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The Weighting of Factors Affecting Credit Risk in Banking

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Abstract

Today's, the credits are one of most significant activities in banking. Banks examines several criteria while giving the credit. The problems which are met to pay the credits lead to the banks to face with the serious risks. So, the banks implement the risk management effectively. Credit risk is most elementarily identified as the potential that a bank debtor will fail to meet its indispensability in compliance with agreed conditions. The banks which implement the risk management effectively evaluate their risks down to the last detail. The banks need to use the foreign funds efficiency, since banking activities are determined in accordance with foreign funds. The banks give credits to their customers in order to obtain the funds. The banks also undertake the risk while giving the credit. Credit risk is nearly related to the potential return of an investment. The conducted studies revealed that the most important risk for the banks is credit risk. Many techniques are used in the measurement of credit risk. Thus, the banks statistically tend to measure the credit outcomes. In this study, the factors which affecting credit risk in banking are evaluated. Analytical Hierarchy Proses which is one of multiple criteria decision making techniques were applied while assessing these criteria. Accordingly factors were compared by paired comparison. The weight of each criteria were determined as a result of comparisons. The consistency ratio was calculated whether comparisons were consistent or not. At the end of the study, the weight of the factors affecting the credit risk was found. Thus, the factors which must be focussed on clearly demonstrated while managing most significant risk of banking.

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Keywords: *Analytical Hiyerarchy Proses, banking, multiple criteria decison making, credit risk, risk management*

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1. Introduction

Risk management in Turkish banking system is to identify, assess, measure and monitor risks. Conducted studies illustrate that risk management is not sufficient for the banks. To ensure this, top management should be supported. All staff should be adopted these studies. Modern risk management techniques and applications of the system has been begun by the imposition of legal regulations. In today's, risk management process in Turkish banking system has been evolved. According to the bank's activities and structure, the attempt is to meet those required after meeting legal requirements.

Today, the banking sector deals with several risks. According to Goyal (2010), the risks which are encountered in the banking sector are credit risk, market risk, operational risk, interest risk, liquidity risk and exchange risk. The concept of credit risk fails to fulfil the borrower's or signatory person's obligations. More precisely, the banks encounter with the risk as a result of credit quality deterioration. Market risk is defined that the assets held by banks in the market are the risk of loss due to movements in market and alterations in market prices (Goyal, 2010). Operational risks are the deviation of the processes or functions within an organization (Shah, 2003). Interest rate risk, reverse movements which occurs due to changes in interest rates can be defined as the impact which occurs a bank's financial structure (Platt, 1986). Exchange rate risk is insecurity due to changes in exchange rates and parity of banks (Coyle, 2000). Liquidity risk is inability to fund the daily operations of the bank (Heffernan, 1996).

In this study, credit risk is addressed since it is the most significant in the banks. Factors which affect credit risk are examined.

The rest of this paper is structured as follows. Section 2 presents factors which affect credit risk. Section 3 explains analytical hierarchy process. In Section 4, factors are evaluated by analytical hierarchy process. Section 5 discusses the solutions. I conclude the paper in Section 6.

2. Literature Review

Today, the banks spend an intense effort and time to develop credit risk measurement methods since they don't encounter credit risks. Therefore, they probe into the credit risk. In addition this, they examine the factors which affect credit risk.

The credit collapse is not only due to the contraction of credit supply and thus is a supply-induced problem (Bernanke, 1993). Deposit guarantee has encouraged taking risk for the banks in Turkey. Problems in the financial structure of the company have led to reduction credits. At the same time, foreign currency risk also affect the credit demand. One of the factors affecting the supply of credit in the banking is augmentation in the return of the credit.

Risk measurement and techniques in the banks are vintage analysis, risk plus, scenario analysis, stress tests, integrated risk management, internal rating method, standard method, legal barriers, firm rating, credit policy, credit demand evaluation and retroactive tests (Yariz, 2011).

According to Yilmaz (2011), the factors are determined by the studies which are conducted in the past. These factors are customer increment, firm bankruptcy, credit derivative products, low profit margin and global competitive. These factors are customer increment (23), firm bankruptcy (21) , credit derivative products (2), low profit margin (16), global competitive (21).