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CAUSES OF THE EMERGENCE OF NON-PERFORMING LOANS IN COMMERCIAL BANKING PRACTICE

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A B S T R A C T

This paper examines the organizational and procedural approaches used by commercial banks to manage non-performing loans (NPLs). It highlights the role of specialized internal units—such as departments or divisions—dedicated to monitoring overdue debts, implementing debt rehabilitation strategies, and managing borrower assets. The study outlines a comprehensive set of measures used to improve the quality of distressed loans, including additional collateral, state guarantees, asset sales, and legal enforcement mechanisms. Furthermore, it discusses early intervention strategies, such as negotiating with borrowers and restructuring management, as well as various recovery methods like debt restructuring, refinancing, and debt sale to third parties. The paper emphasizes that banks select appropriate recovery strategies based on financial efficiency, transaction costs, risk exposure, reputational considerations, and the expected financial outcomes. Overall, the research provides insights into how banks can mitigate credit risk and maintain financial stability by effectively managing problem loans.

K E Y W O R D S

Credit risk, loan default, financial stability, banking sector, credit portfolio quality, loan restructuring, overdue debt, liquidity risk, economic slowdown.

Introduction

The core activity of any modern commercial bank is lending, which inherently involves the risk of non-performing (i.e., overdue or unpaid) loans. This type of risk directly affects the quality of the bank's credit portfolio, its financial stability, and liquidity levels. Therefore, credit risk is considered one of the most critical and pressing financial risks for commercial banks. The effectiveness of credit risk management is a key determinant of a bank's overall performance, profitability, and credibility in the financial market.

Currently, the rising share of non-performing loans in the banking sector remains one of the most urgent issues in the development of the financial sector. Lending is the most significant and prioritized active operation within the activities of commercial banks. The quality of any given loan is primarily assessed by the degree to which it is serviced on time and in accordance with the loan agreement. The main criterion for loan quality is the borrower's ability to meet their obligations fully and within the prescribed timeframe.

Literature review

John Maynard Keynes noted that defaults or high levels of non-performing loans can trigger an economic crisis, as banks begin to restrict lending, which in turn leads to a decline in investment and a slowdown in economic growth [1]. Economist Joseph Schumpeter emphasized that the presence of problem loans can undermine trust in the banking system, which also results in reduced investment and lower lending volumes, negatively affecting the pace of economic development [2].

According to T.N. Saveleva, non-performing loans are those in which the borrower fails to repay the principal and/or interest within the specified period, resulting in overdue debt [3]. Such loans are classified as non-repaid over a certain period and may threaten the bank's financial stability.

I.V. Mikhailova defines problem loans as those in which the borrower has failed to meet their obligations on time and has not repaid the debt in accordance with the agreed terms [4]. This category includes both loans with overdue payments and those whose repayment terms have been modified or restructured.

Financial analyst N.V. Gorbunova states that non-performing loans are credit obligations for which payments on the principal or interest have not been made for an extended period [5]. This leads to a deterioration in the quality of the bank's assets and an increase in credit risks.

According to V.S. Denisenko, non-performing loans represent debt for which the borrower fails to meet the payment obligations for either principal or interest on time, resulting in the deterioration of the financial condition of both the borrower and the lending institution [6].

A.A. Kozlov believes that problem loans are those that are not repaid in a timely manner, where borrowers are unable to fulfill their obligations. Such loans may increase banking risks, reduce liquidity, and pose a threat to the stability of the entire financial system [7].

Research methodology

In carrying out this research work, methods widely used in scientific research methodology were used. In the process of scientific analysis, these scientific research methods were widely used, in particular, observation, generalization, grouping, comparison, analysis and synthesis methods were used.

Results and analysis

For a commercial bank, the timely execution of loan payments in accordance with the schedule set forth in the loan contract ensures operational stability. If the borrower adheres strictly to the payment schedule attached to the loan agreement, the relationship between the bank and the client remains stable and balanced. Full compliance with contractual terms minimizes delays and associated risks.

Under such circumstances, the loan is classified as high quality after several successful payment cycles. This, in turn, indicates a low risk level within the credit portfolio, consistent profitability, and the effective execution of the bank's financial intermediation function.

Nevertheless, not all loans are serviced in accordance with the agreement. Due to a combination of financial, operational, or behavioral factors, borrowers may fail to meet their payment obligations on time, which can lead to the accumulation of arrears or, in more severe cases, complete default on the loan. In such cases, the borrower may be deemed dishonest, and the quality classification of the issued loan is downgraded. The presence of overdue loans in a bank's portfolio can lead to numerous negative consequences:

Firstly, any bank loan is usually issued using deposit funds attracted from clients. The commercial bank bears full legal responsibility for these deposits.

Secondly, overdue loans are subject to strict oversight by the regulator (Central Bank). The regulator requires the creation of loan loss provisions for any loans that become overdue. Commercial banks must regularly report on the presence of non-performing loans and the amount of reserves formed for potential loan losses.

The growth of non-performing loans has a direct negative impact on a bank's financial condition. If the share of problem loans reaches critical levels, the bank's operations may cease altogether. For instance, in 2008, several commercial banks exited the financial market for this reason.

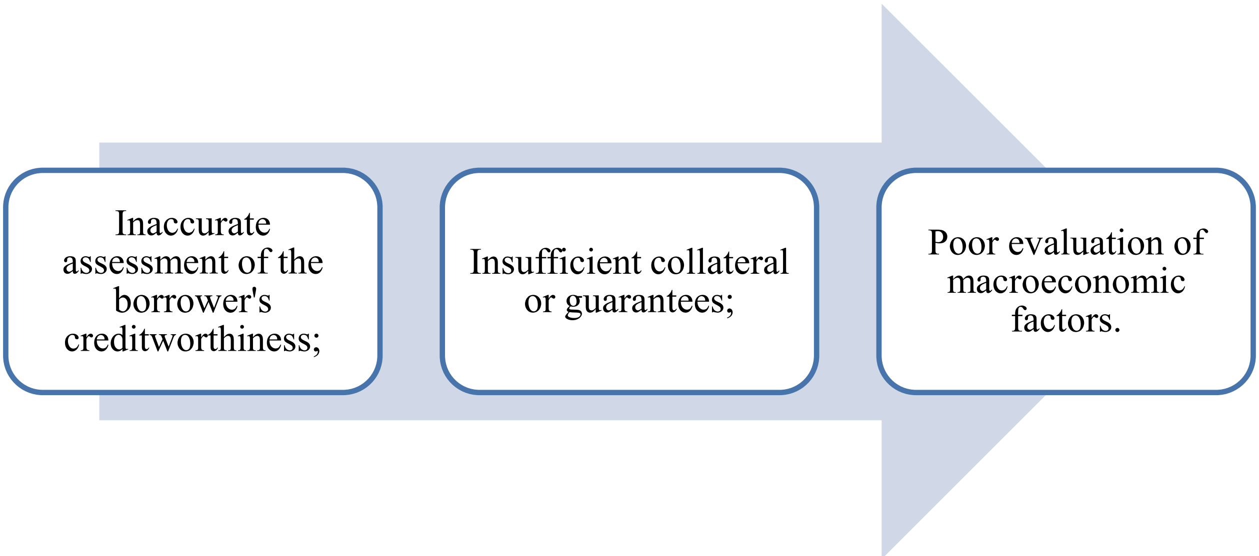
Currently, there are two main strategies to prevent the increase in non-performing loans:

Thorough pre-loan borrower assessment. Before issuing a loan, banks employ various evaluation methodologies, including scoring models, internal security checks, and other risk assessment tools. Most banks develop proprietary assessment systems, which are considered commercial secrets.

Active management of overdue debt. The reasons for loan defaults vary. Sometimes, borrowers simply forget to make payments or face technical issues like insufficient account balances. Others may be experiencing temporary financial difficulties, while some borrowers never intended to repay the loan an act considered fraudulent.

To date, no universal mechanism has been developed for effectively managing overdue debt. Many questions remain unanswered regarding optimal approaches to managing non-performing assets. Each commercial bank defines its own recovery strategy based on its internal governance structure, the size and quality of its credit portfolio, interdepartmental coordination, and the degree of portfolio risk.

The most common causes of non-performing loans (NPLs) in commercial banks can be effectively illustrated through a comprehensive diagram that categorizes both internal and external risk factors contributing to loan defaults



Picture 1. Main Causes of Non-Performing Loans in Commercial Banking

This situation is exacerbated in periods of economic instability, particularly when borrowers face financial and social difficulties.

A loan is classified as overdue if the borrower fails to make payments as scheduled in the loan agreement. Whether a loan is classified as non-performing depends on the internal credit policy of the bank. Some banks consider loans overdue after just one or two days of delay, while others use a 30-day threshold.

Typically, commercial banks attempt to contact borrowers within the period defined in the credit contract, identify the reasons for the delay, and implement measures to resolve the issue. If the loan is secured by collateral, the bank has the right to initiate enforcement procedures if necessary.

Based on the table below, an analysis is conducted of the commercial banks operating in Uzbekistan that have the highest levels of non-performing loans (NPLs).

Table 1

Comparative Analysis of Non-Performing Loan (NPL) Ratios in Selected Commercial Banks in Uzbekistan [8]

Bank Name	Total Loans (billion UZS)	NPL Volume (billion UZS)	NPL Ratio (%)
Madad Invest Bank	307	74	24,1%
Garant Bank	797	118	14,8%
AVO Bank	283	36	12,5%
Ipoteka Bank	35,094	3577	10,2%
Yangi Bank	138	12	8,7%
Business Development Bank	22527	1915	8,5%
Saderat Bank	21	1	6,6%
Agrobank	59436	2,903	4,9%
Microcreditbank	17416	804	4,6%
Kapital Bank	31584	1437	4,5%

This table presents the volume of total loans, the number of non-performing loans, and the corresponding NPL ratio (%) for selected commercial banks operating in Uzbekistan. The analysis reveals that Madad Invest Bank has the highest NPL ratio at 24,1%, indicating that nearly a quarter of its loan portfolio is not being serviced properly. This suggests significant credit risk and potential weaknesses in credit evaluation or recovery mechanisms.

Garant Bank (14,8%) and AVO Bank (12,5%) also demonstrate relatively high levels of problem loans, placing them in a high-risk category. Ipoteka Bank, Business Development Bank, and Yangi Bank also report elevated NPL ratios, ranging from 8,5% to 10,2%, signaling a need for strengthened credit risk management practices.

Meanwhile, Agrobank, Kapital Bank, and Mikrokreditbank show comparatively lower NPL ratios (between 4,5% and 4,9%), but even these levels require close monitoring, as a persistent NPL rate above 4% may still have a negative impact on asset quality and financial stability in the medium term.

In commercial banks, the management of non-performing debt is typically handled by a dedicated structural unit. Depending on the scale and organizational structure of the bank, this unit may take the form of a department, sector, or division. The activities of this unit are governed by internal regulations, which define the procedures for dealing with non-performing loans (NPLs).

This unit is responsible for monitoring non-performing and overdue loans within the bank's credit portfolio, implementing measures aimed at the rehabilitation of distressed assets, and, in some cases, managing the borrower's assets and cash flows.

A comprehensive set of measures aimed at improving the quality of non-performing loans may include the following actions:

a) Attracting additional collateral – including guarantees, third-party sureties, or pledging of movable and immovable assets;

b) Partial sale of collateral;

c) Obtaining government guarantees for loan repayment – utilizing budgetary funds to repay the principal and interest;

d) Loan repayment through the sale of the borrower's assets and preventing investment in low-profitability assets;

e) Strengthening control over accounts receivable and inventories, allowing cash flow to be redirected toward loan repayment;

f) Imposing penalty sanctions;

g) Repayment of the loan through the attraction of additional capital or financial support by the borrower.

If early signs of credit deterioration are detected (especially in loans issued to legal entities), the bank may take the following organizational and administrative measures:

Discussing with the company's owners the potential replacement of management;

Concluding a settlement agreement with the borrower to avoid legal proceedings;

Appointing observers or consultants to work with the borrower on behalf of the bank.

In cases where there is a significant delay in loan repayments and a comprehensive recovery strategy is needed, the bank may, depending on its internal policies, apply the following measures:

Debt restructuring;

Refinancing;

Full realization of collateral;

Enforcing obligations through guarantors and sureties;

Judicial debt recovery;

Selling the debt to third parties (e.g., collection agencies).

When determining the method for recovering overdue loans, the bank evaluates the efficiency and cost of each option. In doing so, it considers the following key criteria:

a) Financial costs associated with the chosen recovery method;

b) Transactional costs – including costs of negotiation, decision-making, oversight, legal enforcement, and information processing;

c) Risk factors – such as credit, interest rate, country, and operational risks;

d) The bank's reputation;

e) The financial outcome of debt recovery efforts.

Overall, a high NPL ratio reflects deteriorating loan quality and may signal broader structural or operational issues in a bank's lending policies, risk assessment, and debt recovery practices. These indicators are also influenced by external macroeconomic conditions and borrower behavior patterns.

Conclusion

Non-performing loans (NPLs) remain a critical challenge for commercial banks, directly affecting their credit portfolio quality, liquidity, and overall financial stability. A high level of NPLs weakens banks' ability to extend new credit, undermines investor and depositor confidence, and can trigger broader economic consequences, including reduced investment and slowed growth. The causes of NPLs are multifaceted, ranging from poor borrower assessment and inadequate collateral to adverse macroeconomic conditions. Effective credit risk management, timely monitoring, and strategic loan restructuring are essential to mitigate the impact of problem loans. Ultimately, minimizing NPLs is not only vital for the health of individual financial institutions but also for ensuring the resilience of the entire banking system.

Furthermore, the effective management of non-performing loans requires a balanced approach combining preventive measures and responsive strategies. Preventive mechanisms include comprehensive borrower assessment, strict underwriting standards, and robust credit monitoring systems. On the other hand, responsive strategies such as timely loan restructuring, enforcement of collateral, and the use of specialized recovery units help banks minimize losses associated with distressed assets. Regulatory frameworks must also support banks in accurately classifying and provisioning for NPLs, thereby enhancing transparency and safeguarding financial soundness.

In the long term, reducing the volume of NPLs strengthens not only individual bank resilience but also contributes to the stability and efficiency of the financial system as a whole. A healthy banking sector is crucial for sustainable economic growth, as it facilitates the smooth flow of credit to productive sectors of the economy. Policymakers, regulators, and bank managers must therefore work collaboratively to identify early warning signals, promote financial literacy, and ensure that risk management practices evolve in line with changing economic realities.

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