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Credit Risk and its Management in the Banks: A Conceptual Review

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Abstract: Risk plays a significant role in uncertainty and the possibility of losing, both of which can happen in every business transaction, at any place and at any time. Credit risk is the potential loss of assets or income that could occur if a borrower is unable to comply with the conditions of a loan agreement with the bank or otherwise carry out as agreed. According to the credit risk theory, the lender is largely at risk, which includes lost principal and interest. A bank that is insolvent may be unable to repay a depositor's money, for example, leading to a disruption loss that might be either full or partial. The study's major goal was to investigate the idea of credit risk as it applies to banks and to comprehend how it may be handled to prevent bank failure. Information from original journal papers that investigated the connection between credit risk and commercial banks' performance was gathered to fulfill the main purpose. According to the assessment, credit risk is more dangerous for banks if it is improperly managed, so efficient solutions should be used to lessen the impact of credit risk on banks.

Keywords: risk, credit risk, credit risk management

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Introduction

Risk plays a significant role in uncertainty and the possibility of losing, both of which can happen in every business transaction, anywhere, at any time. Financially speaking, operational risk, credit risk, market risk, and other risks are all included in business risk. The probability that borrowers won't fulfill their financial obligations is referred to as credit risk. Establishing identity, evaluating credit risk exposures, finding mitigations, monitoring, and overseeing them are all part of credit risk management (Lalon, 2015). All nation must have a robust banking system since banks play a significant role in both the economy and as sources of credit. It is crucial for a nation's banking systems to be stable in terms of investment. Credit management is an active field in which it is

necessary to distribute funds in various ways in order to reduce risk and increase return on investment (Mosharrafa, 2013). Banks face aggressive market competition, and it is their duty to take on various financial and nonfinancial risks. In order to decide the level of risk they will tolerate, banks must classify both preventable and unpreventable dangers. Banks and other financial institutions' profitability is significantly impacted by risk (Jain, Sharma, and Somani, 2017). In order to reduce credit risk, which is a fundamental risk experienced in the tasks of banking, it is important to use appropriate tools to manage and control this risk. For example, the concentration of loans and the connection of the debtor's risk, management of risk connected with credit is essential for assessing the risk of a specific loan or the risk of the entire portfolio (Cibulskiene and Rumbauskaite, 2012). The effectiveness of the banking system relies on credit risk management's role in evaluating the creditworthiness of borrowers. The ability to recover provided loans and advances is significantly hindered by inaccurate credit risk assessment. Bank underperformance and failure are often attributed to inadequate credit risk management (Ghosh, Islam, and Hasan, 2014). The mainstay of forward-thinking in banking procedures is now risk management. Risk associated with credit, interest rate risk, liquidity risk, operational risk, investment risk and strategy risk are some of the significant challenges that the banking industry is currently experiencing. These dangers could jeopardize both a bank's performance and continuity. It is evident from the results of prior research undertaken by different writers that commercial banks offer significant amounts of loans in a variety of sectors to enhance overall economic growth and sustainable development. Credit risk management is one of the biggest challenges commercial banks confront when carrying out the banking activities that generate their profits. Commercial banks play a vital part in developing economic development.

Credit Risk Definition and Concepts, As Well As Credit Risk Management

Credit risk is defined as the current and future risk of losing money or other assets as a result of a borrower's inability to adhere to the terms of any agreements made with the bank or carry out other agreements as agreed (Muritala & Taiwo, 2016). The counterparty, issuer, and borrower performance are key factors in determining credit risk in all transactions. Credit risk has been found. When bank funds are increased, employed, invested, or otherwise exposed through explicit or implicit contractual arrangements, whether or whether they are recorded on the balance sheet, it happens. Common actions include failing to make payments on time, moratoria, changes to credit ratings, and restructurings (Mohamed, 2016). Events like bankruptcy are considered credit incidents. The danger that a loan or asset won't be repaid if there

is a default or a delay in making repairs is what Alshatti (2015) means when she uses the phrase "credit risk." According to Kwabena and Boye (2014), for the majority of banks, loans are the biggest and most evident source of credit risk. Other credit risks exist both on and off the balance sheet, though. The investment portfolio, overdrafts, and loan letters are pockets. A bank poses a risk while providing financing for a variety of products, processes, and services, including financial management, derivatives, and foreign exchange. Agyiri (2012) asserts that the method a bank uses to manage credit risk will either lessen or raise the danger of reimbursement.

The bank's main defenses against excessive credit risk are its unique lending strategy, good underwriting standards, a fair and efficient process of approval, and qualified lending administration staff. Due to the fact that banks cannot easily overcome borrowers with dubious abilities or personalities, these variables have a significant impact on the quality of credit. Due to internal or external economic pressure, borrowers who perform poorly financially or rely on inaccurate projections for payback will soon become disruptive (Gong, 2014). Yet, if the initial credit decisions are good, credit risk management might be compromised once a loan is granted by inadequate credit structure or tracking. In the past, banks have focused on managing their overall credit risk by monitoring individual loans (Yeboah-Mensah, 2015). Banks should take into account credit risk management in addition to this focus, which is essential for both the individual portfolio portions and the total portfolio. Hence, for successful credit risk management, the board and management must be aware of and in control of the bank's risk profile and lending practices. They must possess a solid understanding of the risks and the bank's loan portfolio the portfolio's structure in order to accomplish this. They must be aware of the portfolio's overall attributes, including the product mix, levels of sector and region, average risk ratings, and other elements (Maino & Tintchev, 2012). They must ensure the soundness of the strategies, practices, and policies put in place to control the risks of certain loans and portfolio segments as well as the adherence of loan personnel to those policies.

The capacity to measure credit risk is essential for its effective management. Due to the fact that when credit risk increases, the realized rate of return on the loan portfolio lowers and a higher level of capital is needed, the key difficulty is figuring out how to accurately quantify credit risk exposure and portfolio level (Cole et al., 2012). Two crucial strategies for evaluating or quantifying credit risk are mentioned by Muhammad and Garba (2014). The cost per loan advanced and the default ratio (DR) are a couple of these. Default Ratio (DR): The DR is a ratio that assesses how many non-performing loans there are relative to all other loans and advances during a given time period. It displays the overall percentage of loans and advances that were

not repaid. Additionally, it demonstrates the effectiveness with which management oversaw the portfolio of loans over time. Cost Per Loan Advanced Ratio (CLA): The CLA measures the typical cost per loan advanced to a client in terms of money. This is done to demonstrate how efficiently loans are distributed to customers (Kolapo et al., 2012).

The Credit Risk Theory

According to the credit risk theory, the lender is largely at risk, which includes lost principle and interest. A bank that is insolvent may be unable to repay a depositor's money, for example, leading to a disruption loss that might be either full or partial. In order to lower the risk to the lender, the lender may run a credit check on the potential borrower, demand that the borrower obtain the necessary insurance, such as mortgage insurance, or look for security or guarantees from third parties. Generally, the riskier an investment is, the greater the interest rate that borrowers will be required to pay (Ewansiha et al., 2022).

Credit Evaluation

Basic to limiting loan loss is the loan function of credit evaluation. The bank uses credit evaluation and/or analysis to try to ascertain the borrower's capacity to pay back the legitimate loans that were provided to him. Banks aim to minimize potential losses in their loan portfolio by rejecting credit to potential borrowers whose financial condition is deemed inadequate based on research. This step is crucial as it ensures the quality of loans (Nwankwo, 1991). Credit is granted based on the lender's confidence in a borrower's ability to repay their debts. This, (also known as credit worthiness) is determined by the borrower's capability and willingness to pay back the loan. Lenders consider various factors when formulating their credit policies. In assessing the credit quality of borrowers, financial models are employed. Character, capital, capacity, condition, and collateral are the five financial analysis methods that are most frequently utilized. The "5 C's of credit" are a common name for these instruments (Machiraju, 2004).

Credit risk in the banking

In banking, credit is a legal arrangement whereby a borrower receives something of value now and commits to paying the lender back at a later time. In contrast, credit risk is the likelihood that certain of a bank's assets, particularly its loans, could lose value and possibly become worthless. It results from a borrower's failure or refusal to perform in accordance with the pre-committed and agreed-upon terms. (Page 6 of Joan Selorm

Tsorhe) Or otherwise, according to R.S. Raghavan (2003), Credit risk is the likelihood that a counterparty or bank borrower won't fulfill their commitments. There is always the chance that the borrower will stop making payments for any reason, which would result in an increase in credit risk for the bank.

Modules of credit risk in banks

Three modules make up a bank's loan portfolio's credit risk:

1. Transactional Jeopardy
2. Inherent Peril
3. Concentration on single borrower

(1) **Transactional Jeopardy:** Transactional Jeopardy is concerned with the erratic nature of earnings and credit quality as a result of how the bank evaluates specific loan transactions. Underwriting, selection and operations are the three parts of transaction jeopardy.

(2) **Inherent Peril**: the risk present in some business ventures and advances made to specific industries is its main idea. Construction loans for salable real estate are fundamentally riskier than money lent to consumers. An industry or line of business' vulnerability to historical, prognosticative, and lending risk variables is addressed by intrinsic risk. The industry or company line's past success and stability are covered by historic aspects. The focus of predictive components is on traits that are changeable and might have an impact on performance in the future, either favorably or negatively. Focus is placed on examining how the conditions and collateral available in the business line or sector affect the inherent peril in lending aspects.

(3) **Concentration on single borrower**: Lending to a single borrower, a single sector of the economy, a single region of the country, or a single line of business can result in risk of concentration, which equals to the accumulation of inherent and transactional danger within the bank's portfolio. For each of these aggregations, the bank must specify acceptable portfolio concentrations. A significant objective is achieved via portfolio diversification. A bank can avert calamity thanks to it. Portfolio intense or directed towards a specific location will define the scope of problems a bank may face in difficult circumstances.

Measurement of Credit Risk

The average amount of credit losses that banks might anticipate are usually predictable. These types of losses are categorized as:

(a) Expected losses (EL), in the eyes of financial institutions, are a necessary evil.

(b) Unexpected Losses (UL) are losses that occur even if banks expect them to, even though the time and severity are unpredictable. Although the market may not provide enough prices to cover unforeseen losses, some parts of such losses can be mitigated by the interest rate charged on credit exposure. The potential loss that a bank might incur in case the borrower fails to pay back the loan is known as "Loss Given Default" (LGD).

To cover the risks of such losses, cash is therefore required. Banks are compelled to minimize since lowering capital frees up economic resources that can be used to an effective investment. On the other hand, a bank's likelihood of failing increases with decreasing capital will not be able to cover its losses in a given year, meaning it won't be able to pay its debts by profit plus capital available, and therefore the bank will go bankrupt (Hosna et al., 2009). So, banks need to carefully weigh the benefits and dangers of maintaining capital. The amount of capital that a bank ought to have can be determined in a number of ways. The Basel II IRB method is centered on the frequency of bank insolvencies (the situation in which the bank fails to satisfy its senior commitments) resulting from credit losses that regulators are willing to accept (Hosna et al., 2009). The Basel Committee sought to create a framework that is trustworthy, prudential, and accurately represents solid risk management procedures. For a very long time, banks have used internal grading systems to group their exposure into broad, qualitatively distinct levels of risk (Hosna et al., 2009).

Strategies for Credit Risk Management

Banks employ credit risk management solutions as a means of lowering or eliminating credit risk. Minimizing credit risk's detrimental effects. Because it contributes to boosting revenue and ensuring survival, a thorough credit risk management framework is essential. The following is a list of the major ideologies guiding credit risk management strategies. Holding individuals accountable is one of them, including the establishment of a transparent structure, assigning authority, maintaining discipline, and facilitating communication at all levels. In 2012 (Kolapo et al.). Banks use credit risk management solutions to mitigate or eliminate the negative consequences of credit risk. For banks to increase profitability and ensure survival, credit risk system effective management is necessary. Below is a breakdown of the major tenets of the process of managing credit risk:

(**a) Selection:** According to Gestel et al. (2009), the initial step in successful credit risk management is choosing appropriate borrowers and matching them with suitable products. To accomplish this, loan officers with expertise and operational risk

assessment models must be in place. Because choices are made by the full committee, this is a highly important stage. In this situation, lenders refuse credit to borrowers who are at risk of default or require them to put up more security for the loan to lessen the impact of a default.

(b) Limitation: According per Gestel et al. (2009), by lessening the amount of loss a borrower experiences, this strategy benefits the bank. By doing this, the possibility that the counterparty won't fulfill their end of the bargain is avoided, which would negatively impact the bank's financial performance. There are very few hazardous transactions brought to the holder.

(c) Diversification: In such scenarios, banks have to handle various counterparties, comprising both corporate entities and individuals. This makes it easier for banks to absorb losses by spreading the risk across a larger number of borrowers; it works considerably better for big, global banks. That is, the spread or diversity of risks employed in credit risk management (Gestel et al. 2009).

(d) Credit Enhancement: In reference to Gestel et al. (2009), if a bank identifies an excessive risk associated with an identified borrower, it can mitigate this by obtaining a policy of insurance that will provide coverage for any potential losses. This leads to an improvement in the quality of the lending facility and is known as minimization of credit risk.

(e) Compliance to Basel Accord: The Basel Committee on Banking Supervision expands the methods by which a bank can manage its credit risk exposure. The notion that things change and are evaluated continuously is one of the guiding concepts. According to the nation's current economic trend by adapting their credit-risk policies. By introducing new goods and services, this can be accomplished. The Basel Committee on Banking Supervision (1999) suggests that banks should conduct thorough due diligence on their clients to enhance their understanding of the customer. This approach can aid in reducing the level of credit risk exposure faced by the banks, but it cannot entirely eliminate credit risk. Nonetheless, this strategy can enhance the financial performance of banks. There are three bedrocks of Basel II:

1. Least or minimum capital requirement
2. Procedure for supervisory review
3. Discipline in the market

The first bedrock deals with the least capital prerequisite (LCP), which is the formula the banks used to determine their supervisory capital. Under Basel II, the minimum necessary capital ratio (8%) stayed constant, but the formula for determining risk-weighted assets has altered. Basel II second bedrock pertains to the procedure of

supervisory review and has been introduced in addition to the least capital prerequisite. Thus, regular communication between banks and supervisors is crucial for assessing and planning capital adequacy (Lind, 2005). The last bedrock aims to complement these initiatives by implementing high-level discipline in the market and disclosing serious information about the risk management practices of the bank and abundance of capital (Ferguson, 2003). This could potentially enable market participants to assess the bank's risk profile and level of capitalization.

Credit risk management indicators

Regulators have raised their requirements for examination and enforcement in response to previous business and financial crises. Basel II has created a clear connection between the required minimum regulatory capital and the underlying credit risk, market risk, and corporate risk exposure of banks in the banking sector. This process demonstrates how crucial capital management is to risk reduction and management. Yet, creating useful critical risk indicators and managing them provide a substantial difficulty. Policies and regulations can offer valuable guidance for identifying key risk indicators, and adherence to regulatory requirements can serve as indicators of effective risk management. A bank can increase profitability by choosing superior risk-based product pricing and resource allocation strategies with a more thorough capital management framework. Basel II's goal is to establish an international standard for how much capital banks must reserve to protect themselves from the many kinds of risks they encounter. In actuality, Basel II aims to accomplish this by establishing stringent capital and risk management standards designed to ensure that banks maintain capital reserves proportional to the risks they undertake. According to the stated regulations, a bank must retain a larger amount of capital to protect its solvency the more risk it is exposed to (Hosna et al., 2009).

Conclusion

In summary, risk is an essential part of uncertainty and the possibility of suffering a loss, both of which may happen in every business transaction, at any place and at any time. Credit risk is the potential loss of assets or income that could occur in the present or in the future if a borrower is unable to comply with the conditions of a loan arrangement or otherwise carry out as planned. The credit risk hypothesis emphasizes that the risk, which includes lost principle and interest, is primarily that of the lender. Disruption losses can occur in a variety of situations, such as when an insolvent bank is unable to repay funds to a depositor, and they can be either whole or partial. Conducting a credit evaluation is a crucial aspect of loan management aimed at minimizing loan

losses. Credit in the context of banking refers to a contractual arrangement whereby the borrower receives something of value now and commits to paying the lender back at a later time. In a bank's loan portfolio, three elements make up the peril of credit: transaction jeopardy, inherent peril, and risk of attention. Banks can typically predict the average amount of credit losses they can anticipate to incur. Banks implement credit risk management strategies to minimize or alleviate the adverse impacts of credit risk. In conclusion, banks must implement effective ways to reduce credit risk's detrimental effects because failing to do so increases the risk to banks.

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