Credit Risk Management Practices of Commercial Banks in Bangladesh

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ABSTRACT

Credit risk is defined as the probability that some of a bank's assets, especially its loans, will decline in value and possibly become worthless. Because banks hold little owners' capital relative to the aggregate value of their assets, only a small percentage of total loans need to go bad to push a bank to the brink of failure. Thus, management of credit risk is very important and central to the health of a bank and indeed the entire financial system. The present study has conducted to find out the credit risk management practices of commercial banks in Bangladesh and examine whether commercial banks of Bangladesh follow the rules and regulations of credit risk management policies. The study was conducted in the area of Dhaka city in Bangladesh. Five Banks were selected for the study such as Sonali Bank Ltd, Janata Bank Ltd, Agrani Bank Ltd, Bangladesh Development Bank Ltd and Islami Bank Bangladesh Ltd. From each bank 25 respondents were selected. So, total 125 respondents were selected. The respondents were credit risk related officer, mid level officer and management level officers. Data were collected from primary and secondary sources. Primary Data were collected from the respondents of the study area. Secondary data were collected from various secondary sources. Collected data were analyzed by using Computer Program Microsoft Excel. From the result it was found that a common and very important problem in credit process is lack of proper appraisal of credit proposal and adequate valuation of collateral. In absence of proper appraisal process the bank will fail to recognize early signs that asset quality will deteriorate and will miss the opportunities to work with clients to stem their financial deterioration and to protect the bank's position. Risk areas should be identified, risk appetites should be assessed, and risk parameters should be determined and risk controls should be established towards mitigating risks associated with a bank's business. Banks higher officials should convey risk-related information to the Managing Director and the board. Banks audit committee and risk committee should work independently with close consultation with Managing Director and Board of Directors. Bank's coherent risk parameters should be developed, facilities should be provided including operation tools and financial system/software and recruiting strategy. Extensive measures should be taken through continuous training to prepare all levels of employees and executives well about bank's risk policy, risk appetite, mitigating tools and creating awareness about consequences of risk failure. Major credits should be approved. Information about the bank's exposure and its management and control of credit risks should be presented in time. Credit policies and standards should be established so that it can confirm regulatory requirements and the bank's overall objectives. It should be ensured that the banking operation is in compliance with rules and regulations.

Keyword: - *Credit, Risk, Management, Bank, training, audit, committee, board*

INTRODUCTION

Credit risk may be defined as the possibility that the potential client or counterparty will fail to meet its obligations in accordance with the agreed terms with the bank. It also signifies the risk of making credit to a risky customer for a risky venture which is not likely to generate enough revenue to repay the money back to the bank. Credit risk is the largest and most obvious source of risk in banking and it comes from a bank's credit portfolio. The credit portfolio of a bank usually consists of money market portfolio, capital market portfolio and general credit portfolio. Here a bank is highly exposed in the risks of capital market and general credit portfolio. In recent times, the awareness among the bankers has grown regarding the need for managing perceived risks in credit related activities. One of the goals of credit risk management in banks is to maximize a bank's risk-adjusted rate of return by maintaining credit

risk exposure within the acceptable level. Hence, the credit risk assessment and grading system are being applied to evaluate, identify, measure and monitor the level or status of perceived risk associated with a credit proposal. A number of financial and non-financial factors or parameters are used by the banks for these purposes. The use of comprehensive credit risk assessment and grading techniques increasing very rapidly in the banking sector in Bangladesh because of deterioration in the credit standing of the clients, adoption of Basel accords, compliance of international accounting standards (IAS) & international financial reporting standards (IFRS) and the fast revolution of technologies that has made the bankers user friendly in the adoption of these technologies and techniques.

As banks sanction loans, they need to make provisions for loan losses in their books. The higher this provision becomes, relative to the size of total loans, the riskier a bank becomes. An increase in the value of the provision for loan losses relative to total loans is an indication that the bank‘s assets are becoming more difficult to collect (Tshore, Aboagy and Koyerhoah Coleman). Credit risk is the risk of a loss resulting from the debtor's failure to meet its obligations to the Bank in full when due under the terms agreed (R.S. Raghavan 2003). Credit risk has the highest weight among risks taken by the Bank in the course of its banking activities. Credit risk management in the Bank is carried out using the following main procedures:

- putting in place limits for operations to limit credit risk;
- putting in place indicative limits for credit risk concentration and the share of unsecured loan portfolio;
- creation of security for credit operations;
- setting value conditions for operations with respect to payment for risks taken;
- permanent monitoring of risks taken and preparation of management reporting for the Credit Committee, the Bank's management and units concerned;
- evaluation of regulatory and economic capital necessary to cover the risks taken in respect of the Bank's operations and ensuring its sufficiency;
- carrying out hedging operations;
- permanent internal control over the Bank's units in respect of observing regulations on operations procedure and risk assessment and management procedures by independent units.

The Bank's risk management envisages:

1. Applying systematic approach to overall Bank's loan portfolio risk management and separate operations with certain borrowers/counterparties (group of related borrowers/counterparties);
2. Applying unified methodology for identification and quantitative assessment of credit risk which is adequate to the nature and scale of the Bank's operations; and
3. Balanced combination of centralized and decentralized decision-making in respect of operations related to taking credit risk.

The main tool to restrict and control the credit risk taken by the Bank is the credit limit system. The following types of credit risk limits are put in place:

- counterparty limits;
- limits for independent risk-taking by the Bank's branches; and
- credit risk limits by countries/industries/regions.

Credit risk limits are determined and recommend by the Credit Committee and approved by the Bank's Managing Director & Chief Executive Officer or Board of Directors according to the delegation powers. A part of authorities for putting credit limits in place is delegated to Branch Credit Committees (for standard credit operations within the special limit for independent credit risk-taking by branches), as well as to the Small Credit Committee.

OBJECTIVES OF THE STUDY

The objectives of the study are as follows:

1. To find out the credit risk management practices of commercial banks in Bangladesh.
2. To examine whether commercial banks of Bangladesh follow the rules and regulations of credit risk management policies.

METHODOLOGY OF THE STUDY

Study area:
The study was conducted in the area of Dhaka city in Bangladesh.

Design of the Study:
The study was survey type.
Sample size:
Five Banks were selected for the study such as Sonali Bank Ltd, Janata Bank Ltd, Agrani Bank Ltd, Bangladesh Development Bank Ltd and Islami Bank Bangladesh Ltd. The respondents were credit risk related officers. From each Bank 25 respondents were selected. So, total respondents were 125. The respondents were credit risk related officers, mid level officers and Management level.

Source of Data
Data were collected from primary and secondary sources.

Source of Primary Data
Primary Data were collected from the respondents of the study area.

Source of Secondary Data
To conduct this research, secondary data were collected from various sources including authentic writings, Annual Report of the selected Banks, Annual Report of Bangladesh Bank, Loans and advances statement of the selected Banks, books, thesis, articles, documents etc. of eminent authors, journals, statistical reviews, academic papers, government documents, newspapers, magazines, souvenirs, published and unpublished research works, internet homepages etc. relevant to the main theme of the study.

Tools for data Collection
Questionnaire was used for data collection.

Method of data Collection
Data were collected by face to face interview with the respondents.

Data Analysis:
Collected data were analyzed by using Computer Program Microsoft Excel.

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RESULTS AND DISCUSSION

Table 1: Experience of respondents in banking sector

Experience	Percentage
Less than 1 year	-
1-2 years	14.23%
3-5 years	57.24%
More than five years	28.53%
Total	**100%**

Source: Field Survey, 2018

From the result it was found that 57.41% respondents had experience working with in the bank 3-5 years. Whereas, the respondents who had working experience in banking sector more than five years was 28.57%, 1-2 years was 14.23% and less than one year was null.

Table 2: Experience of respondents in the area of risk management

Response	Percentage
Less than 1 year	2.38%
1-2 years	45.24%
3-5 years	33.33%
More than five years	19.05%
Total	**100%**

Source: Field Survey, 2018

The result revealed that 45.24% respondents had experience working with risk management area 1-2 years. Whereas, the respondents who have working experience in risk management 3-5 years was 33.33%, more than 5 years was 19.05% and 1 to 2 years was 2.38%.

Table 3: The expectation from credit risk management

Expectation	Percentage
Reduce financial loss	26.14%
Improve communication with customers	22.76%
Improve decision making	37.10%
Improve resource allocation	14.00%
Total	**100%**

Source: Field Survey, 2018

The results show that 26.14%respondents expect credit risk management can be done by reducing financial losses, 22.76% of the respondents expect effective credit risk management can be done by improving communication with customers 37.10% respondents expect effective credit risk management can be done by improving decision making and, 14.00% respondents expect effective credit risk management can be done by improving resource allocation.

Table 4: The percentage of who has the authority to establish credit risk management in organization

Authority	Percentage
Chief executive officer	-
Chief financial officer	-
Board/committee	95.25
Executive management committee	4.75
Internal auditor	-
Staff	-
Total	**100%**

Source: Field Survey, 2018

In the beginning, the researcher asked a question about commitment and support from top management. In the table above, the respondents asked to identify who has the authority to establish credit risk management in their organization. The results of this question were closely expected because it assumed the top-level should have the authority to establish risk management. As it can see in the table, the majority of the respondents (95.25%) specify that the board and committee have the authority to establish risk management. Next was the executive management team (4.75%).

The surveys show that respondents identified commitment and support from top management as the most important. Top-level management responds to business processes and manages credit risk. Most of the organizations believe that it is the responsibility of the Board of Directors or Committee and Executive Management team to establish credit risk management. Top management decides the objectives and strategies for organizational credit risk management activities, mission and overall objectives.

The respondents indicated that there are many ways in which top management can support risk management policy as showed in the table 4. They set up a particular credit risk management teams, regularly revision of risk management plans, clear to allocate credit risk management responsibilities, strictly obey in credit risk management policy, listen a problems from employees and allocate appropriate resources. Most of the organizations have a policy

to support the development of credit risk management. The benefit of top management support is effective decision-making to manage risks .This is one of the expectations from the respondents.

Table 5: Whether organizations have a documented credit risk management guideline or policy

Response	Percentage
Yes	100%
No	-
Total	**100%**

Source: Field Survey, 2018

In this table, it was used a yes/no question to ask the respondents if their organizations have a documented credit risk management guideline or policy. 100% of respondent replied yes. This helps the organization to manage their credit risk. Because the employees of the organization works under the guideline or policy developed by the organization. Organizational structure involves an organization‘s internal pattern in relationships, authority and communication. Structure is comprised of formal lines of authority and communication, and the information as well as data that flow along these lines (Stank, Daugherty and Gustin, 1994). Structure and processes of the organizations are most effective when their design function match their environment and impact to organization‘s strategies (Hunter, 2002). The respondents agree that their organization have a documented guideline or policy for risk management.

Table 6: The percentage of guidelines that support the goals and objectives of credit risk Management

Response	Percentage
Yes	100%
No	-
Total	**100%**

Source: Field Survey, 2018

In this table, shows that 100% of respondents replied that they had guidelines that support the goals and objectives of credit risk management. All of the respondents believed that the guideline supports the goals and objectives of risk management. As Hasanali (2002) and Department of State and Regional Development (2005) argue, one of the most important aspects of effective risk management is organizational structure. Organizational structure provides concepts, guidelines, direction and support to employees that conducted by the steering committee. The respondents understand the risk management guideline or policy.

Table 7: The percentage of yes/no question that we asked about do you understand the credit risk management guideline or policy

Response	Percentage
Yes	95.24%
No	4.76%
Total	**100%**

Source: Field Survey, 2018

From the result it was found that 95.24% of respondents understood the risk management guideline or policy. But 4.76% did not understand the risk management guideline or policy. From the table it can be generalized that almost all the worker of credit risk management understand the guidelines that developed by their organizations, this enables the employee to manage the credit that arise in their organization.

Table 8: The percentage of how often the respondents ‘organizations change its guidelines or policies to manage risk

Response	Percentage
Once per year	66.67%
Once per two years	23.81%
Once in more than two years	9.52%
Never	-
Total	**100%**

Source: Field Survey, 2018

From the result it was found that most of the respondents (66.67%) replied that their organization changes their guidelines or policies to manage credit risks once per year. 23.81% of the respondents replied that their organizations changed their guidelines or policies one every 2 years and changing once in more than 2 years had 9.52%. That means that most of the organizations think they should change their guidelines or policies to manage credit risks once per year.

Because the financial world is always in fluctuation, Carey (2001) suggests that organizational structure must be reviewed regularly and adjusted to adapt to changing financial environments. All of the respondents stated that their organization changes its guidelines or policies in order to manage credit risks. Most of the organizations implement changes and review their organizational structure every year. Moreover, Grabowski and Roberts (1999) suggest that risk management is primarily associated with the fluidity of organizational structures. It is a flexible approach to respond in different ways and respond quickly in the face of changing conditions.

Table 9: The percentage of organizations which have a policy to support the development of risk management

Response	Percentage
Yes	92.86%
No	7.14%
Total	**100%**

Source: Field Survey, 2018

The results show that the amount of respondents who chose yes was 92.86%, which means that top management is willing to support the development of future risk management policy and 7.14% respondents replied no.

Table 10: The percentage of how many organizations offer training for new employees

Response	Percentage
Yes	100%
No	-
Total	**100%**

Source: Field Survey, 2018

The results showed that 100% have a training course for employees. That mean most of the respondents organizations think training employees is important. Risk management becomes a part of good business practice and should include training staff appropriately. The main reason for an education and training program is to ensure that the members are comfortable with the system and increase the expertise and knowledge level of the members. Most companies offer training courses for new employees. The purpose of training is to improve knowledge, skills and attitudes that in turn increase confidence, motivation and job satisfaction (Fill and Mullins, 1990).

Table 11: The percentage of how often organizations provide risk management training courses

	Percentage
Never	-
1 times per year	69.05%
2 times per year	14.29%
More than 2 times per year	16.66%
Total	**100%**

Source: Field Survey, 2018

The results show that most of the respondents' organizations (69.05%) had a risk management training course one times per year. 16.66% have a risk management training course two times per year and, more than 2 times per year percentages, 11.89%. Since the purpose of training is to improve knowledge, skill and attitudes to job satisfaction it is better to know how frequent the organizations provide training for employees. According to table 11 it can be concluded that the organizations give training to employees' one times per year. This is short be period and enables employees to understand the credit risk management practices and to do better effort in the behalf of the organization benefit.

Table 12: The percentage of organizations which have established procedures for keeping up to- date and informed with changes in regulations

Response	Percentage
Yes	90.48%
No	9.52%
Total	**100%**

Source: Field Survey, 2018

The results show this graph show that 90.48% of the respondents answered Yes‘, their organization does have established procedures for keeping up-to-date and informed with changes in regulations. But 9.52% do not. From the table it can be concluded that the organization is in the way to provide training to its employee for the changes that will be happen in the regulations of credit risk management. The ability to respond to changing conditions in an organization‘s operation is related to a range of activities including the development of risk training courses and involvement of staff in responding to an early warning system (Carey, 2001). The respondents state that their organizations have established procedures for keeping up-to-date and informed with changes in regulations to their staff. In addition, they provide risk management training courses at least once per year. The other companies also offer training courses more than once a year.

Table 13: The percentage of the processes of communicate to reduce industrial credit risk

Response	Percentage
Creating clear and trustworthy information	27.10%
Developing understanding between management team and employee	28.62%
Fast communication between management team and customers	10.95%
Regular communicating among management and staff	22.86%
Creating and maintaining a clear communication	10.57%
Total	**100%**

Source: Field Survey, 2018

In this table, the researcher would like to know how the organizations effectively communicate in order to reduce industrial credit risk. In this question, the respondents could choose more than one answer. The results show that the most common way of communicating effectively to reduce risk is developing understanding between management team and employee, with 28.62% of the respondents picking this answer. It means that most of the respondents think that developing this understanding is a first priority for organizations. The next results were regularly communicating among management and staff with 22.86%. Creating clear and trustworthy information and fast communication between management team and customers followed with 38.10%and 10.95% respectively. The lowest ranking was creating and maintaining a clear communication, with 10.57%. This means that Creating and maintaining a clear communication is not a common way of communicating to reduce risk and is outranked by creating understandable and clear information. The responses believed that developing understanding between management team and employee, regularly communication between management and staff, create information clear and trustworthy, maintaining clear to communication and fast and sharp communication in organization all is support effective communication in risk management procedures.

Table14: The percentage of organizations has internal credit rating system

Response	Percentage
Yes	100%
No	-
Total	**100%**

Source: Field Survey, 2018

From the result it was found that 100% of the respondents answered Yes‘, their organization does have internal credit rating systems. The internal credit rating system has been developed by looking different factors like term loan, merchandise loan, letter of guarantee, trade bill discount, advance on export bill, type of financial statement (financial standing), quality of management and banking relationship are some of them. From the above table it can be concluded the financial institution have developed internal credit rating to manage their credit risk. Well-managed credit risk rating systems promote bank safety and soundness by facilitating informed decision making.

Rating systems measure credit risk and differentiate individual credits and groups of credits by the risk they pose. This allows bank management and examiners to monitor changes and trends in risk levels. The process also allows bank management to manage risk to optimize returns. The challenges that the respondents‘ face in credit risk management lack of experience because it is a newly emerged department, lack of technology to manage the portfolio data, implementation of policies at the grass root level, miss interpretation of policies, unknowing the exact feature of customers especially individual borrower, effects of changing in government policy, inadequate human capacity, poorly organized of industries to evaluate their worth ness, problem of collateral registration, low level of awareness to ward credit risk management, bad attitudes of the staffs towards satisfying the need of their organizations, unable to get full information about customer from external sources, the department is under staffed, use of traditional or simple measurement tools, and absence of relevant information on time. In addition the researcher identifies the major kinds of tools or methods used to mange credit risks. The tool that the banks used to manage their credit risks includes:

Loan portfolio management: The need for credit portfolio management emanates from the necessity to optimize the benefits associated with diversification and to reduce the potential adverse impact of concentration of exposures to a particular borrower, sector or industry. Portfolio management shall cover bank wise exposures on account of lending, investment, other financial services activities spread over a wide spectrum of region, industry, size of operation, technology adoption, etc. There should be a quantitative ceiling on aggregate exposure on specific rating categories, distribution of borrowers in various industries & business group. Rapid portfolio reviews are to be carried on with proper & regular on-going system for identification of credit weaknesses well in advance. Steps are to be initiated to preserve the desired portfolio quality and portfolio reviews should be integrated with credit decision-making process.

Loan review: Multi-tier Credit Approving Authority, constitution wise delegation of powers, sanctioning authority‘s higher delegation of powers for better-rated customers; discriminatory time schedule for review / renewal, Hurdle rates and Bench marks for fresh exposures and periodicity for renewal based on risk rating.

Credit Audit/Loan Review Mechanism: This should be done independent of credit operations, covering review of sanction process, compliance status, review of risk rating, pick up of warning signals and recommendation for corrective action with the objective of improving credit quality. It should target all loans above certain cut-off limit ensuring that at least 30% to 40% of the portfolio is subjected to LRM (loan review mechanism) in a year so as to ensure that all major credit risks embedded in the balance sheet have been tracked and to bring about qualitative improvement in credit administration as well as Identify loans with credit weakness. Determine adequacy of loan loss provisions. Ensure adherence to lending policies and procedures. The focus of the credit audit needs to be broadened from account level to overall portfolio level. Regular, proper & prompt reporting to Top Management should be ensured. Credit Audit is conducted on site, i.e. at the branch that has appraised the advance and where the main operative limits are made available.

Exposure Ceilings: Prudential Limit is linked to Capital Funds for individual borrower entity, for a group with additional for infrastructure projects, subject to approval of the Board of Directors.

Risk Rating Model: Set up comprehensive risk scoring system on different point scale. Clearly define rating thresholds and review the ratings periodically preferably at half yearly intervals, to be graduated to quarterly so as to capture risk without delay. Rating migration is to be mapped to estimate the expected loss. In addition to the above tools the banks also use collecting data from internal and external sources, evaluation of collateral, identifying the risk with the source, communicating with customers, and etc as a tool for credit risk management.

CONCLUSION

Concentration would include concentration of credits to single borrower or counterparty, a group of connected counterparties, and sectors or industries. Banking supervisors should have specific regulations limiting concentrations to one client or set of related clients, and, in fact, should also expect banks to set much lower concentrations Banks are to explore techniques to identify concentrations based on common risk factors. Many credit problems reveal basic weaknesses in the credit sanctioning and monitoring process. A thorough credit assessment (or basic due diligence) needs for financial information based on sound accounting standards and

timely macroeconomic and flow of funds data. When this information is not available or reliable, banks may dispense with financial and economic analysis and support credit decisions with subjective information. The absence of testing and validation of new techniques of credit decision making is another important problem. Many banks that experienced asset quality problems due to lack of effective credit review process. The purpose of credit review is to provide appropriate checks and balances to ensure that credits are made in accordance with bank policy and to provide an independent judgment of asset quality.

A common and very important problem in credit process is lack of monitoring client and adequate valuation of collateral. In absence of monitoring process the bank will fail to recognize early signs that asset quality will deteriorate and will miss the opportunities to work with clients to stem their financial deterioration and to protect the bank's position. In some cases, the failure to perform adequate due diligence and financial analysis and to monitor the client can result in a breakdown of control to detect credit related fraud. So, an effective credit review department and independent collateral valuation are important protective measures. Due to lack of sufficient account of business cycle effects in taking credit decisions, the banks will fail to understand the income prospects and assets value that may change for changing business cycle. Effective 'stress testing' which takes account of business or product cycle effects is one approach to incorporating into credit decisions a fuller understanding of a client's credit risk. The lack of applying risk sensitive pricing methodology in credit decision making. Banks that lack a sound pricing methodology and the discipline to follow consistently such a methodology will tend to attract a disproportionate share of under-priced risks. These banks will be increasingly disadvantaged relative to banks that have superior pricing skills.

RECOMMENDATIONS

The banks and financial institutions could prepared a credit risk management policy accordingly establish a credit risk management team that should be responsible for the following actions that will help in minimizing credit risk specially industrial credit risk.

1. Risk areas should be identified, risk appetites should be assessed and risk parameters should be determined and risk controls should be established towards mitigating risks associated with a bank's business.
2. Banks higher officials should convey risk-related information to the Managing Director and the board.
3. To improve weaknesses of banks risk control, risk management systems should be monitored and evaluated regularly.
4. Banks audit committee and risk committee should work independently with close consultation with Managing Director and Board of Directors.
5. Bank's coherent risk parameters should be developed, facilities should be provided including operation tools and financial system/software and recruiting strategy.
6. Extensive measures should be taken through continuous training to prepare all levels of employees and executives well about bank's risk policy, risk appetite, mitigating tools and creating awareness about consequences of risk failure.
7. Recommending measures and control mechanism should be taken regularly considering the present situation and forthcoming changes in the policy and market condition.
8. The development in risk factors in domestic and international markets should be kept up-to-date and should be informed the Managing Director and the board with probable solutions/changes as deemed to the necessary.
9. Bank officials should participate in meetings of Bank's various committees including credit committee. ALM committee, compliance committee, audit committee and addressing any risk factors, if and when evolved.
10. Provisions should be taken so that any change in the relevant rules and regulations and issuance of any new circular are disseminated in a timely manner so that all concerned officers and executives are fully aware of changes/ circulars.
11. During working with Business Groups bank officials should be aware in keeping aggregate credit risk well within the banks and financial institutions risk taking capacity (risk tolerance).
12. Major credits should be approved.
13. Information about the bank's exposure and its management and control of credit risks should be presented in time.
14. Credit policies and standards should be established so that it can conform regulatory requirements and the bank's overall objectives.
15. It should be ensured that the banking operation is in compliance with rules and regulations.

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