ISLAM, ACCOUNTING AND FINANCE
CHALLENGES AND OPPORTUNITIES IN THE NEW DECADE

Norhayati Mohd Alwi | Sherliza Puat Nelson

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CHAPTER 3

AN ANALYSIS OF THE CREDIT RISK OF ISLAMIC BANKS OPERATING IN PAKISTAN

Azam Ali
Salina Kasim
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Mazhar Khan

1. Introduction

Banking institutions face a variety of risks, but credit risk is probably the most common one (Lampros and Loannis, 2006). Although banks in the Islamic system face fewer solvency and liquidity risks than their conventional counterparts, the efficacy of their credit operations is extremely important and provides the basis for ensuring the solvency of debtors. Credit risk comprises default risk, downgrade risk, counterparty risk and settlement risk. It covers 80% of an average bank's Banking book asset portfolio and is the cause of 80% of bank failures (Tariqullah, 2002).

Credit risk in banking is commonly defined as the probability of a borrower to default on his loan commitments. Credit risk in an Islamic bank is in the form of settlement/payment risk arising when one party to a business transaction pays money (for example, in a Salam or Istisna contract) or delivers assets (Murabahah contract) before receiving its own assets or cash, thereby exposing it to potential loss (Khan and Ahmed, 2001). Numerous methodologies have been adopted to measure credit risks and to predict bankruptcy. While the majority of financial analysts used the subjective analysis for assessment of credit risk, there are also a wide range of credit risk assessment models comprising qualitative and quantitative methods, logistic regression models and causal and hybrid models.

Numerous studies have been conducted to analyse the relationship between performance and credit risk in the Islamic banks. While there are a number of studies analysing the credit risk of conventional banks and Islamic banks in various countries, there are hardly any on the analysis of the credit risk of Islamic banks in Pakistan. This study intends to fill the gap by analysing the credit risk of Islamic banks in Pakistan by running a rigorously tested regression model on the data from 2002 to 2010.

The motivation for the study primarily comes from the importance of credit risk for any banking institution, as outlined above. During the last decade, Islamic finance has captured substantial interest in the global finance industry. Much of that keenness came from a liquidity glut in GCC, however, the growing size of Islamic banking in Islamic countries has increased its significance and implications for the banking industry as well as the economy.