

Impact of Credit Risk Management Practices on the Profitability, A Case of Askari Bank Limited

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Abstract

The paper is a study to check credit risk management efficiency of Askari Bank Limited (ABL), and to conclude how Credit Risk Management CRM practices are impacting to increase profitability of commercial banks. Credit risk management (CRM) is a separate department that needs procedures for monitoring and control of the credit risk exposures. For conducting this research, secondary data is collected from annual report of Askari Bank Ltd. The study discusses CRM in general and then it's implication in context of Askari Bank. The impact of CRM on banks profitability is analysed using regression analysis in which Return on Assets (ROA) was dependent variable and Non-Performing Loan Ratio (NPLR), Loan Loss Provision ratio (LLPR) and Capital Adequacy Ratio (CAR) were independent. The findings show that NPLR has negative impact whereas CAR and LLPR has positive impact on the ROA.

Keywords: ABL, CRM Practice, ROA, NPLR, LLPR, CAR.

1. Introduction

The element of risk, uncertainty and the expectation of loss is a central tendency of a business matters occurring in a particular place, time and mode. From a financial perspective, there are few categories of risks that includes market risk, credit risk and operational risk. It is significantly important for a bank or other financial institution to mitigate and manage the credit risk as it alone accounts for more than fifty percent of the various risks faced by these businesses. Credit risk means the loss that is possible due to borrower's inability to pay back the loan or debt. Meanwhile, Credit risk management is taking care of bank's capital and loan loss reserves by decreasing those losses. Credit Risk Management is one of the complex department that has always been a challenge for the financial institutions to deal with.

Credit Risk Management put into the regulatory spotlight due to the credit crisis and global financial crunch that followed. Therefore, regulators began to insist more transparency. Regulators wants that a bank should have enough know how of client details and the relevant information before issuing credit.

To act in accordance with the requirements of regulatory department of managing credit risks and absorb capital costs for credit risk most of the banks are modifying their practices of managing credit risk. This is compliance that is required to be met for the long term sustainability of banks. The banks with better and improved credit risk management practices enjoy the advantage of profitability and have competitive advantage over the other banks. In the type of counterparties variety is increasing (from individual to sovereign government) and in the form of obligation there is ever expanding variety (from auto loan to complex derivative transactions) shows that credit risk management plays a vital role in the overall risk management activities carried out by firm in the financial service industry (Fatemi & Fooladi, 2006).

The key objective is to identify importance and advantages of CRM on the perspective of banking institutions and to examine that how CRM practice impact on banks image and profitability.

2. Literature Review

2.1 Credit Risk Management

Credit risk can be termed as the potential that a bank borrower will not be able to meet its obligations as per agreed terms and conditions (Basel, 2000). Credit risk management is a planned way of risk assessment to manage uncertainties, managing it by developing appropriate strategies, and effective use of managerial resource to mitigate the risk. The strategies consist of avoiding the risk, transferring the risk to another party, decreasing the risk's negative effects, accepting little or all of the consequences. The risk management process involves two main steps. The first step deals with the identification of the source causing risk in this step the variables that cause the risk are identified. The second step is designing of approaches to quantify and compute risk using mathematical model and reducing it using proper instruments. The second step is about developing mathematical models to evaluate the risk. Hence the banks need to have a proper framework for risk management. The long term development and sustainability relies on it (Van Greuning & Iqbal, 2007). Banks are the largest financial institutions around the world, with branches and subsidiaries. Banks have so many types which differentiate them from each other. The differentiation occurs due to difference in products and services they are offering (Howells & Bain, 2008). Example is hold and deposits accounts in commercial banks, giving them away together as loans, payments mechanism for operations, etc. As a financial institutions banks pull out credit to

their customers in form of loans, overdrafts, off balance sheet activities (i.e., letter of credit), and credit card facilities. Banks issue credit to increase their revenues streams, to act as its bargaining power in the industry, sustain a competitive edge, as to enhance the relationship with their customers.

The banks, in order to have maximum rate of return, should maintain the credit risk in adequate limits. The credit risk is an inherited part in a bank and therefore it cannot be avoided but the only way is to control it. Various other risks and their relationship with the credit risk should also be considered. Therefore a bank needs an effective risk management strategy to mitigate the risks and it is necessary for the success of the bank in the long run (Hull, 2013).

There is no isolated environment for banks to work. Bank can face uncertainties in the future and they are operating in a dynamic environment, has always risks involved in some extent. For last ten years, world's financial crisis and Basel 11 Accords can be the most suitable example impacted the banking industry. For past few years these global financial crisis has negatively influenced the overall economy and resulting in a great depression, thus disturbing the financial sectors, both in developed and under developed countries (Gamo, 2009).

The base of credit risk management lies on developing a creation of a structure that setup the process to accept corporate concern, loan process approval, risk rating instrument, developing a risk evaluating system, loan mechanism review and complete reporting system (Pyle, 1999). Even though negative consequences appears to the bank due to all types of risks, but the credit risk has been identified as one of the key risk that badly influence the bank performance negatively (Jr Sinkey & Sinkey Jr, 1992). The banks fail to perform if this credit risk is not managed properly. Therefore, it is required to handle CRM practices very carefully for the success. Because there is no other way against it to get funds back and recovering the losses. Now it is understandable that why management of credit risk is very vital is because banks have a narrow ability to absorb loan losses and these losses can only be recovered by the income generated by other services of bank and by using banks capital (Boffey & Robson, 1995). The bank when utilize income to recover the loss incurred through loan, this action affects the capital adequacy of the bank and even its profitability in future.

Regardless of all the problems that banks might face, the loan which paid after maturity date have a very negative consequences and become more hard to bank to take control on lose (Shanmugan & Bourke, 1990). This term is credit risk in banking environment. It is seen that Credit risk is a major issue to look after, because debts of bank rise when it borrow more credit in order to meet its demands especially from its customers who are resulted for cash withdrawals. Under these circumstances high interest will be paid, capability to borrow reduced, consequently profits also reduced because few customers will borrow, equity will increase, value of shareholders decreases, capital investments in future are less, restraining the bank's long term business performance, or increasing trade credit taken from suppliers (Maness & Zietlow, 2004).

2.2 Bank Performance Measures

In order to ensure the stable growth economy, the banks should have strength. This requires that the assessment of financial condition of a bank is the major objective of regulators ((Halling & Hayden, 2006). The banking system financial stability and safety lies on profitability and capital adequacy. Profitability shows management methodology and competitive position of bank in market-based banking. This parameter is helpful in absorbing some of the risk level and supports them against short-term problems." ((Tabari, Ahmadi, & Emami, 2013)). (Haslem, 1968) had done a study and concluded that the factors that affect the bank's profitability are management, location, size and time.

Researchers in the past had used various measures to determine the performance. Various studies are found in which either qualitative or quantitative aspects of profitability were used. Cole (1972) introduced the method of ratio analysis to measure and evaluates the performance of a bank. He was of the belief that the major and core source to measure the performance. According to him, there are various ways to measure profitability. The process required the researcher to focus on the size and resources of that organization along with the risk taken by it. Based on Cole's method, Brealey and Myers (2003) identified many important instruments that can be used to measure profitability. The net profit ratio, ratio of return on equity (ROE) and ratio of return on assets (ROA) was considered important by them.

2.3 Non-Performing Loan Ratio (NPLR)

Nonperforming loans are a strong indicator of the failure of a firm. It was observed that most of the financial organizations were having too many loans before they failed. They are considered to be the key reasons behind various economic issues. More the non-performing loans found in a financial division will result in more unprofitable organizations ultimately leading to economic instability. In order to improve the economic condition, it is necessary to get rid of nonperforming loans. If they are left to exist as they are, resources will be wasted in sectors which are not beneficial, resulting in poor growth and inefficient economy. (Biabani, Gilaninia, & Mohabatkah, 2012).

The loans that are in default or are about to being in default are called non-performing loans (NPLs). After

90 days of being in default, many loans become non-performing loans. This also depends on the terms in the contract. when the interest and principal payments are due by 90 days or more, or at least 90 days of interest payments have been capitalized, refinanced or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons to doubt that payments will be made in full (International Monetary Fund, 2005).

Turner (2006) defines non-performing loan as a loan that is no longer generating income. The guidelines state that loans are non-performing when: principal or interest is due and unpaid for 90 days or more; or interest payments for 90 days or more have been re-financed, or rolled-over into a new loan.

The literature has clearly identified two distinct sets of aspects that can explain the evolution of nonperforming loans. The first group focuses on the variability in the NPLs in different banks and features the non-performing loans to factors at bank level (Klein, 2013). Berger and DeYoung (1997), showed a two way causal relation of NPLs and cost efficiency. They referred this causality as "bad luck" caused mainly by the destruction of economic conditions. This causality between the two factors was explained as the "bad management". The hypothesis showed that reduction of cost efficiency results in weak management ultimately leading to poor loan monitoring, control, underwriting and non-performing loans tend to increase.

Ekrami and Rahnama (2009) found that in today's banking system, high credit risk is the result of high non-performing loans. This makes the banks exposed to market and liquidity risks. No matter how hard the banks try to keep these risks under control in an organization, the high probability and its negative impact on future cannot be overlooked. Morton (2003) stated that the non-performing loans are created due to fragile criteria of credit assays, unproductive policies, and acceptance of risk and mistaken indicators of functions.

2.4 Loan Loss Provision ratio (LLPR)

Businesses are set up to generate profits. Hence it's the profitability of an organization that is the main goal. This is the basis for the long term survival of business. It is important for an organization to measure the past and present profits it had earned. Businesses earn income through their activities. Therefore it is likely that a business generating higher profits will provide more return on investments to the owners (Waweru & Kalani, 2009). A strong banking sector has the ability to avoid the negative factors and provide stable foundations for financial structure. The profitability of a bank is affected by the changing environment in which the bank operates. This also includes credit risk. Previous studies have shown this empirically that macroeconomic factors along with the bank related factors play an important role in the profitability of the banks (Stephen, Randolph, Jaffe, & Bradford, 2007).

3. Methodology

3.1 Data sources:

Five years data, from 2010 to 2015, for the variables which are Return on Assets (ROA) Non-Performing Loan Ratio (NPLR), Loan Loss Provision ratio (LLPR) and Capital Adequacy Ratio (CAR) has been extracted from the annual financial statement of the Askari Bank limited.

3.2 Trend Analysis

Trend analysis is widely used technique in the field of finance. It is based on the prediction of the future performance on the basis of past performance. It gives us an idea that how a company or stock will perform in the future. Statistical and mathematical techniques are used to calculate the past performance and then predict the rate of change or performance in the future time periods, usually a year.

3.3 Multiple regression analysis

Regression analysis is used to find relationship between two or more than two variables. Regression analysis tells us how much change is brought in dependent variable due to change in independent variable. Dependent variable is called regressed whereas independent variable is called regressor. It is expressed in the form equation as follows

$$Y = a + b_x + u$$

Above equation represent relationship between dependent and independent variable. Y is dependent variable, X is independent variable, a is intercept, b is slope whereas u regression residual.

We have constructed the regression model as follows

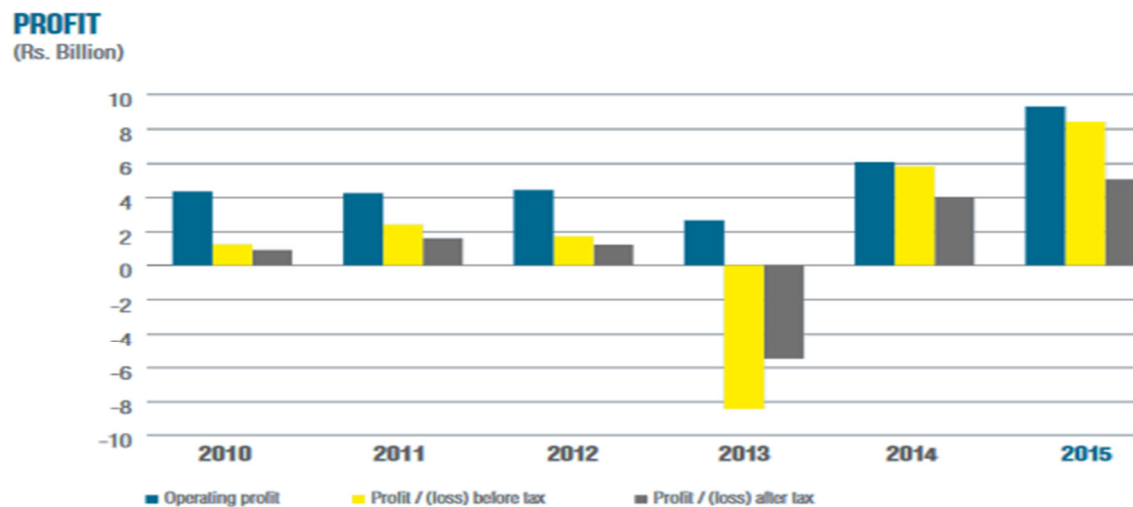
$$ROA = a + b_1 * NPLR + b_2 * CAR + b_3 * LLPR + u$$

4. Results and Discussion

4.1 Trend Analysis

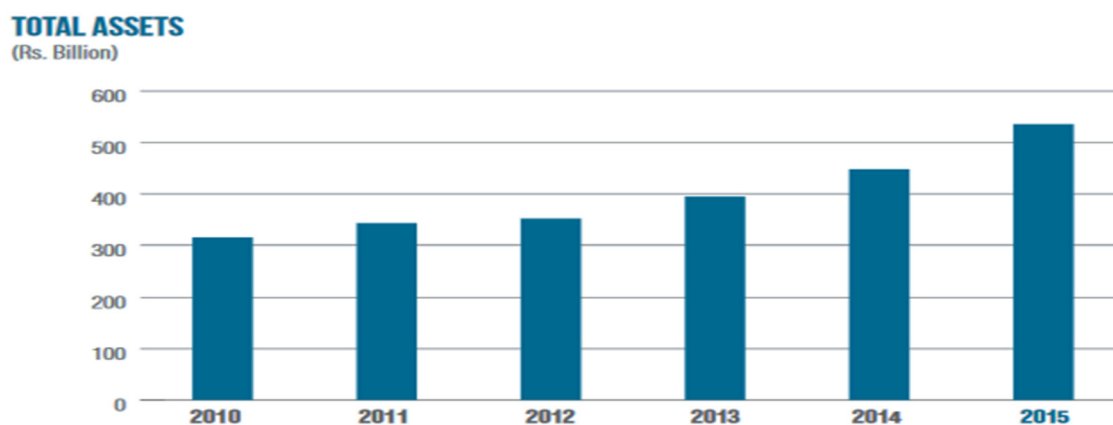
The below analysis is the forecasted analysis that relies on historic time series data for the prediction of future. In this research, the Askari bank trend analysis is analysed for credit related factors that includes classified and unclassified loans.

Figure 4.1.1



Askari Bank's Profit before tax for 2015 amounted to Rs.8,432 million and profit after tax amounted to Rs.5,043 million registering a robust growth of 46 percent and 26 percent, respectively.

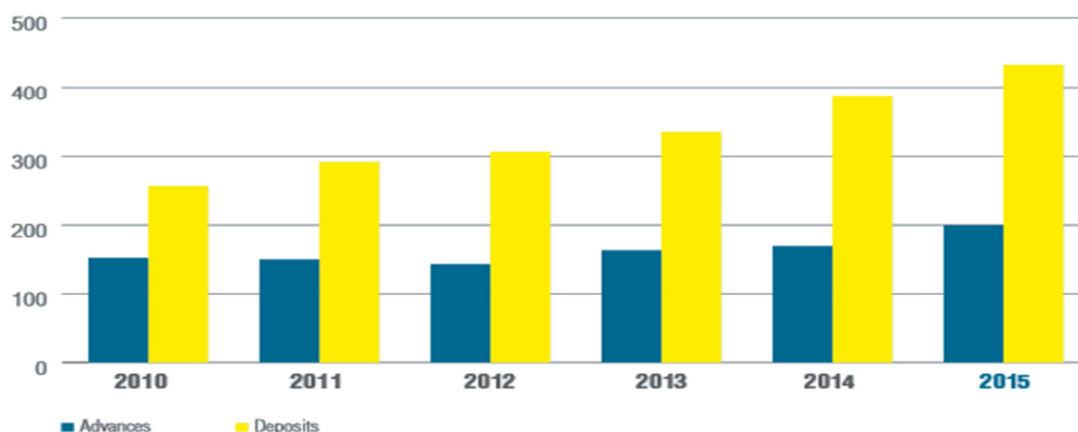
Figure 4.1.2



The total assets have crossed 500 billion for the year 2015 which is a remarkable growth.

Figure 4.1.3

ADVANCES AND DEPOSITS
(Rs. Billion)



The above chart shows the comparison the advances and deposits in the Askari Bank.

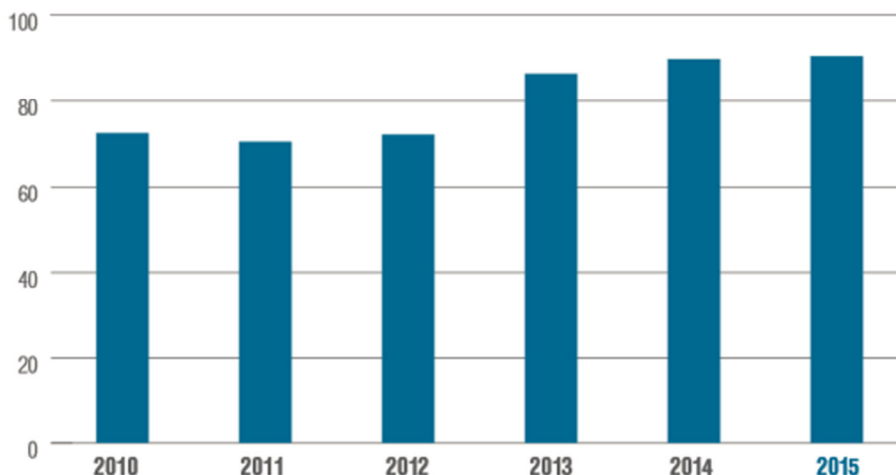
NPL Coverage

At the end of 2015, the NPLs is unchanged compared to 2014; however, additional charge of Rs. 316 million recorded against NPLs. As a result, the coverage ratio improved by 69 bps to 90.5 percent from 89.8 percent at end 2014.

Figure 4.1.4

NPL COVERAGE

(% age)



The non-performing credits (NPLs) of the Bank at end 2015 remained practically unaltered contrasted and the position at end 2014. Net arrangement charge against NPLs adding up to Rs.316 million for the present year contrasted with a net inversion of Rs.83 million a year ago.

The net extra charge is basically because of withdrawal of the advantage of constrained deal estimation of guarantees; down-degree of effectively grouped records according to endorsed time based criteria; and order of certain new records. The NPLs to gross advances proportion enhanced to 13.8 percent from 15.8 percent a year ago for the most part because of a 14.9 percent expansion in gross advances. NPL to arrangement scope enhanced marginally to 90.5 percent at end 2015 against 89.8 percent at the end of 2014.

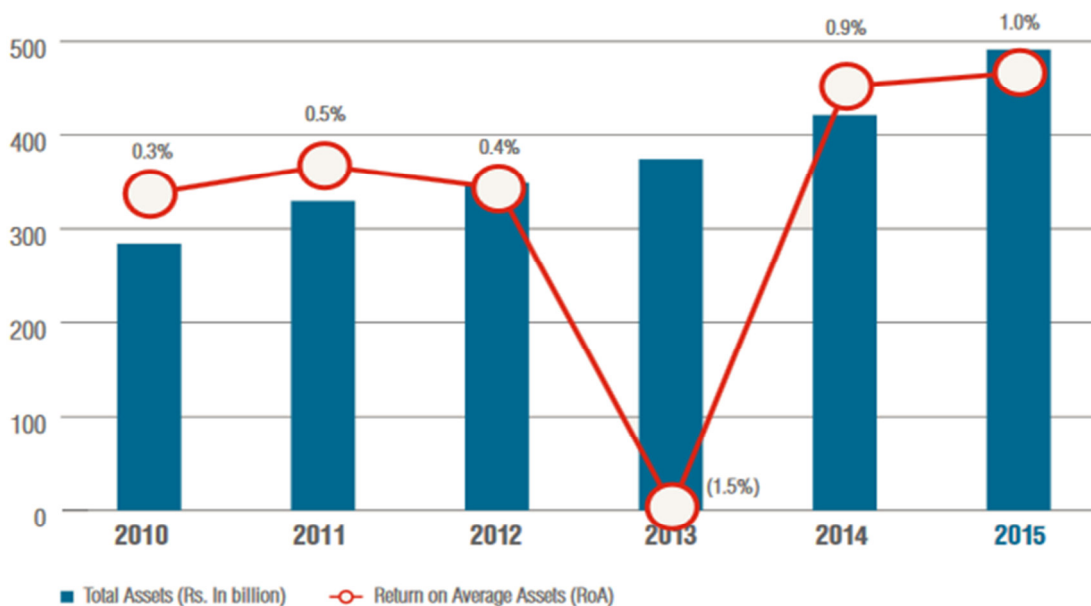
Return on average assets (RoA)

In 2015, ROA has increased because of increase in profit by 25.6 percent which is more than increase in total average assets (net) of 16.7 percent.

Figure 4.1.5

RETURN ON AVERAGE ASSETS

(Rs. Billion)



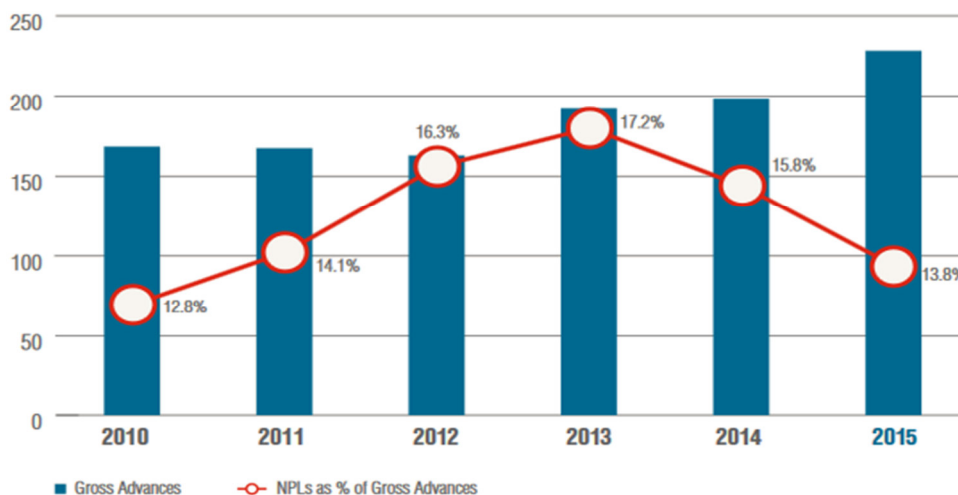
Non-Performing Loans (NPLS)

The NPLs of the Bank as on December 31, 2015 remained practically unaltered contrasted with the most recent year. In any case, the proportion of NPLs to gross advances enhanced by 200 bps to 13.8 percent, which was 15.8 percent at the end of 2014. The change is owing to the development of 14.9 percent in gross advances of the Bank amid the year, which remained at Rs. 228 billion at end 2015 against Rs. 199 billion at the end of a year ago.

Figure 4.1.6

NON-PERFORMING LOANS

(Rs. Billion)



4.2 Regression Analysis

The sample of the data required for the regression analysis is gathered from annual report of Askari bank. For the analysis, the ROA that comes under the profitability is taken as dependent variable whereas NPLS, CAR and LLPR are being analysed as independent variable. The model for the equation is

$$ROA = a + b_1 * NPLR + b_2 * CAR + b_3 * LLPR$$

TABLE 4.2.1

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.999 ^a	.997	.990	.0592412

a. Predictors: (Constant), CAR, LLPR, NPLR

The value of R =0.999 states the high positive relationship among dependent and independent variables. The R2 indicates 99.8% of the variability in dependent variable ROA is explained by the independent variables LLPR, NPLR and CAR.

TABLE 4.2.2

ANOVA^b

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1.384	3	.461	131.472	.004 ^a
	Residual	.004	1	.004		
	Total	1.388	4			

a. Predictors: (Constant), CAR, LLPR, NPLR

b. Dependent Variable: ROA

F ratio is 131.472 which describes overall test and the significance level is .059 which is close to .05. The overall relationship is significant. We accept our hypothesis that there is relationship between ROA and the Credit Risk Management.

TABLE 4.2.3

Coefficients ^a						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.201	.353		6.236	.001
	NPLR	-.353	.019	-.960	-18.158	.035
	LLPR	.010	.006	.078	1.521	.030
	CAR	.041	.019	.116	2.159	.016

a. Dependent Variable: ROA

The next table 4.2.3 shows the multiple linear regression estimates including the intercept and the significance levels. The regression beta coefficient is negative for NPLR; the interpretation is that for every 1-unit increase in the predictor variable, the dependent variable will decrease by the unstandardized beta coefficient value.

Using the above table, the equation can be expressed as:

$$ROA = 2.195 + (-.353 * NPLR) + .041 CAR + .10 LLPR$$

The unit change in NPLR causes the dependent variable ROA to change with value -.353 keeping LLPR and CAR are constant. The negative signs show that the impact is reverse. It means when NPLR increase, ROA will decrease.

The equation tells a unit change in LLPR causes the dependent variable ROA to with .010 keeping NPL and CAR constant. This impact is positive. When LLPR will increase, ROA will increase and vice versa.

We get regression as 0.041. If NPLR and LLPR are kept constant, ROA will change by 0.041 with a unit change in CAR, and the resulted movement is in same direction.

Conclusion

Credit risk is the loss of investor's money which arises from the borrower who cannot pay according to the agreed terms. The credit risk management in financial organizations and banks is of significant importance because of the nature of activities of these organizations. Therefore it is crucial for the banks and other financial organizations to adequately manage the risk they are exposed to. A comprehensive strategy for the credit risk management is crucial to ensure the stability and future progress in terms of financial performance.

Numerous elements are involved in the credit risk management that is Credit processing, approval, documentation, administration, recovery, disbursement, and classification etc. The organization will have to bear the cost of training the employees and keeping them motivated which are considered as challenging for the firm.

This research was focused on the credit management practices implemented by the Askari Bank Ltd. it follows the rules and regulations as proposed by State Bank of Pakistan. The main focus of the bank is credit policy. There is a separate department in Askari Bank that is involved in approval, recovery, operation and asset management. The methods used by Askari Bank to recover its bad portfolio is through file transfer, legal notice, management write off, early alert account and inspection of credit.

In Askari Bank Ltd, the level of credit risk was moderate. An increasing trend was observed in the classified and unclassified loans. The results have indicated a good amount provision against classified loans. The non performing ratio was adequate for Askari Bank.

It is seen that the relationship between both the variables that is credit risk management and profitability are positive. Hence it is concluded that the profitability of the banks is increased by an effective credit risk management strategy.

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