CREDIT RISK MANAGEMENT IN INDIAN BANKING SYSTEM

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ABSTRACT - The Indian Banking Industry is making a great advancement in terms of quality, quantity, expansion, diversification and is keeping up with updated technology, ability, stability and thrust of financial system, where commercial bank play very important role and emphasize a need of strong effective control system with extra concerned for risk involved in the business. Risk is inherent part of bank's business. Effective risk management is critical to any bank for achieving financial soundness. Credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. The goal of credit risk management is to maximize a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Banks need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions. Banks should also consider the relationships between credit risk and other risks. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organization.

KEY WORDS: - Bank, Borrower, Credit risk, Loan, Risk Management.

I. INTRODUCTION

Credit risk is the oldest form of risk that is faced by the bankers across the globe. It is the risk of default on loans. Credit risk is the biggest risk the bank face by the virtue of nature of business, inherits. Important in a bank relationship is "know your client principles," by becoming familiar with the borrower. It is important that bank deal with customer with sound reputation and creditworthiness. Therefore banks need to manage the credit risk in their credit portfolio but also that in any individual credit or transaction. The effective management of credit risk is a critical component of comprehensive risk management and essential for the long success of a banking organization.

In recent decades credit risk has become pervasive. Companies borrow to make acquisitions and to grow, small business borrow to expand their capacity and individuals use credit for other purpose. Since exposure to credit risk continues to be the leading source of problems in banks worldwide, banks and their supervisors should be able to draw useful lessons from past experiences. Banks should now have a keen awareness of the need to identify, measure, monitor and control credit risk as well as to determine that they hold adequate capital against these risks and that they are adequately compensated for risks incurred.

II. LITERATURE REVIEW

Article 1

Title: Credit as well as credit risk management in banks, February 2005

Author: R S Raghavan

About the Research:

Lending methods adopted by banks is a combination of turnover method, cash flow method, cash budget method, projected balance sheet method, net owned fund method and the popular one-size fits all second method of lending. Credit monitoring is an important function of credit management. Credit department should be expertise oriented. Credit risk components include quantity & quality of risk. Exposure ceilings, review, risk rating model, risk based scientific pricing, portfolio management, credit loan review mechanism are the tools of credit risk management.

It concludes that banks should lend according to their risk appetite within the need based assessment of the credit requirement of the borrower. An ideal credit risk management system should show a single number as to how much the bank would lose on credit portfolio and how much capital it ought to hold.

Article 2

Title: "RISK MANAGEMENT IN COMMERCIAL BANKS" (A CASE STUDY OF PUBLIC AND PRIVATE SECTOR BANKS), December 2005

Author: **Prof. Rekha Arunkumar**Ph.D., from University of Mysore, **Dr. G. Kotreshwar**Ph.D., M.Com, ICWAI,Professor of Commerce,.

III. ABOUT THE RESEARCH

This article illustrates that credit risk management in today's deregulated market is a challenge. The very complexion of credit risk is likely to undergo a structural change in view of migration of Tier-I borrowers and, more particularly, the entry of new segments like retail lending in the credit portfolio. These developments are likely to contribute to the increased potential of credit risk and would range in their effects from inconvenience to disaster. To avoid being blindsided, banks must develop a competitive Early Warning System (EWS) which combines strategic planning, competitive intelligence and management action. EWS reveals how to change strategy to meet new realities, avoid common practices like benchmarking and tell executives what they need to know – not what they want to hear.

It concludes that the reputation of a bank is very important for corporate clients. A corporation seeks to develop relationship with a reputable banking entity with a proven track record of high quality service and demonstrated history of safety and sound practices. Therefore, it is imperative to adopt the advanced Basel-II methodology for credit risk. The Basel Committee has acknowledged that the current uniform capital standards are not sensitive and suggested a Risk Based Capital approach. Reserve Bank of India's Risk Based Supervision reforms are a fore-runner to the Basel Capital Accord-II. For banks in India with the ' emerging markets' tag attached to them going down the Basel-II path could be an effective strategy to compete in very complex global banking environment. Indian banks need to prepare themselves to be competed among the world's largest banks. As our large banks consolidate their balance sheets size and peruse aspirations of large international presence, it is only expected that they adopt the international best practices in credit risk management**.**

Article 3

Title: Risk management in Indian banks: Some emerging issues, 2010

Author: Dr. Krishna A Goyal, Convener & Head, Management Department, Bhopal Nobel' (P.G.) College, Udaipur, Prof. Sunita Agrawal, Director, Pacific Business School, Udaipur (Raj.)

About the Research:

The article speaks about the various types of risk the banks face in the current scenario. It speaks about the need for risk management and the process of risk management. The tools required for risk control such as diversification of business, insurance and hedging, fixation of exposure ceiling and transfer of risk to another party on time, and securitization and reconstruction are also mentioned. It also talks about the structure of BASEL II. Capital ratio is defined as,

Total capital –Tier I + Tier II + Tier III
Credit risk + Market risk + Operational risk

This is minimum capital requirement for banks to manage credit risk. It also talks about the implementation challenges faced by Indian banks in light of risk management, such as implementation of new framework which requires substantial resources, increase in capital requirements due to new norms, data intensiveness of risk management, building models and forecasting and trained and skilled manpower.

Article: 4

Title: BASEL BANKING NORMS: THEIR EFFICACY, ANALYSIS IN THE GLOBAL CONTEXT & FUTURE DIRECTION, 2010

Author: Mohane, Yatin and Shenoy, Akshay

About the Research:

This article aims to first build a deeper understanding of the emergence of Basel banking norms (Basel I), and the transition to each of the subsequent regulations (Basel II and Basel III). The primary purpose of developing this understanding is to further analyze the extent of effectiveness of the Basel norms. To explore how such regulations impact an economy, author has specifically looked at four economies of the world, which are geographically apart, in this context. The idea is to study how; for instance, banking institutions have shaped up to these norms – and whether the effects were favorable or adverse. Then conclude by conceptually looking at the future direction of regulations such as the Basel norms in the banking industry.
The Basel norms, at some level, aim to create a global banking system that is fairly homogenous. While this very aim purports to build a more robust financial system, it may actually be its undoing. Simply speaking, a diverse group is an advantage since an attack only affects a certain percentage of its constituents.
The Basel norms also fail to consider national competencies. We have a global scenario where individual countries vastly differ in their extent of development. In an age where international banks are so prevalent, such differences across geographies can become tricky to deal with. The Basel accords need to incorporate, in some form, the element of national competencies so as to create a level-playing field.

While the Basel accords aim to bring along a host of benefits, they inevitably imply high costs for the adopting nations. This is especially true because there is no single set of dates corresponding to the implementation of a particular Basel regulation (say, Basel III) worldwide. This lack of synchronization in the adoption of the norms dilutes their efficacy. The proposal of phases and timelines for implementation should be put forth in a manner that ensures a fair amount of coordinated adoption.

Article 5

Title: An Empirical Analysis and Comparative Study of Credit Risk Ratios between Public and Private Sector Commercial Banks in India, 2011

Author: Somanadevi Thiagarajan (Ph.D. Scholar, Management Sciences, Anna University of Technology, Coimbatore, India Lecturer faculty of Management, A. Ramachandran (Director, SNR Institute of Management sciences, SNR son's college, Coimbatore, India)

About the Research:
In this article, a study was carried out to measure the credit risk component of the Indian Scheduled Commercial Banking Sector by using data of ten years (2001-2010). It illustrates how credit risk ratios can be used to measure the credit risk in the banking sector. The results of the study indicate a consistent increase in the total loans to total assets ratio and the total loans to total deposits ratio for both public and private sector during the period of study. There was a gradual decrease in the ratio of nonperforming loans to total loans for both public and private sector banks from 2001 to 2008 but there has been a gradual increase from 2009 to 2010 and this is significantly higher for private sector banks as compared to public sector banks. Also the study indicates a significantly drastic increase in the total loans to equity ratio in the public sector banks in the last four years. It also indicates that banks can have their own risk management practices but has to be appropriately disclosed.

IV. Objectives of Credit Risk Management:

- Evolve integrated framework for categorizing various types of loans and advances and determine implications on quality of credit risk.
- Draw up suitable strategies at the corporate level to attain the prescribed level of exposure and issue guidelines to strategic Business Units. Benchmarks could be in terms of recovery percentages, NPA levels, volume of exposure, etc.
- Review the exposure and performance periodically.
- Devise suitable control or monitoring mechanisms.
- Evolve and refine analytical tools assess risk profiles, for ensuring healthy portfolio and guarding against sickness.

V. Components of Credit Risk

The primary components of a sound credit risk management process are:

- A sound, well-defined credit-granting criterion.
- A comprehensive risk measurement and evaluation approach.
- A detailed structure of limits, guidelines and other parameters used to govern risk taking.
- A strong management information system for controlling, monitoring and reporting risks.
- An effective problem credit management process.

VI. Sound Credit Risk Management and Monitoring

- Establish an effective loan review system and address key elements of an effective loan review program (such as qualification and independence of loan review personnel, frequency, scope and depth of review of findings and follow up and work paper and report distribution.)
- Establish a comprehensive and effective credit grading system.
- Create portfolio mix and risk diversification guidelines and limits.
- Establish collection and problem loan resolution procedures.
- Establish charge- off and nonaccrual policies.
- Establish the methodology for determining the adequacy of the allowance for loan and lease losses. It should also ensure compliance with Accounting standards codification and regulatory guidance.
- Establish a threshold for annual credit reviews to assess the financial strength of borrowers.

- Establish procedures to identify, approve, monitor and report all loan policy exceptions with acceptable risk mitigates. Additionally, the loan policy should set risk tolerances for total policy executions.

The loan policy should be tailored to the organization and reflect the local or regional economic conditions and credit needs. At least annually, the board should review and revise the policy and communicate the policy to all appropriate personnel. Deviation from the loan policy should not be recurring or excessive and should be reported (by policy exception and in the aggregate) to the board of directors.

VII. EVALUATION PROCESS FOR CREDIT ACTIVITIES

- Banking institutions should identify and manage credit risk inherent in all products and activities.

- Banking institutions should conduct a product approval program to assess the risks inherent in any new product or area of business. They should ensure that the risks of products and activities new to them are subject to adequate procedures and controls before being introduced or undertaken. These products / activities should be approved by the Board or an appropriate committee. Where this function is being carried out by a committee, the Board should be informed at the nearest Board meeting. Industry specialists should be engaged to assist the banking institution in its risk assessment, where necessary.

- For existing products, a regular evaluation program should be conducted. The Board or the appropriate committee should set a policy on review interval or date.

- Each product approval / evaluation program should be signed off by the various management in charge of the following risks:
  - Credit risk
  - Market risk (if any)
  - Liquidity risk (if any)
  - Legal risk
  - Accounting and financial reporting
  - Audit and internal control

To ascertain that the relevant issues surrounding the product pertaining to their area have been properly examined and that they are satisfied with being able to assimilate them properly into their respective scope of responsibility.

VIII. MITIGATING CREDIT RISK

Lenders mitigate credit risk using several methods:

- Risk-based pricing: Lenders generally charge a higher 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 estimates the effect on yield (credit spread).

- 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 full, at the lender's request, in certain events such as changes in the borrower's debt-to-equity ratio or interest coverage ratio

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

- Tightening: Lenders can reduce credit risk by reducing the amount of credit extended, either in total or to certain borrowers. 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*.

- 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.

- Deposit insurance: Many governments establish deposit insurance to guarantee bank deposits in the event of insolvency and encourage consumers to hold their savings in the banking system instead of in cash.

IX. CONCLUSION

The major cause of serious banking problems continues to be ineffective credit risk management. For this reason, credit quality is considered a primary indicator of the financial soundness of these institutions. The objective of credit risk management is to maximize a financial institution's risk adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Credit risk management should not only effectively address the credit risk inherent in the credit portfolio, but should also consider the relationships between credit risks and other risks. The effective management of credit risk is a critical component of a comprehensive approach to total risk management and is fundamental to the safety and soundness of financial institutions. Appropriate policies, procedures and systems should be implemented at each financial institution to effectively identify measure, monitor and control credit risk.

The bottom line for today's banking institutions, particularly the largest and most complex ones, is that they must continue to monitor very carefully the embedded risks of their credit products and services, pay close attention to subtle changes in business practices that could affect the risks related to a given product, and fully understand how the risks in all their business lines intersect and combine to affect the risk profile of the consolidated entity.

X. References

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