

Credit Risk Transfer

Author: Abd Elrahman Elzahi Saaid Ali

Published by

Islamic Research and Training Institute (IRTI)

A Member of Islamic Development Bank Group (IDB)

This study investigates the impact of credit risk transfer on Islamic banks' lending behavior and financial stability. The recent financial crisis has further increased the interest to investigate techniques of credit risk management by banks in general and Islamic banks in particular. The behavior of credit risk transfer of the commercial banks has been studied in the framework of conventional banks but little attention has been paid to the behavior of credit risk transfer of the Islamic banks. Therefore, the study intends to fill this gap. Data were collected from 60 Islamic banks and analyzed in panel-pooled framework to investigate the behavioral impact of the credit risk transfer.

Most of the estimated variables such as the Islamic banks total lending to asset ratio (TL/A), equity capital to assets ratio (CAP/A), liquidity to assets ratio (LIQ/A), profitability ratio (ROA), and credit risk transfer (CRI) proxy by dummy variables, Gross Domestic Product (GDP) and the exchange rate (EXR) were significant either at 1% level or 5% level, with the expected signs.

The research finds that Islamic banks with low capital might adjust their lending by reducing their assets up to the required level rather than raising it. This is due to the cost of acquiring additional capital. Likewise, Islamic banks reduce their lending portfolio when they fall short in the liquidity level. However, this might shrink their volume of lending.

The study attempts to capture the impact of credit risk transfer on the lending behavior of the Islamic banks through a proxy of dummy variables, which were found to be positively related. Credit risk transfer and banks' lending behavior shows that Islamic banks behave in risk averse manner when some sorts of credit risk management techniques are used. These results are consistent with previous findings regarding conventional banks, which behaved more aggressively in granting more loans when they used advance risk management techniques. Hence, this study concludes that there is no significant difference in the behavior of credit risk transfer of the Islamic banks and their conventional counter parts when modern risk management techniques of credit risk transfer are used. Since,

Islamic banks were using less modern credit risk transfer techniques at the time when the financial crisis hit the entire globe; therefore, they remained relatively stable during the recent financial crisis.

Lessons learned:

1. Using more risk management techniques might lead to more credit risk as the banks become less risk averse in lending.
2. Banks whether conventional or Islamic need to pay more attention and behave more rationally when they are using modern risk instruments to manage their credit risk.
3. Islamic banks were resilient and relatively stable during the recent financial crisis because they were not using modern credit risk management instruments like financial derivatives, which were part of the causes of the crisis.
4. Islamic banks need to be very selective when they choose one or the other techniques for credit risk management to mitigate their risk.
5. To avoid the risk of financial instability, banks regulators are advised to monitor Islamic banks more closely when they try to select and use modern risk management instruments.
