

Framework of Credit Risk Management in Indian Banks as Per Basel Norms

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ABSTRACT

Credit risk management is fundamental to the stability and performance of banks, especially in a dynamic economic environment like India. The Basel norms provide a comprehensive framework for effective management of credit risk. This paper delves into the framework related to credit risk management in Indian banks in alignment with Basel norms, focusing on the principles, practices, and regulatory guidelines that shape this critical aspect of banking. It includes a review of literature and analysis of current practices, highlighting the importance of robust credit risk management systems for maintaining financial stability.

KEYWORDS: Credit, Risk Management, Banking Sector, Basel norms, Framework

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INTRODUCTION

The banking sector in India is pivotal to the country's economic development, acting as a financial intermediary and a driver of economic growth. Credit risk, which refers to the possibility of a borrower not able to meet their obligations, is one of the most significant risks faced by banks. Effective credit risk management is essential to ensure the health and stability of banks. The Basel norms are designed by the Basel Committee on Banking Supervision (BCBS). These aim to provide guidelines globally to manage credit risk and are crucial for the Indian regulatory framework.

Literature Review

The literature on credit risk management and Basel norms is extensive. This section reviews key studies and publications to provide a comprehensive understanding of the subject.

Evolution of Basel Norms

The Basel norms have been significantly advanced since its initiation. Basel I was presented in 1988, focusing on credit risk management and least capital requirements for banks. It was followed by Basel II in

2004, which introduced a three-pillar approach: minimum capital requirements, supervisory review process, and market discipline (Basel Committee on Banking Supervision, 2004). Basel III, introduced in response to the 2008 financial crisis, further strengthened the capital framework and introduced new regulatory requirements for liquidity and leverage (Basel Committee on Banking Supervision, 2011).

Credit Risk Management in Indian Banks

Credit risk management practices in Indian banks has been influenced by global best practices and regulatory guidelines issued by the Reserve Bank of India (RBI). Studies by Ghosh (2012) and Khan and Jain (2018) highlight the evolution of credit risk management practices in Indian banks, emphasizing the adoption of advanced risk assessment and mitigation techniques. Research by Narayanasamy and Mary (2013) examines the effect of Basel norms on credit risk management in Indian banks, highlighting the developments required in risk management frameworks and practices.

Implementation Challenges

Implementing Basel norms in Indian banks has not been without challenges. According to Das and Ghosh (2007), Indian banks face several issues, including the need for advanced risk management systems, data quality, and skilled personnel. Sengupta and Vardhan (2017) discuss the challenges related to the adoption of Basel III norms, including higher capital requirements and the impact on profitability.

Impact of Basel Norms

The influence of Basel norms on the banking sector has been widely studied. Research by Bhattacharya and Roy (2012) indicates that Basel norms have significantly improved the risk management practices of Indian banks. However, studies by Mohan and Rajesh (2017) suggest that the increased capital requirements under Basel III have led to concerns about banks' lending capacity and profitability.

Framework of Credit Risk Management in Indian Banks as per Basel Norms

The framework of credit risk management in Indian banks, guided by Basel norms, encompasses various principles, practices, and regulatory guidelines. This section explores these elements in detail.

Principles of Credit Risk Management

The Basel Committee on Banking Supervision (BCBS) has laid down key principles for credit risk management, which are adopted by Indian banks:

- 1. Board and Senior Management Oversight:** Effective credit risk management starts at the top, with the board of directors and senior management playing a crucial role in setting the risk appetite and ensuring robust risk management practices.
- 2. Sound Credit Granting Process:** Banks must have a well-defined process for granting credit, including comprehensive credit assessments and risk rating systems.
- 3. Credit Administration, Measurement, and Monitoring:** Continuous monitoring of credit exposures and maintaining accurate and up-to-date records are essential for effective credit risk management.
- 4. Control Over Credit Risk:** Banks must have controls in place to mitigate credit risk, including collateral management and techniques of mitigation of risk.

Regulatory Framework in India

The Reserve Bank of India (RBI) has issued several guidelines to ensure the implementation of Basel norms in Indian banks. Key regulatory guidelines include:

- 1. Requirements of Capital Adequacy:** As per Basel III norms, Indian banks need to maintain a bare minimum capital adequacy ratio (CAR) of 9%, which is higher than the global standard of 8%.
- 2. Risk-Based Supervision (RBS):** The RBI has implemented a risk-based supervision framework to assess the risk profile of banks and ensure compliance with regulatory requirements.
- 3. Internal Capital Adequacy Assessment Process (ICAAP):** Banks are required to have an internal procedure to review their capital adequacy with respect to their risk profile and business strategy.
- 4. Mitigation of Credit Risk:** The RBI guidelines emphasize the use of credit risk mitigation techniques, such as collateral, guarantees, and credit derivatives, to manage credit risk.

Credit Risk Management Practices

Indian banks have adopted several practices to manage credit risk in line with Basel norms. These practices include:

- 1. Credit Risk Rating Systems:** Banks use internal credit risk rating systems to assess the creditworthiness of borrowers. These systems assign ratings are based on several factors, including the borrower's financial health, industry position, and repayment history.
- 2. Credit Scoring Models:** Statistical tools, such as credit scoring models, are used to predict the likelihood of a borrower defaulting on a loan. These models consider multiple variables, such as income, employment status, and credit history.
- 3. Collateral Management:** Banks often require borrowers to provide collateral to secure loans. Collateral reduces the risk of loss in case of default, as banks can seize and sell the assets to recover the loan amount.
- 4. Diversification:** Diversifying the loan portfolio across different sectors and industries helps mitigate credit risk. By spreading exposure, banks reduce the impact of defaults in any single sector.
- 5. Loan Covenants:** Banks include covenants in loan agreements that require borrowers to meet certain conditions, such as maintaining specific financial ratios or restrictions on further borrowing.
- 6. Stress Testing:** Banks conduct stress testing to assess the impact of adverse economic scenarios on their loan portfolios. This involves simulating various economic conditions to evaluate the potential impact on borrowers' repayment capacity and the bank's financial stability.

Challenges in Implementing Basel Norms

While the Basel norms implementation has strengthened credit risk management procedures, Indian banks face several challenges:

- 1. High Non-Performing Assets (NPAs):** Levels of NPAs are significantly high and this continues to be a substantial challenge for Indian banks. Effective implementation of credit risk management practices are vital for reducing NPAs and enhancing asset quality.
- 2. Economic Volatility:** Economic fluctuations, such as variations in interest rates, inflation, and exchange rates, can impact borrowers' repayment capacity and increase credit risk.
- 3. Regulatory Compliance:** Keeping up with regulatory changes and ensuring compliance with Basel norms require continuous monitoring and adaptation of risk management practices.
- 4. Data Quality and Availability:** Accurate and comprehensive data is crucial for effective credit risk management. Limited access to reliable data, especially for small and medium-sized enterprises (SMEs), poses a challenge for banks.
- 5. Technological Advancements:** Rapid advancements in technology offer opportunities for improved risk management but also introduce new risks, such as cybersecurity threats and data breaches.

Case Studies: Implementation of Basel Norms in Indian Banks

To understand the practical application of Basel norms in credit risk management, this section examines the implementation practices in two leading Indian banks: State Bank of India (SBI) and HDFC Bank.

State Bank of India (SBI)

SBI, the largest public sector bank in India, has implemented a comprehensive credit risk management framework in line with Basel norms:

- 1. Credit Risk Assessment:** SBI uses a robust credit risk assessment framework that includes credit scoring models, risk rating systems, and financial analysis tools to evaluate the creditworthiness of borrowers.
- 2. Risk Mitigation Strategies:** SBI employs various risk mitigation strategies, such as obtaining collateral, guarantees, and covenants in loan agreements. The bank also diversifies its loan portfolio across different sectors and industries.
- 3. Monitoring and Reporting:** Continuous monitoring of borrowers' financial health and repayment behavior is a key aspect of SBI's credit

risk management. Regular reporting to senior management and regulatory authorities ensures transparency and accountability.

- 4. Stress Testing:** SBI conducts stress testing to assess the impact of adverse economic scenarios on its loan portfolio. This helps in evaluating potential risks and maintaining financial stability.
- 5. Implementation of Basel III Norms:** SBI has implemented Basel III norms to ensure adequate capital adequacy and absorb potential losses. This includes maintaining greater capital ratios and implementing vigorous risk management practices.

HDFC Bank

HDFC Bank, one of the leading private sector banks in India, has also adopted advanced credit risk management practices:

- 1. Advanced Risk Rating Systems:** HDFC Bank uses sophisticated risk rating systems to assess the creditworthiness of borrowers. These systems incorporate quantitative and qualitative factors to assign risk ratings.
- 2. Credit Scoring Models:** The bank employs advanced credit scoring models to predict the likelihood of default. These models use machine learning algorithms and data analytics to enhance accuracy.
- 3. Collateral Management:** HDFC Bank places significant emphasis on collateral management, requiring borrowers to provide high-quality collateral to secure loans.
- 4. Diversification and Covenants:** The bank diversifies its loan portfolio and includes covenants in loan agreements to mitigate credit risk. These covenants ensure that borrowers adhere to specific financial and operational conditions.
- 5. Stress Testing and Scenario Analysis:** HDFC Bank conducts regular stress testing and scenario analysis to evaluate the impact of adverse economic conditions on its loan portfolio. This helps in identifying potential risks and taking proactive measures.
- 6. Compliance with Basel III Norms:** HDFC Bank complies with Basel III norms, maintaining higher capital adequacy ratios and implementing robust practices of risk management. To achieve financial stability, the bank focuses on liquidity and utilizes management's skills.

Conclusion

Credit risk management is a critical banking sector function, and the adherence to Basel norms has

significantly strengthened the framework of risk management in Indian banks. The principles and practices outlined by the Basel Committee on Banking Supervision, provide a comprehensive approach to managing credit risk effectively. Indian banks have adopted numerous risk assessment, mitigation, and monitoring techniques to align with Basel norms and ensure financial stability.

Despite the challenges, such as high NPAs, economic volatility, and regulatory compliance, the implementation of Basel norms has improved the overall credit risk management practices in Indian banks. The case studies of SBI and HDFC Bank demonstrate the practical application of these norms and highlight the importance of robust credit risk management systems.

Going forward, Indian banks need to continue evolving their credit risk management practices, leveraging advanced technologies and data analytics to enhance accuracy and efficiency. By maintaining a strong focus on risk management, Indian banks can contribute to the stability and growth of the financial sector.

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