Impact of Risk Management on Non-Performing Loans and Profitability of Banking Sector of Pakistan

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Abstract

The aim of this study is to investigate the impact of risk management on non- performing loan and profitability of banking sector of Pakistan. Five banks were selected for data collection and whole data was secondary in nature. The result of this study reveals that there is no proper mechanism for risk management in banking sector of Pakistan. Study also concluded that non-performing loans are increasing due to lack of risk management which threatens the profitability of banks. This study provides suggestion that banking sector can avoid their non-performing loans by adopting methods suggested by state bank of Pakistan.

Keywords: Risk management, Non-performing loans, profitability and commercial banks.

1. Introduction

Risks in financial services are larger in scope and scale than ever before. Along with revenue maximization and operational cost minimization, risk management has moved to center stage in defining superior performance. Differences in risk management philosophy and technique can produce prosperity, mediocrity, or failure. No senior management of today's financial institutions can perform its function without a vastly expanded understanding of the dimensions of risk and the various tools to manage it. Banks are in the business of risk. Many of these risks are of a traditional sort: credit risk, interest rate risk, liquidity risk. However, numerous risks are more recent, such as regulatory risk, currency risk, and human resources risk. The past couple of decades have seen dramatic losses, in the global as well as local, banking industry.

Firms that had been performing well suddenly announced large losses due to credit exposures that turned sour, interest rate positions taken, or derivative exposures that may or may not have been assumed to hedge balance sheet risk. In response to this, banks have almost universally embarked upon an upgrading of their risk management and control systems.

Banking sector have been delivering services to consumers and businesses remotely for years. Continuing innovation and competition among banking sector and new market entrants has allowed for a much wider array of banking products and services for retail and wholesale banking customers. These include traditional activities such as accessing financial information, obtaining loans and opening deposit accounts, as well as relatively new products and services such as electronic bill payment services, personalized financial “portals,” account aggregation and business-to-business market places and exchanges. During this many problems arises in Banking sectors, one of the major problem is customer fail to return loan and resultantly they become Non Performing. This may include the capacity to pay and intention to pay, banks have to verify it prior approval of loans through their procedures of risk management that a customer may have the capacity to repay the loan in future or it went to default.

The State Bank of Pakistan brings its best effort to improve risk management continuously to address reduce the Non Performing Loans, one of the major problem of banks as it hampering the profitability.

However, some managers have reacted to this daunting task of Risk Management, by pulling back from risk. They decline to accept transactions where the risk is significant (i.e. long-term, fixed-rate loans) or they transfer risk (e.g., hedging). While these techniques have an important place in the risk management process, they can also compromise a financial institution's value through excessive risk avoidance. Placing the firm at the appropriate point between excessive risk acceptance and avoidance is what has separated the winners from the losers.

Nonetheless, the overwhelming majority of the risks facing the banking firm are in their on-balance-sheet businesses. It is here that the discussion of risk management and the necessary procedures for risk management and control, developed in the recent past, has centered.

Significance

Risk management is recognized in today’s business world as an integral part of good management practice. In its broadest sense, it entails the systematic application of management policies, procedures and practices to the tasks of identifying, analyzing, assessing, treating and monitoring risk.

Financial institutions are exposed to various risks in pursuit of their business objectives; the nature and complexity of which has changed rapidly over time. The failure to adequately manage these risks exposes financial institutions not only hampering the profitability as their earnings are converting in to bad debts but also increasing interest rate and causing economic slowdown, ultimately rendered them unsuccessful in achieving their strategic business objectives. In the worst case, inadequate risk management may result in circumstances so catastrophic in nature that financial institutions cannot remain in business.

Since the risk management procedures and policies are still in the nascent stage in Pakistani banking sector, so this study would be a useful contribution for the industry to better understand risk management and will provide prolific observations for understanding risk management practices in an organization and strive seriously to tackle the problem of loan recovery and tighten their credit assessment scrutiny policy and arrange appropriate monitoring procedure in order to keep an eye on NPLs. It is a fact that NPLs are steadily causing lesser profitability of banking sector, as the spread of banks is shrinking due to the lower recovery of loans and decreasing yield on lending.

Research Objectives

- There is a global recognition towards need of an effective risk management and control systems in financial sector, the objective is to prepare comprehensive Risk Management procedures for the bank/DFIs that would help them to avoid disastrous crisis and to examine the process of Risk Management as it is practiced by banks in Pakistan and to figure out there short comings.
- In the past this improper risk management has deteriorated the banks performance in the form of Non Performing loans and other financial crisis. The non-performing loans (NPL), showing an increasing trend. So it would be intended to device a strategy for the management of such catastrophic risks.

Another objective is to contribute to the already scarce research in the area of risk management in Pakistan. The objective is to pave way for the coming researchers in this area.

2. *Previous Research*

Any definition of risk is likely to carry an element of subjectivity, depending upon the nature of the risk and to what it is applied. As such there is no all encompassing definition of risk. Chicken & Posner (1998) acknowledge this, and provide their interpretation of what a risk constituents:

Risk = Hazard x Exposure

They define hazard as "... the way in which a thing or situation can cause harm," and exposure as "... the extent to which the likely recipient of the harm can be influenced by the hazard". Harm is taken to imply injury, damage, loss of performance and finances, whilst exposure imbues the notions of frequency and probability. It can be argued that hazard is not the "... way in which ..."rather it is the 'thing' itself.

The Royal Society (1983) view risk as the probability "… that a particular adverse event occurs during a stated period of time, or results from a particular challenge." The Royal Society also states that "as a probability in the sense of statistical theory risk obeys all the formal laws of combining probabilities".

According to the definition provided by SBP (2004) financial risk in banking organization may be defined as "possibility that the outcome of an action or event could bring up adverse impacts".

Regardless of the sophistication of the measure, banks often distinguish between expected and unexpected losses.

- **Expected losses** are those that the bank knows with reasonable certainty will occur (***e.g.***, the expected default rate of corporate loan portfolio or credit card portfolio) and are typically reserved for in some manner.
- **Unexpected losses** are those associated with unforeseen events (e.g. losses resulting from sanctions imposed in the aftermath of nuclear tests). Banks rely on their capital as a buffer to absorb such losses.

According to the banking regulation and supervision board of Turkey (2005), risk may be defined as "The probability of decrease in economic benefit due to a monetary loss or an unexpected expense or loss occurred concerning a transaction"

It further subdivided into two categories;

- **Controllable risks:** Risks where the probability of a loss that may be incurred by the bank can be mitigated by using risk mitigation techniques or imposing limits to transactions that may generate risk;
- **Uncontrollable risks:** depending on the variability of controllable risks over time, Risks of loss which cannot be predicted by using any risk measurement and mitigation techniques or by implementing exposure limits, and which is realized when emerge;

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, and systems of from external events (Basel Committee on Banking Supervision, 2003). Operating risks can have major on other risks (e.g. Mittelstaedt, 2005).

Liquidity risk arises when banks meet obligations of deposit withdrawals or banks wants to take advantage of profitable opportunities that cannot support the existing liability base. Credit risk is the possibility that loan payments may not be made in time or loan principal may not be fully recovered in case of default. Credit risk is measured by the percentage of nonperforming loans to total loans (Julie A. Dolam and Robert N. Collender, 2001).

Market risk is defined as the impact that movements in market traded variables can have on the economic value of the bank (Basel I, 1996).

Risk management is the systematic use of organization-wide processes of identify, assess, manage, and monitor risks such that aggregated information can be used to protect, release, and create value (The European Foundation for quality management, 2005).

Risk Management, the acceptance and management of risk is inherent to the business of banking and banks' roles as financial intermediaries. Risk management as commonly perceived does not mean minimizing risk; rather the goal of risk management is to optimize risk-reward trade –off (Roger Williams and Boundewijn et al, 2006).

Banks Managing These Risks, in every financial institution, risk management activities broadly take place at strategic level, macro level and micro level, according to standard economic theory, managers of value maximizing firms ought to maximize expected profit without regard to the variability around its expected value. However, there is now a growing literature on the reasons for active risk management including the work of Stulz (1984), Smith, Smithson and Wolford (1990), and Froot, Sharfstein and Stein (1993) to name but a few of the more notable contributions.

Non Performing Loan (NPL) provisions are regarded as a controlling mechanism over expected loan losses. Previous practices shown that provisions are triggered by default incidents on loans, higher level of non-performing loans are associated with high rates of provisioning (Hasan and Wall, 2004).

Banking Profitability may also reflect the risk taking behavior of managers. Banks with high profitability are less pressured to revenue creation and thus less constrained to engage in risk credit offerings. At the same time, inefficient banks are more likely to experience high level of problem loans. Poor management can imply weak monitoring for both operating costs and credit quality of customers, which will include high levels of capital losses. Under this "bad management" hypothesis advances by Berger and DeYoung (1997), mangers lack competencies to effectively assess and control risks incurred when lending to new customers.

Godlewski (2004) is using the adjusted ROA as a proxy for performance, shows that banks profitability negatively impacts the level of non performing loans ratio. Garciya-Marco and Robels-Fernendz (2007) found that profit maximizing policies will be accompanied by higher level of risk.

The acceptance and management of financial risk is inherent to the business of banking and banks' roles as financial intermediaries. Risk management as commonly perceived does not mean minimizing risk; rather the goal of risk management is to optimize risk-reward trade-off. Notwithstanding the fact that banks are in the business of taking risk, it should be recognized that an institution need not engage in business in a manner that unnecessarily imposes risk upon it: nor it should absorb risk that can be transferred to other participants. Rather it should accept those risks that are uniquely part of the array of bank's services. An important aspect regarding various risk categories is their correlation. On the other hand tightening of the risk management process and arrange appropriate monitoring procedure for financing against high risk securities and projects and keep an eye on NPLs.

Risk Management → Banking Sector

Risk is inherent to the business of banking and banks' roles as financial intermediaries as it take deposits and lends it to others so to tackle the problem of loan recovery they must have a strict policy for lending.

Risk Management
- Market Risk
- Credit Risk
- Liquidity Risk
- Operational Risk

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Banking Sector
- NPL
- Profitability

Risk inherent to the business of banking and it exposes to various risks. Major risks faces by Pakistani Banks are Market Risk, Credit Risk, Liquidity Risk and Operational Risk.
Whereas problems in loan recovery arises the failure to return loan and resultantly they become Non Performing and hence causing lesser profitability.

3. Research Methodology

Sample

For the purpose of the study a sample of banks has been taken. Five banks was taken for this study Habib Bank Limited, United Bank Limited, Askari Commercial Bank Limited, Alfalah Bank Limited Summit Bank Limited (Formerly Arif Habib Bank Limited).

Source of Data:

The main Sources for data collection are

- Audited annual report and accounts
- Other statutory statements
- Prospectuses
- Economics publications
- Central Bank Publications
- Press Cuttings
- World Wide Web
- Books and other Publications.
- Interviews / Questionnaires.

Data Analysis Procedure:

Data is analyzed in five steps:

First the profile is prepared from various publications and internet.

Secondly, the relevant information was gathered through Questionnaires.

Third, the data gained in the first two steps was summarized and compiled.

Fourth, data was analyzed to study the Risk management as practiced in banks and variation of NPL & Profitability through Bar & Pie Chart analysis.

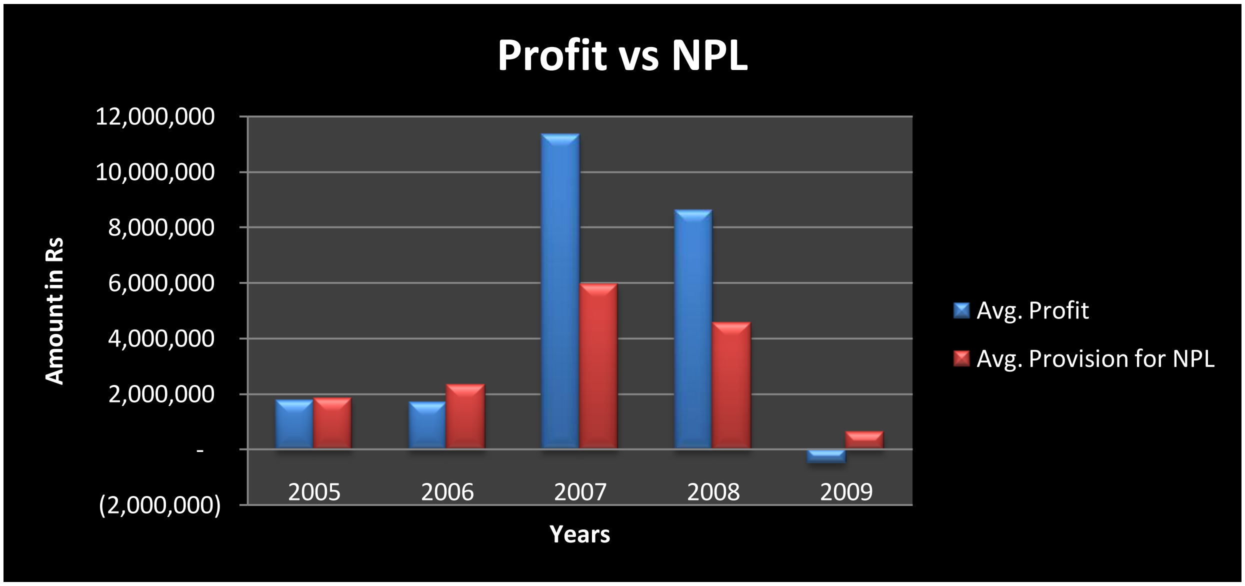
Finally on findings conclusion will be given.

4. Findings and Conclusion

Risk Management at Banks

Banks does not have a separate Risk Management department. The main responsibility of risk management rests with the credit administration department, which takes into account Credit Risk, Market Risk. As far as the credit risk is concerned main emphasis is to manage default by the customer. Further more, in Market Risk the bank considers Industry Risk, Political risk, Economic risk, and International trade risk. In managing market Risk the bank caters for the changes in market conditions adversely affecting the client and the bank.

The banks do have a risk committee, which comprises of members from Audit and Credit department. However, the banks do not have any Chief Risk Officer or personnel having the responsibilities of Chief Risk Officer. There is no formal risk management training given the employees, but the banks hires Management Training Officer which are rotated through various departments of the bank to better understand the various functions of the banks. As far as the current scenario of excess liquidity is concerned, the bank is also trying to introduce new products to entice investments. The bank follows all the prudential requirements of State Bank for risk management. Future steps for risk management to be taken by the banks are dependent on the SBP regulations and the bank intends to rely on the guidelines provided by SBP in this regard.



The figure shows the as the risk management in banks is improving but it adversely effects the profitability behavior, however, despite best efforts of respective banks and regulatory bodies including State Bank of Pakistan, the amount of NPLs continues to grow. NPL is also creating pressure on the banking sector for revenue creation.

Risk Management Techniques

Following are the various Risk Management Techniques out lined by SBP in its BSD Circular No.07, dated 15 August 2008.

- The Gap Analysis
- Measuring Risk to Net Interest Income (NII)
- Measure of risk to Economic Value
- Full Valuation Approach
- Duration
- Convexity
- Value at Risk

Analysis

Risk Management Techniques

The major risks to which the financial institutions can be exposed are credit, market, liquidity, and operational risks. Analysis for identification, measurement, monitoring, and controlling of these risks as practiced in Pakistani banks is given by State Bank of Pakistan. During the year 2008 some major amendments were made in the banking laws which gave autonomy to the State Bank in the area of banking supervision. Under Section 40(A) of the Banking Companies Ordinance, 1962 it is the responsibility of State Bank to systematically monitor the performance of every banking company to ensure its compliance with the statutory criteria, and banking rules & regulations.

Managing Excess Liquidity and Profitability

As a result of various Geo-political and Economic changes and rising inflows of remittances there is an excess supply of loan able funds at the disposal of the banking system.

To manage this, banks have embarked on aggressive marketing to sell their loans. The beneficiaries of this excess supply of funds are the well established corporate sector firms which are able to obtain credit at very thin margins, thus squeezing the profitability of the banking system.

Pakistani banks, which once shunned small borrowers and invested in government debt for high yields, are now eyeing low- and middle-income customers to stay profitable.

The sea change in the banking sector has come just as banks are finding it increasingly difficult to make good profits on traditional staples such as Government Treasury bills and Pakistan Investment Bonds. Yields on such instruments have tumbled in the past year.

The old style of banking, in which banks invested in Government-Guaranteed paper and relaxed, is now over. Government borrowing has reduced. It is pumping in money into a market flush with liquidity.

Now banks are flooding the market with schemes aimed at wooing small borrowers.

The central bank, meanwhile, is pushing banks to offer small loans in the agriculture sector, where 80 percent of Pakistan's workforce is employed. Special focus is also on SME's for giving loans.

Banks' Write-Offs

The banks are in the business of risk taking and there are occasions when economic shocks or business cycles or frequent changes in government policies do turn some of their assets sour. Until and unless there is no personal motive of the bankers or any political pressure, the write-off of irrecoverable loans and cleaning up of their balance sheets is the normal practice of the banks all over the world.

Pakistani banks have also taken action, like other banks, to write-off loans and waive off charges on the basis of transparent criteria and policy guidelines. The only exception is that willful defaulters are taken to task and made to pay their liabilities. Legal action is taken against them and their cases are referred to National Accountability Bureau (NAB). But there are legitimate businessmen and individual borrowers who have been victims of circumstances such as business down turn, erratic government policies of tax and tariff, abrupt changes in regulatory environment as well as business misjudgments, etc. They may not be in a position to continue making payments according to the original contractual agreements under the changed circumstances. Both parties – the banks and borrowers – are better off if they take timely action to restructure the loans and turn them into a performing contract. In doing so, the banks may have to waive off i.e. write-off some accrued charges and/or take a partial discount on the principal. The upside, however, is that the quality of restructured asset gets upgraded. The borrower will then be in a position to operate the unit and generate cash flow to service liabilities.

Therefore, write-offs are in essence recognition of reality – that the original asset has diminished in value and therefore, it needs to be carried on the balance sheet at its realistic value. For many years, the banks were carrying huge non-performing assets but were not recognizing this value erosion. It should also be noted that a write-off represents an accounting entry recognizing that a loan has become un-collectable but does not in any way impair a bank's ability to take action against a borrower in case assets belonging to the borrower be identified at a later point in time. The exception is when a compromise agreement is arrived at or in the case of settlements made under SBP's scheme or banks' own schemes.

Another important issue related to write-offs is: Why is there in some cases a large difference between outstanding liabilities and collateral value? The answer is that whereas the outstanding liabilities go on increasing because of the application of mark-up, the collateral value goes on receding because the unit is shut down and this explains why often the outstanding of closed units are substantially greater than the collateral or forced sale value. In absence of these write-offs, the banks have to make provisions out of their income against these NPLs. On a sustained basis this translates into accumulated losses which, in turn, diminish the capital of the banks. This is why the Government of Pakistan/State Bank of Pakistan had to inject Rs.46.6 billion to make up the shortfall in the Capital Adequacy of Habib Bank and United Bank.

The SBP has allowed the Board of Directors of Banks to write-off loans in the loss category in a transparent, non-discriminatory and uniform manner according to well defined policies. The banks are required to disclose the details of the parties and individuals who have been allowed write-off of above Rs. 0.5 million in their annual financial statements.

In addition, the Corporate and Industrial Restructuring Corporation (CIRC) has been empowered under the law to acquire NPLs from the public sector banks/DFIs and the difference between the acquisition price and book value is written-off from the books of the banks.

The committee for Revival of Sick Industrial Units (CRSIU) formed by the Government of Pakistan also restructures the loans of the sick industrial units to make them viable and the banks have to write-off or waive off the amounts decreed by the CRSIU.

There are 80,157 cases pending in the Courts of Law and the decretory amounts given by the Court, at times, fall short of the book value of the loans. The banks have, therefore, to make up this shortfall through write-offs or waivers. In some of the well publicized cases of some industrialists, the write-offs have resulted because the auction amounts recovered due to execution of Court decrees were lower than the book value of the loans carried by the bank

Conclusion

Risk Management encompasses risk identification, assessment, measurement, monitoring and controlling all risks inherent in the business of banking. The basic principles relating to risk management that are applicable to every financial institution, irrespective of its size and complexity, include:

i. The overall responsibility of risk management vests in bank's board. The board should outline risk management strategy and formulate well-defined policies and procedures. Risk management department be made on portfolio or business line basis, to adopt a holistic approach judging the overall risk exposure in assessing and managing risk profile of the bank.
ii. Irrespective of a separate risk review or management function individual business lines or units should also be accountable for the risk they are taking.
iii. Wherever possible risks should be quantitatively measured and reported.
iv. The risk review function should be independent of those who take risk.
v. Banks should have contingency plans for any abnormal or worst case scenarios.
vi. The risk category specific recommendations are discussed hereafter.

Other issues

In addition to above following issues should also be addressed

- One of the most important aspects in risk management philosophy is to make sure that those who take or accept risk on the behalf of the institution are not the only ones who measure, monitor and evaluate the risks. The findings of their reviews should be reported to business units, Senior Management and, where appropriate, the Board.
- Institutions should have a mechanism to identify stress situations ahead of time and plans to deal with such unusual situations in a timely and effective manner. Contingency planning activities include disaster recovery planning, public relations damage control, litigation strategy, responding to regulatory criticism etc. Contingency plans should be reviewed regularly to ensure they encompass reasonably probable events that could impact the organization.
- There is starvation of qualified people in the field of risk management. In this regard state bank of Pakistan, various universities of the country and banks should initiate training and academic program. State bank should organize special workshops to have sufficient pool of qualified people in this field. Universities should include risk management in their curriculum.

Credit Appraisal Techniques to Avoid Bad Debts:

The important thing to remember is not to be overwhelmed by marketing or **profit center reasons** to book a loan but to take a balanced view when booking a loan, taking into account the risk reward aspects.

Generally banks remain optimistic during the upswing of the business cycle, but tend to forget to see how the borrower will manage during the downturn, which is a **shortsighted approach**.

Furthermore banks tend to place greater emphasis on **historic financials**, which are usually outdated; this is further exacerbated by the fact that a descriptive approach is usually taken, rather than an analytical approach, to the credit. Thus a **forward looking appro**ach should also be adopted, since the loan will be repaid primarily **from future cash flows**, not historic performance; however both can be used as good repayment indicators.

Company Profile / Ownership

- This should cover the legal structure of company, i.e. is it public / private / listed. If listed then
- Broker reports can be an additional source of information besides share price. When dealing with individual Group companies it is essential go review overall Group exposure to ensure that the Group Risk is adequately analyzed and monitored, and Group limits also set.

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