Credit risk during financing small and large enterprises

Salem Shtawi Elghawil

pHD Candidate, University Singidunum Belgrade

Abstract- Credit risk can jeopardize lending and the financial areas of banks and credit unions. In every bank can appear losses occur at every bank; credit risk that is not properly evaluated and managed can lead to excessive loan losses and damaging the financial condition of financial institutions. Properly managing credit risk, along with improving the earnings of the loan portfolio, can prevent excessive financial damage. All lenders must reduce their risk of loan loss. Credit risk management has responsibility to prevent potential loan loss. Borrowers with consistently poor credit reports or excellent credit scores allow lenders to make easier approval and rejection decisions.

Index Terms- risk, credit, banks, finance, management

I. Introduction

The last decade has unexpected losses of large amounts in the banking industry. Firms that had been performing well suddenly announced large losses due to credit exposures that turned sour, interest rate positions taken, or derivative exposures that may or may not have been assumed to hedge balance sheet risk. In response to this, commercial banks have almost universally embarked upon an upgrading of their risk management and control systems.

Commercial banks are providing services such as accepting deposits, making business loans, and offering basic investment products. It also deals with deposits and loans from corporations or large businesses, as opposed to individual members of the retail banks. Commercial banks have to avoid financial risk with their investments and cash security measures; also they must establish credit risk policies that minimize loan losses.

II. Bank loans and liquidity

Modern economies depend on credit to finance all forms of activity, from large commercial credits to retail credit such as mortgages and credit cards. Managing credit and understanding associated risks are as important to consumers as they are to bankers and investors. Commercial banks have a great influence on the growth of a nation's economy. The profitability of commercial banks is largely attributed to the interest charged on loans they advance to their customers. If these loans are defaulted, banks face the risk of collapsing and the entire economy will be threatened. Banks use credit derivatives to protect themselves against credit risk arising from loan defaulters. Loan defaulting has been and continues to be a cause of financial distress in the banking sector locally as well as globally. [1]

III. Managing risks

Banking operations involves constant level of risk. Effective risk management is critical to any bank for achieving financial soundness. It must be obviously constituted to bank's organizational structure and business strategy has become integral in banking business. Credit risk is the bank's risk of loss arising from a borrower who does not make payments as promised.

Credit risk management encompasses identification, measurement, monitoring and control of the credit risk exposures. The effective management of credit risk is a critical component of comprehensive risk management and essential for the long term success of a banking organization.

IV. Risk management

Risk management focuses on identifying and assessing the risks and managing those risks to minimize the possibility of losses. There are no risk-free financial operations. Risk management can be defined as a number of procedures and actions that allow managers to identify, assess, monitor and address risks before they transform into problems. It is desirable to identify risks as early as possible and certainly before they become problematic. When the risk is identified, it is necessary to make a decision about the outcome.

V. Risk management process

Basically there is managerial equipment that can help companies make better decision in the risk management process. Companies have to make a decision about setting up a goal or risk policy where risk acceptance criteria will be involve.

However, with a good analysis basing on available information's all hazards of the activities shall be identified and the consequences of the risk will be assessed. Thereafter, there shall be risk evaluation comparison with the acceptance criteria. In extreme cases where the risk is not acceptable, there is the need for the companies to make a decision to Composite Risk Index.[2]

---

[1] Diamond, D W and Dybvig, P H, 'Bank Runs, Deposit Insurance, and Liquidity', Journal of Political Economy, Vol. 91(3), June, 1983

[2] Chapman.. C, Ward.. S, Project Risk Management: Processes, Techniques and Insights, John Wiley & Sons, 2007

VI. Basic Steps of Risk Management Process

Risk management process is the basic principle of understanding and managing risks. It consists of the several phases. [3] All steps in this process should be included when dealing with risks, in order perform business with minimal losses.

According to the standard ISO 31000 "Risk management – Principles and guidelines on implementation," the process of risk management consists of several steps as follows:
Risk management contains:

1. identification,
2. measurement,
3. aggregation,
4. planning and management,
5. as well as monitoring of the risks arising in a banking business.

VII. Benefits from Risk Management

To maximize the efficiency of risk management, the risk management process should be incorporated in all segments of business performance from the beginning. In this way, risks will be discovered and managed on time. In other words, risk management contributes to a better view of possible consequences resulting from unmanaged risks and how to avoid them.[4]

VIII. Credit Risk

Credit risk is the possibility of occurrence of adverse effects on financial result and capital of the bank caused by the debtor's failure to fulfill its obligations to the bank.[5] Credit risk arises from non-performance by a borrower. It may arise from either an inability or an unwillingness to perform in the pre-committed contracted manner. This can affect the lender holding the loan contract, as well as other lenders to the creditor. Therefore, the financial condition of the borrower as well as the current value of any underlying collateral is of considerable interest to its bank.

The risk of loss stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower is expecting to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation.

Credit risk is the primary financial risk in the banking system and exists in virtually all income-producing activities. How a bank selects and manages its credit risk is critically important to its performance over time; indeed, capital depletion through loan losses has been the proximate cause of most institution failures. Identifying and rating credit risk is the essential first step in managing it effectively. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

The higher the perceived credit risk, the higher the rate of interest those investors will demand for lending their capital. Credit risks are calculated based on the borrowers' overall ability to repay. This calculation includes the borrowers' collateral assets, revenue-generating ability and taxing authority (such as for government and municipal bonds). Credit risks are a vital component of fixed-income investing, which is why ratings agencies evaluate the credit risks of thousands of corporate issuers and municipalities on an ongoing basis. [6]

IX. Case Study of Credit Risks in Libyan Banks

This study will attempt to address another aspect of analysis of the problem through an applied study, in which other previous studies did not address, to illustrate to what extent commercial banks operate in Libya rely on financial analysis in their credit decision.

According to the Central Bank of Libya, there are sixteen banks in Libya. Libya's banking system is dominated by four banks which are owned in full or in the majority by the Libyan Central Bank (Jamahiriya Bank, Wahda Bank, Sahara Bank, Umma Bank and the National Commercial Bank). These banks constitute almost ninety percent of Libyan banking sector assets.

All of these banks have capital of at least 10million Libyan Dinars, and two of them (Wahda Bank and Sahara Bank) were in the process of being privatized in 2006. Frances BNP Paribas acquired 19% of Libyan Sahar Bank in July 2007, and took operational control of the bank. The deal also includes an option allowing BNP Paribas to purchase additional shares up to 51% of Sahara's capital over the next three to five years. In November 2007, five foreign banks were short listed for the privatization of Wahda Bank, including French, Italian, Jordanian, Bahraini and Moroccan institutions; Arab Bank (of Jordan) was selected. They bid on a 19% of the share of Wahda Bank, with the option to increase their ownership to 51% in three to five years. The Central Bank announced in October 2007 that it would merge Umm bank and Jamahiriya bank into a single entity; that process was completed in year 2000, although there are still branches open under the banner of each bank.

Libyan Banks get most of their funding from customer deposits, which were 83% of their liability base as of Nov. 30 2008. They reinvest most of these funds with the Central bank of Libya in the form of demand and time deposits. Also, loan/deposits ratio has been consistently decreasing going from 41% on Jan 31 2007 to 23% on Nov. 30/2008(Libyan central bank, 2009).

---

[3] Smith, N.J., Merna, T. and P. Jobling, Managing Risk in Construction Projects, Oxford: Blackwell, 2006

[4] Thomas, P., Strategic Management, Course at Chalmers University of Technology, 2009

[5] Gundlach, Matthias & Frank Lehrbass: CreditRisk+ in the Banking Industry. Springer. Berlin. 2004

[6] Gundlach, Matthias & Frank Lehrbass: CreditRisk+ in the Banking Industry. Springer. Berlin. 2004

According to the World Bank, financial intermediation continues to be low in Libya compare to other comparable countries. Commercial banks credit has been decreasing over the past few years because its being crowded out by credit from specialized credit institutions. In 2007, it reached 13 percent of GDP. The availability of financing on the local market is weak. Libyan banks offer limited financial products, loans are often made on the basis of personal connections (rather than business plans), and public bank managers lack clear incentives to expand their portfolios. Lack of financing acts as a brake on Libya's development is hampering both the completion of existing projects and the start of new ones. This has been particularly damaging in the housing sector, where particularly small-scale project often languish for lack of steady funding streams.

REFERENCES

[1] Acharya, Viral V., and Lasse Pedersen, Asset pricing with liquidity risk, Journal of Financial Economics, 2005

[2] Allen, F. and Santomero, A. "The Theory of Financial Intermediation," Journal of Banking and Finance, 1997

[3] Altman, E. "Valuation, Loss Reserves and the Pricing of Corporate Bank Loans," Journal of Commercial Bank Lending, 1993.

[4] Arif, A.; Nauman, A., Liquidity risk and performance of banking system, The Journal of Financial Regulation and Compliance 20, 2012

[5] Aspachs, O. E. Nier, M. Tiesset., "Liquidity, Banking Regulation and the Macroeconomy", 2005

[6] Babbel, D. And Santomero, A. "Financial Risk Management by Insurers: An Analysis of the Process," Journalof Risk and Insurance, June 1997

[7] Bank of England, 'The Measurement of Liquidity', Notice to Institutions Authorized under the Banking Act 1987, July, 1982

[8] Basel Committee on Banking Supervision (BCBS), An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements, 2010

[9] Basel Committee on Banking Supervision (BCBS), Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems, Bank for International Settlements, Basel, 2010

[10] Basel Committee on Banking Supervision (BCBS), Results of the Comprehensive Quantitative Impact Study, Bank for International Settlements, Basel, 2010

[11] Basel Committee on Banking Supervision (BCBS), Revisions to the Basel II Market Risk Framework, Bank for International Settlements, Basel, 2009

[12] Basel Committee on Banking Supervision , 'Sound Practices for Managing Liquidity in Banking Organizations', February, Bank for International Settlements, Basel, 2000

[13] Basel Committee on Banking Supervision , 'Sound Practices for Managing Liquidity in Banking Organizations', February, Bank for International Settlements, Basel, 2000

[14] Berger, A. and Udell, G., "Securitization, Risk, and the Liquidity Problem in Banking," Structural Change in Banking, M. Klausner and L. White, editors, Irwin Publishers, Illinois, 1993.

[15] Bessis, Joel: Risk Management in Banking. 2nd ed. Wiley, 2002.

[16] Bhattacharya, S. and A. Thakor, "Contemporary Banking Theory," Journal of Financial Intermediation, 1993. Economist, "A Survey of International Banking," April 10, 1993.

[17] Bol, Georg (et.al) Ed.: Credit risk: Measurement, Evaluation and Management. Physica, 2003

[18] Bryman, A. and Bell, E., Business Research Methods, Oxford University Press, Oxford UK, 2003

[19] Chapman.. C, Ward.. S, Project Risk Management: Processes, Techniques and Insights, John Wiley & Sons, 2007

[20] Cooper, D., Grey, S., Raymond, G., and Walker, P., Project Risk Management Guidelines: Managing Risk in Large Projects and Complex Procurements,Chichester: John Wiley & Sons, Ltd, 2005

[21] Cossin, Didier & Hugues Pirotte: Advanced Credit Risk Analysis: Financial Approaches and Mathematical Models to Assess, Price and Manage Credit Risk. Wiley, 2000

[22] Davis, E.P., "Market Liquidity Risk", paper for the SUERF conference, Dublin, 1994

[23] Diamond, D W and Dybvig, P H, 'Bank Runs, Deposit Insurance, and Liquidity', Journal of Political Economy, Vol. 91(3), June, 1983

[24] Diamond, D., Rajan, R., A theory of bank capital. Journal of Finance 55, 2000

[25] Diamond, Douglas W., and Philip H. Dybvig, Bank runs, deposit insurance, and liquidity, Journal of Political Economy, 1983

[26] Diamond, Douglas W., and Raghuram G. Rajan, Liquidity risk, liquidity creation, and financial fragility: a theory of banking, Journal of Political Economy, 2001

[27] Duffee, G.R., Zhou, C., Credit derivatives in banking: useful tools for managing risk? Journal of Monetary Economics, 2001

[28] Fallon,W., "Calculating Value-at-Risk," Working Paper 96-49, Wharton Financial Institutions Center, The Wharton School, University of Pennsylvania, 1996.

AUTHORS

First Author – Salem Shtawi Elghawil pHD Candidate, University Singidunum Belgrade