

Financial risks in banking sector of Pakistan: An empirical study

Submitted to

School of Business and Economics

in Partial Fulfillment of the Requirements

for the Degree of

MASTERS OF SCIENCE in FINANCE

by

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October, 2017

RESEARCH COMPLETION CERTIFICATE

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Annex H: MS/TAP/H
Thesis Examination Sheet

The Thesis titled

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has been examined by the undersigned panel of examiners and has received full approval
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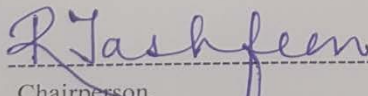
Dated this 07-09-2017




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I, Hafiz Muaaz Ahmad, ID # 15008096-001, hereby declare that the work entitled "Financial Risks in Banking Sector of Pakistan; An Empirical Study" is my own work and no part of this dissertation has been copied from any other source except where explicit acknowledgement is made in the text.

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DEDICATION

To

My Parents and Teachers

ABSTRACT

Banking industry plays a vital role in economic performance of every country. Banks used to generate its profit by taking loans from one party with the lower interest rates and lend it to the other party with the higher interest rates, the difference between these interest rates are basically the profit of banks but this process of generating income is not as smooth as it looks like. Banks has to face lots of threats which are known as financial risks. This study covers all the financial risk which includes market risk, credit risk, liquidity risk, rate of return risk, interest rate risk and equity risk for Islamic banks and conventional banking sector prevailing in Pakistan. This comparative study investigates the different determinants of all type of risks and the level of financial risks prevailing in banking industry. Furthermore, it examines which banking sector (Islamic or Conventional) is more sensitive to the underlined risks. The aim of this study is to examine that up to what extent Pakistani banks are affected by financial risks and to compare the all financial risks that what type of risks are more harmful for Islamic banks and what type of risks are more hazardous for the conventional banks. Secondary data is being used in this study and it is collected from annual reports, SBP web site and from different articles from 2002 to 2016. Total 10 banks are being undertaken in this study as a sample in which 5 banks are Islamic and 5 are conventional. Regression model is used in this research and Descriptive Analysis, Fixed and Random Effect, Hausman Test are the techniques which has been used with the help of E-views and MS Excel. The results depict that Islamic banks are more sensitive to liquidity risk and credit risk as compare to the conventional banks. In case of market risk, both sectors are facing approximately the same level of risk. Conventional banks are more sensitive to equity risk, interest rate risk and rate of return risk.

Key words: Financial risks, Conventional banks, Islamic banks, Regression, Pakistan.

ACKNOWLEDGEMENT

I am using this opportunity to express my gratitude to everyone who supported me throughout the course of this research work. I am thankful for their aspiring guidance, invaluable constructive criticism and friendly advice during the research work. I am sincerely grateful to them for sharing their truthful and illuminating views on a number of issues related to the completion of this thesis.

I express my warm thanks to Mr. Muhammad Mahmood Shah Khan for their support and guidance as a supervisor in providing valuable suggestions to make my work easier and in continue right direction.

I would also like to thank my project external guide Dr. Ishfaq Ahmed from the Hailey College of Commerce, University of Punjab, Pakistan and all the people who provided me with the facilities being required and conducive conditions for final thesis as a partial fulfillment for my MS degree in Finance.

Thank you,

Hafiz Muaaz Ahmad

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1. INTRODUCTION

Financial industry plays a vital role in economic performance of every country. Banking sector being a part of this financial industry has to face the most important and risky challenges. One of the challenges is to invest the public savings in a maximum productive way that it may ultimately leads to the economic development of the country. Banking sector is also considered to be an important source of financing for most businesses. Banking sector is like a backbone of a country, due to this sector needed to perform well. The banking sector in any country has been subject to a great deal of regulations. The aim of these regulations is to improve the performance quality of banking institutions in a country. According to Basel II committee, it is significant to maintain the minimum capital to absorb loss in case of uncertainty.

In the financial sector, the risk is a major component. Financial activity is subject to internal and external environmental factors, so the degree of uncertainty or risk is high. In today's fast-moving business environment, banks are exposed to a large number of risks: credit risk, liquidity risk, market risk, operational risk, interest rate risk, equity risk or foreign exchange risk, etc. Due to such exposure to various risks, efficient risk management is required. Therefore, banks in order to develop the effective risk mitigation tools and systems should concern about the financial and economic variables that impact on financial risks being faced by the industry.