**CREDIT RISK MANAGEMENT IN COMMERCIAL BANKS:**

**AN INDIAN EXPERIENCE**

**Prafulla Kumar Rout\***

***ABSTRACT***

*Recent cases of bank failure across nations have been traced largely to rising „toxic assets‟ in commercial banks loan portfolio..Risk is inherent part of bank’s business. Effective risk management is critical to any bank for achieving financial soundness. Financial risk in a banking organization is possibility that the outcome of an action or event could bring up adverse impacts. Such outcomes could either result in a direct loss of earnings or capital or may result in imposition of constraints on bank’s ability to meet its business objectives.*

*This study evaluates the influence of credit risk management on financial performance of Commercial Banks in India. Aligning risk management to bank’s organisational 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 as event is called as default. 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 wind of economic liberalization that is blowing across the globe. India is no exception to this swing towards market-driven economy. Better credit portfolio diversification enhances the prospects of the reduced concentration credit risk as empirically evidenced by direct relationship between concentration credit risk profile and NPAs of public sector banks.*

**Key words:- Credit risk, , Banks, credit management, Risk in fund, fund management ,**

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

\*Research Scholar, P.G.Dept. of Commerce, Utkal University, Vani Vihar, Bhubaneswar.

**INTRODUCTION**

The past decade has seen dramatic losses in the banking industry. Firms that had been performing well suddenly announced large losses due to credit exposures that turned sour, interest rate positions taken, or derivative exposures that may or may not have been assumed to hedge balance sheet risk. In response to this, commercial banks have almost universally embarked upon an upgrading of their risk management and control systems.

The health of the financial system has important role in the country as its failure can disrupt economic development of the country. Financial performance is company’s ability to generate new resources; from day to day operation over a given period of time and it is gauged by net income and cash from operation. The financial performance measure can be divided into traditional measures and market based measures. During the 1980’s and 1990’s when the financial and banking crises became worldwide, new risk management banking techniques emerged. To be able to manage the different types of risk one has to define them before on can manage them. The risks that are most applicable to banks risk are: credit risk, interest rate risk, liquidity risk, market risk, foreign exchange risk and solvency risk. Risk management is the human activity which integrates recognition of risk, risk assessment, developing strategies to manage it, and mitigation of risk using managerial resources whereas credit risk is the risk of loss due to debtor’s nonpayment of a loan or other line of credit (either the principal or interest or both). Default rate is the possibility that a borrower will default, by failing to repay principal and interest in a timely manner. A bank is a commercial or state institution that provides financial services, including issuing money in various forms, receiving deposits of money, lending money and processing transactions and the creating of credit.

 Credit risk management is very important to banks as it is an integral part of the loan process. It maximizes bank risk, adjusted risk rate of return by maintaining credit risk exposure with view to shielding the bank from the adverse effects of credit risk. Bank is investing a lot of funds in credit risk management modeling. Credit risk is the current and prospective risk earnings or capital arising from an obligor’s failure to meet the terms of any contract with the bank or otherwise to perform as agreed. Credit risk management is a structured approach to managing uncertainties through risk assessment developing strategies to manage it, and mitigation of risk using managerial resources. The strategies include transferring to another party, avoiding the risk, reducing the negative effects of the risk and accepting some or all of the consequences of a particular risk. Credit risk management is very important to banks as it is an integral part of the loan process. It maximizes bank risk, adjusted risk rate of return by maintaining credit risk exposure with view to shielding the bank from the adverse effects of credit risk.

When banks grant loans, they expect the customers to repay the principal and interest on an agreed date. A credit facility is said to be performing if payment of both principal and interest are up to date in accordance with agreed repayment terms. The non-performing loans (NPLs) represent credits which the banks perceive as possible loss of funds due to loan defaults. They are further classified into substandard, doubtful or lost. Bank credit in lost category hinders bank from achieving their set target.

Credit risk in commercial banks represents the most important type of risk. Banks bear the credit risk attached to bank loans and forward contracts. The risk of defaults or protracted arrears on outstanding loan is termed as credit risk . Credit Risk is the potential that a bank borrower or counter party fails to meet the obligations on agreed terms. It mainly arises from the potential that a borrower or counterparty will fail to perform on an obligation.

**Literature Review**

Some of the related literature reviews have been critically examined in this paper relating to the credit management and risk in banking sector in India.

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.

Boyd (1993) 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.

Altman, Caouette, & Narayanan, (1998) 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) 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.

Demirguc-Kunt and Huzinga (1999) opined that credit risk management is in two-fold which includes, the realization that after losses have occurred, the losses becomes unbearable and the developments in the field of financing commercial paper, securitization, and other non-bank competition which pushed banks to find viable loan borrowers.

Basel (1999) reported that 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.

Kargi, (2011) studied that Credit risk management maximizes bank’s risk adjusted rate of return by maintaining credit risk exposure within acceptable limit in order to provide framework for understanding the impact of credit risk management on banks’ profitability.

**OBJECTIVE OF THE STUDY**

* to make a study on the credit management in different commercial banks
* to suggest the risk minimisation in credit management system in commercial banks

**Risk Management in Commercial Banks:**

Risk management is an essential element of corporate governance, needed to balance risk and reward- threat and opportunity- strategy and operations. Sound and effective risk management and controls promote both bank and industry stability making the investors and counterparties feel rather confident to involve in financial deals. Banks have economic and commercial incentives to employ strong risk management internal control systems. Without such controls, a bank is vulnerable to risk. The importance of risk management and controls in protecting against serious and unanticipated loss is best illustrated by some recent cases where risk management and controls broke down or were not properly implemented

Initially, the Indian banks have used risk control systems that kept pace with legal environment and Indian accounting standards. But with the growing pace of deregulation and associated changes in the customer’s behaviour, banks are exposed to mark-to-market accounting. Therefore, the challenge of Indian banks is to establish a coherent framework for measuring and managing risk consistent with corporate goals and responsive to the developments in the market. As the market is dynamic, banks should maintain vigil on the convergence of regulatory frameworks in the country, changes in the international accounting standards and finally and most importantly changes in the clients’ business practices. Therefore, the need of the hour is to follow certain risk management norms suggested by the RBI and BIS.

The Reserve Bank of India has been using CAMELS rating to evaluate the financial soundness of the Banks. The CAMELS Model consists of six components namely Capital Adequacy, Asset Quality, Management, Earnings Quality, Liquidity and Sensitivity to Market risk. In India, the focus of the statutory regulation of commercial banks by RBI until the early 1990s was mainly on licensing, administration of minimum capital requirements, pricing of services including administration of interest rates on deposits as well as credit, reserves and liquid asset requirements. In these circumstances, the supervision had to focus essentially on solvency issues. After the evolution of the BIS prudential norms in 1988, the RBI took a series of measures to realign its supervisory and regulatory standards and bring it at par with international best practices. At the same time, it also took care to keep in view the socio-economic conditions of the country, the business practices, payment systems prevalent in the country and the predominantly agrarian nature of the economy, and ensured that the prudential norms were applied over the period and across different segments of the financial sector in a phased manner.

**Credit Risk Management : A correlative impact**

A deposit-banking firm like most financial institutions tend to hold little owners capital relative to the aggregate value of its assts. The implication of this is that only a small percentage of total loans need to turn bad to push the entire credit portfolio to the brink of failure. According to Peter and Sylvia (2008) the probability that a deposit banking institution‟s credit portfolio declines in value and perhaps become worthless is known as credit risk while various attempts designed to control and protect banks against adversities associated with these risk exposure are referred to as credit risk management processes.

The process of analyzing credit risk, ranking and quantifying them constitute a substantial aspect of the framework and governance structures for most bank management .Among the reasons advanced for Credit Risk Management include managerial self-interest and appraisal goal; high cost of financial distress and the existence of capital market imperfection. Other motivation for expending managerial resources on Credit Risk Management according to Meyer (2000), it is the need for insolvency avoidance, given the likelihood of poor credit risk management snowballing into financial crisis.

**Credit Risk Management in Commercial Banks :**

The first step in effective credit risk management is to gain a complete understanding of a bank’s overall credit risk by viewing risk at the individual, customer and portfolio levels.While banks strive for an integrated understanding of their risk profiles, much information is often scattered among business units. Without a thorough risk assessment, banks have no way of knowing if capital reserves accurately reflect risks or if loan loss reserves adequately cover potential short-term credit losses. Vulnerable banks are targets for close scrutiny by regulators and investors, as well as debilitating losses.

The key to reducing loan losses – and ensuring that capital reserves appropriately reflect the risk profile – is to implement an integrated, quantitative credit risk solution. This solution should get banks up and running quickly with simple portfolio measures. It should also accommodate a path to more sophisticated credit risk management measures as needs evolve. The solution should include:

* Better model management that spans the entire modeling life cycle.
* Real-time scoring and limits monitoring.
* Robust stress-testing capabilities.
* Data visualization capabilities and business intelligence tools that get important information into the hands of those who need it, when they need it.

**Credit Risk Mitigating processes**

* Banks assess the credit worthiness of the borrower before sanctioning loan i.e., credit rating of the borrower be done beforehand. Credit rating is main tool of measuring credit risk and it also facilitates pricing the loan.
* By applying a regular evaluation and rating system of all investment opportunities, banks reduce its credit risk as it get vital information of the inherent weaknesses of the account.
* Banks fix prudential limits on various aspects of credit – benchmarking Current Ratio, Debt Equity Ratio, Debt Service Coverage Ratio, Profitability Ratio etc.
* There is a maximum limit exposure for single/ group borrower.
* There should be provision for flexibility to allow variations for very special circumstances.
* Alertness on the part of operating staff at all stages of credit dispensation – appraisal, disbursement, review/ renewal, post-sanction follow-up can also be useful for avoiding credit risk.

**Challenges to Successful Credit Risk Management:**

The challenges are many and some of the major challenges in credit risk have been outlined here as :

* **Inefficient data management.** An inability to access the right data when it’s needed causes problematic delays.
* **No groupwide risk modeling framework.** Without it, banks can’t generate complex, meaningful risk measures and get a big picture of groupwide risk.
* **Constant rework.** Analysts can’t change model parameters easily, which results in too much duplication of effort and negatively affects a bank’s efficiency ratio.
* **Insufficient risk tools.** Without a robust risk solution, banks can’t identify portfolio concentrations or re-grade portfolios often enough to effectively manage risk.
* **Cumbersome reporting.** Manual, spreadsheet-based reporting processes overburden analysts and IT.

**CONCLUSION**

Risk is indispensable for banking business, proper assessment of risk is an integral part of a bank’s risk management system. Banks are focusing on the magnitude of their risk exposure and formulating strategies to tackle those effectively. In the context of risk management practices, the introduction of norms and its subsequent adoption by RBI is a significant measure that promises to promote sound risk management practices.RBI enhance the risk sensitivity of capital requirements, promote a comprehensive coverage of risks, offer a more flexible approach through a menu of options, and is intended to be applied to banks worldwide.

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.

Moreover, the RBI has adopted a series of steps to ensure that individual banks tackle risks effectively by setting up risk management cells and also through internal assessment of their risk exposure. Apart from this, RBI has opted for on-site and off-site surveillance methods for effective risk management in the Indian Banking sector, so that systemic risk and financial turmoil can be averted in the country.

**REFERENCE**

* Altman, E., Caouette, J., & Narayanan, P. (1998). Credit-risk Measurement and Management: the ironic challenge in the next decade. *Financial Analysts Journal, 54*(1), 7-11.
* Benedikt, G., Ian, M., Judit, V. C., & Wolf, W. (2007). Bank Behaviour with access to credit risk transfer markets. Research discussion paper, Bank of Finland
* Campbell, A. (2007). Bank insolvency and the problem of nonperforming loans. *Journal of Banking Regulation, 9*(1), 25-45.
* Demirgüç-Kunt, A., & Huizinga, H. (1999). How does foreign entry affect domestic banking markets?.*Journal of Banking & Finance*, *25*(5), 891-911. Diego: Elsevier.
* Gande, A. (2008). Commercial Banks in Investment Banking. In V. T. Anjan & W. A. B.

Arnoud (Eds.), *Handbook of Financial Intermediation and Banking* (pp. 163-188). San

 Diego: Elsevier.

* Jimenez, G., & Saurina, J. (2006). Credit cycles, credit risk, and prudential regulation. *International Journal of Central Banking, 2*(2), 65-98.
* Kargi, H. S. (2011). Credit Risk and the Performance of Nigerian Banks.*AhmaduBello University, Zaria*.
* Kithinji, A. M. (2010). Credit risk management and profitability of Commercial banks in kenya. *School of Business, University of Nairobi, Nairobi*.
* Macaulay, F. R. (1988). Some theoretical problems suggested by the movements of interest rate, bond yields, and stock prices in the United States since 1856.*, New York, NBER*.
* Sacerdoti, E. (2005). *Access to bank credit in sub-Saharan Africa: key issues and reform strategies*. International Monetary Fund.
* Santomero, A. M. (1997). Commercial bank risk management: an analysis of the process. *Journal of Financial Services Research*, *12*(2-3), 83-115.
* Valencia, F. (2012).*Systemic banking crises: a new database* (Vol. 12). International Monetary Fund.
* Waweru, N. M., & Kalani, V. M. (2009). Commercial Banking Crises in Kenya: causes and Remedies. *African Journal of Accounting, Economics, Finance & Banking Research*, *4*(4).