ANWESH: International Journal of Management and Information Technology
3 (2), September 2018, 33-36
http://www.publishingindia.com/anwesh

Case Study on Credit Risk Exposure Issues and Challenges

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Abstract: This case study is based on recent updates on credit risk in banks which is emerging as a big demon to our economy. An attempt is made to depict the following:

- **Different aspects of credit risk.**
- **Agencies that checks the worthiness of investors.**
- **Authorities and their role in minimizing such risks.**
- **Suggestions to tackle the risk.**

It hovers around the conversation between a management graduate named Kautuk and his faculty Savant on the credit risk and their logical suggestions to tackle such type of risk. An effort is made to understand the concept, credit rating agencies, legal framework and credit risk management and assessing role of authorities in this context.

Keywords: Credit risk, Default risk, Non performing assets, Risk management.

I. Introduction

As a management teacher in universities we speak on live case histories and their analysis to bring interest in our teaching pedagogy. Kautuk was our management graduate who always asked why before what. As a finance faculty Savant was renowned one among the teaching fraternity. One day he was speaking to Kautuk on current emerging issues on banking industry and risk associated, especially on default and credit risk. He had several questions on non performing assets and Indian economy. Recent news on big business giants defaulting has created innumerable questions in his mind. He expressed himself by saying, *"Sir when our system is strong and we have windshield rules and regulations in offering loans and collection system then why such type of fraud or default can happened? Where does the fault lies? Who is responsible? The person or party who has defaulted or the authorities? How does this affect our economy? Why can't we control?*

Savant could not sleep that night. Those questions were troubling him. He wanted to answer but he decided to help Kautuk to find logical explanation on the same.

Next day morning Savant asked Kautuk to meet him in library. He started with the history of banking industry. "Banking Sector in India is backbone of the economy, as they contribute towards resource mobilization to the large extent (more than 70%). Early stages had witnessed a slow development. There were ups and downs in this era of pre independence from 1986 to 1947. Whereas post independence era after1947 to till date this sector has experienced tremendous transformation. Although banking industry caters resource mobilization through loans offered to individuals and different companies, operates multiple system of payments and assist and support saving and various accounts of individual as well as institutions it has experienced different risk". Kautuk was listening very patiently; Savant proceeded further and commented "in this process of lending and recovering the Credit Risk is in highest order among all other risks in our banking industry".

He added, as per Reserve Bank of India "it is the possibility that a borrower may not meet their obligation in terms of the loan agreed terms and conditions". Default in the payment to banks for various reasons, party who has taken loan is unable to pay back within stipulated time. Kautuk commented, *"In banking industry this risk is emerging as a demon".*

Savant continued on different aspects, like,

- Credit default risk where debtor has exceeded 90 days past due of his payment.
- Concentration risk where single party exposure or industry exposure that may hinder core operations of bank.
- Countries risk the exposure due to freezing foreign currency payments.

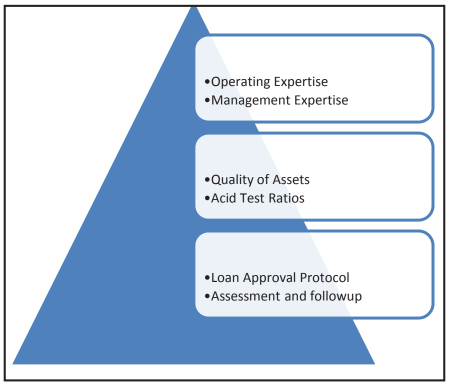
Counterparty unable to meet the term and concentration of banks and exposure to various sectors respectively. Credit Risk of a bank is affected internally due to banking operations and externally by economic and fiscal conditions.

To minimize such type of risk there are good number of agency who perform credit health checks and share the credit scores with interested parties.

In India we have credit rating agencies on Credit Information Bureau India Limited (CIBIL), Credit Rating Information Services of India (ltd) CRISIL, Investment Information and Credit Rating Agency in India (ICRA), Credit Analysis & Research Ltd (CARE), Onida Individual Credit Rating Agency in India (NICRA), Small and Medium Enterprise Rating Agency of India Ltd (SMERA) Equifax CIS and several others.

These institutions have a framework i.e., used by banks and lending institutions to grant credit to clients.

However, following flow chart explains the various qualitative and quantitative parameters:



Above aspects are considered before clearing the loan. However, it is disheartening to learn that in Indian Banks contribution towards bad debts resulting into distressed assets ruining the very first objective of resource mobilization.

Kautuk commented, "Sir for example in case of Mallyas default to 17 banks including SBI,PNB,IDBI,BOB,UBI and several others nearly 3,700 crores these banks are struggling to recover their funds. SBI has complained and Enforcement Directorate has filed a new charge sheet against him and his companies on behalf of consortium of banks for causing loss. "Savant thought yes it's very true, it's a huge loss to our banks and to our economy. But it's just one example, there are several cases. Recent stability report of RBI has published the following data.

Table I

(Amount in Billion)					
Asset Quality	Amount Outstanding	Amount Outstanding	Amount Outstanding	Amount Outstanding	Amount Outstanding
	2016-17	2015-16	2014-15	2013-14	2012-13
Gross NPAs	7918	6119	3233	2644	1941
Net NPAs	4331	3498	1754	1426	987
Gross NPA ratio (Gross NPAs as percentage of gross advances)	9.3	7.5	4.3	3.8	3.2
Net NPA ratio (Net NPAs as percentage of net advances)	5.3	4.4	2.4	2.1	1.7
Provision Coverage Ratio (Per cent)**	43.5	41.9	44	44.7	47.6
Slippage ratio (Per cent)	5.7	6.3	3.2	3.3	2.8

Source: rbidocs.rbi.org.in

Savant explained his pupil that the above table shows outstanding amount for different years varying from 2012-13 to 2016-17 on various scales of Gross NPAs, Net NPAs and its respective ratios.

II. A Road Map to Credit Risk Management

Kautuk wanted know how we can management credit risk and he suggested why can't the banks use proved models before forwarding loan documents like Altman's Z Score Model, Merton Model, Credit Metrics Model, Value at Risk Model etc. These models calculate working capital, retained earnings, market value of equity, sales ratios to assess the financial conditions and health of the applicants companies. Apart from these they also calculate portfolio assessment and time horizon estimate also. Savant was happy to learn that what he had taught in the class on different models is remembered by his student and he is trying to apply the same. He also continued with RBI's guidelines for reduction of credit risk. RBI had laid mechanism like credit scoring to measure risk, estimation of losses through quantifying risk, lending rate as contributor to risk and control mechanism for effective loan review and control.

Savant continued that in of the report India's bad loan problem is really a concern as per the report by consulting editor and advisor of the leading bank, the average bad debts of public banks are 75.53% of their net worth and for some of the banks this figure is exceeded. This is the main concern that RBI and government have reasons to be worried. The band-aid approaches of our central bank and government towards the loans have the deep gash.

Following are the major reasons for emergence of bad debts:

- Corrupted Banking Officials.
- Lack of Credit Appraisal Expertise.
- Lack of Monitoring system of loans.
- No Market Survey conducted before forwarding loans to big B giants.

- More preference to balance sheet growth.
- Misleading of economic scenario of 2008 recession and RBI Policy on credit.
- Optical illusion of lower bad loans.
- Disconnect between Rating & loan disposal.
- Status of legal framework.

Like, credit transaction is based on mutual agreement with parameters on terms of credit including amount of credit, interest rate, maturity of loans, frequency of loan servicing and collateral. However, incase of default there should be strict norms to be imposed on sanctioning authority and borrower that can build strong wall between the banks and defaulters.

As per the analysis by the rating firm Icra Ltd, *gross bad loans of Indian banks in 2007 have been 9.5% of their loan portfolio, out of which 5.5% are net loans. Banks are also suffering with optical illusion i.e., writing down the bad loans and taking out the same from balance sheet, by parking them aside. As and when the money is recovered, banks add the amount to their profits. In Mar 2017, public sector banks had 11.4% of gross bad loans and private sector banks had 4.2%.*

Kautuk was concerned after listening to this and he was in mere shock to know India having a long history of bad debts and credit risk in the midst of legal framework, efficient banking system they are still becoming victims in the hands of defaulters. Total quality measures are required to curb this problem.

III. Case Analysis

To curb the problem of credit risk following measures can be incorporated:

- Stringent Loan Policy
- Double Edged Credit Analysis
- Cross check
- Viability of proposal
- Deployment of loan in multiple stages
- Continuous Monitoring and Remainder system
- Strict Follow up
- Speedy Action Oriented System
- Adhering to norms of Controlling authority
- Inter Bank Checks

Authorities are trying their best with different type of legal structuring to cover the individuals and companies who are defaulting. There are many legal framework lay to deal with default cases from time to time. Like Legal Financial Level frameworks.

Table II

Legal Framework	Features
The Debt Recovery Tribunals (DRT)1993	These tribunals governed to decrease the time settling cases
Credit Information Bureau-2000	It provides information system for maintenance and sharing credit data
Lok Adalat 2001	Upto 5 lakh rupee loan are tackled in recovery
Compromise Settlement 2001	Tackles advances below Rs. 10 crs
SARFAESI Act-2002	Permits banks to deal with default cases without court intervention
ARC 2002	Companies are created to unlock value from stressed loans
CDR 2005	Provides more time to repay with decreased rates
5:25 Rule 2014	Maintains the cash flow to companies for long time line and refinance
JLF 2014	Prevents the cases of one party taking loan to give loan to other banks
Mission Indradhanush 2015	Aims at transforming the PSB's
SDR 2015	Banks get right to convert the part/full loan to equity in the loan taken company
Asset Quality Review-2015	Provision to identify the stressed assets at early stage
S 4 A 2016	Diversification of outstanding debts to sustainable debt-equity/quasi equity
Insolvency & Bankruptcy Act 2016	Addresses finance related problems by consolidating & amending the laws related to insolvency
Public ARC Vs Private ARC 2017	Forum of debate by moot between PARC Vs PriARC
Bad Banks 2017	As per economic survey 2016-17 proposal to form a bad bank that take all stressed loans to tackle the problem

IV. Conclusion

In the light of above action proposed time to time to care of the problem we are still puppets in the hands of unethical and corrupt mediations. "Precaution is better than cure" if in early stages utmost care is taken and authorities adhere to the protocol of collection system credit risk can be tackled positively.

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