Signs of Bad Loans and their Quality Management

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Annotation: The concept of "problem loans" plays a significant role in managing the quality of the loan portfolio. Statistical indicators when formulating the quality of a loan portfolio usually come from the share of" problem loans " in the total loan portfolio. If the interest rate is high, then the quality of the loan portfolio is poor, and accordingly, if the interest rate is low, then the quality is good. However, paradoxically, the term "problem loan" is not fixed in legislation. However, the Central Bank of Uzbekistan "On the procedure for Forming Reserves by Credit Institutions for Possible Losses on Loans, on Loan and Equivalent Debt "defines a "problem loan". In this Provision, a non-performing loan is a quality category IV loan – a loan with a high credit risk and a probability of financial losses due to the borrower's default on the loan, which causes it to be devalued in the amount of 51% to 100%. For a more precise definition of a "problem loan" in domestic and foreign countries, please refer totable 1.

Table 1. Comparative data on the concept of problem credit [1, p. 10]

Organization	Definition of non-performing loan debt
Central Bank of the Republic of Uzbekistan	Overdue and doubtful loan debt, including promissory notes, interest payments, as well as overdue debt on commissions due to the bank
International Monetary Fund	An obligation whose full repayment is doubtful due to inadequate financial condition of the debtor or collateral for this obligation, as well as there is a delay in payment of the principal debt and (or) interest on it for more than 90 days.
US Federal Reserve System	A loan or loan that does not generate income, i.e. interest payments and / or interest payments that are delayed for more than 90 days.
Basel Committee	A credit product for which there are significant violations of the terms of fulfillment of obligations to the bank, a significant deterioration in the financial condition of the debtor, as well as a deterioration in its quality or loss of collateral for it.

As we can see from Table 1, an analysis of domestic and foreign legislation shows that there is no consensus on this issue. A more precise description is provided by the Basel Committee, however, the phrases "significant violation of deadlines", "significant deterioration in financial condition" can be interpreted in different ways. The wording of the International Monetary Fund and the US Federal Reserve is more specific, since if the delay in principal or interest is more than 90 days, then the loan is automatically classified as problematic.

According to the wording of the Central Bank of the Republic of Uzbekistan and the Basel Committee, the classification of a loan as problematic is more related to subjective factors. This means that, in many ways, the commercial bank itself decides whether to classify the loan as a problem or not. Central Bank of Uzbekistan regulation this by law:" Determining the quality category of a loan (determining the probability of loan impairment) in the absence of other significant factors taken into account when classifying a loan is carried out using professional judgment based on a combination of two classification criteria (the borrower's financial position and the quality of debt service) in the absence of other significant factors taken into account when classifying a loan. according to Table 2" [2, p. 11].

Table 2. Determination of the loan quality category, taking into account the borrower's financial situation and the quality of debt service.

Debt service (on the right) Financial position (below)	Good	Average	Unsatisfactory
Good	Standard (I quality category)	Non-standard ones (II quality category)	Questionable ones (III quality category)
Average	Non-standard (Quality category II)	Questionable ones (III quality category)	Problem areas (IV quality category)
Bad news	Questionable ones (IIIquality category)	Problem areas (IV quality category)	Hopeless cases (V quality category)

You can also see some uncertainty here. Since, in the same regulation, it is noted: "the financial position of the borrower is assessed in accordance with the methodology (s) approved by the internal documents of the credit institution that meet the requirements of these Regulations." As can be seen from the analysis, the share of subjectivity in the process of determining bad loans (and other categories of loan quality) is quite high. On the one hand, this is a negative factor, since artificially overestimating the quality categories of loans leads to a decrease in the RVPS (reserve for possible loan losses). This, in turn, makes the bank vulnerable to crisis events. However, on the other hand, at the moment it is not possible to define in the legislative level the criteria for assessing the financial situation of the borrower and servicing borrowers to the smallest detail. Since the activities and nature of the business introduction of credit institutions and borrowers are extensive and diverse, it is physically impossible to grasp all the details of such an assessment.

In addition to the financial signs of a "problem" loan, there are also organizational signs. Sometimes these signs are the only signal for commercial banks to conduct extraordinary inspections and conduct in-depth analysis when monitoring borrowers. Organizational features include:

unjustified delays in receiving financial statements from the borrower. They are especially significant when the loan agreement contains conditions that require quarterly reporting;

unwillingness of the borrower to provide a detailed explanation of the financial statements. In this case, the loan officer needs to conduct a thorough analysis of the situation and determine whether the borrower is abusing their right not to disclose certain information;

abrupt changes in the borrower's business plans, transition to new markets of activity and sales;

radical changes in the management structure of the borrower's enterprise;

unfavorable trends in the development of the market in which the borrower carries out its financial and economic activities;

frequently changing your legal address, location, phone numbers, etc.;

long-term lack of contact with the company's management and employees;

requests to defer payments on previously extended loans.

It is obvious that combining "organizational" and "financial" attributes is the most effective measure in managing the quality of a loan portfolio, in particular "bad loans".

To summarize, it can be noted that, despite the huge amount of scientific and practical literature, the term "problem loan" is interpreted differently. The term "problem" in science is a contradictory situation that appears in the form of opposite positions in the explanation of any phenomena, objects, processes and requires an adequate theory to solve it. The author believes that "problem loans" should be considered those loans that have lost their primary level of quality (the primary level of quality is the quality at the time of loan issuance). It is known that the quality of a loan portfolio depends on the credit risk, liquidity and profitability of the loan and the loan portfolio as a whole. Therefore, the deterioration of the borrower's financial situation leads to an increase in credit risk, loan restructuring leads to a decrease in loan profitability and, accordingly, the quality of the loan worsens. Assigning a loan to the III-IV quality categories (in domestic practice), in turn, determines additional time and financial costs to resolve the "problem" situation. Therefore, it would be more logical to call all loans except for the first quality category problematic, and call the fourth quality category differently.

References:

1. Decree of the President of the Republic of Uzbekistan “On additional measures implemented within family business development programs” No. PQ-5041 March 27, 2021
2. Aleksandrov A. Yu. Managing the portfolio of problem loans of a commercial bank: abstract of the PhD thesis: St. Petersburg, 2010-23 p. (in Russian)