
Economic potential and perspectives of Europe, Russia and CIS states

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Management of problem loans in the bank: influencing factors and principles of management

Управление проблемными кредитами в банке: факторы и принципы построения системы управления

Problem statement. Specialists in Management believes that the management of a modern bank is one of the most difficult areas of human activity. In a market economy, banks are at the center of the set of contradictory and unpredictable processes taking place in the economy, politics and social life. The banking crisis in Ukraine in 2008–2009 was due to the global financial crisis and domestic macroeconomic issues that affect the outside banks. In addition, the crisis has been linked to the influence of internal factors. Among the internal factors occupied a significant place not only financial problems but also difficulties in management, technology and organize their own activities.

In such circumstances, increase the efficiency of the bank requires banks to introduce evidence-based system of financial management. Of particular note is the system of problem loans because of their impact on the bank's financial position is strong. The theme is relevant in view of the fact that the amount of bad loans in Ukrainian banks is great, as evidenced by the performance of the banks in 2013. All this indicates imperfect methodology for management of problem loans.

Review of recent research and publications on the topic. Academics and practical aspects of problem loans have been explored in a number of publications. Methodological and organizational structure management debt problem has been investigated in studies Danilishyna, In. Kloby, In. Mishchenko, L. Sloboda, Alexandria th, OH. Kovanov th, p. Im Kuznetsov, A. Nurzat, M. Smykov th, M. Yashin th and others.

Remaining part of the problem. Numerous studies managing problem loans banks do not solve the problem completely. unanswered questions remain numerous problems in the theory and practice of managing problem credits.

This study combines theoretical approaches and practical experience forming a system of problem loan management in banks (hereinafter — SPLMB), which can operate effectively in times of economic instability.

The main results of the study.

In 2009, the share of bad loans in the loan portfolios of Ukrainian banks increased from 2.5% to 9.2% according to the Bank. In 2010, the quality of the credit portfolio of Ukrainian banks deteriorated and the share of problem loans increased to 11%.

In June 2012, bad debts reached a minimum in the last two years and amounted to 75.6 bln. However, the fall of 2012, the volume of bad loans began to rise again and reached 78.2 billion, or 9.5% of the total loan portfolio. In 2013, the share of problem loans is 11% of total loans.

International rating agencies assess the situation in Ukraine worse.

According to Fitch Ratings in the level of bad loans in banks of Ukraine is about 45–50% of all loans on the balance sheets of banks. The World Bank estimates the level of bad loans in Ukraine in 41%, and rating agency Moody's — 35%¹.

Management of bank bad debts is not possible without understanding the nature of problem loans.

The publication of A. Moroza, L. Prymostky V. Mishchenko and other local scientists the SPLMB is defined as follows: the SPLMB is a loan for which one or more payments is not spent in time, significantly decreased the market value of collateral, and the bank has reason to doubt the return of the loan².

That is, if the borrower fails to comply with the return period specified in the loan agreement or the planned repayment schedule of the loan, and in the case of other adverse changes in the condition of the borrower, researchers propose to transfer credit into the category of problem.

The Basel Committee on Banking Supervision considers the SPLMB as credit, which is characterized by significant impairments timing obligations to the bank, a sign of worsening financial condition of the debtor, a significant reduction in the quality or loss of security³.

By definition of the International Monetary Fund the SPLMB s are obligations which full repayment is in doubt because of inadequate financial condition of the borrower or security under this obligation, and there is a delay in its principal or interest payment for more than 90 days⁴.

U.S. Federal Banking system considers the SPLMB s as the credit, not bringing income, i.e. principal or interest payment that are delayed by more than 90 days.

To the debt problem Central Bank of the Russian Federation relates overdue and doubtful credit, promissory notes and interest receivable and overdue for commissions.

Criteria of problem debt established by the National Bank of Ukraine.

The Law on the formation and use of bank of Ukraine possible losses on active banking operations and loans are classified into the following categories as:

— I (best) — no risk, or the risk is minimal;

— II — moderate risk;

— III — significant risk;

— IV — high risk;

— V — realized risk. Debt on assets/financial liabilities granted, assigned to the lowest (five categories), is hopeless⁵.

¹ Печорина, Н. Эксперт: Збитки українських банків у вересні пов'язані з високим рівнем проблемних кредитів [Електронний ресурс] : Режим доступу : http://www.ukrinform.ua/ukr/news/ekspert_zbitki_ukraïnskikh_bankiv_u_veresni_povyazani_z_visokim_rivnem_problemnih_kreditiv_1767460

² Александров, А.Ю. Управление портфелем проблемных кредитов коммерческого банка: автореф. дис. на соискание учен. степени канд. экон. наук: 08.00.10/Александров А.Ю. - Санкт-Петербург, 2010. - 23с.

³ Мороз, А. М. Кредитний менеджмент [Текст]: навч. посібник/Мороз А. М. - К.: КНЕУ, 2009. - 540 с.

⁴ Там же.

⁵ Про порядок формування та використання банками України резервів для відшкодування можливих втрат за активними банківськими операціями [Електронний ресурс] : положення, затверджене постановою Правління Національного банку України від 25.01.2012 р. № 23. - Режим

The National Bank of Ukraine also is used the concept of non-performing loans in addition to these key indicators of financial stability.

Quality loan made by a professional evaluation based on a combination of three classification criteria: the financial condition of the borrower, loan security and quality of service the debt. The financial condition of the borrower is assessed by the bank on their own based on their own methods with the advice of the National Bank.

Note that understanding the concept of problem loans varies considerably in the approaches of the National Bank of Ukraine and international financial institutions, leading to significant differences in the assessment of the volume of bad debts of banks.

First, in accordance with the applicable accounting rules in Ukraine in the accounts reflects the amount of arrears only those tranches, which were a violation of the terms of repayment. For international approach to determine the actual amount of problem and potential problem loans must take into account the full amount of the loan, for which there is outstanding debt, not just the amount of payments.

Second, the amount of restructured loans does not apply to the National Bank of Ukraine problematic ones, although such loans by their nature are problematic and international rating agencies take into account when determining the volume of bad debts.

We believe that the problem loans should be classified as loans which found signs of problematic return, i. e. there is a significant breach of the terms of fulfillment of obligations to the bank fails held one or more payments, there is a loss of money or the value of collateral, financial condition worsened borrower or negative information is available about the inability of the borrower of its obligations and other circumstances that allow the bank to have doubts as to full and timely repayment.

We propose to use a comprehensive definition of problem loans adding two kinds of debt: credit debt, which is at the stage «before the onset of problems» and accounts payable with marked signs problematic.

Loans at the stage "before the onset of problems" include debts that are potentially problematic (for loans under intensive control), and the debt which is very likely to become problematic in the short term, but can still be seen in the bank as not problem (credits at the stage of early warning).

This debt must be attributed to the problem and a system of measures aimed at preventing the problems have to be provided. The effectiveness of the preventive measures bases on proper identification of the loans.

Loans with severe symptoms include problematic aspects such as timely repayment of credit (client admitted breach of the loan agreement, the terms of preservation and the size of the security conditions in support of the financial condition, etc.) and non-performing loans (debt borrowers by declaring a default under the internal regulations of the Bank).

This type of debt must be provided with a system of measures aimed at preventing the problems. The effectiveness of preventive measures aimed at preventing the SPLMB based on proper identification of loans that are potentially dangerous and require intervention of the bank.

For each category of problem loans an appropriate criteria and indicators should be developed for guiding the bank.

The following classification of problem loans should be used for substantiation of measures for management¹.

доступу: <http://zakon1.rada.gov.ua/laws/show/z0231-12>.

¹ Крухмаль О. В. Розвиток методичних підходів до управління проблемними кредитами/О. В. Крухмаль, О. А. Криклій//В кн.: Теоретико-методологічні засади прискорення процесів розвитку регіону [Текст] : колективна монографія/За заг ред. П. І. Сокурєнка. – Кременчук : ІПП ІІІрбатих. – 2013. – С. 308–319.

First, we need to define the essence of managing problem credits. As a result of this study we have determined that no unified approach to managing problem loans in the scientific literature has formed. It is appropriate to consider the management of problem loans as a system of preventive measures (designed to work with loans «before the onset of problems») and reactive (designed to work with loans with marked signs of problematic) nature, which is the functional maintenance planning, diagnosis (assessment) regulation and control.

For quality control problem loans need to apply a systematic approach. In this connection it should define the basic elements of such a system — objects, subjects, principles and mechanisms. The interaction of these elements to minimize the risk of loss or bank.

Results of the study suggest that the object of managerial influence a credit exposures. We propose to consider that credit exposures are huge potential losses in the bank's relationship with the borrower who fails to fulfill the obligations under the influence and due to the interaction of external and internal factors.

This statement allows us to formulate the goal of managing problem credits as follows: minimize potential bank losses in the relationship with the borrower carrier risk.

Subjects of problem loans management system we suppose to view as a set of general management body, that are responsible for general credit policy in the bank, and special control body, that is directly involved in dealing with problem loans.

The Supervisory Board and the Board is a body of general management of problem loans. Organs of special management NPL:

- Credit Committee,

- a set of special units directly involved in managing problem credits. This group includes units that directly draw up and issue credit (the credit risk positions, with no signs of problematic), specialized units for dealing with problem loans (the owners risk positions with signs problematic). Also in this group include situational problem debt management center (information and analytical support);

- support centers managing problem credits. Support Center is a security service, the legal department, accounting and reporting.

SPLMB should be based on a number of s principle that we propose to split between general (inherent to any management system) and specific (typical is SPLMB).

The structure of the general principles include:

- integrity — reviewing all SPLMB elements as a complex system;

- Openness — required consideration of the SPLMB relationship with other bank management systems and the external environment;

- complexity — need to consider the complexity of problem loans managements system by controlling large number of factors affecting the credit risk position of the bank, including relationship between them and their possible consequences;

- SPLMB ability to integrate new elements, if required by the need to achieve management objectives;

- resultativity. Management system should provide the possibility of reducing NPLs and/or increase the ability of the bank to minimize the negative consequences of their occurrence;

- flexibility and adaptability, ie the ability of SPLMB to adapt to the changing internal and external environments and high speed of response to them;

- adequacy, ie, results correspond to current market environment;

- efficiency, ie the ability to overcome the negative consequences of the emergence of bad loans with a minimum amount of necessary resources (financial, human, time, material);

- versatility and universality — SPLMB ability to regulate and control the credit risk positions on a permanent basis, despite the impact of external and internal environments;

— hierarchy — providing such a multilevel structure of decision-making on credit risk positions, ensuring adequate distribution of powers and responsibilities.

The above-discussed principles are general, universal. However SPLMB has certain specifics related to the characteristics of the object, purpose and methods of management, which leads to the need to observe the following principles:

- responsibility control for accepted credit decisions and quality of its' service;
- centralization of management in specialized units that should determine how the strategy works with credit exposures and take full responsibility for the results of its implementation;
- awareness, which implies that the control subjects fully aware of the characteristics of credit risk's position;
- ensuring equality of opportunities and actual procedural steps for borrowers, regardless of their financial capabilities;
- uniform standards of work with troubled loans;
- reasonable risk sharing between banks, borrowers and specialized commercial organizations that service distressed debt (hereinafter — SCO);
- use of modern methods for problem loans management;
- specialization for realization of certain features for problem loans management system by including internal units of the Bank and SCO.

In forming SPLMB one should not only be guided by the above-discussed principles but should also take into account factors that affect the control. The external (uncontrollable) factors include:

- factors related to the environment, which has a double effect: the borrower and its ability to fulfill its obligations (economic, social and political conditions in the country) and the possibility to regulate bank credit risk positions (the level of economic interest protection of creditors provided for by law, the effectiveness of regulation and supervision). Their composition is relatively large and heterogeneous, but impact — is very significant and is hardly predictable;
- factors that are related to the partial or complete loss of support (for material support — loss of value, a significant impairment in the period of the loan agreement, damage or total loss of the collateral, for financial support — counterparty's inability to fulfill its obligations, loss of reputation);
- factors that are related to financial, reputational characteristics of the borrower. In case borrower is not able to fulfill their obligations to the Bank under the influence and by the interaction of external and internal factors.

Abilities and instruments to control external factors are very limited, but by acting in timely manner bank can mitigate their impact and avoid significant losses. Primary focus should be given to factors related to the borrower and the collateral. As only they ultimately determine the credit risk profile of the bank and its' credit risk positions. The main tool to prevent the negative impact of these factors group is an effective monetary policy¹.

While forming SPLMB internal factors should be treated in the first role as they can be managed and controlled.

Internal factors that are primarily related to the characteristics of credit risk position, are loan product parameters. They affect the rate of defaults and losses in the distribution of credit exposures. Both in times of crisis, and with the growth of the market, optimal bank loan products are essential in terms of prevention occurrence of problem loans. This effect exists for both the borrower (the parameters of loan products to meet its needs and capabilities) and the bank (the parameters of the

¹ Шустова Е. П. «Проблемный кредит»: терминологическое содержание, критерии определения и факторы возникновения [Текст] / Е. П. Шустова // Вестник Алтайской академии экономики и права. – 2010. – №4. – С. 21-32.

loan meet Banks' opportunities). It is worth noting that the range of credit products, that are prime for the bank, as well as products, unwanted and banned for sale, defined by credit policy.

An in-depth study require internal factors that are not directly related to the characteristics of credit risk positions, but ones that determine the credit risk profile of the bank and the possibility of bad debts. We suggest to consolidate these factors into three groups.

The first defines the objectives of monetary policy, that are aligned to objectives of the bank. In case of an incorrect set of the policy the level of strategic risk increase. In our opinion, that was one of the causes of the banking crisis in Ukraine. The most important strategic failures of banks in the pre-crisis period was unjustified growth in loans ("credit boom") and the development of new market niches, especially mortgage lending. As a result, this led to a significant increase in bad debts in 2009–2010

The second group of internal factors in the bank determines the available resources (financial, material, labor, information) and technologies for achieving these goals, including the ability of management to effectively use them.

To prevent the occurrence of problem's loans it is important to determine whether the bank has enough resources to achieve the objectives set out in its credit policy. Some of the elements of resources are defined by an ability of rapid transformation over time and may be subject to monetary policy purposes (eg, introduction of innovative technologies, the appropriate training of credit managers). The other elements of the resources have limited opportunity for transformations over time due to market constraints, lack of financial resources and other reasons (eg, to increase its share capital, a significant increase in logistics). Therefore, objectives of monetary policy and its implementation mechanism should take into account resource constraints while building internal capacity of the bank, which will prevent the emergence of problem loans.

In research proves that significant number of banks in Ukraine before the crisis developed and implemented the credit policy, without having sufficient amount of resources. The biggest divergence in resources, in our opinion, was observed in:

- financial resources: banks developed mortgages without having proper maturity profile of resources, that in turn brought to a shortage of liquidity;
- workforce: banks offer borrowers more complex credit products, the risks were not properly investigated. In the absence of a sufficient number of qualified personnel for the development of risk assessment models for complex credit products, banks are exposed to additional risks.

The third group includes methodological support (regulations, procedures, process cards, etc.) credit process, credit risk management, problem loans management approved by the relevant authorities of the bank. That should be based on the principles of corporate governance and is consistent with its practical implementation. Qualitative methodological support will minimize the level of operational risk, which can also lead to the emergence of bad loans.

Thus, we determined that the formation SPLMB must consider many external and internal factors that arise during the planning phase of the credit, the formation of resourcing and finally opening and maintaining credit risk positions.

An integral part of any system, including SPLMB are functions among which, we suggest to attribute, is planning (the formation of monetary policy), regulation (management tool to compare actual performance of credit risk position versus the planned and develop measures to address them), analysis (study of credit risk positions and evaluation of their sensitivity to changes in external and internal factors) and control (supervision, inspection and comparison of characteristics of the actual credit risk positions versus planned).

Efficient interaction of these functions is implemented through the mechanism of problem credit managements on both preventive and reactive levels.

As noted above, preventing the proliferation of bad loans in the bank requires the introduction of evidence-based monetary policy, the purpose of which is to control credit risk in the process to ensure the most efficient allocation of credit resources to obtain the maximum possible income from lending operations.

Credit policy should identify the following approaches used in lending and, in the case of effective implementation will prevent the emergence of bad loans: the creation and implementation of qualitative and quantitative credit risk assessment. Standardization of loan products by establishing clear procedures and methods of analysis of potential borrowers to reduce the cost of credit services and improve customer service. Flexible credit terms, depending on the type of credit product (program, individual, complex). Complex credit risk management that is carried by respective departments within their powers on all stages, whether application is pending or under support. Controlling proper funds usage by the borrower.

On the basis of developed monetary policy and its' requirements, a preventive problem loans management system is employed on an ongoing basis and includes:

- monitoring of risk positions for signs that may indicate the occurrence of problem loans. In order to systematize these signs the following matrix of problem loans is presented;

- diagnosis of the borrowers' ability to repay and determination on the basis of diagnosis the characteristics of exposure (standard credit loan, pre-bad loan stage; loan with clear signs of problems).

Matrix of problem loans signs allows to divide loans into four groups depending on the signs of problem and repayment sources of problem loans:

1. the first group «Real signs — the primary source of repayment»: irregular and late payments on the loan, violation of terms of principal repayment and interest; downgrade client's credit rating, illness or death of the borrower, the borrower's bankruptcy;

2. The second group «Potential signs — the primary source of repayment»: retention of reporting borrowers, avoiding contact with the bank, talks about the changes in some areas of credit agreement; sudden and unexplained changes in the size of account balances, use of one-time sources of repayment, reduction in sales, increase in sales on credit, increasing inventories, growth payables, reducing cash balance sheet, income reduction, slow inventory turnover, an increase of overdue debts, etc.

3. The third group «Real signs — Secondary sources of repayment»: loss of collateral, insolvency of the guarantor, insurer;

4. The fourth group «Potential signs — Secondary sources of repayment»: deterioration of the value of collateral, deterioration of market conditions (an increase in time and resources required to sell collateral), deteriorating financial condition and operating conditions of guarantor, or insurer.

If loan is detected to be with severe symptoms of problematic nature, it activates reactive management, which involves the introduction of measures to control bad debts.

While working with problem loans the bank can use two controlling strategies: recovery strategy and elimination strategy.

The main method of recovery of bad loans is its restructuring (changing the initial conditions of the contract) with the failure of the debtor to meet its' obligations. In an agreement of restructuring the following elements might be introduced: restructuring provision, restructuring payment schedule (extension of credit, grace periods) Restructuring charges for loan (loan schemes change from the classic to the annuity, reduced interest rate) conversion of loan and interest, write-off fines and penalties and so on.

The decision on restructuring must be substantiated and adopted in the same manner as the decision to grant credit.

In our opinion, restructuring is not the most effective method to restore credit, because its central goal is to give the borrower an opportunity to restore the financial situation, which is short-term.

This method is effective when the problems of the borrower are temporary and are not systematic. Also its worth noting that in domestic banking practice, this method is often used wrongly whether to hide bad loans or to dress-up the statements.

Recovery of bad loans may allow for sanitation, ie development of methods and actions that are carried out jointly by the bank and the borrower to prevent its bankruptcy.

Activities conducted as part of the sanitation, can be divided into those that mobilize internal reserves of the borrower (reduction in receivables, cut-off of unprofitable business units, deceleration of fixed and variable costs, selling non-core assets, etc.), and such that involves finding external sources of funding (to attract additional capital, seeking new partners, etc.). Sanitation is very expensive method, which does not give instant results, so the bank must carefully assess their capabilities and appropriateness of use.

If the loan recovery strategy recognized inappropriate or do not lead to expected results, the bank applies aggressive methods by forcing debtor to return the principal and interest (to carry out the liquidation of credit) for full reimbursement of bad debts.

Methods for elimination of credit include: enforcing the collateral, the elimination of bad debts by the guarantor (surety), insurance reimbursement from insurance agencies within the time limits specified by the rules of insurance, transfer of distressed assets under management to a third party (collector) with optimizing bank balance, transfer/sale troubled assets of related financial company (SPV onshore/offshore); sale of distressed assets unrelated financial company under factoring, legal action (set of measures for their enforcement).

Feasibility of implementation in practice of a particular bank of these methods defined criterias such as:

- guarantee of the result, which should be considered as full repayment of principal and interest;
- costs to implement the chosen method, (the level of costs must be determined with regard to all additional expenses necessary for method implementation);
- duration of action — in this aspect the regulatory and legal framework for selected procedures should be considered, and the ability to implement them independently of the will of the debtor;
- impact on reputation — this criteria determines the validity of the chosen strategy, the possibility of further cooperation of the bank with the borrower, as well as strengthening or weakening of the position of the bank relative to other borrowers;
- potential external risks and the degree of dependence on results from external factors (market conditions, market prices for collateral, etc..)
- potential internal risks and the degree of dependence on result from internal factors.

Moreover, when choosing the method bank has to take into account the peculiarities of accounting and taxation, the impact on the adequacy of regulatory capital, level of liquidity, an increase in management efficiency, reduction of risk and profitability of the loan portfolio.

In case of failure to return bad loans, a bank can use reserve in the manner prescribed by the National Bank of Ukraine. In 2010, NBU has revised troubled debt write-off technology from the reserves in accordance with the Tax Code. In particular, the NBU permits to write off all loans overdue more than 90 days, except for insider loans and unsecured loans. Decision to write off bad debts taken by the Management Board or the Board of Directors and is reflected in the financial report. Write-off is not grounds for termination of pretenioning of the debtor, and if the bank debt increases the income and pay the tax.

Banks purified balance of NPLs through their write-off or sale. Reducing NPLs Ukrainian banks in 2012, primarily due to write-offs of bad loans from their own funds or bank sale of NPLs (for example, Bank Forum, UkrSibBank, SvedBank, etc.). However, following the bank — a forced and often ineffective way of bad loans. According to the rating agency Fitch Ratings, for improving the management of bad debts Bank of Ukraine should own appropriate infrastructure, such as units that specialize in debt collection and enforcing security.

Conclusions. The article defines the structure of the banking system of problem loans. Such a system is defined as an integrated set of the objects, subjects, principles and mechanisms of interaction, which minimizes losses when dealing with borrowers.

In the article special attention is paid to methods of managing bad debts. The choice of control method depends on the type of problem loans, which allows you to define a matrix of problem loans signs. In addition, the choice of method of managing problem loans depends on the characteristics of the bank and the borrower and other factors should be considered when forming management of problem loans.

Given the importance of the subject managing problem loans in Ukrainian banks and condition of the bank, which is constantly changing, there are objective grounds for further research in this area.