Chapter 6: Credit risk Management

6. Credit risk

Credit Risk is the change in value of a debt due to changes in the perceived ability of counterparties to meet their contractual obligations (or credit rating). Also known as default risk or counterparty risk, credit risk is faced by lending institutions like banks, investors in debt instruments of corporate houses, and by parties involved in contractual agreements like forward contracts. There are independent agencies that assess the credit risk in form of credit ratings. Credit rating is an opinion (of the credit rating agency) on the ability of the organization to perform its contractual obligations (pay the principle and/or interest of the loan) on a timely basis. Each level of rating indicates a probability of default. International credit rating agencies (like Moody's, Fitch, and S&P) use quantitative models along with their experience to predict the credit ratings. Credit scoring models of banks and lending institutions use stock prices (if available), financial performance and sector specific data, and macroeconomic forecasts to predict the credit rating. Although credit ratings for retail lending are not available, credit scoring models for individuals are gaining popularity. Credit risk can be transferred using credit derivatives, and also by securitization an attempt by a consortium of international banks (Basel Accords) to set regulatory standards for lending institutions has lead to development of better and robust credit assessment models.

Banks are in the business of risk and banking is all about managing risk and return. The balancing of risks and returns presents a major challenge and banks are successful when the risks taken are reasonable, controllable and within their financial resources and credit competence. Banks, in the course of their business, are confronted with various kinds of risks, which all these risks are interrelated, interdependent and overlapping in their cause and effects.

The issuers of fixed income securities may default by failing to make interest payments or to repay principal in a timely manner. This is referred to as credit risk. To illustrate, credit risk is virtually non-existent for securities issued by the any government of countries. Credit risk is higher for fixed-income securities issued by corporations. The degree of credit risk is reflected in credit ratings described below. Securities with higher credit risks (and lower ratings) often referred to as high yield securities; generally pay a higher interest rate to compensate investors for the additional risk. In other word credit risk is the risk of a certain security does not honor its commitments within the agreed maturity. Consequently, the fund that holds this security in its portfolio will have a loss equivalent to its investment. Normally, this risk may be evaluated by the rating of the security. Also Credit Risk is simply defined as the probability that a bank borrower will fail to meet its obligations in accordance with agreed terms and involves inability or unwillingness of a customer to meet commitments in relation to lending, trading, hedging, settlement and other financial transactions. Credit Risk is generally made up of (a) transaction risk or default risk and (b) portfolio risk.

Credit risk is the risk of financial loss arising from the failure of a borrower or other financial counterparty to meet its contractual obligations to the Bank. The pursuit of the Bank's development objectives renders substantial credit risk an unavoidable and necessary consequence of its business operations. Credit risk is the major part of the Bank's overall risk, and, in ensuring that the institution remains financially sustainable and is therefore able to achieve its objectives, managing this risk takes precedence.

The Board of Directors and its subcommittee, the Credit Committee, authorize larger credit decisions, while the operations executives are authorized to approve smaller credits. All credit decisions, irrespective of nominal size, are based on a comprehensive and documented appraisal process. In evaluating and monitoring credit risk, the Bank employs a well-tested internal rating model that ensures a thorough and all-embracing risk assessment of each client. Loans and guarantees provided are classified in accordance with the Bank's associated risk classification system and all clients are reassessed on a semi-annual basis, as part of the ongoing risk monitoring process. The semi-annual risk classification process is documented in the form of a credit risk migration matrix, which forms the basis for determining the Bank's loan loss provisioning. Credit decisions are further subject to both single obligor limits and the appraised debt service capacity of the borrowers. As part of the credit risk mitigation process the Bank also requires collateral in the form of eligible assets or third-party guarantees, when deemed prudent. Assets held as security against loans are revalued at prescribed intervals, which vary according to the nature and liquidity of these assets.

Credit risk management is a process, rather a comprehensive system. The process begins with identifying the target markets and proceeds through a series of stages to loan repayment. Different types of risk management techniques need to be employed at each stage of the credit process. Every activity in credit risk management is undertaken with the ultimate aim of protecting and improving the loan quality, which is critical to the health of banks. A healthy loan portfolio, in turn, leads to maximization of profits and shareholders' wealth.

6.1. Objective of credit risk management

The factors and objectives that shape up the bank's policies towards credit risk management are:

- To make available sufficient liquidity to meet loan a ailments, interest, operational and other costs and losses;

- To maximize profits; and
- To support broad national policy objectives of liquidity, interest rate stability, financial stability and above all, allocation of scarce financial resources efficiently to foster economic growth.

6.2. Difficulties face to credit risk management

Banks in emerging markets like India face intense challenges in managing Credit Risk. These may be determined by factors external/internal to the bank. The external factors include:

- Delay in production schedules/production difficulties of borrowers
- Frequent instability in the business environment
- Wide swings in commodity/equity prices, foreign exchange rates and interest rates
- Legal framework less supportive of debt recovery
- Financial restrictions
- Government policies and controls
- Economic sanctions
- Natural disasters, etc

These may be aggravated by internal factors / deficiencies in the management of credit risk within the bank like:

- ✓ Deficiencies in loan policies / administration
- ✓ Lack of portfolio concentration limits
- ✓ Excessive centralization or decentralization of lending authority
- ✓ Deficiencies in appraisal of financial position of the borrowers
- ✓ Poor industry analysis
- ✓ Excessive reliance on collateral
- ✓ Inadequate risk pricing
- ✓ Poor controls on loan documentation
- ✓ Infrequent customer contact
- ✓ Inadequate post-sanction surveillance

- ✓ Lack of articulated loan review mechanism
- ✓ Failure to improve collateral position as credits deteriorate
- ✓ Absence of stringent asset classification and loan loss provisioning standards
- ✓ Inadequate checks and balances in the credit process
- ✓ Failure to control and audit the credit process effectively

These deficiencies can lead to loan portfolio weaknesses, including over concentration of loans in one industry or sector, large portfolios of non-performing loans and credit losses. These may further lead to miss liquidity and ultimately insolvency. The fact that the banks operate in an economic environment that poses objective difficulties for good credit management gives all the more reason to strengthen their credit risk management practices.

6.3. Managing of credit risk

The management of credit risk should receive the top management's attention and the process should encompass:

a. Measurement of risk through credit rating/scoring;

b. Quantifying the risk through estimating expected loan losses i.e. the amount of loan losses that bank would experience over a chosen time horizon (through tracking portfolio behavior over 5 or more years) and unexpected loan losses i.e. the amount by which actual losses exceed the expected loss (through standard deviation of losses or the difference between expected loan losses and some selected target credit loss quantity);

c. Risk pricing on a scientific basis; and

d. Controlling the risk through effective Loan Review Mechanism and portfolio management.

The credit risk management process should be articulated in the bank's **Loan Policy,** duly approved by the Board. Each bank should constitute a high level **Credit Policy**

Committee, also called Credit Risk Management Committee or Credit Control Committee etc., to deal with issues relating to credit policy and procedures and to analyze, manage and control credit risk on a bank wide basis. The Committee should be headed by the Chairman/CEO/ED, and should comprise heads of Credit Department, Treasury, Credit Risk Management Department (CRMD) and the Chief Economist. The Committee should, *inter alia,* formulate clear policies on standards for presentation of credit proposals, financial covenants, rating standards and benchmarks, delegation of credit approving powers, prudential limits on large credit exposures, asset concentrations, standards for loan collateral, portfolio management, loan review mechanism, risk concentrations, risk monitoring and evaluation, pricing of loans, provisioning, regulatory/legal compliance, etc. Concurrently, each bank should also set up Credit Risk Management Department (CRMD), independent of the Credit Administration Department. The CRMD should enforce and monitor compliance of the risk parameters and prudential limits set by the CPC. The CRMD should also lay down risk assessment systems, monitor quality of loan portfolio, identify problems and correct deficiencies, develop MIS and undertake loan review/audit. Large banks may consider separate set up for loan review/audit. The CRMD should also be made accountable for protecting the quality of the entire loan portfolio. The Department should undertake portfolio evaluations and conduct comprehensive studies on the environment to test the resilience of the loan portfolio.

6.4. Credit Approving Authority

Banks usually adopt either a committee or sequential process of credit approval. The former requires ultimate approval of a loan or credit facility by a committee that customarily consists of members of senior management and the heads of the credit departments. The sequential process involves an approval chain of individual loan officers with ascending levels of authority to sanction credit. Most of the Indian banks, especially in the public sector, have adopted the sequential system of loan sanction. The proponents of the committee system believe that:

- ✓ The committee has better decision making capabilities, by virtue of the combined experience of its members and
- ✓ There is greater transparency in the decision making process.
- ✓ Advocates of the sequential system, however, argue that:
- ✓ Majority of the members may follow the preferences of the senior members of the committee.

✓ The system may not always help in speedy decision-making.

✓ It may be difficult to fix accountability to generate more responsible decision-making.

✓ Committee may hence be more risk- prone.

Ultimately, the size of the bank, the scope of its operations and most important - its credit culture will determine the type of credit approval process to be adopted by it. It may be mentioned that RBI in its recent guidelines has asked banks to consider establishment of the 'Committee' system of loan approval.

The banks should also evolve suitable framework for reporting and evaluating the quality of credit decisions taken by various functional groups. The quality of credit decisions should be evaluated within a reasonable time, say 3 - 6 months, through a well-defined Loan Review Mechanism.

6.5.RBI guidelines on credit risk rating

❖ Banks should have a comprehensive risk scoring/rating system that serves as a single point indicator of diverse risk factors of counterparty and for taking decision in a consistent manner.

❖ The risk rating system should be devised to reveal the overall risk of lending which is the critical input for setting price and non-price terms of loans as also present meaningful information for review and management of loan portfolio.

❖ Within the rating framework banks should also prescribe certain levels of standards or critical parameters beyond which no proposals should be entertained. Banks may also consider separate rating framework for large corporate/small borrowers, etc.

Reserve Bank of India in their notification on risk management system in banks has outlined the following guidelines in respect of risk rating of a borrower:

❖ The overall score for risk is to be placed on numerical scale ranging between 1 to 6, 1 to 8, etc.

❖ Bank should ensure that un hedged market risk exposures of borrowers (foreign exchange exposure assumed by the corporate who have no natural hedges) should also be considered in the rating framework.

❖ Credit risk assessment should be reviewed biannually and should be delinked invariably from the regular renewal exercise.

❖ In order to ensure consistency and accuracy of internal ratings the responsibility for setting or confirming such ratings should vest with the loan review function and examined by an independent loan review group.

❖ Bank should undertake comprehensive study on migration of borrowers in the ratings.

6.6.Loan Review Mechanism (LRM)

LRM is an effective tool for constantly evaluating the quality of loan book and to bring about qualitative improvements in credit administration. Banks should, therefore, put in place proper Loan Review Mechanism for large value accounts with responsibilities assigned in various areas such as, evaluating the effectiveness of loan administration, maintaining the integrity of credit grading process, assessing the loan loss provision, portfolio quality, etc. The complexity and scope of LRM normally vary based on banks' size, type of operations and management practices. It may be independent of the CRMD or even separate Department in large banks.

6.6.1. The main objectives of LRM

Accurate and timely credit grading is one of the basic components of an effective LRM. Credit grading involves assessment of credit quality, identification of problem loans, and assignment of risk ratings. A proper Credit Grading System should support evaluating the portfolio quality and establishing loan loss provisions. Given the importance and subjective nature of credit rating, the credit ratings awarded by Credit Administration Department should be subjected to review by Loan Review Officers who are independent of loan administration. The main objectives of Loan Review Mechanism (LRM) include:

- To identify promptly loans which develop credit weaknesses and initiate timely corrective action;
- To evaluate portfolio quality and isolate potential problem areas;
- to provide information for determining adequacy of loan loss provision;

- To assess the adequacy of and faithfulness to, loan policies and procedures, and to monitor compliance with relevant laws and regulations; and
- To provide top management with information on credit administration, including credit sanction process, risk evaluation and post-sanction follow-up.

6.7.None performing assets (NPA)

By its very nature, banking involves taking risks. In most countries, banks have deployed their funds into loans, which form the bulk of their assets. Consequently, one of the most significant risks faced by banks has been and will continue to be credit risk that is the risk, which the counter party will default on his obligations as agreed. Banks are now coming up with new techniques to measure, manage and mitigate the risks to which they are exposed.

Loans become non-performing when borrowers fall in arrears in the repayment of principal or interest payment or both. Some borrowers have the means to repay but do not have the willingness to repay; i.e. they become willful defaulters on the loans. On the other hand, there are borrowers who cannot afford to repay because of hardships of an economic nature. An economic slowdown can severely undermine the capacity of borrowers to continue servicing and to repay their debts. In such circumstances, an effective asset management policy in the financial system can help to come to grips with the problem of non-performing assets and so prevent a crisis that may go out of control.

Traditionally, banks have placed undue reliance on the collaterals when extending credit facilities. When borrowers default and all means are exhausted to recover their dues, banks finally have to foreclose the assets held as security. The foreclosing and disposal of the assets do not always produce the desired results. It's a known fact that the banks and financial institutions in India face the problem of swelling non-performing assets (NPAs) and the issue is becoming more and more unmanageable. In order to bring the situation under control, some steps have been taken recently. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 was passed by Parliament, which is an important step towards elimination or reduction of NPAs.

6.7.1. Indian economy and NPAs

Undoubtedly the world economy has slowed down, recession is at its peak, globally stock markets have tumbled and business itself is getting hard to do. The Indian economy has been much affected due to high fiscal deficit, poor infrastructure facilities, sticky legal system, cutting of exposures to emerging markets by foreign institutional investors (FIIs), etc. Further, international rating agencies like, Standard & Poor have lowered India's credit rating to sub-investment grade. Such negative aspects have often outweighed positives such as increasing fore reserves and a manageable inflation rate. Under such a situation, it is understood that banks are no exception and are bound to face the heat of a global downturn. One would be surprised to know that the banks and financial institutions in India hold non-performing assets worth Rs. 1,10,000 crores. Bankers have realized that unless the level of NPAs is reduced drastically, they will find it difficult to survive.

6.7.2. Global Developments and NPAs

The core banking business is of mobilizing the deposits and utilizing it for lending to industry. Lending business is generally encouraged because it has the effect of funds being transferred from the system to productive purposes that results into economic growth.

However lending also carries credit risk, which arises from the failure of borrower to fulfill its contractual obligations either during the course of a transaction or on a future obligation.

A question that arises is how much risk can a bank afford to take? Recent happenings in the business world - Enron, WorldCom, Xerox, Global Crossing do not give much confidence to banks. In case after case, these giant corporates became bankrupt and failed to provide investors with clearer and more complete information thereby introducing a degree of risk that many investors could neither neither anticipate nor welcome. The history of financial institutions also reveals the fact that the biggest banking failures were due to credit risk.

Due to this, banks are restricting their lending operations to secured avenues only with adequate collateral on which to fall back upon in a situation of default.

6.7.3. Meaning of NPAs

An asset is classified as non-performing asset (NPAs) if dues in the form of principal and interest are not paid by the borrower for a period of 180 days.

However with effect from March 2004, default status would be given to a borrower if dues are not paid for 90 days. If any advance or credit facilities granted by bank to a borrower becomes non-performing, then the bank will have to treat all the advances/credit facilities granted to that borrower as non-performing without having any regard to the fact that there may still exist certain advances / credit facilities having performing status. In berif "Non-performing Asset" means an asset in respect of which:

- Interest or principal (or installment thereof) is overdue for a period of more than 180 days;
- interest for principal is overdue for a period of more than 180 days from the expiry of planning period, wherever applicable;
- any other receivable, if it is overdue for a period of more than 180 days.

6.7.4. Asset Classification

Every Securitization / Reconstruction Company shall, after taking into account the degree of well defined credit weaknesses and extent of dependence on collateral security for realization, classify the assets it has acquired for reconstruction and held by it, into the following categories into four broad groups, *viz.*, (*a*) Standard assets, (*b*) Sub-standard assets, (*c*) Doubtful assets, (*d*) Loss assets:

- *Standard assets* - Standard asset is one which does not disclose any problems and which does not carry more than normal risk attached to the business. Such an asset is not a NPA.
- *Sub-standard Assets* - Sub-standard asset is one which has been classified as NPA for a period not exceeding two years.
- *Doubtful assets* - With a view to moving closer to international practices in regard to provisioning norms, an asset should be classified as doubtful, if it has remained in the sub-standard category for 18 months instead of 24 months, as at present, by March 31, 2001. Banks are permitted to achieve this norm for additional provisioning in phases, as under :
    - *As on March 31, 2001:* Provisioning of not less than 50 per cent on the assets which have become doubtful on account of the new norm.

- *As on March 31, 2002:* Balance of the provisions not made during the previous year, in addition to the provisions needed, as on March 31, 2002.]
- *Loss assets* - A loss asset is one where loss has been identified by the bank or internal or external auditors or in the Reserve Bank inspection report. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

6.7.5. A huge level of NPAs exist in the Indian banking system (IBS)

The origin of the problem of burgeoning NPAs lies in the quality of managing credit risk which concerned by the banks. What is needed is having adequate preventive measures in place namely, fixing pre-sanctioning appraisal responsibility and having an effective post-disbursement supervision. Banks concerned should continuously monitor loans to identify accounts that have potential to become non-performing.

6.7.6. NPAs and India banks and financial institutions

To start with, performance in terms of profitability is a benchmark for any business enterprise including the banking industry. However, increasing NPAs have a direct impact on banks profitability as legally banks are not allowed to book income on such accounts and at the same time banks are forced to make provision on such assets as per the Reserve Bank of India (RBI) guidelines.

In addition, with increasing deposits made by the public in the banking system, the banking industry cannot afford defaults by borrower s since NPAs affects the repayment capacity of banks. Further, Reserve Bank of India (RBI) successfully creates excess liquidity in the system through various rate cuts and banks fail to utilize this benefit to its advantage due to the fear of burgeoning non-performing assets.

6.7.7. RBI guidelines on income recognition (interest income on NPAs)

Banks recognize income including interest income on advances on accrual basis. That is, income is accounted for as and when it is earned. The prima-facie condition for accrual of income is that it should be reasonable to expect its ultimate collection. However, NPAs involves significant uncertainty with respect to its ultimate collection.

Considering this fact, in accordance with the guidelines for income recognition issued by the Reserve Bank of India (RBI), banks should not recognize interest income on such NPAs until it is actually realized.

6.7.7.1. Accounting Standard 9 (AS 9) on revenue recognition issued by ICAI

The Accounting Standard 9 (AS 9) on 'Revenue Recognition' issued by the Institute Of Chartered Accountants of India (ICAI) requires that the revenue that arises from the use by others of enterprise resources yielding interest should be recognized only when there is no significant uncertainty as to its measurability or collect ability. In addition, interest income should be recognized on a time proportion basis after taking into consideration rate applicable and the total amount outstanding.

6.7.7.2. RBI guidelines on NPAs and ICAI Accounting Standard 9 on revenue recognition

In view of the guidelines issued by the Reserve Bank of India (RBI), *interest* income on NPAs should be recognized only when it is actually realized. As such, a doubt may arise as to whether the aforesaid guidelines with respect to recognition of interest income on NPAs on realization basis are consistent with Accounting Standard 9, 'Revenue Recognition'. For this purpose, the guidelines issued by the RBI for treating certain assets as NPAs seem to be based on an assumption that the collection of interest on such assets is uncertain. Therefore complying with AS 9, interest income is not recognized based on uncertainty involved but is recognized at a subsequent stage when actually realized thereby complying with RBI guidelines as well.

In order to ensure proper appreciation of financial statements, banks should disclose the accounting policies adopted in respect of determination of NPAs and basis on which income is recognized with other significant accounting policies.

6.7.7.3. RBI guidelines on classification of bank advances

Reserve Bank of India (RBI) has issued guidelines on provisioning requirement with respect to bank advances. In terms of these guidelines, bank advances are mainly classified into:

Standard Assets: Such an asset is not a non-performing asset. In other words, it carries not more than normal risk attached to the business.

Sub-standard Assets: It is classified as non-performing asset for a period not exceeding 18 months

Doubtful Assets: Asset that has remained NPA for a period exceeding 18 months is a doubtful asset.

Loss Assets: Here loss is identified by the banks concerned, by internal auditors, by external auditors, or by Reserve Bank India (RBI) inspection.

In terms of RBI guidelines, as and when an asset becomes a NPA, such advances would be first classified as a sub-standard one for a period that should not exceed 18 months and subsequently as doubtful assets. It should be noted that the above classification is only for the purpose of computing the amount of provision that should be made with respect to bank advances and certainly not for the purpose of presentation of advances in the banks balance sheet. The Third Schedule to the Banking Regulation Act, 1949, solely governs presentation of advances in the balance sheet.

Banks have started issuing notices under the Securitisation Act, 2002 directing the defaulter to either pay back the dues to the bank or else give the possession of the secured assets mentioned in the notice. However, there is a potential threat to recovery if there is substantial erosion in the value of security given by the borrower or if borrower has committed fraud. Under such a situation, it will be prudent to directly classify the advance as a doubtful or loss asset, as appropriate.

6.7.7.4. RBI guidelines on provisioning requirement of bank advances

As and when an asset is classified as an NPA, the bank has to further sub-classify it into sub-standard, loss and doubtful assets. Based on this classification, bank makes the necessary provision against these assets. Reserve Bank of India (RBI) has issued guidelines on provisioning requirements of bank advances where the recovery is doubtful. Banks are also required to comply with such guidelines in making adequate provision to the satisfaction of its auditors before declaring any dividends on its shares.

In case of loss assets, guidelines specifically require that full provision for the amount outstanding should be made by the concerned bank. This is justified because such an asset is considered uncollectible and cannot be classified as bankable asset. Also in case of doubtful assets, guidelines requires the bank concerned to provide entirely the unsecured portion and in case of secured portion an additional provision of 20%-50% of the secured portion should be made depending upon the period for which the advance has been considered as doubtful. For instance, for NPAs that are up to 1-year old, provision should be made of 20% of secured portion, in case of 1-3 year old NPAs up to 30% of the secured portion and finally in case of more than 3-year-old NPAs up to 50% of secured portion should be made by the concerned bank.

In case of a sub-standard asset, a general provision of 10% of total out standings should be made. Reserve Bank of India (RBI) has merely laid down the minimum provisioning requirement that should be complied with by the concerned bank on a mandatory basis. However, where there is a substantial uncertainty to recovery, higher provisioning should be made by the bank concerned.

6.7.8. Credit Risk and NPAs

Quite often credit risk management (CRM) is confused with managing non-performing assets (NPAs). However there is an appreciable difference between the two. NPAs are a result of past action whose effects are realized in the present i.e they represent credit risk that has already materialized and default has already taken place.

On the other hand managing credit risk is a much more forward-looking approach and is mainly concerned with managing the quality of credit portfolio before default takes place. In other words, an attempt is made to avoid possible default by properly managing credit risk.

Considering the current global recession and unreliable information in financial statements, there is high credit risk in the banking and lending business.To create a defense against such uncertainty, bankers are expected to develop an effective internal credit risk models for the purpose of credit risk management.

6.7.8.1. Requirement as to capital adequacy

Every Securitisation/Reconstruction Company shall maintain, on an ongoing basis, a minimum capital adequacy ratio, which shall not be less than 15 percent of its total risk weighted financial assets. The risk-weighted asset shall be calculated as the weighted aggregate of funded items as detailed hereunder:

WEIGHTED RISK ASSETS - ON-BALANCE SHEET ITEMS	PERCENTAGE WEIGHT
(i) Cash and bank balances including fixed deposits and certificates of deposits with scheduled commercial banks	0
(ii) Investments	
State/Central Government securities	0
(iii) Other financial assets	100

6.7.9. The importance of credit rating in assessing the risk of default for lenders

Fundamentally, Credit Rating implies evaluating the creditworthiness of a borrower by an independent rating agency. Here objective is to evaluate the probability of default. As such, credit rating does not predict loss but it predicts the likelihood of payment problems.

Credit rating has been explained by Moody's a credit rating agency as forming an opinion of the future ability, legal obligation and willingness of a bond issuer or obligor to make full and timely payments on principal and interest due to the investors. Banks do rely on credit rating agencies to measure credit risk and assign a probability of default. Credit rating agencies generally slot companies into risk buckets that indicate company's credit risk and is also reviewed periodically. Associated with each risk bucket is the probability of default that is derived from historical observations of default behavior in each risk bucket. However, credit rating is not foolproof. In fact, Enron was rated investment grade until as late as a month prior to its filing for Chapter 11 bankruptcy when it was assigned an in-default status by the rating agencies. It depends on the information available to the credit rating agency. Besides, there may be conflict of interest, which a credit rating agency may not be able to resolve in the interest of investors and lenders.

Stock prices are an important (but not the sole) indicator of the credit risk involved. Stock prices are much more forward looking in assessing the creditworthiness of a business enterprise. Historical data proves that stock prices of companies such as Enron and WorldCom had started showing a falling trend many months prior to it being downgraded by credit rating agencies.

6.7.10. Usage of financial statements in assessing the risk of default for lenders

For banks and financial institutions, both the balance sheet and income statement have a key role to play by providing valuable information on a borrower's viability. However, the approach of scrutinizing financial statements is a backward looking approach. This is because; the focus of accounting is on past performance and current positions.

The key accounting ratios generally used for the purpose of ascertaining the creditworthiness of a business entity is that of debt-equity ratio and interest coverage ratio. Highly rated companies generally have low leverage. This is because; high leverage is followed by high fixed interest charges, non-payment of which results into a default.

6.7.11. Capital Adequacy Ratio (CAR) of RBI and Basle committee on banking supervision (BCBS)

Reserve Bank of India (RBI) has issued capital adequacy norms for the Indian banks. The minimum CAR, which the Indian Banks are required to meet at all, times is set at 9%. It should be taken into consideration that the bank's capital refers to the ability of bank to withstand losses due to risk exposures.

To be more precise, capital charge is a sort of regulatory cost of keeping loans (perceived as risky) on the balance sheet of banks. The quality of assets of the bank and its capital are often closely related. Quality of assets is reflected in the quantum of NPAs. By this, it implies that if the asset quality were poor, then higher would be the quantum of non-performing assets and vice-versa. Market risk is the risk arising due to the fluctuations in value of a portfolio due to the volatility of market prices. Operational risk refers to losses arising due to complex system and processes. It is important for a bank to have a good capital base to withstand unforeseen losses. It indicates the capability of a bank to sustain losses arising out of risky assets.

The Basel Committee on Banking Supervision (BCBS) has also laid down certain minimum risk based capital standards that apply to all internationally active commercial banks. That is, bank's capital should at least be 8% of their risk-weighted assets. This infect helps bank to provide protection to the depositors and the creditors. The main objective here is to build a sort of support system to take care of unexpected financial losses thereby ensuring healthy financial markets and protecting depositors.

6.7.12. Excess of liquidity

One should also not forget that the banks are faced with the problem of increasing liquidity in the system. Further, Reserve Bank of India (RBI) is increasing the liquidity in the system through various rate cuts. Banks can get rid of its excess liquidity by increasing its lending but, often shy away from such an option due to the high risk of default.

In order to promote certain prudential norms for healthy banking practices, most of the developed economies require all banks to maintain minimum liquid and cash reserves broadly classified into Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR). Cash Reserve Ratio (CRR) is the reserve which the banks have to maintain with itself in the form of cash reserves or by way of current account with the Reserve Bank of India (RBI), computed as a certain percentage of its demand and time liabilities. The objective is to ensure the safety and liquidity of the deposits with the banks.

On the other hand, Statutory Liquidity Ratio (SLR) is the one, which every banking company shall maintain in India. This is in the form of cash, gold or unencumbered approved securities an amount. This amount shall not, at the close of business on any day be less than such percentage of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight, as the Reserve Bank of India (RBI) may specify from time to time.

A rate cut (for instance, decrease in CRR) results into lesser funds to be locked up in RBI's vaults and further infuses greater funds into a system. However, almost all the banks are facing the problem of bad loans, burgeoning non-performing assets, thinning margins, etc. as a result of which, banks are little reluctant in granting loans to corporate.

As such, though in its monetary policy RBI announces rate cut but such news are no longer warmly greeted by the bankers.

6.7.13. High cost of funds due to NPAs

Quite often genuine borrowers face the difficulties in raising funds from banks due to mounting NPAs. Either the bank is reluctant in providing the requisite funds to the genuine borrowers or if the funds are provided, they come at a very high cost to compensate the lender's losses caused due to high level of NPAs.

Therefore, quite often corporate prefer to raise funds through commercial papers (CPs) where the interest rate on working capital charged by banks is higher.

With the enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, banks can issue notices to the defaulters to pay up the dues and the borrowers will have to clear their dues within 60 days. Once the borrower receives a notice from the concerned bank and the financial institution, the secured assets mentioned in the notice cannot be sold or transferred without the consent of the lenders.

The main purpose of this notice is to inform the borrower that either the sum due to the bank or financial institution to be paid by the borrower or else the former will take action by way of taking over the possession of assets. Besides assets, banks can also take over the management of the company. Thus the bankers under the aforementioned Act will have the much needed authority to either sell the assets of the defaulting companies or change their management.

However, the protection under the said Act only provides a partial solution. What banks should ensure is that they should move with speed and charged with momentum in disposing off the assets. This is because as uncertainty increases with the passage of time, there is all possibility that the recoverable value of asset also reduces and it cannot fetch good price. If faced with such a situation than the very purpose of getting protection under the Securitization Act, 2002 would be defeated and the hope of seeing a must have growing banking sector can easily vanish.

6.7.14. Need for effective asset management policies

Non-performing loans represent a major threat to any bank. They carry the potential to bring about the collapse of a bank. In times of economic slowdown, a surge in non-performing loans can be expected which could threaten the whole financial system and, ultimately, the whole economy. The main South Asian countries successfully tackled the problem by using Asset Management Companies (AMCs), which they set up during their economic crisis. An effective asset management policy can help to prevent the problem of non-performing assets assuming unmanageable proportions. An AMC helps to stabilize the financial condition of a distressed bank by the following means:

- ❖ Borrowers get value for money. They are freed from the mercy of unscrupulous buyers.
- ❖ Banks recover their dues.
- ❖ It restores liquidity and solvency to financial institutions, restores confidence in the valuation of assets.
- ❖ It frees banks from the worries of perpetually having to resolve their non-performing loans and helps them to concentrate on banking. The prompt resolution of non-performing assets helps to reallocate resources, which is vital to economic recovery.
- ❖ The simultaneous offer of sale of a large number of similar assets exerts a downward pressure on prices. An effective asset management policy will counter that pressure and help to normalize asset prices.

6.7.15. Asset management

Asset management involves in the first instance the identification of non-performing assets. A non-performing asset means an asset or account of borrower, which has been classified by a bank as a sub-standard, doubtful or loss asset in accordance with the guidelines issued by the central bank. This asset is then categorized into one of four broad categories of selling, recovery, restructuring and setting off depending on the characteristics of the asset. Where any borrower, who is under a liability to a bank under a security agreement, makes any default in repayment, is secured debt or any installment. Therefore, his accounts in respect of such debt are classified by the secured creditor as non-performing asset. Therefore, the bank may require the borrower by notice in writing to discharge in full his liabilities to the secured creditor within 60 days from the date of notice failing which the secured creditor would be entitled to exercise any or all of the following rights to recover his secured debt:

- ✓ Take possession of the secured assets
- ✓ Take over the management of the secured assets of the borrower
- ✓ Appoint any person to manage the secured assets the possession of which has been taken over by the secured creditor55

Where an AMC exists, it will take over from the bank the above responsibilities until the assets are liquidated. The AMC will acquire the assets at a fair market value. Determining a fair value is a complex exercise. The evaluation can be based on net cash flows arising from the loan, viz:

- Expected interest and principal repayments;
- Security value;
- Collection, workout and realization risks;
- Transaction costs.

On acquiring the asset from the bank, the AMC will endeavor to negotiate with the borrower to maximize the prospects of recovery. Various courses of action are open to the AMC:

- Immediate sale of some or all of the loans to a third party;
- Providing borrower additional time to settle his dues;
- Providing additional finance to enable borrower to become viable;
- Re-schedulement of interest and/or principal payments.

The success of any of the above approaches is contingent on the borrower's conditions, type of loan and macro-economic conditions prevailing in the country. The ultimate objective of the AMC is to maximize disposal proceeds and produce a win/win situation for both the borrower and the bank.

6.7.15.1. Types of AMCs

The main types of AMCs currently in place in various countries are:

1. A central disposition agency
2. An entity specific to a particular bank
3. An auction process

The first type would take loans from all financial institutions and manage them alone. The second type would manage the non-performing loans of all the banks forming part of a particular bank and/or group of banks. The auction process would involve accumulating assets rapidly and selling them without considering the other courses of action open to AMCs. It will become evident that the type of an effective AMC will depend primarily on the size of market.

6.15.2. Framework for an effective asset management company

Any effective AMC is highly dependent on two main prerequisites:

(a) Legal Framework and

(b) Licensing and Regulation of AMC.

An AMC should be backed by an adequate legal framework in which both creditors and debtors have confidence. Besides, defining the rights of ownership and the legal obligations of debtors and creditors, the legal framework should provide for the orderly and expeditious resolution of disputed claims, including debt recovery and realization of collateral for unpaid debt.

While the AMC does provide financial institutions with a powerful weapon to bring defaulting borrowers to be up to standard, it should not abuse the rights of borrowers by foreclosing assets indiscriminately. Therefore, the law should provide for rights of appeal. Under the Securitization, Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance 2002 (India) an aggrieved customer may appeal to the Debts Recovery Tribunal within 45 days. If the borrower is still aggrieved by an order made by the Debts Recovery Tribunal, he may appeal to an Appellate Tribunal within 30 days from the date of receipt of the order of the Debts Recovery Tribunal. A sound regulatory and supervisory framework is a basic condition to safeguard the smooth running of an AMC. The mainspring of an asset management policy is non-performing loans. Therefore, the regulator needs to define an appropriate loan classification system and provisioning rules. Licensing and regulation of AMC is usually vested with central banks. Applicants have statutory conditions to fulfill before being licensed. The central bank may cancel a certificate of registration granted to a securitization company if such company fails to comply with any conditions subject to which the certificate was granted. Realization and securitization of Assets in order to ensure transparency, the company should maintain accounts in accordance with requirements and submit or offer for inspection its books of accounts or other relevant documents when so required by the central bank.

6.7.16. **Advances with potential threats of recovery**

In respect of accounts where there are potential threats to recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, it will not be prudent to classify them first as sub-standard and then as doubtful after expiry of two years from the date the account has become NPA. In such cases, the account should be straightaway classified as doubtful asset or loss asset as appropriate irrespective of the period for which it has remained as NPA.

6.7.16.1.**Rescheduled Debts**

An asset where the terms of the loan agreement regarding interest and principal have been renegotiated or rescheduled after commencement of production should be classified as sub-standard/doubtful and should remain in such category for at least two years of satisfactory performance under the renegotiated or rescheduled terms. In other words, the classification of an asset should not be upgraded merely as a result of rescheduling. With effect from the year ended 31-3-1999, the period of two years may be reduced to one year (or four quarters) if the interest and installment of loans have been serviced regularly as per the terms of reschedulement.

6.7.16.2.**Advances granted under rehabilitation packages**

As the banks are not permitted to upgrade the classification of any advance in respect of which the terms had been renegotiated, unless the package of renegotiated terms have worked satisfactorily for a period of two years, they are required to provide for according to the classification of the original advances as sub-standard or doubtful on the additional facilities sanctioned. However, the banks need not provide for a period of one year from the date of disbursement in respect of additional facilities sanctioned under rehabilitation packages approved by BIFR/term lending institutions.