

“The mediating effect of risk management for Palestinian Islamic banks’ strategic planning and profitability performance”

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THE MEDIATING EFFECT OF RISK MANAGEMENT FOR PALESTINIAN ISLAMIC BANKS' STRATEGIC PLANNING AND PROFITABILITY PERFORMANCE

Abstract

This paper examined the mediating effect of risk management for strategic planning and profitability of Islamic banks in Palestine. The questionnaires were distributed randomly among 97 directors who have experience in strategic and risk management. A structural equation model was employed to test the research hypotheses. The result revealed that strategic planning and risk management have a significant positive effect on profitability, while strategic planning has a significant positive effect on risk management. In addition, risk management was evidenced to partially mediate the linkage between strategic planning and profitability. The current study yielded support for the claim that risk management played a significant mediating role in the relationship between strategic planning and profitability. Bank directors having good strategic planning and effective risk control tend to get a higher level of profitability. Therefore, Islamic banks should construct a proper strategy in line with their risk management practices and provide a robust risk assessment to protect their financial resources. Ultimately, they can attain superior profitability.

Keywords

strategic planning, risk management, profitability,
Islamic bank, structural model

JEL Classification

M10, G21, G32

INTRODUCTION

Business organization as well as the banking sector has been facing challenges of high intensity of competition and diversity of customers' desires due to the rapid growth in financial products and services. Therefore, banks require adopting new strategic planning to improve their performance. Especially it is crucial after the lockdown was imposed in serving financial services worldwide and in Palestine as well due to the Covid-19 pandemic. Thus, strategic planning (SP) is one of the most important instruments used to improve the performance of financial institutions. Alosani et al. (2020), George et al. (2019), Jayawarna (2019), Albadri (2018), Sandvik et al. (2014), Greenley (1994), and Beard and Dess (1981) found a significant impact of strategic planning on business performance.

Consequently, strategic planning is a combination of both strategy and planning (Leslie, 2008). Johnson and Scholes (2004) argued that strategic planning is a special kind of decision-making process with some distinctive features. This concept effectively assists organizations in responding to their environmental change (Lunenburg, 2011). Furthermore, Hunjra et al. (2014) stated that strategic planning is a reaction to the internal environment represented by strong and weak performance, and the external environment represented by the opportunities

and challenges. Strategic planning in business is an instrument that was used to achieve a balance between both external environment and internal competencies (Harris & Ogbonna, 2006). It plays a vital role in increasing productivity and improving the quality of services (Abu-Jarad et al., 2010). Fossen et al. (2006) argued that strategic planning can successfully help businesses in dealing with the future challenges by providing the ability to monitor resources, enabling them to effectively respond to their environmental change. Raviv et al. (2009) and Aram and Cowen (1990) have examined the direct relationship between strategic planning and banks' profitability. Hunjra et al. (2014) argued that innovative strategies can efficiently improve the earnings quality of business entities. Consequently, the strategic direction has a vital role in improving profitability performance. Especially, Islamic banks should apply a strategy that aligns enough with vision, mission, strategic objectives, and complies with Islamic rules (Lodhi & Kalim, 2005).

Risk management (RM) is considered an important element that can appropriately identify the potential risks for any business entity (Moeller, 2007). Abdul Rahman et al. (2016) argued that risk management is considered a core element of Islamic banks strategy and enables the banks to improve their operational efficiency and boost their earnings. However, Wahyudi et al. (2015) stated that Islamic banks have unique risks from real assets contracts, equity participation contracts, and complicated sales contracts. Therefore, it requires an appropriate risk management environment, as well as a specific strategic plan that includes risk identification, measurement, and control. Hence, prior studies have confirmed that Islamic banks are efficient in risk management practices to gain more profit (Akther, 2015; Abdul Rahman et al., 2013; Khalid & Amjad, 2012). However, none of them has investigated the influence of risk management on the relationship between these two concepts. In this sense, this study focuses on the mediating of RM because it is considered a monitoring instrument since it reduces the potential losses and is perceived to be effective in protecting bank financial resources. Hence, the problem statement resulting from the earlier discussion is defining the impact of the mediating effect on the relationship between corporate strategy and profitability of Palestinian Islamic banks.

Alternatively, this study delineates the mediating role of risk management on the relationship between strategic planning and profitability of Islamic banks. No previous studies have provided a synthesis of knowledge on this issue in the context of the Islamic banking system. Therefore, bank managers must enhance their internal operational environment (i.e. strategic goals and risk control). Hence, the expected results from this analysis enable Islamic banks to identify their capabilities, control their risk, and attain a high level of profitability.

1. LITERATURE REVIEW AND HYPOTHESES

Strategic planning is one of the key effective approaches to earnings growth for any business entity (Hunjra et al., 2014). Strategic planning aims to describe the vision, mission, and corporate goal of an entity and identify the available resources used to achieve them. Therefore, the main task of strategic planning is to understand the core objectives of organizations and identify methods that were used to achieve those objectives (Hill & Jones, 2012). In this regard, Hopkins and Hopkins (1997) defined strategic planning as a process of formulating, implementing, and controlling strategy and formally documenting the business's future. Aldehayyat and Twaissi (2011) mentioned that

strategic planning enables businesses to deal with fluctuation and threats in the internal and external environment. Lodhi and Kalim (2005) argued that strategic planning assists Islamic banks in compliance with Islamic principles as well as achieving their corporate goals. Permana (2017) confirmed that successful strategic implementation aligning with vision and strategy helps the Islamic banking system achieve financial stability. In this sense, many prior studies asserted that strategy is considered an important factor for improving business profitability (Otieno et al., 2018; Efendioglu & Karabulut, 2010; Raviv et al., 2009).

Most Islamic bank transactions can be in the form of sales-based contracts, profit-loss sharing, or leasing. Islamic business contracts are used to finance

goods and services (Makiyan, 2008; Sundarajan & Errico, 2002). As a result, Islamic banks probably expose several types of risks: Sharia's non-compliance risk, equity financing risk, and profit loss sharing risk (Abdul Rahman et al., 2013). Al Rahahleh et al. (2019) mentioned that Islamic banks are more risk-sensitive due to investment in real products and contracts. Therefore, Islamic banks need to measure every sort of risk by identifying, calculating, mitigating, and controlling the expected and unexpected losses (Khan, 2020; Akther, 2015; Rosman, 2009). Thus, it requires applying effective risk management. This should be done by integrating risk management and strategy. Therefore, Greuning and Iqbal (2008) confirmed that risk management is considered a strategy that banks should use to ensure financial stability and profit.

Recently, Kisman (2020) and Farhan et al. (2020) argued that risk management practices in Islamic banks lead to lower risk and increased profit. Moreover, Edaich and Dymek (2020) analyzed the risk management of Islamic banks during the Covid-19 crisis. They found that the Covid-19 pandemic is causing a negative shock in demand and supply of financial services in Islamic as well as conventional banks. They argued that coordination of financial policies in managing risk between conventional and Islamic banks could be decisive in protecting from the impact of Covid-19. Rabbani et al. (2021) argued that Islamic modes of financing are affected by an economic crisis resulting from the pandemic. They addressed that risk assessment can be effectively utilized at different stages to overcome the influence of Covid-19.

The main purpose of risk management is to control various risks facing Islamic banks and increase their investment opportunities. However, Islamic banks required a constructive strategy that helps them in risk control. Rehman and Anwar (2019) argued that risk management should be directly involved in SMEs' strategy. Therefore, business strategy and risk management are associated with each other to accomplish corporate goals. Moreover, Greuning and Iqbal (2008) mentioned that there was high integration between strategic planning and risk management in the context of Islamic banks.

Bakan (2005) defined profits as a primary goal for all businesses and an imperative element for

its survival and continuity. This concept is considered a vital tool for measuring the efficiency of management in using existing resources. Similarly, Berger et al. (1993) defined profit as an index of the effectiveness and efficiency of any business entity. In the context of Islamic banks, a topic of profitability performance has been widely researched (Nawaz & Bardai, 2017; Ramlan & Adnan, 2016; Trad et al., 2017; Muda et al., 2013; Beck et al., 2013; Iqbal, 2001). It was concluded that Islamic banks were more profitable and stable than commercial banks during the crisis in 2008. Salman and Nawaz (2018), Iqbal and Mirakhor (2010), and Nienhaus (1983) have focused on how Islamic banks generate income from their operations utilizing profit-loss sharing instead of interest-bearing transactions which are prohibited in Islamic laws. However, only Akther (2015) and Abdul Rahman et al. (2016) found that Islamic banks with efficient risk management attain more profit.

George et al. (2019), Jayawarna (2019), and Sandvik et al. (2014) discussed the relationship between strategic planning and firm performance. In addition, Raviv et al. (2009) and Otieno et al. (2018) highlighted the direct impact of strategic planning on profitability. However, no prior studies have examined the mediating role of risk management on the association between strategic planning and profitability. Therefore, the current study aims to examine how strategic planning directly influences profitability and find out how risk management mediates this relationship. More specifically, this study sets out to answer the following questions:

1. Does strategic planning influence the profitability of Islamic banks?
2. Does strategic planning influence risk management in Islamic banks?
3. Does risk management influence the profitability of Islamic banks?
4. Does risk management mediate this relationship?

Based on the literature review and research questions, this study examines the mediating role of risk management for strategic planning and profitability in the context of Palestinian Islamic

banks. Therefore, the argument leads to formulating the following hypotheses:

- H_1 : *Strategic planning has a positive effect on the profitability of Islamic banks.*
- H_2 : *Strategic planning has a positive effect on risk management in Islamic banks.*
- H_3 : *Risk management has a positive effect on the profitability of Islamic banks.*
- H_4 : *Risk management mediates the links between strategic planning and profitability.*

2. METHODOLOGY

2.1. Data collection and descriptive sampling

Primary data were collected from three Palestinian Islamic banks (Arab Islamic bank, Palestinian Islamic bank, and Al-Safa bank) with a convenience sample of 150 respondents distributed randomly among the directors of Palestinian Islamic banks. The key respondents were top managers who are familiar with strategic planning and risk management. Of course, confidentiality and precision were assured. Therefore, only 115 responses were retrieved and 15 incomplete questionnaires were excluded. Precisely, 100 participants were used in data analysis with an acceptable response rate of 66.7% (Sekaran & Bougie, 2016). Demographically, 100 respondents, representing 31% of participants, are banks managers, while 59% are heads of departments. Regarding gender, the percentage was not distributed equally between men and women: 71% of respondents are men and the rest are women. Additionally, the majority of respondents (59%) are ranged between the ages of 30 and 40. Regarding years of job experience, 47 participants representing 47% have from 10 to 15 years of experience, while 38 respondents representing 38% have less than 10 years of experience. Finally, 73% of respondents have a bachelor's degree.

2.2. Measurements

The survey instrument consisted of three main domains; the first domain included strategic

planning items, the second domain asked questions regarding risk management practices in Islamic banks, and the third domain included items of profitability. The final section covers demographic details (gender, qualifications, job title, and job experience). Participants were asked to indicate their level of agreement based on a five-point scale ranging from 1 (strongly disagree) to 5 (strongly agree).

The questionnaire items were constructed based on previous studies. Therefore, strategic planning items were taken from Jayawarna (2019), Otieno et al. (2018), and Hill and Jones (2012). Fifteen items were used to measure the level of strategic planning in Palestinian Islamic banks. Risk management also was measured by adopting five items from Eid and Asutay (2019), Wahyudi et al. (2015), and Abdul Rahman et al. (2013). However, profitability was measured with five items from Otieno et al. (2018) and Raviv et al. (2009). Thus, bank directors were asked about services growth over the last 3 years compared with conventional ones. In addition, they were asked about an increase in demand for financial products, market growth, and return on Islamic modes of investments, etc.

3. RESULTS

3.1. Validity and reliability test

Research hypotheses testing was done using a structural equation model. Therefore, a measurement model should be performed to endorse convergent validity, reliability, and internal consistency before running the structural model (Hair et al., 2013). For this purpose, Confirmatory Factor Analysis (CFA) was tested to detect validity and reliability of structural model including different methods: standardized factor loading (λ), Average Variance Extracted (AVE), Cronbach's alpha (α), and Composite Reliability (CR).

According to the results in Table 1, λ values of factor loading showed that all indicators were above 0.6 and significantly loaded on the structural model. All indicators showed higher value of factor loadings that ranged between 0.941 and 0.606. This affirms the convergent validity of each construct in the estimated model. Furthermore, com-

Table 1. Convergent validity and reliability

Source: Author's calculation.

Latent variables	Indicators	$\lambda > 0.6$	AVE > 0.5	$\alpha > 0.7$	CR > 0.6
Strategic planning (SP)	V1	0.842	0.575	0.873	0.951
	V3	0.889			
	V4	0.743			
	V5	0.670			
	M1	0.691			
	M2	0.830			
	M3	0.774			
	M5	0.790			
	G1	0.773			
	G3	0.606			
	G4	0.647			
	G5	0.721			
	Risk management (RM)	E1			
E2		0.940			
E3		0.941			
RM1		0.602			
RM3		0.721			
Profitability (PROF)	RM4	0.858	0.662	0.871	0.907
	RM7	0.834			
	RM9	0.856			
	PRF1	0.802			
	PRF3	0.730			
	PRF4	0.863			
PRF5	0.811				
	PRF6	0.854			

Note: λ – Factor loadings, AVE – Average Variance Extracted, α – Cronbach's alpha, CR – Composite reliability.

posite reliability values were found above 0.6 and indicated an acceptable value (Hu & Bentler, 1999). Reflective scales have AVE values (calculated using excel) that range between 0.537 and 0.662, which achieves the minimum requirements of AVE that are greater than 0.5 (Hair et al., 2013). Cronbach's alpha values were also satisfactory, and the values for all latent variables were above 0.7 and indicated higher values of internal consistency (Hair et al., 2013). The results were deemed to be valid and reliable for running the measurement model.

3.2. Common method bias and outlier test

This study detects the potential common method bias after primary data were collected. In this regard, Harman's single factor was tested to assess the influence of Common Method Bias (CMB) using component factor analysis (Podsakoff et al., 2003). The result showed that only 5 factors with eigenvalues are greater than 1 and the first factor explained 28.06% of the variance, which is less than a threshold value of 0.5 (Hulland et al., 2018).

Therefore, none of the latent variables explained a majority of variation and this confirmed the absence of CMB.

Mahalanobis distance test was also performed to detect the existence of multivariate outliers in data of structural model using SPSS v.23. Mahalanobis distance value of each item was compared with chi-square distribution to the same degree of freedom. Therefore, any value that less than the cut-off point 0.001 is considered an outlier (Pollet & Meij, 2017). The result showed that only three outliers were below p-value of 0.001. The three outliers were deleted before further tests. Thus, a total of 97 valid questionnaire was used for further analysis.

3.3. Measurement model

The measurement model (Figure 1) indicated a good model fit (Table 2). Hence, CMIN/DF value (1.499) is less than 3, and the Root Mean Square Residuals (RMR) is 3.1%; these values are found to be in the accepted range. Moreover, Root Mean Square Error of Approximation (RMSEA) = 7.1%,

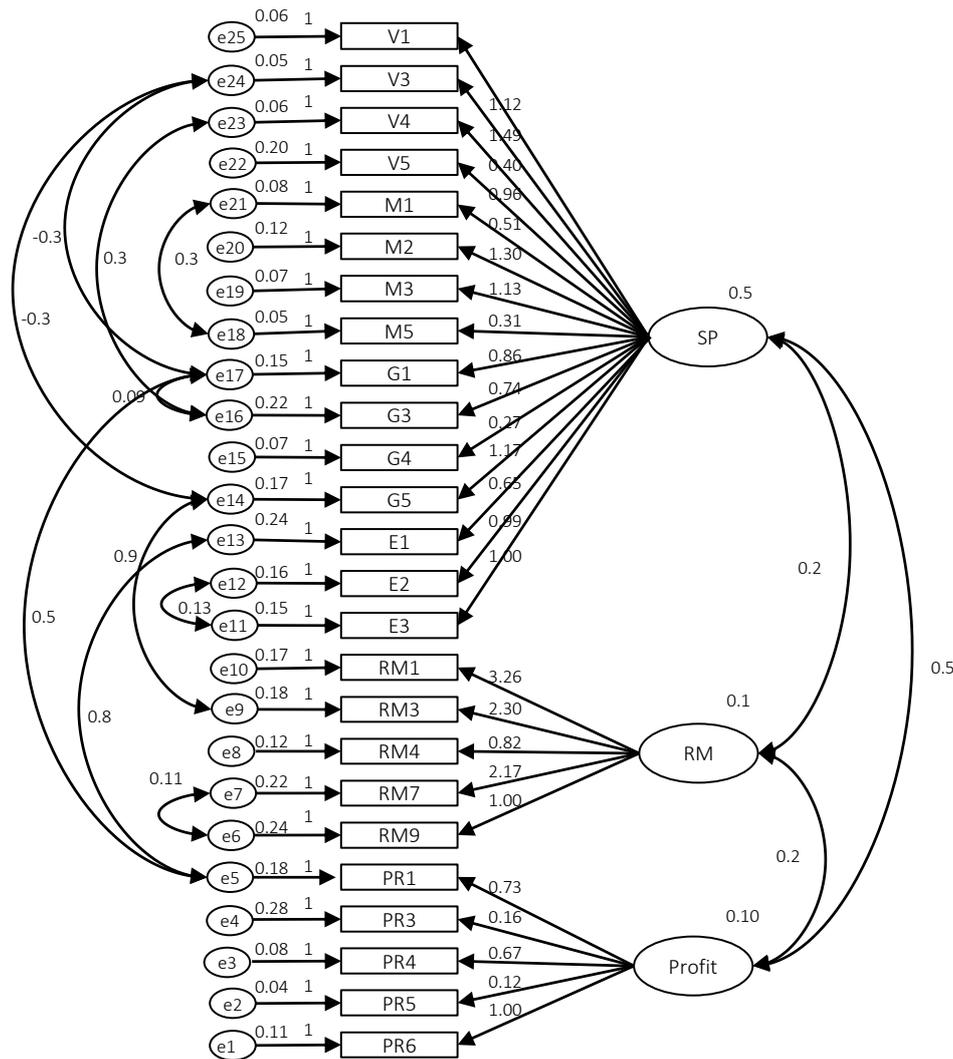


Figure 1. Measurement model

this value was found less than 8% as suggested by Hu and Bentler (1999). Goodness fit model (GFI) = 81%, Comparative fit model (CFI) = 91.1%, and Tucker-Lewis Index (TLI) = 89.5%; the values implied a goodness fit model as the recommended values (Hair et al., 2013). Thus, this indicates that minimum values of the goodness of fit model were achieved. The next step is running the structural equation model (SEM).

3.4. Structural equation models

The first estimated model (Figure 2) was tested to examine the direct impact of strategic planning on the profitability of Islamic banks. The direct model has fitness indicators (Table 2) such as CMIN/DF = 1.542, CFI = 91.4%, GFI = 82.5%, TLI = 89.5%; values achieved the acceptable range as suggest-

ed by Hu and Bentler (1999). Moreover, RMR = 2.6% and RMSEA = 7.4%; these values were also less than the accepted range of 8% and indicated a goodness fit model. The estimated model (Table 3) indicated that strategic planning has a significant positive effect on profitability ($\beta = 0.701$, and $p\text{-value} = 0.009$). This result supported H_1 and the first step of mediation effect is achieved.

The second structural model (Figure 3) was performed to test the direct impact of strategic planning on risk management of Islamic banks. The goodness fit model was tested (Table 2) using CMIN/DF = 1.5, CFI = 90.1%, GFI = 81.4%, TLI = 88.1%, RMR = 2.5%, and RMSEA = 7.3%. The result indicated that all values met the accepted range as recommended by Hu and Bentler (1999). Therefore, the result of the estimated model (Table

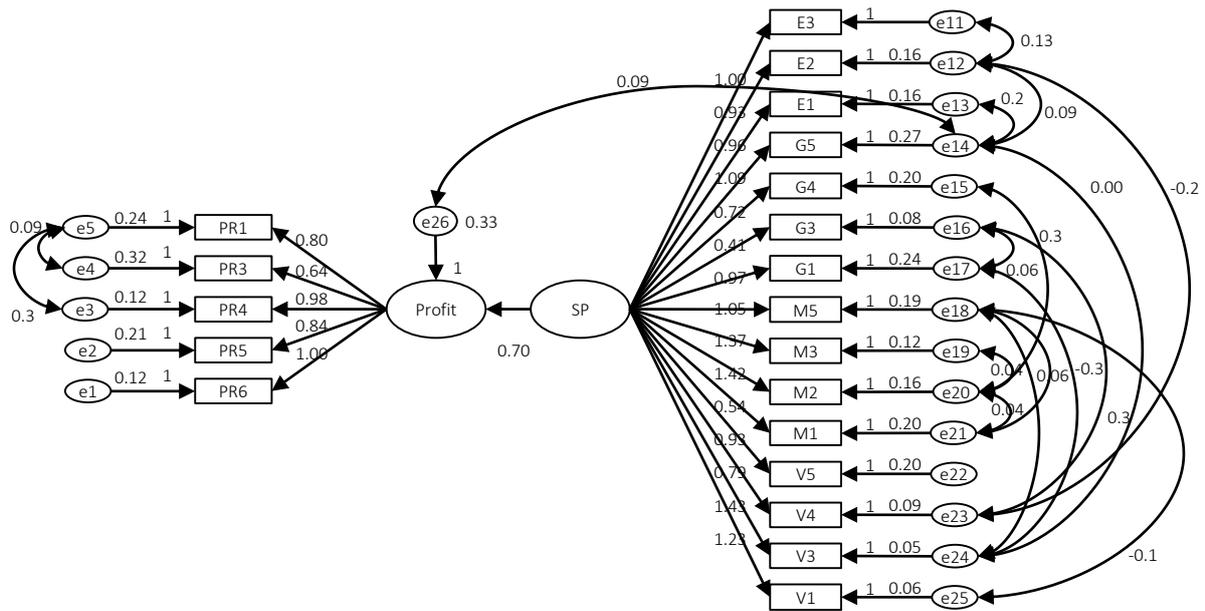


Figure 2. Structural model 1

3) indicated that strategic planning has a significant direct effect on risk management ($\beta = 0.571$, and p -value = 0.048). Thus, this result supported H_2 and the second step of mediation effect is also achieved.

The third estimated model (Figure 4) examines the impact of risk management on the profitability of Islamic banks. The goodness fit model was tested (Table 2) using $CMIN/DF = 1.017$, $CFI = 98\%$, $GFI = 94.8\%$, $TLI = 99.8\%$, $RMR = 2.1\%$, and

$RMSEA = 1.3\%$. The result indicated that goodness fit values were achieved and met the accepted range as recommended by Hu and Bentler (1999). The structural model (Table 3) concludes that risk management has a significant direct effect on the profitability of Islamic banks ($\beta = 0.890$, and $p < 0.01$). In this regard, the finding supported H_3 and indicated that the third step of mediation is achieved. Therefore, the result of H_1 , H_2 , and H_3 testing confirmed that RM mediates the relationship between SP and PROF.

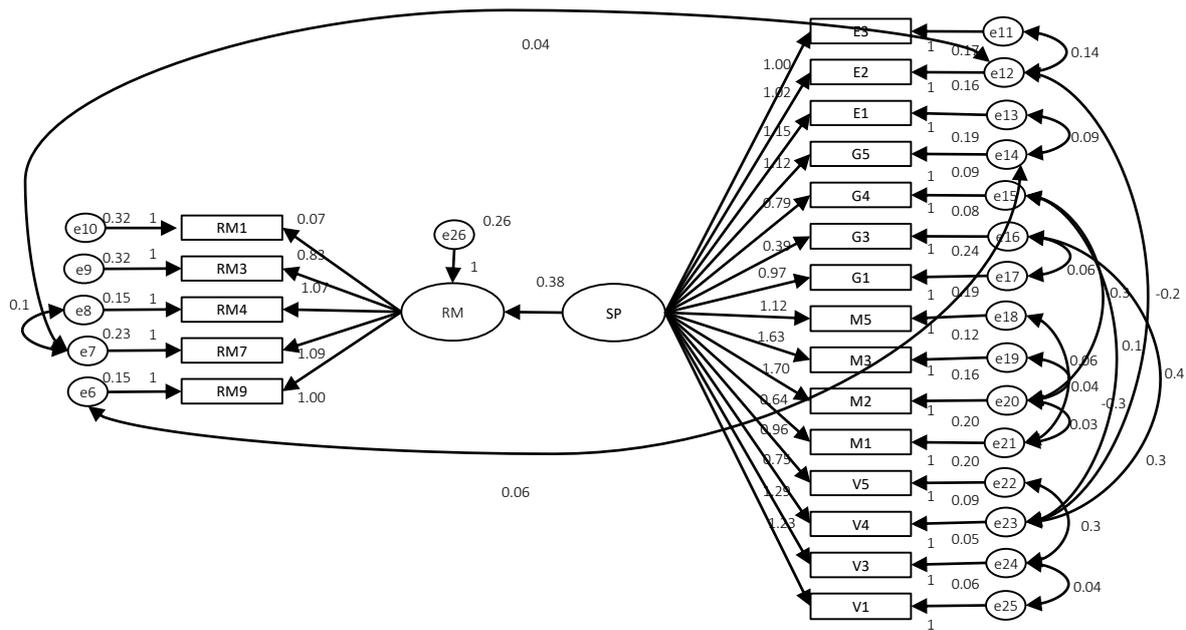


Figure 3. Structural model 2

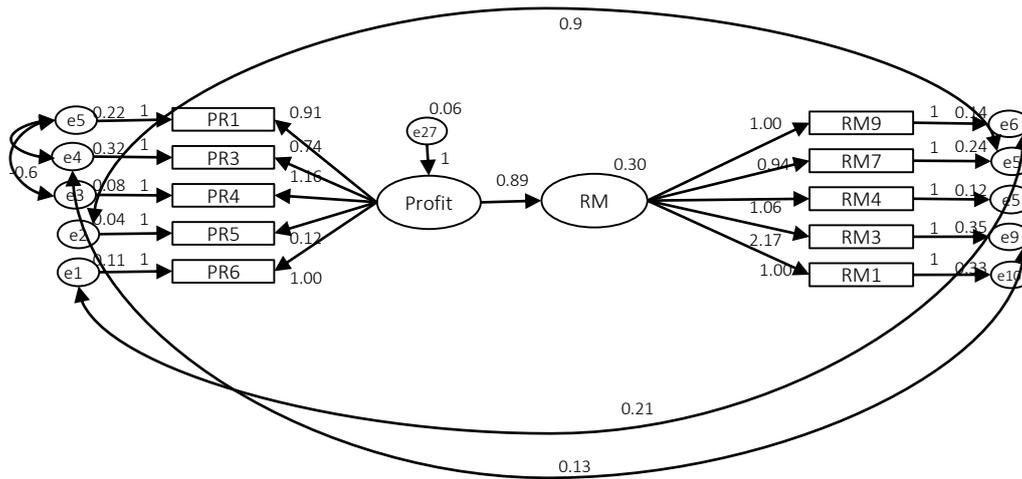


Figure 4. Structural model 3

The mediation effect model was performed to examine whether risk management mediates the relationship between strategic planning and profitability of Islamic banks (Figure 5). The goodness fit model (Table 2) was checked through goodness fit methods; CMIN/DF = 1.528, CFI = 90.5%, GFI = 79.8%, TLI = 88.9%, all values were acceptable as recommended by Hu and Bentler (1999). Meanwhile, RMR = 3% and RMSEA = 7.3%; these values were also below 8% and indicated a goodness fit model.

Table 3 shows that strategic planning has a significant direct effect on the profitability of Islamic banks ($\beta = 0.336$, and $p < 0.05$) and the

indirect effect of SP on profitability also remained significant ($\beta = 0.416$, and $p < 0.05$). This indicates that RM partially mediated the relationship between strategic planning and profitability. Hence, this finding partially supports H_4 . Moreover, SP has direct significant effect on risk management ($\beta = 0.496$, and $p < 0.05$) and the direct impact of RM on profitability of Islamic banks is also significant ($\beta = 0.496$, and $p < 0.05$). Thus, R-squared implies that strategic planning through risk management brings 56.3% of the variation in profitability of Islamic banks. This result provides evidence that strategic planning plays a vital role in improving profitability through RM.

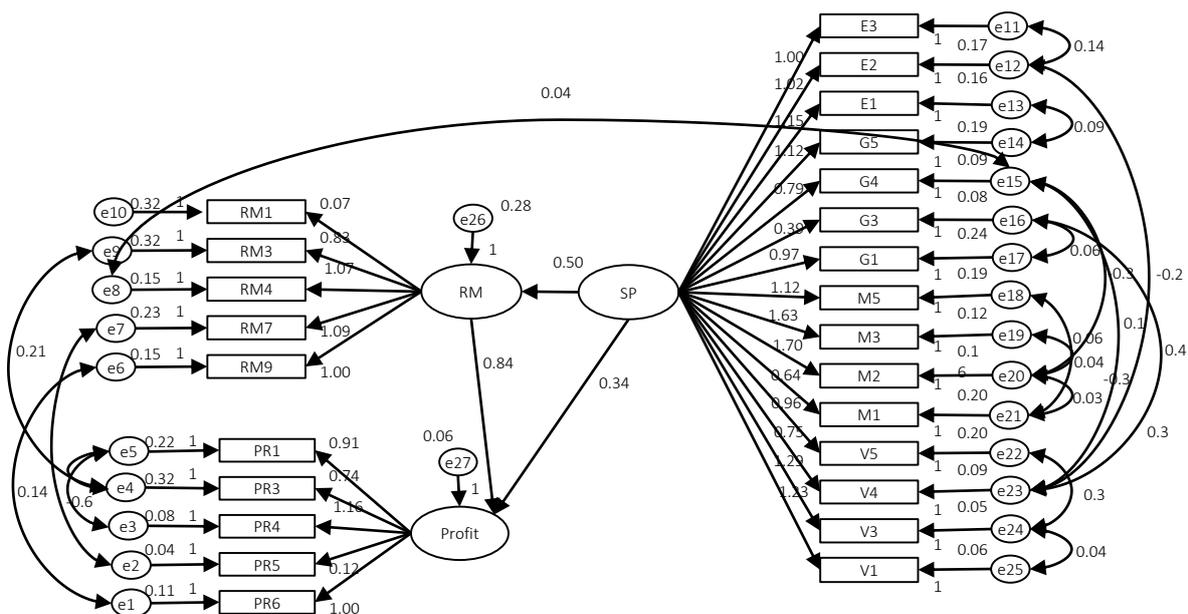


Figure 5. Mediation effect model 4

Table 2. Models fit summary

Source: Author's estimation.

Model	CMIN/DF	RMR	CFI	GFI	TLI	RMSEA
Measurement	1.499	0.031	0.911	0.811	0.901	0.071
SP → Prof	1.542	0.026	0.914	0.825	0.895	0.074
SP → RM	1.50	0.025	0.901	0.814	0.881	0.073
RM → Prof	1.017	0.021	0.980	0.948	0.998	0.013
SP → RM → Prof	1.528	0.030	0.905	0.798	0.889	0.073
Recommended value	> 3	> %8	< 90%	< 80%	< 90%	< 8%

Table 3. Hypotheses testing

Source: Author's elaboration.

Direct effect						
Hypothesis	Relationship	Direct effect	Indirect effect	Total effect	p-value	Decision
H ₁	SP → PROF	0.701	0	0.701	0.009	Support
H ₂	SP → RM	0.571	0	0.571	0.048	Support
H ₃	RM → PROF	0.890	0	0.890	0.000	Support
Mediation effect						
Hypothesis	Relationship	Direct effect	Indirect effect	Total effect	p-value	Decision
H ₄	SP → PROF	0.336	0.416	0.752	0.013	Support
	SP → RM	0.496	0.000	0.496	0.048	Support
	RM → PROF	0.837	0.000	0.837	0.000	Support

Note: p-value is less than a significant level of 5%.

4. DISCUSSION

The contribution of prior studies cannot be underestimated in terms of the relationship between strategic planning, risk management, and profitability. However, this paper helps to understand the mediating role played by risk management between strategic planning and profitability. This study examined the structural model by obtaining primary data from directors that work in Islamic banks of Palestine. Nevertheless, the influence of risk management on Islamic banks' strategy and profitability has been rarely examined. In particular, the mediating role of risk management between business strategy and profitability in Islamic banks has been remained unanswered. This study extends the scope of previous literature by examining the impact of strategic planning on risk management and profitability and highlighting the mediation effect of risk management between strategic planning and profitability.

The results indicated that strategic planning has a significant positive influence on profitability, accepting H_1 . This aligns with George et al. (2019) and Otieno et al. (2018) who affirmed the

positive relationship between corporate strategy and profitability. Hence, based on empirical evidence, this study argues that Islamic banks with unique strategic plans gain a higher level of profitability in the Palestinian money market.

This study also found that strategic planning has a significant positive effect on risk management, supporting H_2 . Similar results were found by Rehman and Anwar (2019) and Greuning and Iqbal (2008) who indicated that risk management is considered an integral part of strategic planning. The current study argues that it is strongly recommended for Islamic banks to formulate strategic goals to implement effective risk management practices.

The results revealed that risk management has a significant positive effect on profitability, supporting H_3 . This argument is in line with Kisman (2020), Abdul Rahman et al. (2016), and Akther (2015) who indicated that good risk management practices lead to a higher level of profitability in Islamic banks. The current study argues that effective risk management achieves better profitability performance for Islamic banks in Palestine.

The research findings indicate that risk management plays a mediating effect for strategic planning and profitability, confirming H_4 . Though more precisely, the result endorses that RM is a partial mediator. Thus, strategic planning does not always directly af-

fect profitability, but risk management mediates this relationship. In this sense, risk management practices in Islamic banks need a specific strategy to protect their financial resources, which in turn can lead to a higher profitability in the marketplace.

CONCLUSION

The study aimed to examine the mediating role of risk management for strategic planning and profitability of Palestinian Islamic banks. The paper found a significant positive relationship between strategic planning, risk management, and profitability performance. The result also reported that risk management partially mediates the relationship between strategic planning and profitability. These conclusions lead to emphasize that risk management practices are a priority issue that Islamic banks have to deal with recently. This would require risk management to be integrated with corporate strategy, as this will endorse strategic planning and profitability in long term and protect Islamic banks' assets from potential crises.

Bank managers in Islamic banks are recommended to apply unique strategic plans and precision of risk control to attain more profit. Some practical implications for stakeholders engaged in the strategic and risk management of Islamic banks are suggested. Hence, the finding concludes that Islamic banks should build a proper strategy to gain more profit. Therefore, the strategy should be constructed for innovative financial products and efficient RM practices. For proper knowledge, Islamic banks' strategy should be utilized in compliance with bank credit policy and risk control to avoid any potential crises and to gain more financial stability. Therefore, bank managers are suggested to configure the internal process and to attenuate the potential causes of risk to attain a robust risk management plan. Risk management needs a specific strategy to mitigate and manage the source of unique risks that potentially faces the portfolio investment of Islamic banks.

Finally, this paper has some limitations that can be addressed by future studies. Firstly, since the sample only includes Islamic banks of Palestine, the research model cannot be replicated in other different cases or different geographic areas. Thus, more valid tests and dynamic data analysis could be used to generalize the results. Secondly, the current study examined strategic planning as a whole instead of classifying it into specific components (vision, mission, and strategic goals). Thus, it is critical to examine how each component affects risk management and profitability. Future studies could examine the connection between each component, profitability, and risk management.

AUTHOR CONTRIBUTIONS

Conceptualization: Mohammed Abusharbeh.
 Data curation: Mohammed Abusharbeh.
 Formal analysis: Mohammed Abusharbeh.
 Funding acquisition: Mohammed Abusharbeh.
 Investigation: Mohammed Abusharbeh.
 Methodology: Mohammed Abusharbeh.
 Project administration: Mohammed Abusharbeh.
 Resources: Mohammed Abusharbeh.
 Software: Mohammed Abusharbeh.
 Supervision: Mohammed Abusharbeh.
 Validation: Mohammed Abusharbeh.
 Visualization: Mohammed Abusharbeh.
 Writing – original draft: Mohammed Abusharbeh.
 Writing – review & editing: Mohammed Abusharbeh.

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