

Risk Management Strategies in The Financial Industry Theoretical Review and Practical Implications

*Risk Management
Strategies in Finance*

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ABSTRACT

The financial industry is confronted with considerable challenges in risk management due to its distinctive risk profile. This study endeavors to assess the array of risks that the financial industry grapples with. The research delves into the domain of risk management through an examination of pertinent literature. It elucidates the spectrum of risks that the financial industry is subjected to. The findings reveal that the financial industry is exposed to multiple risks, including credit risk, liquidity risk, operational risk, legal risk, withdrawal risk, and fiduciary risk. Another noteworthy finding is that Islamic banking is inherently riskier than conventional banking due to the distinctive nature of its financing practices. This heightened risk is further compounded by the lack of a robust money market, limited access to lender of last resort facilities from the central bank, and a dearth of comprehensive market infrastructure, which contribute to an environment of heightened risk for both conventional and Shariah-compliant financial institutions. The financial industry has not demonstrated the capacity to develop effective risk management solutions for the unique set of challenges faced by conventional banks, let alone for their own distinct set of risks.

Keywords: Finance, Risk, Management, Theoretical Overview, Practical Implications

ABSTRAK

Industri keuangan dihadapkan pada tantangan besar dalam manajemen risiko karena profil risikonya yang berbeda. Studi ini berupaya menilai serangkaian risiko yang dihadapi industri keuangan. Penelitian ini menggali domain manajemen risiko melalui pemeriksaan literatur terkait. Laporan ini menjelaskan spektrum risiko yang dihadapi industri keuangan. Temuan menunjukkan bahwa industri keuangan dihadapkan pada berbagai risiko, termasuk risiko kredit,

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risiko likuiditas, risiko operasional, risiko hukum, risiko penarikan, dan risiko fidusia. Temuan penting lainnya adalah bahwa perbankan syariah secara inheren lebih berisiko dibandingkan perbankan konvensional karena sifat praktik pembiayaannya yang berbeda. Peningkatan risiko ini semakin diperparah dengan lemahnya pasar uang, terbatasnya akses terhadap fasilitas lender of last resort dari bank sentral, dan kurangnya infrastruktur pasar yang komprehensif, yang berkontribusi pada peningkatan risiko baik bagi bank konvensional maupun syariah. lembaga keuangan yang patuh. Industri keuangan belum menunjukkan kapasitas untuk mengembangkan solusi manajemen risiko yang efektif untuk menghadapi serangkaian tantangan unik yang dihadapi oleh bank konvensional, apalagi untuk serangkaian risiko tersendiri.

Kata kunci: *Keuangan, Risiko, Manajemen, Tinjauan Teoritis, Implikasi Praktis*

INTRODUCTION

Financial institutions have devised numerous strategies to mitigate risk and enhance overall performance (Alhammad et al., 2020). Risk management constitutes one such strategy deployed by financial institutions to mitigate a plethora of risks. Like their conventional counterparts, financial institutions are exposed to a multitude of critical risks. The approach employed in the financial industry is distinct due to its distinctive nature, particularly with regard to profit and risk sharing. In comparison to conventional banking operations, the financial industry handles a diverse range of products, many of which carry unique and occasionally substantial risks. Consequently, it becomes essential for the financial industry to utilise risk management techniques with a view to mitigating potential risks at all times (Shafique et al., 2013). One of the most significant challenges currently facing the financial industry is the effective management of risk associated with Islamic banking products and services. The central issue is the implications of Shariah compliance on risk management systems. The benefits provided to product users, as well as the prominent level of innovation in the products, have presented themselves as a practical alternative to conventional finance. Islamic banking is now recognised as a valuable constituent of the global financial system (Griira & Labidi, 2021). Risk management strategies are vital for the financial industry in emerging markets (Elgharbawy, 2019).

The financial industry in most markets is rapidly expanding its market share. In Indonesia, Islamic banking has grown by more than 30 percent over the past five years. Currently, it offers a comprehensive range of financial products and services. However, the financial industry represents a modest 10% of banking assets and deposits in Indonesia. The financial industry represents an industry with a promising future, and thus must be capable of doubling its market share. Globally, Islamic banking has also achieved substantial growth. To achieve further substantial growth in the Islamic banking industry, two key elements must be addressed: product development and standardization of regulatory practices. Additionally, the banking industry requires human resource development and marketing (Harahap et al., 2021). The Financial Stability Report (2010) indicates that during the global financial crisis, the financial industry demonstrated asset growth of 38.2% and profit growth of 20%. In comparison, conventional banks exhibited only 16.3% asset growth and a -6.1% profit decline between 2007-2008. This finding clearly demonstrates that financial-industry banks exhibit greater stability and more effective risk mitigation strategies than conventional banks. A comprehensive analysis of bank performance during the financial crisis reveals that the financial industry outperformed conventional banks in most cases (Erfani & Vasigh, 2018; Alexakis et al., 2019).

The ongoing process of globalization and liberalization is leading to the development of more effective risk management techniques for the financial industry, particularly in emerging markets (Mukherjee et al., 2021). While risk management is a well-established practice within conventional financial institutions and markets, it is less suitable and still in its early stages when applied to the financial industry. Internally, the financial

industry faces resource constraints, in particular with regard to trained staff, inappropriate software, digital technology and risk management procedures. The financial industry is confronted with the challenge of costly management information systems and technology for the assessment and monitoring of risks in a timely manner. Given the potential for weaker management and the lack of appropriate risk monitoring systems, the risk exposure of the financial industry is likely to be higher. Consequently, this study aims to describe the existing risks and risk management in the financial industry.

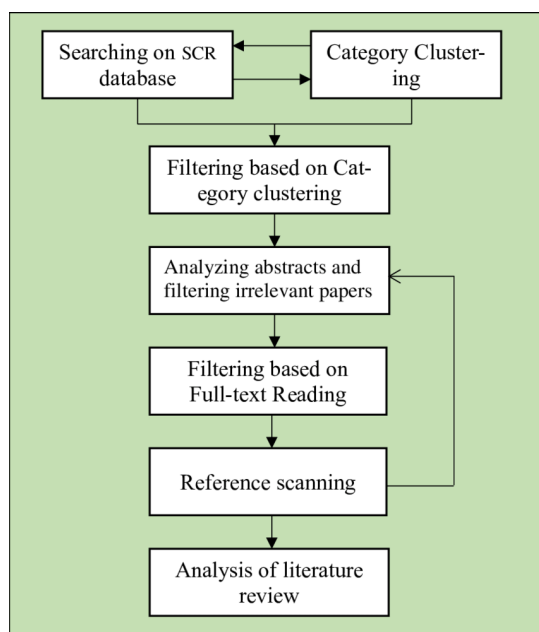


Figure 1. Literature Review Chart

METHOD

This research uses the literature study method to overcome the problems studied. Data was collected through online searches using the keyword risk management. The journal articles used in this research were selected based on strict criteria, namely that they must be indexed in Scopus. Using this approach, research focuses on identifying and publishing relevant, high-quality articles. Content analysis was carried out to assess the extent to which the content of the article complies with the research objectives, which include an in-depth understanding of the risks faced in Islamic banking and the risk management strategies implemented. The research conclusions are drawn by describing the risks commonly faced in Islamic banking as well as the risk management strategies used, based on an extensive and varied literature review. Through careful analysis, this research provides insight into how Islamic banks manage the various risks they face, as well as the effectiveness of the strategies implemented. The results of this literature study provide a strong basis for understanding the dynamics of risk management in the Islamic banking context and can be a guide for practitioners and researchers in developing better risk management strategies.

RESULTS

Effective risk management is a fundamental responsibility for any financial institution. It encompasses the identification, measurement, monitoring, and control of risk factors. Consequently, risk managers require a thorough comprehension of risk and its associated measurement in order to fulfill their assigned duties effectively. Furthermore, risk management serves as a means of ensuring that the decisions taken regarding risk are in line with the business strategy and objectives (Ben et al., 2014). The objective of a robust and effective risk management system is not solely to prevent

financial losses; rather, it is to ensure that a bank achieves its financial objectives with a high degree of reliability and consistency (Abdullah, 2019). It thus constitutes a fundamental prerequisite to the soundness, stability, and sustainability of the banking industry. The field of banking operations is primarily focused on risk management. As a highly risky sector, the banking industry takes, transforms, and embeds risks into its products and services. Consequently, risk management represents an ongoing process and a crucial matter of concern for banks. Banks and financial institutions are themselves integral components of the financial industry that must consistently demonstrate proactive engagement and effective implementation of inherent banking risks.

A multitude of banking and financial institutions operate globally, offering a diverse array of services and products. However, the increasing popularity of the financial industry has led to an array of risks, unique to the sector and inherent to its product offerings. Financial institutions differ from traditional banks in several key aspects, including profit- and risk-sharing, which give rise to a distinct set of risks. There are substantial differences in the concepts and practices used in Islamic and conventional banking systems (Abasimel, 2023). As such, both banks have different styles of recognizing and managing different risk exposures associated with these differences. Given the unique characteristics of the financial industry, it is unsurprising that it faces different types of risks. However, the risk management side does not have a significant difference. Financial institutions are subject to a range of risks, including credit, liquidity, and interest rate risks, which are similar to those faced by conventional commercial banks. The nature of these risks, however, differs due to the unique features of financial products and services. These differences in risk profiles shape the characteristics of assets and liabilities held within the industry (Muriayi et al., 2018).

The objective of risk management is to take precautions against potential risks that could have an impact on the well-being of humanity. It should be noted that profits in the finance sector are inherently linked to risk exposure. Consequently, it is necessary to manage various types of risks in accordance with the financial industry's established risk management framework. An example is Islamic banking, which is a risk management approach that is rooted in Islamic teachings. This approach aims to effectively manage the risks incurred in Muslims' worldly activities. The Quran and Hadith are two primary sources that inform the Islamic approach to risk management. The spectrum of models and processes encompasses all types of risk, including credit risk, liquidity risk, and operational risk (Al Rahahleh et al., 2019). Credit risk is defined as the potential for financial loss resulting from the failure of a borrower or counterparty to fulfill its contractual obligations. This is a major concern for financial institutions, as it can lead to a worsening of their financial position and, in extreme cases, even harm the company. Credit risk management is one of the most important activities that banks must carry out in order to survive in increasingly fierce competition in the banking industry (Akram & Rahman, 2018). Credit risk is intrinsically linked to a bank's fundamental business operations, including lending and deposit activities. This is defined as the risk of incurring economic losses as a result of the counterparty's failure to fulfill its contractual obligations.

This risk has the potential to cause the collapse of a bank. Credit risk is generally divided into two distinct categories: systematic and unsystematic. Systemic risk arises from fluctuations in economic, social, and political conditions and impacts all financial markets and securities traded in those markets. In contrast, unsystematic credit risk is contingent on the unique characteristics of the industry in which a company operates. It encompasses elements such as poor managerial decisions, new innovations, technological developments, and shifting consumer preferences. Identified as unsystematic risks are management, operational, financial, and industry risks (Jagotra, 2018). Credit risk arises from a potential exposure to loss when one party to a transaction makes a payment. This can occur in various ways, such as when a Salam (sale by prepayment for delivery at a future date) or Istisna' (contract for manufacture)

contract is entered into. It can also occur when an asset is transferred or when goods are sold under a Murabahah (sale of goods with a markup) contract. In all of these instances, payment is not received in advance. Murabahah, which is essentially a sale and purchase contract, carries counterparty credit risk, which may arise from non-performing trading partners. The source of such non-performance can be systematic or external. In the context of profit-sharing-based finance, as exemplified by Mudharabah and Musyarakah (profit and loss sharing), credit risk is contingent upon the business owner's or entrepreneur's failure to pay the bank its share of profits when due. This frequently occurs when banks lack sufficient information or encounter issues of asymmetric information pertaining to the actual profits generated by firms in debt with them, as documented (Chamberlain et al., 2020).

The term liquidity is defined by Incekara and Çetinkaya (2019) as the amount of available capital for investment and expenditure. In the context of banking, however, it is more specifically defined as the ability to meet credit demand and debt associated with maturities. Liquidity risk is defined by the same source as a lack of sufficient liquidity required by banks for their obligations and liabilities. It is a well-known fact in the banking industry that liquidity risk can be fatal to the viability of a bank, a claim supported by the numerous instances of bank failure in the past (Incekara & Çetinkaya, 2019). Liquidity risk not only affects a bank's performance but also its reputation. A bank may lose the confidence of depositors if it is unable to provide them with funds in a timely manner. In such a scenario, the reputation of the bank may be at stake. Moreover, a poor liquidity position can result in penalties from regulators. Consequently, it is of paramount importance for banks to maintain robust liquidity arrangements. Liquidity risk has emerged as a significant concern and challenge for contemporary banks, which are facing intense competition for consumer deposits and a vast array of funding products. Furthermore, technological advancements have transformed the landscape of funding and risk management. A bank that possesses sound asset quality, robust earnings, and sufficient capital may still fail if it fails to maintain adequate liquidity. The inability to borrow funds at a reasonable interest rate, or to dispose of assets at a reasonable price, increases the risk of illiquidity. For financial institutions, which are not permitted to engage in interest-based lending, these circumstances are particularly problematic. Furthermore, financial institutions are prohibited from selling debt instruments, with the exception of at face value, making it difficult for these institutions to dispose of their debt-based assets in order to maintain adequate liquidity (Alamad, & Alamad, 2019).

Due to the distinctive characteristics and dynamics of the financial industry, operational risks may emerge as a consequence of human capital vulnerabilities. These risks assume heightened significance for the financial sector, particularly in view of their reliance on personnel with the requisite expertise to manage their novel and complex financial operations. Moreover, the nature of business in the financial industry tends to impede the utilisation of computer software. Consequently, the introduction of such software may necessitate a shift towards adapting existing software or developing new software on a significant scale, thereby posing a significant challenge (Das et al., 2018). It is evident that the financial industry is dependent on the utilisation of non-standardised financial contracts, and furthermore, is subject to an array of additional risks associated with the documentation and enforcement of Islamic Shariah principles. The financial industry must prepare customized contracts to accommodate the diverse financial instruments and transactions it engages in. The contracts must be tailored to align with the financial institutions' needs, concerns, and understanding of Shariah and the country's legal frameworks (Gomber et al., 2018). However, this process leaves financial institutions exposed to greater legal risk due to the lack of a litigation system that addresses issues related to the enforcement of contracts based on Shariah contractual agreements.

This risk arises when a banking institution relinquishes a portion of its profits by acquiescing to the pressure exerted by depositors to prevent withdrawals, which is

typically triggered by a low rate of return. In essence, this represents a transfer of withdrawal risk to the equity holders. The transfer of commercial risk implies that, despite the industry's operational capabilities being below that of other financial industries and competitors, the lower return on investment (ROI) prompts investors to withdraw their deposits. For instance, banks, as a financial industry, lack the capacity to offer competitive ROI when compared to other financial industries and their banking counterparts (Ismal, 2012). This results in depositors seeking alternative investment opportunities, which in turn prompts them to withdraw their funds. To prevent such withdrawals, banks must forgo a portion of their own profits to depositors. When interest rates on savings, investments, or deposits are variable, this introduces a degree of uncertainty regarding the real value of deposits. Consequently, depositors may be more inclined to withdraw funds when they perceive a potential reduction in their returns and a corresponding risk to the value of their assets. For financial institutions, the possibility of offering lower rates of return may represent a withdrawal risk compared to conventional financial institutions. A lower rate of return compared to the general market may lead depositors and investors to perceive that the low rate of return is indicative of mismanagement of funds by the financial sector, and potentially a breach of their investment contract (Ljungqvist et al., 2020). The financial sector failing to comply with the terms of its contracts is one example of a breach of contract that can result in fiduciary risk; given that the financial industry has no choice but full and strict compliance with regulations, it is imperative that it does so. This is particularly relevant when facing serious trust issues arising from deposit withdrawals.

DISCUSSION

Financial institutions, including those engaged in the financial industry, are exposed to various types of financial risk, including credit risk, market risk, liquidity risk, and withdrawal risk. Among the aforementioned risks, withdrawal risk and bankruptcy risk are of particular significance in the Indonesian context (Ismal, 2012). This is due to a number of factors, including the fact that the Indonesian financial industry operates in close proximity to other financial industries, such as conventional banks and Islamic banks. Consequently, it is essential for the Indonesian financial industry to perform well in order to be attractive to customers. Secondly, some customers tend to perceive the sector as distinct from conventional banking. They anticipate it to provide competitive returns, to offer comprehensive banking services, and to offer a wide range of deposit instruments. Consequently, there is potential for commercial risk. Conventional banks may offer attractive returns from various banking products that are not necessarily aligned with their core business activities. In contrast, the financial industry is guided by Shariah principles, which require it to generate profits from tangible business operations and to assume losses when necessary. Furthermore, during periods of economic or financial instability, the upward trajectory of interest rates presents a challenge for the financial industry. This is because rational depositors anticipate higher returns from the financial industry, which may not be feasible in the current environment. Should the financial industry be unable to meet such expectations, it may result in significant losses in commercial risk or withdrawal risk.

The financial industry exhibits markedly divergent financial safety indicators. While commercial bank employees possess a profound understanding of risk and its management, it remains crucial for commercial banks to plan for risk management. Regarding risk management techniques within the financial industry, two primary methods of risk identification include examinations conducted by bank managers and financial statement analysis. The most prevalent risk management tools are benchmarking, credit scores, creditworthiness analysis, risk ratings, and collateral. In addition, it is evident that the three most prevalent risk categories confronting the financial industry are credit risk and operational risk. Furthermore, there are notable contrasts between the financial industry and conventional banks in risk management. Risk management is capable of averting potential risks associated with the objectives

and goals of the financial industry. There is some literature whose findings provide an overview of how risk management is conducted by the financial industry (Zainol & Hj. Kassim, 2012). The findings of the Abu & Al-Ajmi (2012) study indicate that those at the management level perceived credit, market, and operational risks as being the most critical. Additionally, the study revealed that in terms of bank governance, the board of directors assumes the primary responsibility for risk oversight, with risk monitoring delegated to the executive committee and the audit committee tasked with overseeing the bank's operations.

With regard to opinions on the use of risk management methods, the study found that bankers consider internal rating systems to be less important and risk-adjusted rates of return to be more important (Abu & Al Ajmi, 2012). Another study by Khalid & Amjad (2012) yielded the following results: Bank size has a positive and statistically significant association with credit risk, while displaying a negative relationship with operational risk. A positive and significant association has been observed between asset management, liquidity, and operational risk. The debt-equity ratio and NPL ratio have negative but significant relationships with liquidity risk and operational risk. Moreover, capital adequacy has a negative and significant relationship with credit and operational risk, while it has a positive relationship with liquidity risk. (Khalid & Amjad, 2012). In this area, numerous studies have been conducted to examine the risk management practices utilized by various financial institutions, including those operating within the Islamic and conventional banking sectors. Grassa (2012) conducted a survey with the primary objective of elucidating the prevailing practices and prospective trends in the domain of risk management techniques employed within financial and commercial enterprises situated in GCC countries. The results unambiguously demonstrated discrepancies in the deployment of risk management techniques between financial and conventional industries.

These included differences in market valuations, stress testing outcomes, the utilization of credit risk mitigation strategies, and the adoption of operational risk management instruments. The primary rationale for this phenomenon can be attributed to the fact that these instruments are still in their infancy, with their adoption being relatively limited within many financial industries. (Grassa, 2012). Additional research by Chattha & colleagues (2020) compared traditional banking with financial institutions in Pakistan, indicating that the approaches to credit risk assessment differ between the two sectors. It was determined that a significant shift in risk management practices was required in order to accommodate Islamic banking, which lacked the necessary innovation in risk management. The absence of conventional-style risk management tools in the financial industry is predominantly attributable to a dearth of expertise. To illustrate, there is a deficiency of individuals with expertise in risk analysis, IT systems to handle Islamic-style risk management, and banking professionals with experience in Islamic banking. Hence, it is essential to facilitate further product development and innovation in order to enhance the effectiveness of the financial industry's risk management. (Chattha et al., 2020).

CONCLUSION

Financial institutions, particularly those operating within the financial industry, are exposed to a range of risks associated with their financing activities. Due to its distinctive risk profile, risk management in the financial industry has proven to be a particularly challenging endeavor. Consequently, the risk management practices employed in both the financial and conventional industries are distinct. The importance of risk management in the financial industry is clear from the various empirical studies presented in this literature review. The financial industry is exposed to a number of risks, including credit risk, liquidity risk, operational risk, legal risk, withdrawal risk, benchmark risk, and fiduciary risk. A number of factors contribute to the elevated risk profile of the financial industry, including the immaturity of money markets, the limited availability of lender of last resort facilities, and the limited market infrastructure. Other

issues, which are more or less common to both the financial and conventional industries, include foreign exchange and equity risks. Despite the idealism of Islamic banking principles and practices and the earnest efforts of the financial industry to compete with the conventional banking system, Thus far, there is no evidence that the financial industry has developed effective solutions to manage the same risks as conventional banks, nor has it developed a unique risk management approach. In addition to regulatory support from the central bank, financial industry convergence through mutual recognition and harmonization is essential. Financial industries can benefit from cross-fertilization in terms of risk management practices. This occurs as financial industries adapt and learn from their own experiences, as well as from those of others.

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