

A Study of Credit Risk Management in Banks

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Abstract

Risk is the fundamental element that drives financial behavior. Financial institutions, should manage the risk efficiently to survive in the highly uncertain world. The future of banking will undoubtedly rest on risk management dynamics. Only those banks that have efficient risk management system will survive in the market in the end. Credit risk is the oldest and biggest risk that a bank, by virtue of its very nature of business, inherits. This has, however, acquired a greater significance in the recent past for various reasons. Foremost among them is the economic liberalization across the globe. India is an exception to this swing towards market-driven economy. Better credit portfolio diversification enhances the prospects of the reduced concentration credit risk profile and non-performing assets of public sector banks.. Risk Management is the application of proactive strategy to plan, lead, organize, and control the wide variety of risks that are rushed into the fabric of an organization's daily and long-term functioning. Like it or not, risk has a say in the achievement of our goals and in the overall success of an organization. To achieve the objectives of the study data has been collected from secondary sources. Finally, it can be concluded that the banks should take risk more consciously, anticipates adverse changes and hedges accordingly; it becomes a source of competitive advantage, and efficient management of the banking industry. The study identifies various credit risks in scheduled banks and methodologies followed by banks to reduce risks, these by creating a better understanding of credit risks in Banking Sector.

Keywords: Commercial Bank, credit risk, risk management.

INTRODUCTION

Commercial banks are the most important savings, mobilization and financial resource allocation institutions. Consequently, these roles make them an important phenomenon in economic growth and development. In performing this role, it must be realized that banks have the potential, scope and prospects for mobilizing financial resources and allocating them to productive investments. Therefore, no matter the sources of the generation of income or the economic policies of the country, commercial banks would be interested in giving out loans and advances to their numerous Customers bearing in mind, the three principles guiding their operations which are, profitability, liquidity and solvency. However, commercial banks decisions to lend out loans are influenced by a lot of factors such as the prevailing interest rate, the volume of deposits, the level of their domestic and foreign investment, banks liquidity ratio, prestige and public recognition to mention a few. Credit creation is the main income generating activity for the banks. However, this activity involves huge risks to both the lender and the borrower. The

risk of a trading partner not fulfilling his or her obligation as per the contract on due date or anytime thereafter can greatly jeopardize the smooth functioning of a bank's business.

OBJECTIVES OF THE STUDY

- To identify the credit risks faced by the banking industry.
- To study the tools of Credit Risk Management

REVIEW OF LITERATURE

Wu (2002) concluded that Credit risk management has long been the focus of governments, regulatory authorities and financial institutions. Contemporary economy is a credit economy, which has been based on the trusts of different entities. By trust, the lender has the ability that based on the repayment of book value and interest in a certain time or period, to receive money, goods or service.

McKinsey & Company (1997) found that credit risk exposure takes up to 60.0% of risks that banks face while market risk and operational risk take 20.0% respectively.

Duffie and Singleton (2003) found that Credit risk is one of the most general risks that exist in the financial market and a major risk faced by financial institutions.

DeYoung and Whalen (1994) observed that the US Office of the Comptroller of the Currency found the difference between the failed banks and those that remained healthy or recovered from problems was the caliber of management.

Giesecke (2004) concluded that Credit risk is by far the most significant risk faced by banks and the success of their business depends on accurate measurement and efficient management of this risk largely than any other risk.

Basel Committee (1999) found that Risks faced by commercial banks are generally classified into eight categories: credit risk, market risk, interest risk, liquidity risk, operational risk, legislative risk and reputation risk.

In an increasingly complex environment, banking risks can be broadly classified as under.

- **BUSINESS/STRATEGIC RISK**

Business risk is the risk arising from a bank's business strategy in the long term. When a bank fails to adapt to the changing environment as quickly as their competitors do, it faces the risk of losing market share, getting acquired or shutting shop. Technology is changing the banking landscape at an incredibly rapid pace.

- **COMPLIANCE RISK**

In February this year, U.S. Bancorp agreed to pay \$613 million in penalties to state and federal authorities for violations of the Bank Secrecy Act and a faulty AML program. This was a result of the banks' failure to adopt and implement an effective compliance program with adequate internal controls, testing, and training. According to the Bank of International Settlements(BIS), in the banking context, compliance risk is defined as the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to its banking activities. It is imperative for banks to establish an infrastructure to organize and analyze data and efficiently manage legal documentation. The senior management of a bank plays the crucial role in formulating, communicating and managing compliance policies across all business units of the bank to minimize compliance risk.

- **CREDIT RISK**

Credit risk is the one that most would be familiar with as economies continue to recover from the more recent occurrence in the history of financial services: the subprime crisis. Both global and national banks suffered heavy losses due to incorrect evaluation and monitoring of potential default rates on mortgage payments by subprime borrowers. This fiasco resulted in billions of dollars in damages and millions to be jobless overnight. The Basel Committee on Banking Supervision defines credit risk as the potential that a bank borrower, or counterparty, will fail to meet its payment obligations regarding the terms agreed with the bank. It includes both uncertainty involved in repayment of the bank's dues, and repayment of dues on time.

- **CYBER SECURITY RISK**

In May 2018, two of Canada's largest banks, Bank of Montreal, and the Canadian Imperial Bank of Commerce's Simply Financial confirmed hackers stole the personal and financial data of more than 90,000 customers. While the banks took online security measures after the hackers contacted them, it was surprising to see that these processes were not put in place before. Cyber security risk is the most prevalent IT risk in the financial services industry. It refers to the risk undertaken by a financial institution to keep electronic information private and safe from damage, misuse or theft. Cyber security risk is as much of a people risk as it is technology risk.

- **LIQUIDITY RISK**

Northern Rock, a small bank in Northern Ireland, had a small depositors' base and hence financed a significant portion of its loans by securitization. In 2007–08, during the subprime crisis, the bank was unable to sell the loans to other banks that it had originated in the form of new loans resulting in investors withdrawing their money from the bank. This resulted in a liquidity crunch, which led to the bailout by the government and an eventual government takeover. This is a classic example of how imprudent management of liquidity risk can ruin a bank. Liquidity management can be defined as the risk of a bank

not being able to finance its day to day operations. Failure to manage this risk could lead to severe consequences for the bank's reputation as well as the bond pricing and ratings of the bank in the money market.

- **MARKET RISK**

According to The Basel Committee on Banking Supervision, market risk can be defined as the risk of losses in on- or off-balance sheet positions that arise from movement in market prices. The four components of market risk are: **Interest risk, Equity risk, Commodity risk, Foreign Exchange risk**

- **MORAL HAZARD**

The probability for a bank to take on unprecedented levels of risk without evaluating the economic soundness of the decision of risk-taking for all parties involved can be regarded as a moral hazard. The decision is often because a third party/another institution will underwrite the risk. Moral hazard occurs when the bank decides the magnitude of the risk to be undertaken with the knowledge that counterparty bears the cost of the risk taken. Once again, the subprime crisis proves to be a classic example of this. Banks risked depositors' money to facilitate transactions of very risky instruments, knowing they would not face the consequences directly. Top management of all banks can be prone to moral hazard.

- **OPEN BANKING RISK**

An open banking ecosystem functions as a single platform for number participants like regulators and government agencies, data providers, third-party providers, customers, to engage in an open infrastructure with an end motive to enhance the customer experience. While this will push banks to aim at being digital, and make customer data more accessible for the ecosystem to build superior products on, it could also create an environment that would enable more fraud. Aggregated customer data such as transactions maintained in the third-party provider's (FinTech start-up's) infrastructure and servers, can cause significant risk to the bank's cyber security. Banks need to move quickly in complying with PSD2 and GDPR directives laid down by independent government agencies, and the financial regulatory bodies to avoid exposing themselves to a myriad of systemic risks, which could lead to financial as well as reputational damages.

- **OPERATIONAL RISK**

Barings, one of the oldest British Banks in 1995, collapsed due to mismanagement of operational risk. One of its traders successfully hid his trading losses for more than two years due to inefficient and inadequate internal controls. He authorized his own trades without any approvals. The supervisors only noticed once the losses became huge and could not be hidden any longer. It was, however, too late. The Basel Committee on Banking Supervision defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people, and systems or external events. All banks (full

service/others) face operational risks in their day-to-day BAUs across all their departments including treasury, credit, investment, information technology.

- **REPUTATIONAL RISK**

Punjab National Bank, the second largest public sector bank in India, was defrauded for more than ~\$1.647 billion by the largest diamond and jewelry businesses in the country, making it the largest fraud to be detected. The fraud, incidentally, is 49X the net profit posted by PNB for the quarter ending December 31, 2017, and more than twice the amount that PNB got under bank recapitalization plan. This scam has caused immense mistrust in the bank's internal controls and checks causing massive damage not only to its market capitalization but more importantly to its reputation in the country.

- **SYSTEMATIC RISK**

This risk includes a possibility of bringing down the entire financial system to a standstill, what was possibly seen during the dot-com bubble in 1995, or the housing market crash of 2008. This is caused due to a domino effect where the failure of one bank could ripple down the failure of its counterparties/other stakeholders, who could, in turn, threaten the entire financial services industry. The Volatility Index (or VIX) is a good measure of systemic risk. Systemic risk, in itself, would not lead to direct losses. However, in a scenario where VIX is at high levels, there is a high probability of market risks (and other risks) to reach very high levels which would eventually lead to losses.

Tools of Credit Risk Management

- **Credit Approving Authority**

Each bank should have a carefully formulated scheme of delegation of powers. The banks should also evolve multi-tier credit approving system where the loan proposals are approved by an 'Approval Grid' or a 'Committee'. The spirit of the credit approving system may be that no credit proposals should be approved or recommended to higher authorities, if majority members of the 'Approval Grid' or 'Committee' do not agree on the creditworthiness of the borrower. In case of disagreement, the specific views of the dissenting member/s should be recorded.

- **Risk Rating**

As observed by RBI, Credit Risk is the major component of risk management system and this should receive special attention of the Top Management of the bank. The process of credit risk management needs analysis of uncertainty and analysis of the risks inherent in a credit proposal. The predictable risk should be contained through proper strategy and the unpredictable ones have to be faced and overcome. Therefore any lending decision should always be preceded by detailed analysis of risks and the outcome of analysis should be taken as a guide for the credit decision.

- **Risk Pricing**

Risk-return pricing is a fundamental tenant of risk management. In a risk-return setting, borrowers with weak financial position and hence placed in high credit risk category should be priced high. Thus, banks should evolve scientific systems to price the credit risk, which should have a bearing on the expected probability of default. The pricing of loans normally should be linked to risk rating or credit quality.

- **Portfolio Management**

The existing framework of tracking the Non Performing Loans around the balance sheet date does not signal the quality of the entire Loan Book. Most of international banks have adopted various portfolio management techniques for gauging asset quality. The portfolio quality could be evaluated by tracking the migration (upward or downward) of borrowers from one rating scale to another.

- **Loan Review Mechanism (LRM)**

LRM is an effective tool for constantly evaluating the quality of loan book and to bring about qualitative improvements in credit administration. Banks should, therefore, put in place proper Loan Review Mechanism for large value accounts with responsibilities assigned in various areas such as, evaluating the effectiveness of loan administration, maintaining the integrity of credit grading process, assessing the loan loss provision, portfolio quality, etc.

- **Inter-bank Exposure and Country Risk**

A suitable framework should be evolved to provide a centralized overview on the aggregate exposure on other banks. Bank-wise exposure limits could be set on the basis of assessment of financial performance, operating efficiency, management quality, past experience, etc. Like corporate clients, banks should also be rated and placed in range of 1-5, 1-8, as the case may be, on the basis of their credit quality. The limits so arrived at should be allocated to various operating centers and followed up and half-yearly/annual reviews undertaken at a single point.

- **Exposure Ceilings**

Prudential Limit is linked to Capital Funds – say 15% for individual borrower entity, 40% for a group with additional 10% for infrastructure projects undertaken by the group, Threshold limit is fixed at a level lower than Prudential Exposure; Substantial Exposure, which is the sum total of the exposures beyond threshold limit should not exceed 600% to 800% of the Capital Funds of the bank (i.e. six to eight times).

- **Review/Renewal**

Multi-tier Credit Approving Authority, constitution wise delegation of powers, Higher delegated powers for better-rated customers; discriminatory time schedule for review/renewal, Hurdle rates and Bench marks for fresh exposures and periodicity for renewal based on risk rating, etc are formulated.

- **Risk based scientific pricing**

Link loan pricing to expected loss. High-risk category borrowers are to be priced high. Build historical data on default losses. Allocate capital to absorb the unexpected loss.

CONCLUSION

The following are the conclusions of the study.

- Risk management underscores the fact that the survival of an organization depends heavily on its capabilities to anticipate and prepare for the change rather than just waiting for the change and react to it.
- The objective of risk management is not to prohibit or prevent risk taking activity, but to ensure that the risks are consciously taken with full knowledge, clear purpose and understanding so that it can be measured and mitigated.
- Functions of risk management should actually be bank specific dictated by the size and quality of balance sheet, complexity of functions, technical/ professional manpower and the status of MIS in place in that bank.
- Risk Management Committee, Credit Policy Committee, Asset Liability Committee, etc are such committees that handle the risk management aspects.
- The banks can take risk more consciously, anticipates adverse changes and hedges accordingly; it becomes a source of competitive advantage, as it can offer its products at a better price than its competitors can.
- Regarding use of risk management techniques, it is found that internal rating system and risk-adjusted rate of return on capital are important.

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