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Effective Management of Credit Risk Management of Commercial Banks

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Abstract: *This article focuses on the nature of credit risks and areas of its management, which have the greatest impact on the activities of commercial banks, with basic criteria for credit risk assessment, ways to reduce credit risk, basic methods of credit risk management, as well as conclusions and recommendations on credit risk minimization.*

Keywords: *commercial bank, credit, credit risk, management, assessment*

Introduction

In order to achieve the efficiency of banking, to ensure its financial stability, it is necessary to study the impact of all existing risks in the economy on banking. This is because the bank establishes economic relations with various entities during its operation, and changes in their activities may be reflected in the activities of the bank.

In banking practice, the risk is the risk of losing part of the resources, incurring additional costs as a result of certain financial transactions.

While commercial banks are recognized as the leading link in the economy and the locomotive of economic reforms, it is advisable for commercial banks to study the risks associated with their activities more and more deeply than other economic entities. Because commercial banks are accountable for their activities, on the one hand, to their shareholders, and on the other hand, to customers who have entrusted their funds and use banking services.

Main part

There are five basic criteria for assessing credit risk:

A. Reputation. This process should include both personal treatment and work experience (inspection of lenders, suppliers and customers);

B. Opportunities. The ability of the borrower to obtain funds for all its operations (money received by the borrower during its entire activity) or for a specific project and the ability to manage funds (this should be known from previous projects);

C. Capital. The borrower’s capital base and determination to spend its funds for the project for which the loan is requested. The Borrower shall bear the responsibility for the risk of the project together with the Lending Bank, assuming the obligations to which it belongs, providing an acceptable portion of its share capital;

D. Conditions. Current state and description of local, regional and national economy, as well as sectors of the borrower's economy;

E. Collateral. Securely securing a loan in the form of collateral or surety, on the other hand, eliminates weaknesses. There is a good rule of thumb: never lend on the basis of collateral or guarantee [1].

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The following factors should be considered:

Collateral quality - is the equipment obsolete or damaged, is it purchased, can it be sold in the market, is it protected from inflation as collateral?

- Can the bail be legally recovered with ease in case of non-performance of obligations?
- The possible ratio between the market price of the collateral and the loan amount and whether it should be revised frequently?

One of the important ways to assess the level of credit risk is the rating system. Banks use it extensively in their credit checks and asset monitoring. The use of this system helps to determine the income from the loan at the time of the risk.

Banks usually develop their own credit rating systems. Some use simple schemes, while others run complex and fragmented, all-encompassing schemes.

However, the goal should always be the same: to facilitate the decision-making process for the bank's credit department, both in lending and in its pricing. Usually this is done by naming risk categories with numbers or letters, classifying them [2].

It is important to note that the rating is always based on a number of factors and always includes the following:

- Purpose of the loan;
- Loan amount and total loss probability;
- Borrowing sector;
- Borrower's financial condition and previous loans [3].

In banking practice, lending plays a significant role in all operations. Therefore, the development of measures to minimize credit risk remains a very important issue. These measures include (Table 1):

Table 1 Ways to reduce credit risk

#	Risk reduction measures	Note
1.	Assess the customer's creditworthiness	This method involves determining a customer's rating. The criteria for evaluating a debtor are strictly individualized for each bank and should be based on its current position and reviewed from time to time.
2.	Reducing the amount of credit given to a single borrower	This method is used when the customer is not completely sure of their creditworthiness
3.	Credit insurance	Credit insurance implies that it is the responsibility of the organization that fully insures the risk of non-repayment.
4.	Require adequate supply	This method guarantees the return of the amount issued by the bank and the receipt of interest.
5.	Discounted lending	These loans help to reduce credit risk to a lesser extent. Lending in such ways ensures a minimum repayment of the loan.

First of all, it should be noted that banking is not about avoiding risk at all, but about anticipating, anticipating and minimizing it. Risk management aims to complete a business with a positive outcome, even though it often carries with it the “risk” of losing some of the bank’s own funds, incurring a loss of income or incurring additional costs as a result of financial transactions.

In general, bank risk management involves the development of measures to mitigate the likelihood of risk occurring, to prevent adverse events arising from risk, or to reduce their impact.

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Banking risk management requires an in-depth knowledge of the activities of banks, the ability to determine the effectiveness of their operations, to make optimal decisions on credit, investment, monetary policy and other activities of the bank, a thorough knowledge of customers' business and their financial condition.

The main methods of credit risk management are:

- assessment of the financial condition of borrowers, issuers of securities and counterparty banks, further monitoring of their financial condition;
- limitation;
- backup;
- control over previously issued loans;
- diversification of the bank's loan and investment portfolio;
- monitoring of collateral status;
- differentiation of powers of employees;
- determination of threshold values of mandatory indicators in accordance with the current legislation and internal regulations of the bank.

The method of diversification consists in the distribution of loans between a wide range of borrowers, which differ from each other in characteristics (capital size, form of ownership) and activities (industry, geographical region)[4].

A properly designed credit risk management system should include the following components:

- local normative and legal documents on credit risk management, defining management strategies, policies and procedures for identification, measurement (assessment), monitoring and control of credit risk (including counterparty risk);
- Bank divisions (officials) responsible for credit risk management;
- implementation of the process of division of responsibilities and credit risk management.

The main task of a bank manager in managing bank risk is to find the optimal option between the income generated in the course of banking activities and the risks that arise in it.

The current situation in the banking system and the country's economic development strategy in the field of credit risk management by commercial banks, first of all, to ensure the correlation between the maturity of deposits and the profitability of bank assets and further strengthen the guarantees of their timely return; secondly, to effectively apply and improve modern methods of scoring-analysis of creditworthiness of bank customers, taking into account the experience of the world's leading and stable banks; thirdly, in order to increase the effectiveness of banking supervision, special attention should be paid to the use of international standards in risk assessment of credit institutions.

Within the framework of these measures, an important area in credit risk management, namely the credit classification system, plays an important role. First of all, it should be noted that the process of classification of direct bank loans begins with the assessment of the activities of their users. The main criteria to be considered are:

- Trends and prospects of the industry (sector of the economy);
- technical implementation and economic competitiveness of a particular project;
- financial condition and creditworthiness;
- credit history, deterioration of credit supply or decrease in liquidity;

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- economic feasibility of a particular project;
- managerial ability (if the debtor is a legal entity).

The positive and negative state of the specified criteria, as well as changes in them (improvement or deterioration) serve as a basis for determining the level of risk of the commercial bank's loan portfolio.

Conclusion

In this regard, the following areas of credit risk minimization can be identified:

1. The Bank pursues an excellent credit policy, tries to fully cover its risks.
2. The Bank diversifies its loan portfolio by risk groups, types of economic activities and regional diversification.
3. The Bank provides credit products to borrowers only after a detailed assessment of all possible risks associated with the activities of these borrowers.
4. The Bank avoids lending to borrowers associated with high credit risk.
5. The composition of the bank's loan portfolio on the terms of placement of funds is proportional to the terms of raising funds for passive operations.

Despite the fact that the main criteria of the classification system, which is the basis for determining credit risks, have been identified, the implementation of the following measures can increase the efficiency of banking in this area:

1. It is expedient to form a system of macroprudential control. The main part of the negative situation in the economy of our country is due to imbalances in the global economy and the crisis situation. In particular, high prices for goods and raw materials and the exchange rate of reserve currencies. This necessitates the control of a system for forecasting, monitoring and mitigating systemic risks in the global economy.
2. It is necessary to create an electronic system that takes into account all the factors that cause credit risks.
3. Taking into account the experience of the world's leading and stable banks, it is expedient to effectively apply and improve modern methods of scoring-analysis of creditworthiness of bank customers.

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