

## A Preliminary Study on Credit Risk Management Strategies of Selected Financial Institutions in Malaysia

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### ABSTRACT

*Commitment to prudent lending is an important and current issue of discussion in the global banking system today. Banking prudence and efficiency to manage their risks in different business cycle and environment would help to alleviate crises and losses. The effective management of credit risk is an essential component of a comprehensive technique to risk management and critical to the long-term success of all banking institutions. This study aims to investigate the type of risk management strategies and monitoring practices implemented by financial institutions in Malaysia. The sample consists of fifteen institutions and this study found that diversification of loan services, risk mitigation and training and development of staff are three most popular practices implemented by financial institutions. Lastly, this paper is one of the first that attempts to use primary data in credit risk management strategies which is a significant contribution in the area of finance.*

### ABSTRAK

*Komitmen terhadap pelaksanaan memberi pinjaman bijaksana merupakan satu isu yang penting dan semakin mendapat perhatian di dalam sistem perbankan global pada hari ini. Perbankan bijaksana dan kecekapan dalam menguruskan risiko dalam pelbagai situasi ekonomi dapat mengelakkan krisis dan kerugian. Pengurusan risiko kredit yang berkesan merupakan satu elemen yang penting di dalam teknik pengurusan risiko yang komprehensif dan ia amat penting bagi memastikan kejayaan semua institusi kewangan dalam jangkamasa panjang. Kajian ini dijalankan bagi mengenalpasti jenis-jenis strategi pengurusan risiko dan kaedah pemantauan yang dilaksanakan oleh institusi kewangan di Malaysia dan mendapati bahawa tiga jenis kaedah yang sering dilaksanakan oleh institusi kewangan di negara ini adalah pelbagai bentuk pinjaman, mitigasi risiko dan latihan dan pembangunan staf. Akhir sekali, kajian ini merupakan salah satu kajian yang terawal menggunakan data primari dalam pengurusan risiko kredit dan memberikan sumbangan yang penting dalam bidang kewangan.*

### INTRODUCTION

The majority of financial institutions' and banks' losses stem from outright default due to inability of customers to meet obligations in relation to lending,

trading, settlement and other financial transactions. Alternatively, banks also face losses as a result of a fall in financial value of their assets due to actual or perceived deterioration in asset credit quality during recession or crisis. In addition, bank losses can sometimes be due to unethical behaviour of its staff which had happened from time to time as in Leeson at Barings and recently, Kerviel at Societe Generale. Moreover, the recent sub-prime mortgage crisis has caused huge losses for banks in U.S. and European and they have to seek capital injections from Middle East, China and Singapore investors. The world financial market has evolved with instruments that banks and financial institutions have lost track of their real identity causing chaos in the industry. It is essential that banks manage these risks so as to reduce losses and ensure continued existence in the longer term. One major risk that needs to be effectively managed and investigated is credit risk. Bank failures, acquisitions, and consolidations have encouraged surviving banks to take a closer look at how to structure operations, build loan portfolios and improve asset quality.

Credit risk emanates from a bank's dealing with individuals, corporate, financial institutions or sovereign entities. Loans are the largest and most obvious source of credit risk for most banks. Credit risk is simply defined as the prospective that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms and conditions. In addition to direct accounting loss, credit risk should also be viewed in the context of economic exposures. This encompasses opportunity costs, transaction costs and expenses associated with a non-performing asset over and above the accounting loss. Credit risk does not necessarily occur in isolation. The same source that endangers credit risk for the institution may also expose it to other risk: a bad portfolio may attract liquidity as well as credit risk.

The aim of credit risk management is to maximise a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable boundary. Banks need to manage the credit risk inherent in the entire loan portfolio as well as the risk in individual credit or transaction. Banks should also take into consideration the relationships between credit, liquidity and interest rate risks. The efficient management of credit risk is a vital part of the overall risk management system and is crucial to each bank's bottom line and eventually the survival of all banking establishments.

It is therefore important that credit decisions are made by sound analyses of risks involved to avoid harms to banks' profitability. On the one hand, bank profits are directly related to the amount of loans granted but on the other, tighter credit standards are needed to prevent losses and lower credit risk. Banks will have to weigh and balance these two options in order not to impair its overall prosperity.

The aim of this paper is to provide a preliminary investigation of the current credit risk management practices of Malaysian financial institutions so that further criteria can be suggested by regulators to reduce broad bank risks. This paper also wishes to investigate the popular credit risk management strategies implemented by financial institutions in this country. This paper attempts to use primary data in credit risk management which is a significant contribution in the area of finance.

## THE MALAYSIAN BANKING SYSTEM

The Malaysian banking system can be divided into 3 groups: (1) monetary institutions comprising the Central Bank, commercial and Islamic financial institutions; (2) non-monetary institutions namely merchant banks, credit and insurance companies, and development banks; and lastly (3) foreign banks representative offices and offshore banks. The banking system plays a central role in mobilizing domestic savings and funding private investments to ensure continuous economic growth.

The source supporting the robust banking sector can be traced back to the establishment of the Central Bank (Bank Negara Malaysia) in 1959 which led to the development of a progressive, competitive, reliable, as well as secure banking system besides administering financial rules and regulations in this country. At one point in time prior to the 1997 financial crisis, Malaysia had 37 commercial banks, 40 finance companies and 12 merchant banks. After the crisis, consolidation through mergers and acquisitions to obtain synergies and economies of scale in their operations and strengthening of these financial institutions has resulted in a smaller number of wider assets-based institutions. There are currently 22 licensed commercial banks and 11 Islamic banks in Malaysia (according to Bank Negara as of 2007). With the financial services liberalisation measures in progress since the year 2000, the banking sector is in for a fierce and robust future, and financial institutions have to be efficient in all aspects in order to compete with the global market.

The Financial Sector Master Plan launched by Bank Negara Malaysia aims to diversify the financial structure and strengthen the Malaysian financial system to compete in a liberalised global environment. It is well in progress and many issues and recommendations are now in place to improve efficiency of the banking industry on top of the development of an Islamic financial hub in Malaysia to integrate with the international financial system.

## LITERATURE REVIEW

Most financial institutions find that loans are the largest and most obvious source of credit risk; however, other sources of credit risk exist throughout the activities of a bank. Financial institutions are increasingly facing credit risk in various financial instruments other than loans, including acceptances, trade financing, foreign exchange transactions, inter-bank transactions, financial futures, options, bonds, equities, swaps and in the extension of commitments and guarantees.

Since exposure to credit risk continues to be the leading source of problems in banks world-wide, banks and their regulators should be able to draw useful lessons from past experiences. Banks should now have a keen awareness of the need to identify, measure, monitor and control credit risk as well as to determine that they hold adequate capital against these risks. It is also vital that they are adequately

compensated for the risks incurred in the running of their businesses.

The Basel Committee's capital adequacy guideline aims to encourage global banking supervisors to promote sound practices for managing credit risk. The list include: (1) establishing an appropriate credit risk environment; (2) operating under a sound credit-granting process; (3) maintaining an appropriate credit administration, measurement and monitoring process; and (4) ensuring adequate controls over credit risk. A comprehensive list of procedures and recommendations by the Basel II Framework can be found in: *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, Bank for International Settlements. The three major pillars include minimum capital requirements, supervisory review process and market discipline. Due to the importance of credit risk management approaches, Claessens, Krahen and Lang (2005) stressed that Basel II proposal is to encourage banks to upgrade these practices and banks with sufficiently sophisticated risk measurement and management systems have more flexibility to use their own internal systems to determine regulatory capital minimums.

Although specific credit risk management practices may differ among banks depending upon the nature and complexity of their credit activities, a comprehensive credit risk management program should address all these issues. Implementation of the credit risk management strategies should also be applied in conjunction with sound practices related to the assessment of asset quality, the adequacy of provisions and reserves, and the disclosure of credit risk.

As well illustrated by the theoretical models of O'Brien (1983) and recently modified to better reflect current practices, a set of guidelines is released to promote better understanding of credit agreements to assist the banking industry to improve their services. These guidelines include full disclosure of credit history, independent credit analysis, legal consideration, sharing credit information between agents, and prompt response to problems. Based on another study by Wu and Huang (2007) top management support is most important for risk management and mechanism to be successful.

#### CREDIT CRITERIA

Credit criteria are factors employed to determine a borrower's creditworthiness or ability to repay debt. These factors include income, amount of existing personal debt, number of accounts from other credit sources, and credit history. A lender is free to use any credit-related factor in approving or denying a credit application so long as it does not violate the equal credit protections of Bank Negara Malaysia prohibiting credit discrimination.

Swarens (1990) suggested that the most pervasive area of risk is an overly aggressive lending practice. It is a dangerous practice to extend lending term beyond the useful life of the corresponding collateral. Besides that, giving out loans to borrowers who are already overloaded with debt or possess unfavorable credit history can expose banks to unnecessary default and credit risk. In order to

reduce these risks, banks need to take into consideration some common applicants' particulars such as debt to income ratio, business history and performance record, credit history, and for individual loan applicants their time on the job or length of time at residence.

#### CREDIT CULTURE

A bank's credit culture is the unique combination of policies, practices, experiences, and management attitudes which defines the lending environment and determines the lending behavior acceptable to the bank. A credit culture is the glue that holds credit related issues together. More broadly, credit culture is the system of behavior, beliefs, philosophy, thought, style, and expression relating to the management of the credit function. It consists of a policy that guides credit ethic, a practice that drives lending and an audit that protects assets and credit mechanism. Any glitch in one would bring problem to another.

Banks' hiring practices should ensure personnel are committed to strict professional ethics and comfortable in high ethical standard and behavioural environment. Mueller (1984, 1990) stressed the significance of installing a sound credit culture in order to track banks' lending strategy and objectives. This study found that interactive parts of a credit culture must match with and be built upon proven principles and high standards. On the other hand, it must also be sufficiently flexible to compensate for change (Mueller 1993). Similar to Morsman (1985), Swarens (1990) found that credit culture has emerged as an important determinant of credit quality for all types of lending. Subordinates have to be responsible and professional in order to prevent from being bias when evaluating loan applications. Management must also ensure that the reward system compensates good ethical practices and penalises unacceptable and flawed procedures.

#### TRAINING

Training refers to the acquisition of knowledge, skills, and competencies as a result of the teaching of vocational or practical skills and knowledge that relates to specific useful skills. Training and development is the field concerned with workplace learning to improve performance. Such guidance can be generally categorised as on-the-job or off-the-job training. On-the-job describes training that is given in a normal working situation, using the actual tools, equipment, documents or materials that can be used in the actual environment. On-the-job training is usually most effective for vocational work. Off-the-job training takes place away from normal work situation which means that the employee is not regarded as a productive worker when training is taking place. An advantage of off-the-job training is that it allows people to get away from work and totally concentrate on the training provided. This type of training is most effective for training concepts and ideas. Officers should also have good knowledge of consumer protection laws and the ability to identify alternative solutions to problems.

Swarens (1990) believes that a fully trained consumer loan officer should have superior presentation skills, good knowledge of consumer protection laws to reduce the risk of committing a discriminatory mistake. Loan officers should also have the ability to identify remedies to a problem to ensure that customer received the best type of advice and service. Ethical standards and behaviour among subordinates can also be enhanced by training and promotional opportunities.

In another study by Morsman (1985), the paper concluded that bank managers must learn from past mistakes and must be equipped with skills and knowledge to master the fundamentals of loan administration. Farrissey (1993) suggested a training program for community banks to avoid the stormy seas of imprudent lending. This study provided a list of programs that include financial statement analysis, credit information exchange, credit reports, loan documentation and others which are essential skills required for the job.

#### DIVERSIFICATION

Diversification in banking involves spreading investments into a broader range of financial services or loans: business, personal, credit card, mortgage, auto and educational loan. Diversification reduces both the upside and downside potential and allows for more consistent performance under a wide range of economic conditions. Diversifications can be performed across products, industries and countries.

According to Sanford (1985), diversification can reduce risk rapidly with diversification of investment at no cost in expected profits. In other words, the business enterprise that diversified is more likely to be profitable. Total risks of loan provision fall as a variety of loan products and borrowings from different industries increase, assuming the correlation between markets is not perfect. The paper concludes that regulation provides safety and ensures soundness of the banking system.

Swarens (1990) also found that diversification by product line can be achieved by offering a wide variety of lending services. Wyman (1991) acknowledged that bank lending is basically a risky business but as long as banks have a systematic strategy to measure linkages and co-variances among industries and region, they should be able to maximise their return at an acceptable level of risk.

#### RISK MITIGATION

Risk mitigation encompasses a variety of techniques for loss prevention, loss control, and claims management. A risk mitigation program can prevent losses and reduce the cost of losses while creating a safer environment for businesses. Banks use a number of techniques to mitigate the credit risks to which they are exposed. Exposures may be collateralized by first priority claims with cash or securities. A loan exposure may be guaranteed by a third-party, or a bank may even purchase credit derivatives to offset various forms of credit risk.

A study by Bloomquist (1984) reckons that loan portfolio risk can be reduced with an effective credit review of applicants and selective asset backing. When

creditors have extensive rights to repossess collateral assets, there is stronger possibility that they can reduce their risks of losses on one hand and borrowers will be more responsible to pay when their assets are at stake.

#### CREDIT REMINDER

In case of default on interest or principal repayment on the part of a borrower, a formal reminder procedure has to be initiated. Reminder procedures are part of the credit monitoring of individual credit exposure. In order to avoid overlooking the sending out of reminders, credit institutions should apply standardised and automated reminder procedures. If the information technology system registers the occurrence of a default on interest or principal repayment, a collection letter should automatically be sent to the borrower. The length of the waiting period has to be stipulated in the internal guidelines and implemented in the systems. This ensures that collection letters are sent out in time and alarm system appropriately triggered.

#### GUIDELINE FOR LOAN PROCEDURES

Guidelines for loans are steps to be followed when analysing a loan application. It is necessary to analyse, negotiate, structure, and document the different types of loan. Loan procedures must always be consulted to ensure all particulars and documents are in place. In a study by Blomquist (1984), he stressed the importance of a checklist for quality control procedures to be carried out when evaluating loan applications.

In summary, the important elements of managing risk include credit culture, credit criteria, diversification, proper training of personnel, tracking result, setting standard and rewarding success (Wesley 1993). By taking into consideration all the elements above banks could reduce risk and maximize their bottom line.

#### SCOPE OF STUDY

This research investigates credit risk management strategies and practices of selected financial institutions in Malaysia. It focuses on 15 financial institutions in the country and the study is conducted by an interview as well as a set of questionnaire survey for loan officers from the financial institutions. Data for this study is from primary sources. Questionnaire survey on credit risk management strategies are distributed to the respective bank officers and compiled. A brief interview with regard to the types of credit risk management strategies carried out by the bank and the bank's preferences was conducted. A list of financial institutions included in this study is in Table 1.

This study would provide a preliminary understanding of strategies implemented by financial institutions in their credit risk management practice. Financial institutions can also explore effective strategies to manage their credit risk and benchmark with the others to verify whether sufficient procedures are executed. This study should also provide Bank Negara Malaysia – the main regulator, an

TABLE 1. List of participating financial institutions

1	Affin Bank Berhad
2	Alliance Bank Malaysia Berhad
3	CIMB Bank Berhad
4	Citibank Berhad
5	Hong Leong Bank Berhad
6	HSBC Bank Malaysia Berhad
7	Malayan Banking Berhad
8	OCBC Bank (Malaysia) Berhad
9	Public Bank Berhad
10	RHB Bank Berhad
11	Bank Simpanan Nasional (BSN)
12	Standard Chartered Bank Malaysia Berhad
13	Bank Islam Malaysia Berhad
14	Bank Muamalat Malaysia Berhad
15	Bank Rakyat Malaysia Berhad

overall observation of the credit risk management strategies implemented and provide support to financial institutions in their endeavor in managing credit risk.

#### FINDINGS

This section explains the compiled findings from the experiences of the 15 financial institutions. A set of strategies and policies implemented by them to evaluate credit application by customers is listed. A summary of the most popular practices can be found at the end of the section.

#### CREDIT CRITERIA

Credit criterion is employed by financial institutions to determine a borrower's creditworthiness in servicing its debt. Figure 1 shows the list of credit criteria that financial institutions take into account when they evaluate loan applications. The eight main credit criteria in this study consist of the character, reputation and credit history of the applicant, experience and depth of the business, strength of the business, past earnings, projected cash flow and future prospects, ability to repay the loan with earnings from the business, sufficient invested equity to operate on a sound financial basis, potential for long term success and the effect any business affiliates may have on the ultimate repayment ability of the applicant.

The result shows that the majority of financial institutions are very concern with customer's character, reputation and credit history as well as strength of the business when evaluating loan application. Subsequently, other important criteria also include experience and depth of the business, historical earnings and cash flows, ability to repay loan and sufficient equity investment. This shows that financial institutions have credit check procedures in place and they are aware of



the criteria required.

Secondly, financial institutions also rate credit worthiness of clients such by inspecting late payments, delinquencies, bankruptcies, outstanding debt, and length of credit history, new application for credit and types of credit in use by loan applicants. It is not surprising to notice that late payments and bankruptcies are the main guidelines used to rate credit worthiness by financial institutions as shown in Figure 2. Financial institutions also rate credit worthiness of clients in view of

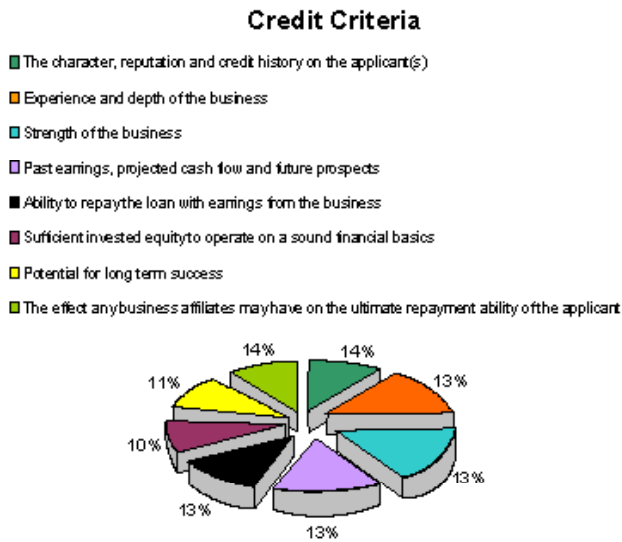


FIGURE 1. Credit criteria of financial institutions

(1) amount of outstanding debt as well as (2) delinquencies.

It is not uncommon for financial institutions to employ specific software to check on default customers. The Central Credit Reference Information System (CCRIS) by the Credit Bureau of Bank Negara Malaysia collects credit information of borrowers that include private individuals, businesses (sole proprietors and partnerships), companies, and even government entities. Financial institutions have used CCRIS as a crucial tool in decision-making when approving customer’s application.

### CREDIT CULTURE

The result in Figure 3 shows that financial institutions take serious account of the ethical issue and relationship between loan officer and customer. Financial institutions wish to build good relationships with customers in order to retain them and to avoid unethical issues in bank practices. When there exist close relation between

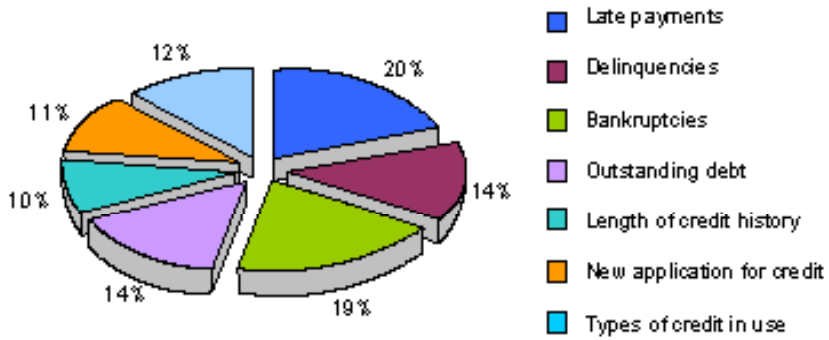


FIGURE 2. Rating credit worthiness

loan officer and customers, the financial institutions will ask another officer to perform the duty and relieve the affected officer from his or her job. It is vital that there is total transparency with no possibility of cronyism or malpractices possible in the processing of loan applicants.

TRAINING

All selected Malaysian financial institutions in this study provide training to their employees in the loan department prior to evaluating loan applications. Even though most financial institutions take less than a month to train their staff, the normal

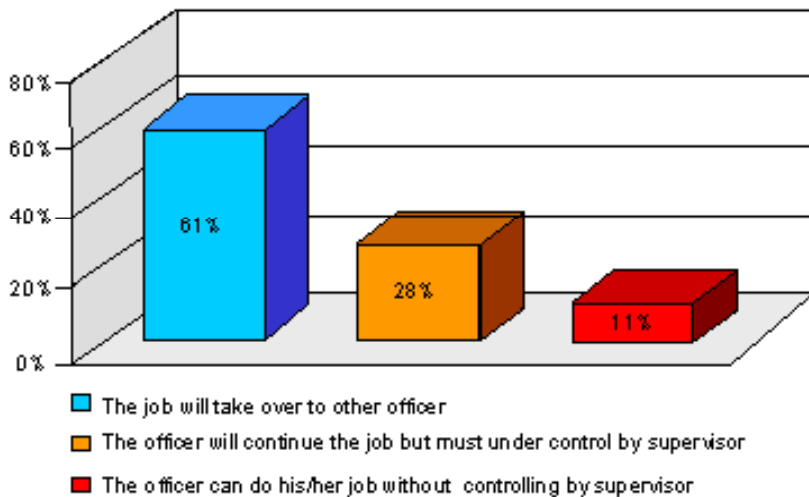


FIGURE 3. Bank's decision on relationship of officer with customers

period of training ranges from less than a week to more than a month. Trainers come from both in-house and outside expert. Most financial institutions prefer in-house trainers but some financial institutions do employ outside consultants which are normally trainers from the banking industry.

Loan officers are provided with continuous training and development throughout their tenure in order to effectively perform their work duties. Training and development can be initiated when a performance appraisal indicates performance improvement is needed, to “benchmark” the status of improvement in a performance improvement effort, as part of an overall professional development program, as part of succession planning to help an employee be eligible for a planned change in role within the organisation and to “pilot” or test the operation of a new performance management system.

The major reasons for training and development of bank officers are: (1) as an overall professional development for their selected staff and (2) as part of the promotion and succession plan to upgrade staff to fill different roles in the organization as shown in Figure 4. All financial institutions in the survey confirmed that they have continuous training sessions for their employees throughout their service

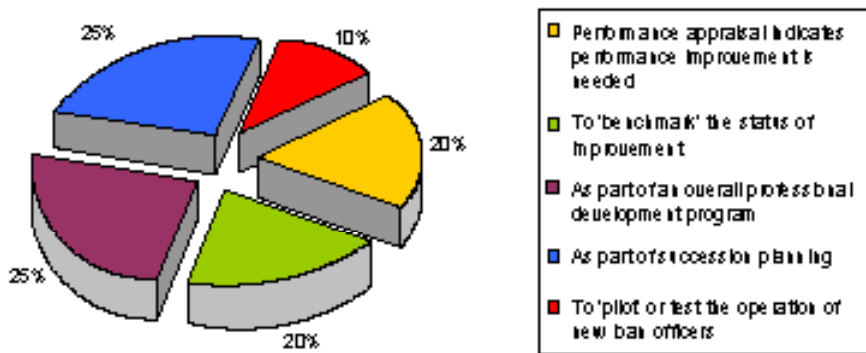


FIGURE 4. Reasons for bank training

and they do stress on improving the quality of their human resource.

Figure 5 shows that 15% of financial institutions prefer training carried out in classrooms and seminars because they believe loan officer would adapt and improve their skills in managing credit risk more efficiently in these settings. On the job training is the second most popular training method because it provides solution to real-life environment and do not take officers away from their job. Among the different methods, self learning in the library is the most unpopular and this may be due to its effectiveness in developing officer skills.

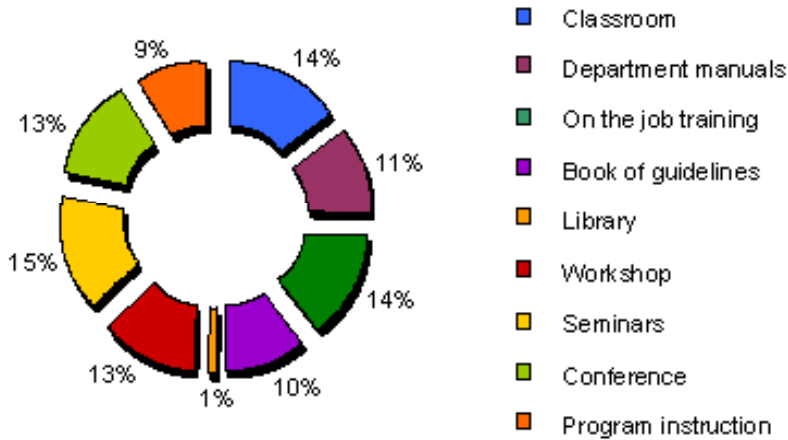


FIGURE 5. Method of training

Portfolio diversification across different products, sectors, industries and geographical areas tend to have beneficial effects on financial institutions’ profitability which leads to improved returns. The respondents from financial institutions believe that it is important that financial institutions diversify their loan portfolio.

The respondents believe that diversification of loans lead to improve bank performance and therefore lower the total risk of financial institutions. They also stress that there is still room for improvement on the current system and they plan to implement more effective strategies in this aspect. Results in Figure 6 show that financial institutions tend to grant a variety of loans to their clients. Auto, mortgage, personal and business loans made up a large portion of their total loans.

Besides the variety of loan products, financial institutions also diversify geographically to reduce their reliance on a particular region. All fifteen bank respondents confirmed that they are extremely geographically diverse not only within the country, even though the majority of loans are granted to different regions within the country, but also into neighboring countries such as Singapore, Indonesia and other industrialized countries as in Figure 7.

Financial institutions respondents also stressed that they provide loan services to a variety of industries in order to reduce their credit exposure as shown in Figure 8. There are at least fourteen different industries that are served by these financial institutions. Out of these fourteen industries, a high percentage of loans are provided to agriculture and industrial machinery, followed by construction, communication and energy products. These sectors may be of priority due to the government’s preference to small and medium industries as well as the strategic policies implemented by the authorities to strengthen certain industries of the nation for future growth.

**Types of Loan Diversification**

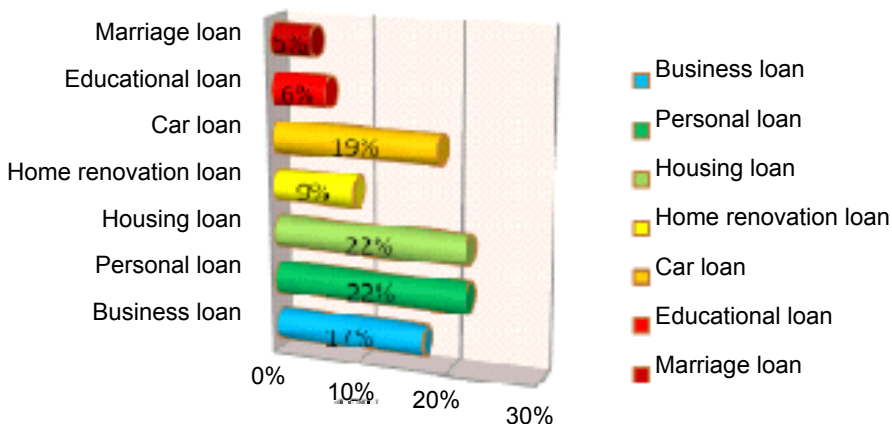


FIGURE 6. Types of loan diversification

**Geographical Diversification**

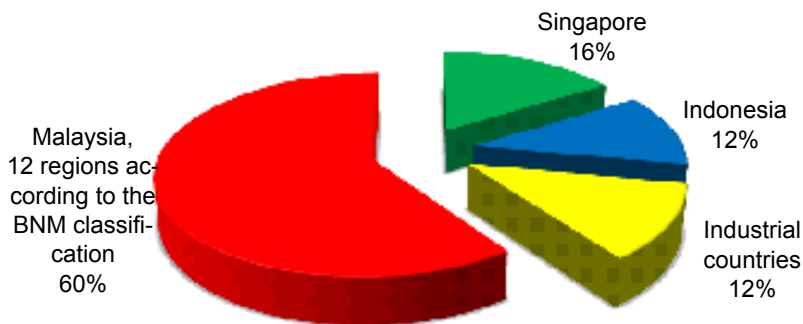


FIGURE 7. Geographical diversification

**RISK MITIGATION**

Credit risk mitigation is the reduction of credit risk in an exposure by a safety net of tangible and realizable securities as collateral assets. Financial institutions generally require corporate and individual borrowers to commit their assets as security for loans. These securities serve as collateral for financial institutions in case of default. This practice is sometimes referred to as secured lending or asset-based

**Industrial Sector Diversification**

- Agricultural
- Iron and non-iron material and ore
- Chemicals
- Office, EDP machinery and others
- Food products
- Paper, publishing & printing products
- Construction
- Hotel and public firms' products
- Energy products
- Agriculture & industrial machinery
- Metal products
- Transport
- Textiles, leather, shoes and clothing products
- Rubber and plastic products
- Services trade and similar
- Communication services

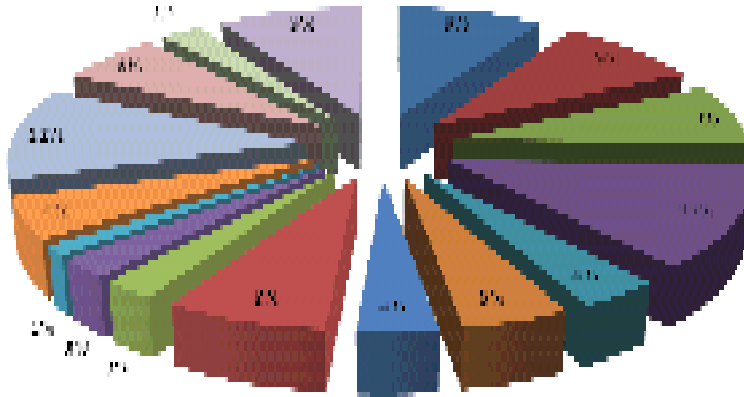


FIGURE 8. Industrial sector diversification

lending. Collateral can take different forms: cash on deposit with bank including certificates of deposit or comparable instruments issued by the financial institutions, debt securities issued by sovereigns or public-sector enterprises and mutual funds.

From the interviews with bank officers, all fifteen financial institutions utilize some form of risk mitigation techniques in managing their credit risk. Figure 9 above shows 39 percent of financial institutions favor some form of collateralization with cash or assets. Other than that, they also accept guarantee by third party, insurance and securitization as instruments of risk mitigation. When the borrower defaults, guarantors are required to stand in place of the borrowers and take over the responsibility of servicing the loan.

Figure 10 shows that 41 percent of financial institutions require cash on deposit with bank including certificates of deposit or comparable instruments issued by the lending bank as their major collateral instrument. Equities held by clients

**Technique of Risk Mitigation**

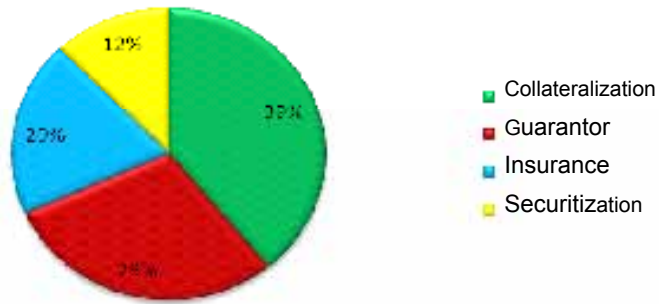


FIGURE 9. Risk mitigation techniques

are accepted as another common form of collateral followed by government and public sector debt and mutual fund.

Besides collateralization, financial institutions accept guarantees on behalf of their customer as a form of credit risk mitigation technique. Guarantees by parent companies, directors of the company and government are three major forms recognize by financial institutions as shown in Figure 11. Majority of acceptable guarantees are from parent companies and directors. Financial institutions have to be prudent and strict in enforcing risk mitigation to prevent exceptionally huge losses due to default.

Even individual clients can be required by financial institutions to pledge an

**Collateral Instruments**

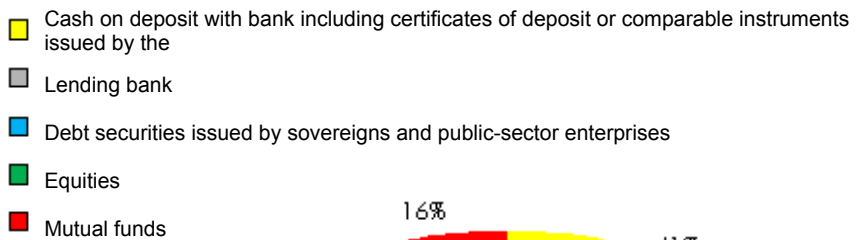


FIGURE 10. Collateral instruments

asset as security for a loan. Figure 12 shows the types of securities that financial institutions prefer from their individual clients: 36% of financial institutions prefer land as a pledge asset, 26% prefer other assets, 7% prefer life insurance and none of the financial institutions wish to receive jewellery or shares as pledged asset according to the survey.

CREDIT REMINDER

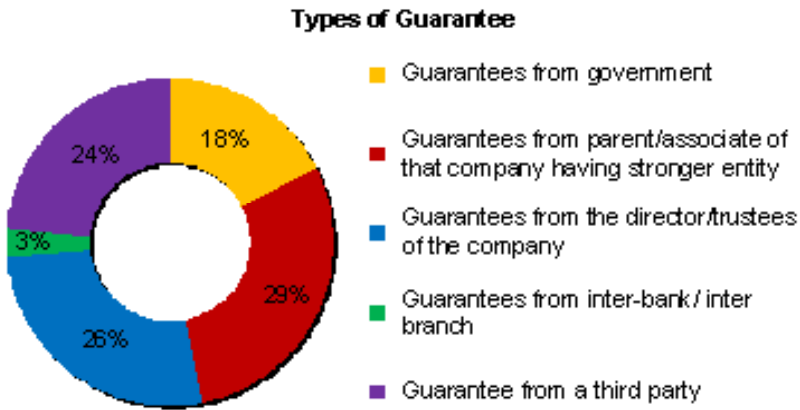


FIGURE 11. Guarantees accepted by financial institutions

of default. Most financial institutions prefer the presence of a guarantor during signing of loan agreement and they will also provide a copy of loan agreement to the borrower and the guarantor. The majority of financial institutions also assign another officer to check or recheck the loan approval and agreement that have

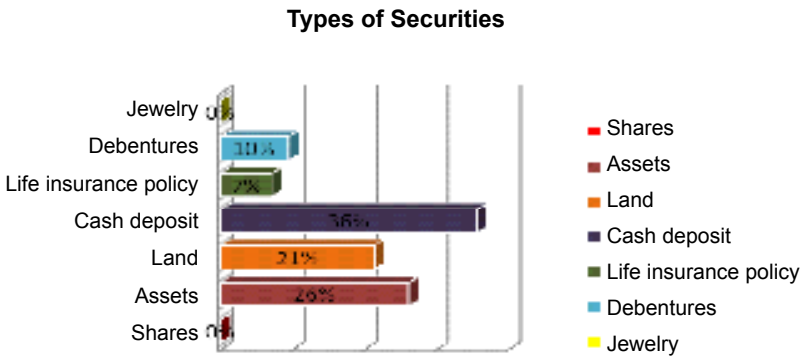


FIGURE 12. Types of securities accepted by financial institutions from individual clients



Financial institutions usually provide credit reminders to their customers within 1-3 months of default payment as in Figure 13. Prompt and immediate reminder acts as a consistent screening device to prevent bad accounts and as a alarm system to attract officers’ attention for further action. Sometimes negligence and misunderstanding on the part of borrowers may be a reason for non-payment but other times it serves as a first indication of problem loans. Credit reminder procedures are also part of the credit monitoring of individual credit exposures. This ensures that collection letters are prompt and further action can be taken without delay.

GUIDELINE FOR LOAN PROCEDURES

All financial institutions (100%) abide by the loan guidelines and procedures prior to granting of loans. All documentation and procedures are followed prior to actual approval of loans. They want to avoid customer disability to pay and probability

**Credit Reminder**

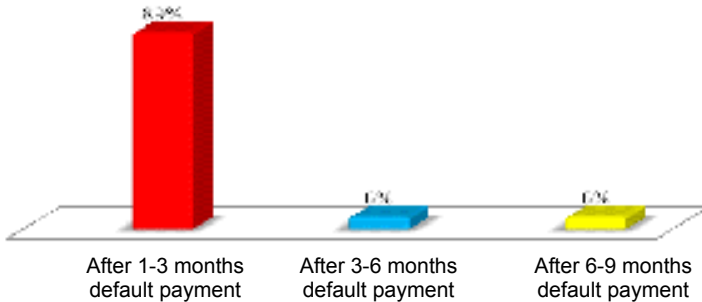


FIGURE 13. Credit reminder

been approved in order to certify that loans given are to the respective applicant. A system of check and balance is in place to prevent errors in the process as gathered by the survey with loan officers.

RECUPERATION OF LOAN

In case of default on interest or principle payment on the part of a borrower, financial institutions need to take action to recover their losses. The result from interviews with bank officers found that in order to cover their risks from customers’ default payments, financial institutions will usually take legal action against their customers in court. Besides, financial institutions also perform public auction to dispose of collateral assets when customers cannot repay their loan. Figure 14 shows the

different strategies financial institutions undertake to recuperate their loan. 38% of financial institutions take legal action against their customers in court, 29% perform public auction and 28% take control over the collateral as security. In summary, financial institutions have credit risk management strategies in place and they do process loan applicants with regard to the set practices accordingly.

CONCLUSION AND RECOMMENDATION

From the data collected from fifteen financial institutions in Malaysia, this study found that diversification of loan services, risk mitigation, training and development of staff as well as guidelines for loan approval are important strategies to manage credit risks. A summary of the key components of credit risk management strategies is provided in Figure 15. 17% of financial institutions practice diversification into different types of loans, geographical areas and industries because they believe

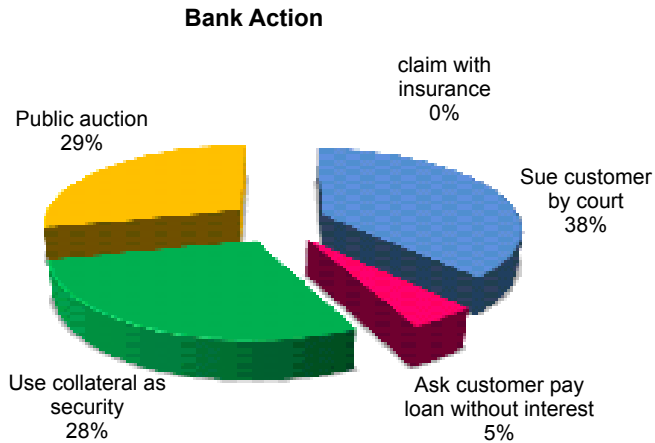


FIGURE 14. Action taken by financial institutions to recuperate loan

a sample consisting of both local and foreign financial institutions to compare the differences in strategies between local and foreign financial institutions and to avoid bias in the study.

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**Key Components of Credit Risk Management Strategies**

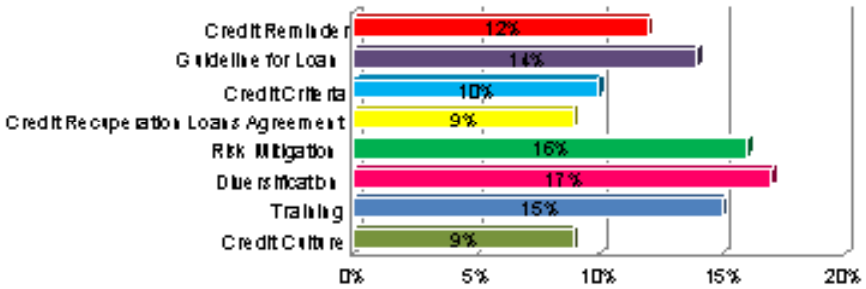


FIGURE 15. Key components of credit risk management strategies

that overall risks of losses would be lower when industrial and geographical credit risk correlation is low. Moreover, they are better able to service customers with different industrial and geographical interests better with a larger variety of loan and other services.

Besides, financial institutions also believe that risk mitigation, staff training and development are the best ways in managing their credit risk through better quality human resources and assets. Training will assist loan officers to be well prepared and gained new knowledge regarding customer application evaluation and financial statement analysis. In order to avoid huge losses from unsecured loans, financial institutions require that corporate and individual clients provide collateral assets, a safety net of tangible and realisable securities, as a guarantee for loan repayment. Even if a customer defaults, there is always an asset or some security that financial institutions can dispose of to recuperate their losses.

In summary, financial institutions utilise a variety of techniques to mitigate the credit risks to which they are exposed. Exposures may be compensated in whole or in part with cash or securities through collaterals or a loan exposure may be guaranteed by a third-party to offset various forms of credit risk. There is no one single strategy that is superior and can cover all exposures but diligence and care must be taken when dealing in any business. There should always be some check and balance in place to ensure that financial institutions are not overly reckless in granting as much loan as possible without taking into consideration the ability to pay of the recipients of these loans. Nevertheless, credit facilities are always needed to stimulate and support the financial system and growth of the country. This study provided significant contribution through the use of primary data in the area of finance in investigating the credit risk management strategies of financial institutions. Future study may include a larger sample of financial institutions or

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