

# Theoretical and conceptual framework essay sample

[Literature](#), [Russian Literature](#)



### Figure 1. Division of Credit Risk (Wiley, 2013)

Credit risk refers to the probability of the loss emanating from the credit extended as a result of the non-fulfilment of contractual obligations arising from unwillingness or inability of the counterparty or for any other reason. The study of credit risk can be divided into two. First is the single borrower credit risk also known as firm or obligor credit risk which can be traced from economic, industry or customer specific factors. Second is the portfolio credit risk which focuses on credit exposure on a group of borrowers. It plays a crucial role in determining the quantum of economic capital required, which is a function of expected credit loss. This division will further facilitate understanding and management of credit risk.

### Figure 2. Major Causes of Credit Risk (Wiley, 2013)

Credit risk is caused by several factors which can categorically be divided into two, the systematic risk and unsystematic risk. Uncontrollable risk or systematic risk is the external forces that affect all businesses and households in the economic system. For example, socio-political risks such as military coup, newly approved government policies and programs, wars, terrorism, international isolation, economic risks such as increase bankruptcies, decline in stock markets due to lower corporate profits, recession, growing unemployment, and other exogenous risks which impact all in the playground or the economy as a whole. On the other hand, the controllable risk or unsystematic risk does not affect the whole economic entity or all businesses and households but rather is industry specific or firm specific.

Figure 3. Stages of Credit Risk Management in Financial Intermediaries  
(Wiley, 2013)

Banks and other financial institutions, in order to achieve good credit management, follow an approach that analyzes credit risks. First step is to know the nature and purpose of the credit. The purpose should be acceptable to the lender, it must be legal, non-speculative, and in accordance with the lender's priorities. It should be used to finance the customer's normal business operations and the amount must be sufficient and reasonable to the resources of the customer.

Second step is to know the type of credit facility the customer wants to borrow. An example is an overdraft which allows an individual to withdraw in excess of his credit balance on his current account, but this type of facility is not allowed in the Philippines. Another is loan, a debit balance on loans account for a fixed amount for a fixed period of time; it can be short or long-term. Examples are working capital loan, term loan, and lease financing. Another type is non-funded lines wherein no funds are provided. The famous facility that has been increasingly used by customers is the credit card which can be used to purchase goods and services on credit, and to obtain cash advances.

Third step is to know the capacity of the borrower. It is important for the lender to know and verify the legal status of the person who applies for credit. Minors, undischarged insolvent and mentally incapacitated are just a few who are not allowed to obtain credit from financial institutions. Fourth step is to assess whether there is a necessity to demand a security from the

borrower. Usually, security is required when the credit risk is high. Three important factors to consider from the security are adequacy, sufficiency and authenticity. Examples of which are receivables, stocks, machinery and equipment, and real estate.

Fifth step is to analyze the financial status of the borrower. Determining the financial position of the borrower, its ability to generate cash flows, and obtain income is vital and essential in granting the credit. Various measures include liquidity, solvency, efficient and repayment capacity, and other financial parameters are used by the lenders. Next step is forecasting the repayment capacity of the borrower. The lender should have reasonable assurance that the borrower has the ability to pay when its obligations fall due. The shorter the term of the credit, the more its repayment capacity is predictable. Different measuring techniques are used for short-term and long-term loans. In making assumptions and projections, historic performance of the borrower and appropriate sensitivity analysis by the lender is taken into consideration. Seventh step is to assess profitability whether the cost of credit and incurred expenses related to this are exceeded by the returns and gains from interest of the loans.

Eighth step is to construct the structure of the credit facility including conditions and covenants. The structure must suit the intended purpose of the credit. Conditions must be mutually agreed by the lender and borrower, and its violation is tantamount to default and the lender may seek claims and start legal proceedings, depending upon the agreement. Covenants must be free from loopholes and errors to avoid continuous adjustments that

might defeat its purpose of providing quality protection. The last step is constant monitoring which includes checking of risk limitations, determining capital allocation and issuing periodical reports on borrowers.

Figure 4. Techniques in Credit Risk Management (Van Gestel and Baesens, 2009)

There are four techniques in credit risk management namely selection, limitation, diversification and credit enhancement. In selection, good risk assessment models and good credit officers are necessary in order to have the best selection strategy. If there is higher default risk, more collateral should be asked to reduce recovery risk. In limitation, the bank determines up to what amount they can give credit to a certain lender based on given risk profiles; this is called credit limit. If the counterpart is riskier, the system of credit limit will be more restricted. In diversification, the banks accommodate different types of borrowers to spread the risk and avoid concentration of credit risk default and problems. If the bank is larger, the credit risk is more likely to be highly diversified. In credit enhancement, banks purchase credit protection in a form of guarantees or credit derivative products. This technique is also called credit risk mitigation wherein credit quality of guaranteed assets is enhanced.

Figure 5. Relationship between credit and risk in commercial banks

Figure 5 illustrates the possible relationship between credit and risk in commercial banks. The diagram is divided into four quadrants, the low credit-high risk, high credit-high risk, low credit-low risk and high credit-low

risk relationships. The assumption is that large amounts of credit would normally lead to high credit risk and small amounts to low credit risk. However, in some instances, low credit-high risk and high credit-low risk relationships may apply due to several internal and external factors. Examples of this credit are government issued bonds and bills.

#### CONCEPTUAL FRAMEWORK

The researchers decided to adopt the building blocks of the Credit Risk Management (CRM) Framework and to add the usage of the necessary profitability ratios. They are primarily concerned with the evaluation of the relationship between credit risk management and the profitability of the top 3 commercial banks in the Philippines based on assets.

#### Figure 1. 4 Conceptual Framework

Figure 1. 4 diagram shows how each commercial bank effectively manages its potential risk of loss arising from borrowings through its CRM policies and strategy, organizational structure and operations/system. Those relevant financial data gathered from the banks in the illustration shall likewise be processed in order to obtain how profitable the lending business section of each commercial bank is. Thus, resulting to an evaluation of the relationship between credit risk management and profitability of each commercial bank. The relevant financial data gathered in each bank shall pass through the two processes required: the credit risk management and the computation of profitability ratios. In order to evaluate the credit risk of each commercial bank, it shall undergo three blocks namely: policies & strategy, organizational structure and operations/system.

Each bank has its own credit risk policy which includes risk identification, risk measurement, risk grading/aggregation techniques, reporting and risk control/mitigation techniques, documentation, legal issues and management of problem of loans. Based on the policies implemented, each unit also has its own strategy in credit-granting activities, taking into consideration the risk-reward trade-off of each granted loan. All of these shall be maintained by the Board of Directors of each bank and the ad hoc committees created by each. The aforementioned organizational structure is also the one accountable for the measurement, control, protection and mitigation of credit risk. In line with the duties of the organizational structure, a proper operations/systems must be established. The last block entails the implementation of a proper scheme of delegation of powers (checks and balances) and the creation of a powerful Management Information Systems.

Chiefly through analyzing the financial statements of each commercial bank, the computation of the profitability ratios is sine qua non in this study in order for the researchers to reach their objectives. The necessary profitability ratios to be considered are operating margin, profit margin, return on total assets, basic earning power ratio and return on equity, all based on the core business of the commercial banks which is the credit business. It should be noted that these profitability ratios would reflect all the effects of the each firm's management of its individual or portfolio credits. The data gathered and processed through the credit risk management framework and the computation of profitability ratios are then subject to various statistical tools for analyses which would help the

researchers evaluate the relationship between credit risk management and the profitability of the said commercial banks.