

Olena A. Kryklii<sup>1</sup>, Olena V. Krukhnal<sup>2</sup>

## PROBLEM LOANS MANAGEMENT SYSTEM IN A BANK

*The article justifies the application the system approach to problem loans management in banks. It was determined that problem loans management system in banks should be defined as its structural and functional integrity. The interaction of its elements allows minimizing losses which may arise from the relationships with borrowers. The strategy of bank's problem debts' mitigation is described.*

*Keywords: problem loans management; problem loans; banks.*

Олена А. Криклій, Олена В. Крукхмаль

## СИСТЕМА УПРАВЛІННЯ ПРОБЛЕМНИМИ КРЕДИТАМИ В БАНКУ

*У статті визначено доцільність використання системного підходу до управління проблемними кредитами в банку. Систему управління проблемними кредитами визначено як сукупність елементів, взаємодія яких дозволяє мінімізувати втрати у взаємовідносинах з позичальниками. Надано характеристику стратегіям врегулювання проблемної заборгованості в банку.*

*Ключові слова: проблемний кредит; управління проблемними кредитами; банки.*

*Рис. 3. Літ. 14.*

Елена А. Криклий, Елена В. Крукхмаль

## СИСТЕМА УПРАВЛЕНИЯ ПРОБЛЕМНЫМИ КРЕДИТАМИ В БАНКЕ

*В статье обоснована целесообразность использования системного подхода к управлению проблемными банковскими кредитами. Систему управления проблемными кредитами предложено определять как совокупность элементов, взаимодействие которых позволяет минимизировать потери банка во взаимоотношениях с заемщиками. Охарактеризованы стратегии регулирования проблемной задолженности в банке.*

*Ключевые слова: проблемный кредит; управление проблемными кредитами; банки.*

### Introduction

While forming and developing the credit policy for 2014–2015 banking institutions in Ukraine should first of all take into account the fact that it will be implemented under the influence of unfavourable environment that is very unpredictable due to the global recession. Uncertainty in financial and commodity markets will generate significant variability of the economic situation in Ukraine. Unfavourable macroeconomic situation may lead to the deterioration of financial conditions of borrowers and thus possible increase in bad debts. As such, there is an objective need for problem loans management in banks to be improved.

### Research and publications analysis

The issue of bad debts mitigating in banking system has been actively investigated in the context of financing, control and credit risk management. Such authors as V. Danilishyn and O. Stefankiv (2012), L. Kloba (2009), V. Kloba (2010), V. Mishchenko et al. (2009), L. Sloboda and N. Dunas (2011) made a special contribution to the development of the issue. Significant scientific results that allowed forming methodological and organizational framework for problem loans management in banks was achieved by Russian academia: A. Alexandrov (2010), O. Kovanev (2009), S. Kuznetsov (2008), O. Nurzat (2011), M. Smykov (2011), M. Yashin (2010).

<sup>1</sup> Ukrainian Academy of Banking of the National Bank of Ukraine, Sumy, Ukraine.

<sup>2</sup> Ukrainian Academy of Banking of the National Bank of Ukraine, Sumy, Ukraine.

### Unresolved issues

Despite the fact that domestic and foreign scientists made significant progress in developing this topic, it should be noted that many issues related to the theoretical principles and practical aspects of problem loans management in banks (object definitions and business management principles formation, the factors that should be considered in system formation management, methodology) are not investigated enough.

**The research object** is to generalize the existing theoretical approaches and practical experience to forming a system of problem loan management in banks (hereinafter – PLMSB) that can effectively function under economic instability. These results will be used as a basis for further development and improvement of the system.

### Key research findings

We suppose that problem loans management system in banks should be based on the system approach, the application of which will improve decision-making and optimize the organizational structure. The most important characteristics of any system are its structure (elements of structure and relationships between them) and functions (the ability of the entity to conduct operations to achieve the defined goals).

That is why we believe that the problem loans management system is a structural and functional integrity of related elements (objects, subjects, principles and mechanisms). The interaction of these elements allows minimizing losses which may arise from the relationships with borrowers.

Credit exposures position which we offer to identify as the risk of potential bank losses which arises from the inability of the borrower to meet obligations under the influence and by the interaction of external and internal factors, is the object of managerial influence.

The definition mentioned above allow us formulating the purpose of problem loans management system, which is to minimize potential losses in the bank's relationship with "risk carriers". In the most general terms, it is determined by the amount of funds provided to a borrower, and the probability of default (probability of borrower default).

We suppose to view subjects of problem loans management system as a set of general management bodies responsible for general credit policy in a bank (the Supervisory Board, the Board of Directors) and special control bodies directly involved in dealing with problem loans (the credit committee, departments that directly manage problem loans and support centres managing problem loans).

In forming PLMSB one should not only be guided by the discussed above principles but should also take into account the factors that affect control (Figure 1).

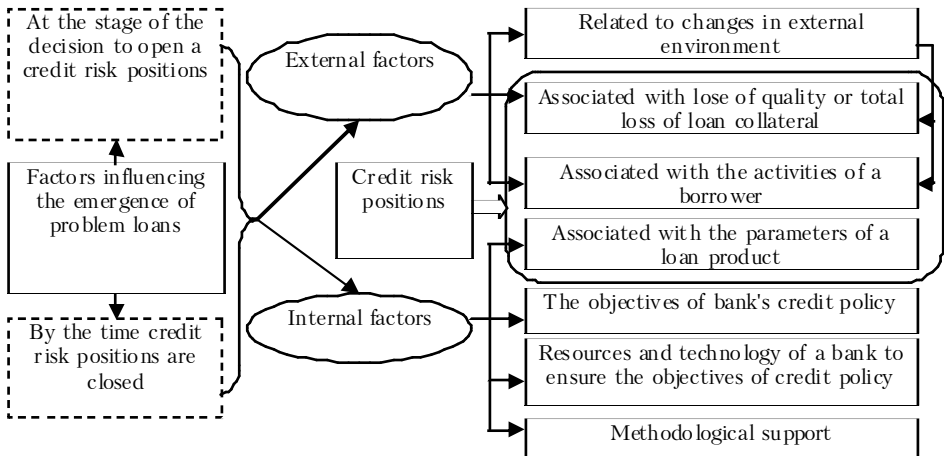
The external (uncontrollable) factors include:

a) factors related to environment, which have a double effect: the borrower and his/her ability to fulfill obligations (economic, social and political conditions in a country) and the possibility to regulate bank credit risk positions (the level of economic interest protection of creditors provided by law, the effectiveness of regulation and supervision). Their composition is relatively large and heterogeneous, but impact is very significant and hardly predictable;

b) factors that are related to partial or complete loss of collateral (for material collateral – loss of value, a significant impairment in the period of loan agreement,

damage or total loss of collateral, for financial collateral – counterparty's inability to fulfill obligations, loss of reputation);

c) factors related to financial, reputational characteristics of the borrower arising from his inability of the borrower to fulfill obligations under the influence and by the interaction of external and internal factors.



Source: Developed by the authors.

Figure 1. Factors to consider under problem loans management

Abilities and instruments of external factors' control are very limited, but bank can mitigate their impact and avoid significant losses. Primary focus should be given to the 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 (Kovanev, 2009; Shustova, 2010). Effective credit policy is the main instrument in the prevention of the negative impact of this group of factors.

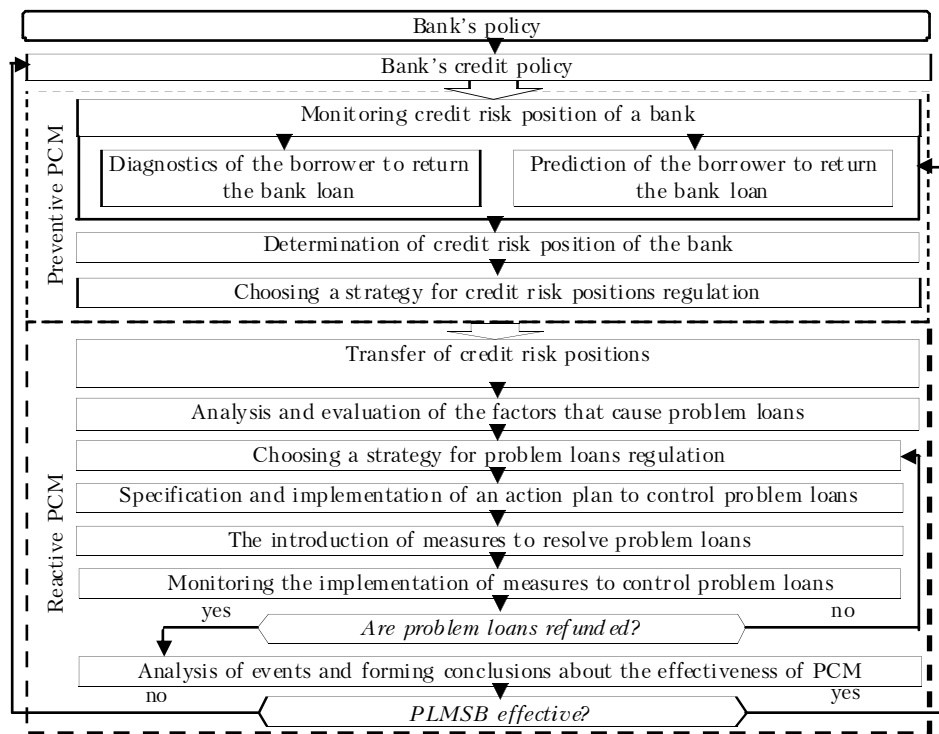
Loan product parameters are internal factors primarily related to the characteristics of credit risk position. They affect the rate of losses from defaults and distribution of credit exposures.

An indepth study requires to consider internal factors that are not directly related to the characteristics of credit risk positions, but the ones that determine the credit risk profile of the bank and the possibility of bad debts appearing. We suggest consolidating these factors into 3 groups. The first defines the objectives of credit policy that are aligned to objectives of the bank. In case of an incorrect set of the policy the level of strategic risk increases. In our opinion, that was one of the causes of the banking crisis in Ukraine. The second group of internal factors in the bank determines available resources (financial, material, labour, information) and technologies for achieving these goals, including the ability of management to use them effectively.

To prevent the occurrence of problem loans it is important to determine whether a bank has enough resources to achieve the objectives set out in its credit policy or not. Some elements of resources are defined by the ability of rapid transformation over time and may be subject to credit policy purposes (e.g., introduction of innovative technologies, appropriate training of credit managers). Other elements of the resources have limited opportunity for transformations over time due to market con-

straints, lack of financial resources and other reasons (e.g., to increase its share capital, significant increase in logistics). Therefore, objectives of credit policy and its implementation mechanism should take into account the resource constraints while building internal capacity of the bank, which will prevent the emergence of problem loans. The third group includes methodological support (regulations, procedures, process cards etc.) of credit process, credit risk management, and problem loans management approved by relevant bodies of a bank. That should be based on the principles of corporate governance and be consistent with its practical implementation.

An integral part of any system, including PLMSB are the functions of planning (formation of credit policy), regulation (management influence to deviations of the actual characteristics of credit risk positions from planned and measures for its mitigation), analysis (study of credit risk positions and evaluate their sensitivity to changes in factors of external and internal environments and governance impact) and control (supervision and verification of conformity of the actual and planned characteristics of credit risk positions). Efficient interaction of these functions is implemented through the mechanism of problem credit managements on both preventive and reactive levels (Figure 2).



Source: Developed by the authors.  
PCM – problem credits managing.

Figure 2. Problem bank loans management mechanism

As noted above, preventing the proliferation of bad loans in a bank requires the introduction of evidence-based credit policy, the purpose of which is to control cred-

it risk in the process of ensuring the most efficient allocation of credit resources to obtain the maximum possible income from lending operations.

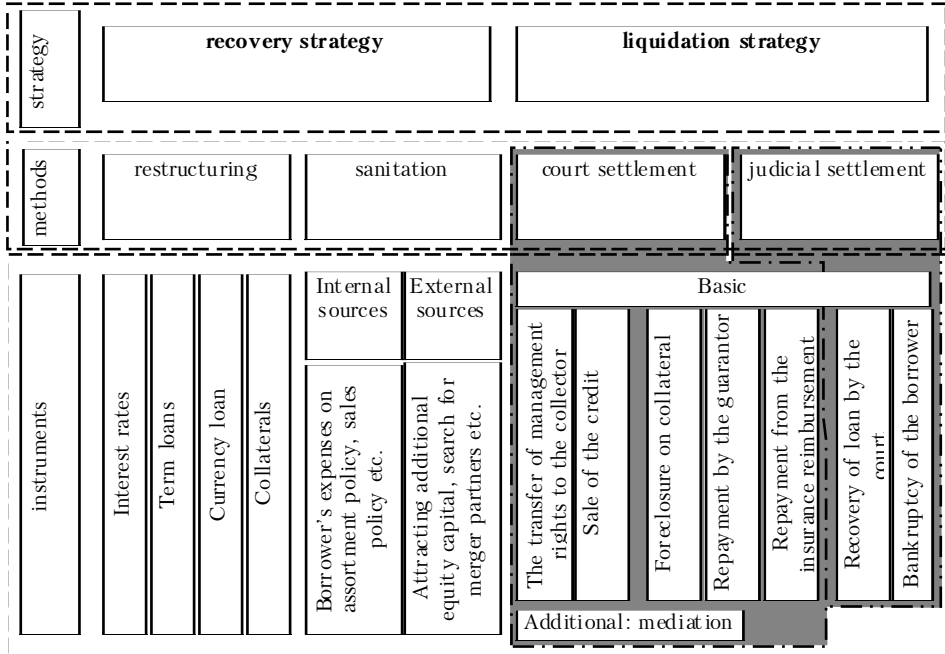
Credit policy should identify the following approaches used in lending and, in case of effective implementation will prevent the emergence of bad loans: 1) the creation and implementation of qualitative and quantitative credit risk assessment; 2) standardization of loan products including establishing clear procedures and methods of analysis of potential borrowers with the view to reduce prime costs of credit services and improve customer service; 3) fixing flexible credit terms depending on the type of a credit product (program, individual, complex); 4) complex credit risk management carried out by structural subdivisions within their credentials at all stages, whether application is pending or under support: 5) ensuring controlling of proper funds' usage by a borrower.

On the basis of the developed credit policy and its requirements, a preventive problem loans management system is implemented on a permanent basis and includes:

- monitoring of risk positions for signs that may indicate the occurrence of problem loans (Shustova, 2010);
- diagnosing the borrowers' ability to repay his debt and determination on the basis of diagnosis the characteristics of exposure (standard credit loan, pre-bad loan stage; loan with clear signs of problems).

If a 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: the recovery strategy and the elimination strategy (Figure 3).



Source: Developed by the authors.

Figure 3. Support of the reactive problem loans management in a bank

Restructuring (changing the initial conditions of a contract) is the main method of problem loans recovering when a debtor is unable to meet obligations. Restructuring agreement may consist of the following elements: collateral restructuring, restructuring of the payments schedule (extension of credit term, grace periods), restructuring charges for loan (changing loan schemes from the classic to the annuity, reduced interest rate), conversion of loan and interest, write-off fines and penalties etc. The decision on restructuring must be substantiated and adopted in the same manner as the decision to grant credit (Kuznetsov, 2008). This method is effective when the problems of the borrower are temporary and not systemic. It should be mentioned that in domestic banking practice this method is often used wrongly to disguise bad loans and improve bank's financial reports (Smykov, 2011).

Recovery of bad loans may provide for rehabilitation, i.e. the development of activities that are carried out jointly by the bank and the borrower to prevent the bankruptcy of the later. Measures conducted as a part of sanitation can be divided into those that mobilize internal reserves of the borrower (reduction in receivables, cut-off of unprofitable business units, reducing the amount of fixed and variable costs, selling non-core assets etc.), and such that involves finding external sources of funding (additional capital raising, seeking new partners etc.). Remediation is a very expensive method, which does not give instant results, so the bank must carefully assess capabilities and the appropriateness of use (Yashin, 2010).

If the loan recovery strategy is recognized as inappropriate or does not lead to expected results, a bank applies the methods of enforcement of principal and interest (to carry out the liquidation of credit) for full reimbursement of bad debts.

The methods for liquidation of credit include: enforcing the collateral, liquidation of bad debts by the guarantor (surety), insurance reimbursement from insurance agencies within the time limits specified by the rules of insurance, transfer of toxic assets to a third party (collector) without bank's balance optimizing, transfer/sale of troubled assets to independent financial company (SPV onshore/offshore); sale of toxic assets to independent financial company under factoring, legal action (set of measures for their enforcement) (Yashin, 2010).

Reasonability of these methods implementation in a particular bank's practice is defined by such criteria's as: guarantee of the result, costs to implement the chosen method, duration of action, impact on reputation, potential external and internal risks, and the degree of dependence on results from external and internal factors.

Moreover, while choosing the method a bank has to take into account the peculiarities of accounting and taxation, the impact on regulatory capital adequacy, liquidity provision, increase in management efficiency, reduce risk and ensure the profitability of loan portfolio.

If it is impossible to return bad loans, a bank can use formed reserves for write-off (recovery) of debt on the loan, which belongs to V (lowest) quality category, as prescribed by the National Bank of Ukraine (25.01.2012, #23).

### **Conclusions**

The article defines the structure of the problem loans management system in a bank as the structural and functional integrity of objects, subjects, principles and mechanism of interaction which minimizes losses while dealing with borrowers.

We argue that it is crucial to develop and select proper methods and strategies to manage problem loans depending on the characteristics of a bank and a borrower, so there are objective prerequisites for further research in this area.

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