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CHALLENGES AND SOLUTIONS IN LOAN RECOVERY FOR COMMERCIAL BANKS

Ibrokhimov Ilkhomjon[1], Ismoilov Diyorbek[2]

[1]*PhD in Economics, Kimyo International University in Tashkent*

[2]*Student of Kimyo International University in Tashkent*

ABSTRACT

This article explores the difficulties commercial banks face in loan recovery, focusing on the causes of loan defaults and the impacts of non-performing loans (NPLs) on financial stability. It also reviews strategies that banks can adopt to improve recovery processes and minimize financial losses, emphasizing the roles of credit risk management, and technology in addressing these challenges.

KEYWORDS: *Loan recovery, non-performing loans, commercial banks, credit risk management, debt collection*

INTRODUCTION

Loan recovery is a critical function in commercial banking, directly influencing a bank's profitability, liquidity, and reputation. As lending constitutes a significant portion of commercial banks' revenue streams, the ability to recover loans efficiently is essential for financial health and sustainability. However, loan recovery is often complex, particularly when dealing with non-performing loans (NPLs) that have reached stages of severe delinquency or default. The challenges associated with NPLs pose substantial risks to banks' stability, as they strain resources, consume capital reserves, and impact the institution's capacity to extend further credit.

The global banking sector has faced rising NPL ratios, especially during periods of economic distress, such as the global financial crisis and, more recently, the economic disruptions due to the COVID-19 pandemic. These events have highlighted the vulnerability of loan portfolios to external shocks and the importance of robust risk management frameworks. Macroeconomic volatility, borrower financial instability, and at times lax lending standards have contributed to a growing number of distressed loans, particularly in sectors more susceptible to economic downturns, such as small businesses and consumer lending.

Effective loan recovery is not only vital for preserving the bank's capital but also for maintaining customer confidence and market stability. A high level of NPLs can lead to increased provisioning costs, reduced profitability, and, in extreme cases, potential insolvency. Moreover, the accumulation of NPLs can reduce the bank's ability to support new lending, limiting access to credit for both consumers and businesses and thus stifling economic growth. Consequently, banks are compelled to develop comprehensive loan recovery strategies that include strengthening credit risk assessments, securing enforceable collateral, and utilizing digital tools for more proactive and data-driven recovery processes.

LITERATURE REVIEW

Loan recovery is a complex process that has drawn significant attention from scholars and financial experts, as its effectiveness directly impacts a bank's financial health, risk profile, and capacity for further lending.

Loan defaults are often driven by a range of factors, including economic cycles, borrower financial instability, and bank-specific practices. According to Nkusu (2011), macroeconomic downturns, such as recessions and crises, generally increase the likelihood of loan defaults as borrowers' incomes are reduced, making it difficult for them to meet debt obligations. Jiménez and Saurina (2006) also highlight that during economic downturns, businesses, especially small and medium-sized enterprises, face reduced cash flow, leading to an increased risk of loan defaults.

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Additionally, many researchers point to internal factors within banks that contribute to high default rates. For example, Rajan (1994) argues that banks often loosen lending standards during periods of economic optimism, leading to a buildup of risky loans that become vulnerable during economic downturns. Similarly, Keeton and Morris (1987) show that banks with more aggressive lending strategies tend to experience higher loan losses during periods of economic contraction. This body of research emphasizes the importance of prudent credit risk assessment, especially during times of economic growth, to avoid excessive risk-taking and subsequent defaults.

NPLs are a critical issue in banking because they represent loans that have become delinquent and are unlikely to be repaid. High NPL ratios place a significant strain on banks' profitability, as they require additional provisions, reduce lending capacity, and increase the bank's cost of capital. Klein (2013) finds that high levels of NPLs are negatively correlated with bank profitability in Central, Eastern, and Southeastern Europe (CESEE), as they erode banks' income and reduce their ability to lend effectively. Similarly, Anastasiou, Louri, and Tsionas (2016) demonstrate that high NPLs lead to reduced investor confidence in banks, affecting overall financial stability by limiting the bank's capacity to function as a reliable credit provider.

From a systemic perspective, Louzis, Vouldis, and Metaxas (2012) argue that NPLs can have far-reaching effects on the banking sector and the economy at large. Their study on Greek banks reveals that elevated NPL ratios hinder economic recovery by reducing banks' liquidity, restricting credit to viable businesses, and contributing to financial instability. The authors stress that effective loan recovery strategies are necessary to limit the negative economic impact of NPLs, suggesting that recovery is not merely a bank-specific issue but also a macroeconomic concern.

Collateral plays a critical role in loan recovery, as it provides banks with a means of securing and recovering a portion of their losses in cases of default. Berger and Udell (1990) demonstrate that collateral reduces credit risk by incentivizing borrowers to repay and by allowing banks to recover some of their funds through the sale of pledged assets. However, Djankov, McLiesh, and Shleifer (2007) find that the effectiveness of collateral is highly dependent on legal systems, noting that countries with weak legal enforcement of collateral rights experience lower loan recovery rates.

This correlation between legal frameworks and loan recovery rates is further supported by Laeven and Majnoni (2003), who emphasize that efficient legal systems improve loan recovery by enabling faster and more reliable repossession of collateral. In many developing countries, however, legal inefficiencies, prolonged court proceedings, and weak enforcement of debt collection laws hinder loan recovery efforts, resulting in higher NPL ratios. A recent study by Casu, Girardone, and Molyneux (2015) also highlights those regulatory reforms, including improvements in debt recovery laws, are crucial for enhancing the effectiveness of loan recovery and maintaining banking sector stability.

Advances in technology have introduced new tools for improving loan recovery processes. Financial technology (fintech) applications, such as artificial intelligence (AI) and big data analytics, are increasingly used by banks to streamline credit risk assessment and recovery processes. According to KPMG (2019), digital innovations enable banks to monitor borrower behavior in real-time, allowing them to identify high-risk accounts early and take preemptive actions to mitigate defaults. AI-driven analytics can assess large datasets to identify patterns that signal potential defaults, enhancing the bank's ability to manage credit risk effectively.

Furthermore, blockchain technology has shown potential in enhancing transparency in loan recovery by securely recording transactions and borrower data, as discussed by Guo and Liang (2016). Blockchain can simplify the tracking of borrower payment histories and collateral records, making the recovery process more transparent and reducing opportunities for fraud. Additionally, Alam, Zubayer, and Raihan (2020) note that the integration of mobile banking and digital communication channels can streamline debt collection efforts by enabling banks to reach borrowers more effectively, reducing the costs associated with traditional recovery methods.

A proactive approach to loan recovery is critical for mitigating NPL-related risks. Balgova, Nies, and Plekhanov (2016) suggest that early intervention strategies, such as restructuring loans and actively engaging with borrowers who show signs of financial distress, can significantly improve recovery rates. Bonin and Huang (2001) also

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support borrower engagement, advocating for open communication and customized repayment plans to help distressed borrowers stay on track.

Furthermore, Allen and Gale (2004) emphasize the importance of robust credit policies that guide loan issuance and recovery processes. By adhering to well-defined credit policies and regularly revisiting risk management practices, banks can minimize defaults and improve recovery outcomes.

Uzbek economists have conducted numerous studies on this subject. Specifically, Sh.Z. Abdullaeva (2012) explains that non-performing loans (NPLs) in banks are deficiencies in loan repayments categorized based on various credit risk criteria. These deficiencies gradually impact the overall quality of bank assets. The different forms of NPLs—such as creditors delaying payments or failing to repay debts entirely, along with the factor of time—serve as the primary focus of our discussion.

Moreover, since credit operations play a central role in the activities of banks, properly organizing their loan portfolios is one of the key factors that enable banks to operate efficiently and sustainably. Shortcomings in managing credit operations can lead to a decrease in bank revenues and, in some cases, even to their collapse. Therefore, monitoring the credit portfolio and its quality is essential for the effective functioning of commercial banks.

Based on the scenarios discussed above, we consistently consider it highly relevant to conduct research on ways to enhance the efficiency of managing non-performing loans in the commercial banks of our republic.

ANALYSIS AND RESULTS

Uzbekistan's banking sector is facing heightened attention as non-performing loans (NPLs) emerge as a key measure of financial stability. According to the Central Bank, as of October 1, 2024, the nation's 36 banks—including nine state-owned and 27 private institutions—collectively hold $1.68 billion in NPLs.

Ipoteka-bank, with $339.43 million in NPLs, highlights significant challenges in managing credit risk. In contrast, KDB Bank Uzbekistan stands out with zero NPLs, reflecting exemplary risk management practices. The performance disparity between state-owned and private banks is notable, with private institutions generally exhibiting stronger credit control measures.

Table 1. Information on Non-performing loans of commercial banks as of March 1, 2024

Information on Non-performing loans of commercial banks as of March 1, 2024				
				billion UZS
№	Bank name	Total loan portfolio	NPL	share in % of loans
Banking System		**472 407**	**20 850**	**4,4%**
Banks with State ownership		**331 151**	**16 142**	**4,9%**
1	NBU	98 797	3 400	3,4%
2	Uzpromstroybank	57 397	2 489	4,3%
3	Agrobank	54 498	2 020	3,7%
4	Asaka bank	38 398	1 875	4,9%
5	People's bank	24 666	1 841	7,5%
6	Business development bank	21 104	2 905	13,8%
7	Microcreditbank	14 199	912	6,4%
8	Turon bank	12 073	305	2,5%
9	Aloqa bank	9 938	394	4,0%
10	Poytakht bank	81	0,1	0,1%
Other banks		**141 256**	**4 709**	**3,3%**
11	Ipoteka-bank	37 488	3 019	8,1%
12	Kapital bank	26 978	490	1,8%
13	Hamkorbank	16 445	120	0,7%
14	Ipak Yuli bank	11 962	111	0,9%

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15	Orient Finance bank	8 873	2	0,0%
16	Invest Finance bank	6 414	131	2,0%
17	Trust bank	5 286	107	2,0%
18	Davr bank	5 176	44	0,8%
19	TBC bank	4 190	87	2,1%
20	Tenge bank	3 989	142	3,5%
21	Asia Alliance bank	3 965	46	1,2%
22	Anor bank	3 301	64	1,9%
23	KDB Bank Uzbekistan	2 700	0,0	0,0%
24	Ziraat Bank Uzbekistan	1 682	51	3,0%
25	Universal bank	1 257	15	1,2%
26	Garant bank	894	85	9,5%
27	Madad Invest bank	286	80	28,0%
28	Octobank	146	111	75,6%
29	Hayot bank	59	0,0	0,0%
30	Uzum bank	50	0,0	0,0%
31	Yangi bank	48	0,0	0,0%
32	Apex bank	32	0,0	0,0%
33	Iranian Saderat bank in Tashkent	19	4	20,1%
34	AVO bank	15	0,0	0,0%
35	Smart bank	0,2	0,0	0,0%

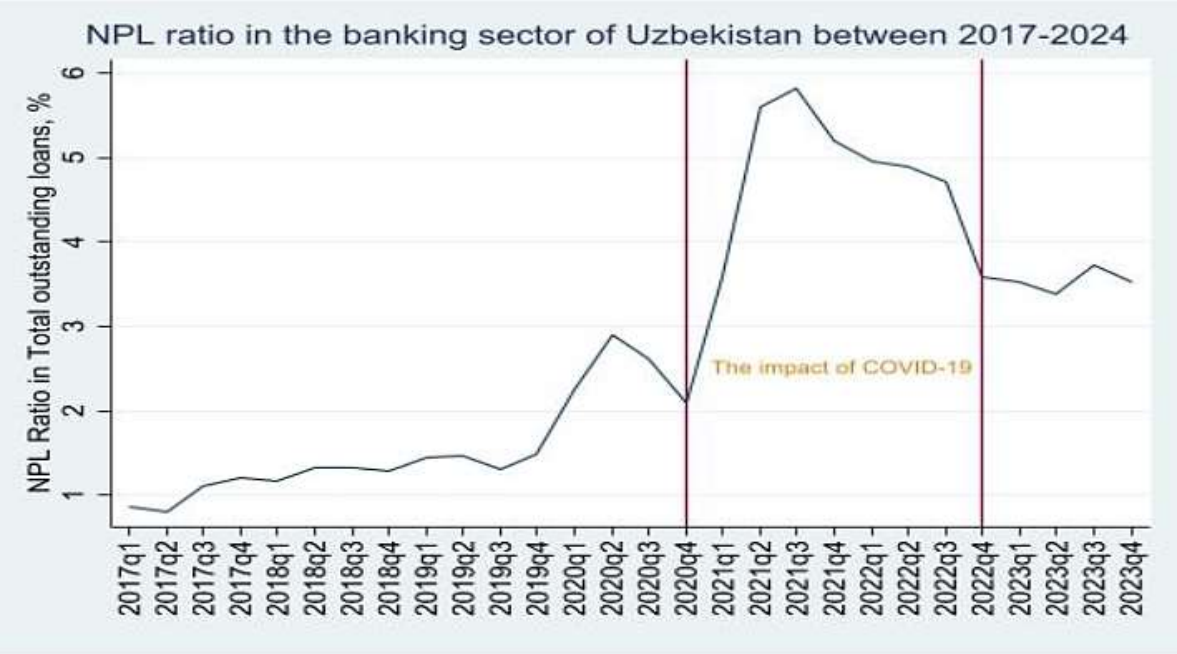
Source: Developed by the author based on cbu.uz

Comparison of Credit Risk Management in State-Owned and Private Banks

Significant differences emerge in credit risk management practices between state-owned and private banks in Uzbekistan. State-owned banks, such as NBU and Xalq Banki (People's Bank), are more exposed to riskier sectors due to the larger size of their portfolios. For example, NBU has managed to maintain a relatively low NPL ratio of 2.85% among state-owned banks, while Xalq Banki has made notable progress in reducing its NPL ratio to 5.31% from a previous 9.15%, indicating improvements in credit management. Conversely, Ipoteka-bank, despite its privatization, still faces challenges with a high NPL ratio of 12.3%, reflecting ongoing struggles with loan recovery.

In 2024, the commercial banking sector, which is a fundamental part of Uzbekistan's banking system, includes around 35 licensed banks. This represents an increase of nearly 30 percent, particularly in the number of non-state-owned banks, which grew from 17 in 2017 to 25 (see Table 1). Despite this growth, the total number of banks remains relatively low when considering the size of Uzbekistan's economy and population, as well as in comparison to the banking systems of neighboring countries like Kazakhstan and the Russian Federation.

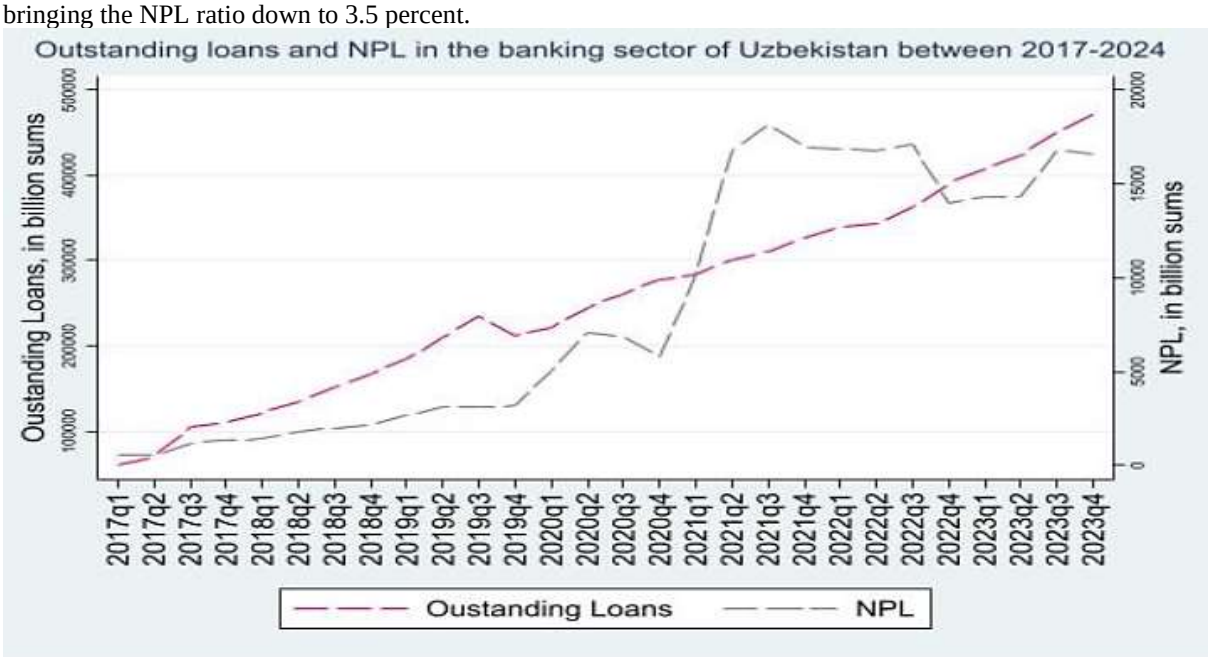
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Picture 1. ShareofNPLs in outstanding loansof the banking sector in Uzbekistan, (measured in percentage)

Source: Developed by the author based on date from CBU.

Since 2017, the quarterly accumulation of non-performing loans (NPLs) in the banking sector increased steadily by approximately 0.5 percent. This trend continued until the third quarter of 2020, when NPLs sharply surged by nearly double, reaching their first peak at 3.6 percent. In the following year, the NPL ratio on outstanding loans escalated rapidly, attaining a second peak of 5.8 percent in the third quarter of 2021 due to post-pandemic conditions. Ultimately, by the fourth quarter of 2023, these figures declined significantly by 40 percent as the economy began to recover and policies were implemented to counteract the slowdowns caused by Covid-19, bringing the NPL ratio down to 3.5 percent.



Picture 2. Trend in outstanding loans and NPL accumulationof the banking sector in Uzbekistan, billion soums

Source: Developed by the author based on date from CBU.

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The loan portfolios of both state-owned and private banks have worsened, as a significant number of loans received multiple deferrals during 2020-2021. Although the Central Bank has intensified its oversight to ensure the proper identification and reporting of Non-Performing Loans (NPLs), challenges remain. As illustrated in Picture 2, the trends for both outstanding loans and the accumulation of NPLs in Uzbekistan's banking sector are on the rise. This indicates that as commercial banks increase their lending, the buildup of NPLs also grows proportionally over the analyzed period. The pandemic notably exacerbated NPL accumulation by causing financial hardships for many borrowers. Additionally, NPL ratios may continue to climb as the repercussions of previous rapid credit expansions become fully evident amid Covid-related risks and potential spillover effects from the Ukraine conflict. Furthermore, Uzbekistan is vulnerable to various natural disasters and the impacts of climate change, which could result in a substantial and swift rise in NPLs if adequate risk management practices and insurance mechanisms are not in place (World Bank, 2022).

Private banks generally perform better in managing credit risk, with KDB Bank Uzbekistan standing out by maintaining a zero NPL ratio, setting a strong industry example. Other private banks, like Kapitalbank with an NPL ratio of 1.67% and Trustbank with a low 0.22%, also show effective loan management and risk mitigation practices. However, challenges persist for some private institutions, as evidenced by Madad Invest Bank with a high NPL ratio of 17.3% and Garant Bank at 14.9%, indicating that certain private banks still encounter difficulties in handling non-performing loans.

CONCLUSION

Uzbekistan’s banking sector exhibits varying levels of success in managing non-performing loans. KDB Bank Uzbekistan sets a benchmark with its zero NPL ratio, yet several other banks, both state-owned and private, continue to grapple with high NPL levels. Banks like Ipoteka-bank, Madad Invest Bank, Garant Bank, and the Iranian Saderat Bank in Tashkent face significant challenges, underscoring the need for enhanced credit risk management practices across the sector.

The European Central Bank underscores that effective NPL management—through stronger credit controls and improved loan recovery processes—is crucial for long-term financial stability in any banking system.

In February 2024, the Central Bank of Uzbekistan's Risk Oversight Committee reviewed key issues affecting NPL performance in the sector. To address financial health and regulatory compliance, the committee imposed sanctions on three banks and issued warnings to six others for non-compliance with Central Bank standards, urging these institutions to strengthen risk management and adhere to prudential norms. The Central Bank also provided guidance to banks and microfinance institutions, emphasizing the need to address financial weaknesses, enhance internal controls, and rigorously follow financial standards. "Specific instructions were issued to bank management to address identified weaknesses, develop corrective measures, adhere to prudential standards, and improve financial health," stated the Central Bank. These actions are aimed at encouraging banks to enhance their loan recovery processes, ultimately reducing NPL levels and strengthening financial stability across the sector.

A significant depreciation of the domestic currency may lead to an increase in the share of non-performing loans in foreign currency. This is because borrowers on loans in foreign currency earn in the domestic currency, with the exception of export-oriented enterprises. As a result, if the exchange rate depreciates sharply, borrowers may find it difficult to repay their loans, and the share of non-performing loans in foreign currency may increase.

In summary, it can be concluded that there are multiple approaches for handling non-performing loans (NPLs), and banks should choose the most effective methods to enhance the productivity and quality of their credit portfolios. Improving not only the quality of the credit portfolio but also the bank’s financial performance, ensuring its stability, and establishing an effective system for managing NPLs remain top priorities.
Based on the topic, the following set of measures is proposed to minimize and manage the share of overdue and problem loans in commercial banks:

1. Strengthen the capacity of divisions specifically dedicated to handling NPLs.
2. Develop streamlined procedures for loan restructuring to simplify the process.
3. Organize regular initiatives aimed at improving clients’ financial literacy.
4. Conduct systematic monitoring of the economic environment, national conditions, and various macroeconomic processes.

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5. Continuously monitor the financial status of borrowers both during loan disbursement and throughout the servicing period.
6. Develop and enhance a comprehensive risk management system.

In conclusion, improving the situation with NPLs involves selecting appropriate methods for managing overdue loans, making decisions that factor in the assessment of risks, and ensuring a balanced structure within the credit portfolio.

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