

Essay on credit risk management

[Business](#), [Risk Management](#)



Credit during the early years of the banking industry was exclusive only to big companies and few privileged individuals who were considered very valuable clients by the bank management. The greater number of the bank's clients – the depositors – were plainly limited to maintaining savings accounts therein. The same funds generated from the deposits of retail savings account-holders were mostly utilized as loans released to borrowers who were deemed qualified by the bank's credit investigation team, and then by the approving officer.

The principal business of banks is to issue loans and to earn interest in the process. It is an acknowledged fact that extending credit is one thing that accounts for the largest use of the banks' resources. Loans, therefore, are among the highest yielding assets a bank can add to its portfolio, and they often provide the largest portion of traditional banks' operating revenue. In the light of this, it is not surprising that credit operations and activities of banks have undergone many changes through time.

Banks have continually improved their existing packages, came up with innovations to make their credit services more attractive, and developed new designs for credit products – all these to make their operations viable. After all, with the multitude of banking entities that have been incorporated and formed, there is little or no room for losers or those whose products have failed to keep up with the demands of the present times. A substantial portion of bank credit is expended to commercial and industrial customers in the form of direct loans.

Historically, commercial banks have preferred to make short-term (whose maturity dates fall within a year from the issuance date) loans to businesses,

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principally to support purchases of inventory as an integral part of their regular business cycle. In recent years, however, banks have lengthened the maturity of their business loans to include term loans that mature longer than a year after issuance. Term loans are used to finance the purchase of buildings, machinery, and equipment.

Moreover, longer-term loans issued out to business firms have been supplanted to some extent in recent years by equipment leasing plans. These leases are the functional equivalents of a loan – that is, the customer not only makes the required lease payments while using the equipment but is also responsible for the required repairs and maintenance and for any taxes due thereon. (Peter S. Rose; Money and Capital Markets: Financial Institutions and Instruments in a Global Marketplace; 2000) These developments have served the business sector well.

Indeed, many businesses have thrived and have gone through expansion phases through the help of credit from banks which readily made available the cash resources they needed to fund capital expenditures and operating expenses. Thus, during such years – and even up to present times – of credit maximization, one only had to work on paying the interests and loan amortizations promptly whenever they fell due and banks would be going after him and his business as a client that they would want to win.

Competition among banks for identified valued clients can be fierce, given that banks offer products and services that are uniform in nature. It is therefore important to package attractive returns for depositors and to put together a loan product that will be most beneficial to the prospective borrower while at the same time ensuring that the spread or yield for the

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bank's funds is satisfactory for the bank management and stakeholders. Good credit standing is tantamount to power.

Industries and companies in it have flourished in partnership with the banking industry and the financial companies offering all sorts of credit and other financial products and services. Then came the time when banks realized that there is the untapped opportunity in catering to the smaller clients - the average depositors - who number millions and therefore can mean figures that are not to be ignored. The small-sized credit transactions that banks can engage in with them as clients can bring in revenues and yield that when taken as a whole can be comparable to the income generated from taking care of the large-sized entities.

Bankers have noted that consumers provide the most of the savings out of which loans are made and financial assets are created in the money and capital markets. Thus, the same consumers ought to be among the most important borrowers in the financial system. (Peter S. Rose; Money and Capital Markets: Financial Institutions and Instruments in a Global Marketplace; 2000) Thus, one of the dynamic areas in bank lending today is the making available of installment loans to individuals and families, particularly loans secured by a property owner's equity in his own home.

Home equity loans can be used to cover a variety of financial needs ranging from tuition fees of the borrower's kids in school to the purchase of a family car. From the collateralized home equity loans evolved the consumer loans. The latter requires no real estate collateral, and the basis for their approval basically lies in the good results of personal and credit background investigations conducted on each prospective borrower-client.

At present times, a growing percentage of the working class - particularly those with white-collar jobs - constitutes the consumer loan borrowers of banks. There is a valid concern today, though, that consumer loans, especially the credit-card variety, have become more risky for banks due to higher default rates. Many banks and credit card companies have increased their issuance of new credit cards including high-credit-limit " gold" or " platinum" cards explosively, democratizing credit in order to reach millions of new customers, many of whom represent serious risk for lenders.

Intense competition has encouraged many banks to give credit cards to customers who may have little or no credit history, some of whom even turn out to be poor credit risks. It has come to this after years and years of stiff competition in the credit card industry. CREDIT MANAGEMENT PROCESS A sound credit management process would be one that minimizes, if not completely eliminates, the credit risk undertaken by the lending bank by providing loans to borrowers. Risk is an integral part of financial services, but it can be managed efficiently and effectively.

An effective credit management process, if properly installed and applied, can mean timely detection of a problem with a specific borrower, which would be followed through by actively tackling the identified account. It can also provide major inputs in the planning and budgeting phases of the operations. With the problems identified and the forecasts more inclined to be reasonably accurate because of the processes and systems in place, the management can make well-informed decisions regarding the directions to take and moves to make concerning the credit services of the bank.

The credit management policies adopted should be integrated into the system and values of the entire company or bank. This synchronization will enable the credit department employees to get the support and backing they require from management and from colleagues in other departments of the company or bank – in terms of budget allocation, peer support, technical collaboration with other departments, regular feedback on prevailing concerns, and others.

In this scenario, credit-related problems are arrested at the onset and when it is beyond the credit department people to see to it or to solve it, then such problems are elevated without delay to the senior management for alternative recourses. Effective credit management requires periodic analysis of the financial performance of the credit department at least quarterly. Performance indicators would then collect and restate financial data to provide useful information about the financial standing of the department, or even more specifically, of each group of borrowers.

The performance indicators critical areas including the portfolio quality, the productivity and efficiency with which the credit officer managed the credit portfolio, the financial viability of each account or portfolio, the profitability of the account, the leverage and capital adequacy and the scale, outreach and growth of the accounts. Risk management effectiveness can be seen from the improvement of all these indicators. The portfolio quality, however, is the recommended focus since it reflects the greatest amount of credit risk that the bank is exposed to.

(Managing Risks; Center for Research and Communication Foundation, Inc. ; 2005) A good loan policy would be one written for the objective of packaging
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and delivering loans that will be paid in full and on time by the borrower. The entire credit management process of a bank should include policies that consistently steer the employees and management of the company or bank toward working for a balanced, profitable and financially healthy credit portfolio. A good loan policy would entitle to credit only applicant-borrowers who would turn out to be good payers.

Thus, at the point of application submission, the bank should have policies regarding what to watch out for, what to verify, what questions to seek answers for, what amount to finally approve for release to each client and what terms will be imposed. One wise rule to follow: Know your client. From this wise rule, the bank would be on guard against clients wanting to borrow more than what they can afford to return. From this same wise rule, the bank would know who to trust and not to trust with credit - especially uncollateralized credit.

ECONOMIC AND COMPETITIVE EVENTS There are the cyclical fluctuations of the demands for credit, and these same fluctuations have been seen through the course of the existence of the banking industry. As an example, between 1990 and 1993, total loans released by banks declined from 62 percent to 58 percent, with the bulk of the drop accounted for by the decline in business loans from 18 percent to 14 percent. This drop and the associated increase in the securities portfolio occurred during and immediately after the 1990 and 1991 recession.

These developments were perfectly consistent with the historical substitution of securities for loans - meaning that demand for loans declines during recessions and so fund managers and banks would opt to park the idle cash

in securities rather than to issue them out as loans. Banks have traditionally treated their government securities portfolio as a residual use of funds – buying government securities during recessions when private loan demand is slack, and then selling them off during business recoveries, when private loan demand is vigorous. (Lawrence S. Ritter, William L. Silber and Gregory F. Udell; Principles of Money, Banking, & Financial Markets 10th Edition; 2000)

The Federal Reserve perennially faces a number of serious problems as it attempts to achieve its most recently announced annual money and credit supply targets. Continuing changes in the public's money-using habits – especially shifts from conventional bank deposits to mutual funds – distort the money supply measures and alter their relationship to the economy. The emergence of the many mutual funds and hedge funds, which all serve as alternative investment vehicles that people can choose, is a reality that banks and other creditors will have to face.

The supply of money that flow into their coffers in the form of savings deposits and time deposits are projected to be not as abundant as before. This, then, lessens the available cash banks have handy for issuance to borrowers; this, then, makes it urgent that they tap other sources of cheap funds for the purpose of continually providing credit services. One source of funds that has become more often resorted to by companies that have the required competencies for it is the initial public offering (IPO) of company shares.

This provides the company with the cash and liquid resources it needs to fund expansion or to provide additional working capital for its operations. To opt for IPO means to sell shares of the company to interested third parties

for prices that the management and current stockholders have approved. Thus, IPOs enable companies to end up with the needed cash without having to recourse to the credit services of banks and other financial institutions. IPOs used to be exclusive to elite companies that are financially sound and that have the goodwill needed to bring in good reception for their shares in the public.

Resorting to IPOs brings in both benefits and complications. All these can be studied by companies contemplating IPOs for their own, better so if they employ investment houses to guide them throughout the IPO ride. Through it all, these challenges have been weathered by the credit industry. Credit services by banks will never be out of style for as long as there will be borrowers – big companies needing billions on standby or small consumers needing thousands as credit card lines – to keep the credit business going.

ASSET AND LIABILITY MANAGEMENT

The assets and liabilities of the banks are on the regular – if not constant – watch of stakeholders. The internal parties concerned would be the stockholders and the management who would all want the bank running profitably and in great shape for the good returns that it can mean on their investments, and for the good performance that it can represent in the eyes of the board of directors, respectively. The employees, too, are after the security of their jobs and bright prospects for their future, and so would also be concerned with the results of the company operations and its financial condition.

External parties interested in the same would be the government monitoring agencies that cover banks and credit institutions, then more importantly, the

depositors and clients of the bank. The depositors would want to be among the first to know if the bank is not in a financially sound condition because this would constitute as the sign to withdraw all that they have deposited in the bank and to transfer them to a safer one. The financial management of the banks involve looking out for the indicators that give sneak peeks of what is happening within.

There are a number of ratios and percentages to constantly monitor, depending on the specific area of concern. Generally, there are ratios and balances between assets and liabilities of the banks that internal and external parties would be interested in. The current ratio is the ratio of the bank's current assets to its current liabilities. This ratio shows whether or not the bank is capable of settling all of its debts and obligations that are to be due within a year from any given date through the use of its cash, reserves and other assets that can be convertible to cash within the period of one year.

The debt to asset ratio, on the other hand, is the ratio of the total debt of the bank over its total assets. It gives the percentage of the total assets of the bank that is financed or provided by the bank's creditors. The bigger this ratio, the more unsafe it is for the bank's creditors. Creditors usually have rules as to the level of existing debts that they will allow for their borrowers. Likewise, there are standards that banks have to stick to, being monitored by the government for the general protection of the public or the bank's depositors. (Eugene F. Brigham and Joel F.

Houston; Fundamentals of Financial Management; 1998) Good financial management should translate to a healthy combination of the assets and
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liabilities of the bank. Assets are resources to be maximized and used for the normal course of business of the bank. Liabilities are obligations to be honored to protect the good name and goodwill of the bank. Good financial managers are ever on look out for all these. They are continually working for that equitable balance between assets and liabilities, revenues and costs – all to maintain a financially healthy bank. CREDIT CONCENTRATION AND RISK MANAGEMENT

Almost everybody is risk-averse. But risk is one reality that is never to be completely eradicated from the picture. An article entitled “ Figuring Risk: It’s Not Scary” begins as follows: When it comes to investing, you would rather not hear about it. That’s why so much money sits in certificates of deposit or Treasury bills linked to that reassuring phrase “ backed by the full faith and credit of the U. S. government. ” (Arthur Keown, David Scott, John Martin and Jay William Petty; Basic Financial Management 7th Edition; 1996) Risk is seen both as an opportunity and a threat.

In a phrase, there is the “ risk-return trade-off. ” One does not and should not take an additional risk without being compensated with additional return. In a similar way, one should not incur additional costs in avoiding and mitigating risks without being compensated by additional benefits. To have effective credit management practices in place, the bank must integrate credit risk management into the organization’s culture. It is the task of the top management to communicate the importance of risk management and to instill a risk management culture at all levels of the institution.

Without a firm commitment to effective risk management from the top management and without the needed resources to implement such

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practices, the employees cannot be expected to perform their respective duties in a manner that mitigates risk. Incentives and other schemes to motivate employees to be constantly practicing proper risk management habits will go a long way. After all, it is the front-line employees of the credit department who attend to the initial stages of the processing of credit for clients.

Even at their levels, they can – out of loyalty to the bank and out of the drive to perform his duties well – save the bank from granting credit to clients who turn out to be unqualified and therefore are candidates for becoming problematic account-holders or delinquent borrowers. Risk management, if tackled in a united and systematic way by the multitudes of people in the bank, managers and rank-and-file employees alike, can be a successful undertaking that will usher in more growth and expansion for the bank.

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