جامعة ميدأوشن

كلية الإدارة

تخصص إدارة المخاطر

عنوان البحث

دراسة كيفية تقييم البنوك لمخاطر الإئتمان وإدارتها

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العام الدراسي:

2025

Midocean University

College of management

Master in Risk Management

Research Title

Examining How Banks Assess and Manage Credit Risk

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Academic Year:

2025

Examining How Banks Assess and Manage Credit Risk

Introduction

In today's fast-changing financial landscape, perhaps the biggest challenge for banks and other financial services firms is managing the risk associated with lending money. Lending always involves uncertainty, as financial services firms do not know whether borrowing customers will be able to repay their obligations. Uncertainty is the nature of credit risk: credit risk refers to the risk that a customer will be unable to meet its financial commitments to the lender in accordance with the deemed credit terms and that the lender incurs a financial loss. Credit risk must be managed effectively not only for the financial health of individual firms but also for the stability of the global economy as a whole. Banks are conduits facilitating intermediaries of credit from depositors' savings to borrowers. These institutions are essential to the efficient and responsible allocation of credit; however, the global marketplace has complicated risk assessment. Moreover, loans and financial products are complicated, as are the credit risks posed by borrowers. Determining risk accurately offers value to the lending institution insofar as it allows them to develop a trend of borrower behavior and acknowledge the probability bond of default, as well as obtain recourse measures such as interest rate, collateral, or application denial. Poor assessment of credit can lead to loan defaults, which equate to financial losses or collapse of a financial institution (Ahmed *et al*, 2021). No financial collapse was more visible and severe than during the global financial collapse of 2008. The goal of this research paper is to examine how banks evaluate, assess, and mitigate credit risk, contrasting the old and traditional credit risk assessment methods with new methods based on data. It will identify the theoretical implications of risk management, analyze previous empirical studies, and assess the practical techniques used by banks to minimize

financial losses from bad debts. By discussing the difficulty banks face in alleviating credit risk as well as possible means to do so, this research contributes knowledge to the literature on bank financial stability and safety.

Problem Statement

While the financial technology and risk management landscape has improved incredibly, credit risk analysis remains a serious challenge for banking and financial institutions. This is because lending is a complex operational decision whereby an entity weighs the possibility of a borrower following through with their promise to repay a loan. Although one wishes to use all available data to make a factual and informed assessment of credit risk, the reality is that there may be unpredictable changes in the borrower's conditions and the occurrence of events in the lender's business or factors influencing the entire economy. A failure by borrowers to meet their financial obligations has significant implications for both the financial institution and the economy as a whole, especially when it involves multiple borrowers. Access to accurate and reliable and hence up-to-date information about borrowers, one of the major challenges in ensuring credit risk, becomes relatively difficult. Bad information or incomplete data would lead to either approval of risky loans or refusals for potentially good borrowers. In addition to that, the ability of the financial markets to work under such clues of growing inflation or employment and global economic events in rapid acquisition would be able to affect the borrower's ability to pay on a loan in swift pacing (Sharma *et al*, 2024). The challenges, on the other hand, typically remain in forecasting these and efficiently incorporating them into their risk assessment models.

Another limitation is the constraints associated with using traditional credit evaluation methods. Many institutions still make lending decisions on the traditional basis of simple financial ratios, credit scores, and opinion-based expert judgments. While such procedures provide a few

useful insights, they may not be adequate for capturing the complexity of constituting borrower behavior or the larger context for economic conditions. Banks can therefore either make an overestimation or underestimation of the risk of credit, leading to poor lending decisions. Therefore, some concerns still exist regarding the influx of sophisticated statistical models and machine-learning techniques. These depend, however, on the historical data whose images on the part of borrowers, especially underscored by economic turmoil, may defy forward extrapolations. The case of excessive, almost blind faith in automated systems may also tend to slacken the consideration of qualitative aspects the borrower's character or the unforeseen market disruption.

Significance of the Study

This study's significance stems from highlighting the crucial role of credit risk analysis in banks for overall economic stability. In the lending process, bankers incur the risks of borrowers' failure to repay loans. Such risks, when not well managed, may lead to significant financial losses, a high level of bad loans, and eventual bank defaults, which, in turn, cause a ripple effect on the entire financial system. As banks assess and manage credit risk, this study offers suggestions for further improvements to curb financial losses. It demonstrates how traditional methodologies fell short while modern data-driven techniques such as statistical models and machine learning might mitigate such risks. With this, the accuracy of predictions concerning credit risk will improve within the exact constraints of the parameters defined for decision-making. Additionally, this approach will assist borrowers by promoting fair and transparent lending practices. Such an assessment will improve deserving borrowers' access to loans and make sure that the banks restrict lending to the riskier ones. Thus, it will establish a stable and well-functioning environment for both lenders and borrowers.

Literature Review & Theoretical Framework

Literature Review

The overview of the research conducted by numerous researchers and financial experts over the years on how banks and financial institutions evaluate and manage credit risk has significantly influenced these institutions. Historically, the qualitative assessment of credit risk was based more on expert inference, borrower interviews, and reviews of financial statements. Altman (1968) postulated one of the oldest models in credit risk analysis, which was the Z-score model for predicting business bankruptcy by means of financial ratios. Although it was innovative at the time, this method faced several complications due to its clearly restrictive reliance on past-oriented financial data and its failure to consider future economic changes. As markets grew more complicated, banks turned to quantitative models to further improve assessments of credit risk. Credit scoring models are widely accepted for evaluating the general creditworthiness of borrowers. Interest is expressed to appreciate how well the lender assesses the ability of borrowers to repay the loan. Among the factors considered are payment limits and credit usage, which help present scores to the lender. According to Golbayani, Florescu & Chatterjee (2020) scoring improves the efficiency of decisions decided by credit in respect of loans and reduces the risks of human errors.

In recent years, technological advances have led to models that are more sophisticated in credit risk analysis. Machine learning and artificial intelligence have drawn the most attention for their ability to process large volumes of data and find rather complex patterns. These authors support their claims by comparing their models to other approaches, such as decision trees, neural networks, and support vector machines, which have demonstrated superiority over traditional statistical models in predicting defaults, as indicated by Baesens et al. (2003). The advanced

systems pose a number of challenges: these include overfitting, data privacy issues, and the need for more specialized expertise.

Theoretical Framework

This study is grounded on risk management theory as the principal theoretical framework guiding this research, which focuses on identifying, measuring, and managing financial risks aimed at protecting an organization's assets and revenues. According to Jorion (2007), effective risk management presupposes an understanding of the very nature of the risks involved, their estimation, and the formulation of proper actions with a view to mitigating them. Within credit risk, the study is a calculation of a borrower's probability of default and determining what potential risk may be taken on by a bank with safety. An equally significant theoretical background is the Basel Accords, a set of regulations for international banking developed by the Basel Committee on Banking Supervision. The promulgation of Basel II and Basel III brought essential guidelines to credit risk management, insisting on banks maintaining minimum capital reserves to cover their potential losses from loan defaults (Alhassan & Abiola, 2014). These accords also emphasized the importance of both quantitative models and qualitative assessments in evaluating credit risk.

Theoretical Premises

This study operates under several theoretical assumptions that shape its analysis of credit risk management in banking. First, the study assumes the importance of having accurate and complete financial data for reliable credit risk analysis. If the bank's information is incomplete or outdated, it may make unnecessary and poor lending decisions that may lead to elevated defaults. Secondly, the study recognizes that no one model for determining credit risk can ever be perfect. Even if a bank employed sophisticated statistical models through machine learning, these

algorithms will not be without error. Hence, credit risk management often charges for the quantity of analysis but always requires the ultimate judgment of experienced financial analysts.

Thirdly, the idea assumes economic and market-related factors are important to credit risk, as fluctuations in inflation, employment, or global market stability may have long- or short-term effects on loan payments through modifications to borrower solvency, etc. As external factors can affect borrower payment ability, these are inputs to off-the-shelf risk models. Finally, the idea assumes better tools for assessing credit risk help support financial resiliency as banks help to manage loss mitigation and better meet the needs of customers.

Research Objectives

This study aims to:

1. Define credit risk and explain its merits in the banking sector.
2. Identify and describe the main methods banks use to assess and manage credit risk, including both traditional and modern techniques.
3. Examine the challenges banks face when trying to predict and control credit risk.
4. Suggest practical recommendations to improve the accuracy and effectiveness of credit risk analysis in financial institutions.

Research Questions

1. What is credit risk, and why is it important for banks to manage it effectively?
2. What are the traditional and modern methods used by banks to assess credit risk?
3. What challenges do banks encounter in managing credit risk?

Methodology

Researchers use the descriptive and comparative approach to examine the credit risk assessment and management practices at banks. The research is largely document-based; it involves a review of academic literature, financial publications, regulatory publications, and published case studies. This document-based approach enables the researcher to investigate how banks manage credit risk and does not require primary data collection. The descriptive aspect of the research identifies and explains what credit risk is and the different practices banks employ to assess and manage it. While doing the document-based qualitative analysis, the researcher found both old methods, like credit scoring systems, financial ratios, and management's expert judgment, as well as newer methods like statistical modeling and machine learning technology.

The comparative component of the study analyzes the strengths and limitations of both methods of credit risk evaluation. The study will compare traditional methods to those from various technology sources to determine the degree of effectiveness of methods in predicting which borrowers will default on their loan and lead to primary financial losses.

Data gathering for the qualitative study conducted in this report included: Academic research reports from finance and banking journals were reviewed for this study. Reports released by financial regulation bodies, including those released by the Basel Committee on Banking Supervision. Case studies from bank credit risk methods that utilize advanced credit risk assessment methods. There are books and online resources that delve into risk management theory and credit risk models.

Primary data, including surveys or interviews, was not collected as part of the qualitative study to quantify findings due to time and resource constraints and the decision to conduct the research utilizing only secondary data analysis. This methodology ensures an objective and

thorough understanding of how credit risk is evaluated and managed by the banking sector at this point and how credit risk management and evaluation might be improved.

Findings & Analysis

This section highlights the major findings of the study, focusing on how banks analyze and monitor credit risk utilizing traditional methods and more modern approaches or combinations of technologies. Furthermore, limited comparisons will be made based on the strengths and weaknesses of both approaches as well as how effective they are in practice in this sector.

Traditional Credit Risk Assessment Methods

Banks have depended on traditional credit risk assessment techniques for many years. Traditional assessment techniques include credit scoring techniques, financial statement analysis, and judgment-based assessment.

Credit scoring techniques, especially FICO scores, are prevalent in consumer lending through banks. Credit scoring techniques assign a number to borrowers based on their allegiance and ownership, external obligations, payment behavior as reported to the creditor and other parameters. Higher FICO scores almost always present less credit risk. Muigai & Maina (2018) references that credit scoring techniques are efficient, objective, and scalable when applied to retail banking.

Corporate lending commonly applies financial statement analysis. Banks are engaged in the assessment of the company's liquidity, profitability, and solvency from quantitative measures that use ratios such as current ratio, debt-to-equity ratio, and interest coverage ratio. Altman's Z-score model, which predicted business bankruptcies through the amalgamation of various ratios, could be one of the first applications of this method.

Limitations of Traditional Methods

Although these methods historically have been successfully applied in the banking sector for over 40 years, they have the following shortcomings: The demand for using a linear combination of historical data is limited in its effectiveness as an indicator of potential future risk. The capacity to handle extensive and intricate data sets is limited. Judgment-based assessments are generally subject to human error or may be highly inappropriate given bias due to judgment. Responses to changing market conditions continue to be slow.

Modern Credit Risk Assessment Methods

Technology advancements have significantly reshaped credit risk assessment through statistical modeling and machine learning. Statistical models can be used to assess the probability of loan defaults using various financial and demographic data and, correspondingly, variables. Examples of these statistical models are logistic regression and discriminant analysis. Bhatore, Mohan & Reddy (2020) noted that machine learning (ML) modeling is the dominant approach for identifying complexity, considering nonlinear relationships, and interpreting parcel-level data into monetarily distinct groups of potential loans for labeling. The most commonly used ML techniques include:

1. Decision Trees—a modeling method using information from numerous financial questions to categorize potential borrowing opportunities by risk types.

2. Random Forests—an ensemble approach used by decision trees in a method that predicts by classifying sites by decision tree forests.

Baesens et al. (2003) reported that default predictions using machine learning models generally outperform more traditional models; the sheer volume of data that machine learning

models can process and their ability to learn from new patterns over time are superior to traditional methods.

Strengths of Modern Methods

Contemporary methods have the ability to process large, heterogeneous, and real-time data sets with ease.

Adapts to changes in borrower behavior and market changes quickly.

Eliminate bias associated with human decision-making.

Increase prediction accuracy, and therefore, decrease financial loss.

Limitations of Modern Methods

These methods depend on well-formed, high-quality data.

Interpretation and transparency can be complicated (black-box models such as ANNs).

Require extensive technology and people investment.

Privacy or ethical concerns related to data.

Comparative Analysis

A comparison of the traditional credit risk approaches and modern credit risk methods highlights the explicit tradeoffs between two different approaches. Traditional credit risk methods offer advantages such as their relative simplicity to understand, ease of implementation, and reliance on established financial indicators and professional judgment; however, they do not address the challenges of processing high-volume and high-complexity data or accounting for changes in a rapidly evolving economy. While modern approaches facilitate higher predictive validity and scalability, modern approaches may exhibit a lack of interpretability, with a lack of significant technical expertise needed to develop, implement, and manage them. In particular, there is significant predictive scope when utilizing machine learning models to identify patterns in large

and complex data patterns, and due to their speed and capacity to evaluate higher volumes or more complex patterns, they can identify complex relationships and variables that may not have previously been developed in traditional credit approaches.

In identifying an overarching strategy, recent patterns emerging from industry best practices suggest that organizations are adopting hybrid models as their primary mode of evaluation. An example of this implementation is for organizations such as banks to incorporate a combination of statistical models and AI or machine learning methods to do their primary assessment and then incorporate expert judgment on the final verification of loan amount, including considering factors related to the applicant that could introduce additional information not accounted for by the initial assessment, such as borrower recommendations or how the applicant fits into the organization's other loans.

Challenges in Credit Risk Management

While these advanced tools are available to banks, they continue to face a number of challenges around how they approach and manage credit risk:

Data Quality: Any incomplete or inaccurate data will weaken their model quality.

Compliance to regulation: Banks must certify that their modeling practices track against financial regulations such as the Basel Accords.

Model Risk: While automation can serve as a benefit to banks' modern credit risk measurement, banks must reckon with the risk of over-reliance if their credit risk assessment model is poorly designed or if the modeling assumptions become obsolete in the future (Bi & Bao, 2024).

Discussion

This study shows that credit risk management in the banking industry has come far but has also advanced from using more static methods, such as credit scoring or financial ratios, to more

advanced predictive methods, such as machine learning and statistical models. While these more dynamic predictive methods have provided more accuracy and effectiveness in preventing loan defaults, there are challenges. Data quality, transparency of the model, and ethics of automated decision-making in credit risk management entailed in using predictive analytics and machine learning will provide challenges to banks. The findings of the study suggest that relying solely on either traditional or modern methods for managing credit risk is inadequate. A preferable method is to adopt a hybrid approach to credit risk management, which involves a commitment to either data-driven predictive analytics and its associated tools or a greater reliance on human judgment by credit practitioners. Ongoing modeling with credit risk will also require constant attention to evolving risk and continued compliance with regulatory obligations or requirements to ensure that credit risk management can be achieved.

Recommendation

I suggest that banks adopt a hybrid method to credit risk that incorporates the advantages of traditional expert judgement with the machine learning features of modern, predictive analytics. Financial institutions need to continue to focus on advancing organization-level data quality and infrastructure to provide advanced analytical modeling at an organizational level, which also sets up regular and ongoing staff operational training based on traditional risk analysis with a mix of emerging tools and technology. Banks must also routinely monitor and re-evaluate risk models to ensure that risk assessments and decision-making at the bank related to credit risk are actualized in the freshest economic context and regulatory landscape. Finally, banks should also be introducing ethical lending methods while facilitating fairness in lending with full transparency where relevant, with respect to credit background decisions, while protecting the borrower's personally identifiable information (PII) in accordance with privacy legislation.

Limitations

While this study provides useful information on assessing and managing credit risk, there are several limitations that need to be addressed. Firstly, the study purely relies on the use of secondary data from existing literature, financial reports, and case studies (Sironi *et al*, 2004). The authors did not collect any primary data by surveying or interviewing participants involved in credit risk management, which may result in a limitation regarding the richness and timeliness of the findings. Secondly, although the study provides an overall outline of risk assessment and management in the banking sector, it may not apply directly, or at all, to insurers or fintech lenders. Finally, because technology is rapidly advancing, some advanced techniques for assessing risk will always be evolving to the point of becoming outdated during the research stage itself.

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