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The Impact of Credit Risk Management on Islamic Banks in Yemen

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Abstract: The study aimed to compare credit risk management processes between conventional and Islamic banks in Yemen. The results of the study were obtained through the financial analysis of credit risk in conventional and Islamic banks for the period 2009-2016, expressed in classified loans and provision for doubtful debts. The results of the study showed that Islamic banks are more sensitive to credit risks, the study recommend that the bank regularly identifies the risks individually and thus develops a strategy to confront these risks. The risks are identified regularly and effectively through a comprehensive risk management system through which all processes, tools, resources and responsibilities required to ensure effective risk management are identified. That each bank has an independent committee called the Risk Management Committee concerned with preparing the general policy or the competent department for risk management to implement the policies and monitor and measure risks periodically and establishing a specific system for measuring and controlling risks in each bank and determining the prudential ceilings for credit and liquidity. Using modern information systems to manage risks and set appropriate safety controls for them. The necessity of having an independent internal audit unit in banks that reports directly to the bank's board of directors and reviews all of the bank's business, including risk management.

Keywords: Credit Risk, Islamic Banks, Conventional Banks

1. Introduction

Commercial banks and financial institutions contribute to the process of economic growth by mobilizing financial resources and providing them to individuals and business sectors, thus balancing savings and investment resources. [1]

Credit facilities are considered one of the important and basic operations carried out by banks, and it is the most important item for investing money with the bank. Bank financing operations are the main source of the bank's revenues. Bank credit is one of the most important investments of commercial banks that carry a kind of risk and profitability at the same time. [2]

Banks provide individuals and facilities in the community with the necessary funds in return for the borrower's pledge to pay those funds and the interest and commissions resulting from them in specific installments. The credit is granted against specific guarantees that guarantee the bank to recover its rights in the event the debtor defaults on payment. [3]

Islamic banks are also institutions that carry out all banking activities and the role of financial intermediation, excluding the interest method and replacing it with the participation system [4], Unlike commercial banks, which are limited in their work to mediation between Lenders and borrowers charge interest rate profit. [5]

Resulted from a host of changes in the international arena, such as the liberalization of international trade in financial services, the full trend towards information technology and the trend towards a market economy.

Banks have recently started to adopt risk management policies and have introduced specialized departments to control the risk levels of the Bank's business, including credit risk. Hence, the issue of credit risk management has become increasingly important for banks and has been included by the Basel Committee as an important aspect of determining bank solvency.

Therefore, financial decision makers, especially bank credit decisions, had to rely on established rules and standards to provide credit for the safety of bank funds, sufficient funds (liquidity) and profits.

Given the importance of the subject came this study is to analyze the credit risk of the two banking sectors (Islamic and conventional) during the period 2009 - 20016.

2. Statement of the Problem

Credit management is a vital and fundamental task in both conventional and Islamic banking. Banks are looking for ways to use money to achieve their goals of improving profitability, providing liquidity and reducing risks under legal, banking and environmental constraints.

Therefore, this research attempts to reveal the extent of the credit operations in conventional banks and Islamic banks. The operations of Islamic banks are based on the principles of Islamic law and the prohibition of usury and illegal speculation, in exchange for risk sharing, ie participation in profit and loss is what distinguishes from conventional banks [6]. Therefore, the problem of the study can be formulated through the following question:

Are there any differences in credit risk between conventional banks and Islamic banks?

3. Significance of Studying

The primary focus of risk management is to achieve optimal trade-off between the risk, return, planning and financing business development. The interests of banks have varied in this respect. Some banks have established separate departments affiliated to the top managements that perform risk management functions, while some other banks have established a unit of a particular department to carry out these tasks. [7]

Credit risk is defined as the possibility of losing money when the loans are not paid, and causing a problem for the bank's management, and the failure of banks in this aspect is due to the existence of bad loans, which may result from facilities granted to dealers about whom they know little, or because they are ignorant of the reality of the borrowers' capital. [8]

IFSBI (2005) defines credit risk as the possibility that the other party will fail to meet its obligations under the agreed terms. Credit risk can occur in all instruments or products offered by banks. The only difference is the degree to which banks are exposed to them and how to mitigate them.

For conventional banks, lending activities are credit risk. As for Islamic banks, as lending has been replaced by investment and partnership contracts, credit risk management becomes more important. This definition applies to Islamic financial services such as Murabaha, Musharaka and Wajar.

IFSBI (2005) notes that credit risk in Islamic finance appears in the accounts payable in the Mudaraba contract, counterparty risk in the peace contract and accounts payable. [9]

4. Objectives of the Study

Risk management includes several issues, including identifying them on a regular basis, measuring and evaluating them, trying to reduce them by correct means, and following up and monitoring them regularly. [10]

There is a difference between traditional and Islamic banks in all these aspects. This is because conventional banks operate with interest rates while Islamic banks operate profit sharing. As a result, the concept of risk in the Islamic financial system differs from that in the traditional financial system. The Islamic financial system is seen to be compromised by two dimensions of "uncertainty" and freedom of contract. The trick in Islamic law is the element of opportunity to contain asymmetric information and uncertainty. It is excluded according to the teachings of Islam. This is not the case in the traditional banking system.

In conventional banks, depositors have a fixed claim on assets to banks according to the predetermined interest rate plus return on capital. Thus, to fulfill their obligations to depositors irrespective of their profitability. In contrast, Islamic banks regulate the principle of risk sharing. Commercial and Islamic banks should therefore develop ways to ensure credit risk assessment to avoid mis-choice and avoid moral hazard. Recognizing the importance of credit risk, this study aims to:

a) Comparison of the impact of credit risk in conventional and Islamic banks in Yemen.
b) Comparison of credit risk assessment and analysis in conventional and Islamic banks in Yemen.
c) Comparison of the practices of the credit process to mitigate credit risk in conventional and Islamic banks in Yemen.

5. Conventional Banks

Simply the banking system can be divided into two systems namely interest-based banking system or conventional banks and free-interest banking system or Islamic banks. Conventional banking system can be defined in where the customer-banker relationship is in the basis of creditor-debtor relationship and the bank is an intermediary whose role is collection of funds and allocation of these collected funds. In other words, the bank collects funds and resells them, so that the differences between receipts from lending or allocation of funds and payment from borrowing or collection of funds are realized in the form of profits or may be losses.

Based on the traditional definition, banks act as intermediaries in the allocation of financial resources and gathering deposits from savers and offering loans to consumers, businesses and governments. In the modern definition of banking, banks are seen as factories engaged in information processing, looking into all aspects of deal e.g., investment, corporate finance, insurance, trust and retirement services [11].

6. Islamic Banks

The Islamic banks are also an intermediary body that its role is collection of funds and allocation of these collected funds on the basis of social priority so that the relationship between the bank and customer is not merely on the basis of creditor-debtor but much more as equity shareholder. Contrary to conventional banks, the depositors in an Islamic bank are not entitled to receive interest in a pre- Chapter One 4 determined rate of interest but much more they involve to investment their deposits in a business in which the nature of business is allocated with risk and after bearing such risk, they are entitled to earn a ratio of profit or loss.

Islamic banks have several specific alternatives as financial products such as Murabahah, Musharakah, Mudarabah, Sukuk and Amanah [12].

These financial contracts prove that Islamic finance is a systematic alternative banking system.

The Islamic financing has two families of contracts; the first (like Musharakah, Mudarabah) where the return is stochastic and depends on the ultimate outcome of the investment. The second family (like Murabahah, Ijarah, Salam, Sukuk) is associated with the sale of goods and services on credit, or the rental of an asset (Sukuk) and leads to the indebtedness of the party purchasing those goods and services at a fixed price of sale including commercial profit [13].

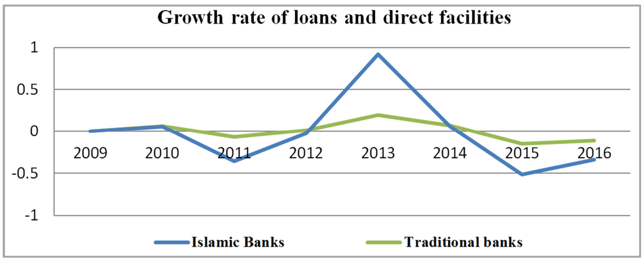
7. Analysis of Financial Statements

Indicators of development of traditional and Islamic banking activity.

Table 1. *Shows the evolution of loans and direct facilities to the traditional and Islamic banks of Yemen for the period (2009-2016).*

total loans and direct facilities		traditional banks			islamic banks		
Years	total value	the value	the ratio	growth rate	the value	the ratio	growth rate
2009	2,028	1,126	0.56		902	0.44	
2010	2,029	1,199	0.59	0.06	898	0.41	0.00
2011	1,758	1,116	0.63	(0.07)	642	0.37	(0.29)
2012	1,750	1,132	0.65	0.01	618	0.35	(0.04)
2013	2,418	1,353	0.56	0.20	1,065	0.44	0.72
2014	2,497	1,447	0.58	0.07	1,051	0.42	(0.01)
2015	1,900	1,231	0.65	(0.15)	668	0.35	(0.36)
2016	1,612	1,098	0.68	(0.11)	514	0.32	(0.23)

Source: compiled from annual reports of traditional and Islamic banks in Yemen [14].



Source: Compiled From data of table 1.

Figure 1. *Growth rate of loans and direct facilities.*

Table 1 shows that total loans and direct facilities reached \$2.028 billion in 2009 and then declined to \$1.758 billion in 2011. As a result of the circumstances surrounding Yemen as a result of political circumstances and then rose to \$2.497 in 2014 and then fell to \$1.612 in 2016.

We also note that the traditional banks have acquired 56% in 2009 to total facilities banking sector and then increased to 68% in 2016, while the Islamic banks note that their investments declined by 44% in 2009 and then fell to 32% 2016, due to the conservative policy of Islamic banks.

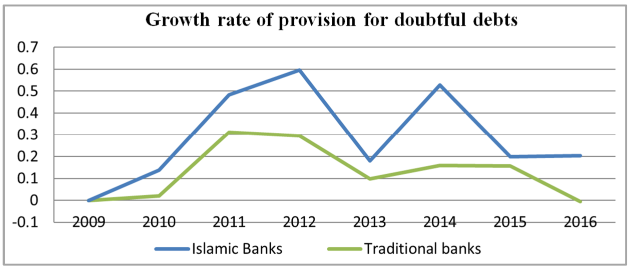
Figure 1 shows that the growth of direct credit facilities in conventional banks is better, growing from \$1,126 billion in 2009 to \$1,447 billion in 2014 and then falling to \$1,098 in 2016. As for the growth of loans in Islamic banks amounted to \$902 million in 2009 and then fell to \$514 million in 2016.

We conclude that direct loans and credit facilities have been affected by the political and economic situation as a result of the political crisis in Yemen. We also note that Islamic banks have been affected more by conventional banks as a result of the political crisis in Yemen.

Table 2. *Shows Growth provision for doubtful debts to the traditional and Islamic banks of Yemen for the period (2009-2016).*

Provision for doubtful debts		Traditional banks			Islamic Banks		
Years	Total value	the value	The ratio	growth rate	the value	The ratio	growth rate
2009	198	166	84%	-	32	0.16	-
2010	205	169	83%	0.02	36	0.17	0.12
2011	263	222	84%	0.31	42	0.16	0.17
2012	341	287	84%	0.3	54	0.16	0.30
2013	374	315	84%	0.1	59	0.16	0.08
2014	446	366	82%	0.16	80	0.18	0.37
2015	507	423	83%	0.16	84	0.17	0.04
2016	522	420	81%	(0.01)	101	0.19	0.21

Source: compiled from annual reports of traditional and Islamic banks in Yemen.



Source: Compiled From data of table 2.

Figure 2. *Growth rate of provision for doubtful debts.*

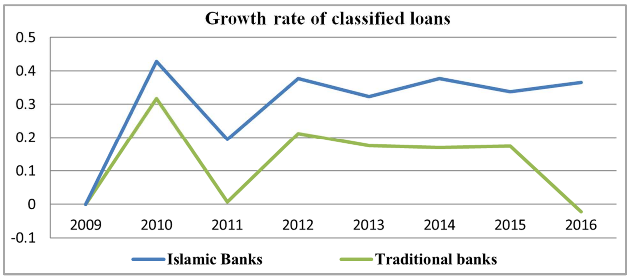
Table 2 shows the growth in provision for doubtful debts, which increased from $198 million in 2009 to $507 million in 2016. This leads us to conclude that the amounts allocated for doubtful debts have been frozen, thus freezing large sums of their investment.

The reason for this rise is economic and political instability. This allocation has doubled from 2011 to 2016 after the political crisis in Yemen.

We also note that traditional banks have acquired the largest proportion, with a provision for doubtful debts of $166 million in 2009 and then increased to $222 million in 2011 and then continued to rise to $423 million in 2016. As for Islamic banks, the provision for doubtful debts amounted of $32 million in 2009 and then rose dramatically to $101 million in 2016. This indicates a higher debt allocation in Islamic banks than the rise in conventional banks.

The figure shows that the provision for doubtful debts in Islamic banks is much higher than that of traditional banks. This allocation in Islamic banks increased from 12% in 2009 to 37% in 2014 and then dropped to 21% in 2016. As for conventional banks, growth fell slightly.

We conclude from this that the Islamic banks have allocated large amounts to meet bad loans. This is good to face the credit risks on the one hand and on the other has been freezing large amounts and not invest.



Source: Compiled From data of table 3.

Figure 3. *Growth rate of classified loans.*

Table 3. *Shows Growth classified loans to the traditional and Islamic banks of Yemen for the period (2009-2016).*

Classified loans		Traditional banks			Islamic Banks		
Years	Total value	the value	The ratio	growth rate	the value	The ratio	growth rate
2009	281	228	81%		53	0.19	
2010	359	300	83%	0.32	59	0.17	0.11
2011	372	302	81%	0.01	70	0.19	0.19
2012	448	366	82%	0.21	82	0.18	0.17
2013	524	430	82%	0.17	94	0.18	0.15
2014	617	503	82%	0.17	114	0.18	0.21
2015	723	590	82%	0.17	133	0.18	0.16
2016	761	577	76%	(0.02)	184	0.24	0.39

Source: Central Bank of Yemen reports, General Administration of Banking Supervision 2009-2016 [15].

Table 3 shows that the growth of loans classified in the banking sector increased significantly to reach $281 million in 2009 and then increased to $372 million in 2011. As a result of the political crisis, these loans continued to rise to $761 million.

We also note that the traditional banks obtained the largest proportion of loans classified as the percentage of the total banking sector 81% in 2009 and then fell to 76% in 2016, while Islamic banks have gained 19% and then rose to 24% in 2016.

Figure 3 shows that the growth of loans classified in Islamic banks increased by 11% in 2009 and then increased to 39% in 2016. For conventional banks it reached 32% in 2009 and then declined to 17% in 2015. This indicates that the risk Credit in Islamic banks has been affected more than conventional banks as a result of the political and economic crisis in Yemen.

Table 4. *Shows total loans classified / total loans and direct facilities to the traditional and Islamic banks of Yemen for the period (2009-2016).*

Years	Traditional banks			Islamic Banks		
	Classified loans	Total loans and direct facilities	The ratio	Classified loans	Total loans and direct facilities	The ratio
2009	228	1,126	20%	53	902	6%
2010	300	1,199	25%	59	830	7%
2011	302	1,116	27%	70	642	11%
2012	366	1,132	32%	82	618	13%
2013	431	1,353	32%	94	1,065	9%
2014	503	1,447	35%	114	1,051	11%
2015	590	1,231	48%	133	668	20%
2016	577	1,098	53%	184	514	36%

Source: compiled from annual reports of traditional and Islamic banks in Yemen.

Table 4 shows the evolution of the ratio of loans classified to total direct credit facilities in conventional banks increased from 20% in 2009 to 53% in 2016. This shows the high credit risk of conventional banks, indicating that the efficiency of performance in conventional banks has not improved during this period. For Islamic banks, this ratio rose from 6% in 2009 to 36% in 2016. This indicates that the risk has increased six fold. Adding that the risk in Islamic banks has risen significantly compared to conventional banks.

Table 5. *Shows total Provision for doubtful debts / classified loans to the traditional and Islamic banks of Yemen for the period (2009-2016).*

Years	Traditional banks			Islamic Banks		
	Provision for doubtful debts	Classified loans	The ratio	Provision for doubtful debts	Classified loans	The ratio
2009	166	228	73%	32	53	60%
2010	169	300	56%	36	59	60%
2011	222	302	73%	42	70	59%
2012	287	366	78%	54	82	66%
2013	315	430	73%	59	94	62%
2014	366	503	73%	80	114	71%
2015	423	590	72%	84	133	63%
2016	420	577	73%	101	184	55%

Source: compiled from annual reports of traditional and Islamic banks in Yemen.

Table 5 shows the ratio of provision for doubtful debts to total loans classified.

The rise in this ratio indicates the bank's ability to hedge against credit risk while saving large amounts. Indicates the inefficiency of traditional banks and the increase in the volume of loans classified in conventional banks, from 73% in 2009 and remained stable at 73% in 2016. For Islamic banks, this ratio dropped from 60% in 2009 to 55% in 2016. Credit risk has risen in recent times and Islamic banks are not avoiding the provision of credit in order to face credit risk.

8. Findings of the Study

a) The traditional banks got 56% in 2009 to the total facilities banking sector and then this percentage rose to 68% in 2016 while the Islamic banks note the decline of their investments, reaching 44% in 2009 and then fell to 32% in 2016. This is due to the conservative policy of Islamic banks.
b) Traditional banks got the largest percentage as the provision for doubtful debts amounted to $198 million from 2009 and then rose to $522 million in 2016.
c) As for the Islamic banks got $32 million in 2009 and then rose dramatically to $101 million in 2016. This indicates a higher provision for doubtful debts in Islamic banks than conventional banks.
d) The growth of loans classified in Islamic banks increased by 11% in 2009 and then increased to 39% in 2016. For conventional banks it reached 32% in 2009 and then declined to 17% in 2015. This indicates that credit risk in Islamic banks has been affected more by conventional banks as a result of the political and economic crisis in Yemen.
e) The evolution of the ratio of loans classified to total direct credit facilities in conventional banks increased from 20% in 2009 to 53% in 2016. This shows the high credit risk of conventional banks, indicating that the efficiency of performance in conventional banks has not improved during this period. The ratio rose from 6% in 2009 to 36% in 2016. This risk increased six fold, suggesting that the risks in Islamic banks have risen significantly compared to conventional banks.
f) The ratio of provision for doubtful debts to total loans classified as high indicates the extent of the Bank's ability to hedge against credit risk. On the other hand, the freezing of large amounts indicates the inefficiency of conventional banks and the high volume of loans classified in conventional banks in 2009 and remained stable at 73% in 2016. For Islamic banks, this ratio dropped from 60% in 2009 to 55% in 2016. Credit risk has increased recently and Islamic banks do not avoid the provision to face credit risk.

9. Conclusion

The study recommend that the bank regularly identifies the risks individually and thus develops a strategy to confront these risks. The risks are identified regularly and effectively through a comprehensive risk management system through which all processes, tools, resources and responsibilities required to ensure effective risk management are identified, we also recommend:

1. That each bank has an independent committee called the Risk Management Committee concerned with preparing the general policy or the competent department for risk management to implement the policies and monitor and measure risks periodically.
2. Establishing a specific system for measuring and controlling risks in each bank and determining the prudential ceilings for credit and liquidity.
3. Using modern information systems to manage risks and set appropriate safety controls for them.

The necessity of having an independent internal audit unit in banks that reports directly to the bank's board of directors and reviews all of the bank's business, including risk management.

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