

Review of theoretical literature: The relationship between credit risk management and bank profitability

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Abstract – Today, commercial banks are the largest financial institutions in our country. Credit risk is one of the biggest risks of these banks due to the nature of their activities. Through effective credit risk management, banks not only support the sustainability and profitability of their business, but also contribute to systemic stability and an efficient distribution of capital in the economy. This paper will focus on the theoretical analysis of the relationship between some indicators of credit risk management and indicators of bank profitability, as well as the evidence of the stability over time of this relationship.

Keywords – Bank, Credit Risk, Profitability, Problem Loans, Effective Management

I. INTRODUCTION

Commercial banks are businesses that carry multiple risks, for this reason they require special attention in the study of financial performance elements and especially in the study of profitability indicators. Commercial banks are financial intermediaries that channel funds from surplus units to deficit units. Their mediation role can be said to serve as a catalyst for the growth of the Albanian economy.

During the process of providing various financial services, they face many types of financial risks. We can say that nowadays the awareness of the great importance of commercial banks in providing diverse services has improved significantly, also due to the fact that they play an important role in the development of the financial system.

Commercial banks use their customers' deposits to grant loans to borrowers, emphasizing the fact that generally the interest earned from granting loans constitutes the main source of income for them. The process of providing loans exposes commercial banks to high risk, which can lead to financial difficulties, including to some extent bankruptcy. Credit risk management is an internal process that aims to balance the banks tendency to generate as much income as possible with ensuring sufficient protection from the risk of the counterparty failing to repay the obligation. This protection means creating internal capacities to manage the risk. The process of risk management, theoretically, goes through four basic steps which are identification, measurement, control and monitoring of risk. In practice, banks design lending policies and internal procedures to create the credit risk management infrastructure. They also create the appropriate

structures within themselves in function of the policies and procedures they design. The profitability of the banks is the result of the entire activity of the banks, to some extent also of the credit risk management process.

II. CREDIT RISK IN BANKS

Efficient intermediation of commercial banks is of vital importance for developing economies as it creates conditions for high economic growth, while their bankruptcy leads to economic crises. But the performance of this function causes different types of risks of different sizes that affect the performance of the bank. The main objective of bank managers is to maximize shareholder wealth. This objective means maximizing the market value of the bank's common stock.

The word "Credit" is derived from a Latin word "Credere" which means faith. A bank exists not only to accept deposits but also to give loans, therefore it is inevitably exposed to credit risk. A good credit policy helps bank managers determine the framework within which credit will be extended and managed. The main causes of serious banking problems are directly related to poor credit standards of borrowers. A poor portfolio assessment or lack of attention to changes in economic circumstances is common in developing economies, Lopez (1999).

Some studies such as (Chaplinska, 2012; Gropp et al., 2010; Mileris, 2012; Romanova, 2012) state that excessive credit expansion, poor credit quality and inadequate credit risk management are the main reasons for the crisis. the last global financial. The problem starts in the application phase and increases in the approval phase, the monitoring and control phase if the credit risk management regulation is not complete.

According to Waymond (2007), one of the main tasks of financial institutions is to give credit which is usually the main source of income of banks, but bank credit also constitutes one of the ways of increasing the supply of money in the economy.

According to Lopez (1999), credit risk is the risk of a decrease in the value of the loan due to a change in the borrower's ability to make payments.

Credit risk is the chance that a debtor or an issuer of a financial instrument will not be able to pay the interest or repay the principal according to the terms

set in a loan contract, Greuning and Bratanovic (2003).

Chen and Pan (2012) showed that credit risk is the rate of fluctuations in the values of debt instruments or their derivatives due to changes in the credit quality of the borrower and related parties.

A bank loan is a debt that involves the redistribution of financial assets between the lender and the borrower. A bank loan usually refers to the borrower taking an amount of money from the lender and having to pay back what is known as the principal. In addition, banks normally charge a fee to the borrower which is interest on the debt. The risk associated with credit is called credit risk, Gregoriou and Hoppe (2008).

Credit risk is the loss from the refusal or inability of credit customers to pay what they owe in full and on time. Credit risk is the exposure banks face when a borrower defaults on its commitments to honor debt obligations on the due date. This risk is capable of putting the bank at risk if not managed properly, Coyle (2000).

Credit risk can also be the risk of loss in credit derivative markets. In the case of liquidation, when the price at which the debt is sold is lower than the price at which the bank bought it, this causes a net loss for the bank in the market.

All in all, they show that there can be many reasons for not returning the loan. Generally, the borrower is in a bad financial situation and may face bankruptcy. He can also refuse to fulfill his debt obligation in case of fraud or legal dispute.

The Basel Committee on Banking Supervision (1999) observed that banks always face credit risk from various financial instruments other than loans, including bank acceptances, interbank transactions, trade finance with foreign exchange transactions, futures contracts, swaps, bonds, equity instruments, options, etc.

Bessis (2002) stated that credit risk is critical, since non-return of loans from a small number of important customers can generate large losses, which can lead to bank insolvency.

According to Afriyie and Akotey (2012), the credit risk situation of a bank can be worsened by insufficient institutional capacity, inefficient credit guidelines, inefficient board of directors, low capital adequacy and liquidity ratios, mandatory amount of

lending as a result of government intervention as well as the lack of proper supervision by the central bank.

III. CREDIT RISK MANAGEMENT IN BANKS

Although market risk has received a great deal of attention in recent years, credit risk management is the "bread and butter" of most commercial banks, Heffernan (2004) Every commercial bank has a loan portfolio. The increase in credit risk will increase the marginal cost of debt and equity, which translates into an increase in the cost of funds for the bank. Credit risk management techniques are generally well known because the banking sector has had a long history of experience in this area. However, credit quality problems in commercial banks are one of the most important causes affecting their failure. For this reason, all bankers, and not only those who work in the credit risk department, should be aware of the main factors that affect the quality of a loan portfolio and the methods for its management.

Afriyie and Akotey, (2012) stated that credit risk management in financial institutions has become crucial for the survival and growth of these institutions. This is a structured approach to managing uncertainty through assessing risk, developing strategies to manage it, and mitigating risk using managerial resources.

According to Charles (2013), risk management is essential for the survival of a bank and this enables management in the distribution of resources for risk units based on a compromise between risk and potential return.

According to Tafri et al (2009), credit risk management is important for both banks and policy makers because a strong banking system can promote the financial stability of a country and increase the resilience of the economy to withstand economic crises. Therefore, studying and measuring the effect of credit risk management on bank profitability is crucial for financial institutions.

Credit risk is managed in different ways where the most important method starts with the proper selection of counterparty banks and products. The authors show that:

First, a good risk assessment model and the presence of qualified loan officers are key requirements for

choosing a strategy. For loans given with a high non-return risk, banks may need more collateral to reduce the risk. Therefore, the price of the product should be set in line with the assessed risk.

Second, credit risk management rules limit the bank's exposure to another bank. It avoids the situation where one loss or a limited number of losses jeopardizes the bank's solvency.

Thirdly, the allocation process of banks ensures a good diversification of risks through different borrowers of different types. The diversification strategy spreads credit risk and thus avoids focusing only on credit risk problems.

Last but not least, banks can also purchase credit protection instruments in the form of guarantees through credit derivative products. In this way, the quality of loans with guaranteed assets has always been increasing. These techniques are translated into the daily organization, into procedures and written policies which determine how the borrowers are selected, determine the risk profile of the loans that have been granted and at what level an assessment by the expert is required.

A good credit risk management avoids important drawbacks such as credit concentrations, lack of credit discipline, aggressive signatures with high-risk institutions and inappropriately priced products. And an effective credit risk management is verified by internal risk control and audit which monitors credit discipline, lending policies, approval policies, object risk exposure and portfolio risk.

The main sources of credit risk include according to Kithinji (2010): limited institutional capacity, inappropriate lending policies, unstable interest rates, poor management, inadequate laws, low capital and liquidity level, direct lending, licensing massive banking, weak loan contracts, leniency in credit rating, poor lending practices, government intervention and insufficient central bank supervision. An increase in bank credit risk gradually leads to liquidity and solvency problems.

The quality of a loan portfolio in a bank can be affected by the change in credit risk affecting the overall performance of the bank, Sufian, (2009).

This argument was further supported by Duca and McLaughlin (1990) as cited by Owojori et al (2011), that a large scale change in bank profitability can be attributed to changes in credit risk management.

Banks that are mainly exposed to credit risk result in reduced profitability.

As long as banks are exposed to risky loans, bad or doubtful loans (otherwise called non-performing loans) tend to increase which ultimately reduce bank profitability, Miller and Noulas (1997).

IV. THEORIES THAT EXPLAIN BANK PROFITABILITY

Profitability ratios are used to measure how well a business is performing in terms of profit. In other words, profitability ratios serve to measure the success of the firm.

Chin'anga (2015) defines profitability ratios as financial metrics that assess the capacity of a business to produce income against business expenses and costs over a given period of time. These ratios are considered to be the basic financial ratios of banking institutions.

Profitability is the main concern for all businesses. If a company has a high profitability ratio compared to its competitor, it shows that this company does a better business than its competitor. A company's profitability ratios, higher or the same compared to previous periods also indicate that the company is doing well.

Nimalathasan (2008) states that improving financial performance requires improvements in the functions and activities of commercial banks.

According to Ruziqa (2013), when a bank will increase and maximize its profit, it must increase risk or decrease its operating cost.

Ongore and Kusa (2013) indicated that profit maximization is the ultimate objective of commercial banks, where all the strategies designed and activities carried out are intended to realize this major objective.

Koch and MacDonald (2000) argued that bank profitability is generally directly related to the riskiness of the bank's portfolio and its operations. As a result, banks in order to increase their return need to know which risk factors have the greatest impact on profitability that will ultimately increase the financial performance in the bank. And as we mentioned above, credit risk is the most important factor for commercial banks.

We emphasize that profitability is the main concept in this paper, since its main focus is to analyze the relationship between profitability indicators and credit risk management indicators.

Guru et al (1999) and Kosmidou et al (2005) state that the determinants of profitability of commercial banks can be grouped into two categories:

- a. Internal determinants - are those determinants that are controllable by management
- b. External determinants - are those determinants that are beyond management's control

Guru et al (1999) show that internal determinants influence the management policies of banks and the decisions they make, on the management of sources and uses of funds, the management of liquidity and capital as well as the management of expenses. They also state that this category of profitability factors can be examined from the financial statements of commercial banks.

Also Guru et al (1999) show that the external determinants are environmental and firm-specific factors.

This paper aims to provide a framework of theoretical results that test the impact of risk management on the profitability of the firm. Determinants that affect credit risk management should be included in internal policies and decisions that can be examined from financial statements.

Guru et al (1999) show the advantages of using ratios as indicators of profitability. They mention that researchers prefer to use ratios as measures of profitability since they are indexed to inflation.

It is important to identify the appropriate indicators to maintain the accuracy of hypothesis validation.

Chirwa (2003) mentions that previous studies have used indicators such as ROE (return on equity) and ROA (return on assets) as indicators of profitability.

Researchers Noman et al (2015) Kodithuwakku 2015, Funso et al 2012, Gizaw et al 2015, Fan Li and Yijun Zou (2014), Abiola and Olausi (2014), Alshatti (2015) and Kithinji (2010) in their studies on tested the impact of credit risk management on the profitability of their banking systems used the return on assets ratio (ROA) as an indicator of banking profitability.

Noman et al (2015) in their study to test the impact of credit risk on bank profitability used the ratio of net interest margin in addition to ROA and ROE indicators as indicators of profitability.

Researchers in their studies to test the impact of credit risk management on the profitability of their banking systems used the ROE ratio as an indicator of banking profitability.

Tafri et al (2009) tested the impact of financial risk on the profitability of Montenegrin commercial banks also used ROA and ROE as indicators of profitability.

Ruziqa (2013), addressed a similar topic for conventional Indonesian banks using ROE and ROA as proxies of financial performance.

Among all the metrics, ROE and ROA are the most important ones, Ongore and Kusa (2013) and Chirwa (2003).

As we see from the previous studies that we mentioned above, ROE and ROA are the most used indicators as indicators of profitability.

V. CONCLUSION

The main conclusions of the study should be summarized in a short Conclusions section. Banks, as institutions of financial intermediation, are defined as businesses that take and manage various risks. The intermediation efficiency of commercial banks is of vital importance for developing economies as it creates conditions for high economic growth, while their failure leads to economic crises. But on the other hand, the performance of this function causes different types of risks of different sizes that affect the performance of the bank. Banking risk management is the most important factor for financial stability and economic growth in developed economies. Risk management in banks means increasing the chances of success, reducing the chances of failure and limiting the uncertainty of the overall financial performance. Among the many banking risks that we mentioned, credit risk is usually identified as the biggest risk that affects a bank's performance. Since the main activity of commercial banks is the granting of loans, they are inevitably exposed to credit risk. The main causes

of serious banking problems are directly related to poor credit standards of borrowers. The increase in credit risk will increase the marginal cost of debt and equity, which translates into an increase in the cost of funds for the bank. Credit risk management techniques are generally well known because the banking sector has had a long history of experience in this area. However, credit quality problems in commercial banks are one of the most important causes affecting their failure. For this reason, all bankers should be aware of the main factors that affect the quality of a loan portfolio and the methods for its management. The existence of a sound credit risk management structure is essential for banks in order to increase profitability and ensure survival.

The main objective of any bank is to maximize shareholder value, therefore we found it important to address the impact of one of the bank's most important risks on its profitability. Profitability is the main concern of banks. Profitability ratios are used to measure how well a bank is performing in terms of profit. So profitability ratios serve to measure the success of the bank. A bank's profitability ratios, higher or the same compared to previous periods also indicate that the bank is doing well.

Credit risk and its management remains one of the most important issues for banks operating in Albania as long as lending is the main activity through which our economy is financed. This risk has been described by most researchers as the biggest risk among all other risks which affects the financial performance of banks.

Credit quality problems in commercial banks are one of the most important causes that influence their failure. For this reason, all bankers, and not only those who work in the credit risk department, should be aware of the main factors that affect the quality of a loan portfolio and the methods for its management. The existence of a sound credit risk management structure is essential for banks in order to increase profitability and ensure survival.

Banks that are mainly exposed to credit risk result in reduced profitability. Profitability indicators (ROE and ROA) are two indicators of the effectiveness of management to generate income, both from the money invested by shareholders and

from the total investments made in the form of assets. The reason that these two indicators complement each other is that while ROE does not indicate anything about the debt financing situation, ROA does, therefore both are taken in our study as proxies of bank profitability.

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