

Evaluating Financial Performance of Commercial Banks in Palestine

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ABSTRACT

This research find out the impact of credit risk on the profitability and liquidity of commercial banks operating in Palestine. Return on Equity (ROE) is used as the indicator of profitability and cash deposit ratio as the indicator of liquidity. The study is purely based on secondary data collected from the audited financial annual reports of the commercial banks in Palestine over the years 2012 to 2016. The data is analyzed by using multiple regression. The findings highlighted that there is a significant impact of credit risk on the profitability and liquidity in Palestinian commercial banks and therefore it is advised to improve credit risk management practices in Palestinian commercial banks.

Keywords: Credit risk, profitability, liquidity, banks, regressions.

I. INTRODUCTION

Economic growth theory believes that financial institutions especially commercial banks are considered a useful tool for improving the productivity of the economy. They provide source of fund for any country through stages of economic growth. Banking sector play a crucial role in the economy through transferring funds from surplus units to shortfall units during financial intermediaries. Commercial banks considered the most important source of financing for individuals. It plays a vital role in economic development with the mobilization of deposits and disbursement of credit score to various sectors of the financial system. The revenues of the banking system gained through the credit facilities are the core of the main revenues for any bank regardless of its other revenue sources.

Financial performance measurement is the process of scientifically making a proper, critical and comparative evaluation of the profitability and financial health of a given concern through the application of the techniques of the financial statement analysis. If the financial performance is efficient and effectively measure, it gives a better platform to perform the industry well in the future. The motivation of conducting this research stems from that rare research studies have examined this issue or tried to better explain the performance of Palestinian commercial banks.

II. HISTORY OF PALESTINIAN COMMERCIAL BANKS

Before the occupation of the West Bank in 1967, there were 11 commercial banks in Palestine (8 in the West Bank and 3 in Gaza) with 30 branches of which 26 were the West Bank and only 4 in Gaza. At that time their credit facilities represented 71.4% of their deposits (ESCWA 1987). The Israeli authorities used military orders to close all bank branches on the eve of occupying the land (West Bank and Gaza) in 1967.

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They kept their assets and confiscated the cash in their vaults and transfer them to the Central Bank of Israel. After a few years, they issued military orders by allowing Israeli Banks to open branches in the West Bank and Gaza. Only 4 banks opened with 22 branches distributed in main cities of the occupied area: Bank Leumi 13 branches, Bank Discount, 6 branches; Bank Hapoalim, 2 branches; and Barcklays Bank, 1 branch (ESCWA 1987). They remain alone until 1981, when the Israeli High Court of Justice allowed Bank of Palestine to reopen its closed branches in Gaza. Israeli banks were unable to attract Palestinian deposits, so they were deficit funds, which made them dependent on government money collected from taxes imposed on the Palestinians. Their roles were limited to transferring money and to paying cheques to Palestinians who received their salaries in Israeli Shekel.

Israeli banks were unable to provide a financial intermediary function because very few customers agreed to deposit their money with them, and their loan portfolio was less than 8% of their assets. Most of their facilities were overdraft granted to merchants who had business with Israeli partners. Banks also simplified the process trade of Palestinian merchants who needed to open letters of credit or letters of guarantees to import from Israel. Despite this, these facilities were profitable to those banks, as they were charging three times the fees banks charge in close countries; but due to lack of business very few could make a profits and sometimes losses create many of them to close their branches. In 1987, due to the Intifada, all of these banks were closed (Harris 1988). There were no banks in Palestine until 1994, except one branch of Cairo-Amman Bank, which was reopened in 1986 in addition to the Bank of Palestine in Gaza.

After the Oslo agreement in 1993, the Wadi Araba Agreement between Jordan and Israel and the Paris Accord in 1994, Israeli government allowed Jordanian banks to reopen their branches closed in 1967. They also allowed the Palestinians to establish the Palestine Monetary Authority in 1995 to overview banks and to give licenses to the newly established banks (Abadi 1997). Since 1995, the PMA has issued several laws and regulations; the most important are the Banking Law, the PMA law and the Money Changers Law. Recently the PMA drafted a Central Bank Law which is awaiting a Presidential decree. The new law is expected to transform the PMA into a fully fledged central bank which will have the authority to issue the national currency whenever the required conditions are met (PMA 2012). Currently, three currencies are circulated in Palestine: the US dollar, the Israeli shekel, and the Jordanian dinar. Since its formulation, the PMA has issued several licenses to new banks and allowed banks to open new branches, which made the number of banks to increase from only two in 1994 to 15 by end of 2017 with over 337 branches and offices (PMA, 2016).

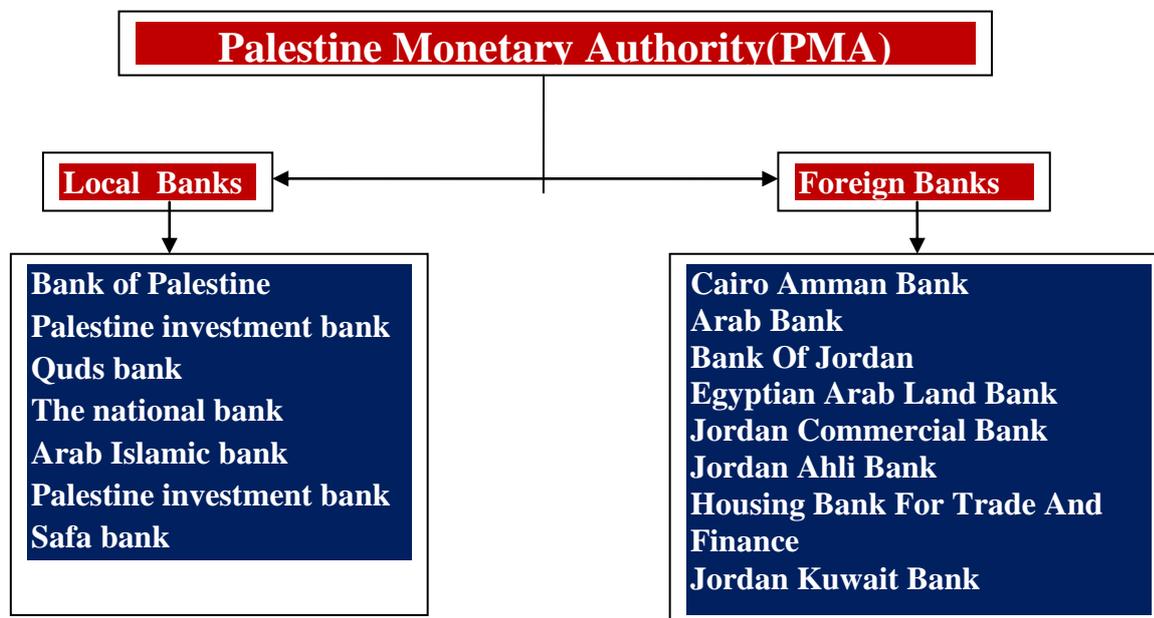
PALESTINE MONETARY AUTHORITY (PMA)

The Palestine Monetary Authority formed by an act of the Palestine Legislative Council's PMA Law Number (2) of 1997, which stipulated the proper authority and autonomy of the PMA and the Banking Law Number 9 of 2010. PMA is an independent public institution responsible for the formulation and implementation of monetary and banking policies to maintain price stability and low inflation, foster financial stability and safeguard the banking sector and promote sustainable growth of the national economy. PMA represents the central bank in Palestine and it regulates the work of banks. PMA works to achieve these goals through development and execution of monetary

policy formed to ensure low inflation and achieve price stability. Effective and transparent regulation and supervision of banks specialized lending institutions and money changers operating in Palestine, and finally overseeing the development, implementation and operation of modern, efficient payment systems.

STRUCTURE OF BANKING SECTOR IN PALESTINE

There are 15 regulated banks working in Palestine, seven of which are Palestinian local banks and eight are of foreign banks, local banks divided into two categories local commercial banks includes four banks as Bank of Palestine, Palestine Investment Bank, Quds Bank and The National Bank, next category includes three local Islamic banks as Arab Islamic bank, Palestine Islamic bank and Safa bank. On the other hand foreign commercial banks includes eight banks as Cairo Amman bank, Arab bank, Jordan Kuwait Bank, Jordan Ahli Bank, Bank of Jordan, Egyptian Arab Land Bank, The housing bank for trade and finance, Jordan Commercial Bank. The chart shows the Palestinian banking structure in 2016.



Source: Palestine Monetary Authority, Annual Report 2016.

LITERATURE REVIEW

Hosna, Manzura, and Juanjuan (2009) defined credit risk as the risk of loss due to the default of an obligation by the obligator in terms of a loan or other forms of credit. It is one of the important risks predicted by the banks due to the nature of its activities. Effective management of credit risk exposure of the banks encourages the viability and profitability of their business and also play role to systemic stability and efficient distribution of capital in the economy. **Poudel (2012)** defined credit risk as the risk that a borrower defaults and does not honour its obligation to service debt. It can occur when the counterpart is unable to pay or cannot pay on time. It is the loss due to the refusal or inability of credit customers to pay what is outstanding in full and on time. It is a probability of loss to a bank due to default by the bank borrowers (counterparties) who fails repay the borrowed money on time, or the borrowed amount becomes irrecoverable. It is due to the failure of borrower to fulfill their financial commitment with bank as per the agreed terms and conditions. **Muhammad, Ammara, Abrar, Fareeha (2012)**

examined the influence of credit risk on profitability of eight commercial banks in Ethiopia. The period of the study was from 2003 to 2014. Data was used to find using descriptive statistics and panel data regression. The study revealed that the credit risk measured by nonperforming loan, loan loss provisions and capital adequacy have significant impact on the profitability measured by ROA of selected banks in Ethiopia. The research conducted by **Onolapo (2012)** find the association between the credit risk measured by NPLR and bank performance measured by ROA of 11 banks in Tanzania. Data was analyzed with the help of regression. The findings of the study find that the indicator of credit risk has negative correlation meaning thereby, higher the credit risk lower the bank performance. **Boahene, Dasah, and Agyei (2012)** examined the influence of management of credit risk on the financial performance of thirteen commercial banks in Jordan for the period of 2005 to 2013. Non-performing loans to Gross loans, Provision for facilities loss to Net facilities and the leverage ratio were used as a measure of management of credit risk. ROA and ROE were used as a measure of financial performance. Two mathematical models were developed and regression was used to find the relationship. The findings concluded that the indicators of credit risk management have an influence on financial performance of in Jordan commercial banks. **Ezike & Oke (2013)** studied the association between credit risk management and profitability of Palestine investment and commercial banks. They used Nonperforming Loan Ratio as a measure of credit risk management and ROE as the measure of profitability. Regression was used to find the data. The findings highlighted that there is no effect of credit risk on profitability of Palestine commercial and investment banks. In the empirical research conducted by **Li & Zou (2014)**, they analyzed that the credit risk is the most significant risk among all risks faced by the bank that could negatively affect the bank because granting credit is one of the main sources of income in commercial banks. They defined credit risk management as a planned format of management of unhappening by evaluation of the risk, formulation of plans to handle the risk and lessening of risk by means of managerial assets and declared that the management of the risk related to that credit affects the profitability of the banks. Besides, the researchers defined profitability as a medium of capability of the bank to bear risk and/or raise the capital of bank and it implies effectiveness of the bank and gauges the excellence of management. Capital adequacy ratio and nonperforming loan ratio have been used as the measures of credit risk management. Return on Asset and Return on Equity have been used as the measure of profitability as per DuPont system. Moreover, they investigated whether there is an association between credit risk management and profitability by taking 47 largest commercials banks in Europe. The period of the study has been from 2007 to 2012. They used descriptive statistics, multiple regression analysis technique to find whether the association exists and they calculated mean and standard deviation to find whether the relationship is stable or fluctuating. The study revealed that the credit risk management does not have positive effect on profitability of commercial banks.

OBJECTIVES OF THE STUDY

- 1) To identify the impact of credit risk on profitability in Palestinian commercial banks.
- 2) To assess the impact of credit risk on liquidity in Palestinian commercial banks.

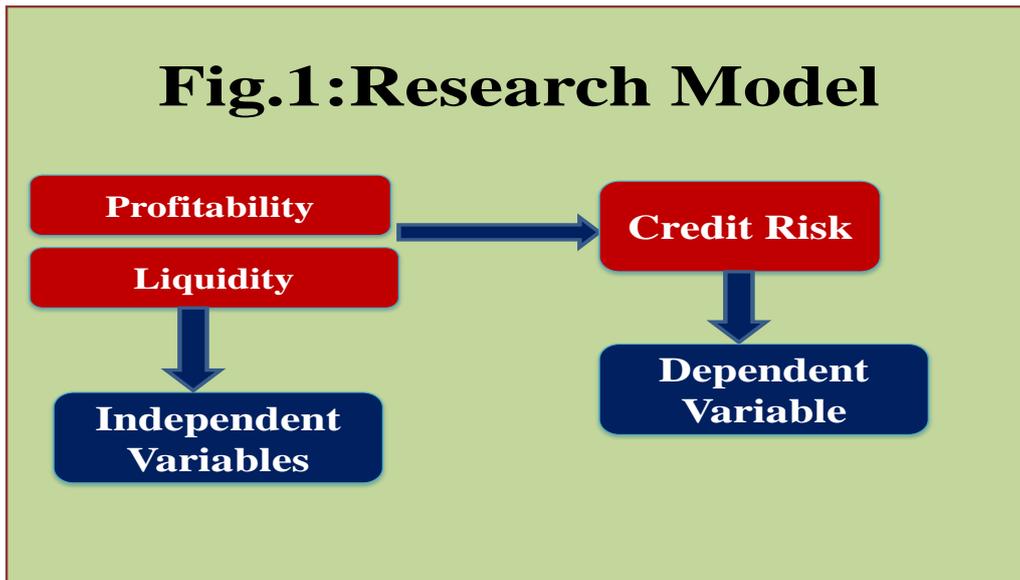
HYPOTHESES OF THE STUDY

H₀1: There is no significant impact of credit risk on profitability in Palestinian commercial banks.

H_a1: There is a significant impact of credit risk on profitability in Palestinian commercial banks.

H₀2: There is no significant impact of credit risk on liquidity in Palestinian commercial banks.

H_a2: There is a significant impact of credit risk on liquidity in Palestinian commercial banks.



III. RESEARCH METHODOLOGY

Explanatory research design is used in this study to assess the impact of credit risk on profitability and liquidity. The researcher is used secondary data which collected from the audited annual reports of Palestinian commercial banks for the years from 2012 to 2016. Besides, multiple regression has been used to investigate the effect of credit risk on the profitability and liquidity of Palestinian commercial banks. Credit risk is the probability that a bank borrower may default on a debt by failing to make required payment as per the agreed terms and the lender may lose the principal of the loan or the interest. Profitability indicates the capacity of the bank to carry risk and/or increase their capital. The credit risk affects the profitability and liquidity in Palestinian commercial banks over Five years. Besides, Return on Equity is a profitability ratio. It measures the return that an investment generates for capital contributors, i.e. bondholders and stockholders. Return on equity indicates how effective a company is at turning capital into profits.

Table 1: Computed Profitability, Liquidity, & Credit Risk of selected Banks

Year	Palestine Investment Bank	Bank of Palestine	The National Bank	Quds Bank

	Profitability			
2012	0.153	0.143	0.1993	0.163
2013	0.308	0.328	0.398	0.318
2014	1.518	1.538	1.98	1.528
2015	0.172	0.182	0.192	0.182
2016	0.183	0.153	0.173	0.193
Liquidity				
2012	0.533	0.433	0.633	0.534
2013	0.267	0.167	0.367	0.268
2014	0.279	0.179	0.379	0.270
2015	0.356	0.256	0.456	0.357
2016	0.644	0.544	0.744	0.645
Credit Risk				
2012	0.063	0.456	0.123	0.351
2013	0.099	0.786	0.789	0.960
2014	0.062	0.156	0.452	0.144
2015	0.052	0.456	0.523	0.410
2016	0.061	0.564	0.456	0.427

Source: Computed from various data available from banks websites

Table 1 show that profitability (ROE) is higher in Palestine investment bank in 2014 as well as high in bank of Palestine. Similarly, it is 1.98 for the national bank and 1.528 for Quds Bank. Besides, liquidity in terms of cash deposited to total assets is higher in the year 2016 that is 0.644 of Palestine investment bank where is the highest of bank of Palestine is 0.544 in 2016 as well as for the National Bank is 0.744 and for Quds banks 0.645. Value of credit risk computed through the relationship between provision for doubtful debt and credit facilities made in the banks. Moreover, the credit risk shown by Palestine investment bank was 0.099 in 2013 as the highest among them whereas same for the bank of Palestine it is 0.786 and in the same year the National Bank is also having the highest credit ratio that is 0.7 89 and Quds Bank also having 0.960 that is because of the change in the economy of Palestine.

HYPOTHESES TESTING

Table 2: Impact of Credit Risk on Profitability

Model-1	Sum of Squares	df	Mean Square	F	Sig.
Regression	0.009	1	0.009	0.288	0.615
Residual	0.150	5	0.30		
Total	0.158	6			

Predictors: (Constant), Credit Risk

Dependent Variable: Profitability

Source: Output of SPSS_20

Table 2 shows regression value 0.009, probabilistic value (Sig.) is equal to 0.615 and is more than $\alpha < 0.05$ significance level hence null hypothesis is rejected and alternative hypothesis is accepted. It indicates a significant impact of credit risk on the profitability in Palestinian Commercial Banks.

Table 3: Impact of Credit Risk on Liquidity

Model-2	Sum of Squares	df	Mean Square	F	Sig.
Regression	0.020	1	0.020	0.743	0.428
Residual	0.138	5	0.028		
Total	0.158	6			

Predictors: (Constant), Credit Risk

Dependent Variable: Liquidity

Source: Output of SPSS_20

Table 5 shows regression value 0.020, probabilistic value (Sig.) is equal to 0.428 and is more than $\alpha < 0.05$ significance level. Hence null hypothesis is rejected and alternative hypothesis is accepted. It indicates a significant impact of credit risk on the liquidity in Palestinian Commercial Banks.

Recommendations and Suggestion for Future Research

- ❖ Through extensive literature review, some ratios were identified as the indicators of credit risk. ROE as the indicator of profitability and cash deposit to total assets as the indicator of liquidity. There are other indicators of credit risk, profitability and liquidity except those indicators involved in this study. Therefore,

it is recommended to include more indicators of credit risk, profitability and liquidity to test the relationship in future.

- ❖ This study is focused only on credit risk of commercial banks operating in Palestine. There are other risks faced by the bank except the credit risk. In future research, it is recommended to include other risks faced by the bank.
- ❖ It is suggested to continue achieve rising growth in profitability to strengthen the competitive and financial position of commercial banks in Palestine.
- ❖ It is recommended to increase the size of indirect credit facilities provided to customers of banks such as letters of credit, guarantees and banking services such as money transfers because of their importance to maximize the Bank's revenues from commissions.
- ❖ Satisfaction of bank customers and create value for them are the mantras to increase the profitability of the bank which lead to raising the size of shareholders' equity.

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