

Impact of credit risk management on financial performance: with special reference to Sri Lankan banking sector

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Introduction

Credit risk is always treated as the major risk inherent in a bank's trading and banking activities since credit creation is the main income generating activity for banks (Kargi, 2011). According to Danson Musyoki (2011) among the other predictors, credit risk is an important predictor of bank financial performance. Good heart (1998) states that the poor Credit risk management (CRM) which results in undue credit risk causes bank failures. Credit risk is the possibility of losing the outstanding loan partially or totally, due to credit events. Sri Lankan banks continued to invest huge sum of financial resources on CRM with the intention to maximizing returns and minimizing bank's risks. The significance of the study is to have a big picture of how commercial banks manage their credit risk effectively. However contradictory findings and the scarcity of studies in relation to this field in the context of Sri Lanka has created an area for study with regard to seek the relationship between Credit Risk Management and Financial Performance (FP) of banks. Parameters covered in the study were; default rate (DR), bad debts costs (BDC), cost per loan asset (CLA) and Return on Asset (ROA). Accordingly, first objective was assigned to examine the relationship between CRM and FP. Second objective was to identify the most affecting Credit Risk Management factor on Financial Performance of banks.

Methodology

Descriptive research design was used for this study. Banking sector consider as the research population. Here, population consist Licensed Commercialized Banks and Licensed Specialized Banks. Due to unavailability of data and inconsistency between time periods only 21 banks registered under Sri Lanka banking act considered as sample. Therefore, secondary data of 21 banks were taken from balance sheet, income statement and notes of banks` for five years of time period. Further interview method was used to collect data from senior managers in various banks. To achieve the objectives of the research, secondary data was analyzed by using correlation coefficients analysis, regression analysis and descriptive statistical techniques. Moreover, the independent variable such as Credit Risk Management was measured using Default Rate ratio, Cost per Loan Asset Ratio and Bad Debt Cost ratio. Dependent variable such as Financial Performance was measured using Return on Asset ratio.

Results and Discussion

According to the Descriptive analysis, the mean value with respect to Default Rate, Bad Debt Cost and Cost per Loan Asset were 0.1043, 0.1014 and 0.2140 respectively. Considering the Bank Financial Performance, the mean value with respect Return on Assets was 0.2365.

Table 01: Correlation between credit risk management and bank financial performance

Credit Risk Management	Pearson Correlation	P-value
Default Rate	-0.469	0.032
Bad Debt Cost	-0.280	0.219
Cost per Loan Asset	0.586	0.005

Source: Modified SPSS output of research data

Note: **Correlation is significant at the 0.01 level (2-tailed) *Correlation is significant at the 0.05 level (2- tailed)

Comparing the three independent variables ROA has statistically significant weak negative relationship with Default Rate. Moreover, it has statistically significant strong positive relationship with Cost per Loan Asset. Furthermore ROA has statistically insignificant weak negative relationship with Bad Debt Cost.

Table 02: Multiple Linear Regression Analysis

Predictor	β Coefficients	Standard Error	T-value	P-Value
Constant	0.124	0.069	1.798	0.090
Default Rate	-0.438	0.202	-2.169	0.045
Bad Debt Cost	-0.096	0.125	-0.765	0.455
Cost per Loan Asset	0.785	0.262	3.000	0.008

Source: SPSS output of research data

The fitted regression model can be expressed as follows.

$$ROA = - 0.438DR + 0.785CLA + \epsilon$$

The regression model shown above was developed according to the Multiple Regression analysis. Considering the multiple regression analysis, Cost per Loan Asset and Default Rate were highly significant for the model as its p-values were less than 0.05. Among these two variables financial performance was highly impacted by Cost per Loan Asset that is 0.785. Bad Debt Cost and constant variable were not significantly contributed to the model hence p-value were greater than 0.05 level of significant. Therefore, new multiple regression models can be articulated using independent variables such as Cost per Loan Asset and Default Rate.

Conclusion

The research mainly based on two objectives. Correlation coefficient analysis used to achieve the first objective that identifies the relationship between CRM and financial performance in this study. Compliance with the correlation coefficient analysis, both Default rate and Bad debt cost has a

weak negative relationship with financial performance. These findings are similar with the findings of Musyoki (2011) and Poudel (2012). However, there was a high positive relationship between Cost per loan asset and financial performance.

Intend to achieve the second objective; multiple regression analysis was used here. Cost per loan asset and Default rate were highly significant for the model. Among these two variables financial performance was highly impacted by Cost per loan asset is 0.785. Bad debt cost was not significantly contributed to the model hence its p-value was greater than 0.05 level of significant. Therefore, if the bank needs to increase the financial performance they have to invest more on Cost per loan asset by reducing the expenditure on Bad debt cost. Therefore, the study recommends the banks to increase the investment on cost per loan asset to enhance financial performance. In addition to that, this study has shown the path for construct the future researches by developing the existing model using new ratios such as capital adequacy, non-performing loan, loan loss provision, return on asset, management efficiency and etc.

References

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