Credit Risk Management In Banks As Participants In Financial Markets

“A qualitative study of the perception of bank managers in Sweden (Umeå region)”

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Abstract

Despite the vital role that banks play in Financial markets (FM) by connecting lenders to borrowers, instability in these financial markets, currency values and the global environment has affected the profitability of banks with those in Sweden inclusive. Most if not all companies including banks go into business because they want to create value. The banks like other firms thus look for ways to manage their risks while striving to improve productivity and performance for this value to be created. This productivity only comes when the banks give credits to customers from money deposited by shareholders or savings from customers thus putting them at risk in case of default. Despite this risk, the bank cannot stop the business of credit granting because it is the main source of its profitability. So she finds herself in a situation with profitability on the one hand and risk of default on the other hand. For success to be attained, the only option is good credit risk management practices since in the process, returns are correlated to risk. The risk management practices vary from bank to bank depending on its policies on credit granting decisions. Different banks prioritize the information gotten about customers for credit assessment differently and although they are faced with the same type of risk, their techniques of management are different.

This paper is thus geared towards looking at how some banks in Sweden go about their credit risk management activities by looking at the qualities which they consider of companies before granting them credits.

This study was carried out using a qualitative research method and open ended interviews. The sample group consisted of three banks in Umeå, Sweden. The analysis of the empirical data showed that credit risk management occupies an indispensible position when lending decisions are carried out. It also goes ahead to show that even though banks may be faced with the same risks, their credit risk management techniques differ, the importance given to the information used for credit assessment differs from bank to bank and collaterals also play a very important role in credit granting decisions. So, for greater results of credit risk management to be attained, banks must value all information about the customer perfectly because any neglected information can be the root cause of their problem or default.

Key words: Credit risk, risk management, financial markets, financial intermediaries.
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CHAPTER ONE
INTRODUCTION

This chapter begins with background information on the importance of financial intermediaries (FIs) (banks in this case) as participants in financial markets (FMs) to any given economy. By use of a diagram, the position banks occupy in the FM (connecting lenders and borrowers) is shown. Some of the problems they are faced with when carrying out this function are mentioned. The chapter continues to give the questions that need to be answered and the justification or purpose why this study is carried out and specifying the limitations of the study to the various FIs studied. It goes on to give definition of some terminologies used and ends up with a disposition of what will be studied in the subsequent chapters.

1.1 - Background information:

Banking is an activity in FMs dated back to a very long period of time and this longevity has been accompanied with its importance in the economy of every nation and the world at large. Banks are very important in every economy because they provide special functions or services which if disturbed or interfered with, can lead to adverse effects on the rest of the economy (Saunders, 2002, p. 85). They make available financial resources necessary for economic growth from lenders to borrowers (Shanmugan & Bourke, 1990, p. 2). They take deposits from those who have to save (lenders) and then lend the money deposited to those who are in deficit (borrowers) as loans. At a certain stage of their evolution, their traditional activity of deposit taking and loan making enlarged with activities like remittance, foreign exchange dealings, trustee services, securities brokerages, investment advisory dealings, bill paying, leasing factoring, etc (Shanmugan & Bourke, 1990, Pg.1). Banks also provide financial information on the economy and provide a greater role to unsophisticated stakeholders by using published financial information to open a restricted form of dialogue with companies (Stapleton & Woodward, 2009, p. 1).

This implies that good functioning of banks in every economy has a direct relationship with its economic growth and poor functioning has a negative effect. The great role banks play by acting as financial intermediaries in the financial market for lenders and borrowers is a very delicate one and its handling thus need a lot of prudence.
Looking at the table, without FIs borrowers by themselves will find it difficult to find lenders especially because of the imperfection of the real world FMs. The FIs (banks inclusive) then come in to ease the process. They solve conflict of interest, facilitate the flow of funds from lenders to borrowers at a low cost, reduce search cost for both parties and also provide the function of bearing and managing risk on behalf of their customers through the pooling of risks and the sale of services as risk specialists (Saunders, 2002, p. vii). The role of FIs and specifically banks in financial markets cannot be undermined given the delicate and important place they occupy.

Source: Wikipedia / Knowledge from general literature
Banks don’t function in an isolated environment. The uncertainties of the future and the dynamic environment in which they operate, has always put them faced with some degree of risks. The global financial crisis and the Basel 11 Accords are good examples of changes that have taken place within the last years and have affected the banking industry. Within the last few years the global financial crisis has affected the global economy and put it in a deep downturn, thus affecting the real and financial sectors, both in advanced, emerging and developing countries. (Gamo et al, 2009, p. vii).

This global financial crisis caused the collapse of some financial institutions, some of them bought out and even financial distress with the consequence being bankruptcy and closure of some banks. Inflation, high and volatile interest rates, recession, spate of banking problems and collapse worldwide has been amongst the pressure that has increased the risk in the banking environment and also, traditional bank management practices have shown to be inadequate by themselves in this demanding, unstable, challengeable, uncertain and hostile operating environment (Garderner, 2007, p. 10).

Despite all the problems that banks might face, the major one which is very delicate and can have very negative consequences stem largely from loans that are not paid even after their due date (Shanmugan & Bourke, 1990, p.3). This is termed credit risk. Credit risk is seen as a very big problem because it results to increase debts since the bank will have to borrow more in order to meet up with its demands especially from its customers who may come for cash withdrawals. This also leads to higher interest payments, reduced borrowing capacity, reduced profits since less customers will borrow, increased equity, reduced shareholders value, reduced future capital investments, limiting the bank’s long term business performance, or an increase in the length (thus amount) of trade credit taken from suppliers. (Maness & Zietlow, 2005, p. 206).

Giving credits to customers is a very profitable activity of the bank since when it does, the customer pays interest on the amount borrowed. But this profitable activity also has consequences or problems which may arise as a result of delayance or default in loan repayments which can be so extended and interconnected. This means, for a bank to be successful and profitable, she has to develop a very good strategy on how to get back the money she is lending out to the customer. This activity or procedures is termed credit risk management. A very good Credit risk management has to be put in place before / after credit is granted to any customer in order to be sure that the customer will be able to pay back the money and also on time. The bank has to be very sure of the credit worthiness of the customer because if a customer borrows and is unable to pay, the bank will find itself in a deficiency coupled with its negative consequences. So, banks always try checking the prospective business partners’ creditworthiness with a rating agency or credit insurer which helps them to thwart risk of bad debt, maintain cash flows and collect late payments (Business credit, 2009, p. 41).
We all understand that when a bank receives money from depositors (lenders) and lend this money to borrowers as a business entity, it does so for compensation. This activity being one of the main functions of a bank comes along with strings attached. One of the strings is the risk involved in this activity; risk of credit granting (to know the exact credit worthiness of the customer) and credit collection (whether the customer will respect payment). If a depositor puts money in the bank and upon return for a withdrawal can’t have money but of which it has been borrowed out to another customer who has not respected payment or defaulted, this leads to problems.

A bank thus has to be very prudent when dealing with credit lending decision because it has to be sure that the customer will be capable of repaying the loan. She needs to have enough information about the customer demanding for credit before concluding their lending decision. This information in some cases can be easily gotten and in some others not. In some advanced economies, rating agencies, credit bureaus and securities market prospectus can be used to verify if the information given by borrowers about themselves is correct. But, in other countries where these means is unavailable it becomes a problem. Many researchers have tried to find out what information is needed or useful when making a lending decision.

Berry & Robertson, 2006, p. 175 say accounting information (revenue and losses) as a whole remain a very important source of information informing the bankers’. In their article, they carried out a research on the type of information which different bankers in the UK use for making lending decisions. In their work, they mentioned different researchers and their findings. Some of the researchers they mentioned say information from the cash flow statement (how their cash comes in and how it is used) is more important than the profit and loss account or balance sheet. Other analysts placed more importance on the actual financial statements than on narrative reports (private communication). Some talked of informal financial information, some talk of bank’s internal records (interview notes, bank account movements, etc) as being very important, some talk of audited accounts being the most important source of information, some talk of the director’s report (operating and financial review), some talk of interim reports (public companies), some talk of bank’s internal records of the company (credit scoring), personal interviews, ratios and financial indicators (liquidity, financial stability, profitability, security, consistency of trends, etc), use of information from external agencies, the non financial components of the financial statements, use of professional advisers, etc. Berry and Robertson concluded that published accounts remain the most important source of information even though some researchers still disagree.

In another article by Fletcher Margaret, 1995, she looks at the different criteria taken by different Scottish bank managers before making lending decisions and their inappropriateness. After her work, she found out that under the Small Firms Loan Guarantee Scheme in Scotland, inadequacies of banks’ appraisal processes in applications for loans were highlighted as problem because a large number of applicant firms were not required to supply even the basic information about them. There was limited technical expertise amongst the bank managers to analyze propositions. There was lack of strategic analysis of the applicant firm in relation to market conditions and competitors’ behavior, and thus, a call for an improvement in the bank appraisal methods.
To address this problem, she proposed that improved risk assessment and greater uniformity of the bank managers’ decision making can help to reduce adverse selection problems and resultant liquidity constraints which are faced by entrepreneur and new small businesses. What she meant is that the bank managers must always carefully examine the diverse factors that can bring about credit risk and also make sure that enough precautions are implemented in order to prevent harm coming or problems arising. A good risk assessment procedure will help to dispense with the above mentioned cause and make the banking business safer, successful and more profitable. She said information asymmetry can be overcome by good sectoral analysis information, supplemented by training. Training of the personnel (technical expertise) to understand the problems peculiar to small firms’ ownership and management and in interpersonal skills like communication and negotiation skills may go some way to help and overcome negativities and problems in the banking /small firms relationship. The final suggestion she made was the importance of bankers/accountants’ relationship being an important criterion in the lending decision in some cases. This is to say, if the bankers could work hand in hand with the accountants of the companies in question, it will help the banks to have the best information needed or required for making their lending decisions.

When companies generate financial data, it is not only for the investors or the shareholders use to know how the business is functioning. Other interested stakeholders like, employees, customers, suppliers, government, etc also need this data to determine the functionality and health of the company (profitability, growth and future plans) (Quint, 2010, p. 19). Amongst these stakeholders banks are also included because the financial data is also very important and necessary for them to have a better knowledge of any company in question before taking its lending decisions. This is because from this data, the bank can know the financial capability or the reliability of the company before deciding whether to grant it loans or not. So, it is very important that before a bank will decide to give credits to a company, it has to be sure of the credit worthiness of the company in question. John Roberts the managing Director of New Zealand and International of Veda Advantage once said,

“Whether it is to ensure repayment on credit or complying with the new anti-money laundering law, now is the time for businesses to improve their knowledge of customers”

How is the bank going to know that she will be able to have the money she is lending to a company? Is it by using their published accounts as Berry and Robertson concluded, or, the different sources (as mentioned by the other researchers), or are they used in combination? Are there other sources different from these ones? If yes, then what about information that is known only to the company which has not been disclosed to the banks called asymmetric information? All the above conclusions have been based on the findings of different researchers after their work but, I can’t just buy the idea of any of them without finding out for myself. That is why I decided to carry out this study before I can have a stand point. During my research, I came to realize that no matter what information is available about a company, the user groups have different ways of rating the importance and use of this information (Berry & Robertson, 2006, p. 177).

Looking at the negative consequences which may befall the bank if they do not carry out a good credit risk management, it is thus the most important responsibility of the bank to do so. The credit analyst even though may have lots of data, complex policy guidelines and folders
full of history, when it comes to making lending decisions, they have to make ones that put the bank in the best position. To accomplish this, they also need a good education of credit risk management. Credit risk management is not an activity that has to be introduced at a certain stage of the lending decision but should be at the start point in any lending decision process.

Sweden like any other economy around the globe has a banking system which has evolved through stages with the passage of time and has undergone and is still facing problems especially as a consequence of the dynamic environment in which they operate. The world’s oldest existing Central bank, Sweden’s Riksbank, opened its doors in 1668. Like other central banks, it evolved in its assigned tasks, its relationship to the state, its interaction with the FM participants and interaction in decision making process. For the past two decades because of the widespread inflation, many changes in its practices took place (Crowe & Meade, 2007, p. 69) and it is only recently that Finance evolved to include the general public. From the 1850s to the 1870s, many institutional and organizational changes spurred a rapidly increasing financial deepening that took off in the late 1860s (Ögren, 2010).

The changing number of banks in Sweden has been accompanied by a change in the number of companies too. These companies or entrepreneurs have some options on how to raise money to finance their businesses. These options include;

- The shareholders
- Internally generated profits
- Reserves
- External debt financing (banks and other financial institutions).

In this work, I will look at the type of information that external debt financing institutions in Sweden (Handelsbanken, Swed and SEB) use when making lending decisions to companies and the risk that is involved. Before giving out credits, these banks usually first consider whether the borrower is a public, private, medium, small or micro firm or company. This is very important because they must be sure to re-establish their liquidity, preserve their financial stability and regain investors’ confidence (Câmara, 2009, p. 8). Trying to know under which of the foregoing groups a company falls is just one point but the most important is their information availability for easy lending decision taking. This will act as a guarantee for the competence of the loan granting and repayment. If from the information, a bank sees that a company has not got a good financial strength or stand, this may restrict them on the amount of credit to be granted. The collateral security that the company possesses also acts as a very big determining force implying that the greater the financial strength and collateral availability, the greater the loan granting possibility.
From the above discussion and looking at Umeå as a city, it is made up of mostly small and medium sized companies. So, my findings will be based on the credit risk management practices that banks in this area put in place before lending to this group of companies. Lending to these groups can be very risky compared to lending to large companies because their financial strength as well as collateral security is limited.

Amongst the many factors that can lead to bank problems, poor credit risk management has always been pointed out by different writers as being the cause of bank problems and failures. This is basically because since banks make their profits from interest gotten after lending money to customer, a poor credit risk management during the lending process will also have negative results on the bank at the end and vice versa. “Directors should be aware that, as accountants already know, non-payment is one of the most critical risks a company faces and all practical steps should be taken to mitigate this risk” (Roberts, John, 2010, p. 32). The effects of different risks types on banks are negative but, credit risk has been pinpointed or identified as the key risk in terms of its influences on bank performance (Sinkey, 1992, p. 279). This is because if granted loans are defaulted, it goes along to affect the liquidity, solvency and profitability of the bank. A failure to reconcile these three, leads to bank failure and even bankruptcy. This failure can also have a chain effect to influence payment systems and thus affect the whole economy in the long run. Despite the consequences of credit risk, it cannot be avoided because it is associated with the core activities of the bank. Banks like any other business entity makes their profits through loan granting so, a collapse is assured with the least mistake in the course of the process. The root cause of this problem has always been poor and unreliable information that lenders get from borrowers even though other factors including poor risk management can be associated.

What is very interesting and puzzling is that, the main activity of the bank (credit granting) which gives profit is the same activity that carries a lot of risk (credit risk) and can even lead to bankruptcy. Despite the situation, the bank cannot avoid the risk since doing so puts the bank off business. How then do the different banks fight or manage credit risk? If they do manage this risk and think that their risk management is effective, why do they still face problems associated with credit risk? Is it that they don’t apply the appropriate measures or they apply them poorly? Does the problem arise from the customer or from the bank? After this study, an analysis of the interviews from the different banks’ interviewees will bring a conclusion which will either support, add or advice managers on some strategies which can be added to known ones to improve credit risk management.

1.2- Research question

In the course of my studies as a Finance student, I have understood that the banking industry is operating in a very dynamic and unstable environment with changes that affect the banks negatively or positively cropping up every day. These changes go along to affect and cause a lot of problems to the bank as it carries out its main activity of credit granting as the main source of external finance for growing companies. Despite all the technological evolution and researches, these banks still find it difficult to distinct between credit worthy customers and bad ones and are thus faced with credit risk as its main source of problem or failure. This
being because some of the customers default or delay payment. Is it because the bankers do not use the most appropriate source /type of information as mentioned by Berry and Robertson from findings in their work and that of other researchers or, it’s as a result of the inadequacies of banks’ appraisal processes in application for loans as highlighted by Fletcher Margaret? This study is unique in that it is out to find out which factors apart from the later still contribute to credit risk being banks main source of problem. This will be gotten only in the course of trying to answer the research question. The above problem background thus leads me to this question which the study will be based on answering.

➢ What is the role of credit risk management when carrying out lending decisions?

1.3- Purpose of the study

The purpose of this study is to understand the risks that bank managers in the Umeå region perceive they are exposed to in the process of credit lending as they try to maintain their place as participants in FMs and in the Swedish economy particularly and to also find out if the credit risk management procedures or techniques are same for the banks studied.

1.4- Demarcations / limitations of the study

Although there are many FIs in the world at large and Sweden in particular, my research work will be limited only to the Umeå branches of three of the four main banks of Sweden (SEB, SWED and HANDELSBANKEN) because it was first of all very stressful to have access to the persons I did interview and contact with other financial intermediaries yielded no results. Despite all ought, am happy with my results because having access to three of the four main banks give better results than if they were two or less. Limitations come from the language barrier given the fact that my working language is English but most people in Sweden prefer to speak Swedish. This too may act as a barrier in some way. The task in this work will be done through the use of interviews, internet and journals (if available). Therefore the results will depend mostly on the outcome of the interviews.

1.5 – Disposition:

Here, I will simply give a layout of what will be covered in the subsequent chapters that is, from chapter two to the end.

Chapter two will present the theoretical framework and literature review. That means the theoretical and conceptual context of the study. It will bring out the risk management concepts and helps to identify / bring understanding about existing ideas on the thesis topic. It will proceed to show how banks handle the scene of striving to strike a balance between
profitability, liquidity and capital adequacy with resultant consequences. Finally, it will present to my readers existing or prior studies/theories related to the area of study.

Chapter three is devoted to the presentation and discussion of the suitable research methodology used in order to perform this research and also describes how the data is collected. In this chapter, I will present and justify why the usage of the chosen strategy.

Chapter four presents the empirical findings of the study extracted from the information gotten from the interviews and will form the basis of analysis, discussion and conclusion for easy reading and understanding for the reader. It will also include a brief introduction of the interviewees and their positions held in the banks.

Chapter five presents the analytical part of the study in which the information from the interviewees is analyzed in relation to the previous literature thus to come out with some discussion, conclusions and recommendations.

Chapter six presents conclusions based on the findings from the empirical data and theories. It then ends with recommendations and conclusion on areas of future research.
CHAPTER TWO

THEORETICAL FRAMEWORK

This chapter is devoted to a good explanation of the theoretical framework / literature review and developed in a manner so as to give an insight and deep understanding of this work. It starts with a review of the risk management concept. The RM concepts or practices in general are then analyzed. It moves on with the theoretical literature to show that even though risk and value / returns are related banks still try to manage this in order to attain their goals. It helps to identify and bring out an explanation about existing ideas on the thesis topic and concepts which are relevant to see if they are consistent or have any implications on the research area. It also helps the reader to identify/gain an understanding about existing ideas about the subject, concepts and theories which are relevant and above all if there are any consistencies or implications on the research area.

2.1 – The concept of Risk management

Management in the simplest understood definition can be defined as the act of planning, directing, controlling, monitoring and testing for desired results to be obtained. Or it is simply the act, manner, or practice of managing; handling, supervision, or control (answers.com, 2010). Risk on the other hand can be defined as the possibility that something unpleasant or dangerous might happen (Macmillan Dictionary, 2002). When companies indulge in business, it is obvious that they will be exposed to one type of risk or another which in most cases is an uncertainty although at times it can be certain that it will occur. Banks are one of such businesses whose risk is very sure because they don’t function in isolation given the dynamic environment in which they operate, the volatility of the FMs in which they participate, diversification and the competitive environment in which they find themselves. (Williams et al., 2006, p. 69). Even though it is certain that risk will occur, it is not always possible in most cases to eliminate, reduce or ameliorate it (Keith, 1992, p. 16). So, the best possibility for companies is to try to manage the risk so as to reduce the possibility of occurrence or to reduce the consequences. These possibilities can range from “do nothing at all” to attempting to nullify the effect of every identified risk (William et al., 2006, p. 67). But, because of the nature of the banking activity, a bank can’t find itself in a position to do nothing at all or to nullify the risk. So, all she does is to live with it but look for means to manage it. Given the riskiness of her activities, a bank does not wait to introduce risk management at a certain stage of its activities but does so right from the start. This is so because her activities are so correlated in such a way that if not well handled, the effect / consequences can be connected and can even lead to bankruptcy. For this goal to be attained, decision makers need to first of all identify the risk involved, measure its intensity, assess it, monitor it and then look for measures on how to control it. This act of managing the risk is called RM. RM is “a course of action planned to reduce the risk of an event occurring and/or to minimize or contain the consequential effects should that event occur” (Keith, 1992, p. 14). This course of action linked, gives rise to a RM process which involved a number of stages. RM is very important and forms a main part of any organization’s activities because it’s main aim is to help all other management activities to reach the organization’s aims directly and efficiently since it is a
continuous process that depends directly on the changes of the internal and external environment of the organization. (Tchankova, 2002, p. 290).

**Figure 2: Risk management process**

| Identification | Measurement | Analysis or Assessment | Control | Monitor |

**Source:** Keith (1992) Pg. 15 / General Literature

Looking at the stage like process, it shows that before risk can be managed, it must be identified. Once the risk is identified, measures are taken to measure its intensity or to evaluate the outcome of the risk, an assessment of the consequences is being done, control measures are then put in place to avoid or reduce its intensity and after that good monitoring is being done to see whether the expected outcomes are as desired.

### 2.1.1- Risk Identification

RM cannot be implemented when first of all the risk has not been identified. This means if there is no risk identified, there is thus no need for risk management. This identification is done by using different techniques depending on the company in question to ascertain all forms of threats she can be faced with both present and future. So risk identification is the first stage of the RM process which develops the basis for the next stages. If success is not attained at this stage, then the risk will be non manageable. This means that the company will not account for the risk and will not take any action related to it and the consequences could be much unexpected. (Tchankova, 2002, p. 290-291). This way, risks related to gains and losses must be identified. The inability to identify the risks of one is as inappropriate as to identify the other. Risk identification thus involves a comprehensive analysis of all present and future risks in the business operations, asset management and support services (Keith, 1992, p. 15). During the process of risk identification, the bank is able to study its activities and the places where its resources are exposed to risk. This will help it especially when it has to carry out a future duty, in terms of developing and implementing new programs for risk control. Although all banks may be conscious of being faced with the same type of risks, the risk identification techniques for each of them can be different. It is always important for managers to identify all the possible risks they can be faced with because any neglected risk can have very negative consequences on the whole system.

Given the importance of risk identification in the risk management process, managers don’t have to focus their attention on what can be insured or mitigated but should start with the following questions as put forward by Tchankova, 2002, p. 291.
- How can the organizational resources be threatened?
- What adverse effect can prevent the organization from achieving its goals?
- What favorable possibility can be revealed?

Starting the identification at this point will give a good kick-off for implementation and no barriers to the type of risks that will be identified.

2.1.2- Risk Measurement.

Risk measurement comes in after the identification phase to give an understanding of the nature and level/extent of the risk so that it can be managed in an appropriate manner. This is because without risk measurement the intensity of effect or consequences which can result from the identified risk if neglected cannot really be analyzed. A good risk measurement will determine the risk management techniques that have to be put in place to manage the said risk. This will go along to bring out the extent and cost associated with the risk should it occur and the company in question then uses the known results to see how much value is at stake or cost is associated. A good risk measurement and understanding is thus vital for the bank so that it will not only settle on the risk considerably but will also improve on her performance drastically so as to improve safely and profitably. This will also help to determine how much effort has to be put in place or the degree of seriousness on how to manage the risk. For competitive and regulatory reasons, it is necessary for all banks to have a sound risk measurement framework. Risk measurement simply put, is the evaluation of the outcome of risk using a set of risk factors which can be observed and measured. A risk factor is something that is likely to increase the chances that a particular event will occur (www.google.com). To measure the different types of risks, different techniques ranging from traditional simple to sophisticated ones are being used. Some include, Value At Risk (VAR), duration analysis, sensitivity analysis, stress testing, and scenario analysis. Even though all banks may be faced with the same type of risk, each may use different risk measurement techniques depending on their individual choices.

2.1.3- Risk Analysis or Assessment

The risk assessment task is to understand what is at risk and what events could potentially cause harm or benefits. The risk is being assessed in terms of the severity of the impact, likelihood of occurring and controllability (Gray & Larson, 2006, p. 215). When this is done, it helps the bank to know the chances that the risk might occur, and if it occurs, the impact it can have on the bank and how they can possibly control it. Risk assessment is done by prioritizing the risk either by using risk analysis or risk evaluation (Williams et al., 2006, p.70). This risk analysis is based on the likelihood and consequences. Likelihood depends on
the probability that the risk will occur and how frequently it will take place. While, consequences on the other hand can be measured by looking at the effects on results or on the enablers of results (Williams et al., 2006, p.70). Knowing the frequency of occurrence of the risk and the effect it will have should it occur, gives the bank the base to know how important the risk is. Risk evaluation is then carried out when a good risk analysis has been undertaken. An evaluation is done against an appropriate risk-acceptance criterion to give a ranking (Williams et al., 2006, p.70). For example:

- Low (tolerable)
- Medium (low as reasonably practical)
- High (intolerable)

The above ranking then determines the decision or stand point of the bank but what should be noted it that a decision depends on each bank independently.

2.1.4- Risk Control

Risk control involves using physical measures, techniques, tools and /or training staff to avoid, reduce, prevent or eliminate the perceived threat / its financial consequences and other undesirable results of risks (Keith, 1992, p. 15). Naturally, risk cannot be avoided or eliminated so the only option is to control it. Banks like other organizations have different ways of approaching risks and the amount of risks each is ready to accept differs. Some will decide either to prevent the risk or to allow it happen and then start looking for measures to tackle it, while others will decide whether to transfer or insure it.

There may also be a wide gap between the level of control possible and the level of control practiced. Risk tolerance is another domain in which banks may vary; some may be risk averse while others will be prepared to run calculated risks. This means the amount of risk that one bank may accept to tolerate differs from that of another bank. So, it is very important that all the aforementioned points be considered when assessing risk control (Keith, 1992, p. 17).

2.1.5- Risk Monitoring

A plan is always made for the activities that are used to manage risk. To be sure that the activities attain the desired goal of the business, monitoring is very important so that the results gotten are in line with the set down goals. If it is noticed that the results are going contrary, readjustment should be done immediately. Risk monitoring is very important and it goes hand in hand with risk control. Risks in banks need to be monitored just like any project in progress. The risk manager needs to constantly do assessment and make updates where there is need so as to be sure to handle any unforeseen risks at the right time before it is too
late (Gray & Larson, 2006, p. 225). This is because any neglected or minimized risk can have very long term big and negative consequences since the banking activities are so interrelated.

2.2- Credit Risk and Value / returns

The risk management process is important to be followed in the management of credit risk because it is an unavoidable risk of the bank based on its activities. The management of this risk is an activity which is indispensable for a bank if really it wants to meet up with competition, create value for itself and create value for the shareholders. Like any other business entity, the aim of any bank is mostly to make profits and thus create value. To attain this goal, they cannot escape from risk whose consequences can be a barrier to this goal attainment. Credit risk is the most important of these risks because it comes about as a result of failure of the borrowers to pay their debts or delayance to meet up with their obligations in time. Credit risk has been pointed out or identified as the key risk in terms of its influences on bank performance (Sinkey, 1992, p. 279). When this risk arises, it leads to less capital adequacy because the bank will look for other sources of finance to cover up the loss. It will also lead to less liquidity to meet up with other customers demand and thus less profitability because of a slowdown in business or even bankruptcy. This goes to show that credit risk and returns are so intertwined so, the more credit risk, the less returns and vice versa. But there is also a tradeoff between the two. Riskier securities (higher yield loans) pay a risk premium (higher average return) because there is a greater uncertainty of payment (Kohn, 1994, p. 186). So, average revenue and thus value/returns can be increased only by increasing risk.

2.3 - Credit Risk Management in the banks

Although the effects of all risks types can cause negative consequences to the bank, credit risk has been pinpointed or identified as the key risk associated with negative consequences in terms of its influences on bank performance (Sinkey, 1992, p. 279). This means if credit risk is not well managed, it can lead to failure. Thus, for any bank to succeed, its CRM must be handled with a lot of seriousness. This is because should a loss occur, the bank will have to “extend its hands” to get funds from other means to meet up or cover the losses. A clear reason why a correct management of credit risk is very important is because banks have a limited capacity to absorb loan losses and this losses can be covered only by using income generated by other profitable loans or by bank capital (Boffey & Robson, 1995, p. 66). If the income is used from these two sources to meet up for a loan that has not been paid, this action will go a long way to affect the capital adequacy of the bank, its liquidity and even its profitability. Looking at the consequences or effects of credit risk, it is important that before a bank gives out a loan, it should try as much as possible to have a concrete view of the borrower. (Greuning & Bratanovic, 2003, p. 136) says “Because of the potentially dire effects of credit risk, it is important to perform a comprehensive evaluation of a bank’s capacity to assess, administer, supervise, enforce and recover loans, advances, guarantees, and other credit instruments”. The bank has to possess its capability of how to recover a loan from a customer while reviewing its credit risk management policies and practices as outlined by the board. This means that the credit risk management process has to be followed in order to ensure that granted loans can be recovered in time and if not, a good collateral can be got in
replacement of the loan. Each bank obviously has to develop its own strategies so as to fight competitors in the same industry by being successful. The bank has to assess the creditworthiness of the borrower and even after the loan is granted, interim monitoring is required until when the borrower has finished repaying the loan. This monitoring is very important because with the uncertainty in the future, any potential event that can cause a borrower to default payment can be fast identified or, a mechanism can be put in place on time to reduce the frequency and/or intensity of a loss should it occur. Early identification of borrowers at risk is good because it enables servicers to adequately staff collections departments, determine the most cost-effective type of customer outreach, and initiate repayment plans before a borrower’s financial situation worsens to the point at which foreclosure is unavoidable. (Focardi, 2009, p. 73)

2.3.1- Credit Risk Management Policy/ philosophy

Banks like any other firm or corporation have formal laid down policies and principles that have been put in places by the board of directors on how to manage credits and this have to be carefully implemented by management. This restricts supervisors or managers on how to take action. They must do so by looking at the policies laid down to know if they are doing the right thing at the right time. Maness & Zietlow, 2005, p. 139 specifies that a credit policy has four major components which include; credit standards, credit terms, credit limits and collection procedures.

- **Credit standards**- This is the profile of the minimally acceptable creditworthy customer

- **Credit terms**- This is the credit period stipulating how long from the invoice the customer has to pay, and the cash discount (if any).

- **Credit limit**- This is the dollar amount that cumulative credit purchases can reach for a customer if credit is extended.

- **Collection procedures**- These are detailed statements regarding when and how the company will carry out collection of past-due accounts.

Despite the rules, it does not mean that the credit policies are stereotyped. “A good lending policy is not overly restrictive, but allows for the presentation of loans to the board that officers believe are worthy of consideration but which do not fall within the parameters of written guidelines”. (Greuning & Bratanovic, 2003, p. 137). Since the future is uncertain, flexibility must be allowed for easy adaption to changing condition (maybe internal or environmental). For a sound CRM to be attained, after the risk in the lending activity has been identified, the bank’s credit risk management policies and the philosophies have to be used in order to control the credit risk (Greuning & Bratanovic, 2003, p. 151). This credit risk
management policies have to constantly change with the changing activities of the banking environment since these activities may come with changing risks too.

According to (Greuning & Bratanovic, 2003, p. 151), specific risk management measures include three kinds of policies:

- Policies aimed to limit or reduce credit risk (concentration and large exposures, adequate diversification, lending to connected parties, or over exposures)

- Policies of asset classification (mandate periodic evaluation of collectability of the portfolio of loans and other credit instruments, including any accrued and unpaid interest, which exposes a bank to credit risk).

- Policies of loss positioning (making of allowances at a level adequate to absorb anticipated loss).

2.3.2- Credit Risk management Practices

As banks have different credit risk management policies / philosophies, same do the risk management practices differ from one financial institution to another despite the fact that they can be open to the same risk types. The practices differ according to their previously laid down policies and philosophies. Some or all of the banks may decide to use hedging strategies or insurance to influence their profits and / or to avoid the costs of variations but, the way they put it in practice or their way of going about this will be different. Another difference can also be seen in the level of risk tolerance. Each and every bank has their individual level of risk that they can decide to let go based on how it is outlined in their risk management policy. To summarize this, it is clear that the same theory can exit for firms in the same industry, but, the implementation in practice differs. Practice is not consistent with theory. In most cases because of data limitation for most industries, it is difficult to describe which firms manage more risk than others or whether firms engage in dynamic risk management strategies and more importantly it cannot be reliably tested whether a firm’s risk management practices conform with existing theories (Tufano, 1996, p. 1097-1098).

2.3.3- Credit risk management strategies.

The Macmillan English Dictionary defines a strategy as a plan (method) for achieving something, or the skill of planning how to achieve something. A strategy thus simply means a way to go about an activity. This thus goes that as banks have different credit risk policies /philosophies and different management practices, their strategies to attain their desired goals in the same way may differ. The idea to go about a particular activity can exist to the knowledge of the bankers but the strategy of how to implement so that desired goals can be attained and / or to make a difference will be different for each bank or company. Given the competitive environment in which banks operate, it is always good to have a strategy position
of how to manage its credit risk that will make or show its difference from its competitors. A strategy positioning means performing different activities from rivals or performing similar activities in different ways - a company can outperform its rivals only if it can establish a difference that it can preserve by choosing to perform activities differently than rivals do (Porter, 1996, pg. 62). When a bank carries out its operational activities which are the same activities carried out by other banks, they should try to make a difference from their rivals by not only trying to be more efficient but by trying to make a difference. This can be done by performing different activities from the rivals or performing the same activities in a different way. For example: although specific risk management practices may differ among banks depending on the nature or complexities of their credit activities, a bank which will want to show a difference will use a comprehensive credit risk management strategy like the others by addressing area like; establishing appropriate credit risk environment, operating under a sound credit granting process, maintaining an appropriate credit administration, measurement and monitoring process and, ensuring adequate controls over credit. But, will go ahead to apply these practices in conjunction with sound practices related to the assessment of assets quality, adequacy of provision and reserves and the disclosure of credit risk. (Basel Consultative paper, 1999, p. 4).

2.3.4 - Credit culture

A bank as an entity can be likened to a community and thus has its own culture which acts as a mirror on how it carries out its own activities. Actions or behaviors out of this culture will be going against the roles or norms of the bank. A bank’s credit culture is the policies, practices, philosophy and management style that are being put in place to act as a guide for the lending manager or personnel to carry out their credit management function. This spells out the lending environment and points out the lending behavior that is acceptable to the bank. In a study made by Mckinley, (1990, cited in Boffey & Robson, 1995, p. 67), Credit culture is defined as “a combination of factors that establish a lending environment that encourages certain lending behavior. It should include such things as management’s communication of values and priorities, the indoctrination of lenders during training, and the bank’s lending philosophy and policy.” Credit culture is thus good because it acts as a guideline for a good bank credit management, performance and maybe failure. Even if there is a wrong move in the credit risk management resulting to losses, the manager personally cannot be blamed if the decisions were taken based on its credit culture. The blame will go to the entire management or decision makers and adjustments can then be made.

2.3.5 - Credit Risk Management Process

The same way that banks have different credit culture, they also have different credit risk management processes. Credit risk management process is a set of outlined activities aimed at managing credit risk. These activities are just like the ones outlined above for the risk management process and will cover the range from credit granting to credit collection. They are risk identification, measurement, assessment, control and monitor. The first step is to identify the risk involved in the credit process. After identification, the risk is measured by evaluating the consequence if it is not well managed. After the evaluation phase, the risk is
then assessed to know the impact, the likelihood of occurrence, and the possibility for it to be controlled. The control and monitoring phase then comes in. These phases are not distinct like the other three. In the control phase, measures which can be used to avoid, reduce, prevent or eliminate the risk are put in place. The monitoring phase is used to make a constant check so that all processes or activities which have been put in place for the risk management process are well implemented for desired results to be gotten and in case of any distortions, corrections are then made. All this is done because credit risk is a very important and delicate risk that banks face and needs to be managed with great care / precaution because its consequences are always very detrimental to the bank. Despite the changes in the financial service sector, credit risk remains the major single cause of bank failure (Greuning & Bratanovic, 2003, p.135).

2.4 – Credit Risk’s effect on Profitability, liquidity and capital adequacy (solvency)

When banks desire to follow good credit risk management policies, practices, strategies or processes, it is all because they long or wish to make profits or create value. Profitability is the ability of a business entity to generate positive net income when cost is subtracted from revenue. For a bank to be profitable, liquidity and capital adequacy or solvency are essential. Liquidity is “the availability of cash or the capacity to obtain it on demand, or the quality of being readily converted to cash”. Solvency shows the company’s after tax income and how likely it will continue to meet up with its debt obligations. (answers.com 2010/03/23).

A bank like any other enterprise has as one of its most important objective, profits or value creation. For this to be attained, she must always strive to strike a balance between profitability, liquidity and solvency (Gardener, 2007, p. 10). This is because the three are interrelated. The lack of good management of one probably affects the others and thus the bank’s value. Sustainable profitability is vital in maintaining the stability of the banking system. Even if solvency is high, poor profitability will in the long run weaken the capacity of a bank to absorb negative shocks and will eventually affect solvency again (Herrero, Gavila & Santabarbara, 2009, p. 2081). A bank receives savings from depositor (who are like lenders) and make it available to borrower in the form of loans. But, like any other FI, she determines among other factors, the efficient allocation of savings as well as the return of savings and investments (Herrero et al. 2009, p. 2080). This is strictly the banking business and for it to be profitable the bank must always have liquid cash (reserves) to meet up with the cash demands of the customers and also to meet up with unpaid loans in case of default payments. So, good functioning of the bank revolves around these three elements which if poorly managed, the deficit of one goes along to affect the others and thus the bank value.

Problems:

When a bank fails to put in place a good credit risk management, she will find herself faced with a lot of problems and negative consequences associated to them. There may be many interrelated problems but the most basic ones which are so obvious and interrelated revolve around trying to be profitable, at the same time trying to be solvent and trying to be liquid:
- **Losses or no profitability:** Profitability is the proof of an effective and well managed business. In this case, it is an indicator of the bank’s capacity to carry risk and / or to increase its capital by revealing indicator of its competitiveness in the banking markets and the quality of its management. The bank as a FI is into business like any other firm with the purpose of making a profit. For this to be attained, losses have to be minimized. Advising on losses suffered by banks is that the same basic causes tend to occur time and again so, it therefore makes sense that before reviewing office procedures, the causes of the different losses which have been incurred both within the bank and by competitors conducting similar business should be looked into (Richard & Simon, 2001, p. 17). The bank has to be sure about the capability of repayment of the borrower before granting any loans.

- **Capital inadequacy (insolvency):** Capital adequacy means the financial capability of the bank to meet up with its financial obligations or uncertainties that may arise and thus will reduce the risk that it may face to some extent. “An acceptable capital adequacy position is equivalent to saying that a bank is not over exposed to risks” (Garderner, 2007, p. 10)). This is because its primary role or main function is to absorb unexpected and exceptional losses that it might experience especially in situations of uncertainty. “The more capital a bank has, the more are its creditors or the government insurance agency protected, and the greater is the capital loss that can be sustained without resulting in bankruptcy”. (Shah, 1996, p. 279). This way, if by giving out credit, the bank does not carry out a good risk management, and the borrower fails to fulfill his or her payments, this will lead to a shortage in capital (given uncertainty) and increase in the risk because operationally speaking, the capital of a bank acts as an internal insurance fund against uncertainty. (Garderner, 2007, p. 10).

- **Lack of liquidity:** A more liquid bank will be more able to meet up with financial demands from its customers and thus create more value. “Bank liquidity creation is positively correlated with bank value” (Berger & Bouwman, 2009, p. 3779). Banks as FI have as main service, the creation of liquidity, but, this good can be destroyed by the behavior of individual financial institutions (Gaffney, 2009, p. 983). This being because when the monetization of the various types of collaterals (such as land or capital) turns over slowly, the bank’s liquidity is lost. A loss in liquidity shows that they cannot meet up with demand if customers turn up and thus crisis can develop (Gaffney, 2009, p. 984).

    Given the foregoing problems amongst others which banks can encounter if they don’t manage their credit risk well, the managers should see into it that while carrying out their operational function of risk assumption, a judicious balance between profitability, liquidity and capital adequacy must be stroked.

    In the past decades, rapid innovations in FMs and the internationalization of financial flow have changed the face of banking almost beyond recognition (Greuning & Bratanovic, 2003, p 1). They have evolved greatly over a long time stemming from the late 1980s, from the traditional banking business to an increase in capital adequacy requirement (Greuning and Bratanovic, 2003, p. 2), undergoing constant innovation today to improve liquidity and to meet up with their set goals or objectives.
In financial terms financial markets are used to match those who want capital to those who have it. So, they facilitate;

- The raising of capital (in the capital markets)
- The transfer of risk (in the derivatives markets)
- International trade (in the currency markets)

Typically, a borrower issues a receipt to the lender promising to pay back the capital. These receipts are securities which may be freely bought or sold. In return for lending money to the borrower, the lender will expect some compensation in the form of interest or dividends.

In the course of their operations, banks are subject to a wide array of risks which fall into four categories; financial, operational, business and event risks. The financial risk in turn comprises two types of risks; pure risks (liquidity, credit and solvency risks) - which can result to a loss if not probably managed and speculative risk (interest rate, currency and market price risks) – which can result to a profit if the financial arbitrage is correct and vice versa. (Greuning & Bratanovic, 2003, p. 3). Banks find themselves with major opportunities in the changing environment, but, these opportunities also entail complex and different risks that challenge traditional approaches to their management. Banks thus need good management techniques or capabilities in order to survive in this market oriented environment, withstand competition (both from local and foreign banks) and also support private sector-led economic growth (Greuning & Bratanovic, 2003, p. 1&2).

2.5- Credit risk and financial distress

One of the bank’s main reasons of fighting for a good credit risk management is to avoid financial distress. The financial viability of a bank is very important for its success. Managers are more and more being obliged to meet up with the financial obligations and expectations, manage risks and increase shareholders value. This is very important because given the function carried out by banks of being an intermediary between lenders and borrowers, a lack or shortage in liquidity can lead to adverse effects on it not being able to meet up with the demand of its customers. This can lead to an effect called financial distress. Financial distress is when the obligations to creditors are not met or are met with difficulty (Arnold, 2008, p. 812). Financial distress arises when a bank starts experiencing financial problems that may force it to close, merge with another bank, declare bankruptcy, eliminate services, or take actions that have adverse effects on the financial service delivery system of a region (Trussel & Patrick, 2009, p. 31). Financial distress is very detrimental to a bank and may have some negative consequences because the margin between cash flows and debt servicing has been narrowed (Ogden, Jen & O‘Connor, 2002, p. 587) According to Arnold, 2008, p. 813, some of these consequences include;
- Loss of confidence especially if the customers suspect that there can be a bankruptcy in the near future. Customers often need assurance that the bank can be sufficiently stable to deliver on promise.

- Loss in shareholders’ value.

- Demotivation of employees in a struggling firm as they sense increased job insecurity and few prospects of advancement.

- Movement of best staff to posts in safer companies

- Companies are forced to sell off their profitable operations in an attempt to raise cash

- The cost of paying for lawyers fees, accountants’ fees, court fees and management time increases.

Credit risk managers are then called upon to act appropriately by following the company’s policies when granting and recovering loans. If they default in their duties, it can also lead to a default in loan repayment or recovering. This will lead to capital inadequacy to meet up with the demands of customers (creditors) and thus lead to other negative consequences.

2.6- Credit Scoring

A credit granting process comes in place when a company which needs a loan from a bank or lending institution hands in an application demanding for a loan. This application then goes through some procedures or processing in the bank which evaluates the application using their individual evaluation method to determine the credit worthiness of the company. Some banks does the evaluation using numbers (credit scoring) while others does so using subjective evaluation like personal ID of the company or the owner. Credit scoring is a statistical technology that quantifies the credit risk posed by a prospective or current borrower and seeks to rank them so that those with poorer scores are expected to perform worse on their credit obligations than those with better scores (Aveny, Brevoort & Canner, 2009, p. 516). Credit scoring has an advantage in that it saves time, cost and believe to increase access to credit, promote competition and improve market efficiency. Credit scoring reduces subjective judgment and possible biases during the credit assessment process (Kraft, 2002, p. 6). This is to say no matter when or who is doing the evaluation, the result is always same because it is computerized. This shows that if a good credit scoring is taken by a bank before granting loans to customers, it can determine the ability of the customers to pay back the loans although in some cases it may not really be a guarantee since the future is uncertain. The way things or situations can be seen today may change tomorrow and obviously affect already taken decisions.
2.7- The “five C’s” of Credit

Each bank has its analytical tools which it uses to minimize losses of money when giving out loans to customers. The bank always find itself in a situation where they can give a loan to a customer who will not be able to pay back or refuses to give to a customer who is good and has the potentials of meeting up with the repayment. To go about a good analysis of potential customers, the five C’s of credit have been introduced as a guide for bankers of what criteria to use. This includes the gathering of both quantitative and qualitative information to assist the bankers in their screening process of bad and potential creditors. This information is gotten using the five Cs of credit as the standards tools. The five Cs include; character, capacity, capital, conditions and collateral (Dev, 2009, p. 34). The character of a company refers to the distinct capabilities about the company which the lenders see that inspires them with confidence that the loan will be repaid. This includes things like the business plan, cash flow, history, management, etc. The capacity of the company incorporates words like sufficiency, adequacy and perseverance. This means what the company as a customer has as assets and the value of those assets which shows that it can be able to repay its loans. Capital of the company means how much adequate funds she has to make her business operate efficiently in generating cash flow and efficiently within its competitive business environment. The condition of the company describes the economic and environmental influences on the company’s financial condition and performance. Lastly, collateral refers to what the company is able to present to the lender which serves as the final source of repayment and protection against loan loss. The figure below shows a diagrammatic presentation of the loan knowledge structure involving the five C’s.
Figure 3: Model of the five C’s

Loans officers receive information

Information is evaluated in four categories

Relationship among the categories are considered forming integrated structures

Accounting
Capacity & capital

Character

Condition

Collateral

Recall of decision- consistent information is affected by long term
memory traces formed by these structures

Source: Beaulieu, 1996, p. 517; Loan Knowledge Structure

The Loan knowledge structure model as put forward by Beaulieu in the diagram above is to show how the bank incorporates the “five C’s (character, capacity, capital, conditions and collateral) in their loan granting process of screening bad from potential creditors. When the loan officers receive the information (quantitative and qualitative) about the customer, they do their analysis not in isolation of each element but in relationship amongst the categories with
the customers character being the centre because it is the character that shows them the distinct capabilities about the customer whether they can pay the loan back or not. This is because a customer could as well show a good capacity, have enough capital, have a good economic / environmental influences on its financial condition and performance and have a good collateral but, if it has a bad character, it will not still act as an inspiration for the bank to grant the loan. On the other hand, if the character (business plan, cash flow, history, management, etc) showed by the customer in question is good, it will go ahead to assure them of the customer’s repayment capability more. This will thus help the bank whether to grant the loan or not or it will determine the credit limit. This is because a customer’s character shows how their previous loan transactions were handled. If after the decision has been taken, whatever may arise in the future, the bank will always recall the decisions taken in the past given the structure they used for their analysis to see if they took the right decision or not.

2.8- Credit granting

When a customer demands for a credit, the bank can’t just grant the loan because the demand has been made. The bank does so while looking at its policies on credit granting. This is important because the bank has to know the credit worthiness of the customer and its capability of repaying the loan. A credit granting decision is a very important and delicate issue to be handled by the bank. This is because banks need to examine and measure any activity which affects their risk profile and must closely monitor accompanying conditions. Loans are the main areas where banks make profits but are also the biggest area of risk. Thus for the bank to effectively carry out its risk management, it is always good to evaluate the credit profile of the transaction in question. This is to say the bank has to look at the purpose of the loan, how it is to be repaid, the repayment history of the borrower of previous loans, its capacity and even the collateral in order to be sure that it is equivalent to cover the loan in a case of default.

Given the importance and implications of credit granting decisions, many research papers have been written based on it because a mistake in it can be very disastrous to the bank. The written works have almost the same elements that have to be considered before granting a loan to a customer. This is because when good decisions are taken, it is as if the loan is almost paid. For example, Maness & Zietlow, 2005, p. 165 said any decision on whether to grant a loan and how much credit to give is taken based on four steps; developing credit standards, gathering necessary information about the customer, applying credit standards, and setting limits. Developing credit standards refers to the minimum standards a customer has to fulfill before he or she can be extended credits. These standards should be set while looking at the customers character (i.e. morals, integrity, trustworthiness and management quality, capital, capacity (i.e. its ability to repay debts when due), conditions (the general economy, the borrower’s environment and the reasons for the loan request), and collateral (the asset which is given as a security to back up the loan).

Gathering necessary information about the borrower is done so as to help the bank to evaluate the possibilities of the borrower repaying the loan or its credit worthiness.
Applying credits standards is done after the necessary information has been gathered. From the information, it is analyzed if the customer has to be granted the loan. If so, how much is to be granted.

In setting the limits of how a borrower can be approved of the loan, the bank can use credit scoring to choose those to whom the loan can be granted. This is done because it is often difficult for the bank as a lender to observe borrowers probability of default. Credit scoring is a model used by lending institutions to rank potential customers according to their default risk which can improve the allocation of resources from a better to a best position (Jacobson & Roszbach, 2003, p. 616).

Thus, it is important that each bank has a procedure or guideline on how to make its credit decision. An example is shown in the diagram below which illustrates how one corporation actually makes its credit decisions.

**Figure 4: Corporate credit analysis**

![Diagram of corporate credit analysis]

Source: Maness & Zietlow, 2005, p. 160

Explanation

When the bank has gathered necessary information about the borrower, the decision must be made whether a loan should be granted or not. If yes, how much? The borrower’s risk classification is determined based on financial analysis and trade experience. The credit limit is set based on information on its previous purchasing patterns. When each new order is received the decision for approval is looked into based on its risk classification and credit limit. Based on the results if approved, the order is automatically filled and if not approved,
there is a manual override possibility to allow an exception to be made or not (Maness & Zietlow, 2005, p. 160).

2.9 – Asymmetric Information

Although it is known that the bank has to have information about the borrower before taking its credit granting decisions, there is no guarantee that the borrower will give all the information about itself. Some, borrowers may have some vital information which could have helped the bank when taking the credit granting decisions but refused to give them because they think that it will act as a barrier of the loan being granted to them or may reduce their credit limit. This type of information which is known only to the borrower and hidden from the bank about a customer it has already financed is called asymmetric information (Shibata & Tian, 2010, p.412-426). The theory of asymmetric information is a new development in the Economics of uncertainty brought forward by Kenneth Arrow, Gerard Debreu and many others in the first decades of the postwar period (Sandmo, 1999, p. 165). Their emphasis was on exogenous uncertainty, the sources of which were found outside the economic system itself. They talked of uncertainty in the case where individuals had different types of information, with the typical situation being that they had private information about their own characteristics that was not directly available to other people, like those responsible for the design of public policies. To make this clearer, they used two examples. Firstly, they talked of a situation between an employer and his or her employees, where the employees have information about their own preferences and skills that are not observable by the employer. Another example is where buyers and sellers have different information about the good to be traded. The provider of a good for example a public good, will always like to have information about the willingness to pay of the consumers who will benefit from it, but of which the consumers are the ones who possess this information for themselves.

FIs (in this case banks), can also face this problem because of the positive role they play of channeling funds from savers to borrowers. Lack of enough information about these people (especially the borrowers) can be very detrimental. Asymmetric information between the bank and borrower exist when either the borrower or the bank has better information about the financial circumstance and prospects of a project or firm than their counterpart (Bruns, 2004, p. 33). If the bank fails to have enough information about a borrower’s potentials to repay the loan, and goes ahead to grant loans (without a good collateral security), it will lead to problems on the banks which can even go as far as affecting the savers should they turn up for cash withdrawals or even bankruptcy.

It should be noted that information asymmetry does not only imply when a borrower refuses to give information about itself to the bank. It also refers to a case where the bank can hide certain information about itself or its management forecast from the borrower just because they want the deal to be favorable but to them. Information problems can also arise from information differences and conflicting incentives between the banks, the savers and borrowers (Healy & Palepu, 2001, p. 2-3). So, for good credit risk management to take place, it is always good for both parties to have adequate information about each other.
2.10 - Credit collection

There is no guarantee that when a bank has a good credit policy, its credit activity cannot encounter problem. There are probably some borrowers who will pass the due date and some may be delinquent. Credit collection procedures have to be implemented on how to collect the loans. It will become a problem if the credit collection procedures were not well formulated, or if the implementation is not well carried out, or if the credit policy was not well followed. This is because if the borrower repays late or defaults payment, the bank will obviously look for other means to meet up with this financial loophole. This can result to increased debts, which can lead to higher interest payments, reduced profits, reduced borrowing capacity, increased equity, reduced shareholders value, reduced future capital investments, limiting the bank’s long term business performance, or an increase in the length (thus amount) of trade credit taken from suppliers. (Maness & Zietlow, 2005, p. 206). So, it is a very important duty of the bank to accelerate it loan collection so as to avoid the above mentioned consequences.

Even though the bank has to collect it loans, while collecting or using efforts to collect them, it has to make sure that it collects the amount owed as close to the credit terms as possible but must always try to preserve customers’ goodwill when doing so (Maness & Zietlow, 2005, p. 213). This is because some customers may fail to pay back their loans as a result of the fact that they may be experiencing temporary problems. If the bank’s personal efforts to collect these loans fail, they can then introduce a collection agency.

2.11- Bank and Customer relationship

The relationship between a bank and its customers is very vital for its success. This is because it is very similar to a parent and child relationship. When a parent has a cordial relationship with the child, it is always very possible to know in advance from the child’s behavior (without he or she telling them) that something is not moving on well with them. This is always done because the parent has developed a dialoguing attitude with the child making him or her to always feel free to inform them of any problem and will give them advice on how to handle certain issues in life even before they encounter them.

Building a good customer relationship with the borrower is also good for the bank because this will help the borrower to develop loyalty and trust and they will know that if they present the bank with a difficulty, they are not going to get a blank stare. It will also help the borrower to bring to the notice of the bank in advance of any problem they might be facing thus giving the bank greater chances and possibility of handling the problem in advance. In the case of a good relationship, the bank can also give the customer advice on how to handle a problem in advance before it dawns on them. This will go a long way to profit the bank because the customer will be able to pay back their credits in time. When the bank also has a good relationship with the customer, it will be possible to call them at any point in time to ask how their business is moving. This can lead to better advice in time before things go off hand. But if the relationship is not good, it will lead to totally negative consequences from the ones mentioned above and even in a situation of difficulty the bank will only come to realize when the customer is not able to pay back the credits or bankrupt and this will go a long way to affect the bank negatively as well. Empirical works like that of (Dahiya, Saunders & Srinivasan, 2003, p. 376) says banks are likely to be better informed about the financial status
of their borrowers and thus will be able to take steps to reduce their loan exposures before the news of a borrower’s distress becomes public information if they had maintained a good relationship.

2.12 Summary of theoretical framework

The theoretical framework has been basically to bring out theoretical concepts connected to my topic which will be used in conjunction with my empirical findings from my interviews in order to give me a good analysis, discussion and conclusion. It has been an elaborated work on the steps and activities that have to be followed if good results of credit management have to be obtained. This is from the inception of the risk when an analysis has to be done before deciding whether to give credit to a customer, through when the credit is given and to when it is collected. It might be difficult to bring out a model which incorporates all the concepts but if the theory is well understood and put into practice, good or better results of risk management can be attained. It should be noted that the concepts are not standard but change with the different banks and also influenced by the dynamic environment in which they operate.

Summarily, when a customer (company in this case) demands for credit, the bank can’t just go into granting the loan without first of all verifying if it is credit worthy or not. The bank goes through the process by using the criteria of the five C’s or credit scoring. If it finally arrives at a decision to grant the loan, it’s no guarantee that the company will repay the money as predicted because the bank is operating in a very dynamic and unstable environment. This means that the banks has to have three options in mind: either the loan is repaid, there is a delayed payment or default. If it is repaid in time, then fine but if otherwise problems start arising especially to meet up with the demand of its customers / other financial obligations or even financial distress. This means risk management has to start from day one. If any risk is identified, continuation of the management process continuous. It should be noted that monitoring takes place at all times to be sure the results are always as intended. This management is being done while following the policies, philosophy, practices, strategies and the credit culture of the bank. The bank is doing all this because its profitability, liquidity and solvency have to be guaranteed. Despite all these efforts by the banks, there are still failures at times or problems which can be attributed to different factors including information asymmetry (vital information which the customer hides from the bank).
CHAPTER THREE

METHODOLOGY

This chapter is devoted to the presentation and discussion of the suitable research method used to achieve the purpose of this research. It starts by giving reasons why this subject choice. So, after going through this chapter any reader will understand why the choice of the methodological approach I used. It contains the perspective and preconceptions, and goes on to give the different approaches used for making a scientific research identifying and expaunciating on the approaches which are relevant. Credibility is included but excluding reliability and validity (which are not really truth criteria in a qualitative study). The chapter draws the curtain on the data collection methods.

3.1 – Choice of subject

The motivation to write on credit risk management came basically from the knowledge acquired from my previous courses particularly investments and cash and risk management. During lectures on the risk management course, I was so interested and kept it in mind that I was going to write my thesis on credit risk management. When it was time for me to start my thesis, I started reading articles on this topic and the article: “The Perils of Risk – Risk Management: Where Banks Fail” Richard Dedman & Simon Robert – Tissot, 2001), gave me a focus – banks. Knowing the important role banks play in all economies globally, I was so interested to know the main cause of their failure and how the management has been tackling this issue for the banks to continue functioning. I then discussed this out with my supervisor and my topic was developed.

I saw this topic to be very interesting, relevant and challenging because the banking industry is growing everyday and so are its activities. But, this growth is taking place in an uncertain environment thus making it to be accompanied by risks which if not well managed can act as a setback. Risk management helps in detecting and handling the risks involved so that the banking industry continue to flourish.

Writers like (Shanmugan & Bourke, 1990, p. 2) gave the important role banks play in every economy and the risks they are faced with. Another writer like Jorion 2007 brought forth a risk management technique (VAR) to help financial institution manage their risk. This goes thus to confirm that the quality of bank management, and especially risk management process, are the key concerns in ensuring the safety and stability of both individual banks and the banking systems as a whole (Greuning and Bratanovic, 2003, p. 5). The banks position of linking borrowers to lenders is a very delicate one because if the borrowers don’t pay back their debt in time and the lenders come for withdrawals, the bank will find itself in a dilemma. “Understanding risk means that financial managers can consciously plan for the consequences of adverse outcomes and, by so doing, be better prepared for the inevitable uncertainty”. (Jorion 2007, p. 4)
I then kept asking myself the question; what then are the techniques or measures that the banks use before granting loans while trying to maintain their profits, relationship and trust with their customers? What is the perception of the bank managers who are assumed to have the responsibility of planning, directing, controlling and monitoring what takes place in the banks?

This topic is not only important for the above reasons but will give me a deeper understanding as someone building a professional career in Finance and my findings will be used by managers to detect whether they have to change or implement some of my findings to ameliorate their credit risk management.

3.2- Perspectives

According to the Oxford advanced learner’s dictionary (7th edition), perspective as a noun refers to a person’s particular attitude towards something, a way of thinking about something or a viewpoint. The perspective of individuals differ because the way or manner in which a person looks at reality or how the person perceives it depends on the individual’s judgment and its difficult to quantify thus associating it to a qualitative rather than a quantitative study. Credit risk management is very important to banks so, I will look at it from the financial management perspective. This means as banks are trying to meet up with their customers’ financial demands, the notion of returns / profitability, returns / liquidity and, returns / capital solvency must be handled with a lot of seriousness. This is because given the role of the banks, if they look to one direction and forgets the other, it may cause an adverse effect on them since profitability, and liquidity and capital solvency are interrelated. So, a good credit risk management can therefore be very beneficial if these three interrelated domains were well managed to have a balance between them and returns.

3.3- Preconception

Credit risk management did not just pop on my mind when I thought of writing my thesis. Before taking my previous course which really motivated me to write on this topic, my experience of three years working in a financial institution after my first degree pointed an arrow to this direction when I found out how delicate credit risk is and the likely consequences which may follow if not well managed. With my undergraduate education in Management and presently masters in Finance, my previous conceptions of the importance of good management and now relating it to the financial world, triggered me to write on this topic.

3.4- Research approach

Research approach simply means the way the researcher will collect the necessary data to answer his or her research questions (Saunders, Lewis & Thornhill., 2003, p. 82). Given the fact that the theoretical method one chooses has a link to the design and method to use for the research and there is thus a relationship between the two, the researcher has to choose the best way of how to go about the research to get the required knowledge. There are basically two types of research approaches namely the inductive and deductive (Saunders et al, p. 85). I
have chosen to use the inductive approach because I think it is suitable for my purpose since I will use a qualitative data. This is because in an inductive method, there is no strength of relationship between reasons and conclusion as is with deduction (Cooper & Emory, 1995, p. 26-27). To induce is to draw a conclusion from one or more particular facts or piece of evidence. To get the facts or perceptions from the bank managers, I will use face-to-face interviews (following the same interview guide). Perception which is defined by the Macmillan English Dictionary, 2002 as a particular way of understanding or thinking about something is difficult to quantify thus, supporting my reason of a qualitative study. The perception of different persons is always different even if they are faced with answering the same questions. In the course of responding to a question, other important questions (which may not have been on the interview guide) may be answered giving more clarification on the topic. In an inductive approach, the conclusion explains the facts and the facts support the conclusion. Based on this, my conclusions will only be based on the facts I get from my interviews which may not be true, valid or agree with the real world as implied by a deductive approach.

3.5- Research philosophy

Research philosophy simply means what reality is. So, choosing the appropriate design to answer the research questions will depend on the research philosophy of the researcher in question. Before specifying my research philosophy, I will identify the different types. Basically, there are two research philosophies:

- Epistemological orientation
- Ontological orientation

The epistemological philosophy deals with how to study social reality. It has two positions; the positivist and interpretive. In the positivist, the researcher uses the reality which exists, to test hypothesis and then gets the knowledge. This reality is not influenced by his or her personal feelings or believes because the facts are there and he or she just uses them. On the other hand, with the interpretive, the researcher interprets the reality because the social action is what is important. (Bryman & Bell, 2007, p. 16-28)

The ontological philosophy deals with the nature of the world and what the researcher knows about it. It also has two positions; the objectivist and constructionist. With the objectivist, social reality which is independent of what is in the researcher’s mind exist externally out there (Bryman & Bell, 2007 p. 22). On the other hand, with the constructionist, social reality is only being constructed and does not exist out there. This means the social phenomena and their meanings are continually being accomplished by social actors (Bryman & Bell, 2007, p. 23)

Following the foregoing definitions / explanations in relation to my study (qualitative), my research philosophy is interpretive /constructionist because I will interpret the reality which I will get from the interviewees and also investigate the credit risk management techniques used by the different banks of which the techniques used change depending on the management of each of them or have been constructed individually. The responses of those interviewed will be given in connection to the interpretive and constructive view point of their management.
3.6- Research method

“A research method is simply a technique for collecting data and involves a specific instrument such as a self completion questionnaire or structured interview schedule, or participant observation whereby the researcher listens to and watches others” (Bryman & Bell, 2007, p. 40). There are two main research methods; qualitative and quantitative. Qualitative is geared primarily to the construction of qualitative data which consist mainly of depth interviewing or focus groups. Quantitative on the other hand is geared primarily to the construction of quantitative data and consist of the usage of formal questionnaires techniques at some stage, whether for face- to- face interviews, telephone research, postal or postal research, or it may involve various forms of experimental or quasi- experimental research (Kent, 2007, p. 10). From the foregoing definitions, I chose to use the qualitative research method because I will only use a connection between theory and research and no measurement will be done. This method will help me fulfill my purpose and have good answers to my research questions. It also ties up well with the research approach I have chosen. From the theory, I will have to interview the authorities concerned with credit risk management in the various banks and then compare their responses to theory. This interview will be done when the interviewees have been well prepared with the answers in advance (since I send the interview guide beforehand). This will facilitate that I get concrete responses unlike what has been done in previous researches where the interviewees responded to questions which came like a surprise to them because they have not prepare and will just give what they could remember on the spot.

3.7- Research design

Research design provides the framework for the collection and analysis of data (Bryman & Bell, 2007, p. 40). Or it is the plan and structure of investigation so conceived as to obtain answers to research questions (Cooper & Emory, 1995). This means it gives the procedure necessary for obtaining the information needed to solve the research problems. I have used a qualitative approach to interview bank managers because I believed that since they are experienced professionals in their field, they must probably have a deep and broader knowledge on the topic. Since the theoretical approach one uses is linked to the design and method, I used interviews data because “it reveals the meaning and significance of artifacts collected in the fields” (Hatch, 2002, p. 34) and help researchers reach a deep understanding of the participant’s experiences through a descriptive account (Lincoln & Guba, 1985, p. 13). The construction of a good qualitative data (which I needed) also consisted mainly of in-depth interviewing of the focus groups. I chose to do interviews using interview guides because I took time to frame the questions based on the research question, and literature review. This was mainly to allow them give a deeper explanation instead of just “yes” or “no” answers. I did not want a situation where I may go off the rail and will not have the necessary information needed for my analysis.
3.8- Data collection methods

Data collection method is a phrase used to describe the way or manner in which a researcher gathers relevant information which he or she is going to use to answer the research questions. There are basically two main sources by which the researcher can collect data; the primary and secondary source. Primary data source is when the researcher collects new information either through observations, interviews, questionnaires and then uses this data for analysis (Saunders et al. 2000, p. 188.) Secondary data on the other hand is when the research uses data that was previously collected maybe for another purpose, used and stored (Hakim, 1982, cited by Saunders et al., 2000, p. 188-190).

Firstly, my choice of subject determined the data collection method in one way because I previously had in mind the subject area I was going to write on. This then pushed me to choose which data collection method I had to start with in order to have a broader idea on the topic and to decide the questions I was going to use for my interview guide.

The data collection method I used for this research work was from both sources (primary and secondary). I started by using secondary sources like the Umeå University data base, Emerald, Business Source Premier, internet, text books, articles and journals where I read information related to my topic and research question. In the course of the process, I found some authors and the work of some researchers which were in line with my area of study. This then acted as a spring board for me to continue with my work and knowing what type of questions to ask during the interview phase. I also used the websites of the banks under study and journals written about them. My primary source was face to face interview using questionnaires (with the personnel concerned). An outlay of the interview guide (seen in the appendix) was sent to them by email before the interview date so that the responses will be subjective to my area of study and the responses will be coherent since they will have enough time to get any information necessary.

With the use of a tape recorder the interviews took place in the offices of the three responsible handling positions relating to credit granting in the different banks. I interviewed those holding the posts concerned so that the answers will be in line with what they put into practice when carrying out their credit granting decision and because they are professionals in the field with enough experiences. I was aiming to have interviews from all the four main banks but despite all my efforts for contacts, only three of the banks gave me the opportunity. I saw these three to be suitable for my work because 75% is more reliable than if it was less. I also saw that as the interviewees are professionals and have had experience in their field (amongst the four main banks) their perceptions or responses will be enough for me to get my conclusions. The advantage of this method is that I did not have the stress of taking down notes in which case I may not have grasped all the information and, the interviewees felt comfortable and relaxed. It also assisted me because each time I needed any information, I just had to go back and listen to the tape.

The disadvantage of this method was that only a single personnel was there to give me the information needed but of which some of the decisions (for example in one of the banks) as the interviewee told me were taken by him and on the spot without using policy guideline. His decisions as a human being in all situations may not always be the best or right.

The interview in the first bank took place on 04th May, 2010 and lasted for fifty six minutes, the interview in the second bank took place on 06th May 2010 and lasted for sixty three minutes and the last took place on 10th May 2010 and lasted fifty eight minutes. When I asked
the three interviewees if I could mention their names in the empirical part of my thesis, one accepted, one refused and the third also accepted (but on condition that the others have accepted too). They all accepted that I could get back to them in case of more questions.

After the interviews, I wrote all the recordings word for word and sent copies back to some of the interviewees (the ones who requested for) who read and made necessary corrections before I proceeded with my work. These corrections also helped me to correct my work before moving to the analysis and conclusion.

3.9- Conclusion:

To conclude, I will first of all say that there are three paradigms (styles) that exist when one is carrying out a research. The researcher can either be as a physicist, a physician or a psychiatrist. Each has a different ontology, epistemology, perspective, theory, method and techniques or research that he or she has used. Following my methodology, the paradigm I have used is like a researcher who is like a psychiatrist. A researcher like a psychiatrist has ontology as subjectivist, epistemology as interpretive, perspective as a participant, theory is inductive, method is qualitative research and techniques of analysis is qualitative (Kent, 2007, p. 49).
CHAPTER FOUR

EMPIRICAL FINDINGS

My empirical framework consists of respondents working in three of the four main banks in Sweden specifically in the Umeå region. These interviewees have been chosen based on their job positions and experience qualifying them to give appropriate answers to my interview questions. I structured the interview guide into the following sub headings; general questions, lending decisions, credit granting / customers, collaterals, loan collection, relationship questions and legislation changes and the conclusion. This chapter will present my findings in such a way as to facilitate reading for the reader. A, B and C are used as synonyms to the respondents and the banks respectively. The structure of the responses follows coherently the structure of the interview guideline. The responses will be given as reported speech (using the exact words of the respondent) and in some cases using his, her, us, we and they which all refer to the bank since their work is done using the bank’s policy guidelines.

4.1. General questions

This section is focused on the respondents’ position in the bank, working experience and their educational qualification. My choice of respondents was based on experience both in theory and practice in the banking field particularly with knowledge in lending coupled with longevity in service since it is widely believed that “experience is the best teacher”. It was not easy to have these respondents directly so, I had to first forward my topic and interview guide to the various banks pleading to them that I will like my interviewee to be a worker who has experience in lending. I was fortunate to have been assigned these respondents but another problem was language barrier. During the interviews, some of the interviewees found it difficult at a certain point to mention or pronounce certain words in English (because they are native Swedish speakers) which they knew better in Swedish. But, due to a good dialogue between us, I came to understand what they meant.

Respondent A is the key account client executive for corporate clients in bank A. He is a holder of a Masters degree in Economics. He has been working since 2001 in this present position putting in seven years in SWED bank as the Umeå branch manager / also working with lending and corporate client and three years now in bank A.

Respondent B is the manager of the corporate financing in bank B. He is a holder of a Masters degree in Economics and has a working experience of twenty years. In his career path, he started working as the area manager for the then Post Company for ten years. He then moved to bank B as the credit specialist and analyst, but has held the manager’s position at different branches of the bank before settling in Umeå in his present position for just over a year now.

Respondent C is the Bank manager in bank C. She was a lawyer with two and a half years of practice in the court before entering the banking industry. In her career path, she has been bank manager in bank C for ten years but has worked in four branches. She started as the security manager, moved to branch manager, corporate manager (corporate division in Umeå), key account manager and presently bank manager for the second time. When I asked her a pop up question of why the transition from a lawyer to a banker, she responded by
saying that it is not a big transition because there are a lot of regulations in the bank which need a good background in law for easy reading. She continued to say that the education to be a lawyer in Sweden is a lot about writing and trying to understand these regulations.

4.2. Credit Risk Management (CRM) in lending decisions

In this section I focused on knowing why the respondents think credit risk management is important because they all acknowledged their exposure to credit risk in their credit lending, why they involve it in their lending decisions if at all they do, the effectiveness of their lending decisions, what they think are the causes of defaults should they occur, what will be their contribution if lending decisions were concentrated in their hands without the bank’s policies and, the risk they think might arise from their decisions.

Respondent A said CRM is important because it gives the same guidelines to persons that work with the same type of issues/customers and, it makes decisions less risky. They (bank) involve credit risk management in their lending decisions quite often and look into the documentation on risk management (credit politics) / policies a couple of times every week. He says their lending decisions have been very effective especially because they use already set down CRM guidelines when it came to a situation where they felt unsecured like how to rely on a person or to believe in the business. In such a situation, the risk management thinking gives them the guideline on how to handle them since they are in line with the risk management policies. They have experience one case of a default and this was related to the client’s poor management of his company, sickness, etc and had nothing to do with the bank. He said that if lending decisions were concentrated in his hands, he would like to have some kind of guidelines to follow before taking decisions, he would like to have a bigger limit of the amount to grant as loans, he will take shorter time to go through procedures, give faster feedback to customers and take less time to analyze and write PMs. The change he would like to be put in place in the lending decisions will be in terms of canceling a phrase written in the policy guidelines of his bank pinpointing some branches of businesses as high risk branches. He said to him, there is no high risk business because the success of the business depends on the entrepreneur’s knowledge of management. He said, the risks that might arise from every kind of lending decision could be connected to the finance, management, customers, tenants, etc and it depends on the type of business.

Respondent B said CRM is very important and helps them to have a very secure system because if the CRM when lending to their customers was not good, FMs will lose trust and it will be difficult for these markets to lend money to the banks. Poor risk management will also lead to higher interest rates arising from more risk, and losses in the bank since customers will be charged more interest when granting them credits. He said it is but natural for them to involve CRM in their lending decisions because it is not risk money they have. The money they have is their customers money and before giving it out, they must be sure to get it back so as to be sure of its availability when the customers come for it. This CRM will also help them to be able to pay back what they have loaned. He said their lending decisions have been very effective especially since they act differently from the other banks by taking most decisions in front of the customers without going to the board meetings and also, they have pretty high limits (in Sweden) for what they can decide for themselves. Their decisions are efficient because they don’t need to take all the papers to write memos suggesting whether they should be granted or denied, it will not have to go to the board meeting where they will have to look and may be a bunch of people will have to go through before a decision is taken.
Simply, just one person makes the decision and it is the person next or closest to the customer. This makes the process easy because you believe the customer, have the business idea, the history, know the customer, etc. It removes the doubt of insecurity which always arises when questions like; how to rely on the person or do you really believe in the kind of business? He said that they have experienced default like any other bank for it is something you cannot avoid. He said, I quote “you can be precautious and try to be as good as you can, but you can’t avoid being in default otherwise you don’t grant loans”. These defaults mostly come because the company’s branches are going up and down financially. For example, if the financial crisis crop up and the company does not have enough savings to meet up with its difficulties, they are forced to go down and there defaults can arise. He said, it does not make any difference now if the lending decisions were to be solely handled by him because he has been the one bringing up ideas concerning lending. He and his team simply inform the credit department frequently of what is happening in the market from their meeting and different day to day experiences “What we do every time is that we follow the market basically and the policies are adjusted a little following that”. The decisions also change at times relatively to the change from uncertainties in the future. He said a great risk which might arise when taking lending decisions will be when someone puts in too much emotion for this can be an error in the long run.

Respondent C said CRM is very important because as a business entity, they want to reduce losses. They involve it in their lending decisions firstly because the regulations of the bank from the head office specifies it and secondly because it reduces losses since they will be able to meet up with their financial responsibilities if need be. She said, they see the effectiveness of their lending decisions today because they have learnt from the last financial crisis. After every crisis, they learn and correct their mistakes. At times she even thinks that the decisions are too effective because the other side of it says that you do less business and thus take no risk. They have experienced some cases of default although they are not so frequent in Sweden. It is less that 1% (annual report). These default often come from the side of the client with the cause being sickness, poor management, unemployment (in the case of private), and the instability of the global environment. She said if she was given the sole responsibility to carry out the lending decisions by herself, she will not bring forth something different from what is in the policies. She will just look at the credit risk and the opportunity for doing good business (that is what their bank does) with the business opportunity for the bank being the most important since every client is business for them. The risk that will be involved in the lending decisions she will take is the risk of default which is of course connected to interviewee A’s view point but not to B’s who talks of the greatest risk being emotion.

4.3. Credit granting / Customers

In this section I focused on who the customers of the bank were, the information they needed about the customer before taking a lending decision, why they think the information is important, which information is most important if at all, the sources of the information, if they are satisfied with the sources of the information, which other sources do they propose that should be used to get information, why they think these sources should be used and if they are conscious of asymmetry information.
Respondent A said even though there are different types of customers, his customers are only corporate clients (companies) with most of them small and medium sized. Before taking a decision of whether to give out loans to these customers, the information needed is quite a lot and is everything one can think of. They look at the company’s revenues for the past years, their cash flow, budgets, description of the business, description of the customers, type of tenants, if they own real estates, how large the company is (external valuation), ability of the management, etc. But, the information will depend on the type of company too. Everything is always quite focused on the cash flow and the management of the business to make money. This information is very important because if a customer is loaning money for a business unknown to him, he needs to know the business by using the information in order to access whether the customer will be able to pay the loan. He said they were always satisfied with the information they get but the problem is always a question of time because they can’t be putting much time to have information about a small company without first of all knowing whether the customer is a good/interesting one. Another source which he thinks is good to get information is informal especially in small towns like Umeå. We can get information by calling three to four people whom we think know a customer so well (rumours). We get the information by talking to the customers, using the internet, Upplysingscentralen (a business and credit information agency in Sweden), talking to colleagues, talking to experts, and using web access to internet tools to make valuation of real estates. But, the company has to present most of the information needed. They also ask questions to the customers to get their view point of how to handle certain situations (what is your view point about this? Do you have an idea on how to manage this or that?). When it comes to bigger companies, they used a special analysis group in the bank that looked into special branches of the company in question. “We think this source should be used because it adds another perspective on the case (second opinion)”. He concludes answering this part by admitting that they know there is certain information that the customer will always keep away from them (asymmetry information).

Respondent B said they have different types of customers but he handles just the corporate. “Before we take decisions to grant loans to the companies, the information needed is quite much. If the company is up and running, we will need the annual report for the last few years, the budget for the next year, their financial situation, the available collateral, business plan, goals, experience of the management, etc. But, these information differs according to the size of the company (small or big) in question although, there is always not so much difference. This information is very important because it helps us to know the capability of the customer to pay back the loan. It is hard for us to grade the most important information because none is undermined. But, I will say the most important will be the company’s history because in the history you can see if the management made it (ups and downs). The budget is also important too but the hard part is to evaluate it. We get this information from the company itself, rating agencies (which we don’t really trust).” The respondent also added that his local experience about the Umeå area and the types of companies is very important because he knows what is going good / bad and what kind of companies that survive / those that do not. He said they do most of their ratings analysis since they look at things from an angle different from that of the investor who is putting in the risk money in the business. Personally, he is not always satisfied with the information from the customers especially when it is a first meeting. But, he always specifies to the customer what type of information he needs from him as a customer and the type he can get on his own for the decision to be taken. Another source which he thinks can be good to have information (especially of an old customer) is to ask from his previous bank and other people whom he believes know him very well. He also concludes by saying that he
knows that there is always some information about the customer not known to them but, that is the risk they take.

Respondent C said their customers are mostly small and medium sized companies. The information they always need before taking a decision of granting a loan to any company is their accounts, budget, liquidity plan, market plan, business plan and management. This information is very important for them because they use it to analyze and evaluate if the customer will be able to pay back the loan or not. So, the question they always have in mind when looking at the information is “can they pay the loan”? The most important information to them is the accounts and the cash flow statement even though all the information is important since, if they do not know a company’s ID they can’t do its evaluation. So, it is more effective when they have all the information. “We get the information from our own system, from the external system, Upplysningscentralen (a business and credit information agency in Sweden) and Bolagsverket (institution where you can get information about the accounts and management). We are satisfied with the information we get especially as it is always easy to get information in Sweden (the hard facts). There are many sources of getting information but the problem is the analysis. We are very conscious that there is information which the customer can keep away from us which they may not see the importance of which it is to us. So, we always ask so many questions”.

4.4. Collaterals

In this section I focused on knowing from the respondents if collaterals are important in a credit granting decision, how they assess the collateral offered, whether there is any situation where the collateral is the determining factor for credit granting and if so, what situation?

Respondent A said they think collaterals are good in credit granting decisions because it is one of the basic points in banking and it is in the legislation. The banking business is built on lending towards collaterals so that in case of default, they can make up for it. The assessment of this collateral is very advanced in banking. They always describe in the pre-memorial how big the risk is in case of default. They then look at the risk and compare it with the collaterals to know how much risk is involved. The techniques used for the different collaterals are described in the policies. They do all type of risk valuation with some easy and some complicated. The theoretical ones being done at the level of top management but at the basic level, they look at it as per customer. “Using sensitivity analysis when it comes to collaterals, we think more about what kind of things will be left in case of a default (risk of default) and then we talk of how big is the sensitivity to become a default”. He concluded by saying that there is no situation where the collateral is the determining factor for loan granting because it is out of the bank rules since having good collateral but poor management is no guarantee.

Respondent B, said collaterals are important because when making a credit decision, they are never sure whether things will go so fine 100% to guarantee repayment. This collateral comes in the second place after they have looked at the cash flow, the management and view of possibility to survive. Even if these criteria proved good but the lack of 100% guarantee gives them the go ahead to ask for the collateral which even if though cannot pay the money, can at least be sold to recover it. So, that is why they need collateral. “We do the evaluation of these collaterals ourselves/ use of agents (in case of real estates) and compare it to what we have in the annual reports because that is where we find the facts. There is no situation where the collateral is the determining factor for loan granting because those will be the bad decisions. It
can happen that we grant a loan basing on collateral now when the market is going well and everything is fine but after a few years, everything goes down. This will lead to a loss in value of the collateral and less money on our part. This is so because the default has something to do with the market and if the market is not going well, the value of the collateral will go down too. So, it is not really a good thing to base the credit decision on the collateral.

Respondent C said collaterals are good because before taking credit granting decisions, they must think of how they are going to get the money back. But, they also need to have these collaterals because it is specified in the regulations. The collateral reduces the losses should they have problems and also the risk. They have also realized that loans without collaterals cost more for them to lend. The assessment of the collateral is something that has been very regulated and put in the system. The regulations give information about the collaterals and specify the percentage of risk that is taken by a particular type of collateral. The collateral is calculated at 75% of the market value. There is no situation where the collateral acts as the only determining factor for a loan granting decision and it is not specified in the legislation.

4.5. Loan collection

In this section I addressed what the respondents might think to be the cause of defaults, how they handle the situation, why they think the approach they are using is the best and what is the effect of the default on the bank/shareholders.

Respondent A said the bank has experienced a single case of default which was not 100% but delayed payment. In his opinion he thinks this happened because the management was not good, the entrepreneur was sick, etc. To handle such a situation, they try to work closely with the customer when they see that the situation is close to a default. They put it high on the agenda and look at it more often. They then develop a special action plan on how to get the customer on the rail again. They advise him on how to handle the situation and on how to make the right decisions that will be favorable for him and for the bank. He sees the approach they use as the best because when it comes to a lot of problems, they have to face them instead of trying to avoid. If they don’t come in, the customer might go astray in the course of being in a panic. The customers don’t always like it but at the end, they are happy after the results. The effect is that their management always experience a tough time because they have to go into their reserves to meet up with expenses and this obviously affect their shareholders too.

Respondent B said they have had cases of default which he thinks happen because the company’s branches are fluctuating financially. To handle this, it first depends on the type of default (whether delayed payment or bankruptcy). In the case where the customer does not respect the repayment time, they first call the customer to ask why they failed to pay on time. Later in the process, they can cut off the loan by cutting the credits, which means any money coming into the account can’t be withdrawn. At the end of the line, they can terminate the credit and tell the customer to pay the entire loan at once before the company goes bankrupt. If the customer doesn’t, they will apply to the court for intervention. This does not always come as a surprise to the company because they have had many discussions with the customer before reaching this stage. In the course of the discussion, if there has been anyway they could save the company then, they will do so.
“We mostly handle situations of default ourselves but also together with the accounting firms that keep the bookings of the company. That will be the natural meeting to have with us as the bank, the owner of the company and the accounting firm that basically can do all the legal stuffs of the company”.

He thinks the approach they use is the best for them because although they work as different individuals in the bank, different personalities, make different decisions, some more rough, some more linear, etc, it is good to always take action. Sometimes one may take too much action early and too little action late. But, to conclude on this, he said the most important thing is to take action.

The effect of the default on the bank / shareholders comes in terms of credit loss. When the credit loss goes up, they pull back and then it is hard for anyone to loan money.

Respondent C said it happens a bit so often that some customers’ default which she thinks happens because of sickness, poor management, priorities, etc. To handle such cases, they steps to follow are already programmed in the system. The system automatically gives out reminders and if after the reminder the customer does not still pay, they phone them from Umeå. They make the customer to understand that the bank payment should be a priority and points out the consequences the customer will face if he defaults. After this stage if the customer still doesn’t pay, the proceedings will continue and even goes to the court. She thinks the approach they are using is the best because when they explain the consequences of the default to the customer, it helps him/her to prioritize and put the bank’s payment first since they will not like to face the consequences as a result. The effect of a default is that it causes a reduction in bank business and thus have an effect on the shareholders.

4.6. Relationship questions

In this section of my work, I will try to know from the respondents if they think a good relationship with a customer is important and if the duration of this relationship has an effect on the credit assessment process. If so, why?

Respondent A said having a good relationship with a customer is good because it helps the customers to look at them like business partners instead of being an institution where they get money. A lengthy relationship with these customers makes their credit assessment process faster simply because they already know their business well, have their information, and have their ID. It therefore takes shorter time to analyze when it comes to lending decisions. But, it is also difficult at times because even if they knew them so well but they lack a professional management, it is at times difficult to take the decisions without going through all the processes. So, it is always good to go through the procedure each time. He admitted that it is always difficult with new customers because since they don’t previously know them and have no ID, they will have to go through all the procedures. To make the process easier for them, it is written in the legislation that when they have a customer of 5 million and above, they should always look into their books every year to see how they are going and describe the company in a short report. This is just to be on the safe side of not increasing the risk.

Respondent B said a good relationship with the customer is good because it helps them to have information and as soon as possible. The customer feels free to inform them in time when things are not moving well and this helps them to handle the situation early unlike in the
case of a bad relationship. When we have had a lengthy relationship with the customer, it
often makes the credit assessment easier and faster because we already know the customer so
well, have information of it and the ID. But, it is so hard at times especially if the customer
lacks a professional management.

Respondent C said too that a good relationship with the customer is important because it
enables us to do more business like cash management and savings. A lengthy relationship
often makes the credit assessment process easier and faster because we already know the
company, have their information and ID. Even if the customer’s information changes over
time, they just come and inform the bank. This is unlike the case with a new customer. “The
main problem is not to give out loans to new customers but the point is that the analysis goes
closer when we already know the customer”.

4.7. Effects of legislative changes on credit granting

In this section of the work, I want to know if legislative changes like the Basel 11 Accord,
instability in the financial market and the global financial crisis have had effect on the various
banks’ credit granting.

Respondent A said the Basel 11 has affected their management so much especially when it
comes to risk evaluation and pricing. Working with it so much has changed the way they look
at banking. High risk customers have high price and low risk customers have low price. This
accord has not changed their way of looking at how they assess customers before granting
loans but more like how to price the loans. To conclude, he said it has affected them
positively even though it is complex.

The instability in the financial market has affected their bank very much on a central basis.
There have been less problems at the local level but very big problems in Baltic. The cause
being higher prices because it was quite difficult to lend money in the market for a while and
this made the prices to rise for some time.

The Global financial crisis has affected their bank in that they still have some problems in the
Baltic like inflation, people losing their jobs, drop in prices of real estates, etc. These
problems have made their bank weaker and less profitable.

“This has not affected our customers so much (not the local ones). It affected the customers’
core business but not their connection with the bank because the rents increased for a while
and later went down to the normal level”.

Respondent B said the Basel 11 has affected their management and he could curse each time
he sees it. He gave the same points as respondent A and says it makes the banking job more
difficult. But, at the bottom line, the Basel 11 has a good ID because good companies with
lower possibility of default are granted loans at lower interest rates unlike those with higher
possibility of default. “When it comes to the Basel 11, we can’t really put in much of our
knowledge of the customers since it is always more expensive to grant loans. But, this Accord
did not affect our credit granting in anyway because we have our policies (which will be for
all time) and it did not make any difference because the instruments we use for loan analysis
were created in our bank in order to fulfill the Basel 11 regulations”.

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The instability in the financial market has made it that they are very precautious when it comes to giving loans to customers. So, it has affected the bank because they need to see more money upfront.

The global financial crisis has affected their bank because they have changed their policies a little bit and how they grant loans. It also had an impact on their results from last year which went down although not as much as in other banks. Turnover was low because of some losses, the margin for loans went down and the loss went up. It affected their international growth because they had plans to open new branches but because of the crisis, they took a break to wait and see.

Respondent C also accepted that the Basel two Accord affected their management in which case the tighter regulations increased the cost of risk for them because the money they give out as loans is being loaned to their bank too. Given the fact that their customers can borrow from them at a fluctuating rate but of which they cannot borrow at that rate, they thus had to loan some of their money on longer terms but of which they can’t give it out to the customers because they will not be able to compete with other banks. So, what they do is that even if 75% of their customers want to loan at a fluctuating rate, they can borrow to them. They give the money out for 1, 2, 3 etc years and do a swap. This thus increases the cost to the bank and lower results are attained. The effect of this in Umeå is that they have to take higher interest from the customers. It has become more expensive and deeper differences between the banks since the last financial crisis because of their own capital in the banks. In the last financial crisis their credit rating was not as good as that of Handlesbanken for example so, it cost more for them to lend money and they have to take that from the clients. So, it differs between them and Handlesbanken making it difficult to compete and thus lower results. The Accord has affected their credit granting in the Baltic because they now have tighter regulations making it not easy to give loans today unlike five years ago.

The instability in the financial market has affected the bank in that they had more credit losses in the Baltic Sea countries (not Sweden) but, they learnt a lesson from the crisis. “We have good analysis, collaterals, low interest rates and low unemployment. So, even if people get unemployed, they can pay back their loans because the interest rates are low”.

The global financial crisis affected the bank in that it led to more expensive real financing, low interest rates and low profits. It has affected their customers so much because they have lost confidence in the bank and they don’t really like the idea that the bank has been involved in the Baltic to lose a lot of money.
CHAPTER FIVE
DATA ANALYSIS AND INTERPRETATION

In this section, I will attempt to analyze the empirical data collected during the interview process connecting it to the theory, giving a clear and well argued answer to my research question/objectives, bringing out my own view points / contributions and taking my stand where I deem necessary.

As earlier mentioned, I interviewed respondents from three different banks who answered questions in the interview guide which I structured into eight different parts. But for the analysis and interpretation of my data, I will talk shallowly on some of the parts and focus mainly on 4.2, 4.3, 4.4, 4.5 and 4.6 which I think can help me to have answers to my research questions since this concerns lending and collection which are the activities that give rise to credit risk. It is worthwhile to note that this analysis is based on what was said to me by the respondents, the impression I got while carrying out the interviews and the way I as an individual has interpreted what was said.

The respondents from the three banks interviewed shared responses with same meaning to most of the questions although in different words. I also found some differences in opinion from bank to bank so, for better understanding of each bank’s position with regards to credit risk management, I will compare and analyze the banks individually. But, what I found out is that almost all their responses tie down with the theory.

5.1. General questions

I asked the respondents general questions to have a better knowledge of who they were and their experience in the banking industry. The responses I got brought out the importance of working experience. A respondent ( for example B) who has twice or longer working experience in the field ( than A and C) showed that working experience is related to knowhow because he handled some lending decisions based on his individual ability or knowledge without relying on policy guidelines. This of course is good only to an extent because if a problem arise based on a decision which he took individually without following the bank’s policy, he will obviously not bear the consequences alone but the whole bank will do. He must have been doing so based on the circumstances of the changing environment in which the bank finds itself but of which the bank’s norms may be neglected. This shows that CRM is solely concentrated in his hands and not following bank’s laid down policies. Even if he is following the policies which he has memorized as a human being, he can still make mistakes. It also goes along to show that since he can handle issues individually, customers can also be treated differently based on his relationship with them.
5.2. Credit Risk Management (CRM) in lending decisions

The role of credit risk management can never be undermined when carrying out lending decisions because the bank has to be sure to recover the money she is giving out especially as its continuous functioning depends on this. So, in this section on lending decisions, I tried to explore the degree of consciousness of the respondents of credit risk management in their lending decisions, the consequences of these decisions, their contribution if they were given the sole responsibility to handle lending decisions without policy guideline and the type of risks connected to lending decisions.

All the three respondents stressed the importance of credit risk management although they did so in different ways. Respondent A said it is important because it makes their decisions less risky, respondent B said it makes them to have a secure and trustful system and respondent C said it helps them to reduce losses. Respondents A and B said they involved CRM in their lending decisions because they often think of risk while respondent C talks of doing so because the regulations of the bank says so. All three respondents admitted of seeing the effectiveness of their lending decisions although some cases of default may arise. This has not always been on the part of the bank but on the part of the customer resulting mainly from poor management although other causes may include; sickness, unemployment, instability in the global environment, etc.

Respondent A admitted that he will like to have some guidelines before he can carry out any lending decisions. Respondent B said “since the bank is not like a box that does not move”, he brings up lending decisions everyday based on their daily market experiences and this goes along to change their policies a little bit. Respondent C said she would like to have guidelines before carrying out any lending decisions because she looks at credit risk in the business and the client as the business opportunity. Looking at the risk that is associated with lending decisions, respondent A said the risk could be connected to the management of the business, customers, tenants, finances, etc (it depends on the type of business). Respondent B said the risk that is involved will be when one puts emotions in the decision he / she takes to grant loans. Respondent C said the risk involved is default risk.

Based on the answers I got from the respondents on the questions in this section and looking back at the theory, both theory and the interviewees were of the same opinion on certain issues which I also agreed with. They all focused on credit risk arising from the side of the customer and not the bank thus showing the importance of a good credit risk management. I agree with this only to a certain extend because I think the blame is strongly put on the customers simply because they are the borrowers and are expected to pay back. The question is, is the customer always well enlightened on the issues of the bank or does the customer know the bank? I think knowledge here should be mutual to a certain extent as supported in the theory by Bruns, 2004, pg. 33 and Healy & Palepu, 2001, pg. 2-3. It is also said that if a customer is well known before the lending decision is taken, the risk is reduced because management will know how to handle it and especially on time as shown in the theoretical part by Dahiya, Saunders & Srinivasa, 2003, p. 376. I also agree but, what I want to stress here is that banks should put it at the forefront that they should not always accuse customers as being the cause of credit risk (default) because in some cases, the bank can be accused too. Before accusing the customer or putting the blame on them totally, they should be absolutely sure of their capacity to follow the credit risk management process up to the level before lending and even beyond. What I mean to say is that the credit manager should always be very sure about this and not just follow the bank’s policy guidelines. I am not very pretty sure
that in each bank’s policy guide lines on lending, the credit risk management process is well outlined. Another important issue will be the contribution which interviewee B brought in - talking of the risk of emotions. I think it has to be spelt out in all banking policies that personal emotions have to be put aside when dealing with customers. He went ahead to say that he took some decisions on the spot without consulting anyone or the policies. A credit manager or personnel can take a decision without consulting the bank policies but what will be the consequence of a decision taken if it happens that the decision taker is not available and the customer is not in line with payment? How will the successor continue to handle the situation since the person who took the decision was doing so with his / her own reasoning without following a written document or policy which can be used by any worker as reference at any point in time? What about the credit culture or practices of the bank?

5.3. Credit granting / Customers

In this section I address the issue of credit granting and the customer (in this case company). A bank can’t just give credit to a customer without guarantee that they are going to have their money back. The bank tries to know of the guarantee by looking into the credit worthiness of the company in question. This is done by using certain information about the company. The different banks may rank the importance of this information differently and there is always some hidden information about the customer that is unknown to the bank (asymmetry information).

Asking questions related to these points, all the respondents admitted that this information is very important because they have to be sure that the company will be able to pay back their money as it is also mentioned in the theoretical part. From the responses of the three respondents, the information needed for analysis is the same (but differs according to the type or size of the company), the sources are almost same although the classification of importance differs. This information include; revenue for the past years, cash flows, budgets, description of the customers, type of business, ability of the management, annual reports, the collateral, business plan, goals, customers, etc. According to respondent A, the most important information is the numbers (description of the profits) and how the company is making its money. Respondent B said it is hard to grade the information but finally cited the company’s history as being the most important. Respondent C talked of the accounts and the cash flow although everything is important. All the respondents acknowledge information asymmetry. The answers to this section tied well with the theory as for which information is needed when taking credit granting decisions. The point which I tried to find out in this area which is contradictory to me is the fact that both theory and interviewees talked of the same information as being needed for analysis but the classification of importance differs. My question is “why does the classification differ?”. I say so because from my point of view or understanding, information that can be taken to be less important may in some cases be the giant cause of a problem. When taking the information, do the banks use credit scoring or do they take questions related to the character, capital capacity, conditions and collateral of each company as specified in the theoretical part by Beaulieu, 1996, p. 517? Even if they do, are they sure that if another bank uses the same information to carry out the scoring, will the results be the same? I hope that even though some information is classified as less important, when it comes to decision taking, none should be minimized based on the fact that it is considered less important. The analysis of the information is very important too before any decision can be taken. They can’t just do the task of collecting information because they know
is a pre-requisite for credit granting without good analysis. If they do so, no matter the good information they may get, bad analysis can also lead to wrong conclusion and of course problems will arise at the end because they may give more credits to companies which they are not suppose to and the collection phase will not go well. Professional management of the company is very important too. So, it does not matter whether they have good information of it to consider lending. Even if the information collected is good but of which the management is bad, it means that the company cannot function well and thus there is no assurance of good functioning or credit repayment.

5.4. Collaterals

In this section I addressed the importance of collaterals in a credit granting decision. How is the collateral being assessed, whether or not is it enough as a guarantee for the credit to be granted and if it can be the determining factor for credit granting?

Reviewing the answers from the respondents for questions related to collaterals, all of them acknowledged its importance but this comes in the second place after the assessment process using the information as earlier mentioned. This is because the collateral gives a guarantee that in case of default or bankruptcy, the bank could be able to at least recuperate some money from the sale of it. When asked how the collateral is assessed, respondent A said the technique they use to do the assessment differs according to the type of collateral. They are described in the pre-memorial and depend on how big the risk is in case of default. The risk is then compared with the collateral to know how much risk is involved. Respondent B said they do their evaluation themselves using their own techniques and compare the results to what they have in the company’s annual report because that is where they find the facts. Respondent C said their regulation specifies the percentage of risk that is taken away by a particular type of risk and has been already regulated and put in the system. All three respondent stood on the point that there is no situation where the collateral is the determining factor for loan granting with A saying “it is out of bank rules” because a company can have good collaterals but bad management, B said “those will be the bad decisions” and C said “it is not in the legislation”. The answers to this section also tie with the theory and I agree too since the collateral only stands as a “should in case”. A good collateral availability is no guarantee for credit granting. This is because any company (even though with poor management), can provide good collateral especially if it knows that this will act as an incentive for the bank to grant it credit. If the bank falls in this pit and does so when at the end the company can’t pay its money back, it obviously lead to greater problems because the bank will going through a lot of stress even at the stage of selling the collateral. Also collateral made available at a point in time can be something which has a good market at then but, what if at the time of default (given the changing environment in which we live) the bank can’t find a good market for the collateral? It will obviously encounter problems. So, a good collateral is not necessarily any guarantee for credit granting.
5.5. Loan collection

In this section I address questions on defaults asking the respondents what they think might cause a customer to be in default, how they handle such a situation, why they think their approach is the best and the effect of the default on the bank and the shareholders.

In answering these questions, all the respondents accepted to have encountered defaults because they can’t avoid it otherwise they don’t grant loans. All of them based the cause of the default on poor management on the part of the customer although respondent C went ahead to mention sickness, priorities, etc. To handle the case of a default will first depend on the type; whether it is late payment or nonpayment. Respondent A and B said in the case where the customer does not respect payment, they call him /her on phone to ask what the problem was.  Respondent C said their system automatically issues a reminder. They try to be close as possible with the customer to see how they can advise them to help solve the problem. If it goes beyond this level with no positive action from the customer, they can then involve the legal proceedings. When I asked the respondents why they think their approach of handling the default situation was the best, respondent A said it was the best for his bank because when it comes with a lot of problems, one has to face them instead of trying to avoid them, respondent B said it was the best because even though they work in the bank as different individuals, different personalities, making different decisions, etc, the most important thing is that they have to take action, and respondent C said the approach is good because when they handle the situation early, they help the customer to prioritize. Talking of the effect of the default on the bank / shareholders, respondent A said it could be a tough time for the bank (because they will have to go into the reserves to meet up with expenses) and the company too . Respondent B said the effect comes in terms of credit loss. Credit loss is something they expect even though they don’t want it. When this loss goes up, the bank pulls back and then it is hard to loan money. Respondent C said the default causes a reduction in their business and thus have an effect on the shareholders.

What I noticed here which was not really clear or is a bit different from theory is that some respondents talked of calling the customer on phone to ask what the problem was or getting closer to them to advise them on how to solve the problem. Why should they allow things to reach the point of default before all these actions are taken? If they had had a good relationship of always being in contact with their customers earlier, it would be possible in some cases not to arrive at this stage. Are the banks really sure that their credit collection procedure were well formulated, or if their implementation was well carried out or if the policy was well followed as highlighted in the theory? Have they been monitoring the customers not only on phone but otherwise because some customers may still hide some information on how they are faring (asymmetric information). I think the banks should go extra mile apart from using the phones to know how the company is doing. They can use spies of even ask some customers of the company about its situation.

Another point of interest is that all the banks had their way of handling the default at the early stage but at a later stage, they involved legal proceedings or collection agencies. In the course of doing so, how do they treat their customers? I say so because I support Maness & Zietlow’s point that no matter what efforts the banks might use for credit collection, they must always try to maintain or preserve customers’ goodwill when doing so. This is because the fact that some customers encounter problems of default does not mean they are bad. Some circumstances might have led to that. If they succeed to come out of the situation, they may turn out to be the best customers in the long run. But, if the good will had been destroyed
because of a previous problem, this customer could be lost to another bank given the competitive environment in which banks operate. Anyway, this is my point, although it may not always hold true in all situations.

5.6. Relationship questions

In this section I explored the effect of the importance and longevity of the relationship of the bank with the company on its credit assessment process.

In response to this question, respondent A said a good relationship with the company is very important because it helps the bank to know them and the company will feel free not to hide any information from them. Respondent B said a good relationship with the company helps them to have information as soon as possible and on time which will help them to tackle adverse situations pretty early. Respondent C said a good relationship is very important because it enables the bank to do more business with the company like cash management and savings. In terms of the longevity of the relationship, all the respondents accepted that a lengthy relationship with the companies hastens their credit assessment process because the bank already has information about the company in their system unlike a new company which they have to go through all the lengthy procedures in order to have the information. But, respondent B went on to say that at times it is also too difficult because even if the bank knows the company so well, but this company lacks professional management, it is still detrimental. So, it is always good to go through the procedure each time the bank wants to change lending.

As concerns, the relationship questions, from the empirical area and relating to theory, I support to a certain extent the results from the longevity of knowing a customer but hold strongly to the conclusion of respondent B who said that no matter how well you know the customer, it is always good to go through all lending procedure at each time. I also agree with Dahiya, Saunders and Srinivasan (2003) that maintaining a good relationship with the customer is good because banks will be better informed about the financial status of their borrowers and thus will be able to take steps to reduce their loan exposures before the news of a borrower’s distress becomes public information. But, what banks should know is that we are living in a world in which we are dealing with human beings. When we talk of customers (in this case companies), they are entities only being runned by individuals. The information on longevity is mostly based on seeing the entity standing there but the management cannot be good. The management can be bad leading to the company falling without the knowledge of the bank especially if the bank does not go extra length to get information but rely on longevity. The banks should also know that as time passes, the environment changes, the company can also change. So, at any point in time before taking any decision, all lending procedures have to be followed.
5.7. Effects of legislative changes on credit granting

This section addresses the effects of the Basel 11 Accord, financial market instability and the global financial crisis as legislative changes on the bank, its management and its customers.

All three respondents accepted the fact that the Basel 11 Accord regulations has affected their management by making the whole banking job more difficult especially when it came to risk evaluation and pricing. Each bank has to allocate money according to the type of risk (risk buffet) where they describe the level of risk they have in each company so as to minimize the buffet capital they hold. When they minimize, they have a higher percentage payback for the shareholders. When they have lower risk, they hold less money and this means customers have to be priced differently. High risk companies, high price and low risk companies, low price. Respondent B said, it has not affected their credit granting in anyway because they have their own policies and instruments which they use in their loan granting analysis. Respondent C went ahead to say this accord has increased the cost of risk for their bank because the money they give as credit to the clients is being loaned also. So, their risk has increases since collaterals are valued in different ways. The financial market instability also affected the banks in different ways as confirmed by all the respondents with credit losses experienced by bank A and C in the Baltic region. Respondent B said it has made them to be very precautious when they grant loans to clients. When asked of the effects of the global financial crisis, respondent A said the effect on their bank has been that they have become weaker and less profitable because of the problem of the Baltic region. Respondent B said the effect was mostly seen on their clients who had to postpone their investments because they felt insecure. Respondent C said it affected their bank in that it led to more expensive real financing, low interest rates and low profits. What I will basically bring forth here is that banks should at all times be conscious that they are working in a very unstable and dynamic environment and their decisions can be affected by an unforeseen change at any point in time. This point is a bit complicated to be handled because they can never know the type of change that will come, the effect on them and the consequences associated. All, they should try to do is to always try to maintain a good credit risk management to at least reduce the effect should they occur.

Looking at the data analysis and interpretation, and specifically concentrating on 4.2, 4.3, 4.4, 4.5 and 4.6 which are the main areas which concern lending and collection it can be seen that CRM is an activity that can’t be avoided by banks as long as they remain functional. This activity can be a bit enhanced if the banks realize that it will be easier when taken as a mutual activity between them and the customers. This means that although the customers are blamed solely because they are the borrowers, the fault can also come from customers’ lack of knowledge of the bank. Even if a bank is blaming the customers, is she sure that the criteria which she used to assess the customer if used by another bank, the same results will be gotten? This is especially the case because each bank is autonomous as well as it management. The criteria a bank might use to assess customers, making them more qualified can be disqualified by another bank using its own criteria. As long as there are different criteria of credit assessment and loan collection procedures, the results must also differ. One bank may use her own procedures and succeed and another may use theirs and do not. This also applies likewise to their relationship with the customers too. The fact that banks are operating in a very unstable and dynamic environment should be an eye opener that their rules too have to be constantly changing.
5.8. Conclusion based on respondents contributions

This area was simply to know from the respondents if they had something in mind which they wished could change in the banking industry. Respondent A said he hoped for stronger local bank branches which could work more on their own in the local market and a calmer financial system. Respondent B said he hoped that the banking industry will take its total responsibilities and not grant loans to companies which cannot pay back because that is what always causes problems in the long run. Respondent C said was silent.
CHAPTER SIX
CONCLUSION AND RECOMMENDATIONS

In this chapter I will present the conclusions drawn from the study and the findings. Based on the research question and the answers obtained from the interviews, the following conclusions and recommendations were made based on my findings. Some contributions / implications for the practitioners and possible areas for future studies is also included.

6.1. Conclusion

The banking industry has come to stay and its activities cannot be undermined given the great role it plays in the economy of every country by receiving savings from the “haves” and making it available to the “have nots” thus boasting productive investments. While carrying out its activity, the banks are faced with a number of risks with credit risk being cited as the most important since its poor management can lead to a total disaster in the bank. Before writing this thesis, I only knew what is credit risk and the importance of its good management theoretically but, after the interviews and the responses I got from the practitioners in the field, I saw the degree to which it is considered important when banks globally and in Sweden in particular are carrying out their lending decisions.

In the theoretical part, (Boffey & Robson, 1995, p.6) pointed this out by saying that CRM has a great role because banks have a limited capacity to absorb loan losses and this losses can be covered only by using income generated by other profitable loans or bank capital. After my findings I still found out that it really has a great role to play because it makes decisions less risky, it helps the banks to have a secure system thus avoiding loss of trust which FMs might develop, it helps to match risk to interest rates and profitability since credits will be granted based on these aspects, it helps to guarantee availability of customers money should incase they come for it and reduces losses since the bank will be able to meet up with its financial obligations. I also came to realize that the implementation of credit risk management starts right from the time a company wishing to take credit deposits it application, through when it receives the credit until when it does its repayment. All the banks are always concerned about the credit worthiness of the loaning companies and will require certain information from which they do their credit assessment. This information is valued differently by the different banks but the sole goal being “to be sure that the customer will repay their money”. The importance given to the information collected is valued differently by the different banks. But, no matter what information is considered important and no matter what techniques is used for the credit risk management, the most important thing is that the goal for the activity should be attained (avoidance of default or late payment and thus success).
6.2. Recommendation

With the importance that is attached to credit risk management when carrying out lending decisions and since each bank value information differently, I would want to recommend that for banks to have greater success, they should always try to value all information about the customers with a high level when doing their credit assessment because the information they may consider to be less important could be the cause of a failure in their decisions or, it could be the area from which the customer’s default arises.

Bank practitioners should have it in mind that credit risk management is not to be introduced or stopped at a particular stage of the banking activity but, should be a continuous process. This I believe will lead to greater success since the risk which leads to this job is associated with the main activity of the bank and can’t be avoided.

Practitioners should be obliged to follow their CRM process, policy guidelines (even if they want to go out of the scope at times) and make their customers know them well. I believe this will avoid some problems, blames and the issue of emotions or confusion in case of the absence of predecessor.

Practitioners should have it at the back of their minds that good collateral is no guarantee for a credit to be granted to a customer. The type of collateral too should be considered especially in terms of availability of its future market.

A good relationship with a customer right from the start, through and along the business will make it easier to identify and if possible solve problems in time before they get off hand. This can indirectly help to automatically bring solutions to some problems beforehand. No matter the situation also, it is always good to maintain customer goodwill and calling customers on phone could be good but not the best way of handling issues.

No practitioner can claim to know a customer, so, it is always good to go through all lending procedures because changes may evolve at any point in time.

When taking any decision at any point in time, practitioners should always have it at the back of their minds that they are operating in a very unstable and dynamic environment. So, at the end of every decision, they should always make allocation for “what if” questions.

6.2.1. Practical implications

The practical implications I will put forth after this work will include the following;

- Bankers should learn to document all decisions they take even if they are from personal reasoning.
- The banks should be conscious that no point should be minimized or neglected when it comes to lending decision making because the same point can turn out to be the root cause of a problem which if it’s not immediate, can be in the long run.
- The banks should also try to make themselves known to the customer in any way they can in order to avoid egoism. Even though the customer is seen as being the cause of credit risk in case of default, he or she also has a right to know the bank.

6.2.2. Theoretical contributions

This study has really contributed to the knowledge base of already existing challenges of bank managers in Umeå Sweden and the world at large. Based on previous theory on this topic that I have read to my knowledge, I have always heard of collaterals being mentioned as being there to make up for a credit if a customer default payment. But, from a response gotten from one of my interviewees, he went as far as talking of the risk of these collaterals not having available market maybe at the time of default. I see it as a very good contribution which practitioners have to consider when taking their decision on collateral.

I will personally contribute to theory by bringing forth a point which I have tried to brainstorm based on my work. In previous theory and based on this work, customers are always blamed as being the sole cause of credit risk because this risk always arises as a result of their default or delayance to pay back their loans. I think the credit analysts (banks) are to be blamed too to a certain extent because this default can in some cases arise as a result of the banks’ failure to carry out their own duties correctly from the beginning, through and to the end of the credit management process.

**Figure 5: Effective knowledge for good CRM**

<table>
<thead>
<tr>
<th>Customer</th>
<th>Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capacity</td>
<td>Management</td>
</tr>
<tr>
<td>Capital</td>
<td>Norms</td>
</tr>
<tr>
<td>Character</td>
<td>Policy</td>
</tr>
<tr>
<td>Capital</td>
<td>Philosophy</td>
</tr>
<tr>
<td>Collateral</td>
<td>Practices</td>
</tr>
<tr>
<td></td>
<td>Strategies</td>
</tr>
</tbody>
</table>

**Source:** Beaulieu 1996 / general literature /author

**Explanation**

For good and effective CRM to be attained, when the bank assesses the customer using the 5 C’s of credit, it does so while reviewing its norms, policies, philosophy, practices and strategies. The results gotten then determine whether a credit should /should not be granted. If the answer is positive, the customer also has the right to know the bank so as always to feel
free at anytime to keep them informed of their situation. A mutual knowledge of each other can to a certain extent facilitate CRM and of course reduces default.

6.3. Suggestions for future research

There have been various studies relating credit risk and credit risk management to customers default. Mention can be made of Sinkey (1992), Boffey & Robson (1995), Focardi (2009) among others. However, there are still some areas of interest for future research which could be looked into especially as we are living in an environment which is evolving daily. My contribution of an interesting area of future research could be:

A study on the extent of a customer being the sole cause of credit risk. Here researchers will look at the part customers and financial intermediaries play when it comes to lending activities. Is the blame solely on the customers because they are the borrowers or the financial intermediaries also have a role? In this study, the researcher will conduct an interview with some customers to know their point of view on credit risk and if they put some blames on the practitioners (banks). A repertory grid technique can be used when especially the research wants to carry out a quantitative study on this topic. Conclusions will obviously open the eyes of practitioners to an extent and put them to more work for greater success to be attained.

6.4. Limitations

I believe that the results of this study would have been more elaborated, generalized or a bit different if I had more interviewees since the managers I interviewed is just a few amongst many financial intermediaries and within a specific geographical area. It was first of all very stressful to have the ones I interviewed and contact with other financial intermediaries yielded no results. So, my results and recommendations should not be taken as an expert or specialist advice but just as a mere academic exercise to bring forward what I found out in the course of this work and what I think (based on my analysis and previous theory read) that practitioner should do in order to improve their results.
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Appendix

Interview guide

General questions:

1. Is it ok that I record?
2. Do you accept that I put your name in the thesis?
3. What is your name?
4. What is your position in the bank?
5. How long have you worked in the bank? What is your working experience?
6. What is your educational qualification?

Credit Risk Management (CRM) in lending decisions

7. Why do you think credit risk management is important?
8. Why do you involve it in your lending decision if at all you do?
9. Do you see the effectiveness of the lending decisions you take?
10. Why do you think it is effective?
11. Have you experiences any defaults from customers despite the lending decisions you took? From your opinion why do you think this happened?
12. If you were given the opportunity to carry out lending decisions all alone without the bank’s policy guideline, what could you bring forth?
13. Why do you think this will be effective?
14. What risk do you think will be involved in the lending decision you will take?

Credit granting / customers

15. Do your bank grant credits to companies?
16. Who are your customers (big companies, small and medium sized, etc)?
17. What information do you need when making a lending decision to know whether to grant
credit to a customer or not?

18. Why do you think this information is important?

19. Is some of this information more important than others?

20. Why do you think so?

2. Where or how do you get information about the customer?

22. Are you satisfied with the sources of the information?

23. Why/or why not are you satisfied / or not?

24. Are there any other sources which you think should be used to get information?

25. Why do you think these sources should be used?

26. Do you know that there can be some information about the customer not known to you?

Collaterals

27. Why do you think collaterals are important in a credit granting decision?

28. How do you assess whether the collateral offered is enough?

29. Is there any situation where the collateral is the determining factor whether the credit should be granted or not? If so, what situation?

Loan collection

30. Have you ever encountered a situation where a customer defaults / delays payment?

31. In your opinion why do you think it happened?

32. How do you handle such a situation?

33. Why do you think the approach you used to handle the situation is the best?

34. What is the effect on the bank / shareholder?
Relationship questions

35. Why do you think a good relationship with a customer is important?

36. Does a lengthy relationship with customers tend to lead to an easier credit assessment process?

37. Why is it so?

38. Does your relationship with new customers make their credit assessment process more difficult?

39. Why?

Effects of legislative changes on credit granting

40. How has the Basel 11 Accord affected your management?

41. How has the instability in the financial market affected your bank?

42. How has the global financial crisis affected your bank?

43. And how in your opinion do you think it has affected your customers?

44. Do you think this Accord has affected your credit granting in any way? How?

Conclusion

What change do you hope can take place in the banking industry?

Do you have anything to add?

Can I get back to you in case of any further questions?