UNIVERSITI TEKNOLOGI MARA

THE EFFECTS OF CREDIT RISK ON THE FINANCIAL FIRM PERFORMANCE IN MALAYSIA

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Final Year Project Paper submitted in fulfillment
of the requirements for the degree of
Bachelor of Business Administration (Hons)
(Investment Management)

Faculty of Business and Management

July 2021

ABSTRACT

Credit risk is the risk of loss due to a borrower not repaying a loan. It refers to a lender's risk of having its cash flows disrupted if a borrower fails to pay principal or interest on time. The issues become critical when performance of the financial companies is affected by the poor credit risk management. Due to that circumstances, this study attempts to investigate in depth on the effects of credit risk on the firm performance, particularly on the financial firms in Malaysia. In this study, Return on Asset (ROA) was used as a dependent variable, whilst Debt to Asset Ratio (DAR), Current Ratio (CR) and Debt to Equity Ratio (DER) were used as independent variables. Data of the selected financial firms in Malaysia are collected from year 2016 until 2020. Panel Least Square (PLS) regression was adopted as main methodology to measure the effects and relationship among variables. As a result of this study, Debt to Asset Ratio (DAR), Current Ratio (CR) and Debt-to-Equity Ratio (DER) have significant effect with the Return on Asset (ROA).

ACKNOWLEDGEMENT

First and foremost, I want to express my heartfelt thanks to my advisor, Madam Nur Liyana Binti Mohamed Yousop, for her unwavering support of my degree research, as well as her patience, encouragement, excitement, and vast knowledge. Her advice was invaluable during the research and writing of this thesis.

Apart from my advisor, who also serves as my first examiner, I would like to express my gratitude to Miss Nadia Nurul Najwa, my second examiner, who is understanding of my circumstances and easy to contact or interact with. Another thank you to the rest of my thesis committee: Dr. Faridah Najuna Misman and Puan Shashazrina Roslan, who assisted me with my panel presentation and thesis editing. I also would like to appreciate my coordinator, Madam Yuslizawati, for continuously reminding me and my friends about this thesis information.

Last but not least, I would like to express my gratitude to my family and friends for assisting me and teaching me about my thesis. For my friends, thank you for always helping me and support me during this thesis. I also apologise for any errors I may have made.

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CHAPTER ONE
INTRODUCTION

1.1 Introduction

For many years, studies on credit risk have been widely discussed by numerous researchers from around the globe. Credit risk is the possibility of loan default as a result of a borrower's failure to make required payments. It generally refers to the possibility that a lender will not receive the owed principal and interest, resulting in a cash flow interruption and increased collection costs.

Credit management practices may differ among financial firms depending on their nature of business and clients. Poor credit risk management may increase the non-performing loans (NPLs) which compresses profitability of the financial firms. In global cases, poor credit risk management causes economic turmoil as financial firms particularly banks fail due to default risk from clients. The effect of the financial crisis in 2008 are still being felt where almost no company is guaranteed secure, and even if one company is, if a risky business is linked to the company, its failure could lead to that company operation's downfall. Since then, credit risk has gone from being a brushed-off part of doing business to a strategic sustainability measure.

Credit risk management is one of the most crucial banking functions where their aim is to keep credit risk exposure within reasonable and permissible limits, minimizing losses by determining the capital and loan loss reserves of a bank at any given time. Banks must control and manage not just the entire portfolio but also individual credits. Failure to adequately mitigate the credit risks could have a significantly negative effect on their business.

Undeniably, the effect of the credit risk may cause an enormous impact on the banks' performance. A small number of creditors defaulting could result in a large loss, and in the worst-case scenario, the firms could go bankrupt (Tefera, 2011). Therefore, it is important for the banks to always investigate the background of their potential borrower before proceeding with the loan process. It is also vital to them to monitor the repayment status of the borrower consistently for the firm to protect its interest and the wealth of its depositors and shareholders.