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PROFITABILITY AND RISK IN RELATION TO CREDIT MONITORING AND RECOVERY STRATEGIES OF PALESTINIAN COMMERCIAL BANKING SYSTEM

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Abstract

Purpose of Study: This study implemented an empirical investigation for the relationship between credit risk management and profitability of commercial banks in Palestine over the period of 3years (2015-2018), ten commercial banks were selected.

Methodology: The financial theory was employed to create the research model; Return on Asset (ROA) is defined as proxies of profitability while credit monitoring (LLPI) is defined as proxies of credit risk management. Panel model analysis was used to estimate the determination of the profit function.

Results: Statistical results revealed that the relationship between the credit monitoring and commercial banks profitability is negative significant ($\beta = -3.419$, $P < 0.05$). Therefore, the results improve that LLPI has a significant effect on Palestinian commercial banks profitability's.

Keywords: *Commercial banks, Credit risk management, Credit monitoring, Profitability*

INTRODUCTION

Credit risk is the kind of risks that bears losses due to the unexpected damage that is seen in the creditworthiness of counterparties. Otherwise, credit or the other party risk belongs to the opportunity that a borrower of the source of a financial instrument from the side of the country, a company, or an individual will not be able to repay the principal and the investment- related cash flow related to the conditions, terms, and obligations determined in a credit agreement (Bessis, 2009; Muzurura, 2018).

When banks' loans are always good, they are not considered to be in the market. In case of abrupt borrower's defaults on interpolation their loans or suddenly stop their repayments, results were the present's values of the asset declines. Banks' managers should undermine losses from loans default and keep it the less degree since it's paid with relation to the property. If the borrower default risks do not be little, this immediately drives to bad bank bankruptcy. Method banks could go through to deviate from "credit risk" by selecting assets which has less hypothetical gain but opposes the main goal of banks which is gain profit and maximize revenues. If the financial institution has some mediums to partial loans quality on its books consequently credit risk will boost. Therefore, an appropriate management of credit risk is usually seen as a fundamental constituent of the prosperity of the financial institution. Thomas *et al.* (2014) has mentioned that the establishment of credit is the essential income which formulates the banks' activities. If the opportunity of fronting credit risk is increased, there would be a trend to have a financial crisis too. Such crisis will lead to have a serious influence on the economy and especially if the central bank and the authority of supervision do not have the ability to stop and outline the causes of the problem. One essential income for banks is the interest put on the loans given to the clients.

The Palestinian sector of banking is considered as one of the most important means of the Palestinian economic stability as it is one of the significant components of the system of finance. In addition, it is a very important funding resource which helps the private and public areas. Several shocks and risks which could be summarized as follows; The Palestinian banking sector is very well-organized and capitalized; however, there is a little exposure to international markets. Credit facilities granted to public sector employees and the risk of default are increased. This is considered as an indicator in either the disability of the government to pay its obligation regularly. Because of that, to have a strong and firm framework of credit risk management there will be an increase product and customer profitability, improve banks collection rates, reduce net bad debt and operating cost, as well as decrease receivables carrying cost and enhance customer management processes.

Thus, a perfect credit risk management is always seen a fundamental component of the prosperity of the banks. The current study tries to see and answer the significant impact which affects profitability of the Palestinian commercial banks due to credit risk management particularly by suitable credit monitoring and recovery strategies. The pre-mentioned problem and objective of this study generated the following question to what extent does credit monitoring affect Palestinian commercial banks profitability.

BANKS CREDIT MONITORING AND RECOVERY STRATEGIES

Monitoring credit comes after having paying the loans. The main aim of the credit monitoring is confirming the exact indicator for any expected alterations with regard to the repayment abilities of borrowers to repay the credit funds and in

addition their financial position. Credit monitoring are using measure to make sure that the present financial condition of the borrower and the counterparty is understood by the bank and thus confirming that the current period is in subjection with regard to all credits. This will surely lead to follow the use made by the customer in a way of approving the credit lines and thus assuring that the debt servicing requirements are in docility with the cash flow on major credits and also confirming that collateral provides sufficient coverage relative (Seppala, 2000; Mustafa *et al.*, 2017). Good supervision can lead to lessen lots of agonies and frustrations of slow and distresses credits since good supervision helps in keeping a good loan to be good. Discovering and visiting the premises of the borrowers is a good way when investigating the state of affairs.

The process of credit monitoring includes on-site visit, check for compliance with covenants in the loan agreements and regular contact. Since its growth is non-stoppable, bank debt recovery assumes an alarming trend (Montana, 2012). The poor economy which affects both consumers and markets around the world is the reason behind such growth. In a way of enhancing their debt recovery and or collection, banks are devising updated techniques and strategies. Some measures are included in an effective monitoring system to ensure that the current financial condition of the borrower and counterparty is understood by the bank, to make sure that the existing covenant is in subjugation with all credits, to follow the use customers make of approved credit lines, to confirm that debt servicing requirements are in compliance with cash flow on major credits, and to ensure that where applicable, collateral provides adequate coverage relative. It is the obligors' condition and identity to classify potential problem credits on timely basis. Greuning and Bratanovic (2009) state that the credit risk's problem starts at the supplication stage of the loan and it witness an increase at the approval of the loan, the supervision and the control stages and in particular when credit risk management guidelines are in terms of policy and strategic procedures because credit processing do not exist, are weak or incomplete.

In order to create trends and monitor the individual credits, it is important to use computers and risk management. Since they are useful in credit analysis, monitor and control, computers are important as they make it easy to keep track on trends of credit within a portfolio, Donaldson (1994). Therefore, in Basel Committee on Banking Supervision (1999) it is important for banks to build and develop comprehensive strategies and information systems so that they monitor the condition of individual credits and single, obligors across banks. The strategies have to define criteria to identify and report expected problem credits and other transactions to confirm that they are subject to more frequent monitoring as well as possible correction actions classification and or provisioning. Koford and Tschoegl (1997) argued that high quality credit risk management staff are critical to show and confirm that the depth of knowledge and judgment needed is always available and thus successfully managing the credit risks in the commercial banks.

A well-known and important saying in the literature confirms that reverse selection and stimulant effects mostly happen once imperfect and asymmetric information in the credit market exist. In this line, it has been stated by Stiglitz and Weiss (1981) that the rate of interest will not let the lender to differentiate between several types of borrowers. Thus, it is crucial to observe the borrowers so that the possibility of repaying the loans is declined (see also Stiglitz and Weiss (1981)).

Unsymmetrical problems in information significantly occur when banks deal with small and medium sized enterprises because of the high capacity of the latter (Berger *et al.*, 2001; Beck *et al.*, 2004; Nasir *et al.*, 2018). Banks, and in spite of the degree of asymmetric information, they may have differences in the ability and incentives to screen and monitor borrowers. It should firstly be mentioned that there is spacious literature which documents that the size of the bank can influence its lending technology (Stein, 2002). In assessing borrowers and investment projects, the large banks depend more on hard information such as the information that report that the loan officer delivers into his superiors: the company's income statements, balance sheet, credit rating and the like. Large banks depend more on screening and thus screened-based lending is likely to reduce credit rationing of big and more transparent firms. By contrary, small size banks have a comparative point in the soft information area i.e. information that is collected by individuals (Berger and Udell, 2006). Therefore, large banks have an advantage point which is the screening techniques, however, small ones may use relationship lending to get exact information on borrowers, and the prediction on the effects of bank size on credit rationing to SMEs is not clear-cut.

LITERATURE REVIEW

Ekanayake and Fernando (2015) used twelve Sri Lanka commercial banks as sample and find that local private commercial banks implement loan loss provisions to facilitate banks income on the other hand the public banks sectors are not following the similar procedures. Findings revealed that there is an adverse relationship between the high level of banks loan growth and the trouble loans level. In 2014; author Kimathi. Study the loan loss provisioning on Nairobi banks profitability for a period of four years from 2010 to 2013. His study results confirmed that a negative relationship between loan loss provision and profitability was exists.

Ahmad *et al.* (2015) used regression analysis model the finding shows that there is a positive significant relationship the loan loss provision and banks profitability. Ahmad *et al.* (2015) argue that a well-established bank is required to be gaining less loan loss provision and higher profitability furthermore the essential role of banks advances and its deposits in the stability level and profitability in Pakistani banks. The finding shows a negative relationship between loan loss provision and banks profitability. So, to operate duly in any economic circumstances the banks should have at least minimum or zero loan loss provision which increase and ensure the national financial stability.

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Hurka (2017) point outed that the loan loss provisioning level should work on reflecting the bank management beliefs on their loan portfolio quality that they operating in it, in addition banks provisions duty is to cover total foreseeable credit losses exactly as they believe that the provisions as a proxy to measure the accurate level of credit risk. In his paper he used thirteen banks to investigate the credit risk management in Nordic commercial banks and its impact on profitability from 2000-2015. Findings showed that loan loss provision was negative significant for both of the profitability measures return on assets and return on equity. Researcher concludes that there is a possibility indicates that LLP may not by the accurate and exact indicator to measure credit risk management.

Broadly, there are several important aspects that researchers on loan loss provision focus on such as Curcio and Hasan (2015); Kilic *et al.* (2012); Bonin and Kosak (2013) they wrote in the first aspect which is the relation between LLP and bank capital. Literature usually investigates whether banks raise LLPs when they suffering from inadequate equity capital to play the compensate role for banks low equity capital level. On the other hand, banks adjust the LLP size to confront the capital regulation exactly the minimum level. In addition, whether bank practitioners possibly report about abnormal loan loss provision predestined in both of the anticipation of high future earning and high non-performing loans. Definitely they also can report about abnormal loan loss provision to manage and mitigate banks prospect losses which generate from customer loyalty loss. Besides that, researchers focused on the bank's loan loss provision behavior in the period of macroeconomic condition fluctuating.

During the period of recession banks managers takes the action of increasing loan loss provision and reducing lending activities. Consequently, this action will affect banks negatively and reducing its net interest margin and definitely reducing banks total profit and damaging the banks situation during the recession. Furthermore, some researchers studied the relationship between loan loss provision and income smoothing and argued that these relations still the most complicated debated area in loan loss provision analysis (Curcio and Hasan, 2015; Ozili, 2017).

A comparison between conventional banks and Islamic banks in Bangladesh (Farook *et al.*, 2014) state that Islamic banks record lower loan loss provision comparative to conventional banks. Furthermore, both of advance audit quality and robust investor's protection lead to constrain the income smoothing extension. Whilst, ownership structure for banks can create additional oversight to impede banks income smoothing (Bouvatier *et al.*, 2014; Nazal, 2017). Finally, Bouvatier *et al.* (2014) point out that, countries with robust banking regulation and supervision are reducing income smoothing.

Financial performance researches wondering whether income smoothing consider ethical or not this totally depend on banks motivation. It considers ethical when banks managers trying to protect their investments, managers and owner's information asymmetry decreasing, to establish stability in the banking system by smoothing out abnormal volatility in reported earnings, to increase risk comprehension between bondholders and banks supervisors (El Sood, 2012; Negrut, 2017). Other researchers like (Leventis *et al.*, 2011; Ahmed *et al.*, 2013) argued that bank income smoothing in some situation considers unethical especially when banks do these following actions: avoiding taxes and develop terms of trade, seek for a fixed dividend pay-out ratio and increase the ambiguity of bank financial reporting.

RESEARCH METHODOLOGY

Credit risk is the most important risk and comes with several economic impacts in the banking sector, it is very critical to determine the relation and the influence of credit with or on profitability of the bank. The theory of banking outlines 6 fundamental risks that have relations with the credit policy of the bank. The risks are "credit risk, credit deficiency risk, operating risk, portfolio risk, interest risk, and trade union risk." Credit risk is the most important one amongst such risks and it asks for special attention as mentioned by Bhattacharya and Thakor (1993). To meet the objectives of the study, a quantitative approach has been used. Secondary data analysis was used to get a full comprehension of the level of activities of lending, operations, and performance of the commercial banks under investigation in the study for the sake of the customers. Thus, it is directed to answer the research questions. Ratio analysis has been employed within the period of the study and this is why the researcher utilised regression analysis model in his analysis of the gathered data from the Palestinian commercial banks' annual reports. Thus, an analysis has been done and there were answers with regard to the research questions have been revealed; this is done based on the regression analysis' output and the results taken from the research questions.

The current hypotheses if there is an effect from the credit risk policies " credit monitoring" on the profitability of the Palestinian commercial banks. In the study, 10 banks were under investigation. The period we aimed to examine was from 2015-2017 this because of this period of time the Palestinian banking sector witnessed a financial challenge affected the bank's profitability. The study theoretical framework is in accordance to the literature review mentioned and shown in the following diagram (Figure 1). It manifests the dependent variable profitability measures (ROA) and the explanatory variable (credit risk policies "Credit Monitoring"). In order to get answers for the relationship between credit risk policies and the profitability of 10 commercial banks in Palestine from the year 2015 to 2017, we used the regression analysis. The current study attempts to examine the following hypothesis:

H_1: there is no significant relationship between credit monitoring and the Palestinian commercial banks' profitability.

We used the SPSS for the following aims: Multiple Linear Regression: it was employed because in the study we had many independent variables. F-Test: it was utilized to investigate the suitability of the model as a complete untie. The Variance

Inflation Factor: it aimed at investigating the overlap between the independent variable. Durbin-Watson Test: statistics is considered the ratio of total of squares of sequential variation of what is left to the total of errors of squares.

Commercial banks working in Palestinian territories have been selected for achieving the purpose of this study. The Palestinian banking sector consists of 2 Islamic banks and 10 conventional banks. While, two Islamic banks and other mortgage banks have been exempted from this study. 10 banks in Palestine were the samples of the study; you may have a look at table (1). This data covers a period of seven years from 2015-2017 and the sample period started from 2015.

The fact behind this current study is the great willing to conduct the analysis to adapt with the future attempts of the Palestinian monetary authority of reaching the level of significant credit risk management practices which is to reach the level of sustainability of the banking sector that is considered the main priority for the Palestinian monetary authority, thus contributing to the economic well-being of the Palestinian society. Those data covered three years, and regression analysis is the implemented method to analysis the sample data.

Table 1: Banks Sample for the Year 2015 Till 2018 in USD Millions

Number	***Bank Names***
1	Arab Bank
2	Bank of Palestine
3	Cairo Amman Bank
4	Bank of Jordan
5	Quds Bank
6	The National Bank
7	Palestine Trade and investment Bank
8	Jordan Ahli Bank
9	Jordan Commercial Bank
10	Jordan Kuwait Bank
Excluded Banks	
11	Arabic Islamic Bank
12	Palestine Islamic Bank
13	Housing Bank
14	Egyptian Arab Land Bank
15	HSBC

Source: Association of Banks in Palestine, (2018)

RESULTS AND DISCUSSION:

Trend Analysis for both of Return on Assets (ROA) and Credit Monitoring (LLPI)

Return on assets (ROA) is a ratio that measures the comprehensive efficiency of the organization in managing its investment in assets, also it does indicate the earned profit amount relative to the total assets investment level (Heikal *et al.*, 2014). Return on assets can be readily calculated by the following formula. It's useful for the purpose of comparison between companies in the same industry. It shows the management efficiency in the stage of income generating. ROA net profit is the profit after tax. ***Return on Asset = Net profit / Total Asset***. To have a good performance, banks must have more than 1.5% return on assets and this is clarified by the banks' international standard performance. With respect to the ten measured banks, the ROA profitability measurement's mean score percentage seen to be 0.67,0.79 and 0.78% Accordingly, this explains that the ten banks' performance did not fit the international standards of profitability and even was higher than those standards.

Such deterioration in the profitability rate in 2015 till 2017 resulted from having an unstable condition in Palestine that caused different kinds of problems as restrictions on movement, increase of inflation rate and the GDP in Israel which is the main trading partner with Palestine which slowed down because of the financial crisis and therefore, trade and employment in Palestine were negatively affected. While, Credit Monitoring (LLPI): it is a ratio that measures the banks credit quality; it could explain by having high credit quality when the ration number is low. Its shows the bank's loan portfolio quality and, therefore, it can be used as a proxy of credit risk. It has been used as an independent variable in many previous studies like: (Bonin and Kosak, 2013; Ahmad *et al.*, 2015; Ekanayake and Fernando, 2015; Hurka, 2017). ***LLPI = Loan Loss Provisions / Net Interest Income.*** The findings reveal that the loan loss provisions are around 11.9% of net interest income. This indicates that it revolves with regard to the standards of the industry.

Table 2: trend analysis explains the ROA and LLPI Mean Scores.

Mean	2015	2016	2017
ROA	0.67%	0.79%	0.78%
LLPI	3.85%	4.16%	3.98%

Correlation Matrix

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With regard to the independent variable, the dependent variable (ROA) the ratio of the banks' profitability, the correlation of such things has been tested using "pearson correlation test". The findings revealed that: Using "LLPI" ratio, a negative correlation has been seen with regard to ROA and credit monitoring. This shows that if LLPI leads to decrease the profitability, ROA gets decreased as (-.278).

Table 3: Statistical finding figures

Variable	Coefficients β	Std. Error	Significant-Statistic	
Constant	2.084	.472	0.000	
ROA	0.059	0.255	0.819	
LLPI	-3.419	1.248	0.026	
R2 **Adjusted R2**	**0.009** **0.064 -**		**F-statistics** **Coefficients (Sig)** **Durbin- Watson** **VIF**	**0125.** **0.000** **1.458** **1.084**

Goodness-of Fit Tests:

According to F-distribution table, the F distribution critical value is seen as 2.545 when the significant was 5%. The F statistic value in table (3) is seen as .125 which is less than the critical value of F (2.545). In this sense, the regression as a whole unite is insignificant. This indicates that ROA is not predicted by LLPI. In addition, the significance is .883. It also shows that there is a kind of a statistical insignificance among them. Hence, with respect to the F value, there seems to be an insignificant relationship between the profitability which has been measured by ROA and credit risk management that was measured by the ratios of LLPI.

The statistic test of Durbin- Watson (DW) states that the errors found in the regression model are produced by the process of first order autoregressive. It demonstrates the total of squares of sequential differences of residuals with regard to the total of errors squares.

Multicollinearity Test:

Each of the independent variable witnessed allowance value that is more than 0.1 when the ROA model variance inflation factors were analyzed. The findings revealed that in all values there was a VIF which was less than 10. This demonstrates that Multicollinearity is not seen as a problem once the explanatory variables where chosen which were used to enhance the expected model in the logistic regression analysis. They were also selected to legitimize the prof mentioned in correlation matrix (see table 3). In a way of evaluating the independent variable significance with regard to the ROA as a dependent variable, we may refer to table 0000 in which we see the t-test with significant factors.

Linear Regression Analysis:

An important goal of multiple linear regression that investigates if the level of relationship of independent and dependent variables is strong or not is investigating the familiarity level, assumptions, flexibility and uses multiple independent variables, with each controlling for the other. The current subset reveals the findings of linear regression analysis related to the model and such findings will be talked about in one part depending on the one independent variables which have been measured by the financial ratios of the commercial banks in Palestine. The bank's ratio credit monitoring which is the Loan Loss Provisions to Net interest income ratio (LLPI) is shown by the table 3 results to have negative relation to (ROA), the profitability measurement. It, LLPI, in addition has a negative effect on ROA with a β coefficient of -3.419%. Such result means that if one unit in LLPI increases, ROA will decrease by 34.19% unites. The LLPI statistical significance is seen as .026. This result is lower than 0.05 which is the significant relationship. The findings are in line with previous results such as. As a result, the null hypothesis is rejected and the alternative hypothesis is accepted.

H2: There is significant relationship between credit monitoring and Palestinian commercial banks profitability.

CONCLUSION AND POLICY IMPLICATIONS

The goal of credit monitoring process is confirming the exact and accurate detector with regard to any expected alternations in relations with the repayment abilities of the credit fund and financial position of the borrower. The founded negative relations occur between credit monitoring and profitability reveal that Palestinian commercial banks credit quality and its loan portfolio are strong. The less loan loss provision provides more safety and profitability in the banking sector and allows it to operate properly under any economic condition. Minimum or zero loan loss provision provides financial stability. Also, it increases the ability of the Palestinian banks mangers to manage the level of the earning volatility and reduce risk-weighted assets fluctuations which in turn affect banks profitability. In addition, it provides them with information regarding banks future.

Furthermore, the results show that Palestinian credit officers are qualified to monitor and evaluate potential and unexpected circumstances which could affect borrower's credit strength. In addition to this, they have efficient ability to screen and monitor borrowers through monitoring the flow of the borrower's business accounts and financial reports. Since the credit monitoring management seemed to give a negative significance in relation to the profitability of banks, there are

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possibilities for these banks to improve profitability by ensuring the accurate determine for any potential changes regarding borrower's repayment abilities of the credit funds also their financial position.

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