IMPACT OF CREDIT RISK MANAGEMENT ON THE PERFORMANCE OF COMMERCIAL BANKS IN SRI LANAKA

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Abstract:

The adoption of credit risk management is becoming a crucial factor for every commercial bank around the world. The objective of this study is to identify the impact of credit risk management on the performance of the commercial banks in Sri Lanka. This study is primarily based on both primary and secondary data. Primary data were collected from eight (08) commercial banks from 24 commercial banks in Sri Lanka. The sample was selected from the population based on the superior financial performance for the period under review and the availability of the consistent data over the set period. The primary data was collected mainly through an interview. The relevant authorities were interviewed personally in order to have their views on the problems and solutions. The secondary data were obtained from various sources such as Annual Reports of the selected commercial banks, relevant articles, books and magazines etc. The panel data of a five year period from 2009 to 2013 from the selected banks were used to examine the relationship between credit risk and performances. The Return on Assets (ROA) is used as performance indicator and Loan provision to Total (LP/TL), Loan Provision to Non-Performing Loans (LP/NPL), Loan Provision to Total Assets (LP/TA) and Non-Performing Loans/ Total Loans (NPL/TL) were used as indicators of credit risk. Further, a regression model was used to establish the relationship between amounts of loan as well as nonperforming loans and profitability during the period of study by using E-views software. The result shows that non-performing loans and provisions have an adverse impact on the profitability. Therefore, the study recommended the banks to implement an effective tools and techniques to reduce the credit risk management.

Key Words: Return on Assets, Non-performing loans, Credit Risk Management, Profitability.

Background of the Study:

Credit remains the primary source of revenue for any bank around the world. However the probability of default borrowers' loan commitments has been an increasing concern for those banks particularly for unsecured bank loans. This risk could be categorized as credit risk. The risk poses a significant exposure not only to the banks (lenders) but also to the entire economy, which is evident

in 2008 financial crises. This is because of the fact that the banking is a vital industry of any economy. This emphasizes the importance of managing the credit risk within the banking sector. Banks grant loans to the customer with an expectation of receiving the capital together with an interest. A loan facility is considered to be performing if payment of both capital and interest are paid accordingly with agreed repayment terms. The Non Performing Loans (NPL) represents credits which the banks perceive as possible loss of funds due to customers failure to repay the monthly installments. They are further classified into substandard and doubtful bank credit category hinders bank from achieving their set targets. Proper risk management is essential for the survival of a bank, and it enables management to allocate resources to risk units based on a tradeoff between risk and return potential (Charles, Okaro Kenneth (2013). The present economic climate of Sri Lanka has further increased the necessity of deploying risk management practices among Sri Lankan banks.

The economic condition has been explained in the annual report of the Commercial Bank PLC as “The banking sector posted a moderate growth in assets. NPL increased across the industry, largely due to a global decline in the price of gold that affected recoveries of gold pledged loans”. The increased interest rate makes it difficult for the customers to repay the facility, thus the possibilities for default facilities are high. In the middle of 2014, there were 24 licensed commercial banks in Sri Lanka. Unlike traditional banking, these banks carry out various activities such as loans, foreign currency transactions, pawning, leasing, hire purchases, savings, fixed deposits etc. This implies that the operations of the banks are highly complex which increases the risk of the banks.

Among different type of risks faced by banks, the management of credit risk would be a vital factor as the losses of loans directly affect banks’ performance. Credit risk management leads to maximize a bank’s performance by maintaining credit risk exposure within an acceptable limit in order to provide a framework of the understanding the impact of credit risk management on banks profitability. To monitor the credit risk more closely, banks are carrying out rigorous credit analysis of counterparties and various products. Banks are also upgrading their forecasting abilities to calculate risk in stressed market conditions. Additionally, regulators have been encouraging banks to monitor their credit risk very closely. The Central Bank of Sri Lanka has imposed a number of regulations and acts. Directions are provided under Banking Act, to help banks better manage their credit risk. The act focuses on the maximum limitation of accommodation or credit facility so as to diversify the risk.

Charles, Okaro Kenneth (2013) examined the impact of credit risk management on capital adequacy and banks financial performance in Nigeria. For this purpose six banks were selected by using positive sampling technique. Data were obtained from the published financial statements from 2004 to
2009. Panel data model was used to estimate the relationship that exists among Loan Loss Provisions (LLP), Loans and Advances (LA), N0n-performing Loans (NPL), Capital Adequacy (CA), and Return on Assets (ROA). Results showed that

sound credit risk management and capital adequacy related positively on banks' financial performance with the exception of loans and advances which was found to have a negative impact on banks' profitability in the period under studied. Based on the findings, they recommended that Nigerian banks establish appropriate credit risk management strategies by conducting rigorous credit appraisal before loan disbursement and drawdown. It is also recommended that adequate attention to be paid for Tire-one capital of Nigerian banks.

Fernando and Nimal (2013) examined the impact of overall risk management on Sri Lankan banks' performance. The main objective of this study was to identify the impact of risk management on bank efficiency in Sri Lankan Banks. This study adopted Second Stage Data Development Analysis based on the data for the period from 2005 to 2011 of Licensed Domestic Commercial Banks in Sri Lanka. In the second stage it applied Tobin Regression to find the influence of external environmental factors on bank efficiency. The mean efficiency of Sri Lankan banks is high compared to the other well improved countries such as India, UK, USA. Taiwan and Islamic Banks located in London. Further, the study found that the risk management programs have improved the efficiency of the Licensed Commercial Banks in Sri Lanka.

Mekasha (2001) investigated credit risk management and its impact performance on Ethiopian Commercial Banks. The researcher used 10 years panel data from the selected commercial banks for the study, to examine the relationship between ROA and loan provision, non-performing loans and total assets. The study revealed that there is a significant relationship between bank performance and credit risk management.

The banks around the island continuously adopt credit risk management practices including the filtering of borrowers, rigorous approvals, credit limits, necessary guarantors etc. All these controls involve cost and time; therefore a bank has to make sure that the benefits of these controls have to exceed their cost. This study focuses as to what extent the cost on these controls, i.e. risk management have an impact on the banks' performance, which is considered in terms of Return on Assets (ROA) and identifies the relationship between the non-performing loans and banks profitability and evaluate the effect of loan and advance on banks. Therefore, the main objective of this study is to investigate the impact of credit risk management on the performance of commercial banks in Sri Lanka. In addition to this primary objective, the study attempted to determine the extent to which non-performing loans affect banks' profitability in Sri Lanka.

Research Methodology

For this study both primary and secondary data were used to investigate the impact of credit risk management on performance of Commercial Banks. Primary data was gathered from eight (08) commercial banks from 24 commercial banks in Sri Lanka. The sample was selected from the population based on the superior financial performance for the period under review and the availability of the consistent data over the set period. Further, the sample includes different closely related parties engaged with International Financial Reporting Standards (IFRS) adoption process. The primary data was mainly collected through an interview. The relevant authorities were interviewed personally in order to have their thoughts on the problems and solutions. The secondary data were obtained from various sources such as Annual Reports of the selected commercial banks, relevant articles, books and magazines etc. The panel data of a five year period from 2009 to 2013 from the selected banks were used to examine the relationship between credit risk and performances. The Return on Assets (ROA) is used as performance indicator and Loan provision to Total (LP/TL), Loan Provision to Non-Performing Loans (LP/NPL), Loan Provision to Total Assets (LP/TA) and Non-Performing Loans/ Total Loans (NPL/TL) were used as indicators of credit risk. Further, a regression model was used to establish the relationship between amounts of loan as well as non-performing loans and profitability during the period of study by using E-views software. Thus, to test the relationship between credit risk management and the performance, the following regression model was applied.

$$Y = \alpha + \beta 1X1 + \beta 2X2 + \beta 3X3 + \beta 4X4 + €$$

Where;

Y = Return on Assets (ROA)

X1 = Non-performing loans to total loans

X2 = Loan provision to non-performing loan

X3 = Loan provision to total assets

X4 = Loan provision to total loans

€ = Error term

Further, the data collected from personal interviews were analyzed by evaluating ten (10) variables. They are objective of credit risk management, establishment of credit risk control policies, risk identification and assessment, risk reporting, cost of credit risk management, procedures for updates and credit risk management training.

Results and Discussion

The collected data were analyzed by using a common theme method. The primary data has been obtained by conducting interview with 100 banking staff members from the selected banks. The data were analyzed by using the nine variables, which are identified as the most important variables for this study. When considering the banking experience of the selected staff members, 88% of them have more than three years experience in banking sector. Further, 69% of the respondents have more than three years experience in the credit/loan section in their respective bank. According to field survey, 69% of the bankers' main objective of having a credit risk management process in their institutions is to reduce the financial losses. But 11% of the bankers' introduced their credit risk management programs to improve their resource allocation process. 12% of the bankers' were implemented credit risk management process in their banks to improve their decision making ability on credit/loans section. 8% of the bankers' have implemented their credit risk management programs with an aim of improving communication skills with their customers. This implies that the main task of having a credit risk management is to reduce the financial losses and thereby it improves the profitability of the banks. 100% of the bankers' appoint a separate committee or a board to establish their own credit risk management policies. Further, the staff members have acknowledged that the board's commitment and support are necessary to reduce the financial losses of the credit risk. It is also concluded that the policies developed by the board would reflect a holistic view of the risk characteristics rather than one or few perspectives.

100% of the bankers in the sample have a well defined or clear and documented methodology for identifying and assessing the credit risk of their system. This is necessary for a bank to mitigate the impact of credit risk, as this would enable all the staff members to clearly identify the risks and assess them on the reasonable conditions. If a bank is aware of its risk, including credit risk, then it can develop all the necessary controls and strategies, based on risk assessment to mitigate the risk. If the methodology is documented, the staff members can have a wider understanding of the risks as they are able to refer it when necessary. Further, a clear process for reporting risk would enable the banks to reduce the impact of risk significantly. This would facilitate the management to develop strategies to effectively define the risk as early as possible. This is also beneficial in terms of any unnecessary tension and complexities due to improper reporting of risk, which would significantly affect the management's time and lead to develop inadequate strategies. According to the field survey, 100% of the respondents have stated that the risk reporting methodology supports the goals and objectives of credit risk control management. Every credit risk management program has involved some cost items such as audit fee, staff salaries, payments for training programs, salaries for risk committee members etc. The results of the field survey indicate that 88% of the respondents believe that the cost involved in credit risk control management process would have an effectiveness of the bank's operations. However, 12% of the respondents believe that the cost is ineffective. Therefore, it can be

concluded that the cost of the credit risk management control are being effectively carried out by the banks in Sri Lanka.

The ability to respond to the changing environmental factors and conditions, new changes in regulations would immensely helpful for the banks to develop successful strategies and policies, which eventually help to improve the performance of the banks that helps to improve the performance of the banks eventually. Therefore, obtaining an understanding on how prepared the banks to the changes occurring in the wider environment are necessary requirement for any bank to align their strategies as well as their policies including risk management policies. This is also important to develop effective training programs for the staff members of the bank that is latest in the present environmental conditions. 100% of the respondents mentioned that their banks have effective procedures for updates on new changes in regulations and other external environmental factors. When it considers the frequency of the changes to the credit risk control management policies, a high frequency would indicate that the banks have acknowledged the changing economic and financial environmental changes of the country as well as the global situation. With the rapidly changing environment prevails at present, not only the banks, but also all the organizations are forced to align their strategies and policies accordingly. This is true for credit risk management policies as well. According to the field survey, 78% of the banks do the changes to credit risk management policies annually and 22% of the banks make changes to their guidelines and policies once per every two years. Therefore, it can be concluded that the most of the banks think that they should change their guidelines or policies to manage their credit risk once per year.

All the respondents indicated that the banks offer training on credit risk management, which implies that all the banks acknowledge the importance of training their staff to improve the awareness on the area. Although most of the training programs bearing the tag of overall credit risk management, all programs specifically focus on credit risk management. The predominant purpose of the training on credit risk management is to improve the expertise and knowledge on credit risk and avoid unnecessary events of those risks being materialized. Hence, these expertise would enable the banks to reduce the impact of credit risk on financial aspects of the banks and improve the profitability through the reduction of cost.

The second part of this study is to analysis of secondary data to identify the relationship between credit risk management and the profitability. To establish the relationship, a multi-factor regression model was performed by using a well-known software of E-views.

Dependent Variable: Return on Asset (ROA)				
Variables	Coefficient	Standard Error	t-statistic	Probability
C	0.023255	0.00641165	3.627044179	0.001679417
NPL	-0.137587	0.181679198	-0.757308467	0.457695229
LPNPL	-0.000792	0.006954929	-0.113945132	0.910417385
LPTA	-0.010139	0.369722494	-0.027425973	0.978391804
LPTL	0.001035	0.005987221	0.17295702	0.864423606
R-squired	0.255253384			
Adj: Rsquired	0.10630406			
F-statistic	1.713692805			
Durbin-Weston Statistic	2.598867148			

Source:2009-2013 Annual Report Data, E-Views output

The regression results of the study suggest that all the independent variables except loan provision to total loan have negative impact on profitability. The non-performing loan, loan provision and loan provision to non-performing loans of the banks are significantly negatively related with ROA. The parameter value shows that 1% increase in non-performing loans decreases ROA by 13.7587% and 1% increase in loan provision decrease ROA by 1.0139%. In addition to that 1% increase in loan provision to non-performing loans decreases ROA by 0.0792%. On the other hand the regression results show that loan provision to total assets of the banks is significantly positively related to ROA. The parameter value shows that 1% increase in loan provision increases ROA by 0.1035%. In terms of fitness of the study model, the coefficient of multiple determinations R^2 indicates that 25.5253% (adjusted R –squired 10.63%) of the variations in ROA are explained by the combined influence of credit risk indicators (NPL/LP and LA/TA) in the model. The Durbin Watson statistic measures the serial correlation of the variables. The result of the Durbin Watson test shows 2.599. Since the value is approximately 2.00, it is accepted that there is no autocorrelation among the successive values of the variables in the model. The results verify the objective of the study that better credit risk management results in better bank performances. The research findings indicates that the banks should ensure that they deploy a well established credit risk management framework.

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