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The Role of Credit Risk in Proactive Risk Management

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Prudent risk management, especially credit risk control, has always been the mainstay of successful banking institutions. In an interview given to the Hindu in October 2020 upon his retirement as the Managing Director & CEO of HDFC Bank, Shri Aditya Puri aptly stated, "The challenge now was to grow without compromising on asset quality, taking undue risks or succumbing to the latest fad. This is where the risk management system of the bank came into play. Insulating the credit function from business was a critical call in this regard." [2]

The context here is the late 1990s when two simple principles laid the basis for any extension of credit. First, looking at the borrower in the eye and establishing the veracity of the transaction. Second, proper reference checks on his/her antecedents to establish a track record with both the market and other lending institutions. Any banker who has lent pre-2000 would testify to these simple ways to establish the ability and intent of a potential borrower. So many cases were rejected due to the tongue of a past-lender scorned and an equal number of entrepreneurs would have faced this heat. And the term "Risk Management" mainly referred to Credit Risk in its entirety, pre-2000.

Come the dawn of this new century and credit depositories such as consumer, commercial bureaus were taking shape. Lender participation started getting formal. Initially, the larger lenders looked suspiciously at whether their monthly submissions of customer credit history would be misused by competition to cross-sell competing products. Such was the starter hiccup. By the time the Global Financial Crisis hit, it was clear during 2009 that the swift & sure lending models need extensive data support. And pooled approaches were required by institutions; else, the fraudsters were ready to spring organised attacks on the ever-hungry lenders. Suddenly

[2] L. Mishra. 'Under penetration is biggest opportunity'. The Hindu, October 31, 2020. Accessed at https://www.thehindu.com/business/Industry/under-penetration-is-biggest-opportunity/article32992900.ece

internal deduplication alone did not build a sufficient wall, and identity frauds could easily wreak havoc with the strongest of lender evaluations. Risk Managers were now in demand, and Credit Risk would be subsumed in their roles since Financial, Operational, Legal, Reputation, Market, Compliance and Technology oversights now demanded individual share of Risk Manager's attention.

By the time the events of the last few years (2015-20) evolved, the regulator had firmly extended the role of risk to both banks and non-banking financial companies (NBFCs). NBFCs are now required to have a Chief Risk Officer who cannot be assigned any other responsibility.[3] This highlighted the need for good independent oversight in order to provide robust mitigation. To this extent, the Indian Financial System has been able to withstand many of the pulls and pressures such as the NBFC Crisis, cross border flows, Yes Bank - PMC Bank events, and last but not least, the current pandemic induced economic stress. The latter leading to pressure on individual institution's ability to disburse loans to chosen credit-worthy target segments while also stressing collections on past loans. Shri Rajnish Kumar, the earlier State Bank of India CMD famously commented, "As of June 30, 2020 we can safely state that our Portfolio is Asymptomatic."[4]

Consumer Credit Evolution in India: 1990 vs. 2020

The initial period was reliance on documents -- salary slip and Income Tax Returns; today there is a whole new procedure-set around Income Assessment -- Bank Statements, Voucher Verification, and Personal Visits.

Fraud was a black and white term then. Now there are hues and colours that are acceptable -- end use relaxation, tenure mismatch, socially engineered applications.

The availability of lenders and choices to the borrower have gone up many times. Hence there are lenders for Super Prime, Prime, Sub-Prime and New to Credit borrowers. Each jostling for space amongst competition to draw out the borrower.

The population's behaviour shift -- attitude to borrowing -- has not been factored in fully. (Almost every report on Indian Economy will start with "low credit penetration"). Yet, the methods for credit evaluation have got to dig deeper.

Today, since channels drive sourcing, the Credit Manager needs to understand the nuances of physical, digital and blended origination structures, in order to calibrate Credit Assessment accordingly.

[3] The RBI notification for NBFCs can be found at https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11557&Mode=0
[4] Refer earnings summary at https://www.thehindubusinessline.com/money-and-banking/sbi-q1-profit-jumps-81-y-o-y-to-4189-crore/article32238613.ece

Management of Credit Risk

Conventional credit risk management relies on two pillars:

1) Independent or Maker-Checker-Verifier oversight; and
2) Robust Monitoring of Portfolio.

While the individual portfolio becomes the first point of reference, the three high-level (borrower constitution based) segregation can be a convenient way to focus on credit risk management:

1) Corporate segment, generally defined as companies above a particular size say Rs. 2,000 crore of annual revenues;
2) Commercial portfolio encompassing different segments such as Agriculture, Real Estate, Medium size companies between say Rs. 200 and 2,000 crore of annual revenues; and
3) Consumer or Retail Lending portfolios covering Credit Cards, Auto, Housing, MSME (up to Rs. 2 crore of loans), Educational and Microfinance loans. [5]

Note that the above construct is neither exhaustive nor unique; individual institutions would choose to categorise their credit exposures in a form most suited to their chosen lending segments. The entire ambit of Investment Management, alongside the Capital Markets linkage thereof, opens separate vistas in Risk Management too. Plus, there would be cutovers across the boundaries, for example, a real estate operating company having annual revenue of Rs. 5,000 crore would find itself straddling all three segments mentioned above. Their suppliers would need Supply Chain Financing solutions (Commercial or FinTech play). Buyers would need Housing and Property Purchase Financing options (Consumer Lending). The company itself would need Construction Finance choices (Corporate Bank).

Credit vs. Risk

Credit Management does not end typically once the customer is on-boarded. Early Warning and Portfolio Quality Management are roles played by the Risk Department. On-going portfolio collections and customer service management are two important pillars that pulse the health of the portfolio. A pipe from Early Warning to Collections Management ensures that overdue receivables are managed efficiently too.

[5] MSME refers to micro, small, & medium enterprises.

Typically Credit Underwriting delegation and Gross Non-Performing Asset budget adherence are credit functions primarily under the responsibility of a credit manager. [6]

CREDIT RESPONSIBILITIES	RISK ROLE
Evaluate and Process Loan Applications	Set Policy & Process Guidelines
Carry Location Surveys to further Loan Disbursal	Study Industry Segments where the lender can grow business sustainably
Make available tools to evaluate Individual Credit Decisions	Scan the market for the best tools and constantly test the efficacy of existing methods
Ensure proper hands-in from Originator Department and robust hands-off to Operations Team	Study the gaps across multiple internal stakeholder departments and plug the same
Use Peer Audit, Concurrent Checks, and RCSA procedures to self-correct	Use of Internal, Statutory, Regulatory audits to establish feedback
Grow or Accelerate the Lending Business	Periodic checks to ensure that the Vehicle is Road-worthy

How independently and objectively each of these is performed ultimately decide the pace at which the organisation climbs the risk-reward slope and the boundaries for the same. Equally, how consistently the credit decisions get taken (say across 23 states or 600 branches, for instance) determine the quality of the Portfolio. And underlying these would be the basic Process, Technology, Training inputs that the organisation functions on. The Risk Overlay adds to the sheen of comfort and how seamlessly Origination-Credit Evaluation-Risk Management are stitched determines the extent to which the gates are manned.

The best organisations embed Risk Management into their functioning. There is no difference in the way they manage risk and grow business. For a young or growing financing company, the CEO of the small-sized firm would herself perform the role of a Chief Risk Officer role until the organisation grows. The other end of the spectrum, in a large financial organisation, sees Risk Management Committee of the Board, periodically evaluating that the controls are in place, functioning. Such a firm is likely to have a Chief Risk Officer to monitor and manage risk actively. Having an able Chief Risk Officer frees the CEO of a large firm to focus on tackling the market, competition, and different stakeholders.

Blending Risk Management into the Customer Life Cycle Management

[6] A 'non-performing asset' (NPA) was defined as a credit facility in respect of which the interest and/or instalment of principal has remained 'past due' for more than 90 days. The regulator's IRAC norms cover the related definitions fully at https://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx%3FId%3D449

It is worthwhile for banks and non-bank financial companies to blend their risk management practices into the management of customer lifecycle.

A Peek into the Future

During the last few years, both digitisation and digitalisation have gained importance causing a shift towards instant credit evaluation and online risk management.[7] As a result, the margin for error has gone down, and simultaneously, both detection-time and reaction-time have crashed. Post-2000, analytics play an important role in any function. On-the-fly dashboards and scorecards are useful tools to help Credit Managers supplement their decision and make the entire process replicable.

Such a backdrop means that understanding the risks is the first step. Step two is to agree on the identified risks. Now starts the interesting journey of mitigating the individual risks identified. Measuring the risks, laying down the controls, and periodic risk review complete the Risk Management journey.

Circa October 2020, understanding and living within the COVID-19 pandemic calls for some more measures:

1) Understanding the pandemic's impact on a borrower;
2) Placing the borrower's business in the global (or national) supply chain;
3) Weatherproofing the borrower to disruption;

[7] Digitisation is closer to automation and work-flow ease while digitalise refers to the ability to convert data and information into analysed buckets. A good discussion on this is available at https://www.forbes.com/sites/jasonbloomberg/2018/04/29/digitization-digitalization-and-digital-transformation-confuse-them-at-your-peril/?sh=4ae812392f2c

4) Assessing Capability of the borrower to ride successfully the 2-Ds -- Digital and Digitise;
5) Building more intuitive and self-use capability into offerings for existing borrowers.

Interesting Days Ahead!

To sign off, it would be useful to remember the following quote from Charles Dickens' famous novel A Tale of Two Cities:

> "It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way – in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only."

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