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THE INFLUENCE OF DISPLACED COMMERCIAL RISK ON BANK PROFITABILITY IN ISLAMIC BANKING INSTITUTIONS

Abstract:

Islamic banks are exposed to a unique risk such as Displaced Commercial Risk (DCR). DCR arises from the assets managed on behalf of the investment account holders which may be borne by the Islamic bank's own capital, when the Islamic banks forgo part or all of its share of profits on the investment account holders funds, in order to increase the return to the investment account holders. In a dual banking system, DCR could be a threat to the Islamic banks given the competition of fixed and higher return from the conventional banks. However, DCR would not be a threat to Islamic banks if their account holders choose Islamic banks due to religious obligatory factor. Pertaining to this issue, this paper aims to examine whether DCR is a threat to Islamic banks' profitability in the case of Malaysia. For that purpose, a model is set up to estimate bank profitability. The model includes other bank specific characteristics and macroeconomic variables as control variables to avoid omitted variables bias. We find that DCR is one of the factor that affects bank profitability, at least in the case of Malaysian Islamic banks. This empirical evidence implies that Islamic banks operating in a dual banking system are affected by displaced commercial risk. Hence, it should be one of the banks' risk management concern.

Keywords:

Islamic Banks; Return On Assets; Displaced Commercial Risk; Bank Profitability; Investment Account Holders; Profit Sharing Investment Account.

JEL Classification: C23, E30, G21