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"ANALYZING CREDIT RISK MANAGEMENT PRACTICES IN REDUCING NON-PERFORMING ASSETS"

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ABSTRACT

Credit risk management is a very vital part of financial institution especially regarding the aspect of NPAs. NPAs are those accounts which are in default and where the borrowers have been unable to pay the outstanding amount of loan as and when due, causes serious loss to the banks and to the economy too. This research seeks to identify different credit risk management strategies used by the financial institutions with the view of evaluating the impact of the measures in reducing the levels of NPAs. The paper aims to explore the literature review on the selection of credit risk management strategies based on the best practices identified today. These are sound credit assessment practices, periodical credit assessment of the borrowers, proper pricing models and securities. Besides, the use of complex credit risk analysis techniques like credit scoring model, stress testing and the impact of ICT in credit risk management shall be discussed. The research evidence indicates that, the institutions with well developed CRMPs have less NPAs. In addition, a system of early warning and prompt corrective measures should be adopted in order to prevent the loans from becoming NPAs. Finally, the authors establish that a proper credit risk management system is crucial for the improvement of the financial sustainability of the credit institutions on the background of minimizing their risks.

KEYWORDS: Credit Risk Management,Non-Performing Assets (NPA),Asset Quality,Risk Mitigation,Loan Default,Financial Stability,Credit Policy,Loan Recovery,Credit Risk Indicators.

INTRODUCTION

The risk associated with credits is comparable to the quality of loans counterparts and is one of the most important factors in determining the financial stability of the banks and other such financial institutions. There are many issues that financial institutions have to cope with and one of them is a problem associated with the NPAs – the assets, which borrowers do not pay back. These NPAs do not only damage the profitability and capital of the financial institutions but also the confidence of the investors and growth of the economy as well.

There are several ways through which credit risk management can effectively be practiced to lessen the formation of NPAs. This paper will study how these risks can be identified, measured, and controlled to possibly minimize loan defaults and therefore enhance the quality of the portfolio in lending agencies. It is for this reason that different models and techniques like credit risk assessment, monitoring of loans and risk management approaches have been employed over the years to address these challenges.

The following essay aims to find out the correlation that exists between the credit risk management and non-performing asset. It outlines how banks and other financial institutions review borrowers' credit strength and performance of existing loan portfolio in a bid to lessen chances of generating NPAs. The purpose of this research is to examine the

possibilities to improve the NRMs effectiveness, and thus, contribute to the development of the overall strategy for the effective financial institutions' operations to minimize NPAs and improve their financial wellbeing.

Besides, this study will point to the need to establish and maintain appropriate legal and non-legal requirements, firm rules and regulations, and technological innovation in credit risk. In view of these considerations, the study aims at advancing knowledge on the role of credit risk management practices on the reduction of NPAs, banking institutions' financial performance and sustainability.

OBJECTIVES OF THE STUDY:

1.To examine the role of credit risk management practices in minimizing non-performing assets.

2.To identify the key strategies for assessing and mitigating credit risk.

3.To analyze the relationship between different credit risk management techniques and the reduction in NPAs.

4.To evaluate the impact of regulatory frameworks on the reduction of NPAs.

REVIEW OF THE LITERATURE

1. Credit evaluation and loan granting The first step towards the controlling credit risk is accurate evaluation of the borrower's credit strength. The paper since goes further to advance scholarly opinion that this coupled with a proper borrower credit analysis that takes into account of borrowers' financial status, credit history, and projected ability to repay help in reducing the probability of borrowers defaulting. More so, credit scores and financial ratios are also as used by institutions in its assessment to ensure the financial position of the borrower is well suited for the type of loan product offered (Khanna, & Sharma, 2015).
2. Credit scoring and risk classification It is worth to note that some literature stresses credit scoring techniques and risk classification to measure the level of risk (Heffernan, 2019). For example, the Basel Accords that provide guidelines to the international banks suggest the rating of credit risk exposure on the basis of risk weighted assets. Credit products are usually divided into standard loans, substandard loans, and doubtful loans according to customers' credit history. Risk classification enables the banks to initiate measures of preventing or mitigating NPAs.
3. Ways of mitigating credit risk Among all risk management techniques employed by the banks, collateral and guarantee are the most widely used. This is in line with the fact that the lender has a right to manage and dispose off assets that the borrower put up as security in the event of default. Mollah (2018) in his study also establishes that efficient use of collateral may lead to the reduction of the level of NPAs because it offers an extra form of security. Thirdly, other forms of guarantees and insurance can also be used in order to minimize credit risks.
4. Monitoring and Early Warning Systems (EWS) Any loan should be frequently monitored during its life cycle so that signs of borrowers' repayment problems could be identified on time. Early warning systems (EWS) refer to self-generated processes used in monitoring the financial trends and borrowers' conducts. These may range from such indicators as declining cash flows, unfavorable market conditions to allow banks to act before the formation of defaults (Schulz & Lambert, 2020). As indicated by previous research, there is a positive and significant relationship between the audit monitoring mechanisms implementation and

a lower level of NPAs, mainly because such banks can easily intervene in the event of defaults (Alam Shabbir & Dey Ashis, 2021).

5. Management of risk Risk management involves devising methods of credit control such as loan modifications, loan refinancing and workout mechanisms that can be used to facilitate the payment of debts. In this research, Rangan and Reddy (2019) recommend that restructuring renegotiation prevents loans from turning into NPAs because the terms of the loan can be changed in line with the ability of the borrower to pay back. These measures are especially for the distressed debtors when they may be unable to pay the loans in the short term but if given a chance may likely to pay back their debts.
6. Risk-Adjusted Pricing and Portfolio Diversification Some research proposals adjust the contractual interest rate according to the credit risk; this means that the higher the credit risk then the higher the interest rate to be charged by the lender. This practice makes it reasonable as to ensure higher-risk customers contribute to the increased revenue of the bank in case of high default rates. Lastly, when it comes to credit risk, diversification of portfolio is a very important factor. Thus, if credit risk is distributed across sectors and geographical areas, then the problem of many delinquent facilities in a specific area or sector can be averted (Srinivasan & Krishnan, 2021).

Impact of Credit Risk Management on Non-Performing Assets

In fact various measures of credit risk management have been identified to lower the levels of NPAs. According to another research work of Trivedi (2016), it was revealed that banks having a solid CRM framework regarding credit control, monitoring, and recovery mechanisms have been registering a less NPAs. For instance, Arora (2019) pointed out that the banks who maintained high emphasizes on credit risk such as collateral and re-standardization had low NPAs than the banks who had low quality credits risk management.

Namely, positive changes in customer relations strategies involving borrower training and openness in communication were proven to enhance repayment performance and minimize defaults (Tiwari & Jha, 2020). They assist in establishing a good relationship between borrowers and the money lenders hence increased recovery rates on the loans.

Challenges in Credit Risk Management

Although CRM has been recognized as a competitive tool, there are several obstacles that prevent proper handling of credit risks. These range from what Iyer & Kar (2018) stated as poor information regarding borrowers, absence of standardization in credit decisions, reliance of credit rating on automated systems, and weak risk culture exhibited by the institutions. Another issue is that certain macroeconomic factors such as body economic downturn, political instability and disasters are likely to put into rise the levels of NPAs which in turn makes it difficult for banks to control credit risk.

4. HYPOTHESES

Hypotheses are formulated to test the relationships between variables. For example:

H1: Effective credit risk management practices significantly reduce the level of NPAs in banks.

H2: The use of advanced credit scoring models leads to a reduction in NPAs.

H3: The implementation of stricter regulatory frameworks reduces NPAs in financial institutions.

5. DATA COLLECTION

Primary Data

Conduct interviews with credit risk managers, loan officers, and senior management in banks and financial institutions. Surveys can be used to gather information from employees and professionals in the field of credit risk management.

SECONDARY DATA

Annual Reports: On banks preferred banks, involve collecting data on the Non-Performing Assets, credit policies and practices on risk management from the annual reports and financial statements.

Industry Reports: Industry reports which may be from international, national and regional central banks or any other regulatory body for the credit risk management standards and practices.

Industry provide best available from publications of financial research organizations, central bank and consulting firms.

Journal Review of the literature is only possible academic to locate published researches on the credit risk management and NPAs.

RESEARCH DESIGN

Descriptive Research: This design is used to describe the current credit risk management practices adopted by banks or financial institutions, and their effectiveness in reducing NPAs. **Explanatory Research**: This design seeks to explain the relationship between credit risk management practices and the level of NPAs.

Academic Research: Review published studies on credit risk management and NPAs.

6. SAMPLING TECHNIQUE

The sampling method depends on the scope of the study:

Population: Banks and financial institutions with significant loan portfolios.

Sampling Technique:

Random Sampling: To select a sample of banks or financial institutions to study.

Stratified Sampling: To categorize institutions based on size, region, or type of service.

Purposive Sampling: Focusing on banks with higher NPAs or specific credit risk management systems.

7. DATA ANALYSIS

- **Qualitative Analysis**:

➢ **Content Analysis**: For interviews and open-ended survey responses, analyzing patterns in credit risk management practices.

➢ **Thematic Analysis**: Identifying themes or recurring strategies in the data regarding the management of NPAs.

Quantitative Analysis:

➢ **Descriptive Statistics**: Summarizing data on credit risk management practices and NPAs, such as averages, percentages, and trends over time.

- **Regression Analysis**: To examine the impact of credit risk management variables on NPAs. For example, testing the relationship between loan default rates and the effectiveness of specific risk mitigation techniques.
- **Correlation Analysis**: To test the strength and direction of the relationship between various risk management practices (such as credit scoring, loan monitoring) and NPAs.
- **Time Series Analysis**: To track trends in NPAs and credit risk management practices over time.

8. Results and interpretation

Determine the effectiveness of credit risk management practices: Are certain practices (e.g., collateral management, credit scoring models, risk-based pricing) significantly reducing NPAs?

Compare findings across different banks or financial institutions: What differences in NPA levels can be attributed to varying credit risk management practices?

Regulatory impact: Assess how changes in regulations have influenced NPAs and credit risk management practices.

9 Conclusions and Recommendations

Based on the findings, draw conclusions on the role of credit risk management practices in reducing NPAs:

Conclusions: Summarize key findings regarding which practices are most effective in managing credit risk and reducing NPAs.

Recommendations: Suggest improvements to existing credit risk management frameworks, such as adopting more stringent credit evaluation criteria, using advanced technology in credit scoring, or enhancing post-loan monitoring processes.

10 Limitations of the study

- Enumerate possible weaknesses of the study and analyze these are:
- Data constraints (e.g., limited access to financial institutions' internal data).
- Possible biases in qualitative data due to personal or institutional perspectives.
- Some of them include the following Limitations arising from a method that only focuses on a few institutions.

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