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CREDIT RATING OF CUSTOMER'S IN BANK LENDING

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RESEARCH PAPER - ECONOMICS

Introduction :

The need for a strong banking system emanates from the fact that a strong banking system is the backbone of a strong and vibrant financial system. Empirical evidence shows that economies with a weak banking system lag in economic development. The East Asian Crisis has resulted largely from bad banking system, rather than pegged exchange ratios or capital account convertability.[1] The Indian banking sector's minimal reliance on external borrowings to fund domestic capital requirements, minimal exposure to property and stock markets reflect the conservative approach to banking. For instance, the exposure of scheduled commercial banks to sensitive sectors such as capital market and real estate accounted for just 2.7 percent of the total advances of Rs. 4430 billion at the time of the crisis.[2] Despite the positive features, the Indian banking system needs to be toned up to fall in line with the best international practices especially, the non-performing assets (NPAs) of the Indian banks. At the operational level, RBI has already insisted on the implementation of risk management systems to monitor credit risks in banks.

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NPAs of Public Sector Banks

The Indian banking industry operated in a regulated and protected environment until 1991. Following the financial sector reforms since 1991, the forces of competition have entered into the banking sector. The commercial banks in India had been working in an environment which was highly regulated. Guidelines from RBI were simply used for fixing credit limits and the rates of interest were also administered. As a result, decision making was simple and the bankers had only to comply with regulatory requirements with respect to security margins, minimum current ratio, minimum turn-over of inventory and book debts. The result is that Indian commercial banks now faces serious problems of recoveries and write-offs and growing non-performing assets (NPAs). The major cause of decline in the quality of the loans and advances portfolio has been the lack of professional approach at the credit risk appraisal stage.[3]

At present, as is evident from the above analysis, most of the public sector banks and term lending institutions are heavily loaded with the problem of huge amount of NPAs. This is mainly attributed to the fact that lending decisions in the past placed undue emphasis on need based bank credit, instead of using the better criteria of risk and credit worthiness of the borrowers. Therefore, bank lending in future has to focus towards the better criteria i.e. risk and credit worthiness. In short, the weak capital position of the Indian banking system is largely due to the result of poor credit management system.

Role of (Internal and External) Ratings in Pricing of Bank loans.

The major cause of decline in the quality of the loans and advances of banks has been the lack of professional approach at the credit appraisal stage. Hence, Indian Banks should have to use credit rating both internal as well as external for determining the pricing of loans on the basis of risk premium criteria.

Banks should develop the practice of charging different rates with different borrowers depending on their credit rating. Similarly, strict prudential norms should be observed while fixing the maximum limit per party, according to the credit rating. Depending upon the credit rating of the borrower, bank lending can be priced at various interest rates. A proposed model of such lending is presented in Table 1.

A bank can formulate its own policies of lending in accordance with the rating

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grades presented in Table 1. The best rated borrowers such as 'AAA' rated blue chip corporates can be charged the lowest rate of interest, say prime rate and successively lower rated ones should be charged increasingly higher rate of interest due to loading of risk premium, which would be within the maximum prescribed band of interest from the prime rate of interest.

Table 1 Rating Scales and Lending Rates

Borrower's Category	Interest Rate	Maximum loan limit per party	Per party exposure limit
A1 (AAA Rated)	PLR	Rs. 20 Crore + 60 %	= Rs. 32 Crore
A2 (AA+ Rated)	PLR +1 %	Rs. 20 Crore + 50 %	= Rs. 30 Crore
A3 (AA Rated)	PLR + 2 %	Rs. 20 Crore + 40 %	= Rs. 28 Crore
A4 (AA- Rated)	PLR + 3 %	Rs. 20 Crore + 20 %	= Rs. 25 Crore
A5 (A+ Rated)	PLR + 4 %	Rs. 20 Crore + 0 %	= Rs. 20 Crore
A6 (BBB Rated)	PLR + 5 %	Rs. 20 Crore - 20 %	= Rs. 15 Crore
A7 and Below	Lack Credit-worthiness	Nil	--

Note : A Proposed Model.

In the liberalised and competitive regime of lending, the functional difference between banks and financial institutions (FIs) are likely to vanish gradually.4 In other words, FIs may start financing the short term working capital needs of borrowers besides providing term loans, while banks may also set up their own project appraisal departments and start financing capital projects in a bigway, in addition to providing working capital finance. So each bank has to spell out its own policy in this regard.

It is concluded from the above analysis that commercial banks as well as financial institutions should have to develop their own lending criteria by using internal as well as external credit ratings to reduce the high level of NPAs as per the norms of BIS and Basle Committee recommendations. Big banks can develop their own internal risk assessment mechanism in addition to the external ratings whereas small banks can use the bank loan

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ratings and other rating services offered by India CRAs in this regard.

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