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Macro-Economic Environment and Credit Risk of Islamic Banking in a Dual Banking System: Evidence from Malaysia and Indonesia

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Abstract: Understanding the effects of the macro-economic environments dynamics on the credit risk of Islamic banking in a dual banking system could help the Islamic banking industry. This article empirically investigates this issue based on Malaysian and Indonesian data from 2007 to 2017 by using the Dynamic Ordinary Least Squares (DOLS) cointegration modelling approach. The study finds a significant long-term relationship between the Islamic banking credit risk and macroeconomic factors such as GDP, conventional interest rates and exchange rate movements. The findings of this study will further enrich our understanding of the impact of the economic environment, particularly the movement of conventional interest rates on the operations and credit risk profile of Islamic banks in a dual banking environment. Findings of this study are expected to benefit not only Islamic bank personnel but also regulatory authorities and policymakers operating in dual banking environments.

Keywords: *Credit risk; Islamic Banking; Macroeconomic environment; Dual banking system; DOLS; Cointegration.*