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Credit Risk Management and Organizational Performance at Commercial Banking Sector in Palestine

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ABSTRACT

This study implemented an empirical investigation for the relationship between credit risk management and profitability of commercial banks in Palestine over the period of 7 years (2008-2014), eleven commercial banks were selected. The financial theory was employed to create the research model; Return on Asset (ROA) and Return on Equity (ROE) are defined as proxies of profitability while capital adequacy (EQTA), credit monitoring (LLPI) and income diversification (NIDR) are defined as proxies of credit risk management. Panel model analysis was used to estimate the determination of the profit function. Results revealed that the credit risk management does have significant effect on the both ROA and ROE. While EQTA has an negative insignificant effect on ROA. However, the relationships between all the proxies are fluctuated.

KEYWORDS: - ***Credit Risk, Capital Adequacy Credit Monitoring, Income Diversification, Profitability***

INTRODUCTION

The banking sector plays an intrinsic role in the economy. They perform as intermediaries between two essential parties that are the surplus and deficit units. This intermediary action is considered decisive to ensure the efficient allocate of resources in the contemporary economy (Rampini and Viswanathan, 2017). As noted in the latest US global financial crisis, the collapse of the financial institutions robustly affects the stability of the whole economy, and, consequently, it is crucial to preserve the veracity, soundness, and stability of the financial institutions.

Financial institution extend credit to the investors for investment purposes there are possibility that investment may not perform worthy or collapsed to generate positive Net Present Value (NPV). If this scenario happens investors are defiantly unable to refund the credit extended by financial institution and risk of default appears. Credit creation is the main income generating activity of banks (Kargi, 2011). With increase in bank exposure to credit it tendency to undergo a financial crisis also increase. These crisis leads to bad impact on the economy as a whole, particularly when central bank and supervisory authority unable to prevent and address the determinants of the problem. Fundamental portion of bank earning is created from the interest gained on loan extended to their clients.

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Kithinji (2010) write credit risk mainly arises due to lack of institutional capacity, in appropriation of credit policies, poor quality of management, lapses of laws and regulation and inefficient lending practices and accurate interference of central bank. So, credit risk management indispensable for profitability and bank survival.

Credit risk is internal determinant of bank profitability. The higher the exposure to credit risk, the higher the tendency for banks to experience financial crisis .Chen and Pan (2012) define credit risk as the extent of value fluctuation of loans and derivatives due to change in the credit quality of borrowers and counterparts as well.

Banks generally utilize depositors' deposit to make credit for the borrowers and this is the greatest and most explicit source of credit risk for most banks loans. Credit activities performed by banks distress them to high default risk drive to financial crisis and failures including insolvency. The Palestinian Authority's Law of 1997 has granted the PMA with the needed discretion to properly supportand protect the Palestinian banking system. Which saw banks extends huge amounts of credit with the major objective of increasing profitability. Some of the loans were "government loans" granted with little or no credit assessment. This subsequently drives to adverse relationship between banks debt collection and banks cash quantity rate and loans become non-performing (Tuyen, 2009).

The importance of these problems emerges from the risk of banks credit portfolio which is considered the most essential and decisive risk effect financial performance of banks in general. These circumstances require Palestinian banks to pay attention for identification of risk and their control model. Therefore, to reinforce effectiveness of banks management in Palestine banks are required to comply with Basel II. In addition, it is important to discover the influence level of credit risk management policies which include capital adequacy, credit monitoring, and income diversification on the profitability level of Palestinian banks which considered a major motivation to do this study.

LITERATURE REVIEW

Al- Tamim (2002) mentions that large number of empirical studies focused on developed country have been studied and analysed factors that influencing banks profitability. However, there are much diverse studies covered emerging countries' economies. Banks profitability determinations through the academic studies are usually diversified into internal and external factors. Return on asset (ROA), return on equity (ROE), return on capital employed (ROCE) and net interest margin (NIM) specify as dependent variable and considering both of internal and external factors as independents variables. In most of banks profitability studies, variables such as liquidity risk, credit risk, capitalization, loans, deposits, asset quality, operation efficiency, diversifications, capital adequacy, overhead cost and banks size are used as internal determinants, whereas both of industry-related and macroeconomic, are variables that indicate and reflect the economic and legal environments where banks are operates.

The following is a summary of the finding of internal factors that affects commercial banks profitability of some of these studies:

Zahid and Saeed (2016) conducted a study entitled "The Impact of Credit Risk on Profitability of the Commercial Banks" the study aimed to measure and analysis the impact of credit risk on profitability of five big UK commercial banks. Return on Asset and return on Equity as measurements of profitability were used. After conducting multiple statistical analysis results showed credit risk indicators had a positive association with profitability of the banks as well as, results reveal that the bank size,

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leverage, and growth are positively interlinked with each other.

A study by Li and Zou (2014) entitled "The Impact of Credit Risk Management on Profitability of Commercial Banks"; this study was done to investigate if there is a relationship between credit risk management and profitability of commercial banks in Europe. Return on Asset and return on Equity as measurements of profitability were used;

while Non-performing loan Ratio and Capital Adequacy Ratio were used as independent variables. The statistic figures reveal that credit risk management does have positive effect on profitability of commercial banks. NPLR has a significant effect on the both ROE and ROA while CAR has an insignificant effect on both ROE and ROA.

Onuonga (2014) illustrates that Kenyan banks sector has faced several difficulties over the time. The government tries to implemented several reform strategies to enhance competition and growth in thissector. This attracted the researcher to investigating the impact of internal factor on Kenyan banks profitability over the period 2008-2013 through implementing least squares method. Finding provides evidence that bank size, capital strength, bank operation expenses, ownership, and loans to assets ratio are considered significant determination to banks profitability. Results confirmed that, capital strength improvement of commercial banks leads to higher profits. Foreign ownership boosts commercial banks profitability. Whereas, banks operational expenses significantly decrease bank profits. Government policies in Kenya should bush and stimulates commercial banks to increase their capital base and assets.

Acaravci and Calim (2013) analyze profitability in Turkish banking sector by using Johansen and Juseliuscointegration test approach of the bank specific and macroeconomic factors that affect profitability. Data are collected from biggest owned, privately- owned and foreign banks from 1998 to 2011. Empirical findings show that, the state- owned banks normally work seriously on attracting more deposits which is essential source of fund for this types of banks. However, deposits for privately- owned and the foreign banks gain an insignificant impact on profitability. The lower the need for external funding, for both of the state- owned and privately –owned banks comes with higher profitability. In the case of foreign banks, lower capitals lead to higher bank revenues. The state-owned bank comes with a feature that it has high liquid assets to reduce liquidity risk of bank. The privately-owned and the foreign banks obtain more opportunities to invest in diverse short term liquid assets.2001 world economic crisis comes with wield disadvantage and negative effect on all Turkish banking sector.

According to Newman (2010) the main reason which generates the decrease in the dollar and foreign reserves is the variation in foreign exchange earnings which also affected banks' capital. Goddard, Molyneux, and Wilson (2004) mention that a bank that is operating over-cautiously and ignoring potentially profitable trading chances should be signified by a high capital adequacy ratio. And a negative relationship between equity to asset ratio and bank performance is implied. Banks which has higher equity to asset ratio usually requires lower needs of external funding and as a result there will be higher profitability (Pasiouras and Kosmidou, 2007). Iannotta,Nocera and Sironi (2007) found an important positive relationship between regulatory capital ratios and two indicators of banks performance using 15 European countries as a sample. Likewise, Lee and Hsieh (2013) found that capital ratios are positively correlated with banks when they examined some banks in Asia. Demirguc-Kunt et al., (2013) stated that in the time of the financial crisis 2007-2008, higher capital ratios have a positive effect on bank stock returns. Further,

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Ozili (2017) studied some African banks and remarked that regulatory capital has a significant positive impact on profits of listed banks, while higher regulatory capital thresholds have a reciprocal influence on the profits of non-listed banks.

Dugan (2009) suggests that the level of loan loss provisioning have to be able to demonstrate the beliefs of bank management on the quality on the loan portfolio that they own stating that provisions must be able to include the whole spectrum of potential credit losses if they think of provisions as a measure of true credit risk. A study by Eng and Nabar (2007) entitled "Loan Loss Provisions by Banks in Hong Kong, Malaysia and Singapore". The study investigated the behaviour of loan loss accounting disclosure of banks in Hong Kong, Malaysia and Singapore covering the period from 1993 through 2000. The study revealed that loan loss provisions are positively and significantly related with both of beginning loan outstanding and change in non-performing loan. This suggests that firms increase their provisions as response to an increase in credit risk. Ramlall (2009) talked about the negative relationship between credit risk and profitability. He shows that whenever there is a negative relationship between them, they reveal greater risk linked with loans, the higher the level of loan loss supplies which thereby and create a trouble at the profit-maximizing strength of a bank. Vong and Chan, (2007) estimation results indicate that, capital strength of Macao banks consider as fundamental important in affecting its profitability. A well- capitalized banks gain feature of perceived to be lower risk and this feature was quickly translated to higher profitability. There is adversely relationship between asset quality which is measured by the loan- loss provisions and the bank's profitability. In addition, banks with a large retail deposit-taking network do not achieve a level of profitability higher than those with a smaller network.

Gremi (2013) analysed the essential and more important eternal factors that affect Albanian commercial banks profitability over the time from 2005 to 2012 through using regression analysis fixed effect. These factors are bank size, credit risk, loans, deposits and interest income. Findings come with various results and show that higher total asset leads to higher profit. Higher loans contribute toward profitability but it comes with less significant impact on overall profitability. There is a negative relationship between credit risk and banks profitability. Total deposits to total assets and total equity to total asset provide a positive and significant relationship with bank's profitability.

Vong (2015) studied the determinants of banking profitability where the bank specific variables gone under investigation with a sample of five different banks. The study revealed that a higher loan-to-total assets does not always lead to a higher level of profits. Because of the competitive credit market condition and the successive cuts in interest rate, the interest spread i.e. the important determinant of profitability becomes narrower. Together with a higher loan-loss, the lower spread leads to lower profitability. As a result, rather than loan size, the spread and the quality of the loan do matter. Further, the study remarked that small banks, on average, achieve higher return on assets than larger banks.

Huang and Chen (2006) believed that non-interest income is one of the important sources of variegation for banks. Chiorazzo, Milani, and Salvini (2008) remarked that non-interest income reduces volatility since it is uncorrelated or somehow least correlated. In addition, changing their concentrations form traditional income sources into non-interest sources, banks will be able to increase shareholders' value (Gurbuz, Yanik, and Ayturk, 2013). Delpachitra and Lester (2013) mentioned that over-diversification of

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revenues increases the risk of default rather than improving profits. In addition, the strategy of income diversification needs great are as extensive diversification of income sources may reduce the financial performance of banks (Sahoo and Mishra, 2012). Being involved in non-interest based activities, income diversification may show new risks for which specialized managerial expertise are required. Being not well-planned, these risks could affect the performance, (Sahoo and Mishra, 2012).

Meslier, Taceng and Tarazi (2014) studied 39 commercial banks in the Philippines. The data were from year 1999 to 2005. A detailed breakdown of annual data on income structure was provided by the Central Bank of the Philippines. Ratings were conducted over various subsamples of banks in accordance with the bank's size, differences in the involvement in non-interest activities, differences in bank asset structure and ownership types. The results of the study revealed that increased reliance on non-interest activities has a positive influence on the profitability of Philippine banks and that this effect is stronger for banks with a lower initial level of diversification.

Gremi (2013) analysed the essential and more important eternal factors that affect Albanian commercial banks profitability over the time from 2005 to 2012 through using regression analysis fixed effect. These factors are bank size, credit risk, loans, deposits and interest income. Findings come with various results and show that higher total asset leads to higher profit. Higher loans contribute toward profitability but it comes with less significant impact on overall profitability. There is a negative relationship between credit risk and banks profitability. Total deposits to total assets and total equity to total asset provide a positive and significant relationship with bank's profitability.

The effect of non-interest income and revenue diversification on performance of Australian banks was the study of Delpachitra and Lester (2013). It has found that non-interest income and diversification of revenue negatively affects the profitability. Besides, despite of the much reliance on non-interest income, the profitability and risk of default were not improved. Turkmen and Yigit (2012) showed the negative effects of sartorial and geographic diversification on performance measures of banks working in Turkey. Gurbuz et al. (2013) observed that income diversification improves the risk-adjusted performance of banks. Soumadi and Aldaibat (2009) aimed in their research to estimate the growth strategy for (HBTF) in Jordan during the period of 2000 to 2009 and variables measures by Descriptive Analytical Method. Researchers came out with this following finding that, there is statistical significant correlation between growth percent in profit, growth percent in total assets and return on equity, and growth percent in asset with return on asset. On the other hand there is no statistical significant correlation between return on assets and growth percent in profit. Sufian and Chong, (2008) founds that, bank size, credit risk, and expense preference behaviour are in negative relationship with banks profitability, whereas non-interest income and capitalization provide a positive relationship with banks profitability during examine Philippines banks profitability on the period of 1990 to 2005. In addition, other empirical studies where made by Dawood (2014) for Pakistan commercial banks; Bejaoui and Bouzgarrou (2014) for Tunisian bank profitability; Almumani (2013) for Jordan commercial bank; Obamuyi (2013) for Nigeria banks profitability; Aljbiri (2013) for Libya commercial banks and Gul , Tariq, Usman , Irshad, and Zaman (2011) for Pakistan commercial banks.

METHODOLOGY

This study conduct empirical examine for quantitative effect of credit risk on the Palestinian

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banks Performance over the period of 7 years (2008-2014).11 commercial banks were chosen from the total existing banks operating in the country. The banks are first bank of Palestine. Arab Bank., Cairo Amman Bank., Bank of Jordan., Quds Bank., The National Bank., Palestinian Investment Bank., Jordan Ahli Bank., Palestine Commercial Bank., Jordan Commercial Bank and Jordan Kuwait Bank. Data pooled into a panel data set and estimated using Panel Data Regression. Panel data technique features that it's more comprehensive and able to remove some of the drawbacks of auto-correlation and multicollinearity. Significant results of Hausman test and rejection of null hypothesis advocated the application of fixed effect regression analysis.

The study measures credit risk by using the ratio of Total Shareholders' Equity to Net Assets (EQ/TA) to measure Capital Adequacy, Loan Loss Provisions to Net Interest Income (LLP/I) is considered as proxy of credit monitoring, Total Revenue – Interest Income to Total Revenue (NIDR) as proxy of income diversification. The performance of banks is measured by through very common proxies of Return on Asset (ROA) and Return on Equity (ROE).Below are the models developed to analyse the relationship between credit risk and banks performance.

$$Y= a+B1\ X1+ B2X2+B3X3+B4X4 +E$$

Where:

Y: Return on Asset (ROA)

Y: Return in Equity (ROE)

(X1): Capital Adequacy

(X2): Credit Monitoring

(X3): Income Diversification

Standard	Our application
y- the value of dependent variable	Y:ROA+ROE-profitability indicator
a- The constant term;	X1: EQTA-credit risk management indicator
X- The value of independent variable:	X2: LLPI- credit risk management indicator
B- The coefficient of the function;	X3:NIDR- credit risk management indicator
E- The disturbance or error term.	

Thus the regression equations become:

Model 1

$$ROA= a+\beta1\ (EQTA) +\beta2\ (LLPI) + \beta3\ (NIDR) +E$$

Model II

$$ROE= a+\beta1\ (EQTA) +\beta2\ (LLPI) + \beta3\ (NIDR) +E$$

REGRESSION RESULTS

Following table 1 explains the results obtained by the time period effect regression analysis for model 1. Table 1 shows results for EQTA affected ROA negatively. EQTA β coefficient was -.707 which indicates that the effect of Equity Capital on ROA was week also means that one unit increases in EQTA decreases ROA by 70.7 % unit while the rest of variables are held constant. The statistical significance of EQTA on ROA is .572 more than 0.05 which was a sign of insignificant relationship. This means that EQTA predicts effect on ROA with 42.8% probability. Then Loan Loss Provisions to Net Interest Income Ratio (LLPI) is negatively related to (ROA), the profitability measure. LLPI, it also had a negative effect on ROA with β coefficient of -3.419. This indicates that one unit increases in LLPI will decrease ROA by 341.9% units, holding the other variables constant. The statistical significance of LLPT is .008 which is less than 0.05 which is a significant relationship. It implies that LLPI predicts effect on ROA with 99.2% probability. While, Income Diversification Ratio (NIDR) was positively related to (ROA), the profitability measure. NIDR β coefficient is 1.142 which means that one unit increases in NIDR increases ROA by 114.2 % units while the rest of variables are held constant. The statistical significance of NIDR on ROA is .007 which is less than 0.05 which is significant relationship also this means that NIDR predicts effect on ROA with 99.3% probability.

R^2represents the prediction level of variance in return in assets (ROA) by capital adequacy (EQTA), credit monitoring (LLPI) and income diversification (NIDR). Which is 0.209.This

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means that 20.9% of ROA can be predicted from the independent variables mentioned above.

Durbin- Watson (DW) statistics test is based on the assumption that the errors in the regression model are generated by a first order autoregressive process. And it indicates to the sum of squares of successive differences of residuals to the sum of squares of errors. According to (Montgomery, Peck, and Vining 2001) if the DW statistic is less than 2, there is evidence of positive serial correlation. The Durbin-Watson statistic was 1.458; it means there was serial correlation between independent variable and ROA.

Table. 1: Dependent Variable ROA

Variable	Coefficients β	Std. Error	Significant-Statistic	
Constant	1.855	.523	.001	
EQTA	-.707	1.247	.572	
LLPI	-3.419	1.248	.008	
NIDR	2.765	.413	.007	
R2	.209		F-statistics	3.747
Adjusted R2	.153		Prob.(F-statistics)	.005
			Durbin-Watson	1.458

Regression results for model 2 provide significant results for fixed effect regression analysis. EQTA affected ROE negatively. EQTA β coefficient was -44.927 which means that one unit increases in EQTA decreases ROE by 4492.7% unit while the rest of variables are held constant. The statistical significance of EQTA on ROE is .000 less than 0.05. This means that EQTA predicts effect on ROE with 100% probability. LLPI, it also had a negative effect on ROE with β coefficient of -19.382. This indicates that one unit increases in LLPI will decreases ROE by 1938.2% units, holding the other variables constant. The statistical significance of LLPT is .001 which is less than 0.05 it implies that LLPI predicts ROE with 99.9% probability. Whilst, NIDR affected ROE positively. NIDR β coefficient is 5.581 which mean that one unit increases in NIDR increases ROE by 558.1 % units while the rest of variables are held constant. The statistical significance of NIDR on ROE is .005 which is less than 0.05 this means that NIDR predicts effect on ROE with 99.5% probability.

R^2represents the prediction level of variance in return on Equity (ROE) by capital adequacy (EQTA), credit monitoring (LLPI), income diversification (NIDR). Which is 0.745. This means that 74.5% of ROE can be predicted from the independent variables mentioned above.

The Durbin-Watson statistic was .914; it means there was serial correlation between independent variable and ROE.

Table. 2: Dependent Variable ROE

Variable	Coefficient β	Std. Error	Significant-Statistic	
Constant	22.781	2.447	.000	
EQTA	-44.927	5.831	.000	
LLPI	-19.382	5.831	.001	
NIDR	5.581	.1.931	.005	
R2	.555		F-statistics	17.736
Adjusted R2	.524		Prob.(F-statistics)	.000
			Durbin-Watson	.914

CONCLUSION

The following conclusions are made from the panel data regression analysis of the effect of credit risk on Palestinian commercial banks performance measured by (ROA) and (ROE).

In the ROA model, the results showed that EQTA was negatively insignificant, LLPI was negatively significant and NIDR positively significant.

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Interesting but quite surprising, the study results showed that in ROE model, all variables, namely EQTA, LLPI and NIDR were significant.

The improvement in ROA and ROE as profitability indicators consider positive, but still weak comparable with the international industry standards.

Based on study findings, it is recommended that borrowers in Palestine strongly depend on banks as the major source of credit provider in the domestic market. Therefore, Palestinian banks need to increase their capital base and equity capital especially. That promotes incentives for banks to reduce their risk of their activities and enhance the stability and competitive status in the financial sector.

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