CREDIT RISK MANAGEMENT PRACTICES OF INDIAN COMMERCIAL BANKS

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ABSTRACT

Risk is inherent part of bank's business. Effective risk management is critical to any bank for achieving financial soundness. In view of this, aligning risk management to bank's organizational structure and business strategy has become integral in banking business. Credit risk is the bank's risk of loss arising from a borrower who does not make payments as promised. Such an event is called as default. Another term for credit risk is default risk. The risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise to meet a contractual obligation is termed as credit risk. Credit risk arises whenever a borrower is expecting to use future cash flows to pay a current debt. Banks are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation.

KEYWORDS: *Bank, Credit Risk, Loan, Risk Management, The Borrower, The Lender.*

Introduction

Credit risk (or counterparty risk) is increasingly faced by banks in their product assortment (not only lending) and can be considered as the oldest and largest risk in banking. Important in a bank relationship is the "know your client principle", by becoming familiar with the borrower and/or credit base1. It is important that banks deal with customers with sound reputation and creditworthiness. Therefore banks need not only manage the credit risk in their credit portfolio but also that in any individual credit or transaction.

The relationship between credit risk and other risks should also be considered by banks. The effective management of credit risk is a critical component of a comprehensive approach to risk management and important to the long-term success of any banking organization. Effective credit risk management process is a way to manage portfolio of credit facilities.

Credit risk management encompasses identification, measurement, monitoring and control of the credit risk exposures. The effective management of credit risk is a critical component of comprehensive risk management and essential for the long term success of a banking organization.

Literature Review

Commercial banking plays a dominant role in commercial lending (Allen & Gale, 2004). Commercial banks routinely perform investment banking activities in many countries by providing new debt to their customers (Gande, 2008). The credit creation process works smoothly when funds are transferred from ultimate savers to borrower (Bernanke, 1993). There are many potential sources of risk, including liquidity risk, credit risk, interest rate risk, market risk, foreign exchange risk and political risks (Campbell, 2007). However, credit risk is the biggest risk faced by banks and financial intermediaries (Gray, Cassidy, & RBA., 1997). The credit risk's indicators include the level of non-performing loans, problem loans or provision for loan losses (Jimenez & Saurina, 2006). Credit risk is the risk that a loan which has been granted by a bank will not be either partially repaid on time or fully and where there is a risk of customer or counterparty default. Credit risk management processes enforce the banks to establish a clear process in for approving new credit as well as for the extension to existing credit. These processes also follow monitoring with particular care, and other appropriate steps are taken to control or mitigate the risk of connected lending (Basel, 1999).

Credit granting procedure and control systems are necessary for the assessment of loan application, which then guarantees a bank's total loan portfolio as per the bank's overall integrity (Boyd, 1993). It is necessary to establish a proper credit risk environment, sound credit granting processes, appropriate credit administration, measurement, monitoring and control over credit risk, policy and strategies that clearly summarize the scope and allocation of bank credit facilities as well as the approach in which a credit portfolio is managed i.e. how loans are originated, appraised, supervised and collected, a basic element for effective credit risk management (Basel, 1999). Credit scoring procedures, assessment of negative events probabilities, and the consequent losses given these negative migrations or default events, are all important factors involved in credit risk management systems (Altman, Caouette, & Narayanan, 1998). Most studies have been inclined to focus on the problems of developing an effective method for the disposal of these bad debts, rather than for the provision of a regulatory and legal framework for their prevention and control (Campbell, 2007).

Macaulay (1988) conducted a survey in the United States and found credit risk management is best practice in bank and above 90% of the bank in country have adopted the best practice. Inadequate credit policies are still the main source of serious problem in the banking industry as result effective credit risk management has gained an increased focus in recent years. The main role of an effective credit risk management policy must be to maximize a bank's risk adjusted rate of return by maintaining credit exposure within acceptable limits. Moreover, banks need to manage credit risk in the entire portfolio as well as the risk in individual credits transactions.

To implement effective credit risk management practice private banks are more serious than state owned banks. A survey conducted by Kuo & Enders (2004) of credit risk management policies for state banks in China and found that mushrooming of the financial market; the state owned commercial banks in China are faced with the unprecedented challenges and tough for them to compete with foreign bank unless they make some thoughtful change. In this thoughtful change, the reform of credit risk management is a major step that determines whether the state owned commercial banks in China would survive the challenges or not. Research however faults some of the credit risk management policies in place the broad framework and detailed guidance for credit risk assessment and management is provided by the Basel New Capital Accord which is now widely followed internationally (Campbell, 2007).

Components of Credit Risk

Credit risk consists of primarily two components, viz, quantity of risk, which is nothing but the outstanding loan balance as on the date of default and the quality of risk, viz, the severity of loss defined by both probability of default as reduced by the recoveries that could be made in the event of default. Thus credit risk is a combined outcome of Default Risk and Exposure Risk.

Objectives of Credit Risk Management

The objectives are to:

- Evolve an integrated framework for charting/categorising various types of loans and advances, and determine implications on quality of credit and risk.
- Draw up suitable strategies at the corporate level to attain the prescribed levels/quality of exposure and issue guidelines to Strategic Business Units (SBUs). Benchmarks could be in term of recovery percentages, NPA levels, volume of exposure, etc.
- Review the exposures and performance periodically.
- Devise suitable control/monitoring mechanisms.
- Evolve and refine analytical tools to assess risk profiles, for ensuring healthy portfolios and guarding against sickness.

Requirements of Effective Credit Risk Management in Banking

Basel II Accord identifies that effective credit risk management is a critical component of a bank's overall risk management strategy and is essential to the long–term success of any banking organization. Overall, the components of effective credit risk comprise.

Active Board and senior management oversight

Sufficient policies, procedures and limits

Adequate risk measurement, monitoring

Management information systems

Comprehensive internal controls

RBI Expectations from Banks on Credit Risk Management

RBI expects that banks take specific measures, mainly at the Corporate Level, for implementing appropriate Credit Risk Management Systems in the bank. The policy will involve the following:

- Policy framework
- Credit rating framework
- Credit risk models
- Portfolio management and Risk Limits
- Managing Credit Risk in Inter-Bank Exposure
- Credit Risk in Off-Balance Sheet Exposure
- Country Risk
- Loan Review Mechanism/Credit Audit
- RAROC(Risk adjusted return on capital) pricing/Economic profit
- Basel II Accord: Implications for Credit Risk Management The

banks are required to

- Ensure that their Risk Management functions considers the above issues as applicable to the bank and put in place appropriate structures/systems. This will ensure that Risk Based Supervision (RBS) is effective.
- Each bank must have a Credit Rating Framework to suit their requirements.

Credit Risk Management Encompasses

The management of credit risk should receive the top management's attention and the process should encompass:

- Measurement of risk through credit rating/scoring;
- Risk pricing on a scientific basis;
- Controlling the risk through effective Loan Review Mechanism and portfolio management; and
- Quantifying the risk through estimating expected loan losses i.e. the amount of loan losses that bank would experience over a chosen time horizon (through tracking portfolio behaviour over 5 or more years) and unexpected loan losses i.e. the amount by which actual

losses exceed the expected loss (through standard deviation of losses or the difference between expected loan losses and some selected target credit loss quantile).

Mitigation of Credit Risk by Banks/Lenders

Banks/Lenders mitigate credit risk by using several methods:

(i) Risk-based pricing: Lenders generally charge a high interest rate to borrowers who are more likely to default, a practice called risk-based pricing. Lenders consider factors relating to the loan such as loan purpose, credit rating and loan-to-value ratio and estimate the effect on yield (credit spread).

(ii) Covenants: Lenders may write stipulations on the borrower, called covenants, into loan agreements:

- Periodically report its financial condition
- Refrain from paying dividends, repurchasing shares, borrowing, further, or other specific, voluntary actions that negatively affect the company's financial position
- Repay the loan in the full , at the lender's request, in certain events such as changes in the borrower's debt-to-equity ratio or interest coverage ratio.

(iii) Credit insurance and credit derivatives: Lenders and bond holders may hedge their credit risk by purchasing credit insurance or credit derivatives. These contracts the transfer risk from the lender to the seller (insurer) in exchange for payment. The most common credit derivative is the credit default swap.

(iv) Tightening: Lenders can reduce credit risk by reducing the amount of credit extended, either in total or to certain borrower's. For example, a distributor selling its products to a troubled retailer may attempt to lessen credit risk by reducing payment terms from net 30 to net 15.

(v) Diversification: Lenders to a small number of borrowers (or kinds of borrower) face a high degree of unsystematic credit risk, called concentration risk. Lenders reduce this risk by diversifying the borrower pool.

(vi) Deposit insurance: Many governments establish deposit insurance to guarantee bank deposits of insolvent banks. Such protection discourages consumers from withdrawing money (when a bank is becoming insolvent, to avoid a bank run), and encourages consumers to holding their savings in the banking system instead of in cash.

Generally the issues related to Credit Risk are addressed in the policies stated in the Bank's policy namely – Loan Policy, Credit monitoring Policy, Real Estate Policy, Credit Risk Management Policy, Collateral Risk Management Policy, Recovery Policy, Treasury Policy (Kanhaiya Singh,2011).

Conclusion

Credit Risk Management Policy of the bank dictates the Credit Risk Strategy. These policies spell out the target markets, risk acceptance/avoidance levels, risk tolerance limits, prefer levels of diversification and concentration, credit risk measurement, monitoring and controlling mechanisms. The ever-improving risk management practices in the Bank will result in Bank emerging stronger, which in turn would confer competitive advantage in the market.

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