

How Credit Risk Management in Australia Can Affect Financial Institutions Growth: A Study

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Abstract

Ineffective credit risk management methods were largely responsible for the collapse, as well as financial problems, of many financial institutions. This particular research is designed to evaluate how insufficient credit risk management brought about the banking crisis of Australia in 2003/2004 determine other contributing factors. It found that inability to effectively manage credit risk was the most important element in the crisis, leading to ineffective management, insufficient risk control, poorly designed strategies for business expanding, persistent liquidity issues, external currency deficiency, as well as diversion from core banking pursuits to speculative non-banking activities. It suggests banks develop and implement credit scoring and assessment methods, update insider lending practices, and adopt prudential business governance methods.

Keywords

Bank Failure, Bank Survival, Risk Management, Credit

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Introduction

Ineffective credit risk management led to the demise of banks in Australia, from forty in 2003 to twenty-nine in 2004. This resulted in some institutions being closed down and others being put under curatorship. Poor credit risk management methods caused the crisis, like insider loans, high concentrations, and speculative lending of credit in a few industries. In countries such as Venezuela and Mexico, similar problems were observed¹. The situation was worsened by the absence of an effective framework for credit risk management. One major factor for banking issues is inadequate portfolio risk management and failure to meet credit standards for counterparties and borrowers. Another contributing factor is the

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failure to consider changes in other or economic conditions that could lead to a decline in the recognition standing of a bank's counterparts².

Most banks have assets in terms of loans or advances. Borrowers find it difficult to repay loans during periods of economic instability, due to high inflation and reduced real incomes. Bank failures in Spain, Kenya and Mexico have been the result of improper lending practices, insufficient expertise, and insufficient organizational and informational methods to evaluate credit risk. The goal of this study is to examine how inadequate credit risk management contributed to the Australian banking crisis of 2004 and determine additional factors that led to bank failures³.

Research Question

Research will only focus on the effect of credit risk management on bank survival. This study will attempt to answer two inquiries: How did inadequate credit risk management lead to bank failures during the Australian banking crisis of 2004? Exactly what led to the Australia bank failures?

Literature Review

Some factors that contribute to bank failure include high interest rates, decreased economic growth, negative trade shocks, exchange rate variations, as well as foreign liabilities. Hooks (1994) argues that local economic conditions such as inflation, exchange rates and interest rates may also be to blame for bank failures. According to Hefferman (1996), regulations on banks can lead to bank failures and worsen macroeconomic factors. The authors of Cane and Rice (1998) argue that government intervention could lead to bank distress by disincentive for customers and creditors to monitor their positions in banks on their own. Miller (1996) gives that stringent rules, insufficient risk management, and rigid regulatory systems can also play a role in bank failures. Ultimately, the lower the capital of a bank, the greater its failure probability (Goodhart 1998)⁴⁻⁷.

Banks struggling to make it through take on more risks, which may lead to dangerous operations. Friedman (Hooks, 1994): Thirty-seven), bankruptcies occur as banks do not keep all their money in reserve money⁵. Moreover, some regulatory bodies permit struggling banks to continue operating without liquidation, contributing to their failure. The main reason for bank failure is poor management, particularly overconfidence (Lepus, 2004)⁸. Tay (1991) says it is difficult to prove that management negligence is solely responsible for bank failure, while bankers might be accused of misconduct. Walter and Smith (1997, quoted by Sezibera and Apea, 2002) argue that fraud, corruption, and bad management lead to banks being unsuccessful. Tay says deregulation, fraud or maybe corruption are also major causes of bank failure. Competence and focus in banking are ultimately crucial⁷⁻⁹.

The primary feature of bank management is not only to collect deposits and make loans, but also to reduce the danger of customer defaults by providing efficient credit risk management. A bank's competitive edge depends on how effectively it manages credit. Bank failures are usually attributed to poor lending choices made with incorrect credit status assessments or a target on lending to particular customers, leading to many non-performing loans⁷. Poor credit risk management is a major cause of bank failure. Poor credit risk management leads to excessive credit risk. Furthermore, lending traditions that encourage a sizable portfolio of unpaid loans can lead to insolvency and decrease funds readily available for new loans. Factors contributing to bank failure are attached lending, abnormal loan committee meetings, fake loans, huge treasury losses, large sums of unrecorded deposits and large money laundering.

The loans, however risky, must be given out to ensure that the banks remain effective. Effective credit risk management, however, can lower the likelihood of a bank failure⁸. A paper by Herrero (2003) on the Venezuela Banking Crisis determined that Bank Latino's disappointment was due to improper lending practices, bad loan quality, and a higher concentration of loans in a single sector. De Juan additionally discovered that bad risk management, especially with credit risk, triggered banking problems in Spain worsened by the focus of the loan portfolio⁶. The combination of high inflation and high interest rates leads to an economic collapse, which raises the burden of servicing debts in both foreign and domestic currency, and leads to falling capitalization ratios of banks (Gil-Diaz, 1994). Gil-Diaz pointed out bad borrower screening, too much credit volume, and the 1993 economic slowdown of Mexico, which led to non-performing loans increasing rapidly⁵.

If the banks start to be controlled by insolvent debtors or lend money to individuals, they know will not pay back their loans, the method is harmed⁸. This becomes particularly relevant when politicians tell banks to lend to particular borrowers, which discourages banks from properly evaluating credit risk. Credit risk can not be managed effectively if it is not measured. The banks should implement action procedures to measure their vulnerability to credit risk, and must implement internal threat rating methods to assess the risk profile of borrowers, as well as possible loan losses. This type of tool is important for any organization responsible for managing risk⁹.

The bank should have a monitoring system that can determine the quality of its credit portfolio and take corrective action if necessary¹⁰. It also recommended the bank's credit policy must offer specific guidelines for credit danger monitoring, which include determining risks as well as responsibilities, evaluating procedures as well as analysis methods, regularly reviewing collaterals as well as loan covenants, conducting site trips and identifying some bank loan deterioration. 90 % of respondents thought inadequate credit risk management contributed to the 2004 Australia Banking Crisis, in a survey of 10 interviews and 20 questionnaires distributed to different banking institutions, even though the remaining 10 % blamed bad corporate governance¹¹. All respondents attributed the higher credit risk to a challenging macroeconomic environment during the period.

The aim of the survey was to get views on the sources of the fiscal crisis, as well as the role banks played in it. Many respondents believed that the obsession of banks with speculative activities was the primary reason for the closure of many institutions. 70 % of respondents also agreed that senior management and the board of banks were aware of the credit consequences they encountered, but failed to handle them properly because of their concentration on speculative activities, which provided higher returns than right banking activities. Others talked about the incompetence of these boards in carrying out activities they'd no previous experience in. Poor business governance practices were thus rampant, and many banks were more focused on surviving economic problems than effectively managing risks. But most respondents agreed that effective credit risk management is critical to a bank's survival¹².

By sticking with the credit risk management recommendations established by regulatory bodies, a bank reduces its compliance danger, and it is necessary to set aside sufficient capital to cover its credit risk. Increasing market share and diversified lending are the key to achieving competitive advantage for banks through effective credit risk management. 60% of respondents said banking institutions had become more aware of risk management since the crisis. Nevertheless, the remaining 40% said credit risk has always been a concern, but banks have grown to be lax with their management before the crisis. 60% of respondents said the Reserve Bank of Australia (RBZ) accused banks of wrongly composing off harmful loans, and also said appropriate procedures weren't followed for doing this¹³.

Methodology

The researcher has used various tools and methods to collect data and answer research questions concerning the threat management system. Data were collected over a six-month period till June 2009, using interviews and questionnaires as research tools. The survey was selected as the proper research approach, and a random sample of 10 commercial banks was selected for analysis. There were twenty questionnaires, with 2 for every commercial bank, and 10 interviews were performed with the heads of senior managers or credit of these banks. The survey consisted of twelve brief questions. The first two were directed at determining the respondent profile, and the rest were aimed at gathering important information about the financial institution.

It is crucial to review the literature available to conduct a comprehensive and well-informed evaluation of the study. In the 2004 risk management document of the Reserve Bank of Australia, credit risk or maybe default risk describes the potential for a client or counterparty not to meet their obligations in lending, hedging, trading, settlement, along with other financial transactions⁸]. Risk of default is the result of doubts about the counterparty's willingness or ability to satisfy their contractual obligations, which may have a decrease in their credit standing. Risk management involves decision-making processes just before granting credit, and also monitoring and reporting obligations⁷. In various countries, bank failures have occurred due to various factors, including terrible bank profitability, minimal net interest margins, management quality, asset quality, low GDP, earnings and liquidity. The variables can be classified as macroeconomic or bank-specific.

The central bank's decision to write off loan guarantees from local banks got mixed responses from the public. 60 % of those polled agreed with the key bank's decision, but 40 % opposed, arguing that hyperinflation had previously devalued the loans, making their payment irrelevant. Also talked about were the reasons indigenous banks were affected. Respondents cited insufficient capital bases, lack of integrity, values and norms, and poor corporate governance as contributing factors. Also, the incompetence of senior management and the board was highlighted, with many banks engaged in non-bank activities to make short-term profits.

Some factors contributing to the demise of banks include a difficult macroeconomic environment, insufficient risk management systems, bad corporate governance, non performing insider loans, persistent liquidity problems, diversion from core banking to speculative tasks, creative accounting, unsustainable earnings, foreign exchange shortages and inadequate regulatory frameworks. Every one of the respondents said efficient credit risk management was crucial to a bank's achievement. Appropriate credit risk management enables banks to lend to many industries, lessening concentration risk and boosting competitiveness. This will also lead to higher profits, higher business growth, and larger market share. As requested by the core bank, all banks reported well documented credit risk management procedures covering similar key areas.

Effective credit risk management in banking requires many critical areas, including lending criteria, profile grading, management info systems, credit goods and borrowers. Credit risk must be revealed, measured, monitored and controlled, along with a plan for controlling nightmare credits. The banks also have to have procedures and policies for insider lending, security, pricing, high-risk aspects and risk assessment. Other important issues include international exposure, delegation of authority, and periodic reviews. The banks are developing new products like derivatives to compete, which requires ongoing development of credit risk management methods. You will find hurdles to effective credit risk management, such as a shortage of resources, inconsistent threat rating methods, data management issues, as well as regulatory requirements. Even so, the banking sector has learned a lot from its mistakes.

Findings

It is crucial for banks to manage credit risk effectively, or they will find it difficult to continue trading after the collapse of the financial system. The respondents suggested an integrated risk management approach is needed, since one risk can lead to another. Along with the credit risk management function, good corporate governance must also be present, with senior management and the Board independent of shareholders. High inflation worsened the crisis, bad interest rates, bad economic growth, and day depreciation of the regional currency, making it difficult for banks to make it and make a profit. Because of liquidity shortages and Treasury bill holdings by the industry, banks had to look for open market money, which were costly and improved competition, bringing higher rates and systemic effects.

Based on the Reserve Bank of Australia, two banks were liquidated due to poor underwriting and credit monitoring requirements. This increased bad loans, not just because the borrowers were unable to pay, but also because the banks did not recognize a decrease in their credit standing. Additionally, ill-conceived growth strategies by the banks led to excessive levels of non-performing insider loans given regionally and internationally to sister companies. The Camelsa Chartered Accountants investigation discovered Trust Bank had substantial non-performing insider loans given with no proper due diligence. This loan led to liquidity challenges and increased default risk. Royal Bankers led the approval of credit cards to businesses in which they would interests, like Gemtree Investments, where 2 directors of the Royal Bank were additionally directors of the business, then Panalla Investments, where 2 spouses of 2 Royal Bankers were directors of the tight. The trust Bank remains under curatorship.

In the past, unsuccessful financial institutions had problems with capital adequacy ratios. Certain banks faced a liquidity gap, as they were not able to draw in deposits because of their damaged name, leading to massive speculation and withdrawals that restricted maturity rollovers. Banks also violated lending guidelines by offering loans to insiders and associated people without charging interest or getting board approval, causing compliance danger and loan losses. Appropriate credit risk management procedures require the recognition of the counterparty arms-length, and the core bank advises senior management or directors on possible conflicts of interest when approving credits for associated parties. Over-concentration of risk within the associated parties boosted default rates and impeded positive credit effects on various other economic activities, leading to a small supply response.

The 2004 banking crisis resulted from many factors, including tough macroeconomic conditions, insufficient risk management systems, bad corporate governance, diversion of core business to speculative tasks, fast expansion, innovative accounting, overstatement of capital, high levels of insider loans, insufficient earnings, persistent liquidity problems, foreign currency shortages, as well as imprudent credit risk management frameworks. The difficult financial environment with skyrocketing inflation, bad development, crumbling infrastructure and depreciating community currency made it hard for banks to make it, and impacted the population's buying power. Hyperinflation is mainly responsible for low or bad actual income for banks, as interest rates for loans advances have been swept away. Furthermore, money market shortages caused the banking crisis in the final quarter of 2003.

Depositors' funds have been used to pay for unregulated businesses, including asset management or maybe investment vehicles, and the banking industry has been using keeping companies as a method to stay away from regulation. Many banks misused the central bank's liquidity support to finance non-banking affiliates and associates, resulting in confined economic activity and eventually bank failure. The desire to expand quickly with no adequate controls and systems has exposed many banks to greater loss risks, leading to unsustainable capital quantities. Some banks even used depositor's funds to fund expansion drives, which goes against excellent corporate governance practices. Some banks have grown to be adept at misrepresenting financial conditions, tampering with info systems to conceal losses and


liabilities, producing fictional assets and understating liabilities and expenses. In some financial institutions, overstating capital levels has also occurred by undersupplying for non-performing loans and also falsifying transactions to conceal undercapitalization.

Conclusion

Many financial institutions had inadequate capitalization before the financial crisis, which violated the Banking as well as Companies Acts. These institutions show high profit margins on paper due to the revaluation of property, consistent with inflation, as well as exchange rate changes, but some are engaged in unsustainable non-core things to make it in an extremely competitive and expensive market. Furthermore, some banks because of a lack of foreign currency speculated on the black market for foreign exchange, further aggravating their already poor liquidity situation and also exposing them to higher liquidity risk. As detailed in the Basel Committee on Banking Supervision, the Board of Directors plays an important role in supervising credit management functions. They should also develop and regularly review credit risk strategies plus policies that guide the bank's credit granting pursuits.

Activities of the bank that involve a substantial credit risk must be discussed in detail. The study reveals that bad credit risk management in Australia is a significant factor in bank failures. Effective credit risk management is therefore essential for banks to improve their performance and stay away from economic distress. Positive risk culture is crucial for the success of the credit risk management program. The banks need to establish an extensive credit risk management system to identify, assess, monitor and manage credit risk, along with other significant risks. They should also ensure they have sufficient capital to hedge against these risks. Establishing an extensive credit risk management process is crucial for the bank's general risk management system. Banks also have to adopt good corporate governance methods, manage risks in an integrated solution, focus on core banking pursuits, and follow prudential banking practices.

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