Chapter 3

Analyzing Risk Management and Non-Performing Assets in Banks

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ABSTRACT

All financial institutions face risks to some degree. When talking about risk it must be analysed which conditions carries more risk than another. Thus, a bank must evaluate both the return and the risk implanted in the portfolio. Banks must measure the anticipated profit and assess the prudence of the various risks tallied to be sure that the result attains the stated goal of maximizing shareholder value. This study was conducted in HDFC bank in India. The study has used both primary and secondary data. The aim of the chapter was to inspect the different practices followed by the bank to different types of risks which a bank faces when credit is given and how these practices has assisted the bank to drop the consequence of the risk on the effectiveness and operations. The chapter also reveals the contemporary developments in the Non-Performing Asset levels of the bank and how bank has been successful in reducing the pace of NPAs to curtail the load of securitization.

INTRODUCTION

Human history is manifested by the exposure to risks of all kinds along with the outcomes applied to mitigate those risks. From antediluvian time, at the arrival of species, the anthropoid adept risk management in order to stay alive. The practice of survival instincts led to the avoidance of risks threatening to extinct the human kind. The very survival of mankind today is the evidence of the triumph of applying risk management approaches by our dynasties. Risks are suspicions. In the banking cosmos, there are a large number of risks. As the goal of any company, the central goal of bank’s management is to increase the shareholders’ value. Insolvencies in the financial sector are expensive, not only for the equity and debt holders of banks’ but often also for taxpayers of the country. In order to evade that the banks are continually under burden and have to take up high risks and at the same time manage the risks in order to avoid, or at least lessen losses.
Throat-cut competition in the banking sector is usually seen as injurious to financial stability. The basic notion is that when banks strive passionately for deposits, interest rates fall and their brand value is battered. Banks have then less to lose from a default and their spurs to take on risk surge. This argument has been very important in shaping banking regulation around the world, for instance in the form of competition and merger policies.

All financial institutions take on risks to some degree. When talking about risk it must be analysed which state brings more risk than another. Thus, a bank must evaluate both the return and the risk implanted in the portfolio. Banks must ration the expected profit and appraise the discretion of the various risks counted to be sure that the result achieves the stated goal of developing shareholder value. How is risk dignified? As in the case of defining risk, stating the degree of risk has also more tactics. On one side, there is the link created between the degree of risk and the probability of happening. According to ISO Standards Guide 73:2009 on Risk management – Vocabulary, risk can be defined as the combination of the probability of an event and its consequences. Therefore, risks may have positive or negative outcomes or can result in uncertainty. Therefore, we can say that risks can be connected to a loss (when it has a negative outcome), to a prospect (when it has a positive outcome) or to an increase in the degree of ambiguity. In the case of the individual, the hope is that no loss will befall, so that the probability of a deviation from what is hoped for (which is the measure of risk) varies directly with the probability that a loss will happen.

Risk management is often accomplished by an organizational unit, ideally a sovereign staff function reporting directly to the board of directors, making risk management a board obligation and task. The board has to set strategic marks and ensure, via strict controls, that the deputized goals are actually achieved within the centrally authorized guidelines. Running a risk-management function in a centralized manner is beneficial because it allows for an independent, integrated view of all types of risk, so that only the net positions need to be managed and specialized staff can achieve better pricing in the capital markets. Management has to develop strategic goals for the various risk areas (risk strategy) that are proportionate.

Banks usually classify as nonperforming assets any commercial loans which are more than 90 days overdue and any consumer loans which are more than 180 days overdue. More generally, an asset which is not producing income.

Action for enforcement of security interest can be initiated only if the secured asset is classified as Non-Performing Asset. Non-Performing Asset means an asset or account of borrower, which has been classified by a bank or financial institution as sub-standard, uncertain or loss asset, in accordance with the directions or guidelines relating to asset classification issued by RBI.

An amount due under any credit facility is treated as “past due” when it has not been paid within 30 days from the due date. Due to the development in the payment and settlement systems, recovery climate, upgradation of technology in the banking system, etc.

It was decided to dispense with ‘past due’ concept, with effect from March 31, 2001. Accordingly, as from that date, a Non-performing asset (NPA) shell be an advance where

1. Interest and/or instalment of principal remain overdue for a period of more than 180 days in respect of a Term Loan.
2. The account remains ‘out of order’ for a period of more than 180 days, in respect of an overdraft/cash Credit(OD/CC).