Credit Risk and Banks' Profitability in Malaysia

Norlina Kadri, Bakri Abdul Karim and Kelvin Lee Yong Ming
Faculty of Economics and Business, Universiti Malaysia Sarawak (UNIMAS), Malaysia

ABSTRACT

This paper examines the relationship between credit risk and profitability of Malaysian local commercial banks which consist of eight banks they are Maybank, CIMB Bank, Hong Leong Bank, Public Bank, RHB Bank, AmBank, Alliance Bank, and Affin Bank. For the purpose of analysis this study covers a period of eight years from 2005 to 2012. The empirical tests employed in this study are Pooled Ordinary Least Square (OLS) and Panel regression. Based on the findings of this study its shows that the non-performing loan to total loan ratio (NPL/LA) and the ratio of loan loss provision to total loan (LLP/LA) have a negative effect on profitability meanwhile the total loan to total deposit ratio (LA/TD) found to have a positive effect on the return on asset (ROA). Overall the results of this study concluded that to some degree, Malaysia's commercial banks have a very good credit risk policy.

Keywords: *Credit risk; Profitability; Banks, Malaysia*

INTRODUCTION

As a monetary institution that is crucial to the economic development by providing various financial services to the public such indicators as bank's performance will always attract the interest of the consumer public (Kolapo, Ayeni & Oke, 2012). In fact, banks play a crucial role in the operation of most economies (Demirguc-Kunt and Huizinga, 1998). A bank exists not only to accept deposits but also to grant credit facilities (loan), inevitably exposing this institution to credit risk (Kolapo et al. 2012). Credit risk or default risk is one of the key indicators to banks and economy of a country. Having mention this, there are many factors that can influence the credit risk. The most common method used by researchers to measure credit risk according to Chen & Pan (2012) was calculating the financial ratios and non-performing loan to total loans. Non-performing loan to total loan ratio can be calculated by dividing non-performing loan with total loan.

It is crucial for a financial institution to maintain its credit risk at a lower level and be able to manage its credit risk in order to avoid the damaging effect of credit risk to the financial institution profitability. Lesson learned from the collapsed of Lehman Brother due to the 2008 mortgage crisis caused by an extremely high level of default risk in mortgage loan or Mortgage Backed Securities (MBS).

There are rather limited studies examining the relationship between credit risk and banks' profitability particularly in emerging markets. Studies by–Cerci, Kandir, and Onal (1997), Aduda and Gitonga (2011), Kolapo et al. (2012), Nawaz et al. (2012), Boahene et al(2012); Poudel (2012), Syafri (2012), Sufian and Noor (2012), Berríos (2013) , Abbas et al (2014) and Abiola and Olausi (2014) are worth highlighting. From the findings of studies, their studies indicated mixed results. For example, Kolapo et al. (2012) and Nawaz et al. (2012) Findings indicated that the non-performing loan to loan & advances (NPL/LA) and loan loss provision to total loan Have a negative effect on profitability (ROA) of banks in Nigeria. In addition, Aduda and Gitonga (2011) also find a negative relationship between credit risk management and profitability in commercial banks in Kenya. On the contrary, Boahene, Dasah and Agyei (2012) Findings showed that the credit risk have a positive and significant relationship with the profitability performance (ROE) of the banks. The results are also consistent with Abiola and Olausi (2014) study that discovered the credit risk positively affected the profitability (ROA) of the commercial