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Article

Formation, Consequences and Mechanisms for Managing Problem Loans in Commercial Banks

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Abstract: The banking sector plays a pivotal role in economic development, with lending as a core function that sustains production, investment, and consumption. However, the rise in non-performing loans (NPLs) poses a significant threat to the financial stability and effectiveness of commercial banks globally and within Uzbekistan. While previous studies have discussed credit risk in general, there is a lack of comprehensive evaluation of the multifactorial causes and management mechanisms of NPLs specific to the context of Uzbekistan's banking sector. This study aims to investigate the formation causes, consequences, and strategic management approaches of problem loans in commercial banks, using Uzbekistan as a case study. The findings reveal that problem loans result from a combination of microeconomic, macroeconomic, institutional, and behavioral factors, including poor financial literacy, macro-instability, inadequate risk assessment systems, and weak internal governance. Additionally, empirical analysis shows that in recent years, problem loans have accounted for 5–7% of total bank assets in Uzbekistan, impairing liquidity, profitability, and credit intermediation. The study integrates international practices with local regulatory structures and banking behavior, offering a multi-stage approach to problem loan management that emphasizes pre-loan risk assessment, post-loan monitoring, and institutional reform. The research underscores the need for systemic reforms in bank governance, borrower evaluation, financial education, and regulatory oversight. Implementing these measures will help reduce the share of NPLs, stabilize financial institutions, and enhance the real impact of banking services on economic growth.

Keywords: Commercial Banks, Problem Loans, Credit Risk, Bank Liquidity, Restructuring, Loan Portfolio Quality

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1. Introduction

The banking and financial system is the foundation of the economy of any developing or developed country. The effective functioning of this system ensures the stability of economic growth, has a positive impact on the investment climate, and contributes to the improvement of macroeconomic indicators. One of the main areas of activity of banks is lending. Through loans, the activities of economic entities are financed, production capacities are expanded, and consumer spending is covered[1].

However, the lending process also involves certain financial risks. In particular, non-payment or non-fulfillment of financial obligations by borrowers leads to a decline in the quality of the loan portfolio. This situation poses a serious threat to the stability of the banking system. From this perspective, the problem of non-performing loans (NPLs) is seen as a factor that directly affects not only the success of individual banks, but also the stability of the entire financial system[2].

In international practice, non-performing loans are loans for which payments on the principal or interest have not been made within the established deadlines, or the financial situation of the borrower does not allow for repayment. According to the World Bank and the International Monetary Fund, an increase in the amount of non-performing loans in the share of gross loans weakens the financial intermediation function of the banking sector and reduces economic growth rates[3].

Although the banking system of the Republic of Uzbekistan has also achieved significant growth in recent years, systemic credit risks, in particular, the increase in the volume of problem loans, are emerging as one of the weak points of this growth. For example, during 2020–2024, the volume of problem loans of commercial banks reached 5–7 percent of bank assets at certain periods. This had a negative impact on the liquidity, profitability and capital adequacy indicators of banks[4].

2. Materials and Methods

This study employs a qualitative-analytical approach grounded in the examination of theoretical sources, practical observations, and national and international banking regulations to analyze the causes, consequences, and mechanisms of managing problem loans in commercial banks. The research is based on descriptive and comparative methods to identify the structural and functional dynamics of non-performing loans (NPLs), particularly within the banking sector of Uzbekistan. Statistical data from official reports by the Central Bank of the Republic of Uzbekistan were utilized to assess the scale and impact of NPLs between 2020 and 2024[5]. International standards such as those by the IMF, World Bank, and Basel Committee were referenced to contextualize problem loan classifications and risk criteria. A critical evaluation of the Regulation No. 349 issued by the Central Bank on April 1, 2023, was also conducted to understand domestic classification and provisioning practices. The methodology includes identifying both microeconomic and macroeconomic factors contributing to loan delinquency and analyzing management practices such as restructuring, judicial collection, and collateral realization. Emphasis was also placed on reviewing the effectiveness of credit risk management systems, borrower evaluation procedures, and early warning mechanisms. Additionally, the study incorporates a review of best practices from foreign banking institutions and evaluates the applicability of those methods in the Uzbek context. The synthesis of these techniques provided the basis for formulating practical recommendations and strategies for improving the quality of loan portfolios and minimizing systemic banking risks[6].

3. Results and Discussion

This article analyzes the reasons for the formation of problem loans in commercial banks, their impact on banking activities and the economic system, as well as effective mechanisms for combating this problem on a scientific, theoretical and practical basis. In addition, the existing practical experience and international approaches in the banking sector of Uzbekistan are considered on a comparative basis. The purpose of the article is to develop proposals and recommendations for the effective management of problem loans in commercial banks[7].

Credit risk is an integral element of banking activities, and its most obvious manifestation is expressed in the form of problem loans. The term problem loans (in English - Non-performing loans, abbreviated NPLs) is used in the theory and practice of the financial sector as one of the main indicators determining the quality of the loan portfolio. This concept is understood as loans where the borrower fails to pay the principal and/or interest payments stipulated in the loan agreement within the specified period, or where the payment of these payments is in doubt[8].

The International Monetary Fund (IMF), the World Bank (WB), the Basel Committee and other international financial institutions rely on the following criteria in classifying problem loans:

a) Failure by the borrower to make principal or interest payments for a period of 90 days or more;
b) The borrower's financial condition is assessed as unable to fulfill its payment obligations;
c) The loan has been restructured by the bank and it is still experiencing difficulties in repaying the loan[9].

Also, problem loans are among the “risky” assets that directly affect the capital adequacy and asset quality of a commercial bank. Therefore, their presence on the bank’s balance sheet is an important factor in a consistent analysis of financial stability.

In the Republic of Uzbekistan, there is a legal framework for the concept of problem loans and their accounting, which is regulated by regulatory legal acts established by the Central Bank. In particular, the Regulation of the Central Bank of the Republic of Uzbekistan No. 349 dated April 1, 2023 “On the Procedure for Classification of Loans and Other Assets and Formation of Reserves” is the main document for identifying problem loans[10].

According to this document, bank assets are divided into the following categories:

a) Standard assets - loans that are fully paid according to the payment schedule;
b) Non-standard (i.e. low-quality) assets - loans with a payment delay of up to 30 days;
c) Doubtful assets - loans with a payment delay of 31 to 90 days;
d) Bad (lost) assets - loans with a payment delay of more than 91 days or unlikely to be repaid[11].

Based on this classification, banks are required to allocate the necessary amount of reserves (provisions) for each category of loans. This serves to reflect the real level of risk in financial statements.

In cases of problem loans, commercial banks must take the following measures:

a) Review (restructuring) the loan agreement;
b) Adjust the payment schedule through negotiations with the debtor;
c) Collect the debt by applying to the court;
d) Launch procedures for the realization of collateral assets[12].

In addition, the Central Bank of the Republic of Uzbekistan monitors the quality of loans on an ongoing basis. If the share of problem loans in commercial banks exceeds the permissible limit, the Central Bank may tighten capital requirements, temporarily restrict lending activities, or initiate a bank inspection as a control measure.

The formation of problem loans is a complex and multifactorial process, which is caused by a complex of economic, institutional, and social factors. Although the quality of the loan portfolio in commercial banks directly depends on the solvency and financial discipline of borrowers, this problem is not only the result of the irresponsibility of borrowers, but is also directly related to internal shortcomings in the banking system, macroeconomic instability, and weak credit policy[13].

First of all, if we consider the factors at the microeconomic level, problem loans often arise as a result of low financial literacy of borrowers, making bad decisions and using loan funds for no purpose. Most borrowers, especially small businesses and individuals, assume financial obligations without fully understanding the terms of the loan. Loans granted on a project basis are based on optimistic and unrealistic business plans that do not correspond to real economic conditions. As a result of the failure of such projects, the borrower cannot repay the loan within the specified period. In addition, unstable sources of income, seasonality or uncertain cash flows also cause loans to be classified as problematic. In some cases, the use of loan funds by borrowers for other purposes, artificially inflating the value of collateral or incorrect presentation of financial statements are also among the roots of this problem[14].

Macroeconomic factors also play an important role in the increase in problem loans. In particular, high inflation reduces real incomes of the population, which negatively affects the timely payment of loans by individuals and the private sector. Also, exchange rate instability complicates the repayment of loans taken out in foreign currency. If there is a depreciation of the local currency, the volume of problem loans increases due to an increase in the debt burden. In addition, as a result of high interest rates or an increase in the key rate by the Central Bank, loan payments become more expensive for borrowers. This leads to a violation of payment discipline, especially in consumer loans and small business loans. External economic and political factors, such as pandemics, geopolitical conflicts or trade restrictions, worsen the financial situation of large entities engaged in export and import, which negatively affects the repayment of bank loans. Another important cause of problem loans comes from the banks themselves, namely from shortcomings in credit policy and internal management systems. The root of this problem in the banking system is the insufficient introduction of modern technologies in assessing credit risks, the weakness of the credit monitoring system, passivity in monitoring the activities of debtors, and errors such as incorrect assessment of the value of collateral. Loans issued by bank employees under political pressure, corrupt practices, or based on acquaintances also later become problematic. After the loan is granted, the failure of control mechanisms to control it leads to a deterioration in the quality of the loan portfolio[15].

In addition, some psychological and social factors also exacerbate this problem. In particular, there is a misconception among some borrowers that "a loan from a bank is not an obligation, but a support." They perceive the loan as an opportunity, not an obligation to repay. This weakens credit discipline. In addition, factors such as the population's prioritization of consumer spending over credit obligations, lack of financial planning skills, and failure to take into account the increase in financial burden after the loan also lead to an increase in the number of problematic loans.

The factors described above demonstrate the multifaceted and systemic causes of the formation of problem loans. To combat this situation, it is not enough to take measures only unilaterally - that is, at the borrower or bank level. A systematic approach is needed at all stages of lending, management and monitoring, macroeconomic stability, increasing financial literacy and improving the banking management system. Only through such comprehensive measures will it be possible to keep the volume of problem loans in commercial banks under control.

The impact of problem loans on the activities of commercial banks is extremely deep and multifaceted, negatively affecting not only the financial stability of an individual bank, but also the reliability of the entire banking system and the efficiency of financial intermediation in the country. If the main purpose of loans is to provide market participants with the necessary financial resources, this mechanism will fully function only in conditions of high payment discipline, debt culture and high quality of the loan portfolio. Otherwise, loan intermediation will become a risky activity for the bank.

First of all, problem loans pose a direct threat to the liquidity of the bank. If debtors fail to make payments on time, the bank, in turn, may not be able to fulfill its obligations to other clients - depositors or investors. In particular, high volumes of problem loans lead to a decrease in liquid assets and problems with financing current operations.

Also, problem loans have a serious negative impact on the bank's interest income. Interest on loans is the main source of income for banks. When borrowers fail to meet their obligations, these interests are either delayed or lost altogether. This leads to a decrease in bank profits. As a result, the bank's profitability indicators decrease, which reduces the profitability of capital investments and makes the bank less attractive to investors.

An increase in the volume of problem loans also directly affects the bank's capital adequacy indicators. According to the requirements of the Central Bank, commercial banks are required to form a certain percentage of reserves for problem loans. These reserves are deducted from the bank's profit, which reduces the taxable base on profits and reduces the volume of total financial resources. An increase in reserves, in turn, leads to a decrease in lending capacity, which slows down investment activity in the economy.

In addition, problem loans reflect a decrease in the quality of assets in the bank's financial statements. Deteriorating financial statements, in turn, lower credit ratings and limit the bank's ability to raise funds from foreign and domestic markets. International rating agencies, such as Moody's, Fitch or S&P, classify banks with a high share of problem loans as high-risk institutions. This reduces the bank's credibility in financial markets.

The increase in the number of problem loans also reduces public confidence in the banking system. The population is more cautious about placing their deposits in commercial banks, and investors are afraid of making long-term investments in the banking sector. At the social level, this situation leads to a negative attitude towards banks, the formation of opinions that "loans will not return", "banks are not taking risks".

The above factors, taken together, have a negative impact on the main areas of banking activity - lending, intermediation, payment system management and investment operations. Therefore, problem loans are considered one of the most serious risk factors in banking activities, and their management is a matter of strategic importance for any commercial bank.

Problem loans are one of the most important sources of risk for banks, and their early detection and effective management play a decisive role in ensuring the stability of the banking system. To eliminate this problem, it is necessary for banks to develop individual credit strategies, comply with regulatory and legal requirements, strengthen internal control systems and introduce modern financial technologies. Because a passive approach to problem loans only deepens losses, while an active and systematic approach serves to restore the quality of the loan portfolio.

First of all, it is important to strengthen risk assessment mechanisms in banks at the stage before granting a loan. Each debtor should be thoroughly analyzed financially, and a comprehensive rating should be given based not only on financial indicators, but also on its business model, market position and credit history. In this regard, systems such as credit scoring and behavioral scoring, which are widely used in international practice, serve as an important tool. Such technologies allow for automatic assessment of the risk level of debtors, which reduces the human factor and the likelihood of subjective decisions.

At the stage after the loan is granted, the effectiveness of the credit monitoring system plays an important role. The bank should regularly analyze the payment discipline, changes in business activities, market conditions and the financial performance of the debtor for each active loan. Especially when working with large legal entities, credit inspection departments are required to identify early warning signs through constant monitoring and develop the necessary corrective measures.

Another important strategy for eliminating problem loans is loan restructuring. This method alleviates the debtor's temporary financial difficulties: the repayment period is extended, the interest rate is reduced, or compromise solutions are found for overdue interest. At the same time, this process must be carried out based on strict criteria and while protecting the interests of the bank. Otherwise, this approach may further undermine credit discipline.

For high-risk loans, debt recovery mechanisms are used through the sale of collateral, judicial collection, or working with external law firms. In some developed countries, the practice of removing problem loans from the balance sheet by banks by selling them to external companies (collection agencies) is widespread. This removes high-risk assets from the bank's balance sheet and focuses on core activities. In recent years, Uzbekistan has also been developing experience in establishing "problem asset companies".

Another important aspect in reducing the share of problem loans is increasing financial literacy. Banks should conduct extensive explanatory work with the population and entrepreneurs so that borrowers can correctly assess their financial obligations and deeply understand the financial consequences of interest rates and loan terms. In this regard, the Central Bank, in cooperation with banks, is also implementing special programs on financial literacy.

In addition, the formation of problem loans can be prevented by strengthening internal governance systems in banks, in particular, ensuring the independence of internal audit, risk management departments, credit committees, and reducing the risks of conflicts of interest among employees. All this increases the transparency and accountability of bank management.

In conclusion, the strategy for managing problem loans should be based on a multi-stage and systematic approach. All processes, from borrower selection to loan allocation, monitoring, and finding solutions in the event of a problem, must be under close control. Although the banking system of Uzbekistan has begun to update its practices in this regard based on international experience, the need to further improve existing mechanisms remains urgent.

Problem loans are one of the main risk factors threatening the financial stability of commercial banks. Their increase undermines the liquidity, income, asset quality, and overall loan portfolio efficiency of banks. As a result of delayed or incomplete loan payments, banks are forced to cover losses at the expense of profits and capital reserves, which leads to a slowdown in financial intermediation processes. As a result, the banking system's real credit support to the economy decreases and has a negative impact on overall economic growth.

The analysis shows that there is no single reason for the formation of problem loans. Their occurrence is closely related to microeconomic (at the borrower level), macroeconomic (inflation, currency risk, interest rates), and institutional (credit policy and internal management of banks) factors. Therefore, a multifaceted, systematic and strategic approach is needed to solve this problem.

The following recommendations and proposals can be put forward to effectively manage the volume of problem loans and prevent their future formation:

1. Improving mechanisms for preliminary risk assessment - Banks should conduct a thorough analysis of the solvency of borrowers before granting loans, introduce automated rating systems (scoring).
2. Strengthening credit monitoring - Regular financial analysis of allocated loans, on-site studies, identification of early warning signs and development of rapid action algorithms are necessary.
3. Updating the strategy for working with debtors - Loan restructuring, negotiations with debtors and assistance in restoring their business are important tools for reducing problem loans.
4. Increasing financial literacy - Continuous explanatory work should be carried out among the population and entrepreneurs about credit discipline, the financial consequences of credit obligations, and the priority of loan payments.
5. Reviewing internal management and credit policy - Strengthening the activities of credit committees, increasing employee responsibility, and preventing conflicts of interest will reduce bank risks.
6. Developing special institutions for working with bad assets - It is advisable to remove problem assets from the balance sheet, sell them to special companies, or introduce refinancing mechanisms through separate funds.
7. Strengthening the role of the regulator (Central Bank) - It is necessary to constantly monitor banks for the quality of their loan portfolios, provide incentives through tax and capital requirements, and apply appropriate control measures to banks with an increased share of problem loans. In conclusion, the issue of problem loans is an important balancing point for the reliability of the banking system and economic growth. At the current stage of Uzbekistan's economic development, it is urgent to address this issue with a modern approach based on international experience. This will allow banks to conduct their activities more efficiently, increase the volume and

quality of lending, and most importantly, raise the level of real service provision to the economy to a higher level.

4. Conclusion

The issue of problem loans remains one of the critical challenges facing commercial banks in Uzbekistan, significantly affecting their financial stability, profitability, and ability to function as effective financial intermediaries. The analysis confirms that problem loans arise from a complex interplay of microeconomic, macroeconomic, and institutional factors, including borrowers' financial illiteracy, unrealistic project expectations, currency fluctuations, interest rate hikes, and deficiencies in credit risk management. These loans not only jeopardize the liquidity and capital adequacy of banks but also erode public confidence in the financial system and hinder long-term investment activities. To effectively combat this issue, a comprehensive strategy is required—one that incorporates advanced risk assessment techniques, active credit monitoring, targeted restructuring of debt, and continuous education of borrowers. Internal governance within banks must be strengthened, with credit committees operating transparently and free of conflict of interest. Furthermore, the establishment of specialized asset management companies and the enhancement of the Central Bank's regulatory oversight are vital to insulating the banking sector from systemic risk. By adopting these multidimensional and preventative measures, commercial banks in Uzbekistan can not only mitigate existing credit risks but also lay a strong foundation for sustainable lending practices. This approach will enhance the resilience of the banking sector, increase the quality of loan portfolios, and ultimately contribute to economic stability and growth. Addressing the problem of non-performing loans with such a proactive and systematic approach is essential to elevating the efficiency and reliability of financial services in the country.

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