

## Credit Risk Management: An Insight into Its Policies and Strategy Formulation

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### Abstract

**Purpose:** *The purpose of this paper was to have an insight into policies and strategy formulation of credit risk management in Ghana. Commercial banks play a critical role to emerging or developing economies like Ghana where borrowers have no or limited access to capital markets*

**Design/methodology/approach:** *The study adopted both qualitative (case study) and quantitative methods respectively. Banks were selected to gather data, which was acquired from answers obtained from our administered questionnaires. The population of the survey constituted the management and non-management staff and customers of Ecobank (EBG), Ghana Commercial Bank (GCB) and Stanbic Bank.*

**Findings:** *The data gathered for the study were analyzed using correlation. Results of the study showed that there are high positive correlation between the constructs of credit risk management, its policies and strategy formulation.*

**Keywords:** *credit risk management, credit risk policies, credit risk strategies and Ghanaian banking industry.*

## 1. INTRODUCTION

The significant role played by banks in a developing economy like Ghana (where access to capital market is limited) cannot be overemphasized. In fact, well-functioning banks are known as catalyst for economic growth whereas poorly functioning ones do not only impede economic progress but also exacerbate poverty (Barth et al, 2004). However, banks are exposed to various risks such as credit, market and operational risk. Although all these risk militate against the performance of banks in several ways, Chijoriga (1997) argues that the size and the level of loss caused by credit risk as compared to others were severe to collapse a bank. Laxities of credit standards for borrowers and counterparties have caused serious banking problems, including loan losses, for many banks especially those in developing countries including Ghana.

In the commercial banking industry, it seems as if we really have not understood our borrowers or their industries as much as we should. Inevitably, this fundamental failure has produced significant credit problems. Most commercial banks have taken the main ingredient needed for quality assets for granted. Asset quality problems are therefore the consequence of ignoring the fundamentals of credit. In retrospect, most

commercial banks are guilty of lending excesses that sourced and turned into credit problems. There should be a transition in the fundamental economies of lending precipitated by poor credit risk management habits and an obvious decline in credit underwriting standards. The tendency to disregard structuring, strong loan documentation, and diligent monitoring and servicing of credits have increased the credit impairment of most rural banks in Ghana thereby making them less profitable. The researchers complement and extend this stream of the literature by having an insight into policies and strategy formulation of credit risk management in Ghana.

The remainder of this paper is structured as follows. Section 2 will be present both the theoretical background and hypothesis to this study. Section 3 provides the research methodology of the study. In section 4, the researchers present the statistical results and discussions of finding. Finally, this study in section 5 discusses the conclusion of the study.

## 2. THEORETICAL BACKGROUND AND HYPOTHESIS

### 2.1 Overview of Risk Management

Risk management as a discipline can be defined as "A management discipline whose goal is to protect and profits of an organization by reducing the potential for

loss before it occurs, and financing, through insurance and other means, potential exposures to catastrophic loss such as acts of God, human error, or court judgments. In practice, the process consist of logical steps: risk or exposure identification; measurement and evaluation of exposures identified; control of those exposures through elimination and or reduction; and financing the remaining exposures so that the organization, in the event of a major loss, can continue to function without severe hardship to its financial stability” (Thornhill, 199) According to Duffie and Singleton (2003), risk management is the process of adjusting both risk of large losses and the firm’s vulnerability to them. This vulnerability depends on the portfolio of positions and on the amount of capital that is backing the firm’s investment activities. Vaughan (1997) also defines risk management as a scientific approach to dealing with pure risks by anticipating possible accidental losses and designing and implementing procedures that minimize the occurrence of loss or the financial impact of the losses that do occur.

The heart of bank financial management is the ability to manage the portfolio risk. To quote Walter Wriston of Citibank (the economist 10<sup>th</sup> April, 2003): “The fact is that bankers are in the business of managing risk. Pure and simple, that is the business of banking”. Financial institutions are exposed to a different types of risk in carrying out their operations (Hitchins et al, 1996) identify nine types of risks namely credit, liquidity, interest, currency, market, operational, legal and regulatory, environmental, and health and safety risks. Heffernan (1996) further identifies other forms of risks apart from the nine risks identified above as settlement payment, gearing or leverage, political, and risks of global financing.

## **2.2 Credit Risk Management, Polices and Strategy Formulation**

An overall credit risk management review will include an evaluation of the credit risk management policies and policies of a bank. The evaluation should also determine the adequacy of financial information received from a borrower or the issuer of a financial instrument, which has been used by a bank as the basis for investing in such financial instruments or the extension of credit; and the periodic assessment of its inherently changing risk (Greuning and Bratanovic, 2003). According to Richard, Chijoriga and Kaijage (2006) considerations that form the basis for sound credit risk management system include policy and strategies that clearly outline the scope and allocations of a bank credit facilities and manner in which a credit portfolio is managed, that is, how loans are originated, appraised, supervised and collected.

Credit risk management framework in a commercial bank may be broadly categorized into three main components namely: Board and senior management’s oversight; Organizational structure and systems and procedures. This framework helps identification, acceptance, and measurement, monitoring and controlling credit risks.

The Board of directors of commercial banks has the overall responsibility to approve and periodically review the credit risk strategy and significant policies relating to credit risk of their respective banks. Credit risk strategy should always be based on the banks’ overall business strategy. The strategy always reflects the banks’ tolerance for risk and the level of profitability they expect to achieve from incurring various credit risks. The overall strategy has to be reviewed by the board, preferably annually. The responsibilities of the board with regard to credit risk management include delineating the banks’ overall risk tolerance in relation to credit risk; ensuring that banks’ overall credit risk exposure is maintained at prudent levels and consistent with the available capital; ensuring that top management as well as individuals responsible for credit risk management possess sound expertise and knowledge to accomplish the risk management function; ensuring that the bank implements sound fundamental principles that facilitates the identification, measurement, monitoring and control of credit risk; ensuring that appropriate plans and procedures for credit risk management are in place, Basel(1999)

According to Greuning & Bratanovic (2003), board of directors must ensure that a banks’ lending function fulfills the three fundamental objectives of credit, that is loans should be granted on a sound and collectible basis; funds should be invested profitable for the benefit of shareholders and the protection of depositors; and the legitimate credit needs of economic agents and or households should be satisfied. It is crucial for the board of directors to assess if lending is well-organized, policies well-reflected in internal procedures and manuals, staffing adequate and diligent in following established policies and guidelines, and the formation normally available to participants in the lending process timely, accurate and complete. The senior management of the bank develops and establishes credit policies and credit administration procedures as a part of overall credit risk management framework and get them approved by the board of directors and for developing policies and procedures for identifying, measuring, monitoring and controlling credit risk. Senior management continuously ensures that credit policies and strategies are clear and communicated throughout

the organization. They also ensure that these policies and strategies are implemented through appropriate procedures, and periodically revised to take into account changing internal and external circumstances to the board and corrective measures taken (Basel, 1999)

Bank supervisors place considerable importance on formal policies laid down by the board of directors and diligently implemented or administered by management. This emphasis is perhaps most critical with regard to the banks' lending function, which requires that a bank must adopt a sound system for managing credit risk. A lending policy should contain an outline of the scope and allocation of a bank's credit facilities and the manner in which a credit portfolio is managed, that is, how loans are originated, appraised, supervised, and collected. 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 parameters of written guidelines. Flexibility must exist to allow for fast reaction and early adaptation to changing conditions in a bank's earning assets mix and market environment (Greuning and Bratanovic, 2003).

According to Basel (1999), a cornerstone of safe and sound banking is the design and implementation of written policies and procedures related to identifying, measuring, monitoring and controlling credit risk. Credit policies establish the framework for lending and guide the credit-granting activities of the bank. Credit policies should address such topics as target markets, portfolio mix, price and non-price terms, the structure of limits, approval authorities, exception reporting, etc. Such policies should be clearly defined, consistent with prudent banking practices and relevant regulatory requirements, and adequate for the nature and complexity of the bank's activities. The policies should be designed and implemented within the context of internal and external factors such as the bank's market position, trade area, staff capabilities and technology.

Policies and procedures that are properly developed and implemented enable the bank to maintain sound credit-granting standards, monitor and control credit risk, properly evaluate new business opportunities and identify and administer problem credits. Credit policies and procedures provide guidance to the staff on various types of lending including corporate, small and medium scale enterprises, consumer, agriculture, and others. At minimum a credit policy should include a detailed and formalized evaluation or appraisal process, approval authority at various hierarchy levels including authority for approving exceptions, risk identification, measurement, monitoring, control and risk acceptance

criteria; origination and administration and loan documentation procedures, roles and responsibilities of units or staff involved in origination and management of credit, guidelines on management of problem loans.

Greuning and Bratanovic (2003) also indicated that considerations that form the basis for sound lending policies should include a limit on the total outstanding loans, geographic limits, concentration limits, the type of loans and other credit instruments that the bank intends to offer to clients and guidelines for specific loans, the maximum maturity for each type of credit and loans granted, loan pricing, lending authority, appraisal process, impairment reporting, methods of collections and reporting, and borrowers' financial information needed. Greuning and Bratanovic (2003) pointed out that a lending policy should be supplemented with other written guidelines for specific departments of the bank. Written policies and procedures that are approved and enforced in various departments should be referenced in a bank's general lending policy. The absence of written policies,

### **3. RESEARCH METHODOLOGY**

#### **3.1. Research Design**

Research is a process of steps used to gather and evaluate information in order to increase understanding on an essential topic. It consists of three steps, namely posing a question, collecting data to answer the question, and presenting an answer to the question (Creswell, 2009). The research design for the current study refers to a quantitative form. This research concentrates on the relationship among variables more than on testing activity impact, and uses correlation design. Based on the described research objective, this study will adopt a correlation design. Correlation design allows us to predict an outcome and know the relation between variables.

#### **3.2 Study Area**

The study was conducted in Accra the capital city of Ghana. The location of the city makes it the commercial center and a nodal point from which roads radiate to the central business areas of the region. Ecobank (EBG), Ghana Commercial Bank (GCB) and Stanbic Bank in Ghana were chosen because it has greatest market share in the industry

#### **3.3 Population and Sampling**

The population of the survey constituted the management and non-management staff and customers of Ecobank (EBG), Ghana Commercial Bank (GCB) and Stanbic Bank in Ghana. The researchers used the simple random sampling. The study used a sample size of six hundred (450) and due to adequate time the researchers

devoted for the data collection, the researchers were able to get five hundred and forty-five (417) questionnaires that were administered

**4. DATA ANALYSIS**

After collecting data, we evaluated the policies and strategy formulation of credit risk management in Ghanaian telecommunication industry. Based on

analysis of the collected data and using description statistics for demography, it was found that most respondents were male at 60.4% and the most of the research participants (49.7%) are aged between 25 and 40. Additionally, most people (48.2%) have some undergraduate education level and most respondents are married (58.9%).

**Table 1: Correlations between credit risk management, firm policies and strategy formulation.**

		Credit Risk Management	Firm policies	Strategy Formulation
Credit Risk Management	Pearson Correlation	1	0.723**	0.615**
	Sig. (2-tailed)		0.000	0.000
	N	417	417	417
Firm policies	Pearson Correlation	0.723**	1	0.611**
	Sig. (2-tailed)	0.000		0.001
	N	417	417	417
Strategy Formulation	Pearson Correlation	0.615**	0.611**	1
	Sig. (2-tailed)	0.000	0.001	
	N	417	417	417

Moreover, to achieve the research objective the relationship between credit risk management, firm policies and strategy formulation should be assessed, and from table 1, the Pearson correlation was utilized. There is a strong relationship between credit risk management and firm policies with a correlation coefficient of 0.723 at the 0.01 level (2-tailed), credit risk management and strategy formulation with a correlation of 0.615 at the 0.01 level (2-tailed), firm policies and strategy formulation with a correlation coefficient of 0.611 at the 0.01 level (2-tailed).

**5. CONCLUSION**

The banking industry is one of the fastest growing kinds of industry and its products and services are in high demand since customers use it daily. Moreover, credit risk management, firm policies and strategy formulation guarantee profitability, and they play pivotal roles for companies within this industry, consequently.

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