



Credit Risk and Bank Performance: The Moderating Effect of Political Instability in the Palestinian Context

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Abstract

Objectives: This study aims to examine the impact of credit risk on bank performance in the Palestinian banking sector and to investigate the moderating effect of political instability on the relationship between credit risk and bank performance.

Methodology: The study employed a balanced panel data approach using a sample of 10 Palestinian banks operating during the period 2012–2024, yielding 130 bank-year observations. Bank performance was measured using return on assets (ROA) and return on equity (ROE). Fixed effects regression models were applied, and the robustness of the findings was verified using alternative measures and the difference generalized method of moments (GMM).

Findings: The results indicate that credit risk has a significant negative effect on both ROA and ROE. Political instability was found to have no direct significant relationship with bank performance. However, it significantly and negatively moderates the relationship between credit risk and bank performance, intensifying the adverse impact of credit risk on profitability.

Implications: The findings suggest that banks and the Palestinian Monetary Authority should strengthen credit risk management practices by reviewing lending standards and implementing stricter monitoring and regulatory mechanisms to mitigate the negative effects of credit risk, particularly during periods of political instability.

Conclusions: This study contributes to the banking and finance literature by providing empirical evidence on the moderating role of political instability in the relationship between credit risk and bank performance within the Palestinian context, an area that has received limited scholarly attention.

Key words

Credit risk, Political instability, Bank performance, Nonperforming loans, Panel data, Palestinian banks.

1. Introduction

In emerging economies, the banking sector is central to economic growth and development and to the maintenance of economic stability. As banks are the main source of financing for the economy, regulators must understand how to preserve stability while enabling the banking sector to be profitable. The need for the efficient management of credit risk (CR) has been highlighted by the 2007 financial crisis. In particular, CR was a major factor in the collapse of the financial system, causing major crises in many economic settings worldwide (Harb et al., 2022). Risky assets, combined with uncertainty, contribute significantly to bank underperformance and insolvency. Therefore, banks should adopt efficient CR management procedures to ensure investor returns, keep them attractive to foreign investors, and maintain sustainability.

In Palestine, increased bank lending is expected to contribute positively to economic growth. Loans enable households to buy houses without having to save the full amount upfront, thus stimulating economic activity. Moreover, credit enables governments to reduce spending to increase cash holdings by investing in infrastructure projects and reducing the cyclicity of tax revenues (Awad & Al Karaki, 2019). Despite the pressures and difficulties facing the Palestinian economy as a whole and the banking sector in particular, the Palestinian Monetary Authority (PMA) and the banking sector have worked together to provide loans of approximately USD 11 billion, resulting in a loan portfolio increase of approximately 2.8 percent over the previous year. This expansion of the loan portfolio has raised the loan-to-deposit ratio in Palestine to approximately 67.1 percent (PMA, 2022). CR is one of the main risks banks face during economic development. As the economy improves, credit increases, thereby posing a challenge for different commercial banks. Given the likelihood of CR and its impact on bank profitability, this relationship calls for

comprehensive analysis. Considering the importance of this issue, a number of studies have examined the impact of CR on bank performance in various economic contexts (Abbas et al., 2019; Ekinici & Poyraz, 2019; Hunjra et al., 2020; Sharma et al., 2024; Twum et al., 2022).

Uncertainties and instability related to possible policy changes and their consequences may affect the behavior of policymakers and the banking sector. Accordingly, governments have numerous opportunities to design policies to provide a framework for supervision and regulation and a suitable privatization plan to help maintain the stability and efficiency of the banking system (Doong & Doan, 2021). In 2022, the Palestinian banking sector faced increasing pressure and difficulties owing to the economic instability caused by the occupation and its policies and by global developments. These challenges have been followed by unprecedented price and inflation increases, tighter financial and monetary policies, and rising interest rates worldwide (PMA, 2022). Therefore, political instability (PI) arises when an unstable government is perceived as a major obstacle to economic expansion and a negative constraint on resources. Financial risk is likely to increase, and the stability of the banking sector is likely to be affected by large-scale government interventions (Javid et al., 2022).

The association between politics and bank profitability has been extensively examined (Diab et al., 2023; Yahya et al., 2017). However, most existing studies have focused on the impact of individual factors rather than providing a comprehensive framework integrating CR and bank profitability while considering the potential interaction of these factors in a complex economic and political context. Therefore, the relationship between CR and bank profitability should be explored within a framework that allows for a comprehensive assessment of the interactions

and impacts of the variables. This approach will enrich the understanding of how banks manage risk and achieve financial stability in a complex environment.

Previous empirical studies have examined the link between CR and bank performance, but their findings remain inconclusive (Javid et al., 2022 Ekinci & Poyraz, 2019; Hunjra et al., 2020, Sharma et al., 2024, Diab et al., 2023). Moreover, most previous evidence comes from stable economies. Thus, in politically unstable environments such as Palestine, empirical evidence remains limited. More importantly, the moderating effect of PI on the relationship between credit risk and bank performance in the Palestinian banking sector has not been empirically studied. PI may alter the relationship between CR and bank performance by increasing uncertainty, reducing borrowers' ability to repay, and affecting banks' risk management practices. Therefore, the current study aims to fill this empirical gap by examining the relationship between credit risk and bank performance while considering the moderating effect of PI in the Palestinian context. Addressing this research problem will help bank managers and policymakers in politically unstable environments such as Palestine manage CR more effectively and maintain financial stability.

Given the significance of this issue, this study addresses the influence of CR on the performance of banks operating in Palestine from 2012 to 2024. Furthermore, this study explores whether PI moderates the link between CR and bank performance. The consideration of the moderating effect of PI distinguishes this study from others and provides a distinct perspective. Specifically, this study clarifies the recurring theme of the current situation and reaches a conclusion by considering the following research questions in the context of Palestine.

RQ1: Does CR affect bank performance?

RQ2: Is PI related to bank performance?

RQ3: Does PI moderate the relationship between CR and bank performance?

The remainder of this manuscript is structured as follows. Section 2 introduces the study context. Section 3 presents the literature review and hypothesis development. Section 4 describes the methods used in this study. Section 5 provides the analysis and discussion of the study's findings. Finally, Section 6 concludes the paper.

2. Institutional setting

The emerging Palestinian economy is characterized by extreme PI, which indicates a lack of government regulation and authority over basic financial and economic policies. The West Bank and Gaza Strip have been under direct Israeli occupation since 1967. In 1993, the Oslo Accord between the Palestine Liberation Organization and Israel officially established the Palestinian National Authority and gave it limited jurisdiction over parts of the West Bank and Gaza Strip. Under these arrangements, the Paris Protocol on Economic Relations, signed in 1994, imposed important restrictions on Palestinian monetary independence, including the absence of a national currency. This constraint limits the ability of the monetary authority to use traditional monetary policy instruments to cushion economic shocks and preserve financial stability.

The Palestine Exchange (PEX) was founded as a private company in 1995 to promote investment in Palestine. It later became a listed public corporation in 2010. As a result of the Gaza war, the market value of PEX companies fell by USD 271 million to USD 4,625 million at the end of 2023 and by a further USD 545 million to USD 4,080 at the end of 2024 (PEX, 2024). In this context, the PMA was established under

Presidential Decree No. 184 to regulate and supervise the banking sector and ensure financial stability. The PMA's responsibilities include creating a safe and reliable banking system and maintaining the country's financial stability. Moreover, the PMA achieves financial inclusion and controls inflation to maintain monetary stability (Aqel, 2022).

The Palestinian banking sector, which comprises 7 domestic banks, 6 foreign banks, 337 money changers, 9 specialized credit institutions, and 5 electronic payment companies, plays an essential role in financing economic activities (PMA, 2024). However, the sector operates in an environment characterized by continued PI, decreasing external assistance, ongoing clearance of income deductions, and recurrent political tension. These conditions have a negative impact on economic activity and debtors' ability to repay.

These institutional features have a significant impact on bank risk and performance. On the one hand, monetary policy restrictions and reduced lender of last resort capabilities increase banks' exposure to CR as they have fewer tools to manage liquidity shocks and rescue distressed borrowers (PMA, 2024). Consequently, CR is expected to have a more pronounced negative impact on bank profitability. On the other hand, PI increases economic uncertainty, reduces borrowers' ability to pay, and increases the risk of default, which, in turn, increases CR. Therefore, PI is expected to exacerbate the negative impact of CR on bank performance by strengthening the negative correlation between the two.

3. Literature review and hypotheses development

3.1. Credit risk and bank performance

Banks are exposed to different risks such as CR and market, liquidity, and political risks. CR is characterized by the failure to partially or completely

collect loans granted by banks (Saleh & Abu Afifa, 2020). Risk management is critical for banks to assess financial risk and efficiency and decide whether to attract new customers and investors to enhance their competitiveness and maximize profitability (Rangkuti, 2020). CR is considered the most important risk affecting banks and can result in losses that cannot be absorbed by banks' income (Olalekan & Adeyinka, 2013). Banks generate income primarily through lending activities. However, a higher CR is likely to negatively affect bank profitability.

Theoretically, CR influences bank performance through several interconnected channels. When CR increases, the level of nonperforming loans (NPL) increases, reducing the expected cash inflows from interest and principal payments (Jiajia et al., 2023), thus negatively affecting the operational income of the bank. Moreover, banks must recognize loan loss provisions to cover potential credit losses in line with regulatory requirements and accounting standards, as these provisions are linked to the level of CR and the NPL ratio of banks (Osei-Assibey & Asenso, 2015). These reserves are recognized as expenses in the income statement, which directly reduce net profits. In addition, an increase in NPLs weakens the capital position of banks and limits their ability to extend new loans (Ozili, 2019), thereby reducing their capacity to generate future interest income. Accordingly, a higher CR increases the perceived riskiness of a bank among investors and depositors, which may lead to higher funding costs and reduced market confidence, ultimately leading to the deterioration of the bank's financial performance.

CR leads to lower profitability for banks because of higher losses from bad loans and reduced interest income. Consequently, bank capital becomes stretched in the face of higher CR, contributing to weaker performance (Boussaada et al., 2023). Previ-

ous research has shown that CR is a major threat to the banking sector (Sharma et al., 2024; Twum et al., 2022). The relationship between CR and profitability has been extensively investigated in the relevant literature using both accounting and market indicators (Kosmidou & Zopounidis, 2008). Some studies have provided evidence for a particular economic context. For example, Ali and Puah (2019) found that CR has a significant impact on profitability, as measured by return on equity, in the Pakistani banking sector. Twum et al. (2022) found that CR and bank performance in China are negatively correlated. Similarly, Fahlenbrach et al. (2016) analyzed U.S. banks from 1972 to 2014 and found that banks with higher loan growth in the top quartile than in the bottom quartile had significantly lower profits in the following three years. This trend is due to banks not properly assessing the risk of lending in times of rapid growth. In the Turkish context, Ekinci and Poyraz (2019) identified a negative correlation between CR and the profitability of Turkish commercial banks between 2005 and 2017.

Other studies have provided comparable evidence from different countries. Abbas et al. (2019) examined the impact of CR on the performance of banks in developed Asian countries relative to that of commercial banks in the United States. Their findings show that CR has a negative impact on bank profitability in both regions, with the impact being stronger for U.S. banks. Similarly, Hunjra et al. (2020) examined the impact of CR, among other interbank factors, on the performance of South African banks. Their findings show that CR has a negative and significant effect on bank profitability. Similarly, Harb et al. (2022) reported a weak but negative correlation between CR and the performance of banks in the Middle East and North Africa (MENA) region.

The above discussion indicates that CR adversely

affects bank profitability in different economic environments. This trend is in line with the argument that a higher CR, through its impact on loan losses, reduced lending capacity, and higher funding costs, ultimately leads to a deterioration in the financial performance of banks. Based on the theoretical and empirical discussions above, this study proposes the following hypothesis:

H1. CR is significantly and negatively correlated with bank performance.

3.2. Political instability and bank performance

PI affects the social, safety, and economic aspects of everyday life and is regarded as a key factor in banking sector stability, especially in emerging markets. PI is one of the main factors behind bank underperformance, particularly when combined with high levels of corruption and poor governance (Leko, 2021). In the Middle East, the political and economic situation is affecting economic activity (Bourauoui & Hammami, 2017). Political changes, social unrest, governance problems, and other sources of PI increase emerging market risks and thus weigh on bank performance (Yunan et al., 2023).

Previous research has examined the impact of political situations on the economy and on bank performance (Al-Shboul, 2020; Seelanatha, 2021; Yahya et al., 2017). Doong and Doan (2021) examined the impact of PI on the efficiency of banks in 20 emerging economies and found that bank efficiency usually suffers during election years because of PI. Similarly, Jadah et al. (2020) identified a strong negative correlation between PI and the performance of banks in unstable political situations. Yunan et al. (2023) examined how PI affects the performance of banks in emerging markets and found that military involvement in political activities and corruption can destabilize and increase the risks of the banking sector. The

study also showed that Islamic banks tend to be more profitable when operating in a less risky socioeconomic environment.

In the Palestinian context, PI is expected to negatively impact bank performance. The political situation in Palestine is characterized by high levels of economic and social uncertainty, which reduces the ability of debtors to repay and leads to tighter lending policies by banks. This condition in turn limits the possibilities for financing and hampers profitability. Moreover, PI may discourage investors from entering new economic activities, limiting growth opportunities and negatively impacting banks' financial performance.

Based on the above arguments, the second hypothesis is formulated as follows:

H2. PI negatively influences bank performance.

3.3. The moderating effect of political instability on the link between credit risk and bank performance.

Based on the previous discussion, PI is expected to influence the impact of CR on bank performance. In particular, PI increases economic uncertainty and reduces banks' ability to effectively assess, monitor, and recover loans, thereby exacerbating the negative effects of CR. In politically unstable conditions, borrowers' ability to repay becomes more fragile, and banks face greater problems in managing NPLs. Consequently, the negative impact of CR on bank performance is likely to be more pronounced in times of heightened PI. Therefore, this study proposes the following hypothesis:

H3: PI negatively moderates the relationship between CR and bank performance.

4. Research methodology

4.1. Sample and data

This study explores the impact of CR on bank performance while considering the moderating effect of PI. In particular, the study employed panel data, and the first sample included all 13 local and foreign banks operating in Palestine in January 2024. Three local Islamic banks were excluded from the sample because they have special characteristics and conduct transactions based on Shariah principles. Thus, the final sample included 130 observations from 10 local and foreign banks from 2012 to 2024. Although the exclusion of banks that have exited or merged might introduce survival bias, this approach was necessary to ensure data consistency and reliability. The excluded banks comprise a minor part of the Palestinian banking sector. The required data were collected from the annual reports of banks listed on the PEX (for domestic banks) and the Palestine Banking Association (for foreign banks). Table 1 lists the sampled banks.

Table (1): Sample selection steps

Bank-year observations	
Local bank-years between 2012–2024	91
Foreign bank-years between 2012–2024	78
Less: Islamic bank-year	36
Final sample	133

4.2. Measurement of variables

The dependent variable, bank profitability, was measured using two proxies: return on assets (ROA) and return on equity (ROE). ROA and ROE have been widely used to measure bank performance in previous research (Boussaada et al., 2023; Harb et al., 2022; Hunjra et al., 2020; Twum et al., 2022). ROA is calculated as net income divided by total assets. Meanwhile, ROE is computed by dividing net income by total equity. The existing literature provides evidence that ROA and ROE are influenced by CR and PI (Ek-

inci & Poyraz, 2019; Jadah et al., 2020; Kosmidou & Zopounidis, 2008).

The independent variable, CR, is measured by the NPL ratio, which is calculated by dividing the NPL by total loans according to previous studies (Gafrej & Boujelbéne, 2021; Harb et al., 2022; Le et al., 2021). Higher NPLs negatively impact a bank's performance by reducing interest income, leading to poor performance (Harb et al., 2022).

PI, as a moderating variable, is measured using the World Bank index for Political Stability and Absence of Violence (Diab et al., 2023). This index measures the likelihood of politically motivated violence or instability and examines the impact of such instability in 163 countries representing 99.7% of the world's population. The value of PI ranges between -2.5 and +2.5, indicating weak and strong governance, respectively (World Bank, 2024).

For the control variables, bank size (SIZE) was measured using the natural logarithm of total assets in accordance with previous studies (Aqel, 2022; Yunan et al., 2023). The existing literature provides evidence that bank performance is significantly influenced by bank size (Boussaada et al., 2023; Javid et al., 2022). Meanwhile, the ratio of total debt to total assets was used to measure bank leverage (LEV). The leverage ratio serves as a useful measure of a bank's financial risk tolerance and provides information on the best possible capital structure. Therefore, the ratio of total debt to total assets indicates what claims shareholders still have (Quoc, 2021). Previous research also suggests that leverage significantly affects bank performance (Mishra & Dasgupta, 2019; Twum et al., 2022). In this study, the ratio of equity to total assets was used to measure bank capital (CAP). Bank capital is an important input for banking activities and plays a crucial role in bank profitability. Boussaada

et al. (2023) reported that bank capital is positively and significantly linked to bank performance. Bank age (AGE) was measured as bank age in years since establishment. According to Hunjra et al. (2020), older banks are more profitable than younger ones. The cost-to-income ratio (OEIO) was also measured by dividing total operating expenses by total operating income (Dsouza et al., 2022). The ratio of liquid assets to total assets was used as an indicator of bank liquidity (LIQ). Liquidity significantly reduces banks' profitability as suggested by Boussaada et al. (2023). A bank with more liquid assets is less profitable because it is less risky (Aqel, 2022). Finally, the deposit-to-assets ratio (DTA) was measured by dividing total deposits by total assets (Javid et al., 2022).

4.3. Econometric model

To test these hypotheses, we used a balanced panel data approach (also referred to as longitudinal data). Therefore, we developed two models where ROA and ROE represented bank performance. Three diagnostic tests were then conducted to select the most appropriate empirical model. The findings are presented in Table 2.

Table (2): Statistical tests for selecting the most appropriate panel data model.

Statistical test	Wald test	Breusch-Pagan LM Test	Hausman Test
Panel A: Model 1			
Test Statistic	14.9125	120.9853	26.226294
P-value	0.0001	0.0000	0.0010
Panel B: Model 2			
Test Statistic	19.3210	73.59432	31.830507
P-value	0.0000	0.0045	0.0000

First, the Wald test was used to determine whether fixed effects or pooled ordinary least squares (OLS) were better for the model. Table 2 indicates that the P-value for the Wald test is significant at the 1% significance level, leading to the rejection of the null hypothesis (i.e., the model does not contain fixed effects).

Therefore, the fixed effects model was deemed more appropriate than the pooled OLS model. Second, the Breusch–Pagan LM test was conducted to choose between pooled OLS and random effects. According to Table 2, the P-values for the two models are significant, and accordingly, the null hypothesis was rejected (i.e., the model does not contain random effects). Consequently, the random effects model was considered more appropriate than the pooled OLS model. Third, the Hausman test was performed, and the null hypothesis (i.e., the fixed effects model is inappropriate) was rejected because the P-value was significant at the 1% significance level. Consequently, the fixed effects regression model was deemed the most suitable for the panel data. The following econometric models were estimated:

$$ROA_{i,t} = a + b_1 CR_{i,t} + b_2 PI_{i,t} + b_3 SIZE_{i,t} + b_4 LEV_{i,t} + b_5 CAP_{i,t} + b_6 AGE_{i,t} + b_7 OEOI_{i,t} + b_8 LIQ_{i,t} + b_9 DTA_{i,t} + BankFE + E I \dots\dots\dots(1)$$

$$RO_{i,t} = a + b_1 CR_{i,t} + b_2 PI_{i,t} + b_3 SIZE_{i,t} + b_4 LEV_{i,t} + b_5 CAP_{i,t} + b_6 AGE_{i,t} + b_7 OEOI_{i,t} + b_8 LIQ_{i,t} + b_9 DTA_{i,t} + BankFE + E I \dots\dots\dots(2)$$

Table 3 presents definitions of the study variables.

Table (3): Variable definitions .

Variable	Symbol	
Dependent variables		
Return on assets	ROA	Net income/total assets (Boussaada et al., 2023; Harb et al., 2022; Hunjra et al., 2020)
Return on equity	ROE	Net income/total equity (Javid et al., 2022; Hunjra et al., 2020)
Independent variables		
Credit risk	CR	Nonperforming loans/total loans (Harb et al., 2022; Gafrej & Boujelbène, 2021; Le et al., 2021)
Political instability	PI	Political Stability and Absence of Violence index released by World Bank (Diab et al., 2023; World Bank, 2024)
Control variables		
Bank size	SIZE	Natural log of total assets (Aqel, 2022; Javid et al., 2022; Yunan et al., 2023)
Bank leverage	LEV	Total debt/total assets (Mishra & Dasgupta, 2019)
Bank capital	CAP	Total equity/total assets (Boussaada et al., 2023)
(Bank age (Age	AGE	The number of years since the foundation of the bank (Harb et al., 2022; Hunjra et al., 2020)
Cost to income	OEOI	Total operating expense/total operating income (Dsouza et al., 2022)
Bank liquidity	LIQ	Liquid asset/total assets (Aqel, 2022; Quoc et al., 2022;)
Deposits-to-assets ratio	DTA	Total deposits/total assets (Javid et al., 2022)
Interaction variable		
Moderating role of political instability	CR × PI	The interaction between credit risk and political instability
Additional variable		
Loan loss provision to total assets	LLP	Loan loss provision/Total assets (Twum et al., 2022)

5. Results and discussion

5.1. Descriptive Statistics

Table 4 presents the descriptive statistics for the variables used in this study. The mean ROA is (0.0070), which is lower than the mean values of (0.011) and (0.01) reported by Hunjra et al. (2020)

and Javid et al. (2022), respectively. Therefore, the overall ROA is low, indicating the low profitability of all sampled banks in Palestine. The mean ROE is (0.0561), which is also lower than the mean ROE values of (0.178) and (0.113) reported by Twum et al. (2022) and Aliyu et al. (2023), respectively. The mean CR as a proxy for NPL is (0.0083), which is lower than the values of (0.2010) and (0.033) reported by Twum et al. (2022) and Diab et al. (2023), respectively, in the MENA region. This result indicates a lower CR in Palestine than in other countries. The mean PI is (-1.888), indicating relatively weak governance and a correspondingly high level of PI. On average, bank size is (20.551), indicating relatively larger banks than those in previous studies (Boussaada et al., 2023; Javid et al., 2022). The mean LEV is (0.8567), indicating high leverage in the Palestinian context. For capital, the mean is (0.14421), which is lower than the value of 0.690 reported by Boussaada et al. (2023). The average AGE of banks is around 26 years, with a minimum of 6 years and a maximum of 64 years. The average OEOI is (0.7654), which means that the total costs are, on average, three-quarters of the operating income. This result indicates a moderate level of operational efficiency, reflecting the relatively high cost structure of the Palestinian banking sector. The mean LIQ is (0.469) with a minimum of (0.241) and a maximum of (0.913). Furthermore, the mean DTA is 0.812, indicating high bank deposits. This result is in line with the report of the PMA (2022), which states that customer deposits were around USD 16.500 billion by the end of 2022.

Table (4): Descriptive statistics for the study variables

Variable	Observations	Minimum	Maximum	Mean	Std. Deviation
ROA	130	-0.036000	0.018877	0.006965	0.008513
ROE	130	-0.10022	0.221228	0.056102	0.081558
CR	130	0.00230	0.080302	0.008259	0.05312
PI	130	-2.160502	-1.659977	-1.88807	0.129888
SIZE	130	18.13878	22.84673	20.55292	0.9996
LEV	130	0.602888	0.925381	0.856709	0.064860
CAP	130	0.074619	0.397112	0.144211	0.065504
AGE	130	6.0000	64.00000	26.49231	12.09218
OEOI	130	0.483471	1.759128	0.765447	0.174420
LIQ	130	0.214500	0.913653	0.445978	0.184914
DTA	130	0.506810	0.987260	0.812465	0.077277

5.2. Multicollinearity analysis

In regression analysis, a correlation often exists between the dependent and independent variables. However, correlation between independent variables is undesirable and leads to multicollinearity. In a multiple regression model, multicollinearity occurs when two or more test variables are highly correlated, resulting in a high standard error of the coefficients (Gujarati & Porter, 2009). Multicollinearity in a regression model occurs when two or more test variables have a high degree of correlation, which increases the standard error of the coefficients. Therefore, by increasing standard errors, multicollinearity affects the reliability of the regression model, as certain variables that should be statistically significant become statistically insignificant (Shrestha, 2020). To test whether multicollinearity exists in the econometric model, we conduct Pearson correlation and variance inflation factor (VIF) analyses. The findings are presented in Tables 5 and Table 6. All pairwise correlations in Table 5 are below 80%, indicating no multicollinearity in the regression model (Twum et al., 2022). Additionally, as shown in Table 6, the highest VIF for all explanatory variables is 2.787, which is lower than the critical threshold of 5, as indicated by Kim (2019). Consequently, no multicollinearity exists between the test variables in this empirical model.

Table (5): Results of Pearson correlation analysis for the explanatory variables

Variable	CR	PI	SIZE	LEV	CAP	AGE	ETNI	LIQ	DTA
CR	1								
PI	-0.111	1							
SIZE	0.122	0.099	1						
LEV	-0.016	-0.028	0.502	1					
CAP	0.214	-0.046	-0.467	-0.518	1				
AGE	-0.051	0.084	0.410	0.207	-0.268	1			
OEOI	0.415	-0.077	-0.405	-0.152	0.485	-0.15	1		
LIQ	-0.088	0.013	-0.003	0.077	-0.094	-0.0203	-0.267	1	
DTA	-0.211	0.076	0.428	0.281	0.528	0.079	0.418	-0.002	1

Table (6): Results of variance inflation factor (VIF) analysis

Independent Variable	Collinearity Statistics	
	Tolerance	VIF
CR	0.807	1.239
PI	0.963	1.039
SIZE	0.338	2.962
LEV	0.676	1.480
CAP	0.239	4.180
AGE	0.767	1.304
ETNI	0.576	1.736
LIQ	0.839	1.193
DTA	0.491	2.035

5.3. Regression analysis

This study uses panel data to investigate the effects of the explanatory variables on bank performance in Palestine. In particular, we perform diagnostic tests on the panel data to confirm the use of the appropriate empirical model (see “Econometric Model” section). The results indicate that the fixed effects model is the most suitable for this study. The findings of the fixed effects regression for the two models are presented in Table 7. As Table 7 shows, the two models corresponding to ROA and ROE are significant at the 1% level, indicating their validity.

Consistent with the expectations CR and bank performance show a negative and significant relationship, as measured by ROA and ROE (P-value = 0.0077 and 0.0310, respectively). This result shows that a 0.01 increase in NPL leads to a change in ROA

and ROE of -0.000943 and -0.00301250 , respectively. Therefore, a bank's performance is heavily influenced by an increase in NPLs, indicating that many clients have difficulty repaying their loans. Thus, because of asymmetric information, commercial banks need to control their customers and reduce CR to prevent moral hazards and adverse selection problems (Bofondi & Gobbi, 2003). This finding is in line with those of previous studies (Abbas et al., 2019; Ekinici & Poyraz, 2019; Fahlenbrach et al., 2016; Hunjra et al., 2020). Consequently, Hypothesis 1 is supported for both models.

Surprisingly, PI is found to have a negative but insignificant relationship with ROA and ROE (P-value = 0.1470 and 0.2516, respectively). Therefore, despite the unstable political conditions in Palestine, the impact of these situations on banks is not significant. PI has a particularly strong impact on corporate governance in emerging economies, particularly in Palestine, where corruption and a lack of robust legal frameworks and effective law enforcement are widespread (Doong & Doan, 2021). Nevertheless, bank performance appears to have been relatively unaffected by unstable political conditions. The numbers published by the PMA support this conclusion. The loan portfolio represented 51.6 percent of banks' total assets, valued at approximately 11 billion USD. Furthermore, NPLs accounted for only about 4 percent of the total loan portfolio in 2022, even though loans accounted for about 57 percent of the GDP (PMA, 2022). This finding contradicts that of Yunan et al. (2023), who showed that military interference in politics and corruption can destabilize the business environment and lead to deteriorating banking performance in emerging markets. Yahya et al. (2017) found that unstable political situations have a positive and significant effect on bank performance in Yemen, a country with an unstable political situation similar to Palestine. Accordingly, Hypothesis 2 is rejected.

The results in Table 7 also indicate that OEOI is negatively and significantly related to ROA and ROE at the 1% significance level (P-values = 0.0000). This result indicates that banks with operating costs higher than their income tend to be less profitable, underlining the importance of operational efficiency in determining financial performance.

Table (7): Fixed effects regression results

Variables	Empirical Model (1)		(Empirical Model (2	
	Coefficient	P-value	Coefficient	P-value
CR	-0.094305	0.0077***	-0.301250	0.0310**
PI	-0.025404	0.2857	-0.000281	0.9976
SIZE	0.004855	0.4608	-0.014534	0.5776
LEV	-0.140477	0.1141	-0.834737	0.0187
CAP	0.015102	0.9001	-0.689525	0.1503
AGE	0.000509	0.6520	0.002197	0.6233
OEOI	-0.175358	0.0000***	-0.734745	0.0000***
LIQ	-0.002138	0.9163	0.029962	0.7105
DTA	0.036192	0.5215	0.050091	0.8229
Intercept	0.065851	0.7129	1.600531	0.0257**
Bank FE	Yes		Yes	
Observations	130		130	
Adjusted R ²	0.452901		0.48229	
F-statistics	0.0000***		***0.0000	

Notes: Significance levels: *** P-value < 0.01, ** P-value < 0.05, * P-value < 0.10 Standard errors are clustered at the bank level.

Table 8 presents the results of the moderating effect of PI on the relationship between CR and bank profitability. As shown in the table, the interaction variable CR × PI has a negative and significant association with ROA at a significance level of 10% (P-value = 0.0573) and a positive significant relationship with ROE at a significance level of 5% (P-value = 0.0437). This result suggests that PI amplifies the negative effects of CR on bank performance. In the economic context, banks face increased uncertainty and reduced efficiency in monitoring and recovering loans, accentuating the negative impact of CR on profitability in a politically unstable environment. As PI increases, the negative impact of CR on ROA and ROE becomes more pronounced. Accordingly, Hypothesis 3 is supported.

Table (8): Moderating effect of political instability on the relation between credit risk and bank profitability

Variables	Empirical Model (1)		(Empirical Model (2	
	Coefficient	P-value	Coefficient	P-value
CR	2.016906	0.0816*	-5.267315	0.0045***
PI	-0.039091	0.1147	0.050958	0.3115
CR × PI	-0.7226	0.0573*	-0.8237	0.0437***
SIZE	0.005468	0.4020	-0.000309	0.9771
LEV	-0.159629	0.0721	-0.346629	0.0136**
CAP	0.034739	0.7713	-1.529552	0.1290
AGE	0.000270	0.8103	-0.003207	0.1489
OEOI	-0.173961	0.0000***	-0.553216	0.0000***
LIQ	-0.001186	0.9530	-0.026018	0.4918
DTA	0.046203	0.4107	0.051531	0.5989
Intercept	0.037423	0.8332	1.002542	0.0011***
Wald test (P-value)	0.000***	0.000***		
Breusch-Pagan LM test (P-value)	0.000***	0.0002***		
Hausman test (P-value)	0.001***	0.001***		
Bank FE	Yes		Yes	
Observations	130		130	
Adjusted R ²	0.444242		0.498989	
F-statistics	0.0000***		0.0000***	

Notes: Significance levels: *** P-value < 0.01, ** P-value < 0.05, * P-value < 0.10 Standard errors are clustered at the bank level.

5.4. Robustness check

Two sensitivity analyses are conducted to ensure the robustness of the main results. In the first sensitivity analysis, we employ different measures of CR and PI. The proxy for CR is changed to the ratio of loan loss provision to total assets (Twum et al., 2022). Earnings per share (EPS) is used as an alternative measure of profitability. The findings are presented in Tables 9 and 10. Table 9 presents the robustness check using the above alternative measures by applying fixed effects regression. The findings are consistent with those of the main analysis. CR has a negative and significant connection with EPS. Table 10 also presents the robustness check for the moderating effect of PI on the relationship between CR and bank profitability. As shown in the table, the interaction variable CR × PI has a negative relation with ROA

and ROE, thereby confirming the results of the main analysis.

Table (9): Robustness check using alternative measures

Empirical Model		
Variables	Coefficient	P-value
CR	-0.058940	***0.0077
PI	-0.015877	0.2857
SIZE	0.003035	0.4608
LEV	-0.087798	0.1141
CAP	0.009439	0.9001
AGE	-0.0014	*0.0681
ETNI	-0.109599	***0.0000
LIQ	-0.001336	0.9163
DTA	0.022620	0.5215
Intercept	0.041157	0.7129
Wald test (P-value)	0.0000***	
Breusch-Pagan LM test (P-value)	0.0003***	
Hausman test (P-value)	0.0001***	
Bank FE	Yes	
Observations	130	
Adjusted R ²	0.452901	
F-statistics	0.0000***	

Notes: Significance levels: *** P-value < 0.01, ** P-value < 0.05, * P-value < 0.10 Standard errors are clustered at the bank level.

Table (10): Robustness check (the moderating effect of political instability on the link between credit risk and bank profitability)

Empirical Model		
Variables	Coefficient	P-value
CR	0.2502	0.0382**
PI	-0.024432	0.1147
CR*PI	-0.99251	0.0641*
SIZE	0.003418	0.4020
LEV	-0.099768	0.0721*
CAP	0.021712	0.7713
AGE	0.000168	0.8103
OEOI	-0.108726	0.0000***
LIQ	-0.000741	0.9530
DTA	0.028877	0.4107
Intercept	0.023389	0.8332
Wald test (P-value)	0.0000***	
Breusch-Pagan LM test (P-value)	0.0000***	
(Hausman test (P-value)	0.0002***	
Bank FE	Yes	
Observations	130	
Adjusted R ²	0.452901	
F-statistics	0.0000***	

In the second sensitivity analysis, this study uses the generalized method of moments (GMM). The difference GMM is used to solve problems related to endogeneity, autocorrelation, omitted variables, and heteroscedasticity and provides robust and reliable estimates (Boussaada et al., 2023; Uddin et al., 2017; Racicot, 2014). To avoid instrument proliferation, the model is carefully managed to ensure validity. The Hansen J test confirms the overall validity of the instruments, and the Arellano-Bond test shows no residual second-order autocorrelation, supporting the reliability of the estimated coefficients (Arellano & Bond, 1991). The results are presented in Tables 11 and 12. Table 11 shows that CR is negatively and significantly related to ROA and ROE. It also indicates that the interaction variable CR × PI is negatively correlated with ROA and ROE. Consequently, the robustness checks confirm that the primary results are robust to the alternative proxies and the system GMM, demonstrating the validity and reliability of the main findings.

Table (11): Robustness check using difference GMM

Empirical Model (1)			Empirical Model (2)	
Variables	Coefficient	P-value	Coefficient	P-value
ROA(-1)	-0.085996			
ROE(-1)			0.041543	0.4944
CR	-0.457328	0.0361**	-0.6124970	0.04333**
PI	-0.029072	0.1597	0.028032	0.6128
SIZE	-0.003091	0.6938	-0.023263	0.4818
LEV	-0.414951	0.0171**	-1.244740	0.0239**
CAP	-0.110720	0.2250	-1.173707	*0.0729
AGE	0.001494	0.1115	0.002726	0.5858
OEOI	-0.212823	0.0000***	-0.789342	0.0005***
LIQ	0.008197	0.6512	0.085759	0.1842
DTA	0.021988	0.7536	0.182807	0.3230
AR (1) test (P-value)	0.0229**			
AR (2) test (P-value)	0.2658			
Hansen test (P-value)	0.305871			

Table (12): Robustness check using difference GMM (the moderating effect of political instability on the relation between credit risk and bank profitability)

Variables	Empirical Model (1)		Empirical Model (2)	
	Coefficient	P-value	Coefficient	P-value
ROA(-1)	-0.059403			
ROE(-1)			0.018745	0.7680
CR	-0.425171	0.0051***	-1.7624752	0.02036**
PI	-0.031393	0.1208	0.078877	0.2136
CR × PI	-0.525182	*0.06992	-2.203094	0.0213**
SIZE	0.002501	0.3808	-0.040169	0.3739
LEV	-0.244383	0.1682	-4.479573	0.1142
CAP	0.015618	0.8957	-2.570324	0.0515*
AGE	0.001045	0.1260	0.003834	0.4343
OEOI	-0.188869	***0.0002	-0.819668	***0.0000
LIQ	0.010364	0.5722	0.121472	0.2044
DTA	0.091197	0.1450	0.057939	0.6725
AR (1) test (P-value)	0.01952			
AR (2) test (P-value)	0.29542			
Hansen test (P-value)	0.34587			

6. Conclusion, policy implications, limitations, and future research

6.1. Conclusion and policy implications

This study investigated the impact of CR on bank profitability and considered the moderating effect of PI in the Palestinian context. The study used a sample of 10 banks in Palestine that offered services from 2012 to 2024 and applied the panel data estimation technique, which included fixed effects and random effects models. Furthermore, the robustness of the results was validated using various measurements and the difference GMM.

The findings show that CR is negatively and significantly related to ROA and ROE. This finding is consistent with those of previous studies (Abbas et al., 2019; Hunjra et al., 2020; Twum et al., 2022), which showed that commercial bank CR is a global plague in both developing and developed countries. Therefore, bank management must clearly understand the

extent of the impact of CR and determine appropriate measures to mitigate it. The findings also show that PI has a statistically significant negative moderating effect on the correlation between CR and the two performance indicators (ROA and ROE) of Palestinian banks. Thus, PI reinforces the negative impact of CR on bank performance. Accordingly, a higher PI level makes the negative impact of CR on ROA and ROE more pronounced. Furthermore, OEOI has a negative and significant relationship with ROA and ROE, suggesting that banks with higher operating costs relative to income are less profitable and highlighting the importance of operational efficiency.

This study makes several practical recommendations for bank management the PMA as the regulatory authority for the banking sector. First, bank management should carefully review credit standards, increase the risk awareness of loan officers, assess recruitment policies, and increase employees' overall understanding of CR. Second, bank risk managers should pay particular attention to CR management and improve post-lending monitoring processes to reduce defaults and thus improve bank profitability. Third, the PMA should review existing lending regulations and adopt more stringent guidelines to control bank lending by ensuring adequate collateral. While the results suggest that PI has a moderating effect and exacerbates the negative impact of CR on bank performance, regulatory measures such as the requirement for credit insurance may help mitigate CR and are likely to have a positive impact on bank performance.

6.2. Limitations and future research

This study has certain limitations that provide opportunities for further research. First, the study sample is limited to only 10 banks; therefore, the generalizability of the results is limited. Future studies should focus on an expanded sample, including banks from other Arab countries with similar characteristics such

as Jordan, Lebanon, and Iraq, and compare the results with those from the Palestinian environment. Future studies could also include other capital markets in the Arab region with similar characteristics and compare them with those in the Palestinian context. Second, variables related to corporate governance are not included in this study because only four commercial banks are listed on the PEX. Therefore, future research should consider corporate governance variables with a range of data linked to other countries. Further research on PI could also divide the region into zones of high, medium, and low political stability to gain new perspectives on the Arab region and other parts of the world.

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