

Credit Risk and Non-Performing Assets



Commerce

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ABSTRACT

The banking sector being the backbone of the economy, social orientation of banking had been considered essential for the planned economic development of India. It is with this acknowledged aim that the Bank Nationalization was initiated in. 1969. The Indian banking system, endowed with a large network of branches and wide range of financial instruments, has achieved considerable progress in the two decades after Nationalization. The concept of banking had undergone a dynamic change in keeping with the need to achieve rapid socio- economic progress. As the traditional banking theory, a shift in the approach to lending from security-orientation to purpose- orientation also became a predominant concept during the period.

Despite the overall progress made by the financial system, poor capital base, inefficient organizational structure, declining profitability and very high and ever growing non-performing assets had become the major stumbling blocks in the banking sector during the post-nationalization decades. It was against this background that the Financial Sector Reforms became inevitable and were initiated In India.

Credit Risk

Credit Risk is the potential that a bank borrower/counter party fails to meet the obligations on agreed terms. There is always a scope for the borrower to default from commitments for one or the other reason resulting in crystallisation of credit risk to the bank. NPAs are closely linked with credit management and the main aim of the credit policy of a bank will free to screen out the best proposal for acceptance. The bank can in fact quantify its Credit Risk on the level of NPAs. Credit risk can be quantified in terms of the ratio of the percentage of earning before tax as a proportion of NPA (ENPA). However, despite continuous monitoring, banks usually do end up with a few of their credit turning into NPA.

Introduction

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Credit Risk

Credit Risk is the potential that a bank borrower/counter party fails to meet the obligations on agreed terms. There is always a scope for the borrower to default from commitments for one or the other reason resulting in crystallisation of credit risk to the bank. These losses could take the form of outright default or alternatively, losses from changes in portfolio value arising from actual or perceived deterioration in credit quality that is short of default. Credit risk is inherent to the business of lending funds to the operations linked closely to market risk variables. The objective of credit risk management is to minimize the risk and maximize bank's risk adjusted return by assuming and maintaining credit exposure within the acceptable parameters. Measurement of credit risk is crucial if the banks have to appropriately price their loan products, set suitable limits on amount of credit to be extended as well as the loss exposure it accepts from any particular counter party. Credit risk consists of primarily two components, viz. Quantity of risk, which is nothing but the out-

standing loan balance as on the date of default and the Quality of risk, which is the severity of loss defined by Probability of Default as reduced by the recoveries that could be made in the event of default.

Thus credit risk is a combined outcome of Default Risk and Exposure Risk. The elements of Credit Risk are Portfolio risk comprising Concentration Risk as well as Intrinsic Risk and Transaction Risk comprising migration/down gradation risk as well as Default Risk. At the transaction level, credit ratings are useful measures of evaluating credit risk that is prevalent across the entire organization where treasury and credit functions are handled. Portfolio analysis help in identifying concentration of credit risk, default/migration statistics, recovery data, etc.

Tools of credit risk management

The instruments and tools, through which credit risk management is carried out, are detailed below:

a. Exposure Ceilings:

Prudential Limit is linked to Capital Funds -say 20% for individual borrower entity, 45% for a group with additional 5%/10% for infrastructure projects, subject to approval of the Board of Directors, Threshold limit is fixed at a level lower than Prudential Exposure; Substantial Exposure, which is the sum total of the exposures beyond threshold limit should not exceed 600% to 800 % of the Capital Funds of the bank (i.e. 6 to 8 times).

b. Review/Renewal:

Multi-tier Credit Approving Authority, constitution wise delegation of powers, sanctioning authority's higher delegation of powers for better-rated customers; discriminatory time schedule for review / renewal, Hurdle rates and Bench marks for fresh exposures and periodicity for renewal based on risk rating, etc

c. Risk Rating Model:

Set up comprehensive risk scoring system on a six to nine point scale. Clearly define rating thresholds and review the ratings periodically preferably at half yearly intervals, to be graduated to quarterly so as to capture risk without delay. Rating migration is

to be mapped to estimate the expected loss.

d. Risk based scientific pricing:

High-risk category borrowers are to be priced high. Build historical data on default losses. Allocate capital to absorb the unexpected loss.

e. Portfolio Management

The need for credit portfolio management emanates from the necessity to optimize the benefits associated with diversification and to reduce the potential adverse impact of concentration of exposures to a particular borrower, sector or industry. Portfolio management shall cover bank-wide exposures on account of lending, investment, other financial services activities spread over a wide spectrum of region, industry, size of operation, technology adoption, etc. There should be a quantitative ceiling on aggregate exposure on specific rating categories, distribution of borrowers in various industries & business group. Rapid portfolio reviews are to be carried on with proper & regular on-going system for identification of credit weaknesses well in advance. Steps are to be initiated to preserve the desired portfolio quality and portfolio reviews should be integrated with credit decision-making process.

f. Credit Audit/Loan Review Mechanism

This should be done independent of credit operations, covering review of sanction process, compliance status, review of risk rating, pick up of warning signals and recommendation for corrective action with the objective of improving credit quality. It should target all loans above certain cut-off limit ensuring that at least 30% to 40% of the portfolio is subjected to LRM in a year so as to ensure that all major credit risks embedded in the balance sheet have been tracked and to bring about qualitative improvement in credit administration as well as identify loans with credit weakness. Determine adequacy of loan loss provisions. Ensure adherence to lending policies and procedures. The focus of the credit audit needs to be broadened from account level to overall portfolio level. Regular, proper & prompt reporting to Top Management should be ensured. Credit Audit is conducted on site, i.e. at the branch that has appraised the advance and where the main operative limits are made available.

Rating can be used for the anticipatory provisioning; certain level of reasonable over-provisioning as best practice. Given the past experience and assumptions about the future, the credit risk model seeks to determine the present value of a given loan or fixed income security. It also seeks to determine the quantifiable risk that the promised cash flows will not be forthcoming. Thus, credit risk models are intended to aid banks in quantifying, aggregating and managing risk across geographical and product lines. Credit models are used to flag potential problems in the portfolio to facilitate early corrective action.

Non-performing Assets

With the introduction of Prudential norms relating to Income Recognition, Asset Classification and Provisioning, banks have realized the impact of non-payment risk associated with credit portfolio on the profitability of the banks. Containing the Non-Performing Assets has been in focus ever since the banking sector reforms were initiated to 1992 and all banks have been making efforts to limit the NPA levels and reduce the impact on their profitability.

Non-Performing Assets (NPA) reduce the income of banks and make it impossible for them to quote finer Prime Lending Rates (PLR). Higher level of NPA forced the banks to charge higher PLR and PLR interest rates. This will attract high-risk borrowers which, in turn, may result in higher level of non-performing advances in future. Thus the risk of non-performance and non-payment in the credit portfolio needs to be controlled for improving the management efficiency of banks. A periodic review of the Credit Risk involved in the

loan plays a vital role in controlling the Non-Performing Assets. Continuous monitoring enables the bank to assess the financial position of the borrower and thereby timely action can be taken before the NPAs become loss assets.

Non-Performing Assets have been substantially reduced since regulation was tightened in 1993, but improvement has recently slowed down and the levels of NPAs remains high compared to international standards. In 2001, the commercial banking system's gross NPA to gross advances ratio was 11.4 per cent: net of provisions was 6.2 per cent. The high level of NPA as compared to other countries attracted the attention of public and international financial institutions which has gained further prominence in the wake of transparency and disclosure measures initiated by Reserve Bank of India in recent years. The singular reason for not realizing the full profit potential of banks is the higher level of NPA. "A lasting solution to the problem of NPAs can be achieved only with proper Credit Assessment and Risk Management mechanism. It is therefore necessary that the banking system is equipped with prudential norms to minimize, if not completely avoid the problem"

The NPA concept introduced in India by the Reserve Bank of India in the year 1992 contains Prudential Norms for the identification NPA. If expected income is realized from an asset, it is treated as performing asset and when it fails to generate income on due date, the asset is treated as non-performing. All 'performing' assets are classified as standard assets and 'non-performing assets' are classified into sub-standard, doubtful or loss assets, depending on the period for which they have remained as NPA. When a borrower fails to repay the instalment of principal and interest within the first quarter, it becomes non-performing in the next quarter, if the past due amount of advance remains outstanding for the second quarter, it becomes non-performing in the third quarter and the past due amount remaining uncovered for the last quarter, the amount would be classified as NPA for the whole year. According to RBI norms, NPA has been defined as a credit facility in respect of which interest has remained past due for a period of four /three / two quarters as on 31 March 1993, 31 March 1994 and 31 March 1995 respectively, and onwards. An amount under any credit facility is past due when it has not paid within 30 days from the due date.

According to RBI directives, banks were asked to calculate two NPA figures on gross and net basis. While the gross NPA will be calculated as the percentage of had loans of the total advances portfolio of bank, the net NPA will be arrived at after deducting provisions and claims received from the DICGC from the gross NPA figure and then calculating it as a percentage of total advances.

NPAs are closely linked with credit management and the main aim of the credit policy of a bank will free to screen out the best proposal for acceptance. The bank can in fact quantify its Credit Risk on the level of NPAs. Credit risk can be quantified in terms of the ratio of the percentage of earning before tax as a proportion of NPA (ENPA). However, despite continuous monitoring, banks usually do end up with a few of their credit turning into NPA.