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A Deep Dive into Credit Risk and Default Prediction Technologies

Rupinder Kaur Sodhi*

In the complex world of finance, the assessment and management of credit risk stand as important elements in maintaining the stability and profitability of lending institutions. Credit risk, the possibility that a borrower will default on their financial obligations, has far-reaching implications not only for individual entities but also for the global economy. The history of financial markets is peppered with instances where inadequate credit risk management led to dire consequences, highlighting the critical need for accurate prediction and mitigation strategies. From the savings and loan crisis of the 1980s to the subprime mortgage debacle in 2008, the financial sector has learned hard lessons about the importance of vigilant credit risk assessment.

This article aims to navigate through the evolving landscape of credit risk and loan default prediction, tracing the journey from traditional methodologies to the cutting-edge innovations of today. We may learn a great deal from the mistakes made in the past about the limitations of previous methods and the motivation behind the development of more advanced predictive models.

With the advent of big data, analytics and artificial intelligence, the field of credit risk management is on the cusp of a new era. These technologies offer the promise of more accurate risk assessment, potentially safeguarding against the kind of oversights that led to historical financial crises. Our exploration will not only highlight the current state-of-the-art techniques employed by banks but also speculate on future trends and innovations that may redefine what is possible in credit risk prediction.

Understanding the Credit Risk

At its core, credit risk involves the possibility that a lender may not receive the owed principal and interest, which in turn, leads to disrupted cash flows and increased costs for capital. This risk is inherent in any lending agreement, from personal loans and credit cards to corporate bonds and mortgages. The stakes of effectively managing this risk are high, as failures can lead to significant financial losses and in extreme cases, the collapse of financial institutions.

Types of Credit Risk

- *Credit Default Risk:* The risk of loss arising from a borrower failing to make payments as agreed upon. It is the most straightforward type of credit risk and the primary focus of loan default prediction models.
- *Concentration Risk:* Arises from any single exposure or group of exposures with the potential to produce losses large enough to threaten a financial institution's health or ability to maintain its core operations.
- *Country Risk:* Involves the risk that country-specific economic, political or social events will affect a borrower's ability to meet its financial obligations.

* Chief Manager (Research), State Bank of India.

- *Counterparty Risk:* The risk that the other party in an agreement will default on its contractual obligation before the expiration of the contract, which is a particular concern in derivatives markets.

Impact of Credit Risk on Financial Institutions

The implications of credit risk extend beyond individual loans, affecting the financial health and operational stability of lending institutions. High levels of credit risk can lead to loan losses that deplete capital reserves, necessitating increased borrowing costs and impacting profitability. Moreover, the regulatory capital that banks must hold against potential losses ties up resources that could otherwise be deployed more productively.

The impact of credit risk on financial institutions has become increasingly complex, especially in the wake of the COVID-19 pandemic, which has dramatically altered the landscape of credit risk management. Before the pandemic, financial institutions relied on conventional sources of data for credit-risk assessments, such as historical financial performance and repayment histories. However, the pandemic's onset rendered such data nearly obsolete, highlighting the need for high-frequency, real-time data to evaluate borrower's resilience effectively. The sudden economic downturn exposed many borrowers to unprecedented levels of debt, challenging banks' ability to predict loan defaults accurately under traditional models.

Financial institutions have historically depended on credit-related assets for a significant portion of their total revenues, approximately 40%. However, credit-related costs, including provisions and write-offs, constitute a considerable fraction of expenses. This financial balance underscores the critical importance of managing credit risk effectively, not only to maximize returns but also to minimize costs and sustain value, especially during periods of market volatility. Advanced analytics and optimization of credit processes can substantially reduce operating expenses and risk costs, thereby, improving customer experience in the process.

In summary, the changing dynamics of the global economy, exacerbated by the COVID-19 crisis, have illustrated the vital importance of agile, data-driven credit risk management practices. Financial institutions are now tasked with integrating real-time analytics, reassessing traditional credit assessment models and navigating new regulatory and economic challenges to manage credit risk effectively.

In India, financial institutions use the Ind-AS 109 model for credit loss accounting, aligned with the global International Financial Reporting Standards (IFRS) 9 standard. The Ind-AS 109 model, aligning with the global IFRS 9 standard, was developed in response to the 2008 financial crisis. It aims to provide more accurate reflection of credit risk by requiring the recognition of expected credit losses from the inception of a financial instrument, rather than waiting for a loss event to occur. It emphasizes assessing credit risk at initial recognition and throughout the financial instrument's life, necessitating collaboration between risk, finance and IT departments for effective implementation. The transition to Expected Credit Loss (ECL) under Ind-AS 109 is data-intensive, requiring historical data and a robust validation process for the models used in ECL computation.

Traditional Credit Risk Assessment Methods

Historically, credit risk assessment relied heavily on financial statement analysis, credit scoring models and the expertise of credit analysts. These methods focus on evaluating the borrower's repayment ability based on past financial behaviour, current indebtedness and economic conditions. However, as we will explore, these traditional approaches have limitations, especially in the face of complex and modern financial ecosystems.

Learning from the Past - Failures in Credit Risk Prediction

The journey towards refining credit risk prediction methods is paved with lessons from past failures. These episodes offer invaluable insights into the complexity of financial markets and the challenges of accurately predicting loan defaults. By examining these failures, we can better understand the limitations of traditional prediction models and the necessity for innovation.

Notable Failures in Credit Risk Prediction

- *The Subprime Mortgage Crisis (2007-2008):* At the heart of the 2008 financial crisis was a massive underestimation of credit risk associated with subprime mortgages. Financial institutions and rating agencies relied on historical data and conventional risk assessment models, which failed to account for the bubble in housing prices and the innovative, but ultimately risky, financial products being offered. The collapse of the housing market exposed the fragility of these models, leading to widespread defaults and significant losses for lenders and investors alike.
- *The Savings and Loan Crisis (1980s):* This crisis was partly attributed to poor credit risk management among savings and loan associations. Deregulation allowed these institutions to engage in more commercially risky activities, including speculative real estate lending, without a corresponding enhancement in risk assessment capabilities. Many savings and loans failed to adequately assess the risk of their investments, resulting in a wave of defaults and financial institution collapses.

Lessons Learned

From these failures, several key lessons emerged:

- *The Importance of Stress Testing and Scenario Analysis:* Stress testing of a financial institution's portfolio against extreme but realistic events has become increasingly important. This practice helps in identifying potential vulnerabilities before they lead to crisis.
- *Diversification:* Over concentration of loans in specific sectors was a contributing factor to both crises. Diversification across borrowers, industries and loan types is now recognized as a fundamental risk management strategy.
- *The role of Regulation:* Both crises underscored the need for robust regulatory oversight to ensure that financial institutions maintain adequate capital reserves and follow sound lending practices. Regulations such as Basel III were developed in response to these lessons.
- *Innovation in Risk Prediction Models:* There is a continuous push for innovation in credit risk assessment models to better capture the nuances of borrower's behaviour and broader economic trends. This has led to the adoption of more sophisticated data analytics and machine learning techniques.

Moving Forward

The past failures in credit risk prediction have acted as a catalyst for change, leading to innovations in risk assessment methodologies and technologies. As we delve into the current state of credit risk management, it is clear that the lessons learned from these failures have been instrumental in shaping more resilient financial institutions and more accurate prediction models.

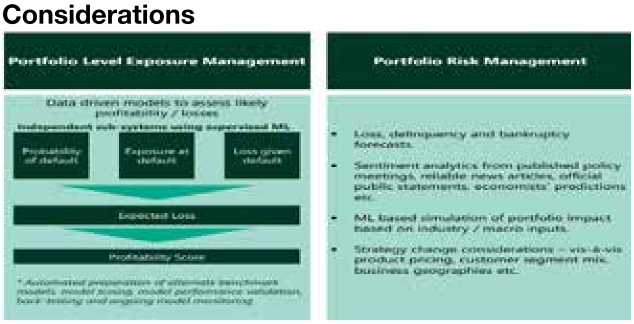
Credit Risk Modelling: Key Components

Credit risk modelling, a crucial aspect of financial risk management, employs statistical methods and analytics to predict the likelihood of borrowers defaulting on their obligations. This model is underpinned by three essential components:

- *Probability of Default (POD):* This measures the likelihood that a borrower will default on a loan within a specified time period. It is a critical indicator of credit risk, helping financial institutions to manage and price the risk associated with lending.
- *Loss Given Default (LGD):* LGD estimates the amount of loss a lender faces if a borrower defaults, after accounting for the recovery of any collateral. It is expressed as a percentage of the total exposure at the time of default.
- *Exposure at Default (EAD):* EAD quantifies the total value exposed to loss at the time of default, incorporating the outstanding balance and potential future credit extended to the borrower.

Each component plays a vital role in the comprehensive assessment and management of credit risk, enabling lenders to make informed decisions and set aside appropriate capital reserves to cover potential losses.

Figure 1: Loan Portfolio Management Considerations



Source: Infosys.com

Loan Default Prediction - Traditional Methods

In the aftermath of financial crises and the valuable lessons learned, the financial industry sought to refine its approach to predict the loan defaults. Traditional methods, though once the cornerstone of credit risk assessment, have evolved, blending historical insights with newer and more dynamic models. Here, we explore these traditional approaches, their benefits and inherent limitations.

Overview of Traditional Prediction Methods

Traditional loan default prediction methods primarily rely on financial data and historical repayment behaviours to assess credit risk. Some of the key methods are mentioned below:

- *Credit Scoring Systems:* Perhaps the most widely used, credit scoring systems like Fair Isaac Corporation (FICO) scores or the more popular ones used in India like Credit Information Bureau (India) Limited (CIBIL), Experian, Equifax etc. aggregate financial data, including credit history, loan amounts owed and payment histories, to assign a score to potential borrowers. Higher scores indicate lower risk.
- *Financial Statement Analysis:* This involves a detailed examination of a borrower's financial statements, assessing liquidity, profitability and leverage ratios to gauge creditworthiness.
- *Expert Judgment:* Lending decisions, especially in the commercial and corporate sectors, often incorporate the expert judgment of credit analysts. These professionals evaluate a borrower's financial health, industry position and even managerial competence to make lending decisions.

Advantages of Traditional Methods

- *Simplicity and Familiarity:* Traditional methods are straightforward and widely understood, making them accessible to a broad range of financial institutions.

- *Proven Track Record:* Years of application have provided a wealth of data on the effectiveness of these methods, allowing for incremental improvements over the time.

Limitations and Challenges

- *Lack of Flexibility:* Traditional methods often struggle to adapt to rapid changes in economic conditions or borrower's behaviour, as they rely heavily on historical data.
- *Data Limitations:* These methods may not fully capture the complexity of a borrower's financial situation, especially for small businesses or individuals with limited credit history.
- *Overreliance on Qualitative Data:* Traditional models can overlook qualitative factors, such as industry trends or management quality, that may significantly impact a borrower's credit risk.

Case Study: The Dotcom Bubble Burst

A poignant example of the limitations of traditional credit risk prediction methods can be seen in the dotcom bubble burst in the early 2000s. The Dotcom Bubble burst was due to excessive speculation and investment in Internet-based companies. During the late 1990s, investors were eager to invest in any company associated with the internet, leading to inflated stock prices and unsustainable market valuations. Many of these companies, despite lacking solid business models or revenue, went public with high initial stock prices. When it became apparent that expectations of rapid growth were unrealistic, investor's confidence plummeted, resulting in a massive sell-off of tech stocks and the collapse of many dotcom companies.

The growth expectations during the Dotcom Bubble were unrealistic because they were based on the assumption that traditional business metrics (like profitability and cash flow) could be ignored in favour of rapidly increasing market share. Many believed that continuous investment and growth in internet-related businesses would indefinitely lead to profits, overlooking the importance of sustainable business models and actual revenue generation. This resulted in exaggerated valuations that were not supported by the fundamental business success, which caused the bubble to burst.

The Role of Big Data and Analytics in Credit Risk Assessment

The digital era has ushered in a huge volume of data, offering new insights into consumer behaviour, economic trends and financial risk. Big data and analytics have become pivotal in credit risk management, enabling institutions to harness complex datasets to make more informed lending decisions.

Big Data in Credit Risk Management

Big data refers to the vast quantity of structured and unstructured data. In credit risk management, this data encompasses traditional financial metrics, social media activity, transaction history and even geographical information. The comprehensive nature of this data provides a more refined view of a borrower's financial health and potential risk factors.

Analytics Techniques and their Application

Advanced analytics techniques, including predictive modelling, machine learning and data mining have become instrumental in processing and interpreting big data. These methods allow for the identification of patterns, correlations and trends that traditional models might miss. The key applications include:

- *Predictive Modelling:* Uses historical data to predict future outcomes, such as the likelihood of a loan default. These models are continually refined as new data becomes available, enhancing their accuracy.
- *Risk Assessment:* Machine learning models can adapt to changing market conditions and borrower's behaviours, offering risk assessments in dynamic situations.
- *Sentiment Analysis:* Analyzing text data from social media, customer reviews and other sources to gauge public sentiment towards a borrower or industry can be an early indicator of potential financial stress.

Success Stories: Big Data and Analytics in Action

- *Alternative Lending Platforms:* Companies like Kabbage and Lending Club utilize big data and machine learning algorithms to assess the creditworthiness of small businesses and individuals, often providing loans to those who might not qualify under traditional models. These platforms consider a wide range of data, including online sales, shipping information and customer reviews, to make lending decisions.

  A notable fintech example widely used in India is CRED, which focuses on rewarding individuals for their creditworthiness. By paying their credit card bills through the CRED app, users gain CRED coins which can be used for various rewards, encouraging timely bill payments and instilling financial responsibility. This model indirectly assists in credit assessment by promoting and rewarding good credit behaviour among consumers, contributing to a positive credit culture.
- *Dynamic Risk Assessment:* Some banks and financial institutions now employ real-time data analytics to continuously update their risk assessments on borrowers. This approach allows for early detection of potential default risks, enabling proactive management and mitigation strategies.

Challenges and Considerations

While big data and analytics offer significant improvements in credit risk assessment, they also present new challenges. Privacy concerns and data security are critical considerations. Ensuring the ethical use of data and algorithms is paramount to maintain trust and fairness in financial lending practices.

Machine Learning and AI in Loan Default Prediction

The advent of Machine Learning (ML) and Artificial Intelligence (AI) technologies has marked a new era in financial services, particularly in the realm of credit risk assessment. These technologies have the power to analyse vast datasets, learn from trends and patterns and make predictions with a level of accuracy and efficiency that was previously unattainable.

AI and ML in Understanding Credit Risk

AI and ML models excel in their ability to process the large volumes of complex or diverse data. They can identify subtle patterns and relationships that human analysts and traditional statistical models might overlook. This capability is particularly valuable in predicting loan defaults, where the risk factors are numerous and often interconnected in non-obvious ways.

- *Deep Learning Models:* Deep learning, a subset of ML, can analyze complex data similar to the way human brain operates. In credit risk management, deep learning models can predict default probabilities by analyzing borrowers' financial transactions, social media activity and even text from financial news.

- *Natural Language Processing (NLP):* NLP is used to understand and interpret human language, allowing AI models to analyze unstructured data like loan application forms, customer support communications and social media posts for insights into borrowers' creditworthiness.

How Machine Learning leads to Revenue Opportunities

Source: Birlasoft.com

Examples of AI and ML in Action

- *JPMorgan Chase & Co.:* The banking giant has implemented machine learning algorithms to analyze legal documents and extract important data points, a process that significantly reduces the time and cost associated with manual reviews. While not exclusively about loan default prediction, this application of ML demonstrates the broader potential for these technologies to transform financial analysis and risk management.

- *ZestFinance:* This company uses machine learning to help lenders make more accurate and fair credit decisions, particularly for borrowers with sparse credit histories. By analyzing thousands of data points, ZestFinance's models can identify patterns that indicate reliability and creditworthiness beyond what traditional credit scores might reveal.

- *HDFC Bank:* HDFC's Electronic Virtual Assistant (EVA) is a prime example of NLP application. While EVA is primarily known for enhancing customer service through chatbots, the underlying NLP technology also aids in analysing customer queries and feedback to identify dissatisfaction or potential financial distress signals. This indirect method can help in predicting loan defaults by flagging customers who may be facing financial difficulties.

Challenges and Ethical Considerations

While the potential of AI and ML in credit risk management is immense, it has also introduced new challenges:

- *Data Privacy and Security:* The use of personal data in ML models raises significant privacy concerns. Ensuring that data is collected and used ethically and in compliance with regulations is crucial.

- *Biasness and Fairness:* When trained on data that contains biases, AI and ML models may unintentionally reinforce or even worsen those prejudices. Therefore, it is essential to develop and implement these models with an awareness of potential biases and to take steps to mitigate them.

- *Complexity and Explainability:* The "black box" nature of some AI and ML models can make it difficult to understand how they arrive at their predictions. This lack of transparency can be a barrier to regulatory approval and public trust.

Moving Forward

The integration of machine learning and AI into the credit risk assessment process represents a significant shift towards more dynamic, accurate and comprehensive risk management strategies. These technologies offer the promise of enhancing the ability of financial institutions to identify and mitigate risks before they lead to defaults. However, the successful implementation of these advanced tools requires careful consideration of their ethical implications, regulatory compliance and the potential impacts on customers.

Regulatory Environment and Ethical Considerations

The use of AI and ML in loan default prediction has raised important questions about regulations, privacy, fairness and accountability. As financial institutions increasingly rely on these technologies, regulatory bodies worldwide are grappling with how to ensure their responsible use without stifling innovation.

Regulatory Frameworks Governing AI and ML

- *General Data Protection Regulation (GDPR) in the European Union:* GDPR has set a precedent for the protection of personal data, including provisions that affect how AI and ML can be used in credit risk assessment. It includes rights to explanation and consent, directly impacting models that use personal data to predict loan defaults.
- *Fair Credit Reporting Act (FCRA) and Equal Credit Opportunity Act (ECOA) in the United States:* These acts are designed to ensure fairness, accuracy and impartiality in the credit reporting process. As AI and ML models are integrated into credit scoring and lending decisions, their compliance with FCRA and ECOA is scrutinized to prevent discriminatory practices.
- *Basel III and IV Frameworks:* While not directly regulating AI and ML, these international banking regulations emphasize risk management, requiring banks to maintain certain levels of capital reserves based on the risk profile of their assets. The accurate prediction of loan defaults using AI and ML can impact how capital requirements are calculated and met.

Regulatory Frameworks Governing AI and ML In India

India's approach to regulate the use of Artificial Intelligence (AI) and Machine Learning (ML) in credit risk management and loan default prediction is still evolving. However, several guidelines, policies and initiatives by regulatory bodies and the Government provide a regulatory backdrop that impacts how these technologies are applied, particularly in the financial sector.

The Reserve Bank of India (RBI), which is the regulatory authority for financial institutions in India, has been actively monitoring and guiding the adoption of emerging technologies like AI and ML in banking and finance. Key aspects of the regulatory environment include:

- *Data Protection and Privacy:* The use of AI and ML in banking, especially for credit risk management, involves processing large volumes of personal and financial data. While India awaits a comprehensive data protection law, the RBI mandates banks to adhere to stringent data privacy guidelines to protect customer information. This is critical for AI and ML applications that rely on data analytics.
- *Cybersecurity Framework:* The RBI has issued guidelines and frameworks to ensure the cybersecurity of the banking sector, which indirectly governs the deployment of AI and ML technologies. Banks are expected

to ensure that their AI and ML systems are secure against cyber threats and do not compromise the integrity of banking systems.

- *Regulatory Sandbox:* The RBI launched a regulatory sandbox framework that allows banks and fintech companies to test their innovative technologies, including AI and ML applications, in a controlled environment. This initiative helps in assessing the implications of such technologies on financial stability, consumer protection and data security.
- *IT Framework and Guidelines:* The RBI requires financial institutions to establish robust IT governance and risk management practices. This includes the use of AI and ML technologies, where banks are expected to implement sound practices in model development and validation.

Other Relevant Policies

- *Digital Personal Data Protection Act, 2023:* The Digital Personal Data Protection Act casts obligations on Data Fiduciaries to safeguard digital personal data, holding them accountable, while also ensuring the rights and duties of Data Principals.
- *AI Ethics and Guidelines:* The Indian Government, through the NITI Aayog (National Institution for Transforming India), has drafted an approach document for the responsible use of AI, which includes ethics, privacy and security considerations. While not legally binding, these guidelines could influence the regulatory framework for AI and ML in banking.

In summary, the regulatory framework in India for using AI and ML in credit risk management and loan default prediction is a combination of existing data protection, cybersecurity measures and evolving guidelines. Banks and financial institutions are navigating this space with a focus on innovation, while ensuring compliance with the regulatory standards set by the RBI and other relevant authorities. As AI and ML technologies continue to mature and their applications in banking become more pervasive, it is likely that the regulatory landscape will become more defined and specific to these technologies.

Moving Forward: Balancing Innovation with Responsibility

The future of AI and ML in credit risk management depends on finding a balance between leveraging these technologies for their immense potential benefits and addressing the ethical and regulatory challenges they present. Financial institutions, regulators and technology providers must work together to develop standards and practices that ensure fairness, transparency and accountability.

- *Ongoing Dialogue:* Regulators and industry leaders are engaging in ongoing discussions about how to adapt existing laws and develop new framework that can accommodate the rapid advancements in technology.
- *Ethical AI Practices:* There is a push towards developing and implementing AI systems in a manner that prioritizes ethical considerations, including the proactive identification and mitigation of biasness.
- *Advancements in Explainable AI (XAI):* Research and development efforts are focused on making AI and ML models more transparent and their decisions more understandable to humans, facilitating compliance with regulatory requirements and building trust with consumers.

Future Trends and Innovations in Credit Risk and Loan Default Prediction

The landscape of credit risk management is on the cusp of significant transformation, driven by rapid technological advancements and changing regulatory environments. The future promises even greater integration of AI and ML technologies, alongside emerging tools and approaches that could redefine how financial institutions assess and manage credit risk.

Blockchain for Credit Risk Management

- *Smart Contracts:* Blockchain technology, through the use of smart contracts, offers the potential for automating parts of the credit risk assessment and loan origination process, reducing the potential for errors and biasness and enhancing transparency.
- *Decentralized Finance (DeFi):* The rise of DeFi platforms could transform traditional credit markets by leveraging blockchain to facilitate lending and borrowing directly between parties, with implications for credit risk assessment and management.

Regulatory Technology (RegTech)

- *Enhanced Compliance Tools:* RegTech solutions, leveraging AI and blockchain, promise to streamline compliance with evolving regulatory requirements, making it easier for financial institutions to adapt their credit risk management practices to legal standards efficiently.
- *Dynamic Regulatory Frameworks:* Future regulatory frameworks may incorporate AI to dynamically adapt rules based on changing market conditions and emerging risks, fostering a more responsive and effective regulatory environment.

Ethical AI and Responsible Lending

- *Standardization of Ethical AI Framework:* Expect to see a push towards international standards for ethical AI, including guidelines for fairness, transparency and accountability in AI-driven credit risk assessment.
- *Consumer Empowerment:* Innovations that enhance consumer understanding and control over their financial data, as well as how it is used in credit decisions, will become increasingly important.

The Role of Quantum Computing

- *Revolutionizing Data Analysis:* Quantum computing holds the promise of processing and analysing data at speed unachievable by traditional computers, potentially unlocking new frontiers in predictive accuracy for loan default risks.

The Road Ahead

The journey through the past, present and future of credit risk and loan default prediction underscores a field in constant evolution, driven by technological innovation, regulatory adaptation and ethical consideration. As we stand on the brink of a new era marked by AI, ML, blockchain and quantum computing, the potential to enhance financial stability and access to credit has never been greater. However, this potential comes with the responsibility to ensure these technologies are used ethically, transparently and inclusively.

Embracing the future of credit risk management requires a collaborative approach among financial institutions, technology providers, regulators and consumers. Together, these stakeholders can navigate the complexities of a digital financial world, ensuring that advancements in credit risk prediction serve the broader goals of financial health, economic stability and fair access to financial services.

As we continue to witness the unfolding of these innovations, the importance of staying informed and adaptable cannot be overstressed. The future of credit risk management will undoubtedly be marked by the balance between leveraging cutting-edge technologies and adhering to the highest standards of ethical practice and regulatory compliance. In this dynamic environment, the only certainty is change and the readiness to embrace this change will define the success of financial institutions in the years to come.

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