A STUDY ON CREDIT RISK MANAGEMENT IN SCHEDULED BANKS

M. Rajeswari
Associate Professor, Department of Management Studies,
Arupadai Veedu Institute of Technology, Chennai-Tamil Nadu, India

ABSTRACT

Risk is the fundamental element that drives financial behavior. Financial institutions, should manage the risk efficiently to survive in the 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. 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 economic liberalization across the globe. India is on exception to this swing towards market-driven economy. Better credit portfolio diversification enhances the prospects of the reduced concentration credit risk profile and non-performing assets of public sector banks. The study identifies various credit risk in scheduled banks and methodologies followed by banks to reduce risks, these by creating a better understanding of credit risks in Banking Sector.

Key Words: Risk, credit, Scheduled Banks, Exposure

1. INTRODUCTION

India has strong and vibrant banking sector comprising state owned banks, sector banks and local area banks. In addition there are non-banking financial companies which play the role of financial intermediaries. Since the launch of economic liberalization and global programme in 1991, India has considerably relaxed banking regulations and opened the financial sector for foreign investment. India is also committed to further open the banking for foreign investment in pursuance to its commitment to the World Trade Organisation. As monetary authority of the country, the Reserve Bank of India (RBI) regulates the banking industry and lays down guidelines for day-to-day functioning of banks within the overall framework of the Banking Regulation Act, 1949, Foreign Exchange Management Act, 1999 and Foreign Direct investment (FDI) policy of the government.
STATE OWNED BANKS- A OVER VIEW

The Indian banking sector is dominated by 28 state owned banks which operate through a network of above 50,000 branches and 13,000 ATMs. The State Bank of India is the largest bank in the country and along with its seven associate banks has an asset base of above Rs. 7,000 billion (approximately US$ 150 billion). The other largest public sector banks are Punjab National Bank, Canara Bank, Bank of Baroda and IDBI Bank. The public sector banks have overseas operations with Bank of Baroda topping the list with 52 branches, subsidiaries, joint ventures and representative offices outside India, followed by SBI (45 overseas branches/offices) and Bank of India (26 overseas branches/offices). Indian banks, including private sector banks, have 171 branches/offices abroad. SBI is present in 29 countries followed by Bank of Baroda 20 countries and Bank of India 14 countries granted licenses after the government liberalized the banking sector. Some of the well known private sector banks are ICICI bank, HDFC bank and Indus Ind Bank. Yes Bank is the latest entrance to the private sector banking industry. In terms of reach the private sector banks with an asset of over Rs. 5,700 billion (above US$ 124 billion) operate through a network of 6,500 branches and over 7,500 ATMs.

Foreign banks as many as 29 banks originating from 19 countries are operating in India through a network of 258 branches and above 900 ATMs. With total assets of more than Rs. 2,000 billion (above 44 billion US dollars) they are present in 40 centers across 19 Indian states and Union Territories. Some of the leading international banks that are doing brisk business in India include Standard Chartered Bank, HSBC Bank and Citibank N.A. In addition, 31 foreign banks (as on September 15, 2006) belonging to 14 countries were operating in India through their representative offices.

CONTRIBUTION OF REGIONAL BANKS

Rural area in India are served through a network of Regional Rural Banks (RRB’s), urban cooperative banks, rural cooperative credit institutions and local area bank. Many of these banks are not doing well financially and the government is currently engaged in restructuring and consolidating them. Local area banks were of recent origin and as on March 31, 2006 four such banks were operating in the country.

Financial institutions India has seven major state-owned financial institutions which include Industrial Development Bank of India (IDBI), Industrial and Finance Corporation of India (IFCI), Tourism and Finance Corporation of India (TFCI), Exim Bank, Small Industries Development Bank of India (SIDBI), National Bank for Agricultural and Rural Development (NABARD) and National Housing Bank (NHB). These institutions provide term loan and arrange finance. There are also specilised institutions like the Power Finance Corporation (PFC), Indian Railway Finance Corporation (IRFC), Infrastructure Development Finance Company (IDFC) and state level financial corporations. Non banking financial companies.

India also has a vibrant NBFC sector comprising 13,000 NBFCs that are registered with the RBI and find activities like equipment leasing, hire purchase etc. out of the total about 450 NBFC’s are allowed by the RBI to collect funds from the public. Large NBFC’s have an asset base of about Rs. 3,000 billion (about 65 billion US dollars).

RECENT DEVELOPMENT IN BANKING SECTOR

Although the banking companies are registered under the Companies Act, 1956 they are regulated by the RBI which grants license to companies for operating a bank, operating branches and off site ATM’s, fixes statutory liquidity ratio (SLR) and cash reserve ratio (CRR) and lays
down other conditions for day to day operations. The RBI permission is also needed for board level appointment in banks.

With regard to interest rates, individual banks are free to fix rates with the exception of savings banks rate which is decided by the RBI. The individual banks are free to fix lending rates, under the cover of maximum interest rate for loan amount between 25,000 to 2 lakhs should be at 13.5%.

The last decade has seen many positive developments in the Indian banking sector. The policy makers which comprise the Reserve Bank of India (RBI), Ministry of finance and related government and financial sector regulatory entities, have made several notable efforts to improve regulation in the sector. The sector now compares favorable with banking sectors in the region on merits like growth, profitability and non performing assets (NPA). A few banks have established an outstanding track record of innovation, growth and value creation. This is reflected in their market valuation. However, improved regulations, innovation, growth and value creation in the sector remains limited to a small part of it. The cost of banking intermediation in India is higher and bank penetration is far lower than in other markets. India’s banking industry must strengthen itself significantly if it has to support the modern and vibrant economy which India aspires to be. While the onus for this change lies mainly with bank managements, an enabling policy and regulatory framework will also be critical to their success. The failure to respond to changing market realities has stunted the development of the financial sector in many developing countries. A weak banking structure has been unable to fuel continued growth, which has harmed the long-term health of their economies. In this white paper, we emphasize the need to act both decisively and quickly to build an enabling, rather than a limiting banking sector in India.

**BANKS GOOD PERFORMANCE IS A QUESTIONABLE HEALTH**

Indian banks have compared favorable on growth, asset quality and profitability with other regional banks over the last few years. The banking index has grown at a compounding annual rate of over 51 per cent since April 2001 as compared to a 27 per cent growth in the market index for the same period. Policy makers have made some notable changes in policy and regulation to help strengthen the sector. These changes include strengthening prudential norms, enhancing the payments system and integrating regulations between commercial and cooperative banks. However, the cost of intermediation remains high and bank penetration is limited to only a few customer segments and geographies.

While bank lending has been a significant driver of GDP growth and employment, periodic instances of the “failure” of some weak banks have often threatened the stability of the system. Structural weaknesses such as fragmented industry structure, restrictions on capital availability and development, lack of institutional support infrastructure, restrictive labour laws, wear corporate governance and ineffective regulations beyond Scheduled Commercial Bank (SCB), unless addressed, could seriously weaken the health of the sector.

Further, the bank management (with some notable exceptions) to improve capital allocation, increase the productivity of their service platforms and improve the performance ethic in their organizations could seriously affect future performance.

**OPPORTUNITIES AND CHALLENGES FOR BANKS**

The bar for what it means to be a successful player in the sector has been raised. Four challenges must be addressed before success can be achieved.
First, the market is seeing discontinuous growth driven by new products and services that include opportunities in credit cards, customer finance and wealth management on the retail side and in fee-based income and investment banking on the wholesale banking side, these require new skills in sales and marketing, credit and operations.

Second, banks will no longer enjoy windfall treasury gains that the decade long secular decline in interest rates provided. This will expose the weaker banks. Third, with increased interest in India, competition from foreign banks will only intensify. Fourth, given the demographic shifts resulting from changes in age profile and household income, customers will increasingly demand enhanced institutional capabilities and service levels from banks.

The ministry of finance and the RBI and other relevant government and regulatory entities for the banking sector are the “policy makers”. We believe a coordinated effort between the various entities is required to enable positive action. This will spur on the performance of the sector. The policy makers need to make coordinated efforts on six fronts: help shape a superior industry structure in a phased manner through “managed consolidation” and by enabling capital availability. This would create 3-4 global sized banks controlling 35-45 per cent of the market in India. 6-8 national banks controlling 20-25 percent of the market 4-6 foreign banks with 15-20 percent share in the market and the rest being specialist players (geographical of product/segment focused).

Focus strongly on social development by moving away from universal directed norms to an explicit incentive driven framework by introducing credit guarantees and market subsidies to encourage leading public sector, private and foreign players to leverage technology to innovate and profitable provide banking services to lower income and rural markets, create a unified regulator, distinct from the central bank of the country, in a phased manner to overcome supervisory difficulties and reduce compliance costs.

Improve corporate governance primarily by increasing board independence and accountability, accelerate the creation of world class supporting infrastructure (e.g. payments, asset reconstruction companies (ARC), credit bureaus and bank office utilities) to help the banking sector focus on core activities. Enable labour reforms focusing on enriching human capital, to help public sector and old private banks become competitive.

RESEARCH PROBLEM

The commercial banks are involving in many credit loans to customers in order to sustain in the highly competitive world of banks. India’s rate of credit card default has jumped from 50 to 70 percent in the past two years. Credit cards lending rose 85 percent from the past couple of years. And if you do go in the default Indian credit card companies may legally charge up to 49 percent interest.

NEED FOR THE STUDY

The root cause of the current economic slowdown in the US goes back several decades’ indebtedness. In the past, customer spending actually helped the economy as it rose firms sales and encouraged more hiring. But the associated rise in household debt, more obviously in the recent housing bubble.

For more than two decades banks had consumer led growth, which actually mitigated the recessions of the early 1990s and 2001, part of the reason banks had mild recessions was due to consumer strength. But banks kept building up debt. It was also a period of falling nominal interest rates. This meant that every cycle of low interest rates was another opportunity for people to refinance on better terms and extend their spending further.
This economy is changing, however, and banks can’t rely on consumer spending to keep rising beyond its already inflated level. Households can no longer push the debt limit because the credit isn’t there. As a part of global market, India is also affected due to recession.

OBJECTIVES AND SCOPE OF THE STUDY

This project done is undertaken with an objective. Without any objective a project work is rendered meaningless. The main objectives for undertaking this project are:-

Primary Objective: The study has been conceived with the following primary objective:

- To study the present credit risk management steps undertaken by banks in issuing credits to consumers.
- To identify the areas where there is a scope for improvement ad offer suggestions

Secondary Objective

- Existing training to bank managers in identifying customers credibility
- Experience factor of a manager in foreseeing risk

Scope of the Study

To estimate the process and flow of activities while processing a loan application in scheduled banks. It also includes the factors that can be taken in to consideration when providing credit to a credit seeker.

2. REVIEW OF LITERATURE

Credit risk management is a very important area for the banking sector and there are wide prospects of growth and other financial institutions are face problems which are financial in nature. Also, banking professionals have to maintain a balance between the risks and the returns. For a large customer base banks need to have a variety of loan products.

If bank lowers the interest rates for the loans it offers, it will suffer. In terms of equity a bank must have substantial amount of capital on its reserve, but not too much that it missed the investment revenue, and not too little that it leads itself to financial instability and to the risk of regulatory non compliance. Credit risk management is risk assessment that comes in a investment. Risk often comes in investing and in the allocation of capital, the risk must be assessed so as to derive a sound investment decision. And decisions should be made by balancing the risks and returns. Giving loans is a risky affair for bank sometimes and certain risks may also come when banks offer securities and other forms of investments. The risk of losses that result in the default of payment of the debtors is a kind of risk that must be expected.

A bank to keep substantial amount of capital to protect its solvency and to maintain its economy stability. The greater the bank is expose to risks, the greater the amount of capital must be when it comes to reserves, so as to maintain its solvency and stability. Credit risk management must play its role then to help banks be in compliance with basel II accord and other regulatory bodies. For assessing the risk, banks should plan certain estimates, conduct monitoring and perform reviews of the performance of the bank.

They should also do loan reviews and portfolio analysis in order to determine risk involved. Banks must be active in managing the risks in various securities and derivatives. Still progress has
to be made for analyzing the credits and determining the probability of defaults and risks of losses. So credit risk management becomes a very important tool for survival of banks. (The importance of Credit risk management of banking by: Ajeet Kumar Singh, Product Manager, ICICI bank)

Credit risk emanates from a bank dealing with an individual, corporate, banks, financial institutions or a sovereign. The present paper is designed to study the implementation of the credit Risk Management Framework by commercial banks in India.

To achieve the above mentioned objective a primary survey was conducted. The results show that the authority for approval of credit risk vests with Board of Directors in care of 94.4 percent and 62.5 percent of the public sector and private sector banks respectively. This authority in the remaining banks, however, is with the credit policy committee.

For credit risk management most of the banks (if not all) are found performing several activities like industry study, periodic credit calls, periodic plant visits, developing MIS, risk scoring and annual review of accounts. However the banks in India are abstaining from the use of derivatives products as risk hedging tools. The survey has brought out that irrespective of sector and size of bank, credit risk management framework in India is on the right track and it is fully based on the RBI’s guidelines issued in this regard. (the IUP Journal of Bank Management, B.S. Bodla and Rocha Verma)

Credit risk arises from non-performance by a borrower. It may arise from either an inability or an unwillingness to perform in the pre-committed contracted manner. This can affect the lender holding the loan contract as well as other lenders to the creditor. Therefore, the financial condition of the borrower as well as the current value of any underlying collateral is of considerable interest to its bank.

The real risk from credit is the deviation of portfolio performance from its expected value. Accordingly, credit risk is diversifiable, but difficult to eliminate completely. This is because a portion of the default risk may, in fact result from the systematic risk outlined above. In addition, the idiosyncratic nature of some portion of these losses remains a problem for creditors in spite of the beneficial effect of diversification on total uncertainty.

This is particularly true for banks that lend in local markets and ones that take on highly liquid assets. In such cases, the credit risk is not easily transferred, and accurate estimates of loss are difficult to obtain. (Commercial Bank Risk Management: an Analysis of the process by Anthony M. Santomero). The importance of credit risk management for banking is tremendous. Banks and other financial institutions are often faced with risks that are mostly of financial nature. These institutions must balance risks as well as returns. For a bank to have a large consumer base, it must offer loan products that are reasonable enough.

However, if the interest rates in loan products are too low, the bank will suffer from losses. In terms of equity, a bank must have substantial amount of capital on its reserve, but not of much that it misses the investment revenue, and not too little that it leads itself to financial instability and to the risk of regulatory non compliance. Credit risk management in finance terms regards to the process of risk assessment that comes in the investment.

Risk often comes in investing and in the allocation of capital, the risks must be assessed so as to derive a sound investment decision. Likewise the assessment of risk is also crucial in coming up with the position to balance risks and returns. Banks are constantly faced with risks. There are certain risks in the process of granting loans to certain clients. There can be more risks involved if the loan is extended to unworthy debtor. Certain risks may also come when banks offer securities and other forms of investment.

The risk of losses that result in the default of payment of the debtors is a kind of risk that must be expected. Because of the exposure of banks to many risks, it is only reasonable for a bank to keep substantial amount of capital to protect its solvency and to maintain its economic stability. The second basel accords provides statements of its rules regarding the regulations of the banks
capital allocation in connection with the level of risks the bank is exposed to. The greater the bank is exposed to risks, the greater the amount of capital must be when it comes to its reserves, so as to maintain its solvency and stability. To determine the risks that come with lending and investment practices, banks must assess the risks. Credit risk management must play its role then to help banks be in compliance with Basel II accord and other regulatory bodies. To manage and assess the risks faced by banks, it is important to make certain estimates, conduct monitoring and perform reviews of the performance of the bank.

However, because banks are into lending and investing practices it is relevant to make reviews on loan and to scrutinize and analyze portfolios. Loan reviews and portfolio analysis are crucial in determining the credit and investment risk. The complexity and emergence of various securities and derivatives is a factor banks must be active in managing the risks. The credit risk management system used by many banks today has complexity, however it can help in the assessment of risks by analyzing the credits and determining the probability of defaults and risks of losses. Credit risk management for banking is a very useful system, especially of the risks are in line with the survival of banks in the business works. (http://ezinearticles.com/?expert=Sam_Miller)

Risk is inherent in all aspects of a commercial operation and covers areas such as customer services, reputation, technology, security, human resources, market price, funding, legal, regulatory, fraud and strategy. However, for banks and financial institutions, credit risk is the most important factor to be managed. Credit risk is defined as the possibility that a borrower or counterparty will fail to meet its obligations in accordance with agreed terms. Credit risk, therefore, 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 effected;
- 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 reputation 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.

Credit risk management enables banks to identify, assess, manage proactively, and optimize their credit risk at an individual level or at an entity level or at the level of a country. Given the fast changing, dynamic world scenario experiencing the pressures of globalization, liberalization, consolidation and disintermediation, it is important that banks have a robust credit risk management policies and procedures which is sensitive and responsive to these changes.

The quality of the credit risk management function will be the key driver of the changes to the level of shareholder return. Industry analysts have demonstrated that the average shareholder return of the best credit performance US banks during 1989 - 1997 was 56% higher than their peers. Low loan loss banks stage a quicker share price recovery than their peers, and in a credit
downturn, the market rewards the banks with the best credit performance with a moderate price decline relative to their peers.

The last year has seen financial institutions worldwide announce wire downs of hundreds of billions of dollars as a result of participating in the US mortgage market, in particular in sub prime and other lower-rated mortgage-backed securities. Improving the practice of credit risk management by banks has thus become a top priority. Researchers Huang (Delft University of Technology) and Oosterlee (CWI) in the Netherlands focus on quantifying portfolio credit risk by advanced numerical techniques with an eye to active credit portfolio management, this work is sponsored by the Dutch Rabobank. Credit risk of loss resulting from an obligor’s inability to meet its obligations. Generally speaking, credit risk is the largest source of risk facing banking institutions. For these institutions, sound management involves measuring the credit risk at portfolio level to determine the amount of capital they need to hold as a cushion against potentially extreme losses,. in practice the portfolio risk is often measured by value at risk (VaR), which is simply the quantile of the distribution of portfolio loss for a given confidence level. With the basal II accords (the recommendation on banking laws and regulations issues in 2004 by the basel committee on banking supervision), financial regulators aim to safeguard the banking institutions solvency against such extreme losses. From a banks perspective, a high level of credit risk management means more than simple meeting regulatory requirements. The aim is rather to enhance the risk/return performance of credit assets. To achieve this goal, it is essential to measure how much a single obligor in a portfolio contributes to the total risk, i.e. the risk contributions of single exposures. Risk contribution plays an integral role in risk sensitive loan pricing and portfolio optimization.

Extrapolation of credit risk from individual obligors to portfolio level involves specifying the dependence among obligors. Widely adopted in the industry is the Vasicek model, on which is built the Basel II internal rating based approach. It is a Gaussian one factor model. With default events being driven by a single common factor that is assumed to follow the Gaussian distribution and obligors being independent conditional on the common factor.

Under certain homogeneity conditions, the vasichek one factor model leads to very simple analytic asymptotic approximations of the loss distribution. VaR and VaR contribution. However, these analytic approximations can significantly underestimate risks in the presence of exposure concentrations, i.e. when the portfolio is dominated by a few obligors.

In their research, Huang and Oosterlee showed that the saddle point approximation with a conditional approach is an efficient tool for estimating the portfolio credit loss distribution in the Vasicek model and is well able to handle exposure concentration. The saddle point approximation can be thought of as an improved version of the central limit theorem and usually leads to a small relative error, even for very small probabilities. Moreover the saddle point approximation is a flexible method which can be applied beyond the vasichek model to more heavily tailed loss distributions which provide a better fit to current financial market data.

The single factor in the Vasicek model represents generally the state of economy. More factors are necessary if once wishes to take into account the effects of different industries and geographical regions in credit portfolio loss modeling. For example, in the current crisis the financial industry is taking the hardest hit, while back in 1997 East Asian complicate the computational process, as high dimensional integrals need to be computed. For this, the researchers proposed efficient algorithms of adaptive integration for the calculation of the tail probability, with either a deterministic multiple integration rule or a monte carlo type random rule.

In the Vaiscek model the loss given default (LGD) – the proportion of the exposure that will be lost if a default occurs – is assumed to be constant. However, extensive empirical evidence shows that it tends to go up in economic downturn. A heuristic justification is that the LGD is determined by the value of collateral (eg. House process in the case of mortgage loans), which is
sensitive to the state of economy. To account for this, Huang and Oosterlee proposed a new flexible framework for modeling systematic risk in LGD in which the quantities have simple economic interpretation. The random LGD framework combined with the fat tiled models, further provides possibilities to replicate the spreads of the senior tranches of credit market indices (e.g., CDX), which have widened dramatically since the emergence of the credit crisis to a level that the industrial standard Gaussian one factor model can not produce even with 100 percent correlation. (Improving banks Credit Risk Management by Xinzheng Huang and Cornelis W. Oosterlee)

3. METHODOLOGY

Explorative research design is adopted for the study. The data collected from both primary and secondary sources.

The sample size is 30. Sampling Method is convenience sampling is used in this study. Questionnaire is used for data collection. The questionnaires are administered personally and also mailed to the respondents and electronically distributed through emails.

Tools used for Analysis: Percentage Analysis and Chi-Square Test

4 - ANALYSIS AND INTERPRETATION

It is inferred that 26.26% of the respondents are of employment of 10-20 years and above 30 years and 80% of the respondents expects scrutiny of documents are performed for processing loan application in banks. 46.67% of the respondents considering training help in reducing bad debts. 40% of the respondents don’t have sufficient training that helps one to identify bad debts easily. 60% of the respondents are given sufficient training that helps one to identify bad debts easily. 53.33% consider that immorality of borrowers is a main cause for the bad debts. 46.6% of them consider that major bad debts occur due to personal loan issues by the banks. 23.3% of the respondents are major bad debts occur from creditors who are business men. 66.67% are supportive to have village/socially responsible person to certify credit holder to control bad debts. 33% of the respondents do give ineligible loan seekers sanctioned loans due to favoritism. 60% of the target population accepts frequent transfer of bank officials cannot affect in identifying the credibility of the customers in locality. 63.33% of the says that agents are not the key factor for the bad debts. It is observed that 53.33% of the respondents are expecting limited and speedy processing of loan application make a cause of bad debt. Comparing if the risk foreseeing factor of the banker is dependent on the year of experience as well as training of the bank staff is dependent on the year of experience.

1. Null Hypothesis (H0): there is no significant relationship between experience in field and risk foreseen possibilities of a manager. For degree of freedom and 5% level of significance the table value is 7.815. The calculated value of chi square is more than the table value, hence the alternate hypothesis is accepted. There is a significant relationship between the experience of a manager and risk foreseen possibility.

One Way Anova Test- Comparing if the risk foreseeing factor of the banker is dependent on the year of experience as well as training of the bank staff is dependent on the year of experience.

2. Null Hypothesis (H0): there is no significant relationship between experience in field and risk foreseen possibilities of a manager.
The tabulated value of F \((p = 0.05)\) where \(u\) is df of between treatments mean square (2) and \(v\) is df of residual mean square (6) is 5.1. Calculated F value exceeds this and even exceeds the tabulated F value for \(p = 0.001\) (F=21.0). So there is a very highly significant difference between treatments.

There is a significant relationship between the training of the staff and risk foreseen possibility. The tabulated value of F \((p = 0.05)\) where \(u\) is df of between treatments mean square (2) and \(v\) is df of residual mean square (6) is 5.1. Our calculated F value exceeds this and exceeds the tabulated F value for \(p = 0.001\) (F=1.875). So there is very highly significant difference between treatments.

There is a significant relationship between the experience of a manager and risk foreseen possibility.

5. SUGGESTIONS AND RECOMMENDATIONS

- The bankers can employ the enforcement of having village heads/socially respected persons to certify the credibility of borrower.
- The training to the bank managers regarding the bad debts identification and removal as to be extended. This will provide a long term benefit to the bank.
- Amend the credit policy. Certain things can be tweaked or adjusted that makes it more difficult for customers to get approved when the economy is experiencing a recession. The policy can always be reversed during more prosperous times. A lending institution may want to stay away from customers on the verge of going over what is an acceptable amount of debt. If a customer wants money for home improvements perhaps debt can be considered in the process. Asking for collateral can also entice a customer to make payments.
- Reduce the credit limit on high-risk customers. Many creditors will reduce your credit limit if they feel you are a high risk customer. When payments are late or if you have too much other debt, your credit limit will be lowered. This prevents you from making additional purchases especially during tough economic times when layoffs are a possibility for many industries.
- Follow up earlier with customer. Some banks wait until an account is past due 30 days before they start to follow up with the customers. As soon as a customer misses a payment a latter should be mailed reminding the customer to make their payment. The longer an account goes without a payment the more difficult it becomes to collect.
- Offer new arrangements. When customers are experiencing hardship they need to be offered every available payment option. If someone loses a job there will be a reduction in income. A customer will now pay the most important bills first, such as mortgage, rent and utilities. If you offer unconventional repayment plans customers may consider paying a past due credit card. One solution is reducing the interest rate on a customer account to zero and only required the debtor to make a payment every month until going back to work. This is like throwing the customer a life line. It helps to keep the customer afloat until he returns to work and keep the account from reaching the 180 day bad debt mark.
- Communicate clearly the outcome if an account becomes bad debt. If payment arrangements are made and the customer does not stick to them a letter should be sent that clearly explains the possible outcome when an account becomes a bad debt. Many creditors will forward accounts on to a collection agency when they become bad debts. This information is also reported on the customer credit file for seven years. Collection agencies can petition a court for you to appear and they could be awarded a judgment. When a judgment is received, the collection agency can process with a wage garnishment or bank garnishment. Sometimes a creditor will file a lien against real estate property as a means of collecting a debt.
6. CONCLUSION

The study of Credit Risk Management in Scheduled banks has thrown light on many interesting aspects. 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 risks and other risks. For more banks, loans are the largest and most obvious source of credit risk. However, other sources of credit risk exist throughout the activities of a bank, including in the banking book and in the trading book, and both on and off the balance sheet. Banks are increasingly facing credit risk (or counterparty risk) in various financial instruments other than loans, including acceptances, inter bank transactions, trade financing, foreign exchange transactions, financial futures, swaps, bonds, equities, options and in the extension of commitments and guarantees and the settlement of transactions. 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.

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