CREDIT RISK MANAGEMENT AND PROFITABILITY OF URBAN CO-OPERATIVE BANKS: DETERMINANTS

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Abstract

Credit risk management is a important part of the banking industry. If the credit department is effectively handled, all operations within banks will proceed seamlessly. Credit risk refers to the situation when borrowers are unable to repay the principal and interest owed to the creditor. Credit risk management involves reducing this risk by implementing various approaches and instruments to analyze borrowers. The profitability of a bank is contingent upon the effective management of credit risk, as the utilization of funds by bankers within their institutions significantly influences this outcome. Idle funds or unutilized capital can be effectively employed by banks to generate profits. Therefore, the recovery and effective utilization of funds can be achieved through the adoption of Credit Risk Management. This article examines the aspects and components of CRM and their impact on the profitability of Urban Co-Operative Banks. This paper additionally covers the conceptual underpinning of credit risk management.

Key Words: Credit Risk, Credit Risk Management, Profitability.

Credit risk and its management are crucial factors in determining the profitability of banks. Credit risk pertains to the potential for loss arising from borrowers' failure to repay debts. Credit risk management is the practice of reducing the possibility of losses by evaluating the credit risk of a borrower, which involves analyzing factors such as credit history, credit rating, and affordability etc.

In the banking sector, loans play a crucial role in generating profits for banks. If loans are not adequately recovered, it would adversely impact the banks' profitability and serve as a cause for non-performing loans. When examining urban cooperative banks, it becomes evident that there is a higher occurrence of non-performing loans (NPL). This highlights the need for effective implementation of credit risk management.

Objectives of the Study

1) To study the components of Credit Risk Management
2) To understand the connections between urban cooperative banks' profitability and its CRM components.
3) To study the determinants of credit risk management

Research Methodology

Source of Data: Since this work is empirical, Researcher has reviewed a variety of publications, websites, and RBI bulletins.

Research Design: Descriptive Research

Introduction

The steps involved in managing credit risk include credit policies and procedures, credit analysis, credit review. These steps will be followed everywhere in the CRM department. credit policies and procedures cover consumer creditworthiness, KYC, risk assessment, and other related topics. Credit standards, risk ratings, default risk, and other related topics are covered in this set of policies and procedure The CRM's next step is credit analysis, which is carried out using a number of ratios such as the loan-to-asset ratio, the capital adequacy ratio, the non-performing loan ratio, etc. The CRM's last step, credit review, is where banks retain track of their customers. After loan approval, the bank will keep an eye on the clients. There are Several credit risk management elements significantly impact the profitability of urban co-operative banks. Let us examine these factors using a conceptual framework. The components and parts of credit risk management are included in this conceptual framework. Many research publications neglect important aspects of credit risk management. Therefore, the researcher has determined through this article which elements and components are affecting the profitability of urban cooperative banks. Let's review the subsequent research model.

Conceptual Framework
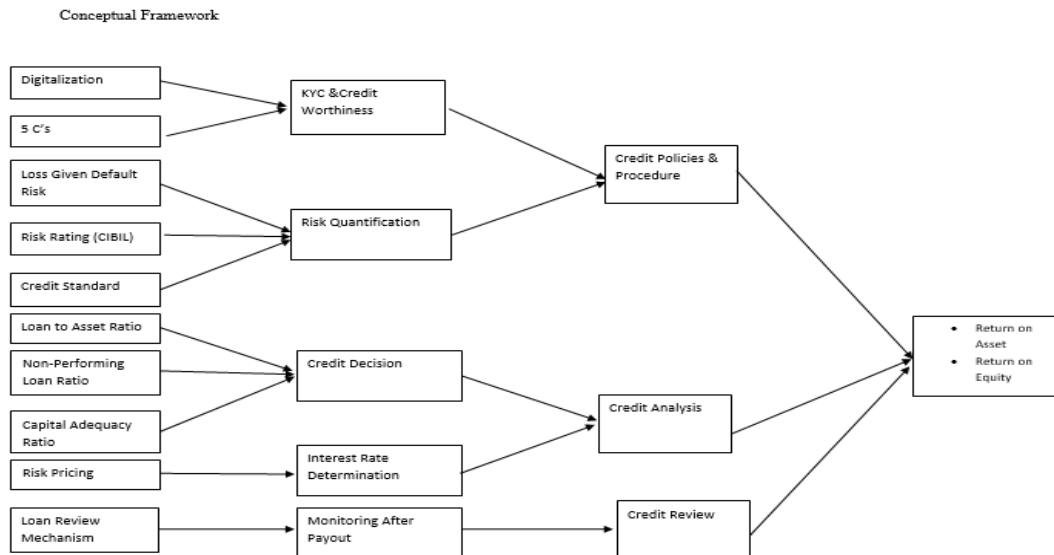
Let's discuss the components of credit risk management and how they affect the profitability of urban cooperative banks.

Digitization

Otso Manninen,Kimmo Koskinen (2019) responds to digitization in the financial sector, which needs efforts by European banks. Higher market volatility and an increase of political risks reduced bank profits. European banks' net interest revenue has been affected by low interest rates and a worse environment. Bank's important source of income will generate from net interest income. Banks continue to face numerous long-term structural concerns, therefore in the coming years, banks must adapt to the challenges posed by digitalization. Finally, it concludes that Profitable banks can give money to finance business investment; yet, if profitability is poor, banks will have difficulties during economic downturns. As a result, it suggests that having a large branch network, reducing NPLs, and investing in IT systems, R&D, and new operating models help to reduce risk while also exposing banks to the risks associated with change. Hence, Digitization helps to improve the profitability of banks. Customer's records or KYC, need to be digitalized so that urban cooperative banks can prepare for forthcoming problems.

5 C's

Peprah et al. (2017) has focused on the five criteria when assessing loan borrowers. In order to perform a survey, this paper used Yamane's statistical formula. This paper has focused on the following areas: capital, condition, character, collateral, and capacity. It has been said that the five Cs are the components that are consistently used in credit evaluation to control the loan borrower's risk levels. This paper examines the banking sector's records from Ghana and finds that the number of non-performing loans is rising, which suggests inadequate credit analysis. Therefore, in order to lower NPL and raise loan quality, this study emphasises the need of 5C credit analysis. This paper discusses the meaning of the five C's: capacity, which refers to the borrower's ability to repay the loan (Sharma and Karla); character, which refers to analysing the borrower's past loan repayment history; capital, which refers to the firm's capital to cover the unexpected loss; collateral, which refers to security or an alternative source of loan repayment; and condition, which refers to the industry, economic, and political environment that have an impact on the country's business.

As a result of this paper, bank responses were gathered using a rating system ranging from 1 to 5. Five is the most significant number, and one is the least. According to research, the borrower's capacity is the most crucial factor in the credit analysis, and banks can use this information to prepare for future loans. By examining the five Cs, bankers can increase their profitability since they can determine a customer's creditworthiness, which allows lenders to evaluate the borrower's capacity to repay loans, and from which banks can make credit decisions. Repayment ability determines the bank's ability to recover the loaned funds as well as its ability to generate regular interest and principle, both of which contribute to the profitability of urban cooperative banks.

Loss Given Default Risk

According to (Fan et al., 2023) One of the parameters of credit risk is loss given default risk. Credit risk exposure can be more accurately assessed and managed when one is aware of the loss given default risk. Both credit risk management and bank financial system stabilization will be aided by LGD. Credit risk management helps banks become more profitable by helping them recover the money they have lent

Risk Rating

Treacy & Carey (2000) has concluded that internal rating systems were introduced primarily to support loan approval and loan monitoring processes, and that internal rating systems have an effect on credit risk management ability. According to Brice(1992), In credit risk management, risk rating is crucial. Risk assessment determines loan loss provisions, loan reviews, and loan prices. It also controls the credit process, portfolio management, and other aspects of lending. Therefore, it does handle loan-related issues well, which could be a positive indicator of the bank's profitability.

Credit Standard

According to Berlin (2009), banks tighten requirements as a result of their capital restrictions and loan rules. It also looked into a few factors that influence lending standards, such as harsh competition that encourages lending without proper credit checks and herding, which can happen when banks are worried about their reputation. Finally, it has been determined that bankers adopt excessively liberal credit requirements during an upturn and excessively strict credit standards during a downturn. It has been recommended that credit standards be properly established, with positive net present value being one example. Bankers need to establish appropriate credit criteria that fit the current state of the economy. A well-established credit standard will prevent loss for the bank and provide easy recovery, allowing bankers to make a healthy profit.

Loan to Asset Ratio

According to (Fahrul Puas, 2018) Bank liquidity can be determined by looking at the loan to asset ratio. More income from loans and investments is indicated by a greater loan to asset ratio; income from non-interest earning sources, such as trading or asset management, is indicated by a lower ratio. A greater percentage of the total income of banks with lower loan-to-asset ratios comes from more varied, non-interest-earning activities including trading and asset management. A profitability statistic that shows the profit a company makes on its assets per dollar is the return-on-assets ratio.

Non-Performing Loan Ratio

According to Hanifa et al. (2015) non-performing loan Ratio is a measure of credit risk and a factor in credit risk mitigation. NPL is a sign of the bank's asset quality. Better asset quality, less doubtful debts, and reduced credit risk are all associated with a lower non-performing ratio. Therefore, banks need to track the NPL ratio since it influences their ability to make credit decisions. A lower NPL ratio results in more credit facilities offered to customers, while a larger NPL percentage results in less credit facilities offered to consumers.

Capital Adequacy Ratio

According to Silaban (2017), A bank's ability to finance its operations is indicated by a high capital adequacy ratio, and this beneficial situation could significantly boost the bank's profitability (ROA). banks must maintain a minimum Capital Adequacy Requirement of 8% of Risk Assets in accordance with RBI guidelines. As per the guidelines of RBI, Banks must notify the central bank of their risk exposure and capital adequacy requirements. The bank must make sure that it maintains capital buffers of 2.5% that are used in times of crisis and retained in good times, with a minimum Tier 1 capital ratio of 7% and a minimum Tier 2 capital ratio of 2% of risk-weighted assets. Silaban (2017) says the capital adequacy ratio (CAR) measures the proportion of a bank's total assets that are financed by its own capital as opposed to funds from outside sources and that are associated with risk (credit, securities, bills in other banks etc.)

Risk Pricing

According to Ruthenberg & Landskroner (2008) Prior to establishing price parameters, Banker establish some fundamental return goals, such as ROA, ROE and net income margin, For high-risk clients, banks will adopt a standardized approach to prevent an increase in high rates. When market interest rates are rising, banks will increase lending rates; when they are falling, banks will decrease lending rates.

Therefore, banks must determine the risk profile of their customers before setting the price of their loans. If they do not, incorrect loan pricing and unpaid loan amounts will negatively impact the bank's profitability.

Loan Review Mechanism

According to Nails (2010)Loan review should evaluate each loan individually and repayment risk., assessing adherence to lending regulations and procedures, finding document gaps, etc. After loan approval, bankers should follow up with clients to find out how they are using their money and whether they will be able to repay the loan. This can be done by looking into the customers' activities and fund usage. Therefore, loan review helps banks remain profitable by reducing the chance of default. This loan review will satisfy the requirements of the urban banks' credit review section.

Conclusion

Through this paper Researcher will conclude that All banks have a credit risk management section; they are not limited to urban cooperative banks. CRM departments are present in everywhere, not only in banks. CRM is essentially the banking industry's way of managing credit risk through the use of numerous tools. A few tools for managing credit risk include loan pricing, loan reviews, credit standards, and so on. A bank can lower its risk and boost its profitability by implementing a few tools and techniques.

Therefore, bankers need to identify what drives profitability and credit Risk management. How some factors affect a bank's profitability should be treated with caution. There are a few factors that have an immediate impact on profit and a few that have an indirect influence; these should be recognized so that the bank may utilize the appropriate tools to reduce its credit risk.

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