



# Module-C Unit-7

## CAIIB PAPER-1

### **Advanced Bank Management (ABM)**



## CAIIB Paper 1 (ABM) Module C Unit 7: Risk Management and Credit Rating

### Credit Risk Monitoring

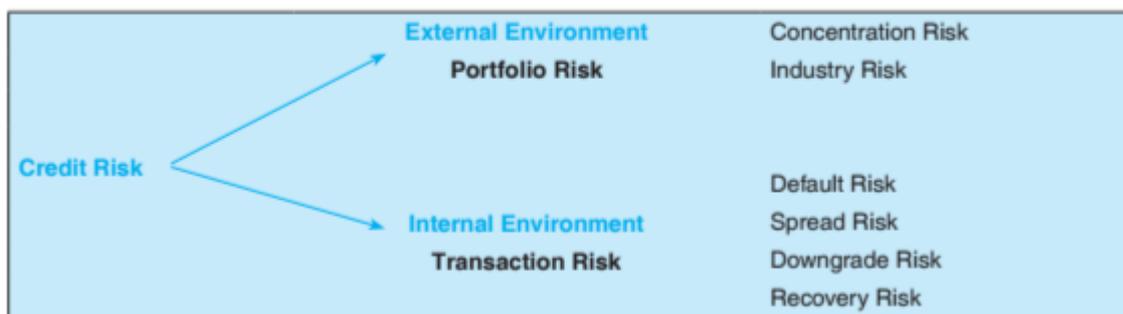
*The risks faced by the business of banking can be classified into three broad categories;*

- **Operational Risks:** The examples of such risks are losses due to frauds, disruption of business due to natural calamities like floods etc.
- **Market Risks:** These are the risks resulting from adverse market movements of interest rates, exchange rate etc.
- **Credit Risks:** The credit risk can be defined as the unwillingness or inability of a customer or counterparty (e.g. the L C opening bank in a bills negotiation transaction under that L C) to meet his commitment relating to a financial transaction with the bank.

### Factors Affecting Credit Risk

- **External Factors:** These factors affect the business of a customer and reduce his capability to honor the terms of financial transaction with the bank. The main external factors affecting the overall quality of the credit portfolio of a bank are exchange rate and interest rate fluctuations, Government policies, protectionist policies of other countries, political risks, etc.
- **Internal Factors:** These mainly relate to overexposure (concentration) of credit to a particular segment or geographical region, excessive lending to cyclical industries, ignoring purpose of loan, faulty loan and repayment structuring, deficiencies in the loan policy of the bank, low quality of credit appraisal and monitoring, and lack of an efficient recovery machinery.

The whole credit risk factors can be summarised as follows:



### Steps Taken To Mitigate Credit Risks

The major objective of credit risk management is to limit the risk within acceptable level and thus maximize the risk adjusted rate of return on the credit portfolio.

**Following are the main steps taken by any bank in this direction;**

- **Macro Level:** The risks to the overall credit portfolio of the bank are mitigated through frequent reviews of norms and fixing internal limits for aggregate commitments to specific sectors of the industry or business so that the exposures are evenly spread over various sectors and the likely loss is retained within tolerable limits. Bank also periodically reviews the loan policies relating to exposure norms to single and group borrowers as also the structure of discretionary powers vested with various functionaries.
- **Micro Level:** This pertains to policies of the bank regarding appraisal standards, sanctioning and delivering process, monitoring and review of individual proposals/categories of proposals, obtention of collateral security etc.

### **Credit Ratings**

The level of credit risk involved in each loan proposal depends on the unique features of that proposal. Two similar projects, with different promoters, may be appraised by a bank as having different credit risks. Similarly, two different projects, with same promoters, may also be appraised by the bank as having different credit risks. While appraising a credit proposal, the risk involved is also **measured and often quantified by way of a rating with the following objectives;**

- To decide about accepting, rejecting or accepting with modifications/ special covenants
- To determine the pricing, i.e. the rate of interest to be charged
- To help in the macro evaluation of the total credit portfolio by classifying it on the ratings allotted to individual accounts. This is used for assessing the provisioning requirements, as also a decision making tool, by the management of the bank, for reviewing the loan policy of the bank.

### **Internal and External**

- **Most of the banks in India have set up their own credit rating models as till recent past**, the rating agencies were not equipped well enough to provide the ratings, so reliable as to banks depending on these for credit decisions. However, with experience gained in last few years, these rating agencies have gained confidence of the banks.

*The following are the CRAs accredited by*

| Type          | ECRA   |
|---------------|--|
| Domestic      | <ol style="list-style-type: none"> <li>1. CARE Limited;</li> <li>2. CRISIL Limited;</li> <li>3. India Ratings and Research Private Limited (India Ratings)</li> <li>4. ICRA Limited.</li> <li>5. Brickwork Ratings India Pvt. Ltd. (Brickwork)</li> <li>6. Acuite Ratings and Research Limited (earlier SMERA)</li> <li>7. Infomerics valuation and Rating Pvt. Ltd</li> </ol> |
| International | (a) FITCH (b) Moody's (c) Standard & Poor's  |

### **Methodology of Credit Rating**

Based on its loan policies and risk perceptions, each bank has its own rating model. Common feature in all the risk models is that a score is given for different perceived risks by allotting different weightages. The sum of all these scores forms the basis for deciding on risk rating of a proposal. **Normally, the broad categories of risk areas which are scored, are:**

- Promoters/Management aspects and the securities available
- Financial aspects based on analysis of financial statements
- Business/project risks

### **Use of Credit Derivatives For Risk Management**

Credit derivatives are used to hedge the risks inherent in any credit asset without transferring the asset itself. The hedging is comparable to insurance and comes at a cost. Therefore, if the anticipated risk does not materialise, the return from the asset will be less than what it would have been without the hedging.

While simple techniques for transferring credit-risk, such as financial guarantees, collateral security and credit insurance have been prevalent in the Indian banking industry for long, the recent innovative instruments in credit risk transfer (CRT) such as collateralised debt obligations (CDO), etc.,

- **Credit Default Swaps (CDSs):** This is a bilateral contract in which the risk seller (lending bank) pays a premium to the buyer for protection against credit default or any other specified credit event. Normally, CDS is a standardized instrument of ISDA (International Swaps and Derivatives Association).
- **Credit Linked Notes (CLN):** In this, the risk seller gets risk protection by paying regular premium to the risk buyer, which is normally a SPV which issued notes linked to the underlying credit. These notes are purchased by the general investors and the money received from them is used by the SPV to buy high quality securities.

### **Credit Information System**

#### **Credit Information Companies (CIC's)**

- **CIC or Credit Information Company is an independent third party institution that collects financial data regarding loans, credit cards and more about individuals and shares it with its members.** Banks, Non-Banking Financial institutions are usually the customers of Credit Information Companies.
- The Credit Card Company collects financial information about all these individuals and forms a credit report based on their financial history. This credit report plays a very important role as it helps banks and other financial institutions determine the creditworthiness of an individual applying for a loan or credit card with them.

### Credit Information Companies Regulation Act (CIC Act)

- **Credit Information Companies in India are licensed by the Reserve Bank of India** and governed by the **Credit Information Companies Regulation Act, 2005** and various other rules and regulations issued by the Reserve Bank of India.
- The CIC Act, 2005 is a legislation that is enacted by the Government of India, in order to regulate the actions of the Credit Card Companies in India. Following the **CIC Act, 2005, the RBI and the Government of India enacted the CIC Act, 2006.**

### List of Credit Information Companies In India

There are exactly four well known CICs in India as of now. Given below is a list of CICs in India:

- CIBIL
- Equifax
- Experian

### Rules and regulations for CIC's

The actions of Credit Information Companies is regulated by the **Credit Information Companies Regulation Act, 2005**, enacted by the Government of India. Following the CIC Act of 2005, the RBI and the Government of India followed up with the Credit Information Companies, **Regulations and Rules Act, 2006.**

According to the Act, only certain entities are allowed to be members of the Credit Information Companies. Given below is a list of entities that can be members of CICs.

- Credit Institutions under **Section 2(f) of CIC Act.**
- Credit information companies under **section 2(e) of the CIC Act.**

A CIC, a credit institution or any authorised individual can request for a credit report anytime. A CIC will adapt to a format approved by RBI during such instances and furnish the requested information within a given time.

If there is any dispute between the CIC and its member related to credit information, the dispute shall be settled by conciliation under the as provided in the **Arbitration and Conciliation Act, 1996**.

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