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MONITORING OF CREDIT RISKS AS FINANCIAL RESOURCES IN COMMERCIAL BANKS

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Abstract: Credit risk analysis can be thought of as an extension of the credit allocation process. After an individual or business applies to a bank or financial institution for a loan, the lending institution analyzes the potential benefits and costs associated with the loan. Credit risk analysis is used to estimate the costs associated with the loan. Credit risk or credit default risk associated with a financial transaction is simply the expected loss of that transaction. In commercial banks, risk has always been one of the most basic concepts. This article examines the measurement and monitoring of the credit risk in commercial banks.

Keywords: Credit risk, lending, external factors, absence of loan, prudential credit, financial obligations, borrowing costs.

Introduction.

One critical success factor for financial institutions lies in their realization of the importance of credit risk and devising solid strategies – such as hedging, diversification and managing their capital adequacy ratio – to avoid shortcomings that could lead to operational catastrophe. Credit risks faced by banks have fundamental impact on the performance because, even few large customers default on loans would cause huge problems for it. The objective of the Credit Risk Management (CRM) process is to maximize the cost-adjusted rate of return of a particular bank by maintaining exposure to credit risk acceptable to its shareholders. Banks have to navigate the credit risk associated with the overall portfolio as well as external risks that may be due to macroeconomic factors in the economy. Banks must also compare the credit risk relationships with other risks. Another specific case of credit risk applies to the method of trying to settle banking transactions. Until and unless both parties settle their payments in a timely manner, bank suffers from opportunity loss. Corporate governance may also have large effect on the risk management strategies used by the bank for reducing credit risks. Majority of commercial banks provide several services that could help them mitigate or manage risk. The significance of effective risk management strategies have been highlighted by many researchers and practitioners over time to assist banks and other financial institutions. Credit risk causes economic downturn as banks fail due to default risk from clients, which has had a negative impact on the economic development of many nations around the world. By definition, credit risk describes the risk of default by a

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borrower who fails to repay the money borrowed. Diversification is the allocation of financial resources in variety of different investments and has also long been understood to minimize such risk. Regulators also require banks to improve internal governance practices in order to ensure transparency and ethical standards to keep the customers satisfied with their products and services. Customers expect the financial institutions to have strong policies that can safeguard their interests and protect them. Therefore, poor understanding of effective credit risk and the acceptable risk management strategies by bank managers poses a threat to the commercial banks advancement and customers' interest.Credit risk or default risk involves inability or unwillingness of a customer or counterparty to meet commitments in relation to lending, trading, hedging, settlement and other financial transactions. The Credit Risk is generally made up of transaction risk or default risk and portfolio risk. The portfolio risk in turn comprises intrinsic and concentration risk. The credit risk of a bank's portfolio depends on both external and internal factors. The external factors are the state of the economy, wide swings in commodity or equity prices, foreign exchange rates and interest rates, trade restrictions, economic sanctions, Government policies, etc. The internal factors are deficiencies in loan policies, absence of prudential credit concentration limits, inadequately defined lending limits for Loan Officers Credit Committees, deficiencies in appraisal of borrowers' financial position, excessive dependence on collaterals and inadequate risk pricing, absence of loan review mechanism and post sanction surveillance, etc.

The Regulation "On requirements for the management of banking risks of commercial banks" developed by the Central Bank of the Republic of Uzbekistan provides a special definition of credit risk.

Credit risk is the risk of financial loss in the bank as a result of partial or complete failure of the borrower to fulfill its financial obligations to the bank under the terms of the contract.

A credit risk is the risk of default on a debt that may arise from a borrower failing to make required payments. In the first resort, the risk is that of the lender and includes lost principal and interest, disruption to cash flows, and increased collection costs. The loss may be complete or partial. In an efficient market, higher levels of credit risk will be associated with higher borrowing costs. Because of this, measures of borrowing costs such as yield spreads can be used to infer credit risk levels based on assessments by market participants.

Losses can arise in a number of circumstances, for example:

A consumer may fail to make a payment due on a mortgage loan, credit card, line of credit, or other loan.

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A company is unable to repay asset-secured fixed or floating charge debt.

A business or consumer does not pay a trade invoice when due.

A business does not pay an employee's earned wages when due.

A business or government bond issuer does not make a payment on a coupon or principal payment when due.

An insolvent insurance company does not pay a policy obligation.

An insolvent bank won't return funds to a depositor.

A government grants bankruptcy protection to an insolvent consumer or business.

To reduce the lender's credit risk, the lender may perform a credit check on the prospective borrower, may require the borrower to take out appropriate insurance, such as mortgage insurance, or seek security over some assets of the borrower or a guarantee from a third party. The lender can also take out insurance against the risk or on-sell the debt to another company. In general, the higher the risk, the higher will be the interest rate that the debtor will be asked to pay on the debt. Credit risk mainly arises when borrowers are unable to pay due willingly or unwillingly.

Most lenders employ their models (credit scorecards) to rank potential and existing customers according to risk, and then apply appropriate strategies. With products such as unsecured personal loans or mortgages, lenders charge a higher price for higher-risk customers and vice versa. With revolving products such as credit cards and overdrafts, the risk is controlled through the setting of credit limits. Some products also require collateral, usually an asset that is pledged to secure the repayment of the loan.

Credit scoring models also form part of the framework used by banks or lending institutions to grant credit to clients. For corporate and commercial borrowers, these models generally have qualitative and quantitative sections outlining various aspects of the risk including, but not limited to, operating experience, management expertise, asset quality, and leverage and liquidity ratios, respectively. Once this information has been fully reviewed by credit officers and credit committees, the lender provides the funds subject to the terms and conditions presented within the contract (as outlined above).

Credit analysis is the method by which one calculates the creditworthiness of a business or organization. In other words, it is the evaluation of the ability of a company to honor its financial obligations. The audited financial statements of a large company might be analyzed when it issues or has issued bonds. Or, a bank may analyze the financial statements of a small business before making or renewing a

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commercial loan. The term refers to either case, whether the business is large or small.

The objective of credit analysis is to look at both the borrower and the lending facility being proposed and to assign a risk rating. The risk rating is derived by estimating the probability of default by the borrower at a given confidence level over the life of the facility, and by estimating the amount of loss that the lender would suffer in the event of default.

Credit analysis involves a wide variety of financial analysis techniques, including ratio and trend analysis as well as the creation of projections and a detailed analysis of cash flows. Credit analysis also includes an examination of collateral and other sources of repayment as well as credit history and management ability. Analysts attempt to predict the probability that a borrower will default on its debts, and also the severity of losses in the event of default.

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