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Risk Management in Public and Private Sector Banks

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Abstract: *Risk is the foremost element that drives financial performance. Without risk, the financial system would be vastly simplified. However, risk is omnipresent in the 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 effective risk controlling system will continue in the market in the long run. The effective management of credit risk is a perilous component of ample risk management essential for long-term success of a banking institution. Credit risk is the oldest and biggest risk that 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.*

Keywords: Risk Management, Banking

I. INTRODUCTION

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. Credit risk is the oldest and biggest risk that 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. Competition from within and outside the country has intensified. This has resulted in multiplicity of risks both in number and volume resulting in volatile markets. A precursor to successful management of credit risk is a clear understanding about risks involved in lending, quantifications of risks within each item of the portfolio and reaching a conclusion as to the likely composite credit risk profile of a bank. The corner stone of credit risk management is the establishment of a framework that defines corporate priorities, loan approval process, credit risk rating system, risk-adjusted pricing system, loan-review mechanism and comprehensive reporting system.

1.1 Significance of the study

The fundamental business of lending has brought trouble to individual banks and entire banking system. It is, therefore, imperative that the banks are adequate systems for credit assessment of individual projects and evaluating risk associated therewith as well as the industry as a whole. Generally, Banks in India evaluate a proposal through the traditional tools of project financing, computing maximum permissible limits, assessing management capabilities and prescribing a ceiling for an industry exposure. As banks move in to a new high powered world of financial operations and trading, with new risks, the need is felt for more sophisticated and versatile instruments for risk assessment, monitoring and controlling risk exposures. It is, therefore, time that banks managements equip them fully to grapple with the demands of creating tools and systems capable of assessing, monitoring and controlling risk exposures in a more scientific manner. Most of the banks have developed internal rating systems for their borrowers, but there has been very littlestudy to compare such ratings with the final asset classification and also to fine-tune the rating system.

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Also riskspeculiar to each industry are not identified and evaluated openly, Data collection is regular driven. Data onindustry-wise, region-wise lending, industry-wise rehabilitated loan, can provide an insight into the future courseto be adopted.There is a need for Strategic approach to Credit Risk Management (CRM) in Indian Commercial Banks, particularly in view of

1. Higher NPAs level in comparison with global benchmark
2. RBI's stipulation about dividend distribution by the banks
3. Revised NPAs level and CAR norms
4. New Basel Capital Accord (Basel-II) revolution

According to the study conducted by ICRA Limited, the gross NPAs as a proportion of total advances for Indian Banks was 9.40 percent for financial year 2003 and 10.60 percent for financial year 20021. The value of the gross NPAs as ratio for financial year 2003 for the global benchmark banks was as low as 2.26 percent. Net NPAS as a proportion of net advances of Indian banks was 4.33 percent for financial year 2003 and 5.39 percent for financial year 2002. As against this, the value of net NPAs ratio for financial year 2003 for the global benchmark banks was 0.37 percent. Further, it was found that, the total advances of the banking sector to the commercial and agricultural sectors stood at Rs.8,00,000crore. Of this, Rs.75,000crore, or 9.40 percent of the total advances is bad and doubtful debt. The size of the NPAs portfolio in the Indian banking industry is close to Rs.1,00,000crore which is around 6 percent of India's GDP.

The RBI has recently announced that the banks should not pay dividends at more than 33.33 percent of their net profit. It has further provided that the banks having NPA levels less than 3 percent and having Capital Adequacy Reserve Ratio (CARR) of more than 11 percent for the last two years will only be eligible to declare dividends without the permission from RBI. This step is for strengthening the balance sheet of all the banks in the country. The banks should provide sufficient provisions from their profits so as to bring down the net NPAs level to 3 percent of their advances.

1.2 Credit Risk Management (CRM) Dynamics

The two distinct dimensions of credit risk management can readily be identified as preventive measures and curative measures. Preventive measures include risk assessment, risk measurement and risk pricing, early warning system to pick early signals of future defaults and better credit portfolio diversification. The curative measures, on the other hand, aim at minimizing post-sanction loan losses through such steps as securitization, derivative trading, risk sharing, legal enforcement etc. It is widely believed that an ounce of prevention is worth a pound of cure. Therefore, the focus of the study is on preventive measures in tune with the norms prescribed by New Basel Capital Accord.

The study also intends to throw some light on the two most significant developments impacting the fundamentals of credit risk management practices of banking industry-New Basel Capital Accord and Risk Based Supervision. Apart from highlighting the salient features of credit risk management prescriptions under New Basel Accord, attempts are made to codify the response of Indian banking professionals to various proposals under the accord. Similarly, RBI proposed Risk Based Supervision (RBS) is examined to capture its direction and implementation problems.

1.3 Objectives of the Research

1. Analysis of trends in Non-Performing Assets of commercial banks in India.
2. Analysis of trends in credit portfolio diversification during the post-liberalization period.
3. Studying relationship between diversified portfolio and non-performing assets of public sector banksprivate sector banks.
4. Profiling and analysis of concentration risk in public sector banks vis-à-vis private sector banks
5. Evaluating the credit risk management practices in public sector banks vis-à-vis private sector banks.
6. Reviewing the New Basel Capital Accord norms and their likely impact on credit risk management practices of Indian commercial banks.
7. Examining the role of Risk Based Supervision in strengthening credit risk management practices ofIndian commercials banks.
8. Suggesting a broad outline of measures for improving credit risk management practices of Indiancommercial banks.

1.4 Credit Risk Management Practices In Commercial Banks - An Evaluation

A. Sample Data

The study has analyzed the credit portfolio risk management policies and practices of 21 Banks of which 12 are public sector banks and 9 private sector banks. Though it was originally aimed to cover 20 percent of over 800 credit department executives in the selected banks, it was possible to get the response of only about 10 percent of the number. Credit department executives were not easily accessible. They were found either closeted in a meeting or busy otherwise. Therefore, the generalizations formulated here are based on the opinions of this small number.

B. Analysis of CRM Practices

This section is devoted for analysis of CRM practices in public sector banks vis-à-vis private sector banks. For this purpose, various issues covered include scope for NPAs reduction, credit risk measurement, credit evaluation processes, credit rating system and training in credit risk assessment.

C. CRM Perform Index-Public and Private Sector Banks

The questionnaire was designed with a focus on standards of CRM practices envisaged under the New Basel Capital Accord. The important parameters of performance standards considered for analysis included the

Sr. No.	Performance Evaluation	Performance index (%)	
		Public sectors banks	Private sector banks
01	Project appraisal procedures	58	49
02	Availability of comprehensive data	46	39
03	Risk based loan pricing	48	40
04	Development of information technology	46	57
05	Efficiency of internal credit rating system	54	50
06	Practices of fine tuning loan policies	40	36
07	Practice of fine tuning loan policies	55	46
08	Internal audit of CRM procedure	42	49
09	Bank credit standards	51	48
10	Credit decision : merit v/s extraneous considerations	60	46
11	Frequency of credit portfolio reviews	61	58
12	Renewal of borrowers limits	34	42
13	Periodical review of customer credit rations	33	57
	Total	632	617
	Performance Index	**49**	**47**

Overall CRM performance is at below the satisfactory level for both the public and private sector banks. Furthermore, with performance index score of 49 percent and 47 percent for public sector banks and private sector banks respectively, there is no significant difference between public sector banks and private sector banks as regards CRM performance.

Risk Based Supervision Problems and Prospects Changes over the past ten years in the banking system have been dramatic. Advances in technology, closer interrelations among economies, liberalization and deregulation etc. have made the world of banking a far more complex place. The system of annual inspection of banks by RBI may soon be a thing of the past. The central bank is expected to follow a system of random and more frequent inspections based on the risk profile of individual banks. RBI insisted that all commercial banks move towards the system of Risk-Based Supervision (RBS) by January 1st 200325, its inspections would be more focused on areas of potential risk such as credit risk, market risk and operational risk. Based on the guidelines to be drafted by the RBI all banks have to submit information to the central bank periodically. With this information, bankers believe that the RBI will always be in the know as how particular bank is operating and can monitor its performance almost on a day-today basis.RBI inspections, both on-site and off-site can be conducted as and when the central bank deems necessary and could be as often as possible based on RBI's risk perception of a bank. "After the recent scams, the RBI wants to tighten norms so that the central bank is informed well in advance about any irregularity". The Basel Committee on Banking Supervision had advocated Risk- Based Supervision of banks and this has been put to practice in various countries. Now RBI has come with a discussion paper on "Move towards Risk Based Supervision of Banks" in Aug 2001 and RBI roll out the process and implemented from the financial year April 2004. This chapter describes the main features of proposed RBS and analyses the responses of executives to the modalities of implementing it.Private sector banks executives are not in-favour for implementation of RBS as vindicated by the sample data according to which 94 percent (an average) of them are against the various proposals of RBS. This negative response reflect the reservations hosted by the private sector banks in general about the various proposals comingfrom a Central Bank leading to more interfere in their internal affairs. On the other hand, the public sector banks show a different scenario as they have almost balanced opinion in favour of RBS.

1.5 New Basel Capital Accord - Implications for CRM Practices of Commercial Banks in India

A. New Basel Accord-Issues in the Indian Context

The Accord, aims at boosting the safety of the world banking system. Regulators in both India and China are anxious to nudge their banks on to the proposed risk-based capital regime, to ensure that they are competitive and managed to the highest standards32. True, banks in these two Asian giants may not all be ready to adopt the full rigorous of the accord dubbed Basel II from the outset, at the end of 2006. The RBI agrees with committee's view that the focus of the New Accord may be primarily on Internationally Active Banks, that is, those with 20% of the business from foreign operations. SBI's Chairman Mr. A. K. Purwar says that SBI's International operations (India's largest bank) contribute about 6% of its business. So the new accord feared by many central banks including the RBI. In this regard, RBI is of the view that all banks with cross border business exceeding 20% of the total business may be defined as Internationally Active' banks and 'Significant banks may be defined as those banks with complex structures and whose market share in the total assets of the domestic banking system exceed 1 percent.

The Basel II accord is a challenge to Indian banks. Indian Banks are conceptually and academically ready to adopt the new norms. It would involve shift in direct supervisory focus away to the implementation issue and also there are lot of difficulties and issues in its implementation in the Indian Context35. These difficulties like availability of historical data, higher risk wrights for sovereign, cost factor, technological up-gradation, diversified products, legal and regulatory guidelines, higher risk weight to small and medium enterprises, credit rating etc.

II. FINDINGS, SUGGESTIONS AND CONCLUSION

2.1 Summary of Findings

The analysis of secondary and primary data resulted in satisfactory results, a summary of which is presented in the following paragraphs.

1. While NPAs level of public sector banks did register a clear decreasing trend during the post-liberalization period, NPAs level of private sector banks remained constant during this period.
2. The concentration risk profile of private sector banks is found to be higher than that of public sector banks.
3. In case of public sector banks, there exists a strong relationship between NPAs level and credit portfolio diversification as vindicated by higher co-efficient of correlation values. The decrease in NPAs level is caused by reduction in concentration risk. This relationship is however, not clearly pronounced in case of private sector banks
4. Credit risk management performance of commercial banks in India is not satisfactory.
5. There exists no marked difference between public sector banks and private sector banks as regards their credit risk management performance.
6. Though the private sector banks executives are not in favour of implementation of Risk Based Supervision, yet they are receptive to the proposals under New Basel Capital Accord. This is vindicated by sample data according to which only 6 percent of respondents have expressed their concurrence with RBS and the remaining 94 percent of them opposing it. In contrast, 67 percent of the respondents expressed their concurrence to the proposals under NBCA and remaining 33 percent of respondents opposing it.

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7. The executives of public sector banks have almost balanced their opinions in-favour of RBS and NewAccord. While 54 percent of them expressed their concurrence to the proposals under RBS, 43 percent ofthem agree with the proposed reforms under NBCA.

2.2 Suggestions

A. Achieving Better Portfolio Equilibrium

Commercial banks need to diversify further to achieve a better credit portfolio equilibrium. The share of transport operations and finance occupations in case of public sector banks was very minimal ie, 1.21 percent and 6.53 percent respectively as on March 31, 2018. Similarly, in case of private sector banks, the share of occupations like transport and finance was very minimal at 1.52 percent and 6.46 percent respectively as on March 31, 2018.

(a) In India now the services sector (including transportation, financial services etc. is playing an important role and in fact it accounts for about one half of India's GDP and this sector is also generating more income and more employment opportunities. Banks will, therefore, have to sharpen their credit assessment skills by providing better training to enhance their conceptual understanding of credit risk and improving their skills in handling it which lay more emphasis in providing finance to the wide range of activities in the services sector.

(b) Retail loans are also a relatively small fraction of the Indian banking system's total loans and advances. In Indiaretail loans constitute about 5 percent of aggregate GDP compared to an average of around 30 percent for other Asian economies. The implication of all this data is that the retail market is relatively under-penetrated" and has significant potential for growth both for public and private sector banks.

(c) Retail products help banks in diversifying their risk by spreading credit to widely dispersed set of individual customers. Retail loans offers banks the opportunity to cross sell various other value added services and retail products like insurance and mutual fund to the depositors.

B. Establishing Risk Management Information System (RMIS)

The effectiveness of risk management depends on efficient information system, computerization and networking of the branch activities. An objective and reliable database has to be built up for which bank has to analyses its own past performance data relating to loan defaults, operational losses etc.

(a) Added to IT expenditure is the cost and effort of training and redeployment of manpower. Besides training in the hard' aspects of understanding risk and using software, it is also need for building in a risk orientation individual officers at the operating level, to create awareness about credit assessment skills and risk mitigation processes is needed.

(b) Public sector banks need to set up modern IT infrastructure in place within one to two years in line with foreign and new generation private banks. There is a need of centralized database so that core banking solution can be implemented.

C. Redesigning the Internal Rating System (RIRS)

In order to ensure a systematic and consistent credit assessment process within the bank, a robust and auditable rating system must be in place. A list of credit drivers or factors that influence the creditworthiness of a barrower / company with a weight assigned on measurable element data like financial ratios and subjective elements like management quality, industry prospects etc. The Basel Committee set up by BIS has been urging banks to set up internal systems to measure and manage credit risk. It is important that Indian banks use credit ratings available from agencies in conjunction with their internal models to measure credit risk.

D. Early Warning Signals

It is essential to identify signs of distress or early recognition of problem loans. The need for early identification of problem loans has been established as one of the principles of the Basel Committee for the management of credit risk. Problem loans most commonly arise from a cash crisis facing the borrower. As the crisis develops, internal and external signs emerge, often subtly. A typical Early Warning Signals process is listed below:

a. Continuous Monitoring by Loan Officers
b. Scheduled Loan Reviews

c. External Examination
d. Loan Covenants
e. Warning Signs
f. Asset Classification and Downgrade Report

2.3 Conclusion

Credit risk management in today's deregulated market is a challenge. The very complexion of credit risk is likely to undergo a structural change in view of migration of Tier-1 borrowers and, more particularly, the entry of new segments like retail lending in the credit portfolio. These developments are likely to contribute to the increased potential of credit risk and would range in their effects from inconvenience to disaster. To avoid being blindsided, banks must develop a competitive Early Warning System (EWS) which combines strategic planning, competitive intelligence and management action. EWS reveals how to change strategy to meet new realities, avoid common practices like benchmarking and tell executives what they need to know - not what they want to hear.

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