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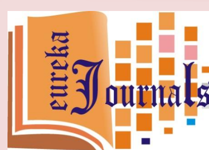

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An Assessment of the Credit Hazards Facing Indian Commercial Banks

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Abstract

The banking sector is an extremely important component of the Indian economy. When conducting banking operations, banks in India are facing several challenges due to the fast expansion of the banking sector over the last few years. One of these risks, credit risk, is affecting the banks' overall financial health. As a result of ineffective methods of credit risk management, financial institutions are experiencing enormous losses. The purpose of this paper is to investigate the potential causes of non-performing assets (NPAs) and credit risks in Indian banks, as well as the different types of credit risk, analyze any potential deficiencies in lending practices, and investigate any potential solutions to the problem of credit risk in Indian commercial banks.

Keywords: Credit Hazards, Commercial Bank, Risk Management, Non-Performing Assets (NPAs), Default Probability

Introduction

The nation's banking institutions underpin the stability and reliability of the Indian financial system. The successful use of deposits, investment of money, and correct distribution of credit to the deserving and productive sectors of the economy are all key roles that banks play, and they fulfill these roles quite well. The soundness of a nation's economy may be inferred from its banking system. Compared to weaker ones, a robust banking system promotes greater economic development. Since the money deposited in banks belongs to the general public, excessive losses sustained by banks can potentially affect the whole nation adversely. Banks promote the practice of saving money among the general public, which in turn contributes to the building of capital.

Indian Commercial Banks

Commercial banks are institutions motivated by the pursuit of profits; they take deposits from customers who have extra cash and provide loans to customers who are short on cash. There are two types of commercial banks in India: scheduled and non-scheduled. Both may be

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categorized as Indian commercial banks. The term "scheduled banks" refers to the financial institutions whose names are specified in the Reserve Bank of India Act, 1934's Second schedule. By the RBI Act of 1934, the second schedule does not contain the names of any non-scheduled banks. Both public sector banks and private sector banks are included in the category of scheduled commercial banks. Banks that belong to the public sector are any financial institutions in which the government owns 51% or more of the shares and exercises controlling authority. Banks considered part of the private sector are those in which private shareholders rather than the government own most of the bank's stock or equity.

Risk Management in Banks: An overview

Risk is defined as the possibility of suffering a loss in the future due to an unpredictable event in the future. Risk is an inherently present aspect of banking operations. Therefore banks must exercise risk management. Yet, the potential future loss may be calculated and reduced as much as possible. Banking institutions' major risks are credit, interest rate, market, liquidity, etc. Banks are increasingly engaged in a diverse range of operations, ranging from their primary banking role to trading sophisticated securities and participating in off-balance sheet activities, all of which provide greater risk management issues.

Because of their enormous leverage levels, banks can exercise control over extremely significant amounts of the public's money. The banking industry likewise manages the payment and settlement system. Because commercial banks deal in money, the banking industry is fraught with significant risk. Risk management is an ongoing process that helps determine the nature and extent of the dangers that a financial institution is likely to face in the future, as well as raise sufficient funds to protect against those risks and construct robust organizational frameworks.

Steps in the Risk Management Process

a) Risk Identification

This is the initial phase in the process, and it involves banks analyzing the types of risks to which they are exposed and the potential effects of those risks on the bank.

b) Risk Measurement

When the risk has been identified, banks are obligated to assess the economic effect that the risk will have on the institution.

c) Risk Control

Financial institutions have implemented control mechanisms to manage credit risks, such as credit approval authority, paperwork, periodic reviews, and the ability to renew credit facilities.

d) Risk Monitoring

This involves analyzing how well the bank's risk management policies are working and providing consistent reports on the risks that have been identified.

Objectives of the Study

The primary goals of the research project are as follows:

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1) To investigate the various forms of credit risk that commercial banks encounter.
2) To be familiar with the many causes of the growing non-performing assets (NPAs) or credit risk in commercial banks.
3) To get an understanding of the current credit risk management procedures used by commercial banks in the process of extending credit to customers.

Research Methodology

Present research work is done based on secondary data. The following may be considered secondary data sources: research publications, books, newspapers, the internet, and online journals that have been published. The investigation is qualitative in nature.

Classification of Credit Risk

A. Default risk

The risk of default occurs when a borrower of loans and advances fails to repay the principal loan amount and the interest amount within the allotted time. This is known as the default risk. The borrower's capacity to pay back the contractual loan amount per the terms and conditions of the loan is evaluated to determine the default risk. This is done by assessing the borrower's ability to repay the loan. The borrower might be in a precarious financial situation, they could have experienced an unexpected financial loss, they could have been the victims of fraudulent activity, the economy could be in a slump, or there could have been a natural disaster.

B. Downgrade risk

The risk of a downgrade A credit risk rating system is a method to evaluate and monitor the existing and prospective credit risk that various types of borrowers might pose. The bank can analyze the amount of risk with the assistance of the risk rating and then take the necessary steps to remove the risk. Rating agencies are responsible for doing routine checks on the borrowing firm's financial situation and performance to determine whether or not the company is creditworthy. Upgrades and downgrades are both possible outcomes for ratings. A reduction in the rank or status of an institution is what is meant by the term "downgrade." If a corporation's credit rating has been lowered, it indicates a greater likelihood of default on any loans provided to the company. When a firm's credit rating is lowered, it becomes more difficult and expensive for that company to get loans from banks and other financial institutions. A borrower may get an upgrade or a downgrade from a rating agency depending on various variables such as their financial statements, the kind of debt they have, their credit history, the capital structure of their company, and the collateral security they have.

The choice of investors to invest may also be influenced by factors such as downgrading or upgrading. As investors, we can access many companies to make investments. Since it may be challenging for investors to make decisions in their best interests, this grading system establishes a standard or criteria for comparing the different businesses.

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C. Concentration risk or Industry risk

This risk manifests when a financial institution extends credit to a certain industry or sector. This exposure might cost the bank a substantial amount of money since it is too dependent on a particular sector of the economy. For instance, if a bank grants loans to businesses that are part of the automotive sector, the bank may be subject to concentration risk if the automotive industry downturned. If financial institutions do not spread their investments over various economic fields, they will be exposed to industry and concentration risk dangers. When a financial institution extends a bigger loan to a single corporate borrower, it puts itself at greater concentration risk. To reduce their exposure to this kind of risk, banks must invest their money across various borrower types.

D. Institutional risk

Institutional risk is the risk that arises as a result of the legal guidelines and regulations that are associated with the process of obtaining a loan. The lending institution and the individuals who take out loans are potentially exposed to institutional risk. The institutional risk may be a problem for financial institutions if there is any form of disturbance in the legal system. When borrowers refuse to abide by the contractual constraints imposed on them, this also constitutes institutional risk.

E. Recovery Risk

The risk involved in collecting the outstanding loan amount, which consists of the principal and the interest amount, from the defaulter is known as the recovery risk. The risk comes with the disparity between the actual amount of the loan and the amount that can be recovered. The greater the disparity between the two amounts, the bigger the recovery risk.

The recovery rate provides the ability to assess the potential amount of loss that might occur if the borrower cannot repay the loan amount. Some elements that impact the recovery rate include the macroeconomic climate, the number of failed businesses, an inadequate capital structure, and poor collateral security.

Sources of Rising NPAs or Credit Risk in Indian Banks

Non-performing assets are assets (such as loans, advances, bills discounted and purchased, etc.) in respect of which contractual payment is due for more than ninety days by the borrowing party. Examples of non-performing assets include loans, advances, bills discounted and purchased, etc. The loan’s interest and principal amount are included in the contractual amount. The profitability of banks and their liquidity situation will both be impacted by NPAs. A significant loss for the banking industry will affect other parts of the economy. Sub-standard, questionable, and loss assets are the three types of non-performing assets that may be seen in a company’s balance sheet. Assets that have been classified as NPA for a period shorter than one year or one year and one month are referred to as sub-standard assets. During a period of time more than one year, questionable assets have been categorized as non-performing assets (NPA). Assets classified as NPA for more than three

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years are considered loss assets. The banks must create a provision for the three types of non-performing assets.

Bank fraud and poor lending practices are the primary causes of financial institutions' nonperforming assets (NPAs). The significant growth in Non-Performing Assets (NPAs) over the last several years is one of the fundamental issues standing in the way of developing the banking sector in India. The most significant reasons for non-performing loans in banks are as follows:

a) Ineffective track of end use of loans

A lending institution always sanctions loans employed by the borrowing firm for productive reasons. A borrower may accept a loan to utilize the credit for a certain productive purpose, but they may purposefully refuse to use the borrowed money for the indicated reason. Bank officials' job is to monitor and maintain track of end-use of loans periodically. With this approach, banks may avoid the misapplication of bank cash towards unproductive ends like hoarding, speculations, etc. Yet owing to a restricted asset monitoring system after loan distribution, credit risk/NPA issues emerge.

b) Poor credit appraisal/assessment system

A credit appraisal mechanism is an essential method to check possible credit risk. This system helps to analyze the creditworthiness of the potential borrower. Due to faulty credit evaluation systems, banks sometimes offer loans and advances to persons who cannot repay the loan amount.

c) Corporate loans

Another important driver of growing bank NPAs is allocating a substantial amount of credit to corporate customers by the banks. In public sector banks, 'corporate loans account for a large share of the bad loans, whereas 'retail loans, such as auto loans, house loans, personal loans, etc., are comparably demonstrating better track records concerning prompt repayment. NPAs originate from corporate borrowers mostly because of insufficient bank loan department risk assessment. These corporate borrowers are highly active in loan scams. The latest blazing instances of corporate fraud in public sector banks are Kingfisher airlines, Jet Airlines, Bhusan Steel, ILFS, DHFL scam, PMC bank scam, etc.

d) Bank scams

Bank scam or fraud is an unlawful means of acquiring loans from a financial institution or bank by any individual or company. It is an intentional act to defraud the financial institution by getting funds through illicit methods. Several business companies deceive or mislead the bank via financial deception. These sorts of borrowers misrepresent their financial condition when seeking loans from a bank. The latest bank fraud incidents are the DHFL scam, Nirav Modi & Mehul Choksi scam, Vijaya Mallya scam, PMC scam, Andhra bank scam, etc.

e) Willful defaults

Public sector banks of India are the greatest sufferer of this form of default. When an individual or company does not repay the loan obligation despite being able to repay the money, it is known as 'willful default.' Willful defaults may be anybody of the following: Intentional default of dues irrespective of having a sound financial situation, willfully deceiving the bank by releasing erroneous information, unauthorized use of the loan money,

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supplying false collateral security, etc. Numerous similar incidents of bank fraud recently transpired in India, such as- the PNB scam involving Nirav Modi & Mehul Choksi, businessman Vijaya Mallya fraud case involving 13 banks, and many more.

f) Credit distribution Mismanagement

Occasionally ill-minded borrowers pay the bank personnel to secure loans with the goal of default. This is an instance of mishandling in the credit distribution system of the bank.

g) Recession in the markets

When there is an economic downturn in the nation, the financial institution faces excessive NPAs. Recession indicates contraction of economic activity i.e. reduction in income level, profit level, employment level, price level, wage level, contraction in volume of production and trade etc. Owing to recessionary scenario prevalent in the economy, borrowers fail to pay back the outstanding loan amount on time.

h) Priority sector lending

A large proportion of bank NPA will come from the priority sector credit. All the public sectors banks are mandated by law to provide credit to the priority sectors i.e. ignored and weaker portion of the economy which are normally denied from acquiring institutional financial help. A key sector comprises agriculture, small scale industries, rural craftsmen, farmers, small merchants, craftsman, khadi artists etc. Public sector banks bears substantial credit risk when distributing funding to this sector.

i) Defective lending practices by Insiders of banks

One of the key reasons of bank NPA is loosened and unsound lending regulations for the borrowers. The bank should constantly follow principles of safety, liquidity and profitability before accepting any loans. However failure to follow these essential rules lead bank to encounter huge risk. Improper lending practice comprises poor verification of financial position and credit rating of borrowers. Occasionally the bank insiders purposely authorize and accepts the loan application of friends, family and companies that are not creditworthy in order to benefit them.

j) Operational failure

All scams are consequence of inadequate credit risk management of banks i.e. operational failure. This includes lack of thorough verification of defective papers given by borrower, minimal precaution taken before allocation of loan and poor loan monitoring by bank employees after distribution of loan.

k) Ineffective Management

Sometimes lack in management translates into non-performing assets. The bank should take just those securities from borrowers which are very secure and marketable. Additionally, the management of bank should spread the capital into diverse industries. If a bank lends loans just to a specific sector, huge company or in specified cities then there are risks of high risk. The management of the bank frequently overlooks these techniques which result into rising number of delinquent loans.

l) Sick industrial crisis

Industrial illness implies when a company performs badly, fails to make profit on regular basis and incurs losses over current and previous financial years are known as sick unit. The reason of sickness can be: “fault in planning, problem in management and labour, inadequate

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technological innovation, improper methods of production, bad investment decision, increased competition, insufficient marketing strategy, unsound pricing, defective capital structure, lack of proper financial management" etc. If a financial institution offers loans to such sick company then there are greater risks of NPA as loan recovery rate would be low.

m) Absence of frequent spot visit

Occasionally, loan recovery rate also drops when the bank employees do not visit the borrower's site. If the bank workers consistently contact the client to collect the contractual debt obligation, there are greater opportunities to minimize NPAs.

Measures to be Taken by Commercial Banks to Reduce Credit Risk

The primary goal of a commercial bank's credit risk management is to cut down on the amount of assets that are considered to be non-performing. By taking into mind the broad suggestions made by the Basel Committee on Banking Supervision, each bank is tasked with developing their own credit risk probability assessment model with the purpose of lowering their NPA (BCBS). A high level of accuracy in the risk assessment procedures assists the banks in lowering their NPA. The following is a selection of the preventative steps that financial institutions take:

a) System of 'Accountability'

In order to address the issue of NPA, it is necessary to put in place an effective system of accountability. The majority of the time, dishonest senior-level authorities will participate in fraudulent operations; yet, lower-level employees will be held culpable for their superiors' illegal behavior. In order to find a solution to this problem, it is necessary to set up an appropriate system of accountability that involves many departments, a variety of employees, and multiple levels of government authorities.

b) Frequent staff turnover in the "Loan Department"

The loan officers of a bank are notorious for engaging in unethical practices such as bank fraud, the manipulation of the bank's finances, and other such activities. So, there has to be a good system in place for the rotation of employees working in the loan department in order to reduce the likelihood of fraud and credit risk.

c) More stringent NPA recovery

In order to increase the percentage of loans recovered from NPAs, banks need to devise more stringent mechanisms for loan recovery. A higher percentage of recovered NPAs is likely to lead to an improvement in the bank's profitability.

d) Precaution while lending to corporate clients

Since corporate loans account for the vast bulk of the non-performing loans that Indian financial institutions must deal with. While personal loans only make up a minor portion of the total. As a result, the review of a corporate client's credit rating is required prior to the sanctioning of a loan.

e) Systematic Training Program

Banks should organize an effective training program for their managers and employees in order to assist them in the prompt detection of clients' creditworthiness.

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f) Credit Approving Authority

Commercial banks have the ability to create a multi-level credit approving system in which a group of officials will review the loan applications. In order to authorize high-value loans, this committee will check the creditworthiness of borrowers, paying specific attention to the creditworthiness of corporate borrowers.

g) An Effective Credit Appraisal System

In order to reduce the amount of risk associated with credit, financial institutions need to build appropriate assessment systems. The lending institution is required to determine whether or not the individual borrowers are creditworthy by analyzing their identification evidence, address proof, income proof, the source and consistency of the borrower's income, credit history, repayment behavior, financial capacity, and other factors.

h) Analysis of Financial statements

Yet another important step in mitigating credit risk is doing an analysis of the borrower's financial statement, which should include both a balance sheet and a profit and loss account. Calculating a variety of financial statistics in order to ascertain the borrowers' actual financial standing is another component of this process.

i) Supervision of end use of funds

Borrowers are required to specify their plans for the money when they apply for a loan. This allows lenders to monitor how the money is ultimately spent. Untrustworthy borrowers often make an attempt to use the money from the loan for anything else. So, a stringent monitoring of the ultimate purpose of the funds is a useful tool for reducing credit risk.

j) Internal Credit Rating Analysis of borrower

The internal credit rating system of a bank is a standard tool that is used to check the creditworthiness of the borrower. The form and operation of a bank's internal credit score or rating process might vary widely from institution to institution. The rating approach used by banks makes an attempt to both detect and quantify the risk. Banks have access to a strong tool in the form of internal credit rating models, which they may use to evaluate a borrower's capacity to repay a loan, including interest and monthly payments.

k) Evaluating Poor Credit Warning Signals

A bank should routinely monitor warning signals or red flags of various categories of borrowers before the credit score or rating falls to an unacceptable level. Warning signs of poor credit include the following: the borrower has failed to make payments on multiple debt obligations; another lending institution has denied the borrower's application for a loan or credit card; the borrower is frequently late in paying utility bills, medical bills, insurance premiums, rent, and other bills; the borrower has difficulty realizing the collateral security at a reasonable market value; and so on.

l) Effective Credit Monitoring

In order for the banks to continuously identify the quality of the loan, the tool known as Loan Review Mechanism (LRM) may be used by the banks. The bank will be able to discover credit problems of the entity that is borrowing money and then take steps to improve the credit quality with the assistance of this tool. Recovery rate is something that may be enhanced via continual monitoring of credit.

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m) Default Probability analysis of borrower

The term "default probability" refers to the potential that a borrower will be unable to repay the amount of the loan. The borrower's internal credit score takes into account the likelihood that they will fail on their loan. By doing accurate and fast credit rating checks on borrowers, banks are able to determine the likelihood that such borrowers would fail on their loans.

Conclusion

The financial sector of any economy plays an important part in the growth and development of the country as a whole. The money of depositors are being put to productive use thanks to the efforts of the Indian banking system, which plays a pivotal role in this process. The banking industry in India has been working hard to level out regional disparities throughout the nation by expanding its branch network into all of its constituent components. Every individual in the country is impacted when banks suffer excessive losses. Losses are incurred by banks for a variety of different causes. One of the reasons for this is the rising tide of "non-performing assets," often known as NPA. Banks are exposed to a significant amount of risk as a result of inadequate credit risk management on their part. One of the most significant financial frauds in recent history took place in India, and it is known as the DHFL scam. There are numerous instances of people who have robbed the banks, such as Nirav Modi, Mehul Choksi, and Vijay Mallya, amongst others. These individuals were all implicated in large banking frauds. Banks need to build an acceptable credit risk assessment model in order to forestall any future failures or cons involving financial institutions of this kind. In addition to this, financial institutions need to enhance their loan recovery process, alter the terms and conditions of loans that are already in place, and reinforce their internal audit systems.

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