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CORPORATE FINANCIAL RISK AND PERFORMANCE: EVIDENCE FROM OMANI FINANCIAL SECTORS.

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Abstract:
This study explores the intricate relationship between corporate financial risk and performance, aiming to provide insights into how Omani firms manage risk to optimize their financial outcomes. Financial risk is a critical aspect of corporate management, influencing decision-making processes, investment strategies, and overall performance. Through a comprehensive review of literature and empirical analysis, this research examines various dimensions of financial risk, including liquidity risk, and defaults risk, and their impact on corporate performance metrics such as return on assets and return on equity. Additionally, the study investigates these variables related to financial sectors companies list in Oman stock exchange with include 14 banks for the period of 2019-2023 2ith total observations of 70 which is suitable to make the regressions model. The findings contribute to a deeper understanding of the complex dynamics between financial risk and performance, offering valuable insights for corporate managers, investors, and policymakers in navigating today's volatile business environment. Using the regressions methods of analysis the study finds that there is significant effect of these risks on financial performance, this is evidence that financial sectors top leadership need to establish the optimal level of liquidity risk to ensure maximum shareholder return. The influence of defaults risk on return on assets was concluded to have a positive relationship with returns on assets when evaluated in separation. The study indicates that when faced with multiple financial risk, banks need to hedge some of the risk to minimize on adverse impact on the shareholder market value.

Keywords: *Financial risk, defaults risk, liquidity risk , Return on assets (ROA) ,Return on Equity (ROE) , OMAN*
JEL Classification: G11, G12, G21

1. Introductions:

The role of banks in the financial system is divided into three categories: financial intermediaries, money facilitators, and supporters. Both commercial and Islamic banks receive deposits from people and companies, who use them for the economy's productive goals. Thus, banks serve as both the repository and resource mobilization center for the economy's wealth as well as a source of funding for commercial enterprises. Banks may be exposed to liquidity risk because of these varied activities since they are strictly obligated to make money accessible when requested by depositors or convert their financial assets on their balance sheets into liquid monies in order to satisfy their responsibilities (Saleh, 2014). Banking is obviously a dangerous industry, and several risk variables, including credit, liquidity, operational, including market risks, have already been highlighted as essential to ensuring that the institutions' position is maintained despite the fierce

competition in the sector. The effectiveness of risk management is crucial for a financial organization's existence and profitability. Since the transition of maturities is one of the most important responsibilities of banks, this paper examines the topic of banking liquidity and how it influences the economic performance of these institutions.

Eight Islamic commercial banks, two specialized banks, and 16 licensed local and international commercial banks make up Oman's banking system. The Central Bank of Oman, which controls and licenses private banks, keeps an eye on interest rates, and issues development bonds and notes, is responsible for banking regulation and oversight. Most Oman's banks have healthy capital ratios and low non-performing loan rates (Salim and Mohamed, 2016). Liquidity risk has recently emerged as one of the most significant issues now confronting the global financial industry, and Arab banking. Liquidity management has attracted significant attention from policymakers and regulators as liquidity becomes a significant concern in banking operations. According to the contemporary theory of financial intermediation, banks are necessary to the economy because they transfer risk and provide liquidity (Abbas and Mourouj, 2015). The liquidity problem also arises when the bank lacks the appropriate cash on hand when the depositors are ready to receive their deposits back. Liquidity risk is viewed as a penalty for bank profitability due to greater financing costs, while liquidity risk displays a benefit on bank performance as a function of banks' net interest margins. Bank performance is negatively impacted by liquidity risk in a market-based financial sector. Therefore, the study focuses on the impact of liquidity risk on performance of 15 banks of Oman. This study seeks to examine the effect of risks management on the financial performance of Oman banks. The focus of risk management in quantitative view lies on improving the measurement and management of specific risks such as liquidity, default risks. Earlier on, literature on risk management focused on single types of risk while missing out on the interdependence of other risk (Miller, 1992), and it was only on the 1990s that academic literature started to focus on an integrated views of risk management (Cumming and Mirtle, 2001; Microlis and Shaw, 2000; Miller, 1992; Nocco and Stutz, 2006; Sabeto, 2010).

2. literature review and hypothesis developments:

2.1 Financial sectors performance (banks performance):

Commercial banks are the main pillars for sustaining a stable monetary and fiscal system, especially in developing countries, where bank lending plays an important role in national development (Lubeteni, 2006). Thus, it can be said that the performance of banks is the main driver of economic and financial stability of a country. Banking institutions have now become more stable, and the key drivers of their continued success remain revenue and efficiency (European Central Bank, 2010). Banking services include profitability, liquidity, liquidity, financial efficiency and ability to pay (King'ang'ai, 2016).

According to the European Central Bank report, the performance of banks represents the ability of banks to generate sustainable income. This source sees profit as a first line from unexpected losses, as, as each bank strengthens capital it can increase the return on deposits and reserves Factors a it refers to the evaluation of bank performance, the author (Ongore, Kusa, 2013) who

emphasized that adequate capital, quality of assets and efficiency are affected, on the other hand he stated that liquidity has little effect on business commercial banks. A study on the performance of banks was also conducted by the authors (Singh, Tandon, 2012) who compared the performance of State Bank of India (SBI), the largest public sector bank in India, with the second largest bank the largest (ICCICI) is regarded as the leading bank in the private sector. The authors highlighted that the state-owned bank (SBI) is performing better than the private sector bank (ICICI) and is in good financial health, while it has performed better than the private sector bank (ICICI) in terms of deposit and debt management. Commercial banks are the main pillars for sustaining a stable monetary and fiscal system, especially in developing countries, where bank lending plays an important role in national development (Lubeteni, 2006). Thus, it can be said that the performance of banks is the main driver of economic and financial stability of a country.

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The authors highlighted that the state-owned bank (SBI) is performing better than the private sector bank (ICICI) and is in good financial health, while it has performed better than the private sector bank (ICICI) in terms of deposit and debt management. Other researches at the determinants of bank overall performance had been conducted by way of the authors (Heffernan, Fu, 2010), (Saliha, Abdessatar, 2011), (Tripathi, Meghani, Mahajan, 2014) and (Ayyappan, Sivaraman, Sakthivadivel, 2014) and so on. A very crucial element of the financial institution's overall performance is the capital structure. Author (Vătavua, 2015) researched the impact of capital structure on the performance of groups, by way of analyzing 196 Romanians production corporations indexed at the Bucharest Stock Exchange. He analyzed the connection between overall performance of businesses and capital shape. As representatives of the capital shape inside the model he set long-term debt, quick-time period debt, overall debt, and overall capital, while go back on assets and return on fairness as consultant of overall performance. In the stop he proved that the overall performance of Romanian groups is higher when they keep away from debt and act based totally on capital. Studies concerning the factors that influence the overall performance were conducted additionally through Muiruri, Ngari (2014). In their studies approximately the effect of monetary innovations in overall performance, they proved that economic improvements have had a prime impact on the economic performance of banks.

According to our examination of existing literature, we discovered that non-interest income is also associated with banks' performance, although interest income presents a stronger correlation. Poudel (2012) supported this notion in their study, "The impact of credit risk management in the financial performance of commercial banks in Nepal," indicating an inverse relationship between credit risk management and bank performance. Poudel recommended that banks develop strategies not only to mitigate credit risk exposure but also to enhance profitability. Similarly, Mondal (2012) proposed in their research that banks can improve profitability by effectively managing intellectual assets.

Liquidity risk, credit risk and stability in conventional banks by Hassan et al., 2019, mention to evaluate the liquidity risk of Islamic banks (IBs) in comparison to that of traditional banks (CBs). Researchers begun by looking at the connection between liquidity and credit risk. It used a simultaneous structural equation model on a large dataset consisting of 52 IBs and CBs from chosen countries in the Organization of Islamic Cooperation from 2007-2015 and discovered a negative correlation between credit risk and liquidity risk. After that, it looked at the connection between liquidity risk and stability and discovered a negative correlation between the two, but only for IBs. By comparing Islamic and conventional banking systems, researchers find that Islamic institutions were superior in their handling of risk.

(Adusei, 2022) mention that the liquidity risk had a considerable and negative impact on MFIs' bottom lines. This potentially detrimental impact was, however, reversed in the presence of credit risk. Additionally, the report revealed that MFIs' financial performance improves when credit risk was present despite the existence of liquidity risk. (Aragon et al., 2019) identify corporate bond mutual funds sold more credit insurance in the credit default swaps (CDS) market. Multi-name credit default swap (CDS) trading was dominated by bigger, more well-established funds and targeted financially troubled counterparty dealers. It was consistent with the higher projected returns from liquidity provision that funds that offered credit protection during the crisis saw increased credit market risk and improved post-crisis performance. Within days of Lehman Brothers' failure, anomalous withdrawals occurred in funds that used the firm as a counterparty, and those funds' returns plummeted by 2%. Fund investors may had been put at risk of loss due to counterparty risk because of the funds' opportunistic trading in credit default swaps. The impacts of various governance factors on company default risk were shown to be continent-specific, with the majority of governance factors significantly contributing to credit risk for Asian businesses whereas only the corporate governance and institution holdings are relevant for European enterprises as mention by (Switzer et al., 2017, Sclip et al., 2018, Han and Zhou, 2016, Slim and Mohamed, 2016, Chen et al., 2016 , Ghenimi et al., 2017) The obtained results indicated that credit risk and liquidity risk do not have an economically meaningful reciprocal contemporaneous or time-lagged relationship , from other side there many studies shown the negative impact related to the variables of the present study which indicated that Findings show that liquidity risk had a considerable and negative impact on MFIs' bottom lines (Adusei, 2022). Within days of Lehman Brothers' failure, anomalous withdrawals occurred in funds that used the firm as a counterparty, and those funds' returns plummeted by 2%. (Aragon et al., 2019)

The numerical experiments in the paper done Chen et al., (2016) under Tittel An Optimization View of Financial Systemic Risk Modeling: Network Effect and Market Liquidity Effect reveal that, as the ongoing deleveraging practice in financial institutions has already significantly shrunk their mutual liability exposure, the market effect may overtake the former to become a dominant force to trigger largescale financial contagion. the profitability of MENA banks is negatively and significantly sensitive to an increase in credit and/or liquidity risks, Hakimi, et al., (2020).

2.2: Hypothesis developments and econometric model

Based on the above argument the hypothesis were developments as following:

H1: there is effect of financial risk on financial performance of financial sectors in Oman.

H1-1 there is effect of financial risk measure by (defaults risk) on financial performance measure by return on assets (ROA).

H1-2 there is effect of financial risk measure by (liquidity risk) on financial performance measure by return on assets (ROA).

H1-3 there is effect of financial risk measure by (defaults risk) on financial performance measure by return on equity (ROE).

H1-4 there is effect of financial risk measure by (liquidity risk) on financial performance measure by return on equity (ROE).

Thus, the following econometric are proposed:

ROA= β0+β1Dr+β2LR+μ……..(1)

ROE= β0+β1Dr+β2LR+μ……..(2)

3. Methodology:

3.1 sample of the study

The primary component of the study is the research design, which serves as the foundation for the methodology. The research design used for the current research work is cross-sectional research design as the financial risk is analyzed on the performance of banks of Oman by using ratio analysis and regression. The population of the research was selected to be all the banks of Oman but the information regarding the annual reports of few banks were confidential due to which only 14 banks of Oman were taken as sample of study from 2019-2023 with a total of 70 observations. Data were obtained from annual reports, audit reports and financial statements of banks published on their official web sites.

3.2 variables definition

The aim of this study to investigate the effect of corporate financial risk measure by default and liquidity risk on financial performance measured by (ROA &ROE) for the financial sectores in Oman during the period 2019-2023. The variables were selected to acheave the purposes of the study as following:

3.2.1 Dependent variable:

- **Financial performance**: which includes the ratios of return on assets and return on equity, return on assets define as a financial metric used to assess a company's profitability in relation to its total assets. It measures how efficiently a company is utilizing its assets to

generate profit. The formula for ROA is: **Net income \ Total Assets ------(1) (Gitman et al.,2012).**

ROA indicates how effectively a company is using its assets to generate earnings. A higher ROA indicates that the company is utilizing its assets efficiently to generate profit, while a lower ROA suggests inefficiency in asset utilization. ROA is commonly used by investors and analysts to evaluate a company's financial performance and compare it with industry peers.

Return on equity define as a financial ratio that measures the profitability of a company in relation to its shareholders' equity. It shows how much profit a company generates with the money shareholders have invested. The formula for ROE is:

Net income \ Shareholders Equity ----------(2) (Gitman et al.,2012).

ROE indicates the efficiency with which a company is using shareholder equity to generate profit. A higher ROE implies that the company is generating more profit with less shareholder equity, which is generally seen as favorable. However, it's important to note that a high ROE could also indicate the company is leveraging debt to boost returns, which might increase risk.

ROE is a key metric used by investors and analysts to evaluate a company's financial performance and compare it with industry peers. It provides insight into how effectively a company is using shareholder funds to generate profit.

3.2.2 Independent variables: Financial risk

1. liquidity risk: Liquidity risk refers to the possibility that an investor or entity may not be able to buy or sell an asset quickly enough to prevent a loss or to quickly access cash without significantly affecting its price. It can arise from a lack of marketability, low trading volumes, or disruptions in the financial markets. Liquidity risk can impact both individual investors and financial institutions.

Quick Ratio (Acid-Test Ratio): This ratio is a more stringent measure of liquidity as it excludes inventory from current assets. It assesses the company's ability to cover its short-term liabilities with its most liquid assets. It is calculated as:

Quick Ratio=Current Assets−Inventory \ Current Liabilities ----------(3)

2. Default risk, also known as credit risk, is the risk that a borrower fails to make required payments on a debt obligation, such as a loan or bond. It arises when the borrower is unable or unwilling to fulfill their contractual obligations, leading to losses for the lender or investor. Default risk is influenced by factors such as the borrower's creditworthiness, financial health, and economic conditions.

Debt-to-Equity Ratio: This ratio measures the extent to which a company is financed by debt relative to its equity. A high debt-to-equity ratio indicates a higher level of financial leverage, which may increase default risk, especially if the company struggles to meet its debt obligations. The formula is:

Debt-to-Equity Ratio=Total Debt \ Total Equity ----------(4).

Table 1: summery of the study variables :

Variables	Measurements
Financial Performance	
ROA	Net income \ Total Assets
ROE	Net income \ Shareholders Equity
Liquidity risk	Quick Ratio=Current Assets−Inventory \ Current Liabilities
Default risk	Debt-to-Equity Ratio=Total Debt \ Total Equity

4: Empirical results and discussion:

4.1: descriptive analysis:

Table 4.1 provides the summary of descriptive statistics of the sample showing mean, standard deviation, minimum and the maximum of the study variables. The results show that 5-year observations in the banking sectors obtained an average return on assets (ROA) of 7.34% with a deviation of 4.52%. while return on equity (ROE) were 7.40% with stander deviation of 4%. The banking industry average financial risk measured by liquidity risk averaged 4.02% slightly below the industry benchmark of 7% with a deviation of 3%. defaults risk (DR) increase during the Five-year period as evidenced by 7.4%.

Table 4.1 Descriptive analysis for study variables

Statistic	ROA	ROE	LR	DR
Minimum	-0.5957	0.0367	- 0.0933	0.6872
Maximum	0.4929	0.1410	0.2074	0.833
Mean	0.0734	0.0740	0.0402	0.74025
Median	0.1572	0.0600	0.0253	0.74395
Std. Deviation	0.4520	0.0407	0.0925	0.0439
N	70	70	70	70

4.2 correlation tests between the variables:

Pearson correlation test was done to confirm the degree of multicollinearity amongst the variables. Table 4.2 revealed return on assets are positively correlated to return on equity only while it is negative correlation to liquidity risk and default risk, same results with return on equity which found negative correlations with both risk The test held correlations coefficients of 0.77,-0.234, -0.368, -0.182, -0.219and -0.233 for ROA, ROE,LR,DR respectively. The highest positive correlation is 0.77 while the highest negative correlation was -0.368 implying absence of multi-collinearity among selected variables.

Table 4.2: Correlations Matrix

Variables	ROA	ROE	LR	DR

ROA	1			
ROE	0.77	1		
LR	-0.234	-0.182	1	
DR	-0.368	-0.219	-0.233	1

4.3 Regression analysis and hypothesis testing

4.3.1 the effect of liquidity risk on return on assets

To examine the influence of liquidity risk and return on assets, the study regressed the ratio Quick Ratio=Current Assets−Inventory \ Current Liabilities as independent variable against return on assets ratios. Table 4.3 shows GLS regression results. Based on correlation structure of the influence of liquidity risk on return on assets was found to be positively significance with a p-value of 0.0138 lower than α =0.05. The significant relationship of liquidity risk on ROA conforms to risk-return relationship under stable economic environment, according to Modern Portfolio Theory. This finding corresponds to the study of Kang & Kang (2009). The null hypothesis is therefore rejected that liquidity risk does not influence the ROA of Omani financial sectors listed in Muscat Securities Exchange.

Table 4.3 Regressing LR on ROA

Predictors	***Dependent variables: ROA***			
	Coefficient value	***Standard Error (S.E)***	***T-value***	***P-Value***
LR	***1.039650***	***0.400054***	***2.598774***	***0.0138***

Significance of influence of Liquidity risk (LR) on return on Assets (ROA) conforms to the study of (Naser et al., 2011; Mehri, 2015; Kang & Kang, 2009). Positive association was related to the study of Alshatti (2015) who found Liquidity risk positively related to return on Assets. This is different to the study of Naser et al. (2011) which established liquidity risk is negatively related to return on assets. The final model of study can be concluded shown as below.

ROA= -1 + 1.039650 LR

4.3.2 The effect of liquidity risk on return on Equity

To examine the influence of liquidity risk and return on Equity, the study regressed the ratio Quick Ratio=Current Assets−Inventory \ Current Liabilities as independent variable against return on Equity ratios. Table 4.4 shows GLS regression results. Based on correlation structure of the influence of liquidity risk on return on Equity was found to be positively significance with a p-value of 0.0268 lower than α =0.05. The significant relationship of liquidity risk on ROE conforms to risk-return relationship under stable economic environment, according to Modern Portfolio Theory. This finding corresponds to the study of Kang & Kang (2009). The null hypothesis is therefore rejected that liquidity risk does not influence the ROA of Omani financial sectors listed in Muscat Securities Exchange.

Table 4.4 Regressing LR on ROA

Predictors	*Dependent variables: ROA*			
	Coefficient value	*Standard Error (S.E)*	*T-value*	*P-Value*
LR	*1.003965*	*0.3800543*	*2.641634*	*0.0268*

Significance of influence of Liquidity risk (LR) on return on Equity (ROE) conforms to the study of (Naser et al., 2011; Mehri, 2015; Kang & Kang, 2009). Positive association was related to the study of Alshatti (2015) who found Liquidity risk positively related to return on Equity. This is different to the study of Naser et al. (2011) which established liquidity risk is negatively related to return on Equity. The final model of study can be concluded shown as below.

ROE= -1 + 1.003965 LR

4.3.3 The effect of default risk on return on Assets

To examine the influence of default risk and return on assets, the study regressed the Debt-to-Equity Ratio=Total Debt \ Total Equity as independent variable against return on assets ratios. Table 4.5 shows GLS regression results. Based on correlation structure of the influence of default risk on return on assets was found to be positively significance with a p-value of 0.0414 lower than α =0.05. The significant relationship of default risk on ROA conforms to risk-return relationship under stable economic environment, according to Modern Portfolio Theory. This finding corresponds to the study of Hyde (2007), Sukcharoensin (2013) and Mouna and Anis (2015), Syed & Anwar (2012). Positive association was related the studies of Mouna and Anis (2015) The null hypothesis is therefore rejected that default risk does not influence the ROA of Omani financial sectors listed in Muscat Securities Exchange.

Table 4.5 Regressing DR on ROA

Predictors	*Dependent variables: ROA*			
	Coefficient value	*Standard Error (S.E)*	*T-value*	*P-Value*
DR	*1.326789*	*0.5579081*	*2.37815*	*0.0414*

This is contrary to the studies Ryan and Andrew (2004) that held defaults risk insignificant to return of assets. The study model is concluded below as:

ROA= -1 + 1.326789 DR

4.3.4 The effect of default risk on return on Equity

To examine the influence of default risk and return on assets, the study regressed the Debt-to-Equity Ratio=Total Debt \ Total Equity as independent variable against return on Equity ratios. Table 4.6 shows GLS regression results. Based on correlation structure of the influence of default risk on return on Equity was found to be positively significance with a p-value of 0.0108 lower than α =0.05. The significant relationship of default risk on ROE conforms to risk-return relationship under stable economic environment, according to Modern Portfolio Theory. This finding corresponds to the study of to the study of Purnamasari et al. (2012), Mehri (2015), Acharya et al. (2010), Wakid et al. (2013). Positive association was found related to the studies of

Acharya et al. (2010) and Wakid et al. (2013). However, Annas and Mohamoud (2013) established that the relationship between financial leverage and stock returns held a negligible effect.

Table 4.6 Regressing LR on ROA

Predictors	*Dependent variables: ROA*			
	Coefficient value	*Standard Error (S.E)*	*T-value*	*P-Value*
DR	*0.08352745*	*0.1262293*	*3.285083*	*0.0108*

The final model of study can be concluded shown as below.

ROA= -1 + 0.08352745 DR

5. conclusion and recommendations

The study makes conclusions based on the findings with regards to objectives of study to establish the influence of financial risk on financial performance of financial sectors companies listed in Oman. The study concludes on the first objective on influence of liquidity risk on financial performance (return on assets) that the portfolio at risk increased with increased in returns of assets. However, when looked at alongside other financial risk the relationship is negative. This is evidence that financial sectors top leadership need to establish the optimal level of liquidity risk to ensure maximum shareholder return. The influence of defaults risk on return on assets was concluded to have a positive relationship with returns on assets when evaluated in separation. The study indicates that when faced with multiple financial risk, banks need to hedge some of the risk to minimize on adverse impact on the shareholder market value. Liquidity risk and defults risk individually influence return on assets and return on equity negatively. This is an indication that investors prefer financial sectors to hold minimum liquidity and capital and invest the surplus funds. However, in existence of other risk, adequate liquidity and defaults is vital.

The study summarized with a conclusion that financial risks are systemic and pro-cyclical and therefore financial sector should establish optimal thresholds and risk desires to maintain shareholder wealth's. When risk is too much financial sectors are advised to consider appropriate hedging strategies.

Based on the aforementioned conclusions, the researcher recommends the following: The management of financial sectors in Oman and the policy framework governing financial institutions should prioritize the subject of financial risk and financial performance. Regarding the significant influence of liquidity risk and defaults risk on financial performance, the study advises top management in financial sectors to assess borrowers' risk profiles and establish a clear risk appetite for lending. It is further recommended that adequate provisions be allocated to write off bad loans without jeopardizing the bank's continuity. Policy makers and supervisory bodies should exercise oversight to ensure banks comply with both general and specific provisions. In managing default risk, financial sectors should maintain a balanced portfolio of loans and deposits denominated in foreign currency. The Central Bank of Oman monetary policy should regulate the exchange rate between the Oman Shilling and the US Dollar, considering the financial sector's exposures, and strive to mitigate exchange rate volatility. Financial sectors managers should ensure

sufficient liquidity to meet short-term requirements, with the loans-to-deposits ratio optimized to facilitate lending while meeting customers' daily needs. Central banks should ensure that banks hold an adequate proportion of government securities to cover emergency cash requirements. Additionally, managers should prioritize building reserves and reinvesting bank profits to establish defaults risk to support daily operations, cover unexpected losses, and handle contingencies.

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