Does Indian Banks are ready for Internal Ratings based Approach for Credit Risk?

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Abstract: The Basel III regulations have suggested reducing mechanistic reliance on credit ratings given by external Credit Rating Agencies under Standardized approach (SA) to Credit Risk Management. The committee recommended the implementation of revised SA and Internal Ratings based Approach **(**IRB) approach from1 January 2022 to enhance the reliability in the calculation of risk-weighted assets (RWAs) and get better banks' capital ratios. The Standardized approach used by Indian Banks for Credit risk may not be helping the Indian banks in controlling the rising NPAs leading to increasing provisions, reducing profitability and capital ratios of Indian Banks.

Keywords: Banking, Credit Risk, Basel III, Standardized approach (SA), IRB approach.

Introduction:

The Basel committee on Banking Supervision (BCBS) provided two main approaches for calculating Credit Risk Weighted Assets as per Basel II regulations. They are Standardized Approach (SA) and internal ratings Based (IRB) approach. Under Basel III reforms the BCBS has suggested banks to conduct sufficient due diligence on loans given using external ratings and also suggested not rely on external ratings alone. The Basel committee has also recommended the implementation of revised Standardized approach (SA) and IRB approach from1 January 2022. At present Indian Banks are using Standardized approach for credit risk as per RBI guidelines than using IRB approach for Credit Risk Management. Basel committee has recommended implementation of revised Standardized approach (SA) and IRB approach from1 January 2022. As per new recommendations, banks using credit ratings as per Standardized approach (SA) to credit risk has conduct satisfactory due diligence and not to rely on external credit ratings alone . The Basel committee has also suggested the option of a more detailed internal risk weighting approach to rated corporate exposures. The current approaches to credit risk management in banks as per Basel regulations are

Standardized approach (SA) - Under the Standardized approach **(**SA) banks use a prescribed risk weight schedule for calculating Risk Weighted Assets (RWAs). As per new recommendations, banks using credit ratings as per Standardized approach (SA) to credit

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risk has conduct satisfactory due diligence and not to rely on external credit ratings alone . The Basel committee has also suggested the option of a more detailed internal risk weighting approach to rated corporate exposures.

Internal ratings-based (IRB) approach - Under this approach, Effective internal ratings based approach approved by the banking supervisor can be used by banks for credit risk management.

Back Ground:

The alarming rise of NPAs of Banks in India from 2015 to 2018 has affected the profits and reputation of Indian Banks due to higher provision for NPAs.

The problem:

The alarming rise of NPAs of Banks in India from 2015 to 2018 has affected the profits and reputation of Indian Banks due to higher provision for NPAs indicating poor credit risk management of Indian Banks.

Review of Literature:

Andrew Campbell (2007) observes that ineffective internal control systems as the important factor in controlling the rising NPAs by banks in many countries. He also observes that bank management has to ensure that suitable risk measures were in place for the prevention of NPAs as per Basel guidelines on banking supervision. He emphasizes the need for effective system of banking supervision and regulation to prevent NPAs. Bank supervisors must be satisfied with the credit risk management process of banks with adequate internal controls for management of credit risks to prevent NPAs.

Meena Sharma (2005) observed that NPAs will decrease the profitability of the banks, decrease the credit growth in the economy. So Efficient Credit approval and review mechanism, sound legal framework and strong political will find better solution to the problem of growing NPAs of Indian Banks.

Objectives of the Study:

1. Analyze the Credit Risk Management practices of Indian Banks.
2. Suggest suitable Credit Risk Management framework to Indian Banks.

Methodology of the Study:

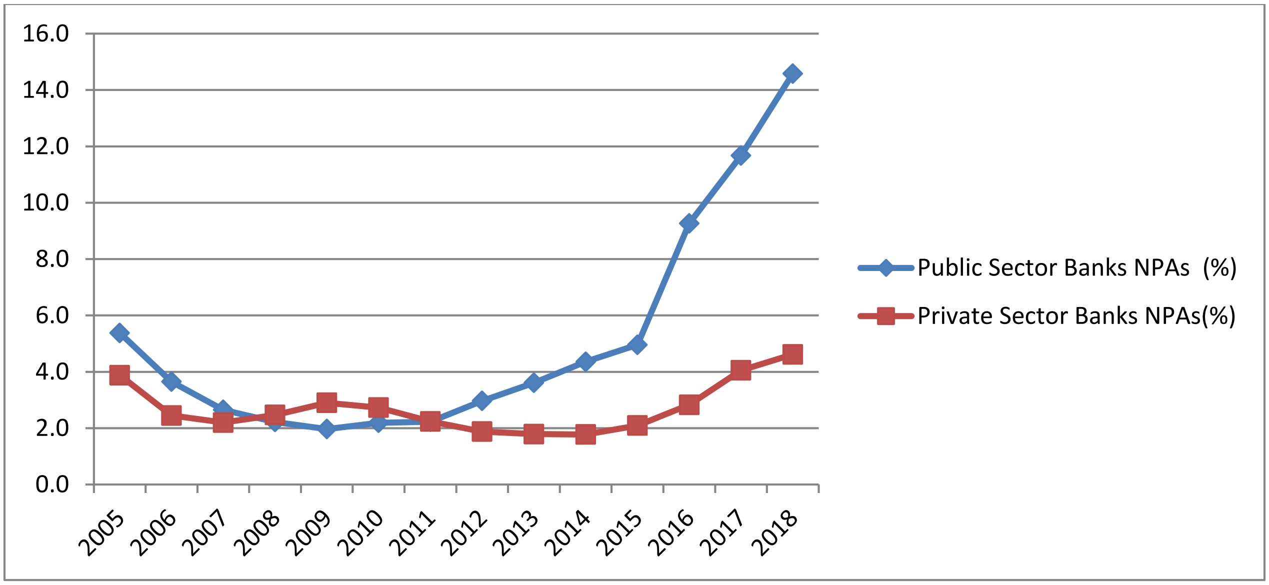
Analyze the data on existing NPAs, Credit Risk management practices of Indian Banks for the last three years by collecting secondary data from banks, RBI and internet sources.

Analysis, Interpretations and Suggestions:

Table 1: Gross NPAs of Indian Public and Private Sector Banks from 2005 to 2018

	Public Sector Banks Gross NPAs (%)	Private Sector Banks Gross NPAs (%)
2005	5.4	3.9
2006	3.7	2.5
2007	2.7	2.2
2008	2.2	2.5
2009	2.0	2.9
2010	2.2	2.7
2011	2.2	2.2
2012	3.0	1.9
2013	3.6	1.8
2014	4.4	1.8
2015	5.0	2.1
2016	9.3	2.8
2017	11.7	4.1
2018	14.6	4.6

Source: RBI

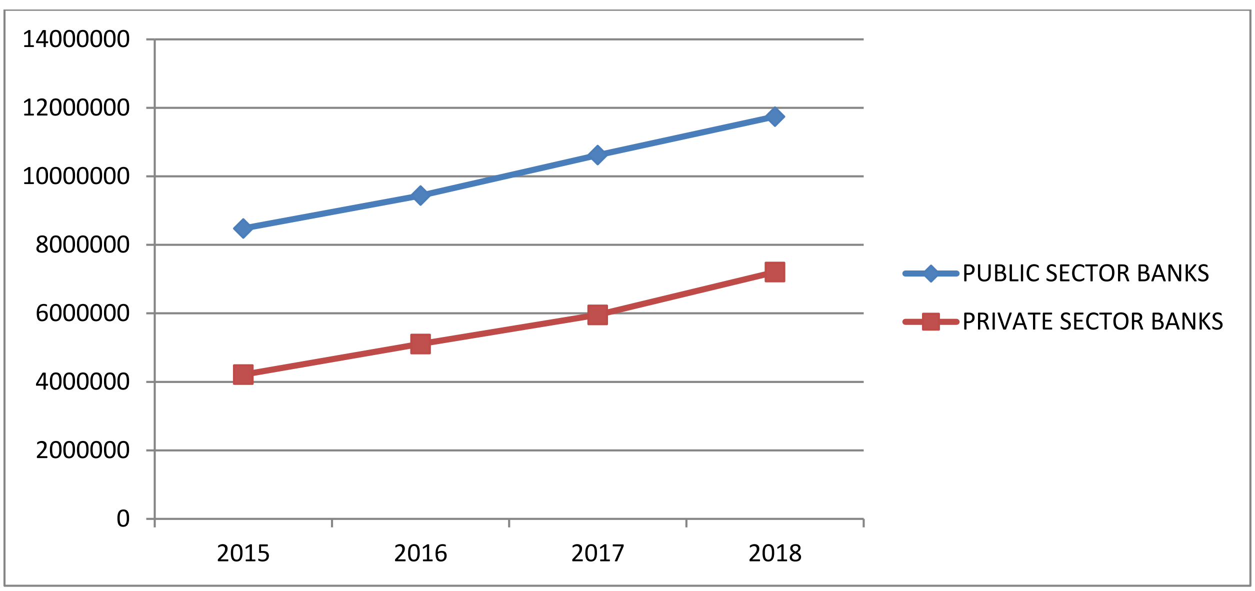


Graph1: Gross NPAs of Public and Private Sector Banks in India from 2005-2018

Table II: Public and Private Sector Banks advances to Sensitive sectors

	2015	**2016**	**2017**	**2018**
Public Sector Banks	8478012	9438330	10619911	11744076
Private Sector Banks	4213026	5105458	5955673	7204958

Source: RBI



Graph2: Loans and advances of Public and Private Sectors Banks to Sensitive Sectors from 2015-2018

Existing Credit Risk Management Framework in Indian Banks:

All the Banks in India are following standardized approach to credit risk in India prescribed by RBI as per Basel II guidelines. Basel III-Pillar 3 disclosures of Public and Private Sectors banks reveal that the industry wide exposures of both private and public sector banks have increased resulting in High level of NPAs during 2015-18. It indicates the weakness in analyzing the changing macro and industry factors by the banks current credit control systems in limiting their exposures to the respective sectors relying only on external risk ratings. It indicates the weakness in credit appraisal system, credit monitoring mechanism and governance followed at Indian banks leading to rising NPAs in public sectors banks.

Addressing the problem:

Over reliance on credit ratings for credit risk by external rating agencies as per Standardized approach is not helping the banks to monitor the loans and advances on timely basis for early recognition of problem loans. Reliance on external rating will have ripple effect on all the banks if the rating downgrade happens to the loan assets. Basel Committee has come up with revised SA and IRB approach to be implemented by banks effective from 1 January 2022. As per new recommendations, banks using credit ratings as per Standardized approach (SA) to credit risk has to conduct satisfactory due diligence and not to rely on external credit ratings alone . The Basel committee has also suggested the option of a more detailed internal risk weighting approach to rated corporate exposures. Effective internal ratings based approach approved by the banking supervisor helps the banks for better credit monitoring reducing the level of NPAs.

Conclusion:

Indian Banks has to implement effective internal risk rating systems approved by RBI as per Advanced Internal Ratings approach for managing credit risk resulting in a low level of NPAs.

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