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Impact of Credit Risk Management on the Financial Performance of selected Public and Private Sector Banks in India

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ABSTRACT

Banks are said to be the financial pillars of the as they play a very important role in the economic development of the nation. Banks are designated the basic duty of accepting deposits and lending credit to the society. Banks need to face different types of risk in this process which affects its financial performance. Credit risk is the most important type of risk faced by the banks which arises due to non-payment of loans. This present paper seeks to study and compare the impact of credit risk management on the financial performance of the banks. Credit risks are measured in terms of Capital Adequacy Ratio (CAR) and Credit Deposit Ratio (CDR). Net Profit Margin (NPM) is taken as a measure for financial performance of the bank. The top ten banks from public and private sector each are chosen on the basis of market capitalization rate. The panel data from the period 2013-14 to 2017-18 are selected and analyzed using the SPSS 21.0 package. The study shows that CAR and NPM are significantly correlated however CDR and NPM tough positively correlated the impact of CDR was found to be significant only when both sector banks are taken together. The study recommends that banks need to pay due attention to all these ratios in order to avoid further credit risks.

1. Introduction

Banks are the catalyst of economic development as they play an important role in channelizing the savings of the public. The Indian banking systems through its systematized and organized structure has become more proactive and dynamic. There are three categories of bank namely Commercial banks, Regional Rural Banks and Co-operative Sector banks. Commercial Banks are profit-making organizations and act as intermediaries between borrowers and lenders, entrusted with the basic function accepting deposits and granting loans which helps in revenue generation for the banks (Drigă, 2012). Hence it is very important that banks carry out these functions with utmost care and due diligence. The loans granted and deposits made by the public form major assets and liabilities for the bank. All loans are always associated with risk. Default in the payment of these loans may lead the banks to crisis.(Mavhiki et al., 2012)

Bankers are mainly concerned with different types of risk. These are credit risk, liquidity risk, market risk, interest rate risk, earnings risk and solvency risk (Rose, 2002). Furthermore country risk, currency risk and cross border risk may arise in case of international lending. Amongst all the different types of risks credit risk area major concern for the banking sector as they increase the probability of non-performing assets. Poorly managed credit risks results into financial losses for banks. Hence it is important that banks employ a proper credit risk management system.

Moreover the functions of the bank are no longer limited to geographical boundaries. Banks need to ensure the safety, liquidity and profitability of the funds invested by the general public so as to boost the customer's confidence. Risk management as a human activity integrates recognition of risk, risk assessment, developing strategies to manage it and mitigation of risk using managerial resources (Appa, 1996) whereas credit risk is the risk of loss due to a debtor's non-payment of a loan or other line of credit (either the principal or interest or both) (Campbell, 2007).Lack of measures to tackle such credit risk can hamper the smooth working of the banks. Thus the present research seeks to investigate the impact of credit risk management on a bank's financial performance with reference to selected of public and private sector banks in India.

2. Review of Literature

The review of literature is divided under two categories.

2.1. Studies related to Financial Performance

Kunt and Detragiache (1999) suggested that bank profitability is an important predictor of financial crises. Understanding the factors affecting the profitability is necessary for creating new policies either for recovery or improvement.

Brealey and Myers (2003) suggested various important measures for determining profitability of an organization which include the net profit margin, return on assets, and return on equity.

Swamy (2013) using panel data techniques analyzed the determinants of bank asset quality and profitability for the period 1997 to 2009. The study concluded that capital adequacy significantly affected the profitability of commercial banks apart from other accepted determinants of profitability.

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