Impact of Credit Risk Management on the Performance of Islamic and Commercial Banks in Saudi Arabia

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Abstract: Both Islamic and conventional banks find the best practices for minimizing financial risks. The managers should report the process that the bank must apply to address such risks. In Saudi Arabia, the reforms were adopted in its new vision 2030 for all sectors, including the banking sector, to enhance an environment of transparency and greater disclosure with outstanding performance, all contributing to the creation of an environment of competition to achieve leadership and excellence in the provision of competitive services. The study aims to identify the performance of Saudi’s banking sector through determining the effect of credit risk in their operation to learn whether Islamic banks or conventional banks have better risk management. The research covers four conventional banks and four Islamic banks, and the data is obtained from the annual reports of these banks. The panel data of a 10-year period, from 2009 to 2018, of the selected banks were used to examine the relationship between credit risk and performance. Return on equity (ROE) is used as a performance indicator, while the ratio of loan provision to total loans (LP/TL), the ratio of loan provision to non-performing Loans (LP/NPL), the ratio of loan provision to total assets (LP/TA), and the ratio of non-performing loans to total loans (NPL/TL) were used as indicators of credit risk. Furthermore, A regression model was used to find the relationship between the banks’ performance and the indicators of credit risk through the period of the study. The software used to run the regression was the SPSS software.

Keywords: Saudi Arabia, Credit risk management, Performance, Islamic banks, Conventional banks, Loan provision, Non-performing loan

INTRODUCTION
Banks, whether Islamic or conventional, are not free from facing financial risks. Such risks always result from the activities the bank performs every day. It is clear that the main sector in any economy is the banking sector. Therefore, making this sector aware of the risks is the main job of the risk management department. In addition, the managers should report the process the bank must apply to deal with different risks. The 2008 international financial crisis that was initiated in the US resulted in an extensive range of influences on the financial performance and operation of numerous banks worldwide. Many banks consequently reported monetary loss because of their associates with a supreme mortgage in the US or were affected by the financial recession in their countries. The effect of the crisis even forced about 123 banks in the US to file for bankruptcy that year. The large American bank Lehman Brother was facing bankruptcy even though it was never expected to fail (Hidayat & Abduh, 2012).

One of the important risks that all banks must consider is credit risk; therefore, efficient credit risk management is essential for all banks. Banks must protect their trust by adopting appropriate credit risk management practices. The primary aim of financial institutions is to maximize returns and offer the greatest value to investors by facilitating an assortment of financial services and particularly by managing this risk (Ahmad & Ahmad, 2004).

Two vital sectors in Saudi Arabia play a significant role in the economy: the banking and petroleum sectors. The banking sector in Saudi Arabia includes four Islamic banks, while the others (9) are conventional banks. This sector is monitored and regulated through the Saudi Arabia Monetary Agency (SAMA). The most recent report of the SAMA indicated that the position of the Saudi economy has improved, and it is expected to experience a spontaneous rise during 2019 regarding the expansionary financial policy. However, disadvantages and risks for the Saudi economy originate from the global economic slowdown and its likely influence on the global oil market.

Furthermore, the slight rise in economic movement has assisted in reinforcing the flexibility of the Saudi banking system, which witnessed improvement in 2018. Asset growth was driven primarily by private sector credit expansion, in contradiction to the growing exposure to national sovereign debt. Yet, there was a commerce-segment-driven contraction of companies’ credit at the end of the year.
The reforms adopted by the government in its new vision 2030 on all sectors, including the banking sector, to enhance an environment of transparency and greater disclosure with outstanding performance contributed to the creation of an environment of competition to achieve leadership and excellence in the provision of competitive services (SAMM, 2020).

This paper chooses some financial determinants from banks’ annual report to identify the credit risk in both Islamic and conventional banks in Saudi Arabia and determine which type of bank performs better at managing this risk.

**Literature Review**

Banks have recently witnessed an increase in non-performing credit portfolios, which contributed greatly to the financial crisis in the banking sector. The banking sector collects deposits and lends to clients; however, when clients fail to fulfill their obligations, problems such as non-performing loans arise.

Konovalova et al. (2016) propose a model to assess credit risk based on a factor analysis of borrowers. They used such a model to ensure predictive control of the level of risk posed by potential clients in commercial banks engaged in consumer lending. The purpose of the research was to control the level of risk characterized by different classes of borrowers to prevent and decrease upcoming credit risk and improve the banks’ risk management. They conclude with the “model of borrowers internal credit ratings” and provide methods of improving credit risk management in conventional banks.

Meanwhile, Kargi (2011) evaluates the impact of credit risk on the profitability of Nigerian banks. The study applied financial ratios to measure Nigerian banks’ credit risk and performance. The data was gathered from accounts of sampled banks and annual reports from 2004–2008. The study applied correlation, descriptive, and regression methods in the analysis. The findings identified that credit risk management significantly affects the profitability of the sampled banks. Therefore, credit risk management must be cautious in setting up a credit policy, which can minimize negative effects on profitability, and understand how credit policy affects the operation of the banks to guarantee a judicious use of deposits.

Ayodele and Alabi (2014) examine risk management in the Nigerian banking sector. The study case covered the first bank of Nigeria PLC, which was the largest and oldest bank of the 23 banks operating in the economy of Nigeria at the time of this study. The questionnaires were used as a source for the study. Based on the findings, Nigeria’s banking sector is greater affected by credit risk and operational risk than market risk. Yet, the risk management techniques launched by banks have already dampened or reduced the various risks facing Nigerian banks. The researchers recommend that the government of Nigeria strengthen the legal framework to enforce loan repayment from borrowers to banks when the loan is due. Furthermore, the financial regulator must implement a risk management method that fully aligns with international standards, focusing on the operational and financial risks faced by banks to follow against any risks associated with banking operations and their existence.

However, as in the previous study, with a greater focus on credit risk, Yimkkaa, Taofeekb, Abimbola, and Olusegun (2015) examine the character of credit risk management in the value creation procedure among conventional banks in Nigeria. The study develops a conceptual model with four precedents for credit risk. It analyzes the influence of total loan and advances, loan and advances loss provision, nonperforming loan, and total asset on accounting return on equity (ROE) and return on asset (ROA). They covered 10 commercial banks on Nigeria Stock Exchange (NSE) between 2006 and 2010. The results indicate that credit risk management has an important effect on the financial performance of sampled banks. They recommend that maintaining a minimum level of non-performing loans against the provision for loans and advances would improve financial performance through the effect on return on equity.

More recently in Nigeria, Taiwo et al. (2017) conducted a pilot investigation into the quantitative impact of credit risk management on the performance of money deposit banks and bank lending growth from 1998–2014. The study employed a multiple linear regression model to analyze the time-series data. It concludes with some findings, such as that the sound credit management strategies can boost saver and investor confidence in banks and create growth in funds for advances and loans, leading to increased profitability of the bank. In addition, credit risk management has little impact on the growth of gross loans and advances by Nigerian deposit banks. They recommend that Nigerian Deposit Money Banks (DMBs) should strictly follow their credit appraisal policies, which guarantee that only creditworthy borrowers have access to lending-capable funds. Banks should ensure that funds are allocated to borrowers with decent to high credit ratings.

in Bangladesh, Kodithuwakku (2015) examines the effect of credit risk on the performance of conventional banks. The research selected determinants obtained from the financial statement. The research concludes that provisions and non-performing loans have an adverse influence on profitability. The research consequently suggests that banks apply areal tools and methods to manage credit risk.

Saeed and Zahid (2016) conducted a study to examine the effect of credit risk on profitability in five large conventional banks in the UK. They used two dependent variables, namely return on asset (ROA) and return on
equity (ROE), and two variables for credit risks, namely impairments and nonperforming loans. The study conducted a multiple statistical analysis and used bank data from 2007 to 2015 to assess the effect of the financial crisis. They found that indicators of credit risk had a positive significant association with profitability in the banks. Although there were strong impacts of the credit crisis in 2008, UK’s banks take credit risks, receive benefits from free interest rates and commissions, etc. In addition, the results expose that the bank size, growth, and leverage were positively inter-linked with each other, and the banks gained profitability after the financial crisis and learned how to challenge the credit risk over the years.

Syed (2017) studied the effect of credit risk management on the performance of conventional banks in Pakistan. The study used secondary data, and pooled regression was implemented to determine the effect of credit risk management on banks’ performance. The findings exposed that credit risk management is negatively associated with bank performance. The management is consequently required to be careful about loans and advances, nonperforming loans, and liquidity ratios, since these ratios severely influence the profitability of Pakistan’s banks. Furthermore, capital adequacy has a positive association with bank performance and should thus be managed.

For credit risk regarding a comparison between Islamic banks and conventional banks in terms of which type is more exposed to this type of risk, we found that Ferhi (2018) evaluated the relationship of credit risk in Islamic and conventional banks and the capital in 14 countries of The Middle East and North Africa (MENA) region. He used a sample of 89 conventional banks and 58 Islamic banks from 2005–2015. The results indicate that the conventional model has a higher credit risk than the Islamic one. Moreover, these results indicate that the larger an Islamic bank, the closer its credit risk will be to that of conventional banks. Similarly, Chamberlain et al. (2020) conducted a study to investigate the differences in the credit profiles of Islamic and conventional banks in the Gulf Cooperation Council (GCC) region and attempted to identify the factors responsible for such differences. They found that Islamic banks have lower credit risk than conventional banks, whereas higher capitalization, better liquidity, and cost inefficiency contribute to the lower risk profile of Islamic banks. Moreover, in terms of focusing on the influence of credit risk on the financial performance in Islamic Banks, Awosanya and Elena (2019) found that the positive relationship between credit risk and Islamic bank profitability in other countries is not the case with African countries such as Tunisia, Egypt, Kenya, and Sudan due to challenges relating to the compliance and regulations of Islamic banking products; higher risks in regulatory sector financing in Africa; and peculiar challenges faced by African Islamic lenders, such as the lack of collateral, absence of property titles, thin business plans, and inadequate financial documentation, which impact due diligence and efficient credit risk management in the African region.

Methodology
This research aims to evaluate the current position of credit risk management in both Islamic and conventional banks in Saudi Arabia. It recommends employing some determinants to identify this risk and the relationship between this risk and the variables. Furthermore, it aims to realize which type of bank performs better regarding credit risk. To achieve the aims, the researcher employs hypothesis testing methodology. This is an empirical statement focused on the relationship between variables.

There are three questions in this research:
1. What are the major determinants of credit risk that could affect the return on equity in Islamic and conventional banks?
2. Are Islamic banks less exposed to credit risk on average than conventional banks in Saudi Arabia?
3. Are Islamic banks more efficient on average than conventional banks in Saudi Arabia?

Conceptual Framework for the Research
The model is adopted from the study by Ahmed et al. (2011) and is as follows:

$$ROE = \alpha_0 + \alpha_1 LNPNL + \alpha_2 LPTS + \alpha_3 LPTL + \alpha_4 NPLL + \pi,$$

- $\alpha_0$ is the intercept.
- $\alpha_i$ (i = 1, 2, 3, 4) are the coefficients or measures of $t$, and $\pi$ is the random variable included in the model to accommodate influences of other variables that might affect profitability but are not included in the model.
- $ROE$ (return on equity), the dependent variable, is a measure of financial performance.
- $LNPNL$ is the ratio of provision for loans to non-performing loans.
- $LPTS$ is the ratio of total loans to total assets.
- $LPTL$ is the ratio of provision for loans to total loans.
- $NPLL$ is the ratio of non-performing loans to total loans.

Study Sample
The study sample covers eight banks in Saudi Arabia. These include four Islamic banks, namely Bank Al-Rajhi, Bank Al-Bilad, Bank Al-Jazira, and Bank Alinma and four conventional banks, namely Riyadh Bank, Saudi
British Bank, Saudi American Bank, and Al Bank Al-Saudi Al-Fransi. All existing Islamic banks were selected; however, the conventional banks were selected based on size and data availability. Foreign banks operating in Saudi Arabia were omitted from the study, as they possess a unique style of operation and management. The study period extends for 10 years, from 2009 to 2018, to include some Islamic banks that have been recently established in Saudi Arabia, such as Bank Al-Bilad and Bank Alinma. The financial data for the sample banks were gathered from the annual reports of these banks provided on their websites.

Research Hypotheses
Six hypotheses were developed to answer the questions:
H1: The ratio of loan provision to non-performing loans (LP/NPL) significantly impacts the return on equity in both types of banks.
H2: The ratio of loan provision to total loans (LPTL) significantly impacts the return on equity in both types of banks.
H3: The ratio of total loans to total assets (TLTS) significantly impacts the return on equity in both types of banks.
H4: The ratio of non-performing loans to total loans (NPLL) significantly impacts the return on equity in both types of banks.
H5: Islamic bank performance is lower than that of conventional banks in Saudi Arabia.
H6: Islamic banks have less exposure to credit risk do than conventional banks in Saudi Arabia.

RESULTS AND DISCUSSION
The regression procedure is employed to achieve the statistical values of the intercept and the effects of the credit risk management variables along with the random variable in the model. The valuation of the values is performed using SPSS statistical software. Panel least squares (PLS) is used to estimate the data. Table 1 presents the variability ratio of the independent variables. The “R square” reveals the relationship between the dependent and independent variables, while “R” represents the square cause of R. The value of R explains how independent variables are linked to ROE. Furthermore, the adjusted R square refers to the statistical contraction of credit risk variables. In other words, the adjusted R square describes the compatibility of the selected independent variables with the dependent variables to validate the determinations based on the regression model.

The table indicates that the total divergence in the performance measured by ROE, due to the change in the independent variables, is equal to 69% and the determination coefficient is equal to 47.5% in Saudi’s conventional banks, while the total divergence in the performance measured by ROE, due to the change in the independent variables, is equal to 68% and the determination coefficient is equal to 46% in Saudi’s Islamic banks.

Table 1: Regression Analysis for Islamic and Conventional Banks in Saudi Arabia

<table>
<thead>
<tr>
<th>Variable</th>
<th>ROE</th>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Islamic Banks</td>
<td>Conventional Banks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banks Type</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>COE</td>
<td>Std. error</td>
<td>T-value</td>
<td>P-value</td>
<td>COE</td>
<td>Std. error</td>
<td>T-value</td>
</tr>
<tr>
<td>(Constant)</td>
<td>-23.389</td>
<td>8.660</td>
<td>-2.701</td>
<td>.011</td>
<td>8.251</td>
<td>4.222</td>
</tr>
<tr>
<td>LPNPL</td>
<td>.031</td>
<td>.015</td>
<td>2.074</td>
<td>.045</td>
<td>.034</td>
<td>.014</td>
</tr>
<tr>
<td>NPLL</td>
<td>-1.361</td>
<td>.996</td>
<td>-1.366</td>
<td>.181</td>
<td>1.376</td>
<td>.956</td>
</tr>
<tr>
<td>LPTL</td>
<td>2.037</td>
<td>1.149</td>
<td>1.772</td>
<td>.085</td>
<td>.075</td>
<td>.893</td>
</tr>
<tr>
<td>TLTS</td>
<td>.437</td>
<td>.129</td>
<td>3.399</td>
<td>.002</td>
<td>-.033</td>
<td>.058</td>
</tr>
<tr>
<td>Model 1</td>
<td>Model 2</td>
<td></td>
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</tbody>
</table>
The regression analysis in Table 1 presents the statistical significance of predictors and their unpredictability over ROE for both types of banks. This significance is illustrated in Table 1 according to the ‘F’ and P-values. In model 1 and model 2, the p-values (0.000) and (0.021), respectively, of the F-test are less than 0.05; hence, the regression of both models for conventional and Islamic banks are statistically significant. In addition, Table 4.1 reveals that the Islamic banks of Saudi’s loan provision to non-performing loans (LP/NPL) and total loans to total assets (TLTS) have a statistically significant and positive impact on return on equity, while the conventional banks of Saudi’s loan provision to non-performing loans (LP/NPL) has a statistically significant and positive impact on ROE.

Table 2: Hypotheses Test Results

<table>
<thead>
<tr>
<th>Hypotheses</th>
<th>Statements</th>
<th>Banks</th>
<th>Coe</th>
<th>P-value</th>
<th>Decision status</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>H1</strong></td>
<td>The ratio of loan provision to non-performing loans (LP/NPL) has a significant impact on return on equity.</td>
<td>Islamic</td>
<td>.031</td>
<td>.045</td>
<td>Accepted</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Conventional</td>
<td>.034</td>
<td>.026</td>
<td>Accepted</td>
</tr>
<tr>
<td><strong>H2</strong></td>
<td>The ratio of loan provision to total loans (LPTL) has a significant impact on return on equity.</td>
<td>Islamic</td>
<td>-1.361</td>
<td>.181</td>
<td>Rejected</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Conventional</td>
<td>1.376</td>
<td>.159</td>
<td>Rejected</td>
</tr>
<tr>
<td><strong>H3</strong></td>
<td>The ratio of total loans to total assets (TLTS) has a significant impact on return on equity.</td>
<td>Islamic</td>
<td>2.037</td>
<td>.085</td>
<td>Rejected</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Conventional</td>
<td>.075</td>
<td>.933</td>
<td>Rejected</td>
</tr>
<tr>
<td><strong>H4</strong></td>
<td>The ratio of non-performing loans to total loans (NPLL)</td>
<td>Islamic</td>
<td>.437</td>
<td>.002</td>
<td>Accepted</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Conventional</td>
<td>-.033</td>
<td>.574</td>
<td>Rejected</td>
</tr>
</tbody>
</table>
In Table 2, research hypothesis one (H1), which states that the ratio of loans provision to non-performing loans (LP/NPL) has a significant impact on the return on equity for both types of banks, will be accepted, and hypothesis four (H4), which states that the ratio of total loans to total assets (TLTS) has a significant impact on return on equity will be accepted for Islamic banks but rejected for conventional banks. All research’s hypotheses will be rejected because there is no significant relationship between the rest independent variables and return on equity (ROE).

The results identify that the positive relationship between credit risk indicators and return on equity (ROE) can be explained by increases in the amount of credit supplied by banks and credit risk management through the monitoring and screening of borrowers could supporting this result. Furthermore, this positive relationship can be explained by increases in secured assets leading to generating income. In other words, the increase in secured assets helps to reduce the amounts of money that banks set aside for provisions to cover expected credit losses. Thus, the increase in secured assets will lead to higher profitability of banks. The findings support that credit risk management is an important indicator of the banks’ financial performance. This reveals that credit risk management is strong in both the Islamic and conventional banking sectors in Saudi Arabia.

Table 3 presents the independent samples t-test for the mean differences of the variables for both Islamic and conventional banks. The return on equity (ROE) in Islamic banks (M = 11.63, SD = 6.29) does not significantly exhibit any difference with respect to conventional banks (M = 13.25, SD = 2.49), t = -1.507, p < .138. As we have selected ROE to be an indicator of the banks’ performance, the research hypothesis (H5) that states “Islamic banks’ performance is lower than that of conventional banks in Saudi Arabia” will be rejected. As with ROE, the determinant of credit risk LPNPL, NPLL, and LPTL has no significant difference in the mean for both types of banks. It is found that the ratio of the total loans to total assets (TLTS) has a significant difference in the mean, so Islamic banks have higher exposure to credit risk (M = 64.21, SD = 6.14) than do conventional banks (M = 60.18, SD = 6.18), t = 2.89, p < .005.

Table 3: Independent samples t-test

<table>
<thead>
<tr>
<th>Variables</th>
<th>Bank</th>
<th>N</th>
<th>Mean</th>
<th>Std. deviation</th>
<th>T-value</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROE</td>
<td>Islamic</td>
<td>40</td>
<td>11.63</td>
<td>6.29</td>
<td>-1.507</td>
<td>.138</td>
</tr>
<tr>
<td></td>
<td>Conventional</td>
<td>40</td>
<td>13.25</td>
<td>2.49</td>
<td></td>
<td></td>
</tr>
<tr>
<td>LPNPL</td>
<td>Islamic</td>
<td>40</td>
<td>141.28</td>
<td>73.99</td>
<td>.672</td>
<td>.504</td>
</tr>
<tr>
<td></td>
<td>Conventional</td>
<td>40</td>
<td>132.21</td>
<td>42.56</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NPLL</td>
<td>Islamic</td>
<td>40</td>
<td>2.06</td>
<td>1.92</td>
<td>1.013</td>
<td>.315</td>
</tr>
<tr>
<td></td>
<td>Conventional</td>
<td>40</td>
<td>1.71</td>
<td>.96</td>
<td></td>
<td></td>
</tr>
<tr>
<td>LPTL</td>
<td>Islamic</td>
<td>40</td>
<td>2.64</td>
<td>1.71</td>
<td>1.654</td>
<td>.103</td>
</tr>
<tr>
<td></td>
<td>Conventional</td>
<td>40</td>
<td>2.12</td>
<td>1.01</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TLTS</td>
<td>Islamic</td>
<td>40</td>
<td>64.21</td>
<td>6.14</td>
<td>2.889</td>
<td>.005</td>
</tr>
<tr>
<td></td>
<td>Conventional</td>
<td>40</td>
<td>60.23</td>
<td>6.18</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The levels of credit risks faced by Islamic banks are found to be significantly higher than those faced by conventional banks, as revealed in the results of the total loans to total assets in this study. Therefore, we rejected hypothesis (H6) that stated "Islamic banks have less exposure to credit risk than conventional banks in Saudi Arabia". This result might be explained by the statement of Van Greuning and Iqbal (2008) when they demonstrated that credit risk management for Islamic banks is complicated because they are compliant with Shariah regulations, which impede them from charging accrued interest or penalties in the event of delay or non-payment of the loan. As a result, the client takes advantage of this by delaying payments to Islamic banks. The capital of Islamic banks is struck due to the unproductive use of their capital, causing pressure on banks due to non-payment of the return to depositors, which will raise the rate of return risk for the bank.

Furthermore, Islamic finance tools could increase credit risk in Islamic banking. Examples include Murabahah contract and move to equity contracts, such as Musharakah and Musharabah. The nature of Murabahah and Ijarah transactions of Islamic banks exposes them to similar credit risk as do commercial credits of conventional banks; however, Musharabah and Musharakah partnerships have unique credit risks. In Musharabah partnerships, the operations depend on the managing partner; therefore, the creditability of the managing partner becomes a major issue. Islamic banks are exposed to credit risk in Musharabah via the managing partner’s fraud, misconduct, negligence, and incompetence. The credit risk of the resulting business exists, as well. If the business cannot generate profits and begins realizing losses, the Islamic bank likewise will realize losses. This type of credit risk applies to Musharakah partnerships, as well. Moreover, Ijarah and Salam transactions expose Islamic banks to credit risk (Al-Wesabi & Ahmad, 2013).

Research Limitation
The main limitation of the study comes from the sample data, which were collected from the context of a single country, namely Saudi Arabia. This made it easier to collect the relevant data and control for heterogeneity when including other international banking systems. However, this essentially limits the generalizability of our findings. In addition, we selected only one type of risk, credit risk, in this study, which could be a limitation because there are other types of possible risks associated with Islamic and conventional banking, such as liquidity risk, market risk, and so on. Therefore, the research is limited in regards to the generalization of these results with respect to marketing, administration, and other risks, especially Shari’ah compliance risks, as they relate uniquely to Islamic banks.

CONCLUSION
This research aims to identify the fundamental issues of credit risk that could affect the performance of both types of banks and to distinguish which types of banks have the best management practices. According to the results, both Islamic and conventional banks have clear strategies to achieve efficient management performance. The study finds that conventional banks have the best practices for dealing with the ratio of total loans to total issues. Additionally, the study concludes that financial performance is influenced by risk management practices and the extent to which the banks develop the strategies to face different risks. Therefore, the powerful risk management committee can insert a crucial role in monitoring risk threatened by banks. The risk committee is required to review risk policies.

REFERENCES