

THE IMPACT OF EFFECTIVE CREDIT RISK MANAGEMENT ON BANK SURVIVAL

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ABSTRACT: *A number of financial institutions have collapsed or experienced financial problems due to inefficient credit risk management systems. The study seeks to evaluate the extent to which failure to effectively manage credit risk led to Zimbabwe's banks' demise in 2003/2004 bank crisis. It also seeks to establish other factors that led to the banking crisis and to outline the components of an effective credit risk management system. The study found that the failure to effectively manage credit risk contributed to a greater extent to the banking crisis. The research also identified poor corporate governance, inadequate risk management systems, ill planned expansion drives, chronic liquidity challenges, foreign currency shortages and diversion from core business to speculative non-banking activities as other factors that caused the crisis. There is also need for banks to develop and implement credit scoring and assessment methodologies, review and update the insider lending policies and adopt prudential corporate governance practices.*

KEY WORDS: *credit, risk management, bank failure, bank survival*

1. BACKGROUND

The year period 2003 to 2004 saw a number of banks being forced to close down in what was termed the Zimbabwean Banking Crisis and the main cause being poor credit risk management. In Zimbabwe the number of financial institutions declined from forty as at 31 December 2003 to twenty nine (29) as at 31 December 2004 and the impact of effective credit risk management on bank survival cannot be overemphasized. Some financial institutions were forced to close down and others were placed under curatorship.

The main cause of the banking crisis was poor credit risk management practices typified by high levels of insider loans, speculative lending, and high concentration of credit in certain sectors among other issues. The failure to effectively manage credit risk created similar problems in countries such as Mexico and Venezuela.

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This situation tends to be exacerbated by the failure of institutions to properly implement an effective credit risk management framework.

Financial institutions have faced difficulties over the years for a multitude of reasons, the major cause of serious banking problems continues to be directly related to lax credit standards for borrowers and counterparties, poor portfolio risk management, or lack of attention to changes in economic or other circumstances that can lead to a deterioration in the credit standing of a bank's counterparties (Gil Diaz, 1994).

The traditional role of a bank is lending and loans make up the bulk of their assets. In unstable economic environments interest rates charged by banks are fast overtaken by inflation and borrowers find it difficult to repay loans as real incomes fall, insider loans increase and over concentration in certain portfolios increases giving a rise to credit risk. Bank failures in Mexico were attributed to improper lending practices, lack of experience, organizational and informational systems to adequately assess credit risk in the falling economy (Gil Diaz, 1994). The same can be said about of banking crisis in Kenya in the 1980s and in Spain in the 1990s.

The study evaluates the extent to which failure to effectively manage credit risk led to bank' demise in the Zimbabwean banking crisis of 2004. Factors that led to bank failures in Zimbabwe are established in this study. The research will be limited to the analysis of the impact of effective credit risk management on bank survival.

2. RESEARCH QUESTIONS

This study seeks answer the following questions: How did the failure to effectively manage credit risk lead to banks' failure in the Zimbabwe Banking crisis of 2004? What other factors led to bank failures in Zimbabwe? What are the components of an effective credit risk management system?

3. METHODOLOGY

In order to find answers to the research questions useful different methods and instruments were used to collect data. The research data was collected over six months to June 2009. The researcher chose the survey as the appropriate research design for the study, and as such, questionnaires and interviews were used as research instruments. Some unclear or hanging issues in the questionnaires were clarified in interviews. A sample of 10 commercial banks randomly chosen was used in this analysis. Twenty questionnaires were used to gather data with two for each commercial bank chosen. A total of 10 interviews were held with the heads of credit or senior managers from those banks.

The questionnaire had 12 short questions designed for the bankers and or senior managers from those banks so that they would not have a difficulty in answering questions. The first two questions constituted the respondent profile. The two questions that followed formed the administrative section where the research was obtaining information about the financial institution. Question five up to the end of the questionnaire formed the main body from which the crucial data for the research was

obtained. Document review was also used to obtain as much data as possible for a comprehensive, detailed and informed analysis of the study.

4. LITERATURE REVIEW

According to the Reserve bank of Zimbabwe (RBZ) risk management operating document (2004), credit risk or default risk involves inability or unwillingness of a customer or counterparty to meet commitments in relation to lending, trading, hedging, settlement and other financial transactions.

Credit risk arises from uncertainty in counterparty's ability or willingness to meet its contractual obligations. Bessis (1998) also includes a decline in the credit standing of counterparty as part of credit risk. Credit risk management covers both the decision making process, before the credit decision is made, and the follow-up of credit commitments, plus all monitoring and reporting processes (Miller, 1996).

5. CAUSES OF BANK CRISES

Bank failures have been experienced in a number of countries that include Mexico, Venezuela, Spain, Kenya, United Kingdom, Sweden and Norway. Analysts' concurred that bank failures are caused by a combination of factors. Herrero (2003) identifies poor bank profitability, low net interest margins and low GDP as some of the causes of bank failure. He categorizes these factors into bank specific and macroeconomic factors. Among the bank specific factors are asset quality, management quality, earnings and liquidity as the key factors. As for the macroeconomic factors, high interest rates, low economic growth, adverse trade shocks, exchange rate movements and foreign liabilities are cited.

Hooks (1994) points out that deteriorating local economic condition for example inflation, interest and exchange rates cause bank failure. Hefferman (1996) asserts that macroeconomic factors worsened by regulations that are imposed on banks lead to bank failures.

Kane and Rice (1998) state that government intervention causes bank distress. They argue that when governments intervene in saving banks from failing, creditors and customers tend to rely on the government to protect their interest. This intervention is a disincentive for other institutions, creditors and customers to effectively monitor their interests in banks in an independent way.

Miller (1996) identifies the following situations, which can lead to bank failures: too many stringent rules causes bank to disregard the measures as superfluous; some dangers bank are exposed to may not be addressed properly in general laws; and a rigid system of rules can inhibit banks from selecting the most efficient means of achieving regulatory goals set for them and may serve as a disincentive for improvement.

The lower the bank's capital, the higher the probability of its failure (Goodhart 1998). As a bank's capital decreases, the higher its motivation for actions towards survival and this leads to more dangerous risk taking operations. Friedman (Hooks, 1994:37), postulates that bank failures arise because banks do not keep all their

deposits in statutory reserve funds. Some regulatory bodies exercise forbearance; however, this contributes to bank failures by permitting distressed banks to continue operating instead of liquidating them. The distressed banks, who are allowed to operate, face deterioration in their capital situation as they lack adequate funds.

Banking crisis mostly come from the absence of good managerial ideas in management decision making (Tay, 1991). Therefore, competence and focus play a major role in banking. Mismanagement, especially excessive risk taking, is the main cause of bank failure (Lepus, 2004).

Tay (1991) observes that even though bankers are accused of misconduct, it is difficult to prove that the negligence of management is the only cause of bank failure. Smith and Walter (1997, cited by Apea and Sezibera, 2002) states that fraud causes banks to fail as happened in the case of Banco Ambrosiano and Hersatt. They add that corruption and fraud have been the general causes of bank failure. Tay also argues that deregulation and mismanagement to fraud and corruption are the major causes of bank failure.

Marrison (2002) articulate that the main activity of bank management is not deposit mobilization and giving credit. Effective credit risk management reduces the risk of customer default. They add that the competitive advantage of a bank is dependent on its capability to handle credit valuably. Bad loans cause bank failure as the failure of a bank is seen mainly as the result of mismanagement because of bad lending decisions made with wrong appraisals of credit status or the repayment of non performing loans and excessive focus on giving loans to certain customers. Goodhart (1998) states that poor credit risk management which results in undue credit risk causes bank failure. Chimarine(1998) concurs with Goodhart, but he goes on to suggest that a bad lending tradition leads to a large portfolio of unpaid loans.

This results in insolvency of banks and reduces funds available for fresh advances, which eventually leads to bank failure. Goodhart et al add connected lending to the causes of bank failure. Irregular meetings of loan committees, false loans, large treasury losses, high sums of unrecorded deposits and money laundering in large amounts, contribute to bank failure.

Kolb (1992) states that the failure of banks is mainly due to the risky credits they give. Irrespective of the extent of risk involved, effective credit risky loans they give. Irrespective of the extent of risk involved, effective credit risk management can reduce bank failures.

Herrero (2003) in his paper, The determinants of the Venezuela Banking Crisis argued that among the reasons for Bank Latino's failure was inappropriate lending practices, which allowed collateral to be used for multiple loans, poor loan quality and a high concentration of loans in one sector. De Juan (2004), argues that banking failures in Spain were caused by poor risk management especially credit risk which was aggravated by the concentration of the loan portfolio in the group to which the bank itself belonged.

High inflation and high interest rates cause economic activity to collapse, and resultantly the burden of serving debts denominated in domestic and foreign currency increases and banks' capitalization ratios fall (Gil-Diaz, 1994). Gil-Diaz asserts that poor borrower screening, credit volume excesses and the slowdown of economic

growth in 1993 in Mexico turned the debt of many into an excessive burden. As such non performing loans, which carry high risk started to increase rapidly. Kolb (1992) is of the opinion that unsound banks, that is, those with poor credit risk management systems become captive to insolvent debtors or carry a portfolio of loans to related borrowers, who have no intention of repaying their debts.

Politically directed lending leads to bank failures as dishonest and greedy leaders exploit the funds of banks as happened in the Philippines in the 1980s (Hussey and Hussey, 1997). In most cases governments direct banks to give loans to certain borrowers, thus discouraging banks to fully make their credit appraisals. The implication is that such loans are not paid off.

It is said if you cannot measure credit risk, then you cannot manage risk (Monetary Authority Singapore, 2003). The measurement of credit risk is of paramount importance in credit risk management. Davies and Kearns (1992) emphasizes that institutions should have procedures for measuring their overall exposure to credit risk as well as exposure to connected parties, products, customers and economic sectors. Bhatia (2005) emphasizes that a well structured Internal Risk Rating system facilitates determination of the obligor's risk profile and likely loan loss. Internal risk rating is an important tool for monitoring and controlling risk inherent in individual and portfolio credits of a bank or a business line.

The Central Bank of Kenya (2005) suggests that banks need to establish a system that enables them to monitor quality of the credit portfolio on a day to day basis and take corrective steps as and when deterioration occurs. The Authority stated that the bank's credit policy should explicitly provide procedural guidelines regarding credit risk monitoring.

At the minimum it should lay down procedure relating to the following:

- the risks and responsibilities of individuals responsible for credit risk monitoring;
- the assessment of procedures and analysis techniques;
- the frequency of monitoring;
- the periodic examination of collaterals and loan covenants;
- the frequency of site visits;
- and the identification of any deterioration in any loan.

6. RESULTS

Responses were obtained from ten interviews held and twenty questionnaires distributed to different banking institutions. Majority of respondents (90%) agreed that the failure to effectively manage credit risk contributed to banks' demise in the Zimbabwe Banking Crisis of 2004. The remainder (10%) was of a different opinion as they cited poor corporate governance as the chief causal factor of the crisis. On how the crisis came to being respondents were asked why credit risk was high during the period in question. All mentioned that difficult macro economic environment had led to the chaos. Half (50%) mentioned incompetence of Board and senior management; 30% stated lack of adequate regulatory guidelines on credit risk; and 90% were of the

opinion that preoccupation with speculative activities by banks contributed to the closure of those institutions.

On whether the board of directors and senior management of many banks were aware of the credit risk their banks faced prior to the crisis. Seventy percent of the respondents agreed that the board and senior management were aware of the credit risks. They attributed their failure to effectively manage it to the following factors: preoccupation with speculative activities as the earnings in such activities was above the Return on Assets (ROA) of proper banking activities as the economic environment was deteriorating.

Other cited incompetence of these boards as they sometimes engaged in activities they had no previous experience before, for example derivatives trading. Thus, the boards and senior management of many banks were worried about surviving the challenging economic difficulties at the expense of proper risk management, hence poor corporate governance activities were rife. Thirty percent of respondents argued that the board and senior management were not aware of the credit risk they faced attributing it to incompetence.

All respondents agreed that effective credit risk management was very important to the survival of a bank. By adhering to the set guidelines on credit risk management by the regulatory bodies a bank reduces its compliance risk and as such it will be compelled to set aside adequate capital for its credit risk. A bank gains a competitive advantage if it manages its credit risk effectively achieved through diversified lending and the higher market share this is most likely to yield. On whether credit risk management has improved since the crisis, 60% of the respondents reported that the crisis had awakened banking institutions and risk management is now highly rated.

The remainder, 40% argued that banks have always been giving credit risk priority as the inherent risk and the most popular type of risk. They went on to suggest that banks, however, were now lax in their credit risk management, thus the high credit risk prior to the crisis. As the Reserve Bank of Zimbabwe (RBZ) had accused banks of improperly writing off bad loans respondents were asked about it. Majority (60%) of the respondents agreed that bad loans were written off without following the properly laid down procedures for doing so. These loans were usually of insiders and those of their related parties and/or sister companies, especially those denominated in foreign currency. Only 40% disagreed with the central bank arguing that the hyperinflationary environment caused loans to lose their real value and thus, their repayment was not a problem and as such writing off was not a problem.

On why indigenous banks were the only ones affected many respondents cited poor corporate governance as they argued that locally owned banks had shareholders as board members and this usually led to conflict of interest. This was very common among many locally controlled banks and this is against international corporate governance practices. It was also argued that indigenous banks lacked corporate ethics, norms and values that are the pillars of banking. Insufficient capital bases also contributed to this trend according to the respondents. As locally controlled banks faced difficulties they had no adequate capital to act as shock absorbers or buffers. Incompetence of board and senior management of many banks was also highlighted;

many banks had improperly constituted boards and senior management who were incapable of steering the banks. As such they ended up engaging in non banking activities in a bid to make short term, supernormal profits as they lacked oversight.

Besides an ineffective credit risk system of banks there are many other factors that contributed to the collapse of banks.

The following factors were mentioned:

- difficult macro economic environment;
- inadequate risk management systems;
- poor corporate governance;
- non performing insider loans;
- chronic liquidity challenges;
- diversion from core banking to speculative activities;
- foreign exchange shortages;
- rapid expansion drives;
- unsustainable earnings;
- creative accounting;
- insufficient regulatory framework.

All respondents agreed that effective credit risk management improve a banking institution's performance. They stated that a bank that manages its credit risk well is likely to lend too many sectors of the economy, thus it will have a diversified lending base and this will reduce its concentration risk. Moreover, a bank gains competitive advantage through proper credit risk management. The pricing of credit products is made easier by effective credit risk management as the bank is able to assess the client's risk profile. It was mentioned that effective credit risk management can lead to business growth through gaining of a larger market share by the bank and high profits and stability realized by the bank.

On the proper Credit Risk Management all banks stated that they had a well documented Credit Risk Management Policy as required by the central bank. The key areas covered in the credit risk management policies of many banks were similar with variations in terminology.

These areas are as follows:

- lending criteria;
- portfolio grading;
- management information systems;
- types of facilities, credit products and borrowers;
- identification, measurement, monitoring and control of credit risk;
- management of problem credits;
- organizational structure;
- concentration of lending;
- credit risk mitigation techniques;
- processes, policies and procedures;
- insider lending policies;
- pricing;
- security;

- approval processes and delegated limits;
- high risk areas;
- administration provisioning policy and grading system;
- measurement methodologies;
- credit risk modelling and scoring;
- key risk factors;
- risk reward;
- writing off policy;
- new products policy;
- risk assessment;
- Know Your Customer (KYC);
- periodic reviews; breach of limits;
- Chinese walls;
- delegation of authority;
- international exposure and controlling facility.

These areas allow for the wholesome management of credit risk by a bank, they address the critical areas in credit risk management. Banks are continuously developing new products in this sophisticated banking world in a bid to gain leverage over others and as such there is need for the continual development of strategies to manage credit inherent in these products. The study established that the most popular among these is the derivatives market which comprises of swaps, futures, forwards and options.

On the potential obstacles to the successful implementation of effective credit risk management systems by banks a number of them were highlighted.

These are as follows:

- lack of resources;
- disintegration of systems across departments;
- inconsistency of risk rating approaches;
- data management;
- stringent regulatory requirements.

Respondents agreed that many lessons were learnt from the banking woes. Poor credit risk management can lead to bank failure, thus effective credit risk management is very crucial for bank survival. Other respondents suggested that there is need for banks to manage risks in an integrated approach as one type of risk gives rise to another. It was also highlighted that credit risk management must go hand in hand with good corporate governance; and there is need for the Board and senior management of banking institutions to be independent from the shareholders.

During the period prior to the banking crisis the level of inflation was very high, interest rates unfavourable, economic was negative and the local currency depreciated on a daily basis. This alone presented banks with a challenging environment under which to survive, let alone make profits. Banks could not access cheaper funds from the central bank due to the liquidity shortages and/or Treasury bill holdings by the market. This shortage of funds from the central bank meant that banks had to source for open market funds which was costly. This increased competition for

funds on the money market which pushed rates up and the increase had systemic effects. By the end of 2004, ten banking institutions had been placed under curatorship and two were under liquidation.

7. DISCUSSION

According to the Reserve Bank of Zimbabwe banks had weak underwriting and credit monitoring standards. This led to many credits turning bad, not only due to the obligors' unwillingness and inability to pay, but also the failure by banks to identify a decline in the credit standing of counterparty. Ill planned growth strategies contributed to excessive levels of non performing insider loans. These loans were given to sister companies locally, regionally and/or internationally. An investigation by Camelsa Chartered Accountants revealed that Trust Bank (still under curatorship) bank had significant non performing insider loans granted without formal loan agreements/facility letters and/or proper due diligence. The non performing insider loans led to the bank having liquidity challenges and exposed to higher default risk. One of the affected banks Royal Bank's directors spearheaded the approval of credits to companies in which they had interests.

In the case of Gemtree Investments two directors of Royal bank were also directors of the company; and Panalla Investments where two spouses of two Royal bank directors were directors of the firm. As a result of these insider dealings the bank realized operational losses which consequently led to the bank failing to meet the prescribed prudential capital adequacy ratios. Other failed financial institutions had similar problems. The liquidity gap widened due to the failure by the bank to attract significant deposits due to a bruised reputation. This was compounded by massive withdrawals, and speculation restricted maturity rollovers which worsened the banks' problems and ultimately leading to their failures.

Some banks disregarded set prudential lending limits to insiders and other related parties. In some cases interests was not even charged on insider loans and were eventually written off without Board approval. This led to problems as set rules were violated and regulations not followed thus giving rise to compliance risk and loan losses. The policies and procedures of proper credit risk management stipulate that credit must be made on an arms length basis irregardless of who the counterparty is. The central bank articulates that directors and/or senior management with potential conflict of interest should not be involved the approval of credits to related parties. This over concentration of risk was usually to related parties and this increased default, as well as hampering a wider positive credit impact on other economic activities for achievement of a broad based supply response.

The Reserve Bank of Zimbabwe (RBZ) pointed out what it terms "imprudent credit risk management practices" as being one of the major causes of the banking crisis of 2004. As many writers concurred with the RBZ on some of the causes bank failures many factors were highlighted. The most common of these were difficult macroeconomic environment, inadequate risk management systems, poor corporate governance, diversion from core business to speculative activities, rapid expansion, creative accounting, overstatement of capital, high levels of insider loans,

unsustainable earnings, chronic liquidity challenges, foreign currency shortages and imprudent credit risk management frameworks.

The skyrocketing level of inflation, unfavourable interest rates, negative economic growth, collapsing infrastructure, the closing down of factories and industry, depreciating local currency, and a tough political environment made life difficult, not only for the banks to survive, but for the economy at large. The income levels for banks were failing and so was the purchasing power of the populace. Hyperinflation swept away the interest rates that were charged by banks for loans and advances; hence the real income for banks was low if not negative in some cases.

The money market shortages in the last quarter of 2003 also catalyzed the banking crisis. Diversion from core business to speculative activities also caused chaos in the banking sector. Holding companies were being used to evade regulation as depositors' funds were being used to fund associate companies such as asset management companies or investment vehicles, which were not regulated. In some cases, notes the central bank, banks abused liquidity support from the central bank to fund non banking subsidiaries and associates' requirements. This meant that economic activity in the real sector was limited and in instances bank failure was inevitable.

Also a strong appetite for rapid expansion without proper systems and controls exposed many banks to greater risk of loss. Resultantly, the capital levels of these institutions could not sustain the excessive expansion programs. In some instances depositor's funds were being used to fund these expansion drives, against good corporate governance standards. Misrepresentation of the institution's financial condition was now popular. This was done through tampering with the information systems so as to conceal liabilities and losses by creating fictitious assets and understating expenses and liabilities.

Some banking institutions were overstating their capital levels by under providing for non performing loans, while others falsified transactions to conceal undercapitalization. In some cases, banks were involved in unethical practices involving use of depositors' and borrowed funds to create an illusion of adequate capitalization, thereby violating the Banking and Companies Acts. Financial institutions recorded high paper profits prior to the crisis.

This was as a result of revaluation of assets in line with inflation and exchange rate developments in the market. Some institutions engaged in non core activities which were unsustainable and non permissible due to increased competition and high operational costs in a bid to survive. The other issue was to do with foreign currency shortages in the economy. Some banks engaged in speculative activities in the foreign exchange 'black' market. This compounded the already fragile liquidity situation at these banks, hence exposing them to high liquidity risk.

As with all other areas of an institution's activities, the Board of Directors has a critical role to play in overseeing the credit management functions of the bank. The Basel Committee on Banking Supervision (1999) stipulates that the Board should develop a credit risk strategy or plan that establishes the objectives guiding the bank's credit granting activities and adopt the necessary policies and procedures for conducting such. The credit risk strategy and credit risk policies should be approved and periodically reviewed by the Board. The Board needs to recognize that the strategy

and policies must cover the many activities of the bank in which the credit exposure is a significant risk.

8. CONCLUSION

The results obtained from the research clearly support the assertion that poor credit risk management contributed to a greater extent to the bank failures in Zimbabwe. Therefore effective credit risk management is important in banks and allows them to improve their performance and prevent bank distress. The success of the systems depends critically upon a positive risk culture. Banks should have in place a comprehensive credit risk management process to identify, measure, monitor and control credit risk and all material risks and where appropriate, hold capital against these risks. Establishment of a comprehensive credit risk management system in banks should be a prerequisite as it contributes to the overall risk management system of the bank. There is also need for banks to adopt sound corporate governance practices, manage their risks in an integrated approach, focus on core banking activities and adhere to prudential banking practices.

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