# 📌 RISK MANAGEMENT CREDIT RATING 🏦

## Chapter – 23 MODULE C ABM By Ashish Sir

Banks face various risks while conducting their operations. These risks can be **classified into three major categories**:

| Type of Risk | Definition | Examples |
|---|---|---|
| **Operational Risks** | Risks due to human error, fraud, system failure, or external events. | Fraud, cyberattacks, system failure, regulatory non-compliance, natural disasters. |
| **Market Risks** | Risks due to fluctuations in market variables like interest rates, foreign exchange rates, or commodity prices. | Rising interest rates affecting loan demand, exchange rate fluctuations reducing international revenue. |
| **Credit Risks** | Risks arising from borrowers defaulting on repayment of loans. | Non-performing assets (NPAs), loan defaults, fraudulent borrowing. |

💡 **Key Insight:** Among these, **credit risk is the most significant** for banks as it directly impacts profitability and liquidity.

## What is Credit Risk?

Credit risk refers to **the possibility of a borrower failing to repay the principal or interest on a loan** as per agreed terms.

### 🔍 Types of Credit Risk:

✔ **Default Risk:** Borrower **fails to pay** principal or interest.

✔ **Downgrade Risk:** Borrower's **credit rating deteriorates**, increasing default probability.

✔ **Concentration Risk:** High exposure to **a single borrower or sector** leads to a potential large-scale loss.

> 📌 **Example:** In 2008, **Lehman Brothers collapsed** due to subprime mortgage defaults, triggering a global financial crisis.

## Factors Affecting Credit Risk

### External Factors 🌍 (Beyond Bank’s Control)

📌 These factors impact borrowers' businesses, reducing their ability to repay loans.

| Factor | Description | Example |
| --- | --- | --- |
| **Economic Fluctuations** | Economic slowdown impacts businesses, leading to loan defaults. | 2020 COVID-19 pandemic caused massive business closures and loan defaults. |
| **Exchange Rate Risks** | A depreciating domestic currency increases repayment burden on foreign currency loans. | A company that took a loan in USD faces repayment difficulties due to a weakening INR. |
| **Government Policies** | Changes in interest rates, taxation, or regulations affect borrowers’ ability to repay. | RBI's repo rate hikes make borrowing costlier, increasing loan defaults. |

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| **Geopolitical Risks** | Political instability, wars, or trade restrictions impact global businesses. | Russia-Ukraine war caused disruptions in energy and commodity markets. |

💡 **Key Insight:** Banks **must continuously monitor global and domestic economic conditions** to assess external risks.

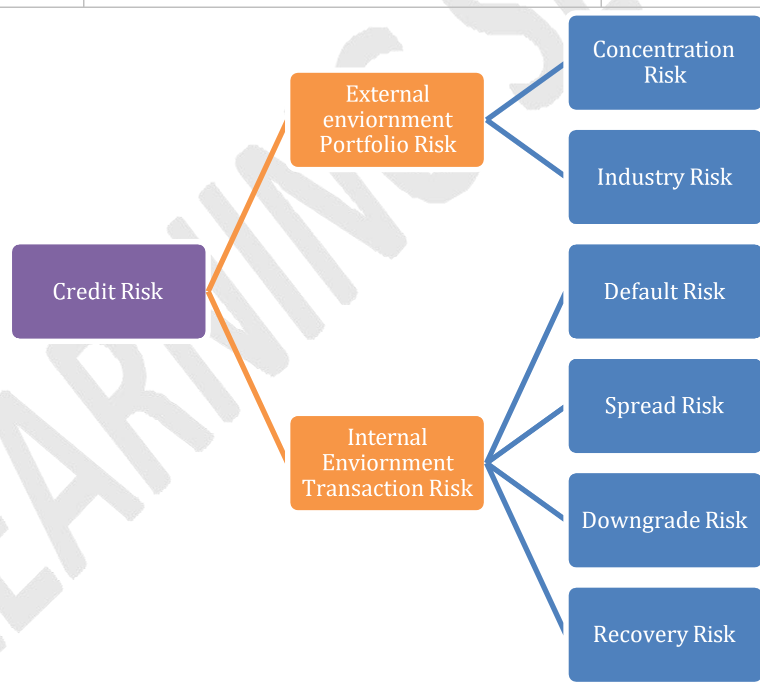
**Internal Factors** (Controlled by the Bank)

📌 These are related to the bank's lending practices, policies, and internal risk management.

| Factor | Description | Example |
|---|---|---|
| **Overexposure to a Sector** | Excessive loans to one industry increase risk if the sector faces a downturn. | Indian banks faced **high NPAs in real estate loans** post-2008 financial crisis. |
| **Faulty Credit Appraisal** | Poor due diligence in assessing a borrower's repayment capacity leads to defaults. | Vijay Mallya's **Kingfisher Airlines** received loans despite weak financials. |
| **Lack of Monitoring** | Failure to track loan utilization leads to fund diversion. | Nirav Modi's **PNB fraud** involved unchecked fraudulent transactions. |
| **Weak Recovery Mechanism** | Poor follow-up on overdue loans increases NPAs. | Many MSME loans turn into NPAs due to **delayed legal actions**. |

## Real-Life Examples of Credit Risk Failures 🚨

| Case | Description | Key Lesson |
|---|---|---|
| **Kingfisher Airlines Loan Default** | The airline received **₹9,000 crore in loans** but failed to repay due to poor financials. | Banks must **assess financial health properly** before granting large loans. |
| **PNB-Nirav Modi Scam** | Fraudulent LoUs (Letters of Undertaking) worth **₹14,000 crore** were issued. | Need for **strong internal controls & transaction monitoring**. |
| **IL&FS Financial Crisis** | Infrastructure lender IL&FS defaulted on repayments due to poor risk assessment. | Banks should **diversify risks** and avoid over-lending to a single sector. |



# 📌 Credit Risk Mitigation Strategies in Banking 🏦

## Steps Taken to Mitigate Credit Risks

The ***primary goal** of credit risk management is to **reduce risks** within acceptable limits* while maximizing the **risk-adjusted return** on the bank's credit portfolio.

### A. Macro-Level Risk Mitigation 🌍

At the **macro level**, banks **analyze, diversify, and monitor** their total credit portfolio to **avoid concentration risk** and minimize large-scale defaults.

| Macro-Level Strategy | Description | Example |
|---|---|---|
| **Sectoral Diversification** | Banks avoid over-lending to a single industry or sector to prevent excessive risk concentration. | RBI restricts banks from **exceeding 25% exposure to the real estate sector**. |
| **Exposure Norms** | Banks fix internal limits on lending to a **single borrower/group** to prevent undue risks. | A bank limits **loans to a single corporate group to ₹500 crore**. |
| **Periodic Loan Policy Reviews** | Reviewing lending norms, risk assessment models, and market conditions. | RBI suggests annual policy reviews for **priority sector lending (PSL)**. |

| | | |
|---|---|---|
| Loan Restructuring | Rescheduling debt payments for stressed businesses to avoid defaults. | RBI's **ECLGS (Emergency Credit Line Guarantee Scheme)** for MSMEs during COVID-19. |

## B. Micro-Level Risk Mitigation 🔍

At the **micro level**, banks focus on **individual loans, borrower assessments, and risk mitigation tools**.

| Micro-Level Strategy | Description | Example |
|---|---|---|
| Credit Appraisal Standards | Evaluating borrower financials, business stability, and loan purpose before approval. | Checking **financial statements, credit history, and repayment capacity**. |
| Collateral Security & Guarantees | Ensuring loan security via mortgages, personal guarantees, and corporate guarantees. | Property mortgages for **home loans**, government guarantees for **agriculture loans**. |
| Loan Monitoring | Continuous tracking of loan utilization and business performance. | Field inspections for **MSME business loans**. |
| Credit Derivatives (CDS) | Banks transfer risk via **Credit Default Swaps (CDS)** and similar instruments. | Large corporate loans hedged using **CDS insurance contracts**. |

# Credit Ratings in Banking 🏦

A **credit rating** evaluates the **default risk of a borrower** and helps banks determine **loan approval, interest rates, and provisioning requirements**.

## A. Objectives of Credit Ratings 🎯

✔ **Approve or reject** loan proposals.

✔ Decide **interest rates** based on risk.

✔ Assess the **total credit portfolio** and provisioning needs.

> 📌 **Example:** A **borrower with a high credit rating (AAA)** gets a **loan at 7% interest**, while a **borrower with a lower rating (BB)** gets a **loan at 11% interest** due to higher risk.

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## B. Internal vs External Ratings 📊

| TYPE | DESCRIPTION | USED FOR |
|---|---|---|
| Internal Ratings | Assigned by banks based on **internal models** and risk parameters. | **Retail loans, small business loans, internal risk assessments**. |
| External Ratings | Given by **accredited rating agencies** based on financial data. | **Corporate loans, bonds, regulatory compliance**. |

C. RBI-Accredited Credit Rating Agencies

📌 **Domestic Credit Rating Agencies (CRAs)** 📜

✔ **CRISIL**

✔ **ICRA**

✔ **CARE Ratings**

✔ **India Ratings & Research (Fitch India)**

✔ **Brickwork Ratings**

✔ **Acuite Ratings**

✔ **Infomerics Valuation & Rating**

📌 **International CRAs** 🌍

✔ **Fitch Ratings**

✔ **Moody's Investors Service**

✔ **Standard & Poor's (S&P)**

💡 **Example:** A corporate borrower with an **AA rating by CRISIL** gets **priority loan approvals and lower interest rates**.

## Methodology of Credit Rating 🔍

Every bank has its **own rating model** but follows a **common framework**:

## A. Key Credit Rating Factors 📊

| Factor | Description | Example |
|---|---|---|
| Promoters & Management | Evaluating experience, credibility, and past business performance. | Strong management leads to **better repayment discipline**. |
| Financial Strength | Analyzing financial statements, cash flows, and profitability. | A **low debt-to-equity ratio** signals a **healthy business**. |
| Industry Risk | Assessing external risks from the business sector. | **Cement sector loans** are **risky during economic downturns**. |
| Collateral & Guarantees | Evaluating security available to cover loan defaults. | **Home loans are safer** than **unsecured personal loans**. |

📌 **Example:** A **large IT company** with strong management, stable profits, and low debt gets **AAA rating**.

A **small textile firm** in a struggling sector with high debt gets a **BB rating**.

## Periodic Review & Upgradation of Credit Ratings 🔄

Since **market conditions, regulations, and financial performance change over time**, credit ratings must be **regularly reviewed**.

When to Upgrade or Downgrade Credit Ratings?

| Scenario | Impact on Credit Rating |
|---|---|
| 📈 **Higher revenue, low debt, stable cash flow** | **Upgrade** rating (e.g., BB → BBB) |
| 📉 **Falling profits, high NPAs, management issues** | **Downgrade** rating (e.g., A → BB) |

💡 **Example:** If a company's **revenue grows 25% annually**, its rating **improves from A to AA**.

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## Real-Life Cases of Credit Risk & Rating Failures 🚨

| Case | Description | Lessons Learned |
|---|---|---|
| **IL&FS Financial Crisis** | The company had a **high credit rating (AAA) but defaulted on ₹90,000 crore loans**. | **Rating agencies must assess actual cash flows, not just assets.** |
| **Yes Bank Crisis (2020)** | Bank gave excessive loans to **high-risk borrowers like DHFL & Jet Airways**. | **Banks must diversify loans across industries.** |
| **Lehman Brothers Collapse (2008)** | Mortgage-backed securities were rated AAA but turned worthless. | **Ratings must be reviewed frequently.** |

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# 📌Credit Derivatives for Risk Management in Banking 🏦

## Understanding Credit Derivatives

Credit derivatives are **financial instruments** used to **transfer credit risk** from one party to another **without transferring the underlying asset**.

✔ **Objective:** Hedge against potential losses due to **borrower default**.

✔ **How it Works:** Similar to an **insurance contract**—the risk is covered by a third party **for a premium**.

📌 **Example:**

🔷 **A bank gives a ₹100 crore loan to a company.**

🔷 The bank fears **default risk**, so it **buys a Credit Default Swap (CDS)** from another financial institution.

🔷 If the company **defaults**, the **CDS seller compensates the bank**.

🔷 If **no default occurs**, the bank **only loses the CDS premium paid**.

## Types of Credit Derivatives 🏦🔄

| Type | Description | Used for | Example |
|---|---|---|---|
| Credit Default Swaps (CDS) | A contract where the protection buyer pays a premium to the protection seller for coverage against default. | Hedging against **corporate bond defaults**. | SBI buys **CDS on Tata Steel bonds** to hedge default risk. |

| | | | |
|---|---|---|---|
| **Credit Linked Notes (CLN)** | Structured financial product where risk is transferred to investors in return for fixed interest. | **Selling risk** to investors & raising capital. | HDFC issues **CLNs linked to real estate loans**. |
| **Collateralized Debt Obligations (CDO)** | Pooling loans together and selling them as securities to investors. | Spreading risk across multiple loans. | **Housing loan CDOs** led to the **2008 financial crisis**. |