

# An Assessment of Credit Risk Management in Banks: A Case of the Nainital Bank Ltd.

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## ABSTRACT

Banks perform the function of financial intermediaries. The funds collected as deposits are deployed in advances to the borrowers and investments in government's securities etc. The security of funds so advanced is a prime concern of banks. The growth and economic development of a country depends upon the robust banking sector. Increasing NPAs have become the cause of concern for banks and Reserve Bank of India. Credit risk management has gained much importance these days. The Nainital Bank Limited, a subsidiary of Bank of Baroda a premier nationalized bank with a total business approximate Rs. 10,000 crores is functional in 5 states of the country, viz., Uttar Pradesh, Uttarakhand, Rajasthan, Haryana, and Delhi. The assessment of credit risk management practice and system of Nainital Bank has been investigated in this research paper. Risk capacity, risk appetite, rating wise distribution of standard advances and concentration risk have been analyzed through various ratio and graphical analysis.

## 1. Introduction

Nainital Bank was established in 1922 by the veteran freedom fighter Late Bharat Ratna Pandit Gobind Ballabh Pant and few other prominent personalities in Nainital. The operations of the Bank were confined to the Kumaun region of the erstwhile Uttar Pradesh, till 1973, having 9 branches only. In the year 1973, RBI directed that Bank of Baroda, should manage the affairs of Nainital Bank Ltd. The Bank was included in the 2<sup>nd</sup> schedule of Reserve Bank of India Act, 1934 on 28<sup>th</sup> November, 1978. Original Share holding of BOB was 30%, currently it is 98.57%. Bank has been earning continuous profits since 1973. Business undertaken by the bank is very simple in nature as Bank has no active treasury, no securitization exposure, no Forex business and does not have any subsidiary of its own. The business affairs of bank is supervised and controlled by Board of Directors consisting of representative from different fields. The chairman and CEO of the bank is a scale-VI officer (Deputy General Manager) of Bank of Baroda on deputation for 3 years term. The Nainital Bank has 139 branches in all in U.P., Uttarakhand, Haryana, Rajasthan and Delhi.

Bank for International Settlement, Basel, Switzerland says "Granting credit involves accepting risk as well as producing profits". Credit risk refers to the probability of loss that the bank or financial institution may suffer as a consequence of inability of counterparty (borrower) to meet its repayment or other commitments and commit default.

Bank's nowadays face stiff competition and subsequent changes are visible in banking operations (credit, deposit or ancillary transactions). RBI guidelines about capital adequacy and IRAC norms have put the banks in more stressful position. The provisioning for NPAs and requirement of more capital for stressed assets has two pronged affect on profit book of banks. According to RBI report on Trends and Progress of Banking in India, the gross NPA ratio of scheduled commercial banks has grown to 11.6% in the end of March, 2018. RBI has issued

guidelines for credit risk mitigating tools like multi-tier credit approval system, prudential limits, credit rating, risk pricing, portfolio-management and loan review mechanism.

According to SAS (Statistical Analysis System, US analytics company), credit risk management is the process of managing the capital assets of banks and the loss of loan reserves. Credit risk itself refers to the likelihood of losses if a borrower fails to repay debt of any kind. Managing credit risk is a way of improving efficiency and attaining a competitive edge.

Moody's analytics mentions credit risk management for community banks and credit unions to enhance the performance of banks while conforming these institutions to various regulations.

Experian, the credit information company, noted that knowing if a new customer is a credit risk, it is a good way to protect the businesses from potentially troublesome accounts and checking credit history before fostering business ties under credit risk management as well.

## 2. Literature Review

Credit risk management has been studied in many research papers.

**Patil Jaykar Bhaskar (2014)** has observed that credit risk is closely linked to market risk variables. He opined that credit risk management is an exercise to maximize risk adjusted rate of return and to minimize risk. Various tools and techniques of credit risk management have been discussed in this paper.

**Sophia Sharon (2013)** has observed that Basell II has been made mandatory for all banks to implement credit risk management. Through survey method and ANOVA analysis authors attempted to evaluate and identify the implementation of CRM. They have taken CRM policy loan disposal and credit management as dependent factors with credit risk model,

monitoring of credit limit and status of borrowers as independent (fixed) factors.

**Singh Asha (2013)** elaborated credit risk management principles and the policy prevailing amongst Indian Commercial Banks. It has also been pointed out that the banks with better CRM do enjoy competitive advantage in longer run.

**Laun James (2015)<sup>25</sup>** discussed risk appetite statement framework along with risk-culture, risk-capacity and risk-tolerance. Risk appetite has been defined as the types and aggregate levels of risk and organizations willing to actively pursue its strategy objectives. Risk appetite is controlled by risk tolerance limit. Hard limits of risk tolerance are not to be exceeded. Risk tolerance limits should be known to all the executives and officers to provide feedback.

**3. Objective**

Objective of this study is to assess the status of credit risk management practice at The Nainital Bank Ltd.

**Assessment of Credit Risk Management Practice in Nainital Bank**

Bank is following standardized approach for credit risk. The Basel III – Pillar 2 guidelines require banks not only to identify and measure the risks and assess adequacy of capital but also to develop and use better risk management techniques. Stress testing, as one of the risk management tools, is an integral part of ICAAP.

**Rating wise Distribution of Standard Advances**

Rating wise distribution of advances in percentage terms has been

Rating	2015	2016	2017
A <sup>++</sup> to A	12.85	14.90	23.17
B <sup>++</sup>	29.76	27.38	36.24
B <sup>+</sup> to C	33.60	30.58	27.87
Unrated	23.79	27.14	12.72

Careful analysis of above table exhibits increasing trends in A<sup>++</sup> to A rating which is a good sign of improvement in quality of borrowers. **B<sup>++</sup> rating shows large concentrations which is also a good sign.** The rating B<sup>+</sup> to C shows decreasing trend which is also appreciable in respect of quality of borrowers. The decreasing trend in unrated category also indicates that bank is slowly moving in the direction of emphasizing the rating of borrowers.

**Risk Capacity and Risk Appetite Statement**

Risk capacity is a measure of the capital available to absorb adverse risk whereas risk appetite is larger concept that includes risk bearing capacity along with target capital or risk return ratios and understanding of the kinds of risks that bank wants to own, and its ability to mitigate and manage those risks. Risk appetite is the amount of risk that a bank is willing to take on in pursuit of profit. It is closely related to bank's business strategy. (McKinsey working paper on risk number 27, mastering ICAAP, May, 2011, page no. 6)

Risk capacity of the Nainital Bank is 9% which is as per prescribed norms by Reserve Bank of India whereas risk appetite has been fixed at 12% by the Board of Directors of the bank.

Year	Actual RWA (A)			RWA At desired capital adequacy level (B)			Capacity to absorb additional RWA (B – A)		
	2015	2016	2017	2015	2016	2017	2015	2016	2017
Risk Capacity – 9%	3365.39	3395.18	4614.73	5557.71	5922.09	6561.88	2192.32	2526.91	1937.15
Risk Appetite - 12%	3365.39	3395.18	4614.73	4168.28	4441.57	4913.91	802.89	1046.39	299.18

It is evident that in terms of both risk capacity and risk appetite Nainital Bank has potential to absorb additional weighted assets (for credit risk, market risk and operational risk).

**Capital Adequacy**

Capital Adequacy for last three years has been appended below:-

	2016 (in %)	2017 (in %)	2018 (in %)
Basel II Norms	15.75	13.02	15.30
Basel III Norms	15.69	12.78	14.95

It is evident from the table as under that bank is also adequately capitalized as per Basel III norms:-

	2016	2017	2018
CET 1 Ratio	15.25	12.47	14.51
Tier II	0.44	0.31	0.44
CRAR	15.69%	12.78%	14.95%

### Credit Concentration Risk

Concentration risk may be used in a broader sense to include concentration by sector, industry, geographical Area, risk mitigant measures etc.

Concentration risk is basically tested upon certain ratios. Credit department of the bank has proposed following prudential limits.

The proposed prudential limit vis-a-vis position as on 31.03.2015, 31.03.2016 and 31.03.2017 is as under:-

S. No.	Risk Measurement Description	Prudential Limit	Position as on 31.03.2015	Position as on 31.03.2016	Position as on 31.03.2017
<b>Single Exposure</b>					
1	Size of Top 20 Single Borrowers (Fund Based) in terms of Total Advances	32%	16.17%	17.18%	24.09%
2	Size of Top 20 Single Borrowers in terms of Total Tier 1 + Tier 2 Capital (Capital Funds)	2.5 times	0.84 times	1.00 times	1.31 times
3	Size of Top 20 Single Borrowers in terms of Operating Profit	12 times	3.99 times	6.40 times	7.04 times
<b>Group Exposure</b>					
4	Size of Top 20 Group Borrowers in terms of Total Advances	30%	3.05%	11.22%	10.73%
5	Size of Top 20 Group Borrowers in terms of Total Tier 1 + Tier 2 Capital (Capital Funds)	2.5 times	0.16 times	0.66 times	0.58 times
6	Size of Top 20 Groups Borrowers in terms of Operating Profit	10 times	0.75 times	4.20 times	3.13 times
<b>Top to lowest ratio</b>					
7	Ratio of Top Borrower to Lowest Borrower among top 20 borrowers	5 times	6 times	7.04 times	4.28 times
8	Ratio of Top Borrower to Lowest Borrower among top 50 borrowers	10 times	12 times	13.05 times	12.99 times
9	Ratio of Top Borrower to Lowest Borrower among top 100 borrowers	20 times	19.35 times	22.98 times	55.27 times
10	Largest Single Sector exposure (Regulatory Retail 1173.51 Cr) in terms of Tier 1 Capital (435.37 Cr.)	3 times	2.72 times	2.61 times	2.45 times

All the ratios except top to lowest ratios are well within the limits hence it can be concluded that credit concentration in Nainital Bank's portfolio is well diversified and in case of variance the reason is the large gap between top borrower and

next to top borrower rendering the top borrower as outlier. **The quantum of advances to top borrower and next to top borrower** is given in the table below:

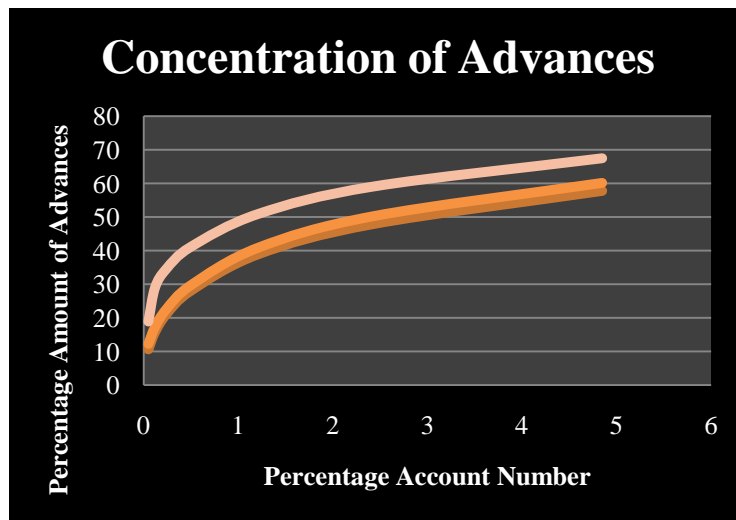
Quantum of Advances	31.03.2015	31.03.2016	31.03.2017
Top Borrower	`59.99 Crore	`74.67 Crore	`80.11 Crore
Next to Top Borrower	`50.00 Crore	`50.00 Crore	`75.00 Crore

Keeping the small size and limited area of operation of the bank, it is assumed that Nainital Bank has inherent concentration risk in its portfolio. Till the bank develops adequate data base to carry out analysis using Herfindahl-Hirschman Index or Gini coefficient, bank continues to add 0.50% for concentration risk in its capital adequacy requirement.

Following table depicts the percentage number of accounts and percentage amount of advances for year 2015, 2016 and 2017 which can give us an idea about the percentage of advances amount involved in different percentage of accounts.

YEAR 2015		YEAR 2016		YEAR 2017	
No. of A/Cs(%)	Amount(%)	No. of A/Cs(%)	Amount(%)	No.of A/Cs (%)	Amount (%)
0.05	10.61	0.05	12.28	0.05	18.97
0.12	15.69	0.12	17.26	0.13	29.01
0.24	21.05	0.24	22.58	0.25	34.59
0.49	27.88	0.48	29.53	0.5	40.99
1.21	38.91	1.21	40.85	1.26	50.9
2.43	47.93	2.42	50.23	2.52	59.07
4.85	57.8	4.84	60.12	5.04	67.46

The graphical representation of percentage amount of advances involved in percentage number of accounts is produced as under:



It is evident from the above figure that the amount involved in similar percentage of accounts had increased in last three years, i.e., the concentration of advances in few percentage of number of accounts has been intensified. Though it is well within the limit fixed by board of directors yet the broad principle of diversification of credit portfolio is compromised to some extent leading to conclude that concentration in advances portfolio is on the rise.

**4. Conclusion**

The top bracket of rating (from A to A<sup>++</sup>) exhibits increasing trend in advances in percentage terms. It ensures improvement in assets quality. Likewise, the lowest bracket of rating (from C to B<sup>+</sup>) depicts decreasing trend in advances in percentage terms. This fact again confirms the improvement in quality of advances whereas, the rating B<sup>++</sup> attracts large concentrations.

Risk capacity of the Nainital Bank is 9% which is as per prescribed norms by Reserve Bank of India whereas risk appetite has been fixed at 12% by the Board of Directors of

the bank. It is evident that in terms of both risk capacity and risk appetite Nainital Bank has potential to absorb additional weighted assets (for credit risk, market risk and operational risk).

Capital adequacy ratios for last three years exhibit that bank is adequately capitalized as per Basel III norms.

Credit concentration is measured through the different ratios like single exposure, group exposure and top to lowest ratio. All the ratios except top to lowest ratios are well within the limits hence it can be concluded that credit concentration in Nainital Bank's portfolio is well diversified and in case of variance, the reason is the large gap between top borrower and next to top borrower rendering the top borrower as outlier. Though credit concentration is within the limit fixed by board of directors yet graphical presentation of percentage of amount of advances involved in percentage of number of accounts of advances leads to conclude that concentration in advances portfolio is on the rise.

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