A Study on Credit Risk Assessment in Management of Banks & Financial Institutions

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Abstract

This study takes a close look at how credit risk assessment helps banks and financial institutions stay stable and operate smoothly. Credit risk—the possibility that a borrower won't repay their loan—has long been a major concern, and it played a big part in triggering the 2008 Global Financial Crisis. To understand how banks manage this risk, we explored various models like Probability of Default (PD), Loss Given Default (LGD), and credit scoring systems. We also reviewed global regulatory frameworks such as Basel I to IV and IFRS 9. Our goal was to see how good risk management affects things like profitability, regulatory compliance, and overall resilience of financial institutions. We used a mixed-methods approach, combining a literature review with a survey of 72 finance professionals. The results showed that most banks—especially in the private sectoruse internal credit rating systems and specialized software to evaluate risk. Still, they face common issues like missing data, complex regulations, and rapidly shifting market conditions. Interestingly, while about 72% of banks say they follow Basel norms, how they actually implement them can vary quite a bit—especially when it comes to updating policies and using technology. One of the big takeaways is the growing impact of artificial intelligence (AI) and machine learning. These tools are helping banks make faster, more accurate decisions by offering real-time insights. The study also stresses the importance of having clear credit policies, ongoing training for staff, and a unified approach to managing risk—like using an Enterprise Risk Management (ERM) system.

Keyword : Credit Risk, Risk Assessment, Basel Norms, Financial Stability, Non-Performing Loans (NPLs),   Credit Scoring, AI and Machine Learning, Regulatory Compliance, Risk Management , Expected Credit Loss (ECL)

Introduction

Credit risk remains one of the most pressing challenges in banking and financial management, with far-reaching implications for stability, regulatory compliance, and profitability That crisis underscored the consequences of poor lending practices and inadequate risk assessment, revealing how quickly credit issues can spiral into broader economic disruption. In the years since, the financial industry has made considerable strides in strengthening credit risk management. Institutions now combine traditional methods like credit scoring and financial ratio analysis with cutting-edge technologies such as artificial intelligence and big data analytics. Meanwhile, global regulatory frameworkslike Basel I, II, and III, and accounting standards such as IFRS 9have reinforced the need for more risk-sensitive strategies, stronger capital buffers, and forward-looking approaches to loss provisioning. Still, credit risk remains a complex and ever-evolving challenge. Economic cycles, fluctuating interest rates, shifting borrower behavior, and the rapid growth of digital finance all add layers of uncertainty. In this landscape, effective credit risk assessment isn't just a regulatory requirementit's a strategic necessity for maintaining financial health, earning stakeholder trust, and securing long-term resilience.

LITERATURE REVIEW

- J.P. Morgan (2000) came up with the "Credit Metrics" model that used Value at Risk (VaR) to understand how likely a bank is to lose money due to credit risk.
- Zhang et al. (2020) showed how AI (especially deep learning) outperforms traditional methods in predicting loan defaults.
- McKinsey (2022) emphasized the use of real-time data and smart tech in lending decisions.
- Basel IV (2023+) introduced stricter global rules to ensure banks are consistent and transparent in their risk assessment.

Objectives of the Research

Primary objective

- To analyze the role of credit risk assessment and management in ensuring financial stability in banks and financial institutions.

Secondary objective

- To analyze the importance of credit risk assessment for financial stability .
- To identify how risk evaluation helps to prevent bank failures .
- To explore best practices in credit risk management bank & financial institutions .
- To find about the successful strategies used by bank to mitigate credit risk .
- To identify the major challenges in credit risk assessment.

DATA ANALYSIS AND INTERPRETATION:

What are the major challenges in credit risk assessment?

Challenge	Count	Percentage
Incomplete data	43	59.70%
Changing market conditions	46	63.90%
Regulatory compliance	41	56.90%
Manual processes	38	52.80%
Other	5	6.90%
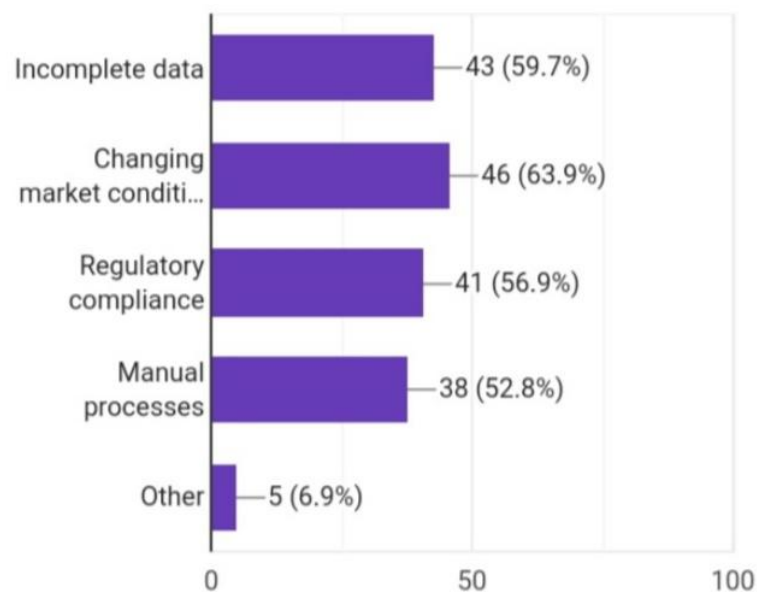
Inference

Changing Market Conditions (63.9%) , Incomplete data (59.7%) , regulatory compliance (56.9%) and manual processes (52.8%), 'Other' (6.9%)

Findings

A notable 80.6% of respondents indicated that their organizations have designated teams specifically focused on credit risk assessment, highlighting the critical value placed on this function within financial institutions. Around 62.5% of surveyed professionals stated that their institutions utilize internal credit rating mechanisms. These systems are customized to their specific operational needs and serve as a key tool in assessing borrower creditworthiness. Furthermore, 72.2% reported leveraging specialized software for evaluating credit risk, indicating a strong shift towards digital solutions and automation in risk assessment processes. When evaluating the repercussions of inadequate credit risk assessment, a significant portion of respondents either Strongly Agreed (27.8%) or Agreed (44.4%) that such lapses could result in institutional failures, emphasizing the potentially severe consequences of neglecting proper risk evaluation

Conclusion

Effective credit risk assessment is fundamental to the sound functioning and stability of banks and financial institutions. The survey data reveals a strong acknowledgment across institutions regarding its critical role in minimizing defaults and avoiding systemic failures. However, the level of implementation varies. While some organizations have advanced systems, dedicated teams, and regular policy evaluations, others continue to face challenges such as outdated processes and inconsistent regulatory compliance. Bridging these gaps through greater investment in digital tools, enhanced staff training, and stronger policy enforcement will be vital in achieving more consistent and resilient credit risk management practices across the sector.