D. Ravishankar

The Indian banking sector demonstrated strong resilience during the global financial crisis and was able to maintain profitability, with asset quality remaining relatively unaffected. There is a big debate going on about whether such resilience displayed by Indian banks is sustainable in the current challenging economic environment.

Banks' exposures are asymmetric and this is particularly true for credit risk, where the upside consists of a small positive yield, and the downside consists of a loss that could range from zero to more than 100 per cent of the exposure. Given the importance of this downside risk, the banks need to focus their energies on understanding and managing the key drivers of such financial loss. In order to achieve excellence in credit and credit risk management, the banks should focus on sound approaches in the form of best practices as highlighted.

Understanding the credit environment

The credit environment significantly affects the underlying asset quality of the bank. The credit behaviour of borrowers may be unique in each of the geography or region or cluster. The repayment behaviour and recoverability affects the pricing and the lending strategy of the bank. The diversification of banks' loan portfolio across large corporate, SMEs, manufacturing, services, priority sectors determine the delinquency levels. The performance of the portfolio is also a function of the economic conditions – whether it is upturn or downturn in the economy. For example, considering the present slow down in the economy, it is challenging to have a portfolio structure – what happens if the demand for new loans slows down? Would there be an availability of cheap funds? Would the current NPA levels maintained? To what extent, liquidity could be created from the existing portfolio? What would be the impact of the global slowdown for the Indian companies and to what extent it would impact the banks' portfolio?

Redefining credit strategy, policy and processes

Rapid changes in lending are forcing banks to re-examine some of the basic assumptions of their existing credit strategies, policies and processes. For example, in the wholesale lending, increasing liquidity is attracting new investors who are taking on credit risk directly at substantially lower credit costs than traditional banks. Similarly, in the small business sector, credit scoring models are displacing the need for expensive manual review of loan applications. The developments such as these are prompting banks to redesign the credit processes in an attempt to reduce the transaction costs and improve overall risk assessment. Over the last few years, crores of rupees have been spent on IT automation and processes have been decentralised and then re-centralised. Too few re-engineering initiatives have gone back to first principles, and asked what the credit process is really trying to achieve?

Reference can be made to the above chart and accordingly, the credit strategy of the bank should be aligned with the business goals and the vision. The business objectives should consider the regulatory constraints and the risk appetite of the management. The credit strategy determines the policy and processes to be adopted for credit risk management: i) asset allocation ii) limit framework iii) capital policy and iv) a bank concentrating on retail, the limit framework could be focused on the extent of exposure in each geography, the limit of product-wise exposure, etc.

Rethinking the fundamentals of how the bank has organised should be based on the three thrust areas: a) Increased reliance on objective risk assessment, b) credit processes are differentiated on the basis of risk and not on the size and investment in front-end and back-end credit processes. Importance of Internal/ External

Credit Risk Rating:

Internal credit ratings are increasingly used in credit risk management of banks. The banks' internal ratings are somewhat similar to external credit rating agencies in that they summarise the risk of loss due to failure by a given borrower to pay as promised. However, bank's internal rating systems differ significantly from that of the credit rating agencies and among the banks in architecture and operating design as well as in the uses to which ratings are put. One reason for these differences is that banks' ratings are assigned by bank personnel and are usually not revealed to outsiders.

In choosing the architecture of its rating system, a bank must decide which loss concepts to employ, the number and meaning of grades on the rating scale corresponding to each loss concept, and whether to include 'watch' and 'regulatory' grades on such scales. The choices made and the reasons for them vary widely, but on the whole, the primary determinants of banks' rating system architecture appear to be the banks' mix of large and small borrowers and to the extent to which

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in practical terms and the definition of grades. In the chart-2 illustration of a two-dimensional rating, one grade typically reflects PD and the other EL. Banks with such systems usually first determine the borrowers' grade (its PD) and then set the facility grade equal to the borrower grade unless the structure of the facility is such that LGD is substantially better or worse than 'normal'. Implicitly, grades on the facility scale measure EL as the PD associated with the borrower grade multiplied by a standard or average LGD as in Chart-2.

Banks use internal ratings in two broad categories of activity: analysis and reporting, and administration. Analytic use includes reporting of risk postures to senior management and the board of directors, loan loss reserving, profitability measurement and product pricing. Administrative uses include loan monitoring, regulatory compliance, and credit culture maintenance.

Dynamic Portfolio Credit Management

The dynamic portfolio credit management involves periodic review of the credit risk evaluation and monitoring process. One of the techniques used here is to compare the actual defaults with expected defaults across different categories. Generally, the dynamic management comprises of a) Portfolio Management and b) Aligning capital and Risk.

Portfolio Management

The portfolio approach to managing credit risk integrates the key credit risk components of assets on a portfolio basis, thus facilitating better understanding of the portfolio credit risk. The insight gained from this can be extremely beneficial both for proactive credit portfolio management and credit-related decision making. It is based on a rating (internal rating of banks/ external ratings) based methodology. Portfolio Credit Risk Management is primarily based on a credit rating framework and therefore can be implemented with minimal modification to Banks internal systems. Being based on a loss distribution (CVaR) approach, it easily forms a part of the integrated risk management framework.

Aligning Capital and Risk

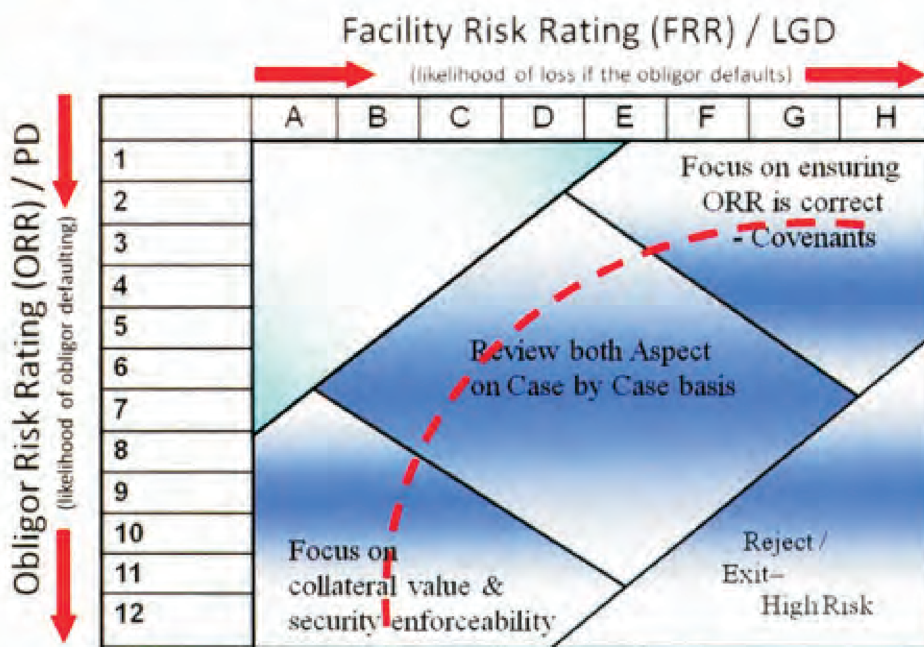
The main purpose of using risk adjusted pricing is to ensure optimal allocation of capital and earn adequate return on it. Mis-pricing of loans results in adverse selection of assets and non-achievement of the desired return on net worth. At a minimum, risk-adjusted pricing means covering expected losses (EL): Price = RFR + EL + (fees & profit). You may require a change in the risk based pricing for a product or the lending strategy based on the observed defaults/ losses.

Stress and Scenario Testing

Stress and scenario testing is the analytical process involved in subjecting a bank's portfolios to a series of tests in order to assess their potential vulnerability to exceptional yet plausible events. They are intended to establish whether a bank has enough capital to absorb losses in a recession. They enable banks to obtain a better understanding of portfolio risk and make potential losses clear. Stress testing is an effective and necessary tool that complements statistical models for quantifying and monitoring risk and capital adequacy. So what forms can stress testing can take?

Real world scenarios

Chart – 3: How to benefit from the FRR dual rating matrix?



from past experience are sometimes better to use, since buy-in can be more easily achieved from business leaders, who may more readily regard them as plausible. This risks, however, underestimating the impact of potential future crises as has been the experience recently. Equally, scenarios are rarely exactly repeated, since controls will have usually been implemented to attempt to prevent recurrence.

Single factor tests are intended to show how portfolios react to changes in relevant economic variables (e.g. interest rate changes) or risk parameters. They can be performed rapidly and provide senior management with a 'quick and dirty' idea of the impact of a change in a financial variable.

Scenario tests should be designed to consider the resilience of firms and the financial system to exceptional but plausible scenarios. They assess how the selected events might impact on the relevant risk factors in a firm's portfolio. Scenarios can be either event or portfolio driven.

- Event-driven approaches identify risk sources that will cause changes in financial markets followed by an assessment of the extent to which risk parameters may change should such an event occur.
- Portfolio-driven approaches start with an assessment of which parameter changes might result in a portfolio loss and assess what kind of events might bring about these changes.

Designing scenarios that will prove useful to the business is not as straightforward as it may seem. While firms have clearly undertaken exercises as a result largely of regulatory necessity, there has been too often a reluctance to entertain scenarios that might upset the status quo. This is changing due to present circumstances and as a consequence of supervisory insistence. Notwithstanding this, the construction of scenarios can often ignore some potentially key elements such as:

Managing NPAs: insolvency practice

The banks must take risk... and they need to have a process to manage the risks and the inevitable losses and hence the need for the capital cushion. The insolvency community (the recovery team within the bank) deals with the risk failure, whether of process problems or due to the environment or borrower or both. The bank need to tap the knowledge to improve their process and decision making so that they can - a) minimise exposure at the time of default and b) recover as much as possible of that amount.

The Facility Risk Rating (FRR) is another way to manage LGD and potentially EAD. The reference may

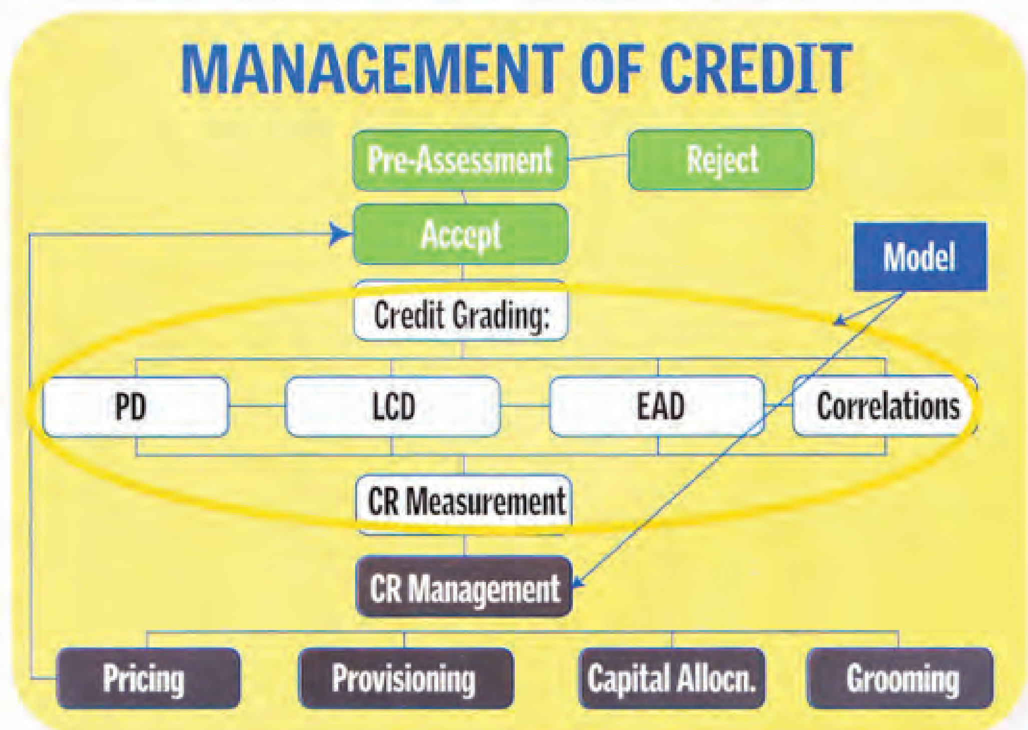


Illustration of a two-dimensional rating

ade	Borrower scale Probability of default (PD) % (a)	Assumed loss in the event of default LGD percent	Facility scale ; expected loss (EL) on loans (%) (a) * (b)
Virtuall no risk	0	30	0
Low risk	0.1	30	0.03
Moderate risk	0.3	30	0.09
Average risk	1.0	30	0.3
Acceptable risk	3.0	30	0.9
Borderline risk	6.0	30	1.8
OAEM	20.0	30	6
Substandard	60.0	30	18
Doubtfull	100.0	30	30

ade to chart-3 and the gs can be translated action guidelines in management. For exe, If the borrower rat- the highest and the ty of facility is the est, the efforts should be made to focus on ensuring that the Obligor Risk Rating assessed is correct. Similarly, when the quality of the obligor is the weakest and whereas the facility risk rating is the highest, the efforts should be to focus whether the collateral value used and the security enforceability information is correct. When the obligor risk rating and the facility risk rating are the highest, there is no effort required and the decision should be to accept on a fast track as this category is the lowest risk. The reverse i.e. when both obligor risk rating and the facility risk rating are weak, the decision should be to reject as this category is the highest.

Conclusion

Banks have good reason to worry about credit and credit risk management; they continue to be caught by dramatic turns in the economic cycle that arrive without much warning. Even if these turns could be predicted in advance, many activities are not yet liquid enough to remove or hedge the risk. The recent global crises indicate that banks worldwide continue to have difficulty in dealing with illiquidity. Moreover, they appear to be caught in a vicious cycle that moves between rapid growth in the 'good times' and virtual standstill when a crisis hits home. To break through this cycle, banks need to adopt a more structured and top-down approach to credit and credit risk management.

The challenge is to make strategic decisions on the desired shape of the institution and ensure that there is a sound balance between businesses such as wholesale and consumer banking.

(The writer is Founder-Director, Brickwork Ratings)

Gold loans are critical for growth: McKinsey

on Kurian

oan against gold will be a critical source of secured credit to sup- consumer and business growth in an uncertain omic environment, a McKinsey report on eway to the defin- decade' brought out art of Bancon 2011. ile this product may deepen financial sav- it can help house- efficiently mon- such stored gold.

Portfolio

rrently, a large por- of the portfolio is led through the in- al sector, mostly for rgency purposes. scheme, with a higher t size, improved fo- customised for higher ne segments (small ness owners, self-em- ed professionals) and fewer documentation requirements could make it very effective for consumers even while managing overall operational risk.

A Gold Accumulation Product, similar to that offered by players in markets such as Japan and China, would be a good alternative product to address consumer needs not met by current financial alternatives to gold.

This product would allow consumers to systematically invest in gold over a 3-5 year period.

By offering price averaging, such a product would attract consumers unable to predict gold prices and having slightly longer-term investment horizons.

For the consumer, transactions costs in this case would be lower than costs of physical gold, while creating a new revenue stream for players across the value chain.

Investors have two ways to monetise their gold stock - a gold deposit scheme that offers a return on their gold stock, or taking a loan against gold that provides liquidity for productive purposes.

Individuals could monetise their existing stock of physical gold assets through this scheme, which may be run by the central bank.