Vol. 5 No.1

ISBN: 978-623-7144-28-1

THE EFFECT OF CREDIT RISK MANAGEMENT ON FINANCIAL PERFORMANCE OF THE INDONESIAN COMMERCIAL BANKS

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Abstract. This research aims at examining the effect of credit risk management on financial performance of the Indonesian commercial banks during the period (2008-2018), four commercial banks have been chosen to express on the whole Indonesian commercial banks. Two mathematical models have been designed to measure this relationship, the research revealed that the credit risk management effects on financial performance of the Indonesian commercial banks as measured by ROA and ROE. The indicators of Non-performing loans/Gross loans, Provision for facilities loss/Net facilities and the leverage ratio that were found significant in determining credit risk management. Also, banks should establish adequate credit risk management policies by imposing strict credit estimation before granting loans to customers, and banks in designing an effective credit risk management system, need to establish a suitable credit risk environment; operating under a sound credit granting process, maintaining an appropriate credit administration that involves monitoring, processing as well as enough controls over credit risk.

Keywords: Credit risk, Financial performance, Indonesian commercial banks.

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1. INTRODUCTION

Credit Risk Management has been the subject of study of many Researchers and Academicians. There are numerous researches on the effect of credit risk management on financial performance, and how could the effective credit risk management assist in reducing the possibility of failure and restricting the uncertainty of achieving the required financial performance. Prior research Poudel (2012) explored the various credit risk management indicators that affected banks' financial performance, he found that the most indicator affected the bank financial performance was the default rate.

Furthermore, some studies conclude that there are positive relationship between effective credit risk management and financial performance banks', among others, (Aruwa et al. 2012); (Boahene et al. 2012). On the other side, some of these studies support the notion that there is a negative relationship between them, as follows, (Kaaya et al. 2013); Berrios (2013). The detailed assessments of the level and the nature of credit risk management with financial performance are thus necessary. The importance of credit risk management in banks is due to its ability in affecting the banks' financial performance, existence and growth.

This research improves on some of the existing researches, in that it uses a variety of credit risk management and financial performance indices to measure the effect of credit risk management on the financial performance of the Indonesian commercial banks. It also contributes to the existing literature by providing a new addition to the previous literature about the effect of credit risk management on financial performance of the Indonesian commercial banks.

The main purpose of this research to answer the following main question (Does the credit risk management effect on financial performance of the Indonesian commercial banks during the period of 2008 to 2018, by answering the following questions: What are the indicators of the credit risk management?, What are the indicators of banks' financial performance (profitability)?, Does the credit risk management effect on banks' financial performance (profitability)?.

2. LITERATURE REVIEW

Risks are everywhere and can come at any time but are difficult to avoid. If the risk of befalling an organization can cause harm to this organization because it requires risk management. Risk Management is related to management functions to protect property and profits of business entities or individuals. According to Hanafi (2012) states "risk management is a risk management system designed by related organizations to improve company goals". While according to Siahaan

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(2009) states management "manages the processes managed by managing" managing risks known as risk management".

Credit risk is one of the most significant risks that banks face, considering that granting credit is one of the main sources of income in commercial banks. Therefore, the management of the risk related to that credit affects the profitability of the banks (Li et al. 2014).

Effective management of credit risk is inextricable linked to the development of banking technology, which will enable to increase the speed of decision making and simultaneously reduce the cost of controlling credit risk. This requires a complete base of partners and contractors (Lapteva, 2009). With the existence of a detailed risk management concept, it means that the company has built direction and mechanism in a sustainable manner.

Prior researches Hosna et al. (2009) found that Non-performing loans indicator effected on profitability as measured by (ROE) more than capital adequacy ratio, and the effect of credit risk management on profitability was not the same for all the banks included in their study. Gakure et al. (2012) investigated the effect of credit risk management techniques on the banks' performance of unsecured loans. They concluded that financial risk in a banking organization might result in imposition of constraints on bank's ability to meet its business objectives.

Kolapo et al. (2012) showed that the effect of credit risk on bank performance measured by ROA was cross-sectional invariant, though the degree to which individual banks were affected was not captured by the method of analysis employed in the study.

Banerjee et al. (2009) said that the objective of the credit management is to maximize the performing asset and the minimization of the nonperforming asset as well as ensuring the optimal point of loan and advance and their efficient management. The lending guideline should include Industry and Business Segment Focus, Types of loan facilities, Single Borrower and group limit, Lending caps. It should adopt a credit grading system .All facilities should be assigned a risk grade.

Musyoki et al. (2012) seek to assess various parameters pertinent to credit risk management as it affects banks' financial performance. They concluded that all these parameters had an inverse impact on banks' financial performance; however the default rate was the most predictor of bank financial performance, on the contrary of the other indicators of credit risk management. Nawaz et al. (2012) found that credit risk management effected on the banks' profitability, and they recommended that management should be cautious in setting up a credit policy that might not negatively affect profitability.

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3. METHODOLOGY

This research aims at investigating the effect of credit risk management on financial performance of the Indonesian commercial banks. Data from annual reports of the Indonesian commercial banks were used to analyze for the study years (2008-2018). The panel regression model was employed to estimate the effect of credit risk management indicators (Capital adequacy ratio (CAR), Facilities credit ratio, Net facilities ratio, Leverage ratio, Non-performing loans) on the banks' financial performance.

This is a descriptive research which is relevant to an inquisitive study as it requires some analysis on the efficient management of bank's credit risk as well as the crystal clear concepts on how the CRM affect on financial performance of the Indonesian commercial *banks.* Types of data secondary sources : the secondary source of information is based on official website, Annual report, operation manual of Credit Risk Management and annual report of Basic bank, Indonesia Stock Exchange, other websites, books etc.

Data analysis*,* this research applies the descriptive, quantitative, ratios and econometrics analysis approaches in determining the effect of credit risk management on banks' financial performance during the time period (2008-2018), including the analysis of the credit risk indicators and profitability ratios, Cross sectional analysis, regression analysis, correlation analysis, and test (F-Fisher) analysis, which are being estimated by the panel squares method (PLS), through applying the statistical program (E-Views) on the cross-sectional data relating to indicators of credit risk and profitability during the study period, based on the annual reports issued by Indonesia Stock Exchange, and the Indonesian commercial banks, and the relevant previous studies conducted on commercial banks and other firms in different sectors around the world. Where the research tries to investigate the overall and subtotal effect of credit risk management on banks' financial performance using certain partial indicators of credit risk.

ROA and ROE measures the effect of the credit risk management indicators on financial performance of the Indonesian commercial banks.

4. CONCLUSION

The main purpose of this research is to investigate the effect of credit risk management on bank's financial performance, through identifying the credit risk management and financial performance indicators, and to find an empirical evidence of the degree to which credit risk management affects banks' financial performance and how the banks can enhance their financial performance ratios.

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This research indicates that the credit risk management effects on financial performance of the Indonesian commercial banks. There are four independent variabels (Capital adequacy ratio, Credit interest/Credit facilities ratio, Facilities loss/Net facilities ratio, Gross facilities ratio, Leverage ratio, Non-performing loans/Gross loans ratio) and depandend variabel is Financial Performance.

Banks in order to design an effective credit risk management system need to establish a suitable credit risk environment; operating under a sound credit granting process, maintaining an appropriate credit administration that involves monitoring, processing as well as enough controls over credit risk.

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ISBN: 978-623-7144-28-1

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