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Problematic of bad debts portfolio in Azerbaijan Commercial Banks: analysis and ways of solution

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Abstract

The main objective of this thesis is to research and analyse bad debts problem in Azerbaijan Commercial Banks and to identify ways of solutions to this problem. As we know the principal business activity of banks is lending. Therefore loan portfolio occupies essential part of bank's assets mainly because they generate income in the form of interest. However some borrowers cannot repay the loan and they turn to problem loans.

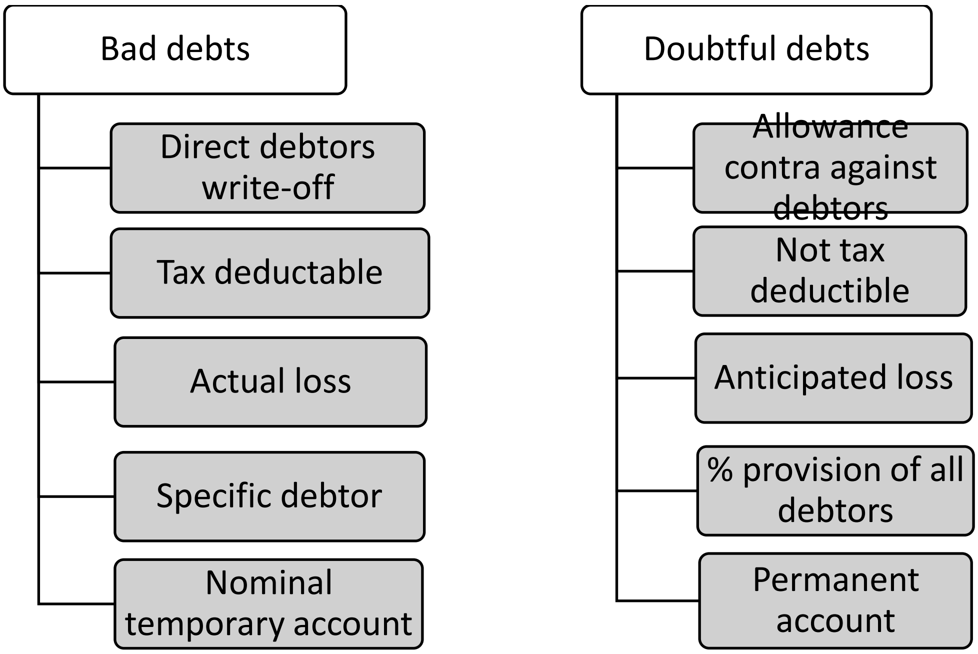
Bad debts affect seriously to financial health of commercials banks and overall banking system. If we consider the increasing trend of bad debts in Azerbaijan Commercial Banks, the need arise to examine and investigate this topic. We will also discuss ways of solution which would suit best to our banking system. Primary and secondary data were used in the thesis.

Contents

Introduction

Commercial Banks have credit of being an important tool of capital for development. Bank accepts loan able funds as a form of deposits, credit and capital. A ‘loan’ is a financial asset resulting from the delivery of cash or other assets by a lender to a borrower in return for an obligation to repay on a specified date or dates, or on demand, usually with interest. (Basel Committee on Banking Supervision, 1999) The amount of deposits must be considerable so the bank can make loans and advances to customers for to generate interest. The banks gain profit and in result they can cover its daily costs, maintain business and can pay sufficient amount of dividends to shareholders. The lending policy of banks assists to control proportion and size of the credit portfolio and find out the common circumstances which it is proper to make an advance. When customers use borrowed money effectively, it positively influence to their production and profit. As a result increase in their profit the borrowers can easily pay back the credit with interest and principal. Then collected loans by banks are lent out to actual borrowers again and the money circulation continues which is crucial for healthy economy. Bad debts prevent full utilization of loans and advances which would benefit the economic well being of the nation.

When the difficulties occur in recollecting of debts , banks’ profit and lendable funds decrease so it makes negative changes in its statements. In order to understand whole essence of this problem we must know the difference between bad debts and doubtful debts.



As we see from above there are significant differences between doubtful debt and bad debts accounts. Bad debt is an amount owed by a debtor that is unlikely to be paid (Dictionary of Finance and Banking 2008, 31).. Bad debts are literally next stage of doubtful debts and among the most serious threats for banks. Healthy loan portfolios are crucial factor which make positive impact on the performance of banks. However, when some of these loans continue to become non-performing they eventually result in bad debts which affect earnings of banks on such loans. Bad loans cost to banks in terms of their connection with the quality of their assets portfolio and profitability.According to banking regulations, banks make provisions for non-performing loans and charge for bad loans which lower their loan portfolio and income.

These years bad debts are one of the major problems of the Azerbaijan economy and requires to be solved as soon as possible in order to improve both country's economy and banking system.It is important to estimate bad debt rate to evaluate its influence to overall banking system. Bad debt rate is the percentage of the bad debt in the total debt of a bank or the whole banking system. According to Central Bank statistics, the sum of problem loans amounted 1,62 billion manat or 14% of the total loan portfolio of commercial banks.This rate doesn't surpass 5% in international practice and in developed countries it is usually around the 3 %. This indicator shows a real concern which threats our economic reputation.

We know that ,the central point on which the banks carry its activities is lending and and it’s the main source of banks’ profit. That’s why, the loan administration has to be organized effectively in order to improve efficiency and effectiveness of allocation and use of lendable funds. In this way,the economic growth and development is also encouraged.

Bad debts are major problem for Azerbaijan banks and it continues to grow each year despite of all efforts made by both government and banks. According to Central Bank of Azerbaijan, the following reasons can be evaluated as the deterioration of the loan’s status:

- The failure in timely submission of financial information requested by the bank;
- Non-payment of interest on the loan and principal amount in time;
- The discrepancy in a forecast and business plan presented in borrower’s cash flows;
- Deterioration of the borrower’s financial position;
- The application for to extend the maturity of the principal and interest on the loan;
- To raise lawsuits against the borrower;
- The borrower’s refusal to meet with bank;
- To obtain information from the Centralized Credit Registry on deterioration the solvency of the borrower;
- Accessing any other information that may have a negative impact on the borrower’s solvency.

All the signs above can result in bad debt that’s why banks should adjust credit policy internally. Each loan and borrower must be reviewed separately in the regulation should be performed.The internal rules should reflect at least following regulatory arrangements:

- Measures ensuring to attract additional financial resources by the debtor and the provision of security;
- Follow cooperative actions with the debtor to find ways to strengthen debtor's financial ability and solvency (attraction of consultant services, reducing operating costs and/or increasing income, preparation of program of sale of assets; reorganization of the enterprise, organization of debt restructuring program,change of terms of the loan,etc.)
- Transmission of debtor's obligations on loan to other person or legal entity;
- Direction of demand to the repayment of the debt in accordance with the legislation.

If the total amount or the ratio to credit portfolio of problematic, especially non-performing loans reached at the predermined limit, bank should restrict lending policy and implement appropriate remedial measures.According to official data, the number of people who took credit from banks in Azerbaijan is 2.5 million.This means that there is a borrower in almost every family.There are some reasons for such an indicator.First of all, experts point double devaluation of manat in respect of dollar in 2015.But this is only one of the factors. Before 2014, experts had also pointed to a high interest rate of bank loans.In some cases, it reached at 40-45%. So, devaluation highly contributed to negative trend but the crisis was expected.

Azerbaijan banks are in the critical level.Their both loan and deposit portfolios are declining.Because of diccifulties in allocating funds, banks are not intend to attract depositors. Problem is serious, strict reforms are inevitable.

2. Definition of credit.

In latin, the word of "credere" (credit) means trust and express respectability.A credit is a real or legal person's cash, property, surety and in the form and nature of the collateral or in any form and value,to be taken back at the end of a certain period of time or to be given guarantee that the asset will be repaid or that an obligation will be fulfilled.

Credits can be divided into a wide variety of classes. Loans classification, loan maturity, purpose of use, sector used, usage area and assurance are included basic criterions.

2. Loans according to Qualifications

- Cash Loans
- Non-cash Loans

2. Loans according to their security

-Secured Loans

-Non-secured Loans

3. Loans by maturity date

- Short Term Loans
- Medium Term Loans
- Long Term Loans

4. Loans by Purpose of Use

-Investment Loans

-Regulatory and Modernization Loans

-Business Loans

-Consumer Loans

5. Usage of loans by Sectors

- Private Sector Loans
- Public Sector Loans

6. Loans by Areas Received

-Training Loans

-Consulting Loans

-Tourism Loans

-Energy and Public Works loans

- Transportation Loans

- Export loans
- Domestic Trade Loans

2.1. Concept of non-performing loans.

In terms of banks, the loan is profitable as well as risky at the same time. The main purpose of the banks is to minimize the risks that may arise during the loan. The timely repayment of a loan is an expected outcome of the bank. However, if the loan is not paid on its behalf, it is referred to problematic credits.

The problematic credit can be defined as the delay of collection and the emergence of the possibility of a loss, by breaking down the repayment agreement between the bank and the borrower significantly. The banks require that all the loans they allocate are collected at the end of the loan and there should be no problems in collection. However, this is not always possible. Generally, the rate of the credits used by the subsequent credits of the banks is normally up to 5%. The higher the rate, the higher the risk. After the bank gives the customer a loan, three different events can take place. First; the credit is collected by the bank according to the terms of the contract. Later; The credit terms and the payment plan are rearranged to the satisfaction of both the bank and the customer. In the third place, some credits can not be collected according to the contract conditions and a problematic loan arises.

1.1.1.The reasons of non- performing loans.

It is observed that there has been an increase in the number of enterprises that have been experiencing financial failure in recent years both in our country and in the west. This increase is generally linked to economic stagnation, tight monetary and credit policy to prevent inflation, high interest rates and increasing financial risk structures of businesses.

Banks must have efficient and effective credit management, considering the risk that their loans will not be returned because they will have a negative impact on their profitability. Banks with effective credit management are banks that minimize credit risk by making optimal decisions in the course of credit allocation and monitoring. Credits are important to be defined and controlled to bear with a high risk in terms of banks.

Often it is not possible to link the causes of problem loans to a single influence or event. There are many reasons why a loan can become problematic. In order to identify the causes of the problem loans, it is necessary to examine the details of the debtor’s work and its relationship with the bank.

The reasons for operating problem loans can be grouped under three main headings: environmental causes and the causes of the banking system.

Operational Reasons

Given the causes of problem loans, it appears that most of them originated from the problems of the businesses. The inability of an operator to manage well can lead to problem loans because the managers are away from the skills such as knowledge, expertise and experience. The greater the ability of managers to see and plan ahead, the greater the likelihood of success.

The ability of a firm to sustain its operations profitably depends on its superiority and quality in the market. Difficulties in the supply of raw materials and energy can affect the costs of not finding quality work force and the production volume negatively. In this process, the marketing activities of the company should be closely examined. Loan borrowers must have a well-regulated marketing policy and effective means to fulfill that policy. Distribution channels must be selected correctly, price policy must be determined and advertising campaigns must be established. If the firm can not create an effective marketing plan and can not determine its position and role in the market well, this attitude may cause sales and profitability to fall and make the loans become problematic.

Equity is very important for firms to be able to sustain their existence. Equity capital, which protects the firm against sudden cash outflows, is also an important resource for companies to evaluate new opportunities and fulfill their obligations. In case the self capital is inadequate, it is important for companies to find low cost funds.

Another goal is to maximize growth rates as well as protect companies’ assets. However, operating uncontrolled growth may shake. The increase in borrowing and the increase in interest expenditures in order to ensure the financing required by the grower may disrupt the company’s capital structure and cause losses.

A firm succeeds if it sells the right product on the right market with the right flare strategy, but if it can not control its activities properly, its failure will be inevitable. In an uncontrolled company, any problem can grow without being diagnosed and the solution becomes impossible.

In addition to this, the technological, environmental, political and economic environment of the enterprise will also affect the operation.

Environmental Causes

In order for an operator to continue their work, it is crucial to determine the changing technological conditions and to adapt to these changes in time, in terms of life force. Thanks to technology, more advanced new products can be marketed and competitive power can be increased. A company that markets new products produced with advanced technology will increase the competitive power of its market and its financial structure will be strengthened.

Both the national economy and the world economy will have a direct impact on the banking sector. Economic impotence, shrinking loan demand due to rising tax rates, interest rates, changes in purchasing power will affect the company's success and therefore the debt-paying power. In addition, many companies are dependent on natural resources because of their raw material supply and energy needs. The supply and cost of these resources may change in relation to supply-demand conditions, political and environmental reasons. For example, the change in oil prices can affect the whole business life to a large extent.

Errors made in banking during the crediting process.

The mistakes made by the credit-granting banks in the case of the loan becoming problematic may have an important role. A customer who is not good at business ethics should not be given credit even if he or she is able to pay for it. The malicious borrower can also extend the payment period as he wishes by taking advantage of the possibilities provided by the rule of law.

The evaluation and interpretation of financial statements in a short time and by non-experts may also cause problem loans. At this stage, employees must be experienced and careful.

Another important mistake in the banking sector during the crediting process is the inadequate analysis of the purpose of the loan and the sources of repayment. This often causes the credit to become problematic. If the banker who is credited with credit can not understand the firm's business well, it will not be able to accurately determine the cash flow of the company, and thus the financing needs, and will not be able to direct the financing it provides in line with needs. Failure to timely schedule credit allocation and repayment will result in inconsistencies between the trades and the cash flow of the company.

As it is known, the guarantees received from the borrower against the allocated loans protect the bank from possible damages. Possible loss may be incurred if it can not be assessed as sufficient from the point of view of the buyer's guarantee, market value and sellability in the market.

Financial Causes

One of the most important financial factors that cause problem loans is the financing of the activities. As is known, one of the main factors determining the foreign resource needs of companies is the financing need that their activities generate. The amount and duration of this need, which is defined as the business capital needs, largely depends on sectoral features and firm strategies. However, financing methods and resources differ from firm to firm and create different results. The selected financing method should be cost-effective and sustainable, and alternative resources must be available.

The financial institutions that the firm provides loans are important criteria in the lending phase. Working with financial institutions that have high resource costs and therefore high cost of borrowing often means higher financing costs.

1.1.2. Impacts of non-performing loans.

The impact of problem loans on businesses and credit institutions is very important. Direct and indirect costs are incurred in the enterprises whose loans become problematic. The direct costs incurred by the problematic loans arising out of the operation of the enterprise arise from the fees to be paid to the third party or group due to the services in the bankruptcy proceedings. These expenses are; liquidation expenses in case of liquidation, and restructuring charges in case of restructuring. Among such expenses are the court, legal proceedings, accounting and other professional service expenses

<u>Impacts on banks.</u>

Banking crises are usually caused by the active part of the balance of the banks. A dangerous increase in the number of problem loans that lead to deterioration in the asset quality of banks is considered one of the biggest signs of crises. In the examination of the bank balance, the transfer of the cash credits to the receivable accounts, the amount of the loans on the active side of the balance will be deducted, and the account receivables will increase. This will cause the bank's asset quality to deteriorate and its profitability to decline.

Banks have to have high financial instruments with high cash value or cash bond ability in order to fulfill their commitments in a timely manner. If a bank does not have the means to meet its commitments, it is facing liquidity risk. This risk arises especially if the short-term commitments of short-term assets can not be met.

Impacts on businesses.

The direct and indirect costs incurred by the borrowers become problematic. The direct costs incurred by the problematic loans of the Operator are due to the costs incurred by the third party or groups due to their services in the bankruptcy process. These expenses are; liquidation expenses in case of liquidation, and restructuring charges in case of restructuring. Among such expenses are the court, legal proceedings, accounting and other professional service costs.

The bankruptcy of the last phase of financial failure opens up some socio-economic consequences. If we summarize these problems; the first is unemployment. In an economy where unemployment is intense, such as Azerbaijan, new unemployed is added to the already existing as a result of bankruptcy. Another negative effect is on new investments. Especially when public joint-stock corporations established by the savings of citizens suffer from financial failure as a result economic and social life ends, it has a negative effect on saving owners. In addition, due to the participation of enterprises in the form of participation in other businesses, financial failures in the case of bankruptcy are seen to have negative consequences for social welfare.

It is possible to take various measures to prevent the loans from becoming problematic. The risk of non-repayment of the loan can be minimized by establishing an effective credit culture, by implementing supervisory and monitoring programs, by predicting the danger signs, and by identifying bank customer relationships at an early stage of deterioration.

The credit check process should be primarily concerned with the basic control points. Critical measures must be taken into consideration, taking into consideration that the measures considered are related to the interests of the institution. The objectives or tasks undertaken by the credit institution should be monitored to ensure that they are complete, productive and timely and should be intervened if necessary.

The main function of the regular audit period is to determine whether the existing conditions at the time of the credit decisions are improving against the bank in the course of credit utilization. There is an important place in the emergence of the situation of the employer regarding the use of credit open loans and especially in evaluating new firms.

1.1.3. Costs of Problem loans.

Costs of problem loans, which lead to inefficient evaluation of country resources, can be listed as follows:

- Funds allocated to problem loans can not be directed to higher-yield alternative projects, but also require legal provision and capital.

- When credits become problematic, substitution costs increase according to the new risk situation.

- Problematic loans lead to higher administrative costs than the need for closer attention and follow-up

- Problematic loans require significant expertise in legal matters and cause high legal costs

- Problematic loans hamper the use of managerial time in more productive areas

- The image of the bank and the name on the market can be damaged, which can adversely affect the growth of the bank.

- Low yields and limited growth in banks with high problem loans have a negative effect on employees’ morale.

- Potential customers will not be able to be credited due to the decrease in the loan amount. In addition, there is a problem of credit justice. While a successful business is standing, giving credit to unsuccessful business creates injustice.While every credit becomes problematic, it certainly gives some early warning signals.The credits do not suddenly become problematic without giving any signal. Ensure that early warning signals are identified and correctly interpreted on time, precautions are taken against the approaching hazard, and resolution of the problem is facilitated.

As a result of the checks made on the balance sheet items, there may be early warning signals if the collection period is long, if there is a large increase in the trade receivables, when the stock conversion rate slows down.Looking at the firm’s income table, there may be a decrease or rapid growth in sales, an increase in costs and a decrease in profit, an increase in doubtful receivable losses, early warning signals. After the loan has been used, the company visits should be continued by the bank and the dialogue with the company management should not be interrupted. In this process, there may be changes in the behaviors of company managers or change of company partners, loss of important production, distribution and raw material resources of the firm, orders to force production capacity, lack of care in factories and machines.

Decreases in customer bank deposits can be premature warning signals for bank operations, such as misplaced and bad planning for operating capital needs, large increases in the amount and frequency of credit requests, large-scale short-term credit utilization, and credit crunch. It is an indication that the firm has entered into the difficulty of payment due to unrecognized checks and protest bills.

Today, banks are required to measure the risk of non-repayment of credits or to determine firm credibility as soon as possible in a careful and best manner. When a credit decision is made, a number of decisions will be taken that set forth the availability of the loan, such as the amount of the loan, collateral conditions, payment terms, pricing. All of these decisions are sound, but will be understood by the smooth repayment of the loan. Depending on this situation, banks are carrying out system development studies to monitor and evaluate loan portfolios easily and effectively.

The aim of the early warning system is to enable the bank's management to develop appropriate customer strategies that enable it to identify as early as possible the problems that may arise in the loan portfolio or in the financial situation and activities of its customers,

Banks may want to set up an early warning system for taking credit decisions in response to the likelihood that the credits will not be credited or all credits will be taken into consideration. In this case, the bank will be closely followed by the risk.

Banks should develop and use rating systems for the organization structure in accordance to early warning systems and to ensure effective risk management. The rating system to be established must be compatible with the size and complexity of the structure of the bank activities.

2. Case of Azerbaijan.

The percentage of non-performing loans in Azerbaijan directly affects to the health of banking system. If the percentage of such loans in banks, it means the banks have difficulties recollecting principal and interests on their credits. The amount of both loan and deposit porfolios are declining. Because of difficulties in allocating funds, banks have no desire to increase deposits. A year ago, deposits in manat were attracted at 15% annualy, it isn't more than 9-10% now and some banks even attract at 6-7%. In respect of this, the loan portfolio dropped to 11.7 billion manat. Last year the deposit portfolio was 7.7 billion manat but now it is 7.3 billion manat. The declining trend is continuing and that's why the both toxic assets and problem loans have to be solved as soon as possible.

The amount of problem loans have been growing since the first devaluation of manat happened in February, 2015. After those devaluations 13 banks are closed in Azerbaijan. Most of banks in Azerbaijan still suffer from increase in overdue loans. We'll look at some cases.

In 2017 gradual improvements were observed in the banking sector. The sector restored profitability in November,2017 which the amount of profit in banks was 549.6 million manat while in 2016 there was 1.7 billion manats loss.

It's obvious that declaring banks' bankruptcy cannot be solution so for this reason different mechanisms and solutions must be analysed and applied.There is " Baku approach" in practice which has been created according to London and Istanbul approaches. This approach supports unity of bank against the growth of overdue loans. The main principles of this approach are that the banks restructure problematic loans and facilitate the terms of loan for borrower who are particularly in difficult situation. "Baku approach" is still developed. The government takes comprehensive measures against growth of overdue loans and give a try to banks and their customers to improve the condition in 2018-2019.

Vugar Bayramov (The head of the Center for Economic and Social Development) offers a mechanism for solving problem loans which have turn into critical issue affecting a large group of population in Azerbaijan. He thinks that the responsibility of problem loans should be shared among state, bank and borrowers themselves. Then each of them will meet only 1/3 portion of debt and it will be easy to handle with situation.

In September 2017, The Institution of Banking Ombudsman was formed in Azerbaijan. More than 160 cases were reviewed by Ombudsman Ikram Karimov and some of them were solved for the benefit of customers. The establishment of this institution is significant event took place in 2017. Of course, it will take a while to assess the effectiveness of this institution but some positive trends are already observed.

2.1. The importance of bank reserves.

Each bank seeks more funds used in circulation despite the fact that,considering the risks, it should allocate some of its equity as a reserve. The Central Bank has concrete guidelines and norms with regard to the amount of reserves.However, there are some cases when banks try to avoid allocation of funds as reserve in order to maintain the high amount of circulating assets.

The main rules of the Central Bank related to reserves are: “Rules for Classification of Assets and Special Reserves for Possible Losses”. Special reserves often refferd as provisions are the assets that are allocated for possible losses on assets.We can explain reserves briefly as they are allocated to cover possible losses within bank’s activities. The reserves will be allocated to meet the bank’s loss if the the bank anticipate any delay on the asset or the probability of non-payment goes up. Allocation of reserves is based on certain criteria. As the lateness days of the assets increase, the interest rates which can cover these losses also increase. Establishing reserves is based on reserve rates and reserve amount mentioned above.

2.2 Asset classification.

Banks classify and create reserves according to regulations and internal procedures. Regulation and recording of assets classification, analysis criteria of asset quality, control procedures also operations to write off loss assets from balance must be based on internal procedures. Assets must be classified by responsible structural division. It is designated by internal procedure of bank according to the avoiding the conflict of interests principle.

An apportionment of assets is as below:

1.Standard assets

2.Non-standard assets.

Standard assets include satisfactory and controlled assets. Non-standard assets include non-satisfactory, doubtful and loss assets.

Asset classification is carried out taking into account the delay time and quality criteria. For classification purposes, assets are divided into assets up to 30 days, from 31 to 90 days, from 91 to 180 days, from 181 to 270 days and overdue for more than 270 days. The date which defined in the relevant agreement for repayment of principal amount and accruals is used to calculate delinquency period of assets.

By quality criteria, assets are divided into high, medium and low quality assets.

The cases which assets are considered to be high quality are follows:

- When the financial position and profitability of the borrower are acceptable to meet contractual obligations on time and in full.
- If any negative factors are not observed which would affect the solvency of the debtor such as decrease in rates of production growth, sharp increase in creditor's and debtor's debt and other economic factors.
- There are not overdue loans of the debtor over the past six month (considered when an asset is placed) .

Assets are considered middle quality in the following cases;

- When financial statements, business plan or other documents proving ability to pay on time are not presented;
- Cash flows on the borrower's operations are not adequate for debt servicing terms;

- The trends caused by change of the economic conditions might have a negative impact on borrower’s solvency ;
- If the borrower is operating with loss or don’t receive enough profit for to meet obligations.
- When the principal payment sources are not sufficient for to pay debts and additional payment sources are needed;
- If there are overdue loans of the debtor over the past six month.

The quality of asset is considered low when;

- The borrower operates at a loss for more than a year;
- The borrower cannot repay the debt and it is found out that there are no additional income sources to pay the debt;
- If the borrower dies, is considered dead or missing in accordance to order specified in the Civil Code of the Republic of Azerbaijan, or the borrower who is not able to pay his/her debts cannot be found.
- If the documents don’t exist which confirm intended use of loans.

Assets are classified based on the table below:

Delinquencies / Quality Criteria	0-30 days	31-90 days	91-180 days	181-270 days	over 270 days
High	Satisfactory	Watch	Non-satisfactory	Doubtful	Loss
Middle	Watch	Non-satisfactory	Doubtful	Loss	Loss

Low	Non-satisfactory	Doubtful	Loss	Loss	Loss

When the debtor is declared bankrupt or for any reason employment or business activities are terminated the loans given commercial purposes are classified as loss assets.

The quality criteria analysis on assets is documented.

2.3. Creation of reserves and loss asset charge off.

Reserves are created for possible losses on assets. They are divided into two categories:

1. Ordinary reserves created for compensation of possible losses on the bank's standard assets.
2. Targeted reserves created for repayment of potential damage to non-standard assets of the bank.

The reserve rates of classification categories as defined below:

- Satisfactory assets- 1%
- Watch assets- categorized as restructured watch assets-2%, and non-restructured watch assets-1% from 23.02.2015;
- Non-satisfactory assets-25%
- Doubtful assets-50%
- Loss assets-100%

Reserves are created according to the total amount of assets in the national currency of Azerbaijan Republic against the expenses of bank. If the payment of principal amount or interest expense are delayed for more than 90 days, reserve is created in the amount of accrued interest. Reserves are created by assessing risks specific to each asset or group of assets on this group(loans, securities, interbanking claims, securities, receivables and other assets).Created reserves are used to pay for possible losses for all assets included that group.

The loss asset is written off from the statement of profit and loss against created reserves .The bank write off loss asset from the statement of profit and loss according to the decision of the Supervisory Board based on the petition of Management Board. All assets are written off from the balance in contrast with outstanding interest and reserves on those assets are recorded and upholden in significant off-balance sheet accounts for five years or more. Reserves are not created, if assets are protected by the types of securitization below:

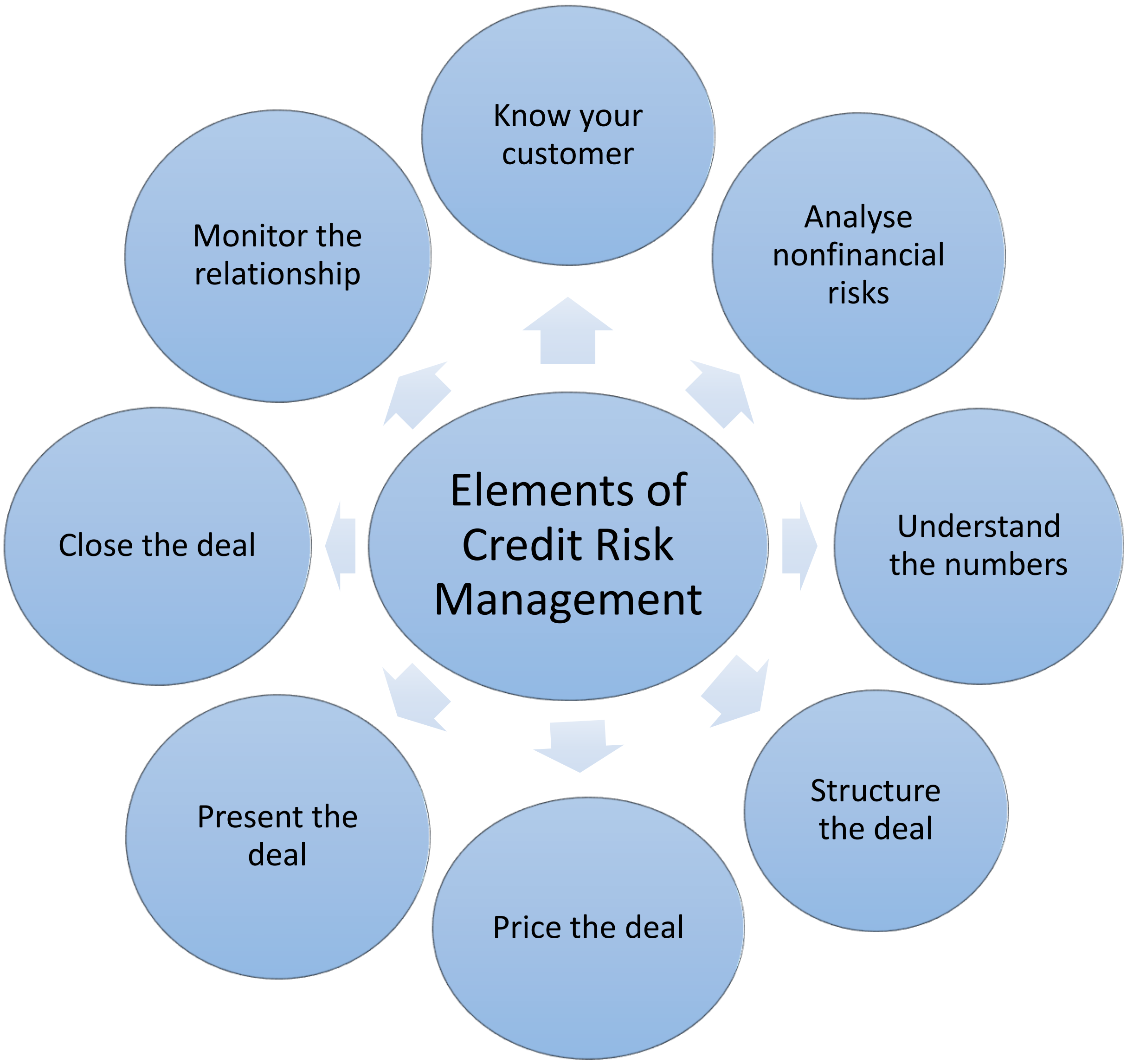
- if funds in hard and national currencies in the borrower's deposit account are prevented by the bank in the value of the asset and the bank is empowered to write off those funds from the specific account without account holder's order based on the contract;
- Government securities of Azerbaijan Republic, securities issued by the Central Bank and the Azerbaijan Mortgage Fund Open Joint-Stock Company, a guarantee issued by the Central Bank or government guarantee;
- Government securities and guarantees of the countries with "A" (sovereign) credit rating at a minimum issued by reputable international rating agencies (Standard&Poor`s, Fitch Ratings, Moody`s), and securities and guarantees issued by central banks of those countries;
- The bank metals deposited as collateral to the bank;
- Guarantees issued by banks with "A" credit rating at a minimum, issued by international rating agencies.
- Reserves are not created on claims with no delinquencies due from the CBAR and banks with the minimum 'A' credit rating given by international rating agencies.
- Created reserves is assessed with respect to adequacy of asset quality by structural division, that operates the classification of assets, at least once a month and no later

than the last business day of a month. When payments on the assets, classified as medium-quality under the criterion, are made on time then this asset might be re-evaluated, and that criterion is regarded during re-evaluation.

3. Credit risk management.

Financial institutions have faced difficulties for many years due to various reasons. The main reasons for serious problems in the banking sector remain dependent on factors such as insufficient credit standards, poor portfolio risk management, or poorly monitored changes in economic conditions and other conditions that may lead to deterioration in the credibility of bank customers.

Credit risk, in its simplest terms, is the likelihood that a bank will not be able to meet its borrower or its counterparty in accordance with the terms of the agreement. The goal of credit risk management is to maximize the risk-adjusted return of the bank by managing the risks that the bank may be exposed to within the appropriate parameters. Banks must manage all credit risks in their portfolio and the risks associated with individual credits and transactions. Banks should also consider the relation of credit risks to other risks. Effective management of credit risk is one of the key elements of a comprehensive approach to risk management. Following chart illustrates key compenents of credit risk management.



For many banks, the most widespread and most visible source of credit risk is the loans opened by the bank, as well as other factors that give rise to credit risk due to the activities of a bank; these are included in both the banking and trade books as well as the balance sheet and off-balance sheet accounts. Banks are faced with the credit risk of various financial instruments other than loans as days go by; for example, interbank transactions, acceptances, trade financing, foreign exchange transactions, swap transactions, bills, options, futures, warranties and sureties.

As exposure to credit risk continues to be the most important source of banking problems worldwide, banks and supervisory and audit authorities should take advantage of past experience and take lessons. Banks must now be enthusiastic and conscious of allocating sufficient capital to cover these risks as much as they are in the recognition, measurement, monitoring and control of the credit risk. The Basel Committee has prepared this document to encourage all banking supervisory and audit authorities to develop effective and reliable practices in credit risk management. The principles laid down in this document should be applied to all activities in which credit risk is present, as well as being generally applicable to lending activities.

Effective applications covered in this document include, in particular: (i) the creation of an appropriate environment for credit risk; (ii) the efficient processing of the lending process; (iii) the maintenance of appropriate credit management, measurement and monitoring functions; and (iv) adequate control of credit risk. These include the four areas in which we consider a comprehensive credit risk management program, as well as different applications between banks in credit risk management, depending on the nature and complexity of credit operations. These practices should be addressed at the same time by disclosing credit risk, adequacy of reserves and reserves, combined with effective practices in assessing asset quality. (These applications are included in the recently published documents by the Basle Committee.)

The approach taken by the supervisory and supervisory authorities of each country depends on various factors such as remote and on-site audit techniques and the extent to which independent auditors are used in the auditing function. All members of the Basle Committee should consider the principles contained in this document in assessing a bank's credit risk management system they need to be implemented. The expectation of supervision and denial in the approach of each bank's credit risk management should be in accordance with the bank's activity area and structure. For banks with relatively smaller or less complex structures, the supervisory and supervisory authority must determine whether the applied credit risk management approach is appropriate for the bank's operations and that the bank has been overcome with adequate risk-return discipline in the management of credit risk management.

The Committee foresees in the document (between chapters II and VI) the principle that banking supervisory and supervisory authorities will resort to the evaluation of a bank's credit risk management system. In addition, the document also provides observations and assessments of credit problems frequently encountered by supervisory and supervisory authorities.

Another example of credit risk is the convergence of financial transactions. One part of a process may not have been completed and the other part may not have been completed, and the damage may correspond to a large part of the process. If one of the processing parties is late in fulfilling its obligation, a loss may be due to other potential investment opportunities. This risk, which is defined as settlement risk, may also include liquidity risk, market risk, operational risk and credit risk. The regulations on co-ordination determine the level of risk. Factors that are of interest to credit risk in such regimes; the timing of the change of value, the result of payment / reconciliation, the role of beekeeping institutions and clearing chambers.

3.1. Principles on the Assessment of Credit Risk Management of Banks.

<u>Establishing an Appropriate Environment for Credit Risks.</u>

1. Principle: The board of directors should regularly monitor the bank's credit risk strategy and consider important credit risk policies. The strategy in question should reflect the bank's tolerance for credit risk and the level of profit it expects to achieve in response to various credit risks it receives.

2. Principle: Senior management shall be responsible for the implementation of the credit risk strategy approved by the board of directors and the development of policies and procedures for the recognition, measurement, monitoring and control of the credit risk. Credit policies related to all banking activities carried out by the bank on both individual loans and in its portfolio should be included in such policies and procedures.

3. Principle: Banks must identify and manage credit risks associated with all products and activities. Banks must ensure that the risks associated with their new

products and activities are subject to appropriate and adequate procedures and controls before they are approved by the board of directors or an appropriate committee.

Finding a Reliable Loan Facility

4. Principle: Banks must work in accordance with credible and clearly defined lending criteria. These criteria should be content that allows both the borrower and the structure of the borrower, the purpose of borrowing, and the repayment source to be adequately informed.

5. Principle: Banks must establish general credit limits for groups of individuals and their individual credit customers, as well as for the affiliated companies, both in the banking and trade books and in the balance sheet and off-balance sheet accounts.

6 . Principle: Banks should have clearly defined functions for approving new loans and increasing existing loans.

7 Principle: Credit must be cautious in making deposits. In particular, lending to companies and individual customers should be monitored closely and other appropriate measures should be taken to control and reduce the risks associated with linked lending.

Appropriate Management, Measurement and Monitoring of Loans

8. Principle: Banks must have a system for the management of various credit risks arising from their portfolios.

9 . Principle: Banks should have a system for monitoring individual loans to include adequate reserves and reserves.

10. Principle: Banks should develop and use internal (internal) rating systems in the management of credit risk. The rating system should be compatible with the structure, size and complexity of the activities of the bank.

11. Principle: Banks should have information access systems and analytical techniques for measuring credit risk in both balance sheet and off-balance sheet activities. Information access systems should provide sufficient information to identify the bank's credit portfolio composition and risk concentrations.

12. Principle: The banks should have the monitoring system of the quality and composition of the loan portfolio.
13. Principle: While banks evaluate individual loans and loan portfolios, they should also consider possible changes in economic conditions and assess the credit risks they may face under difficult circumstances.

Making Credit Appropriate Appraisal.

14. Principle: The banks should establish an independent and uninterrupted system for the examination of loans, and the results of such examinations should be communicated directly to the bank's board of directors and to the senior management.
15. Principle: Banks must ensure that their lending functions are properly managed and credit risks that they are exposed to are kept at levels consistent with prudential standards and internal limits.
16. Principle: Banks should have a system of management of problem loans.

The Role of the Surveillance and Supervision Authority

17. Principle: The supervisory authority should envisage an effective system for the identification, monitoring, monitoring and control of credit risks in banks as an element of the overall approach to risk management. The supervisory and audit authority should independently evaluate the policy, strategy, procedures and practices of a bank's lending function and the uninterrupted management of its portfolios. In addition, banks should set precautionary limits to limit the risks that individual customers or groups of related companies may be exposed to.

Just as in the case of all the activities of a bank, the board plays a critical role in monitoring the functions of the bank's lending and credit risk management. Each bank should develop a credit risk strategy or establish a plan that sets out its objectives for credit granting activities and adopt policies and procedures for the conduct of such activities. Bank strategy and policies related to credit risk should be regularly audited and approved by the board of directors. The board of directors should know that the strategies and policies of the bank cover activities whose risk is an important risk factor.

In the aforementioned strategy, the statement is that the bank is willing to make the lending function according to the type of the loan (eg commercial credit, consumer loan, corporate loan, etc.), given sector, geographical location, currency, repayment and estimated profitability It should be given. In addition, characteristics of the bank's credit portfolio structure (such as diversity and intensity level) and target markets should be specified.

The credit risk strategy should ensure recognition of the nature, origin and size of the credit. Every bank has to be profitable regardless of its size and therefore has to determine an acceptable trade-off for its activities. The board of directors should regularly review the financial indicators of the bank and make the necessary changes in its strategy according to the results of this review. In addition, the board of directors should determine whether the bank has sufficient capital to cover the risks it carries for all its activities.

Any credit risk strategy should be sustainable. For this reason, in a bank credit strategy, we must consider the cycles in the economy and their impact on the nature and composition of the loan portfolio. The credit strategy should be regularly assessed and necessary adjustments should be made, but it should remain valid in the long run despite various economic cycles.

Credit risk strategy and policies should be informed to bank personnel. All relevant personnel should be precise in their approach to the lending function of the bank and be responsible for acting in accordance with such policies and procedures.

The board of directors should ensure that senior management is fully competent in managing all of the bank's credit activities and that such activities are conducted within the framework of risk strategy, policy and tolerance approved by the board of directors. The board of directors should approve loan criteria (maturities and conditions) on a regular basis (at least on an annual basis) for the bank in the framework of credit risk strategy and credit policy. It should also approve the procedures and principles by which the bank lending functions (including the entire portfolio and the independent examination of the loan function) are organized.

The board of directors outside the board of directors for the bank may foresee a new business area and a credit opening may be the subject. In this case, the amount and amount of the credit should be determined according to the current functions of the bank. Board members should not violate the lending and monitoring functions of the bank in order to prevent conflicts of interest.

The board of directors should ensure that the bank's personnel wage and promotion policies reflect the credit risk strategy. Personnel policies that reward behaviors such as deviating from credit policies in order to profit in the short term or exceeding the prescribed limits lead to a weakening of the bank's credit function.

The senior management of the bank is responsible for the implementation of the credit risk strategy approved by the board of directors. Within this responsibility, the bank's lending activities should be in line with the current strategy, written procedures should be established and implemented, credit approval and review authorities should be clearly and appropriately agreed. Senior management should also ensure that the bank's lending functions are regularly assessed independently.

The cornerstone of safe and effective banking is the creation and implementation of written policies and procedures for the recognition, measurement, monitoring and control of credit risk. Credit policies constitute the framework for the bank's lending activities. Topics such as credit policies and target markets, portfolio structure, factors other than price and price, status of credit limits, approval authority, interim reports are determined. Such policies must be clearly defined, consistent with precautionary banking practices and related regulatory rules, and must conform to the structure and characteristics of the bank's operations. These policies should be developed and implemented taking into account various internal and external factors such as the bank's market situation, trade area, the skill of its personnel and the technology it uses. Properly developed and implemented policies and procedures ensure that the bank is able to: i) carry out reliable lending standards, ii) monitor and control the credit risk, iii) assess new business opportunities appropriately, iv) identify and manage problem loans

Banks should also know and understand the risks associated with more complex credit transactions (eg loans to industrial sectors, securitization of assets, credit derivatives, etc.). This understanding is especially important if the credit risks that are not new to banking but are more difficult to understand and require more detailed analysis than the risks arising from traditional lending activities. While new procedures are being formulated for more complex lending activities, the basic principles of credit risk management should continue to be implemented.

The Bank's new initiatives require rigorous planning and careful monitoring to ensure that the risks to be taken are well recognized and managed. Risks associated with banks must be subject to appropriate procedures and controls before they are used or applied, and before they are approved by the board of directors or the committee that delegates approval authority.

It is important for the senior management of the bank to determine whether it is capable of realizing the transaction in accordance with the bank's policies and procedures and in accordance with higher standards in the face of a transaction in which the related personnel have new or known basic and complex risks of the borrower.

3.2. Finding a Reliable Crediting Criterions.

Banks must work under conditions that are reliable and clearly defined. These criteria should be content that allows the borrower and the structure of the borrower, the purpose of borrowing, and the repayment source to be adequately informed.

The effective provision of the loan is based on the establishment of a credible and well-defined credit granting criteria. This criterion should clarify such things as the suitability of the borrower, what amount, condition and what type of loan can be given in the loan.

Banks should provide sufficient information to allow the borrower to assess the actual risk profile in detail. Documents related to the loans presented to him must include at least the following points.

- The purpose of the loan and the source of the necessary funds for repayment,
- credibility and reputation of the claimant,
- the current risk profile (including the nature and amount of all risks), vulnerability to market and economic developments,
- Assessment of current situation and past payment performance for repayment according to past financial trends and cash flow projections,
- Analysis of the repayment capacity according to various scenarios,
- Assessment of the legal status of the borrower to obtain the debt obligation,
- For commercial loans, the status of the sector in which the business operator operates, the entity's past activity and position in the sector,
- Preparing the terms and conditions envisaged for the loan and the possible future changes in the financial condition of the client requesting the loan,
- Assessing suitability and adequacy of guarantees and guarantees by forming various scenarios.

Once the criteria for the lending procedure have been established, the bank must be confident that the information gained is sufficient to enable it to make accurate and appropriate credit decisions. This information will also be a data item for the evaluation of the bank's internal credit rating system.

Banks have to know who to give their credit to. Before entering a new loan relationship with this nen, a bank should be sure that the borrower has a credible reputation and credibility. In particular, strict policies should be made to avoid doing business with people dealing with fraudulent and illegal activities. There are several ways to do this, such as accessing credit records, getting references, knowing the authorities responsible for the company's management, checking personal references and financial records, and so on.

With respect to loans, the banks should, if appropriate, establish appropriate procedures for the determination of circumstances to be considered as a single borrower by aggregating the related companies into a group. In addition to bringing together the risks associated with the accounts of related companies, banks should also develop procedures for bringing the risks associated with individual customers together according to business lines.

Many banks may give syndicated loans or similar credits. Some organizations may require credit analysis of their undertakings or credit ratings on commercial credits. Banks participating in the syndication must independently conduct their own credit analysis and examine the timing of the syndication before participating in the syndication. Each bank should analyze the effect of the syndicated loan and the risk as it is on other loans.

Credit lending for banks requires both risk taking and profit. Banks must assess the risk / return relationship for each loan as well as the profitability account. The credits should be priced taking into consideration all the costs involved and meeting the risks that the bank assumes. When it is considered that the loan is to be given and in which currency, the banks should evaluate the risks to be taken against the charges they are expected to take into consideration, as far as possible, the items that can be charged and unposted (such as guarantees received, restrictions placed on the contract). In assessing the risks, banks should also evaluate the pessimistic scenario and its impact on the borrower. The general problem with the bank is that the correct pricing of the loans can not be made and therefore the risks can not be sufficiently compensated.

Banks must have adequate capital to cover their risks and unexpected losses, which should be aware of the provision of provisions for estimated losses due to potential risks. The Bank should include these aspects in its credit decision-making process and portfolio monitoring function.

Banks may benefit from guarantees and guarantees in order to reduce the risks they are exposed to in individual loans, but transactions must first be made by assessing the repayment capacity of the borrower. Buying collateral should not lead to an ineffective assessment of the credit area nor of the inadequacy of the information gained. Banks should not forget that the value of collateral can also be affected by the same factors that would put the credibility of the loan into jeopardy. The banks should develop procedures for the acceptance of policies and guarantees of what kind of guarantees can be accepted and should have appropriate operations according to the continuity of the guarantees and the realization of the accruals. Regarding guarantees, the banks should assess the legal capacity of the guarantor and the adequacy of the guarantees provided in accordance with the nature of the loan. Banks should include only explicit guarantees in their credit decisions, not government guarantees.

Banks may benefit from guarantees and guarantees in order to reduce the risks they are exposed to in individual loans, but transactions must first be made by assessing the repayment capacity of the borrower. Buying collateral should not lead to an ineffective assessment of the credit area nor of the inadequacy of the information gained. Banks should not forget that the value of collateral can also be affected by the same factors that would put the credibility of the loan into jeopardy. The banks should develop procedures for the acceptance of policies and guarantees of what kind of guarantees can be accepted and should have appropriate operations according to the continuity of the guarantees and the realization of the accruals. Regarding guarantees, the banks should assess the legal capacity of the guarantor and the adequacy of the guarantees provided in accordance with the nature of the loan. Banks should include only explicit guarantees in their credit decisions, not government guarantees.

Netting agreements are an important way to reduce credit risk, especially in interbank transactions. In order to reduce the risk in real terms, such agreements must be reliable and legally feasible.In-house confidentiality and reliability arrangements should be made to prevent any conflicts of interest within the Bank or, if such a potential exists, the bank's ability to secure sufficient information about the borrower.

Banks must create both balance sheet and off-balance sheet accounts to the group of companies associated with the approach can lead to significant risks and the general credit limits for individual borrowers in both the banking and trading books when they come together.

One of the most important elements of credit risk management is to identify the boundaries of the individual credit risk of customers and affiliates may undertake against the group consisting of the bank. These limits are usually determined by the bank's internal rating system, the higher the risk-taking limits for customers can be provided with a better rating. In addition, risk limits should be established for sector, geographical region or specific products. Establishment of similar limits is necessary for all activities in which the bank may be exposed to credit risk. These limits allow the bank to diversify its lending activities accordingly. Some of the banks due to the credit risk they faced up to the trading book and off-balance sheet activities. The limits for these transactions will be effective in effectively managing a bank's entire credit risk. These limits are binding for effective application and should not be changed according to customer requirements.

The bank's credit limits should be established by considering how the liquidity position will be affected if there is any credit loss. If the Bank has made more than one transaction with the debtor, the potential loss risk that may arise from the debtor will change intermittently and significantly to the valuation. Future potential risks should therefore be accounted for by multidimensional time cycles. The limits should also be adjusted according to the scenario for the liquidity situation.

The banks should monitor the risks that may be incurred in comparison to the limits they establish and should include procedures for increasing the monitoring function and taking appropriate measures to meet the limits.

There are a large number of staff in the lending function of the banks. These people function in functions such as credit approval, loan analysis and credit marketing. On the other hand, the same bank customer may be associated with different departments of the bank according to the credit type. The bank may follow various ways in the distribution of authority. However, it is important to take credible credit decisions that the lending function is structured to coordinate the efforts of all staff working on the issue.

For effective loan portfolio management, the bank should formulate formal evaluation and approval functions for creditors. Credit approvals must be in accordance with the bank's written procedures and must be given to the appropriate management unit. There should be clear audit documentation indicating the suitability of the confirmation function and the person or committee that provided the decision and data. Banks create specialized credit groups for the analysis and approval of loans by sector, region, product group or credit line. Banks should invest in appropriate credit risk sources to be able to make reliable credit decisions in accordance with credit strategies.

Each credit proposal should undergo a careful analysis of credit analysts in accordance with the size and complexity of the transaction. The effective evaluation function should determine the minimum qualification level of the information to be analyzed. Policies should be developed for the continuity of pre-approved credits, the renewal of existing credits, or the amendment of the legislation and the ratification of new credits. The information obtained forms the basis for the evaluation or rating of the credit and the correctness and adequacy of this information plays a critical role for the bank management that decides on the acceptability of the credit.

Banks should form a group of experienced personnel with experience and background experience in implementing the voluntary decisions made for possible credit risks. The credit granting and approving function of a bank must include the appointment of the authorities responsible for making credit changes or issuing credit approval and the identification of the responsibilities of the decisions taken.

3.3. Basel I and Basel II credit risk regulations.

The regulations made by the Basel Committee under the BIS (Bank for International Settlement) framework foresees effective capital management and market discipline in the banks and the transfer of the capital of the banks to a certain standard in order to provide confidence in the system by taking account of the adverse developments that may occur due to various reasons.

Basel agreement has led to a significant change in the habits of business owners who demand banks and credits in terms of determining the loan interest rate and which items will be accepted as collateral.

Basel I agreement has set out the basic criteria that banks must meet in order to increase their resilience to crises and financial distress and to ensure financial stability. Basel I agreement suggests that banks should apply certain methods when lending and that risk-taking coefficients should not exceed a certain value. At the same time, international standards have been set in the capital adequacy of banks in order to provide them. Accordingly, the capital ratio of the risk-weighted assets was set at 8%. When a bank allocates a resource for a specific use, it has to hold 8 units of capital for 100 units it generates when allocating cash and non-cash risk. In other words, the bank or credit institution that will give credit may take up to 12.5 times the risk of the capital. In this case, the banks or credit institutions that are to allocate new credits will have to go to the capital increase if they do not complete the risk quintile. This obligation will naturally reflect the customer as the cost of the new loan. The capital adequacy ratio formula according to Basel I is as follows:

$$Capital\ adequacy\ ratio = \frac{\text{Capital}}{Credit\ risk\ weighted\ assets} \geq 8\%$$

The credit risk in the Basel Capital Adequacy Ratio refers to the situation that occurs when the bank fails to fulfill its obligation partially or completely in time, in compliance with the requirement of the contract to be issued. Credit risk is a net loss that arises after deducting collectible values from one direction. The risk of credit also includes the loss of market value caused by the impairment of the other party's financial position.

In accordance with the loan request, the required documents and information are provided by the borrower and are discussed at the credit committee or at the highest level of the bank's board of directors.

In recent years we have experienced the globalization process in financial markets and Basel I began to be inadequate in the face of changes in technology. The proliferation and complexity of financial products made it difficult to implement Basel I agreement . Furthermore, banks do not only carry credit and market risk. When calculating the capital adequacy ratio, other risks should also be taken into account by the bank.

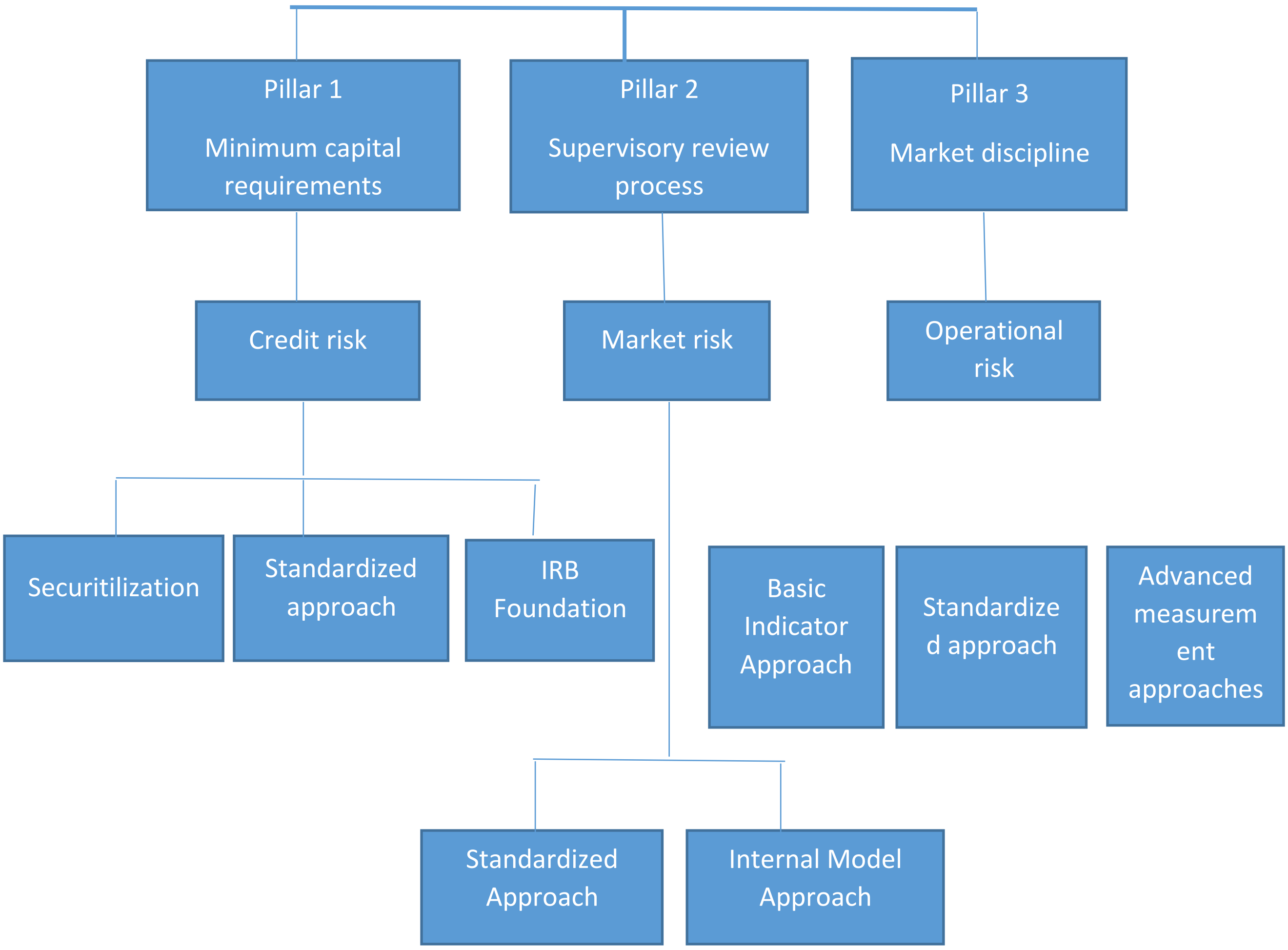
The concept of capital used in the approach of Risk-Based Capital does not adequately express the capacity of a bank to meet its unexpected losses.

The used risk measure is not satisfactory. When assessing the risk of assets, the differences in credit risk are not sufficiently considered. As a result, the banks could go to arbitrage by making financial instruments change in order to be able to hold risk-based capital ratios.

The fact that the risk criteria that constitute the basis of capital adequacy calculation is not enough. only the credit risk is defined, there is not a sensitive risk differentiation between assets held and financial institutions, the risk is not included in the calculation of the risks in the portfolio, and the most important is that the OECD countries have 0% risk to their governments, 20% risk to the debt of the member countries to the banks, while the non-OECD countries have assumed a 100% risk weight of competition inequality are insufficient to ensure that banks have a riskier capital base, which can be counted as the most important deficiencies of the Basel I standard.

The most important change coming with Basel II is foreign debt ratings is considered. According to current standards, 100% risk weight will be applied due to country rating instead of 0% risk weight applied to the country's treasury papers. This means that not only for our country but also for all countries with low ratings, costs increase in foreign trade financing and in foreign borrowing.

The structure of Basel II is as following:



3.4. Reconstruction of problematic loans

Restructuring work in banking is usually carried out with debt restructuring. Otherwise, it is likely that there will be new crises. For this reason, the state is mediating the restructuring process. The most well-known model among these restructuring models is the London Approach.

Due to the economic crises in the world, deterioation in the economic structures of the corporations which play an important role in the economies of the countries, the financial crises and its negative effects on the country's economy make it necessary to take some economic measures.These measures are seen as "restructuring" in the economical language . With this process, restructuring approaches have begun to be implemented by the states.

"In general term, restructuring is defined as the strengthening of the financial structure of banks and other institutions to increase the bank's and other institutions' net worth and thus the ability to fulfill their obligations". The main purpose of the restructuring of banks and other businesses is to improve the financial conditions of institutions and to achieve the power of payment, to increase the profitability levels and to improve the intermediation capacity of the institutions.

With corporate restructuring;

- Restructuring of the companies that are able to sustain their existence, liquidation of those that can not sustain their existence,
- Strengthening the financial sector,
- It is aimed to provide conditions for long-term economic growth.

The role of the state in the restructuring programs is very important. In order to make institutional restructuring programs successful, the government must fulfill certain tasks. The state should play a leading role in reducing the economic and social costs of the financial crisis, constructively correcting negative situations in the real sector and eliminating problems among different interest groups.

According to the restructuring approaches, the state is the intermediary between the debtor firms and banks or between the banks themselves. If there are factors that prevent banks from coordinating the restructuring among themselves, the state will take over the role of intermediary by entering into action here. The state ensures the business is managed by taking responsibility for ensuring harmony among companies, banks and banks themselves. The factors that prevent banks from coordinating their own restructuring include lack of bank capital, inability to communicate properly between borrowers and creditors, or lack of incentives to restructure debt due to ineffective management and supervision. These negative factors constitute a serious cost for companies. Borrowers cause the companies to be liquidated unnecessarily. This situation extends the restructuring process.

To prevent this emerging case, the state must act as a mediator in a more systematic and coordinated manner.

3.4.1. Financial Restructuring: London model.

The most well-known model among the state-mediated restructuring models is the "London Approach". The London approach applied in the UK for the first time, provides guidance to banks and other creditors about how companies that are experiencing economic problems will solve these problems. The London approach is a restructuring system aimed at restructuring the debts of the real sector, whose financial structure is getting weaker and failing to fulfill its financial obligations, by the banks that are creditors of these debts, so that the companies that have come to the financial structure collapse can strength and continue to their former existence. One of the most accepted approaches by the real sector has been the London Approach, since this system allows for more structured resolution of unpaid bank debts outside the bankruptcy option. This approach is based on the principle of voluntary acceptance of solution by banks' .

The London Approach was first put into effect by the Bank of England in 1970s. It is a set of principles that play an active role in the restructuring debts of companies faced with the financial crisis , provide guidance in a sense, and have no binding legality. It is one of the state-mediated restructuring models, and the most common of these restructuring models. The banks in the UK faced with high inflation and economic stagnation in the mid-1970s were forced to create corporate rescue units because of the loans companies suffered from crisis could not afford.

In the mid-1970s, Britain entered a period of stagnation with high inflation. Commercial banks have set policies for debt settlement to set up credit monitoring units and to find solutions to increasingly large-scale follow-on loans. However, the Law did not include the necessary means for restructuring as there was no adequate data on the functioning of credit monitoring units at that time and no necessary revisions were made in the Execution and Bankruptcy Law. The Bank of England then decided to implement the "London Approach", known as non-binding rules, to help the debt restructuring process. Nevertheless, the Central Bank decided to involved actively in corporate rescue operations because there was lack of experience in this matter and the Execution-Bankruptcy Law did not permit voluntary restructuring.

The main objective of the London approach is to take an approach to both banks and other creditors about how follow procedures when they face the challenge of problem loans. However, since the rules are by no means a legal sanction the decisions of the Central Bank are of a recommendation. Since the Central Bank is not a sanction force, banks and other parties are acting in their own interests. Nevertheless, the London Approach does not guarantee that a company with financial difficulties will survive while preventing banks and other creditors from suffering unnecessary losses and resolving problems. The regulatory authorities do not have any intervention in the process. In the London Approach, it is necessary to have extensive participation in the process and to be based on the principle of "volunteering". The London Approach, although implemented in different forms in different countries, has some common features in each country142.

Since the Central Bank is not a sanction force, banks and other parties are acting in their own interests. Nevertheless, the London Approach does not guarantee that a company with financial difficulties will survive while preventing banks and other creditors from suffering unnecessary losses and resolving problems. The regulatory authorities do not have any intervention in the process. In the London Approach, it is necessary to have extensive participation in the process and to be based on the principle of "volunteering". The London Approach, although implemented in different forms in different countries, has some common features in each country.

In the 1980s, as a result of economic growth and developments in the financial sector, the Bank of England looked at companies' policy on debt restructuring and took a decision to leave the development of restructuring strategies to private sector and stepped back to establish direct links with companies experiencing economic contraction. The new role has also been identified as a supporting diplomat and catalyst for the parties to reach out to useful solutions during the restructuring process. As early as the early 1990s, as a result of negotiations with the banking sector it decided not to formalize the restructuring efforts in accordance to probability of the foreign banks against the strict rules,. In order to make the approach flexible and easily adaptable, it has been deemed appropriate to conduct informal interviews instead of official documents. This approach has been adapted in many countries.

3.4.2. The Functioning of the London Approach

There are three main principles of the London approach. These;

- that banks act for collective interests rather than for individual interests.

- Decisions on the binding of debts to the new terms are taken unanimously.

- Related to the outcome of formal bankruptcy proceedings losses and profits are distributed proportionally among the creditors in order of priority.

The basic elements of the London Approach are as follows:

- Principal buyers should be willing to resort to non-legal remedies instead of to resort to formal bankruptcy proceedings due to financial difficulties of the company from the very beginning.

- At the same time, creditors have to analyze the power of long-term survival of the company with the help of information presented and shared with all parties.

- In the course of the review, the creditors of the firm should allow the company to continue its activities normally so that suppliers and customers will not lose confidence.

- From the way out investigation, the main creditors have to make a joint decision on whether the company is worth long-term support and how to support it.

- To speed up these studies, a coordinator or a leading bank can be selected and a monitoring committee can be established.

- In addition, if the debtor firm encounters sudden liquidity problems, it may be necessary to make new additions to the existing loan of the firm.

- If the buyers agree that the company can survive, they can provide longer financial support. The firm's long-term financial need should be met within a jointly agreed plan.

Among the basic principles of the London Approach are the following points: There is wide participation in the restructuring process and voluntary action is important. At this point, it can be said that it is based on continuous volunteerism. For firms that are experiencing serious financial crises, banks are particularly vulnerable to credit and there is no pressure for bankruptcy to corporate that is experiencing economic difficulties. The legal way in the remediation process should not be preferred first. The aim is to ensure that the company maintains its economic presence. The banks are acting together on reconciliation. When it is necessary to make a decision about the future of the company, a joint decision is taken by all the banks on the basis of the comprehensive information obtained about the company.

Conclusion

For Azerbaijani banks, as for other banks, lending is one of the most profitable types of their activities, but at the same time high-risk. This requires banks to exercise close monitoring compliance with established credit principles, as well as target use of credit by borrowers and their efficiency generally. The bank must have timely and accurate information on the credit risks to which it is currently exposed. For the banking sector, in order to continue its activities effectively, an effective control and supervision system is required.

Supervision guidelines should be established in line with the recommendations of the Basel Committee for all countries.

The main objective of supervisory and audit is to ensure that banks are able to hold sufficient capital for the risks they are carrying and ensure that they operate in an environment where reliable conditions have created. The costs of the inspection and supervision function are high, but the problems that a poor supervision system can incur will cost more.

The main objective of the supervision and audit function in banking is to ensure stability and confidence in the financial system and thereby to minimize the risks that borrowers and borrowers will be exposed to.

It is imperative that the supervisor and auditor be independent in their activities so that they can fulfill their responsibilities and maintain their duties effectively. Effective banking supervision and control requires knowledge of the risk profile of each bank and the appropriate allocation of resources for the denomination.

Each bank can face bad debt problem since risks cannot be predicted exactly. However there are some tips which can help to banks in avoiding bad debts. Firstly, credit limits should be set appropriately in accordance to customer's solvency. Banks shouldn't lend high amount of money to new customers even it is confident that they are able to pay it on time. Terms and conditions must be clear and customer awareness has to be provided. Bank should send invoices to debtors and should remind customers additional interests on an overdue payment. But the problem can still occur then there is needed more advance strategies to overcome this problem.

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