developed, Islamic banks have limited access to lender-of-last resort facilities provided by central bank due to lack of Sharia'h compatible lender-of-last resort facilities, value of funds and return rate are not certain, asymmetric information increase the possibilities of moral hazard (Mounira and Anas, 2008). Effective and efficient risk management process is requisite due to these risks faced by banks. One of key task of bank is to discover and manage risks.(Fatemi and Fooladi, 2006). It is necessary for banks either conventional or Islamic, to make risk management an integral part of their business practices as constantly they have to deal with risky transactions either willingly or unwillingly.

Risk management is an essential component of strategic management of an organization. It is an ongoing process of risk assessment through different tools and methods which identify all possible risks, determine which risks are critical to solve as soon as possible and then execute strategies to deal with these risks (Tariqullah and Habib, 2001). Current risk management system based on the Basel II aims to promote financial stability (BCBS, 2006). The Basel Accord has consequently appeared as an attempt to protect banking system all around the world from the affects of financial crises and structures it by using a set of rules which allow for systematic risk management (Makwiramiti, 2008).

An efficient and effective risk management is the need of each and every organization and is one of the key responsibilities of bank. However effective risk management boosts the performance of an organization. The past financial crises uncovered shortcomings in the performance and risk management practices with many banks taking on excessive risk with too little regard for long run performance (Sitanta, 2011). Banks can grab opportunities with greater confidence only with an integrated approach of managing risk and performance.

Literature Review

Sitwat Habib et al. (2014) conducted research on Operational Risk Management in Corporate and Banking Sector of Pakistan. This research aims to find the reasons for the implementation or lack of adoption of integrated operational risk management approach. The paper revealed that risk management can improve organizational performance but in Pakistan, companies do not have appropriate infrastructure and proper knowledge of risk management. Research showed that in banking sector of Pakistan the concept of operational risk management can be seen up to some extent.

Barati et al. (2013) have carried out an empirical study of Risk Management in Iranian Banks. The intention of this research was to study the factors which extensively influence the risk management practices and to study relationship between some banking ratios like cash to asset ratio, capital adequacy, size of bank and debt to equity with liquidity, credit and operational risks. This study concluded that all risks have positive relationship with capital adequacy and debt. On one hand, capital adequacy had a positive relationship with liquidity risk where as the sizes of banks, cash to asset and debt to equity ratios had an inverse relationship with liquidity risk. In case of credit risk, capital adequacy had an inverse relationship with it where as debt to equity ratio and credit risk are positively related and there weren't any relation between credit risk and other variables. On the other hand, the cash to asset ratio, sizes of banks and capital adequacy had an inverse relationship with operational risk. Finally the results of this study also showed that there weren't any relation between the debts to equity ratio and operational risk.

Emira et al (2013) have conducted research on Comparative Analysis of Risk Management in Conventional and Islamic Banks (The Case of Bosnia and Herzegovina). This research paper tried to determine the reliance of banks' financial performance on the risk management. The results of this research reveal that still practices of risk management are developing worldwide. Currently all the banks understand the value of risk management but still they do not have sufficient ways for risk management. Exposure of Islamic banks as compared to conventional banks to risk is much more but its dynamic risk management system allowed it to constantly compete with conventional banks and get good returns. Lastly, banks which have effective risk management system have better financial performance.

Ali Said (2013) has researched on Risks and Efficiency in the Islamic Banking Systems (the Case of Selected Islamic Banks in MENA Region). The objective of this study was to investigate how in Islamic banks, risks and efficiency are correlated with each other. This research concluded that credit risk has negative relationship with efficiency, while operational risk has found to be negatively correlated to efficiency too. The liquidity risk showed insignificant correlation to efficiency in Islamic banks in MENA area.

Naveed et al (2013) conducted research on Risk management practices and attitude of Pakistani Islamic banking system employees. This study was intended to explore the Risk Management Practices in Islamic Banks and to study the impact of independent variables on dependent variables. The independent variable of the study were understanding risk and risk management, risk assessment and analysis, risk identification, risk monitoring, credit risk analysis and the dependent variable was risk management practices. The result showed that four out of five independent variables have positive and significant impact on dependent variable.

Selma et al (2013) conducted research empirically on Risk Management Tools Practiced in Tunisian Commercial Banks. The purpose of the researchers was to investigate risk management practices and procedures followed by banks. The results revealed that banks in Tunisia know the importance of efficient risk management in enhancing bank performance and cost reduction. Moreover banks have active risk management structures in Tunisia. Further researchers concluded that risk management must be an ongoing process which systematically addresses all risks faced by organization in past, present and future.

Omar et al. (2011) conducted research on Risk management and the implementation of the Basel Accord in emerging countries (An application to Pakistan). The aim of this research was to examine attitudes of Pakistani banks towards Basel Accord implementation plans and thus to determine which factors create hindrances in the

Basel Accord implementation in these banks. Results of this research showed that managers' view regarding Basel Accord is positive though operational risk appears as a major obstacle for Basel Accord implementation in Pakistan. Private banks than public banks are technically more capable and favorably inclined towards Basel Accord implementation.

Salman and Zain (2011) conducted research that whether effective risk management affect organizational performance. Their major purpose was to examine the current practices of risk management and impact of these practices on performance of an organization and to identify the likelihood of improvements in software development sector of Pakistan. The finding showed that most of the organizations are not using properly risk management practices besides that most of the organizations do not have documented risk management policy accurately. It also concluded that the organizations which are using risk management practices have high performance compare to those organization which are not using risk management practices.

Naveed et al (2011) conducted research on Risk Management Practices and Islamic Banks: An Empirical Investigation from Pakistan. Their purpose of study was to examine the firm's level factors that have considerable impact on the risk management. The findings of study showed that bank's size and financial risks (credit and liquidity risk) are positively and significantly related with each other while bank's size has negative and statistically insignificant relation with operational risk. The debt to equity and NPLs ratios are negatively and significantly related to operational as well as liquidity risk while they are positively related to credit risk. The capital adequacy has positive significant relation with liquidity where as it is negatively and significantly related to operational and credit risk.

Afsheen et al. (2010) have researched on Risk Management Practices Followed by the Commercial Banks in Pakistan. This research paper aims to examine the awareness about risk management within the banking sector of Pakistan. Both Primary and secondary data collection sources were used. Primary data was gathered from 15 commercial bank's risk management departments The secondary data was collected from performance review of the banking system report of the period of 9 years from 2000 to 2008. Findings of this empirical study have shown that there is a considerable dissimilarity in the use of risk management aspects among the commercial banks in both public and private sectors. Also the financial reliability indicators differ in significance for each type of commercial bank. Although staff of commercial banks has a general understanding about risk and its management, still there is a need for commercial banks to provide training to staff in risk management tailored according to their needs.

Romzie (2009) has conducted research on Risk Management Practices and Risk Management Processes of Islamic Banks (A Proposed Framework). The aim of this research was to suggest conceptual framework and to study the relationship between risk management practices and risk management aspects like understanding risk and its management, its identification, its analysis and assessment and monitoring. This study recommended a conceptual framework on the basis of risk management aspects and its practices. The results showed that risk management practices and all of its aspects are positively related with one another.

Al-Tamimi and Al-Mazrooei (2007) conducted research to compare the risk management practices and techniques in dealing with different types of risk in national and foreign banks of UAE. The aim of research was to identify the risk management practices and procedures in UAE banks. The result showed that these banks are more capable for managing risk and also found that UAE national and foreign banks are unlike to each other in risk assessment, its analysis, examine and controlling.

Problem Statement

The failure of Lehman Brothers, one of the World's leading investment banks in the United States on 15 September, 2008, led to financial crises and recession in the United States that spread globally and results in global economic crises. Those financial crises uncover shortcomings in the performance and risk management practices with many banks taking on excessive risk with too little regard for long run performance. Its mean Organizations lack information regarding the impact of Risk Management on their performance.

Research Objectives

- To evaluate the implementation of risk management in conventional and Islamic banks.
- To study the relationship between risk management and performance of both type of banks.

Research Hypotheses Design

The study by Emira et al. (2013) showed that organization with effective risk management have higher performance and in our country conventional banks have higher performance then islamic banks so now we compare risk management in conventional banks is effective than islamic banks. Under the light of this justification we design our H_1 hypothesis that is:

H_1: Conventional banks act more upon risk management as compared to Islamic banks.

A previous study by Salman & Zain (2011) showed that active risk management increase performance in project management (software industry). Now we are going to study the same in banking industry. For our research purpose we have divided performance into two types: operational performance and financial performance. Operational performance shows the efficiency whereas financial performance shows the profitability of an organization. Under the light of this justification we design our H_2 and H_3 hypotheses that are:

H_2: Risk management increases operational performance of the banks.
H_3: Risk management increases financial performance of the banks.

Research Scope

Risk management was assessed in the Islamic and Conventional banks of Hyderabad district. Meezan Bank, Bank Islami, Soneri Islamic and Dubai Islamic Bank were taken as Islamic banks and HBL, UBL, MCB and Soneri Bank were taken as conventional banks.

Research Methodology

Population

The population of this study was finite in nature and the “content” of population was all employees and customers of both Islamic and Conventional banks, the “Extent” of population was Hyderabad District and “Time” was December 2013.

Sampling Technique

Probability based Sampling techniques was used for this research. From probability based sampling techniques, Stratified and random sampling method were used for collecting data. Stratified method was used for collecting data from employees and simple random sampling method was used for customers.

Sample Size

Total sample size for our study was 150. A sample size for Islamic banks was 75 and for conventional banks it was also 75. Out of which 10 samples were collected from top management, 20 from middle level management, 20 from lower level management and 25 were customers.

Data Collection

For this study a questionnaire was used for primary data collection and it was consisted of close-ended questions which were further divided into categorical and continuous variables.Primary data acquired from questionnaires was then analyzed through SPSS**.**Further secondary data was collected from financial statements of all 3 Islamic banks and 3 conventional banks over three years period from 2010 to 2012 (shown in table 7.4).

Instrument

Standard instruments for this study were used to measure the variables that were Employee satisfaction, Customer Satisfaction and Risk management.

- Employee Satisfaction was measured through eight questions taken from scale (alpha=0.81) evolved by Nick Foster (1999).
- Customer Satisfaction was measured by 9-items scale (alpha = 0.85) operationalized within Oliver's (1997) framework, and then was used by Bloemer en De Reuter (1998).
- For measuring Risk Management, the questionnaire used was similar to questionnaire used by Shaima Al Hussiny and Al-Tamimi and Al-Mazrooei (2007) in their studies.

Data Analysis

The first hypothesis was tested through Student's T-test (Independent Sample Test). For this test one categorical & one continuous variable is required. Here categorical variable is "Bank" which is divided into two categories- Islamic & Conventional; & one continuous variable is Risk Management.

Results yielded by this test, shown in table 8.1, show that the mean score of Islamic banks is 94.00 and Conventional banks is 103. 24 on Risk Management scale, they are significant i.e. P = 0.013

(which is less than 0.05). These results help us to accept alternative hypothesis and reject null hypothesis.

H_0: Conventional banks do not act more upon risk management as compared to Islamic banks.
H_1: Conventional banks act more upon risk management as compared to Islamic banks.

Second Hypothesis, Risk management increases operational performance of the banks, was tested through correlation. In this hypothesis operational performance was operationalized through employee satisfaction and customer satisfaction. Therefore co relation of risk management was found with employee satisfaction and customer satisfaction separately.

For the first part of the hypothesis, two continuous variables used were Risk Management and Employee Satisfaction. And for the second part of the hypothesis, two continuous variables used were Risk Management and Customer Satisfaction.

Results shown in table 8.2 show that Risk Management has not only non significant negative relation with Employee satisfaction (-.220, p=.125) but also with Customer satisfaction (-.263, p=.065). Thus analysis showed that there was insignificant negative relation between risk management and operational performance. These results help us to accept null hypothesis and reject alternative hypothesis.

H_0: Risk management does not increase operational performance of the banks.
H_1: Risk management increases operational performance of the banks.

For testing third Hypothesis Financial Ratios analysis was used and then the findings were related with the risk management. Risk management is already measured above through student T-test where as Financial performance is measured by following financial ratios:

Profitability Ratios

1. Return on asset (ROA) = Profit after tax/ total asset

2. Return of equity (ROE) = Profit after tax/ equity capital

3. Profit expense ratio (PER) = profit/total expense.

Risk and Solvency Ratios

1. Debt to equity ratio (DER) = Debt/ total equity

2. Debt to total asset ratio (DAR) = Debt/total asset

Advances to Debt Ratios

1. Advances to deposits ratio (ADR) = Advances/ deposits

Return on Assets (ROA)

The higher ROA ratio shows higher performance and bank's ability to transfer asset into income. In Figure 8.1 graph of "Return on Assets" showed that in Conventional banks MCB had high ROA as compare to other conventional banks where as in Islamic banks Meezan bank had higher ROA than other Islamic banks. Soneri Islamic had negative ROA in year 2011 whereas ROA of Dubai Islamic bank, Soneri and UBL slightly increase each year. ROA of HBL show fluctuations as high in 2010 then decrease in 2011 and again increase in 2012 where as ROA of Bank Islami decrease each year. Figure clearly showed that MCB had much higher ROA as compare to Meezan bank due greater and continuous increase in net income of MCB. In 2012, ratio of 2.7

means that MCB earns 2.7 rupees on each invested rupee where as Meezan bank earns 1.28 rupee on each rupee invested in sales.

Return on Equity (ROE)

The higher ROE ratio shows higher managerial performance. This ratio increase or decrease due to increase or decrease in paid up capital and net income. In Figure 8.1 graph of “Return on Equity” shows that in Conventional banks again MCB had high ROE as compare to other conventional banks where as in Islamic banks Meezan bank again had higher ROE than other Islamic banks. Dubai Islamic bank, Bank Islami, Soneri and UBL show good progress each year where as Soneri Islamic had negative ROE in year 2011 which improve in 2012 but still it was negative in 2012. ROE of HBL show fluctuations as high in 2010 then decrease in 2011 and again increase in 2012. MCB had slightly stable ROE as compare to Meezan bank as ROE of Meezan bank show great fluctuations from 14.88% in 2010 to 24.6% in 2011becuase of great increase in its net income and again its ROE fall in 2012 from 24.6% in 2011 to 21.2% due to minimum increase in net income.

Profit Expense Ratio (PER)

A high PER shows cost efficiency of bank. In Figure 8.1 graph of “Profit Expense Ratio” point out that in Conventional banks again MCB had high PER as compare to other conventional banks where as in Islamic banks Meezan bank again had higher PER than other Islamic banks. PER of Dubai Islamic bank, Soneri and UBL slightly increase each year. PER of HBL and Bank Islami show fluctuations. Soneri Islamic had negative PER in year 2011 which improve in 2012 but still PER was negative in 2012. When compared relatively MCB had higher PER as compare to Meezan bank because MCB generates more returns out of its assets and income by effectively controlling its expenses.

Debt to Equity Ratio (DER)

DER shows that bank capital can absorb financial shocks and a lower DER ratio is preferable where as higher or increasing ratio is the result of aggressive debt financing by the banks for sake of growth. In Figure 8.1 graph of "Debt to Equity Ratio" showed that in Conventional banks again MCB had stable DER about 6% in each of three years as match up to other banks. DER of Islamic banks excluding Soneri Islamic bank increased each year. DER of UBL decrease each year where as DER of HBL increased over each of three years. DER of Soneri bank showed fluctuations as high in 2010 then decrease in 2011 and again increase in 2012.

Debt to Asset Ratio (DAR)

DAR ratio shows riskiness of bank's business and its financial potency to pay its debtor. In Figure 8.1 graph of "Debt to Assets Ratio" clearly showed that MCB had much lower DAR as compare to other Conventional and Islamic banks excluding Soneri Islamic bank. Lower ratio revealed that less percentage of total assets of MCB and Soneri were financed by debt.

Advances to Deposits Ratio (ADR)

Advances to deposits ratio shows the extent to which the bank had utilized its available funds. A higher ratio means banks not have enough liquidity to face any unexpected fund requirements where as very low ratio reveals banks may not be earning as much as they could be. In Figure 8.1 graph of "Advances to Deposit Ratio" showed that ADR of both conventional and Islamic banks decreases. At one side it shows improvements in banks liquidity but on other side it indicates that banks have ample funds to give loan to public, it is not a good sign. ADR ratio declined due to increase in banks' investment in government securities.

Results of Financial ratios reveal that financial performance of Islamic banks is lower when compared with conventional banks. In the same way results of above student T Test also show that Conventional banks act more upon risk management as compared to

Islamic banks. These results help us to accept alternative hypothesis and reject null hypothesis.

H_0: Risk management is not increases financial performance of the banks.
H_1: Risk management increases financial performance of the banks.

Conclusion

Study aims to examine the impact of risk management on the financial and operational performance of banks. Results reveal that Conventional banks have systematic risk management processes to deal with risks and it has been observed that they have the benefit of high financial performance and market leadership. Exposure of Islamic banks to risk is more than conventional bank and risk management practices are still not practiced widely in the Islamic banking industry of Pakistan. Results also show that there was non-significant negative correlation between risk management and operational performance. Results also prove that banks which have effective risk management system, have high financial performance in contrast to those banks which are not have effective risk management system. Study conducted by Emira Kozarević et al (2013) also reveal that higher the Risk management, the higher will be the financial performance.

Recommendations

As the lack of risk management practices in Islamic banks is observed in the study so it is suggested that they should develop a systematic process for risk management. They should provide trainings to their staff in risk management according to their needs.

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Questionnaire

Instructions

Please read the questions carefully and on a scale of 1-5 (where 1 indicates “Strongly Disagree” and 5 indicates “Strongly Agree”) please rank the extent to which you agree with given statements. The questionnaire is designed to know your opinion in general. Please note it is not to test policies of your banks. There is no right or wrong answer. The data is being collected for purely academic purpose.

Part: 1

	Part-I # Risk Management	
1	Monitoring the effectiveness of risk management is an integral part of routine management reporting	
2	There is a common understanding of risk management across the bank	
3	Responsibility of risk management is clearly set out and well understood across the bank	
4	Accountability of risk management is clearly set out and well understood across the bank	
5	The management of risk makes an important contribution to the success of the bank	
6	The management of risk makes an important contribution to the financial stability of the bank in the current financial climate.	
7	Risk management helps to reduce costs and expected losses at the bank	
8	It is important to continuously review and update risk management techniques	
9	Your bank takes significant steps to keep up to date with current risk management trends	
10	Your bank understands the risk management systems used by other banks and their costs and benefits	
11	Your bank finds it difficult to identify and prioritize its main risks	
12	Your bank finds it difficult to manage its main risks	
13	Your bank effectively assesses the likelihood of different risks occurring	
14	Your bank uses numerical methods to assess risks	
15	Your bank is able to accurately evaluate the costs and benefits of taking risks	

16	Your bank is able to accurately evaluate and prioritize different risk treatments even when there are constraints on risk treatment implementation	
17	Your bank's level of risk control is appropriate for the risks that it faces	
18	Your bank's reporting and communication processes support the effective management of risk	
19	Your bank develops action plans for implementing decisions and management plans for identified risks	
20	Your bank's response to risk includes an assessment of the costs and benefits of addressing risks management	
21	Your bank's risk management processes are well documented and provide guidance to staff about the management of risk	
22	Your bank's training policies encourage formal training in risk management	
23	Your bank specifically looks to recruit highly trained and qualified people in risk management	
24	It is dangerous to concentrate bank funds in one sector of the economy	
25	Bank capital is adequate if the ratio of capital to risk weighted assets is 8%	
26	Your bank has excellent overall risk management practices and processes	
	Part-II # Employee Satisfaction	
27	You are satisfied from working environment	
28	You are satisfied from this job	
29	You are satisfied from this organization	
30	Opportunities are provided to you to make full use of your skills and experience, in this organization	
31	You are satisfied from your work performance and productivity in this organization	
32	You are committed (serious and sincere) to this job	
33	You are enthusiastic about your job	
34	You are interested to advance your career in this organization	
	Part-III # Customer Satisfaction	
35	I am really satisfied with the services quality of this bank.	
36	I am really satisfied with the services of this bank.	
37	Bank's priority is customer satisfaction.	
38	Bank has confirmed my expectations.	
39	I am satisfied with the charges of this bank.	
40	Overall satisfaction with organization is high.	
41	I receive value for money by this bank.	
42	Quality of services is better than other banks.	
43	Development of new services is better than other banks.	

Part: 2

General Information	Response				
Tick the Gender	? Male		? Female		
Tick the Age	? = 20 year	? 21-30 year	? 31-40 year	? 41-45year	= 50 year
Tick the Martial Status	? Single		? Married		
Tick the Education	? Bachelor	? Master	? MPHIL		? Ph.D.
Tick the Organizational Status	? Islamic Bank		? Conventional Bank		