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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.

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.

OBJECTIVES OF CREDIT RISK MANAGEMENT:

Evolve integrated framework for categorizing various types of loans and advances and determine implications on quality of credit risk.

1. 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.
2. Review the exposure and performance periodically.
3. Devise suitable control or monitoring mechanisms.
4. Evolve and refine analytical tools assess risk profiles, for ensuring healthy portfolio and guarding against sickness.

COMPONENTS OF CREDIT RISK:

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

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

SOUND CREDIT RISK MANAGEMENT AND MONITORING:

1. 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.)
2. Establish a comprehensive and effective credit grading system.
3. Create portfolio mix and risk diversification guidelines and limits.
4. Establish collection and problem loan resolution procedures.
5. Establish charge- off and nonaccrual policies.

6. 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.
7. Establish a threshold for annual credit reviews to assess the financial strength of borrowers.
8. 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.

EVALUATION PROCESS FOR CREDIT ACTIVITIES:

1. Banking institutions should identify and manage credit risk inherent in all products and activities.
2. 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.
3. 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.
4. 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.

MITIGATING CREDIT RISK:

Lenders mitigate credit risk using several methods:

1. 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).
2. 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.
3. 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.
4. 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*.
5. 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.
6. 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.

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.

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