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Investigating the Effect of Credit Risk Management Practices on the Financial Performance of Islamic and Conventional Banks

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Abstract: Devolvement of any economy greatly depend on banks' loan. Different sectors of the economy e.g. Industry, agriculture and business get loan from banks. Different sectors face the risk of credit. Yet, the sector which face more risk is financial sector. The major purpose of this research study is to understand how financial performance of commercial and Islamic banks in Pakistan are effected by credit risk management practices. The population of this study was 34 Islamic and conventional banks. This study used primary and secondary data in order to achieve its objectives. The outcomes demonstrate that financial performance of banks are positively and significantly affected by monitoring and identification of the credit risks. Results of the study further explain that the financial performance of the banks are significantly but negatively affected by Credit risk appraisal. The credit risk control has an insignificant however positive effect on the financial performance of bank. This study enables managers and administrators in Pakistan to make supportable prudential principles and approaches to strengthen credit risk management.

Key words: Financial Performance, Credit Risk, Commercial Banks, Islamic Banks and Return on Assets.

1. Introduction

Banking was originated from Italy, where the first conventional bank named as Italian Bank was established in 1973. Later, in the 16th and 17th century the idea of banking spread all through Europe. In the nineteenth century, banks were viewed as the most numerous and Jews supervised this sector on account of their significant effect on the financial markets. Around then, all Americans and Europeans banks were controlled by Jews and, rather than gold and silver, the concept of money was introduced. The first sketch of the Islamic banking system was evident in the 1970s, the Islamic banking sector was largely developed in Islamic countries, such as Pakistan, Bangladesh, Iran and the Arab region. In the

21st century, the banking sector has improved the efficiency of fierce competition with foreign banks, spreading rapidly around the world.

Effective risk management is seen by academics and regulators as the foundation for bank management. Risk management is one of the determinants of bank equity performance (Sensarma & Jayadev, 2009). Banks often face many fundamental risks, including credit risk, interest rate risk, liquidity risk, market risk, currency risk and solvency risk (Toumi, 2011). However, lending is considered a major source of credit risk for commercial banks (Wheelen, 2000). As this may directly affect the solvency of financial institutions, it should be stressed that credit risk is the most expensive risk for financial institutions (Chijoriga, 1997). The term credit risk deals with the chance of not getting back loan from borrowers (Saunders & Allen, 2011). Therefore, based on the above definition, it is clear that credit risk arises once the lender or other counterparty is liable to the creditor who fails to meet the debt obligation (Luy, 2010).

Risk and efficiency are correlated and bank risk is particularly determined by credit risk, since the nature of banking transactions is often influenced by the poor economic and financial situation of the country in which these banks operate Apatachioae, (2015). It is critical that the bank's administration know how to deal with the risks of over-exposure to credit risk (Kimotho, 2015).Gatuhu(2013) clarified that Collection policy, credit risk control and risk appraisal are for the most part affected on performance of the firm. Ahmad (2012) studied about the risk of liquidity and its effect on financial performance of banks in Pakistan. The outcome demonstrate that credit and liquidity risk are unfavorably affect the performance of banks in Pakistan.

Credit risk management studies are limited particularly in conventional and Islamic banks. Mostly conventional and Islamic banks face more credit risk. Yet, the fundamental practices of dealing with a bank have not been sufficiently explored. Likewise, the previous literature, which exists by different researchers, has different results that make it impossible to obtain convincing results. The fluctuation of the results indicate that more research is needed on this issue and the time needed to conduct a thorough study on this particular topic. Therefore the main research question is:

How financial performance of banks in Pakistan is effected by using different credit risk management practices?

2.4 Research Objectives

The Major purpose of this study is to check that how financial performance of banks in Pakistan is effected by using different credit risk management practices. Therefor the objective of this study is as follow:

1. Explain the consequences of credit risk identification on banks financial performance
2. Explain the impact of credit risk appraisal on banks financial performance
3. Explain the impact of credit risk control on banks financial performance.
4. Explain the impact of credit risk monitoring on banks financial performance.

2. Literature review

2.1 Brief history of banking sector in Pakistan

Banks in the 21st century are the most economically important sector. Numerous changes and development have been noted in this sector. Islamic and conventional banks are the two main types of banks operating in Pakistan. Microfinance banks, foreign banks, investment banks, specialized banks, private banks, projected banks and developed financial institutions also operate in Pakistan. In Pakistan, State Bank of Pakistan (SBP) plays an important role in promoting the Islamic financial system in Pakistan according to Sharia and administrative structure. Three types of Islamic banking institutions (IBIs) are operating in Pakistan in which full-fledged Islamic banks, Islamic bank subsidiaries of conventional banks, and independent Islamic banking branches of conventional bank are included which are providing Islamic banking services in Pakistan. The SBP has set similar conditions and enabled Islamic banks to work in parallel with conventional banks, with the primary target of giving different banking opportunities to build up a sound financial system offering opportunities for economic development through sharia-compliant financial operations.

2.2 Empirical Studies

To build up any economy, the financial sector assumes a key part. There is a well-established connection between economic advancement and the financial segment. An efficient financial part is expected to improve utilization of national monetary assets and progressive financial advancement must be accomplished by utilizing assets effectively. The banking division must be sufficiently sound enough to maximize economic growth. However, these financial institutions are facing different types of risk in which capital risk, market risk, reputational risk and many associated risks are involved. Of every one of these risk, risk of credit is the major risk that a financial institution particularly banks face.

"Credit Risk is the chance of occurring losses because of non-payment of loans from last many years it became the credit risk"(Nduku, 2016). Credit risk is the critical factor for banking sector due to its nature that decides the survival, reputation, growth and profit of the banks (Abiola, 2014). Credit risk is an extremely powerful risk that influences the performance of the bank. A study demonstrates that the risk of Islamic banks is proficiency of administration, total assets size and risk-weighted assets however Loss provision risk, weighted risk are the major credit risks that are faced by conventional banks (Ahmad & Ahmad, 2004).

Based on the comparative case studies (2017)examined the non-governmental and conventional institutional risk of microfinance. The outcome demonstrates that credit and operational risks are faced by both of the banks. The literature demonstrates that micro finance institutions face credit risk, yet a group loan, a level of advances and expansion activities can lessen the risk of credit. The Researcher additionally propose that the financial institutional administration and its internal environment are likewise lessen the risk of credit (Naima, 2017).

Banks with very high trade relationships tend to have higher credit risk. In addition, small banks have more leverage, less ROA is more dangerous for their survival. In addition, conventional banks with large boards, senior financial directors and independent boards are identified as having relatively low credit risk (Switzer & Wang, 2013). Kavun and Vorotintcev(2016) have contended that effective and high-quality credit risk measurement models are required for making pattern of risk management in the financial division to make a particular risk management environment for precisely dealing with the credit risk.

Kiprop (2017) proposed that financial performance of institutions is positively affected by the identification of credit risk.. He expressed that financial performance of different organizations are affected by the risk management approach used by the management of particular finical institution.As indicated by Al-Tamimi and Al-Mazrooei(2007), identification of credit risk is an initial phase in the credit risk management process. However, to set up a good credit risk management in the organization, the initial step is to consider the risks and their effect on the association. Credit risk monitoring is a critical procedure that ensures that banks successfully manage credit risk management (Javid, 2009). Different financial organizations used credit risk monitoring technique in order to identify the error and mistake at an early stage. Thus, this can positively affect company's performance (Al-Tamimi & Al-Mazrooei, 2007). Khan and Ahmad (2001) research about different credit risk management practices used by various financial institutions and found that the least effort was put on measuring, mitigating and monitoring risks, and more focused on credit risk management policies and internal control systems.

A study by S. F. Ahmed and Malik (2015) demonstrates that the collection and credit risk control policies are connected to increase the performance of loans. Credit risk appraisal have a positive and significant effect on the bank's performance. Njeru (2016) contemplated about the “Effectiveness of credit appraisal on loan performance of commercial banks in Kenya” and the outcomes demonstrated that credit appraisal is an important factor that could influence business performance. Rajagopal (1996) attempted to analyze the use of different credit risk management practices and a proposed model at deciding the costs of their monetary items in light of the borrower’s credit risk appraisal. The findings of this study indicate that profitability of banks is greatly enhanced by using effective credit risk management approach to identifying risk. Viable credit risk administration applies to the implementation of reporting and review structures to guarantee that risks are appropriately recognized and evaluated and that suitable controls and responses are established (IRM, AIRMIC, & ALARM, 2002)

3. Methodology

This study uses a positivist approach. The deductive approach is used in this study because it generates the results of a quantitative study, which is generally used for future discussions. Researchers used quantitative data for this study, by collecting this through a survey in a cost-effective way. Cross-sectional study is used in this research. Data is collected once from primary and secondary sources. The number of population in this study comprises of all Islamic and conventional banks in Pakistan, which are a sum of 28 conventional banks and six Islamic banks in 2017, since the study covers the performance of both types of banks. The researchers used non-probability sampling technique. The researchers took all the conventional and Islamic banks in Pakistan (total population) and contained no sample in this study.

In this study, primary data was collected using questionnaires. The questionnaire is sublet into two sections: the first part contains the name of banks from which we collect the data and the second part contains the questions on the measurement of credit risk management practices. Structured questioner is used for completing this study. These questionnaires were managed by Islamic banks and traditional bank credit managers. For secondary studies, researchers calculated the financial performance of the bank on the basis of the published annual accounts of these banks over the past five years. These financial statements were used to calculate ROA ratios to measure the financial performance of banks. Regression equations were generated like this;

ROA = β0+ β1 CRI + β2CRA + β3 CRC + β4 CRM +μ.

ROA = Return of Asset, a ratio calculated from net income to total asset

B0= constant term

β1 + β2+ β3+ β4 are the coefficients of regression

μ= Possible error

The researchers called for data collection at all 34 conventional and Islamic banks in Pakistan.. After collecting the data, the data was summarized with descriptive statistics, regression and correlation analysis. The regression analysis is used to test that either financial performance of banks is effected by different credit risk management practices or not and also SPSS tools is used to measure quantitative data on coding, input and measurements.

4. Data Analysis and Results

Table 4.1: Items Reliability Statistics

Variable	Cr. Alpha	No. of Items
CRI	.869	5
CRA	.861	5
CRC	.739	6
CRM	.860	6

The size of data measuring the reliability was 22. Because the reliability of all items is greater than 0.70 so, all items in the survey contributed significantly to the research which shows relatively high reliability of the items.

4.3 Descriptive Statistics

Table 4.2 Descriptive Statistics

Variables	**Mean**	**Std. Deviation**
ROA	1.0015	1.44578
CRI	2.0059	.73606
CRA	2.1353	.89133
CRC	1.9118	.72562
CRM	1.9559	.72562

Source: Research Findings

This table shows the average and standard deviation values of all items. Likert scale is used to measure these items. This table shows the average or means value of ROA of all banks in Pakistan which is 1.0015 with 1.44578 standard deviations. Credit risk appraisal is the important variable having the highest mean value of 2.1353. This shows that the banks of Pakistan practice the credit risk appraisal to a great extent on average and standard deviation of this item is 0.89133. Secondly, the credit risk identification shows the mean value of 2.0059 which shows that the banks practice the credit risk identification technique to a great extent. Credit risk monitoring and credit risk control practices are also being used by Pakistani banks to a great extent. Mean values of both variables are 1.9118 and 1.9559 respectively and both have the same standard deviation that is 0.72.

Table 4.3 Regression Analysis:

Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	-1.599	.788		2.030	.052
CRI	.783	.285	.399	2.752	.010
CRA	-.470	.176	-.290	-2.668	.012
CRC	.222	.245	.111	.906	.373
CRM	.822	.291	.413	2.825	.008

Source: Research Findings

The table shows the multiple regression results between the credit risk management practices and the bank's financial performance in Pakistan. Here, ROA is the dependent variable and CRI, CRA, CRC, CRM are independent variables. Beta coefficients of CRI is .783, its t-statistic is 2.752, and the significant value is 0.010 which means that CRI has significant and positive impact on the finical performance of banks in Pakistan. Although the beta value of the CRA is -0.470, the t-statics is -2.668, and the significant value is 0.012 which means that CRA has significant but negative impact on the finical performance of banks in Pakistan. This table shows that the beta value for CRC is 0.222, t-statics is 0.906 and the significant value is 0.373 which means that CRC is not significantly impact on the financial performance of the Bank of Pakistan (ROA), the beta for CRM is 0.822 and the t-static value is 2.825 and the significant value is 0.008 which means that CRM has significant and positive impact on the finical performance of banks in Pakistan.

5. Discussion

The study found a significant correlation between the identification of credit risk and the financial performance of the bank. At the same time, there is a direct correlation between the identification of credit risk and the financial performance of banks in Pakistan. These results support the results of Kiprop (2017) that the identification of risk positively influences company performance. The results of this study show that credit risk appraisal negatively influence the performance of banks in Pakistan. Along these lines, CRA influences the banks performance in Pakistan. The results of this study confirm the conclusions of NJERU et al. (2016) which examined the effectiveness of credit ratings on the performance of commercial banks in Kenya and the recognition that credit appraisal is an important element that can influence company performance.

The review likewise uncovered an insignificant connection between banks financial performance and credit risk control. The findings clearly show that techniques of credit risk control do not affect the performance of the banks in positive direction. The findings of this study are additionally reliable with Ahmed and Malik (2015), who studied about the credit risk factors which can influence the loan performance of banks in Pakistan. Credit risk managers are selected for data collection and regression model was used to interpret the results. The outcomes demonstrated that the credit risk control and collection policies are connected to the increase in credit performance, however the relationship is insignificant. Client appraisal and credit policies have a critical and positive affect on credit performance.

The outcomes demonstrated a critical positive connection between the monitoring of credit risk and the banks performance. In this way, there is direct link between credit risk monitoring and the financial performance of banks in Pakistan. The outcome of the investigation are additionally reliable with the findings of Sania and Shehla(2012), which examined the risk management techniques and practices of Pakistani banks. The outcomes demonstrate that understanding risk the management, controlling and analyzing credit risk is the fundamental driver of risk management practices.

6. Conclusions

The major purpose of this research study is to understand how financial performance of commercial and Islamic banks in Pakistan is effected by credit risk management practices. Descriptive research model is used in this research study. The population of this study is 34 Islamic and conventional banks. This study used primary and secondary data in order to achieve its objectives. The outcomes demonstrate that financial performance of banks is positively and significantly affected by monitoring and identification of the credit risks. Results of the study further explain that the financial performance of the banks is significantly but negatively affected by Credit risk appraisal. The credit risk control has an insignificant however not adverse effect on the financial performance of bank. This study enables managers and administrators in Pakistan to make supportable prudential principles and approaches to strengthen credit risk management.

7. Recommendation, Limitation and future direction:

This examination assessed the management of credit risk practices and their impact on the execution of commercial and Islamic banks in Pakistan from a financial perspective. So, the results of this study is limited to only two banks and other types of banks are not included in this study. The other limitation of this study is that in this study the combine results of commercial and Islamic bank were analyzed and interpreted. The examination additionally recommends additionally inquire about the effect of credit risk practices in the prospect of loan default.

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