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Credit Risk Management in Public and Private Sector Banks

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Abstract: Risk is the fundamental element that drives financial behaviour. Without risk, the financial system would be vastly simplified. However, risk is omnipresent in the newline real world. Financial Institutions, therefore, should manage the risk efficiently to survive in this 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 long run. The effective management of credit risk is a critical component of comprehensive risk management essential for long-term success of a banking institution.Risk management in bank operations includes risk identification, measurement and assessment, and its objective is to minimize negative effects risks can have on the financial result and capital of a bank. Banks are therefore required to form a special organizational unit in charge of risk management. Credit risk is the oldest and biggest risk that bank, by virtue of its very nature of business, inherits. The study attempts to identify the application and implementation of credit risk management in both public and private sector banks.This study also tries to explore various parameters pertinent to credit risk management as it affects banks financial performance. Such parameters covered in the study were return on assets, non-performing assets.

Keywords*: Public Sector Banks, Private Sector Banks, Non-performing Assets, Credit Risk Management.*

I. INTRODUCTION

Credit risk is inherent to rent to the business of lending funds to the borrower. The exposure to that risk make situation more critical when counter party fails to meet the obligations on agreed terms. Credit risk may increase if banks lend to borrower without getting adequate knowledge about the person or his capability to repay the loan. Thus, careful attention to the impact of creditrisk level on bank's profitability is necessary because intense risk puts serious threat to banks and increasingly level of risk may create a chance of closing down the bank's operations. However, credit risk directly hits the financial strength, earnings of banks. In view of this, various practices are followed to manage risk. There are many parameters to observe the intensity of risk. It is very critical for bank to ensure a healthy risk management practice for achieving its goal. Credit risk managementen compasses with various steps such as identify, measure, monitor andcontrol risk exposure. Thus,credit managementframework includes policies and rules relating to monitor risk. The main concern of the policies and rules are to maintainbalance between risk and return, ensure asset diversification or quality of assets. Credit risk management plays crucial role inenhancing efficiency of banking operations. Credit risk management doesn't mean to eliminate credit risk entirely however itallows bank to bring the danger in acceptable parametersor take a reconciliation step betweenrisk levelsand profits soextreme risk couldn't have an effect on the earnings of banks, with the exception of that through healthy risk management techniques, the intensity of risk is additionally determined. As all activities of banks goes through raising funds and grantingcredit, That'swhy it's essentialpart ofbank andessential forlong run successand survival. CRM practices are beinginitiated by banks to strengthen their system.

II. REVIEW OF LITERATURE

Treacy and Carey (2000), foundthat the qualitative factors played more of a role in determining the ratings of loan to small and medium – sized firms, with the loan officer chiefly responsible for ratings, in contrast to large firms in which the credit staff primarily set the ratings using quantitative methods. Anna and Antonio (2005) the study has been highlighted in the proposed Basel Accord II that includes the internal rating approach to credit risk as one of the cornerstones. Adam Anbar (2006) evaluates the credit risk management applications in the Turkish bank sector. His findings also indicate that banks should accelerate their studies and preparations which are related to data about borrowers and loans that are used in credit risk measurement. Abhiman Das Ghosh (2007) examined the determinants of credit risk of banks in emerging economies and factor affecting problem loans of Indian state-owned bank, taking into account both macro-economic and micro-economic variable.Bodla and Verma (2009) made an attempt tohave an in-depth analysisof credit risk management framework by commercial banks in India. Primary survey was conducted in context with sector and size of bank. Credit risk management framework in India is essential for banking system which would enhance the possibility of long-term survival and growth. CRM practices are fully based on the RBI's guidelines. Sahni and Seth (2017) study the different causes responsible for rising NPAs and the impact it has on the operation of banks. The authors have mentioned several preventive and curative measures to control the NPAs. They have suggested that proper assessment regarding the credit-worthiness of the borrower should be done to ensure the speedy recovery of loans. Mishra and Pawaskar (2017) have recommended that banks should have a good credit appraisal system so as to avoid NPAs. They point out that the problem of NPAs can be solved if there is a proper legal structure to support the banks in recovery of debt. Banerjee *et al.* (2018) have examined the status of gross NPAs and net NPAs in private sector banks and public sector banks to study their effect on the asset quality of the banks. Deliberate loan defaults, poor credit management policies, sanctioning of loans without analysing the risk-bearing capacity of the borrowers are the main reasons for piling up of NPAs. The banks should stress on better strategy formulation and its proper execution as well. Stringent provisions by the government could help in reducing the level of NPAs.

Need of the study: -

Credit risk refers to the probability of loss due to a borrower's failure to make payments on any type of debt. Credit risk management is the practice of mitigating losses by understanding the adequacy of a bank's capital and loan loss reserves at any given time – a process that has long been a

challenge for financial institutions. For this reason, every bank has to make credit risk analysis and put credit risk management into the regulatory spotlight. This results the regulators began to demand more transparency. Better credit risk management also presents an opportunity to greatly improve overall performance and secure a competitive advantage. Singh (2014) analysed the bankers' viewpoint towards various types of e-banking risks in selected public, private and foreign banks in India. For the purpose, sample of 107, 104 and 100 respondents (banks employees) from selected public, private and foreign banks respectively were taken for data collection from the region of Haryana, Punjab, Chandigarh, Delhi and NCR. Statistical techniques such as frequency distribution, mode and standard deviation had been applied for analytical purpose. It was found that operational risk is considered as the most important risk in e-banking in all the three categories of banks followed by reputational and legal risk. Strategic risk was considered as the least important risk by all the three sector banks. Further, significant difference in the bankers' viewpoint towards various types of risks in e-banking is observed.

Objectives of the study: -

The main objectives of this study are as follows:

1.To study and understand the concept of credit risk management, advantages and framework of credit risk management

III. RESEARCH METHODOLOGY

The study is based solely on secondary data which was collected from various pre-published articles and research papers that consisted of primary data collected through many field surveys and experiments.

Credit Risk Management

Credit risk arises from the banks' dealings with or lending to a corporate, individual, another bank, financial institution or a country. Credit risk may take various forms, such as:

- In the case of direct lending, that funds will not be repaid
- In the case of guarantees or letters of credit, that funds will not be forthcoming from the customer upon crystallization of the liability under the contract;
- In the case of treasury products, that the payment or series of payments due from the counterparty under the respective contracts is not forthcoming or ceases;
- In the case of securities trading businesses, that settlement will not be affected
- In the case of cross-border exposure, that the availability and free transfer of currency is restricted or ceases.

The more diversified a banking group is, the more intricate systems it would need, to protect itself from a wide variety of risks. These include the routine operational risks applicable to any commercial concern, the business risks to its commercial borrowers, the economic and political risks associated with the countries in which it operates, and the commercial and the reputational risks concomitant with a failure to comply with the increasingly stringent legislation and regulations surrounding financial services business in many territories. Comprehensive risk identification and assessment are therefore very essential to establishing the health of any counterparty.

CRM Framework: -

Credit risk management framework is the combination of various approaches in which all aspects of credit risk are assessedand limits are determined. CRM framework consist all components of credit process, for the purposeful understanding ofcredit risk management, some approaches should be well defined such as policy for credit, classification of assets becausethese are the indicator of the financial soundness of banking industry. Appropriate policy, procedures should be designed inCRM framework.

The components of CRM framework are:

- Policy framework
  - i Strategy and guidelines
  - ii Organizational structure
  - iii Operations support
- Credit risk rating framework: -
  - i Credit scoring
  - ii Credit rating models
  - iii Credit rating analysts
- Credit risk limits: -
  - i Total credit risk exposure for firm, industry
  - ii Risk exposure for region, banks
- Credit risk modelling: -
  - i Altman's Z score model
  - ii KMV model
  - iii Merton model
- Credit risk mitigation: -
  - i Collateral securities
  - ii Guarantees
  - iii Credit derivative
- Credit audit: -
  - i Quality of credit portfolio
  - ii Review of credit administration and credit quality
  - iii Report on regulatory compliance
- Loan review mechanism: -
  - i Identify promptly loan and potential problem area
  - ii Determine adequacy of loan loss provision
  - iii Proper loan documentation

Credit risk management in Public and private sector banks: -

A credit risk is risk of default on a debt that may arise from a borrower failing to make required payments. In the first resort, the risk is that of the lender and includes lost principal and interest disruption to cash flow, and increase collection cost. The loss may be complete or partial. In an

efficient market, higher levels of credit risk will be associated with higher borrowing costs. Because of this, measures of borrowing costs such a yield can be used to infer credit risk levels based on assessments by market participants.

- ❖ Policy framework
  Strategy and guidelines
  Organizational structure
  Operations support
- ❖ Credit risk rating framework
  Credit scoring
  Credit rating models
  Credit rating analysts
- ❖ Credit risk limits
  Total credit risk exposure for firm, industry
  Risk exposure for region, banks
- ❖ Credit risk modelling
  Altman's Z score model
  KMV model
  Merton model
- ❖ Credit risk mitigation
  Collateral securities
  Guarantees
  Credit derivative
- ❖ Credit audit
  Quality of credit portfolio
  Review of credit administration and credit quality
  Report on regulatory compliance
- ❖ Loan review mechanism
  Identify promptly loan and potential problem area
  Determine adequacy of loan loss provision
  Proper loan documentation

❖ Losses can arise in a number of circumstances, for example:

- A consumer may fail to make a payment due on a mortgage loan, credit card, line of credit, or other loan.
- A company is unable to repay asset-secured fixed or floating charge debt.
- A business or consumer does not pay a trade invoice when due.
- A business does not pay an employee's earned wages when due.
- A business or government bond issuer does not make a payment on a coupon or principal payment when due.
- An insolvent insurance company does not pay a policy obligation.
- An insolvent bank won't return funds to a depositor.
- A government grants bankruptcy protection to an insolvent consumer or business.

To reduce the lender's credit risk, the lender may perform a credit check on the prospective borrower, may require the borrower to take out appropriate insurance, such as mortgage insurance, or seek security over some assets of the borrower or a guarantee from a third party. The lender can also take out insurance against the risk or on-sell the debt to another company. In general, the higher the risk, the higher will be the interest rate that the debtor will be asked to pay on the debt. Credit risk mainly arises when borrowers are unableor unwilling to pay.

Non-Performing Assets:

A non-performing asset is a loan or advances for which the principal or interest payment remains overdue for a period of 90 days. In broad sense non-performing asset refers a loan or an account of borrower, which has been classified by a bank or financial institution as sub-standard, doubtful or loss asset in accordance with the directions or guidelines relating toasset classification issued by Reserve Bank of India. Thus, according to Reserve Bank of India, non-performing asset is an asset, including a leased asset, becomes nonperforming when it ceases to generate income for the bank. In India, on the basis of repayment status, assets of a bank are classified into four categories. These are standard asset, substandard asset, doubtful asset and loss asset.

Non-performing asset is a major problem faced by banking sector in India. Both private and public sector banks are facing this problem in recent times in India. In India to calculate about NPAs or bad loans two concepts are generally used- gross NPA and net NPA. Gross NPA is the total amount of NPAs of the bank simply added. The total amount of sub-standard assets, doubtful assets and loss assets along with loss of interest are termed as gross NPA, while total bad asset minus the provision left aside is termed as net NPA. As per the data of 2016, the total amount of gross non-performing asset for both public and private sector banks were more than six lakh crores. During that period regarding ratio of NPA to total advances Indian Overseas Bank was in the worst position, followed by UCO bank and Bank of India.

CONCLUSION

This paper has highlighted the important aspects of credit risk management and the factors actually effecting the significant relationship between bank performance and credit risk management. Better credit risk management results in better bank performance. To improve the efficiency and profitability, the NPAs have to be scheduled. Various steps have been taken by government to reduce the NPAs. All the banks those who are facing low competitiveness on credit risk management and positive changes in productivity should improve their credit risk management to maintain high productivity. However, it needs to build up its capital adequacy ratio and control its nonperforming assets. The poor credit risk management affects bank failures in India. Therefore, effective credit risk management is important in banks and allows them to improve their performance and prevent bank distress.

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