

**The Ministry of Education of  
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**Credit Risk Management of Bank and  
Non-bank Credit Agencies**

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## **Abstract**

The greatest objective of the banks is to make as much benefit as could reasonably be expected. Today, Major issues of banking industry in Azerbaijan and other countries is credit risk management and increasing on credit losses. Credit risk management procedure covers such a large number of risk, for example, credit, market, liquidity, etc. and in this research I will try to explain them all. This research subject covers many scientist`s research,opinions and different sources.

In this research, also mentioned to other countries (Turkey,Russia,European Union) credit risk management experience and key factors for how to provide succesful credit risk management policy according to this countries experiences.

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# 1 Introduction

## 1.1 Brief information about theme of the study

The essence and sources of credit risk should be considered in the context and interrelations of banking supervision in four main risk categories: credit risk, market risk, liquidity risk and operational risk, which will give an idea of the nature of these risks and the importance of their control and management, including number and methods of documentary supervision and inspection.

The credit risk of a bank can be determined as the maximum future loss that can occur with a specified admissibility for a certain period of time due to a reduction in the estimation of the loan portfolio, due to a partial or full insolvency of the borrower at the time of loan repayment.

Bank credit risk involves the risk of a portfolio and the risk of a lender.

Under the terms of this definition, the germ of credit risk is a separate, certain credit borrower. Among credit there are risks from the dishonesty of private clients, non-return from corporate clients, as well as the risks that a state will lose the ability to pay its obligations. Credit risk management includes:

- dealing with a bank's advance portfolio, the standards of which are reflected in the applicable arrangement as an arrangement for putting credit assets, and so forth.;
  - satisfaction of the credit function;
  - steady checking of the nature of the loan portfolio;
  - the distribution of non-performing loans and the improvement of measures for their return;
  - decrease of credit risks by limiting too much vast loans to an individual, area or even a country, making a booking framework for potential misfortunes, and so on.
- In addition to ensuring the repayment of loans, the bank must raise funds on deposits, since at the expense of own funds only a small share of crediting is made.

Bank credit risk is a risk in which it is considered that the borrower or the debtor may not be able to fulfill the obligations specified in the contract (or agreement). This is the risk of insolvency of the debtor or the borrower.

First, the carriers of credit risks are transactions of the following types:

- direct (pre-delivery) and indirect (post-delivery) lending;
- asset trading without prepayment from the counterparty;
- transactions without a guarantee from the third parties;
- credit risks include the possibility of a debtor's losses. And it's not just about financial loss.

Important factors are also: downgrading the company's rating on the territory, the uselessness of the industry, undermining business reputation, etc., that is, all because of which the borrower will not be able to pay the debt. but the failure to perform duties before the tenants is not all that the bank risks.

Bank credit risk may also be indirect, for example, if the price of the issuer's securities falls or the number of credit reserves needs to be multiplied.

During the establishment of credit risks, the following factors are considered:

- The risk of bankruptcy.
- The admissibility of the fact that the borrower after some time will not be able to pay the loan.
- Credit rating.
- Evaluation of the reliability of various securities.
- Credit migration.
- The possibility of changing the credit rating of the debtor, operation, counterparty, issuer.
- Amount subject to bank credit risk.

- loss that the bank may incur in case of bankruptcy.

As a rule, any relationship implying debt obligations and linking the lender and the borrower carry a certain amount of risk.

Credit risk is what the bank should consider when receiving a new application. It is necessary to review in detail the credit history provided by the loan creditor, his occupation, as well as all the information relating to him. Directly assessment of bank credit risks should be implemented by credit department specialists, since this type of activity requires meticulousness and a professional approach.

The main income of a commercial bank is mainly the income received from credit activities. That is why it is important for the bank to be able to determine the possibility of loan repayment by the borrower. The credit risk of a commercial bank is the main risk that affects effectiveness of banks work

The credit market has recently increased significantly in our country, and with it credit risks have increased. The reasons for the growth of these risks are the increase in the number of borrowers and the size of loans provided. The increase in credit risks is reflected not only in individual lending entities, but also in the entire banking system of our country.

There are several factors that identify the credit risk of commercial banks:

- external - associated with the state of the economic country, monetary, foreign and domestic policy of the state, its possible changes under the influence of state regulation;

- internal - associated with the activities of the lender and its client-borrower.

External factors are quite difficult to calculate and predict, but it is possible to reduce to some extent the losses caused by them. But the internal credit risks of commercial banks directly depend on its activities, competence of the manager and professionalism of the bank staff. The ability to respond in time, predict and prevent

unpaid debts affect all bank operations - this is an important point in credit risk management that can significantly affect the well-being of a bank.

## 1.2 Objective of the study.

Objective of this study is explaining the credit risk that banks and non-bank credit organizations facing, researching factors that increase credit risk in Azerbaijan and finding how to provide positive directly credit risk management policy for credit organizations with using Worldwide experience

## 1.3 Importance of implying credit risk management

One of the mandatory conditions of credit management is that the bank should not provide loans, under conditions that cannot be carefully assessed by bank specialists. Consequently, the specialization of loan officers, qualifications and experience also have a great influence on the characteristics of a bank's loan portfolio.

In forming the structure of the bank's assets, the key factor is the level of profitability of each type of assets. But high profitability, in most cases, is accompanied by a high level of risk; as a result, the bank's management must take both factors into account. If the level of profitability of various types of assets is about the same, then the least risky areas of placement of funds are preferred. In such a situation, the size of the bank's loan portfolio may decrease in favor of the securities portfolio or in favor of other types of active operations.

The level of credit danger of every borrower legitimately influences the level of financing cost on the loan. A high level of risk is associated with a high loan rate, and vice versa. But the loan rate depends not only on risk. It is formed under the influence of the following external and internal factors that must be considered when determining it:

- supply and demand in the loan market,
- the level of competition
- the level of credit risk that is related with a specific client,



- credit policy of the bank
- a category of clients that reflects a bank oriented to the development of relations with this borrower,
- the overall level of profitability of all relations with the client;
- the cost of credit resources for the bank,
- level of base rates,
- A form of collateral and the cost of monitoring its condition.

## 2 Information about credit institutions and their activities.

### 2.1 Banks and what do they perform.

Banking system means historically living and legislative system or organization in a particular country. It includes all banking and non-banking institutions performing separate banking operations. Legislation determines the structure of the banking system, establishes the scope of activities, subordination and responsibility for various institutions within the system.

According to the criterion of property rights, credit and financial institutions differ:

- government credit and credit and financial;
- private credit and credit and financial;
- cooperative;
- mixed (represent different forms of ownership).

The first group includes all central banks and individual credit banks (CB) or specialized institutions, nationalized in full or through the acquisition by the state of a controlling stake. Private financial institutions can be formed on basis of any form of ownership. In international practice, the shareholder form of a banking organization prevails.

By the nature of the activities of the banks are divided into commercial and specialized. Commercial banks are usually universal. Universal banks perform all types of credit, settlement and financial transactions.

Specialized banks limit the number of banking operations to one or three types of services or single out one of the types of activity. These banks are mainly classified according to three criteria:

- functional;
- industry;
- by customers.

Separately, we single out the territorial feature. According with it, banks are divided into international, national, regional, interregional, municipal, foreign (for example, Russian banks abroad). In addition, in the process of concentrating and centralizing banking capital, various associations of banks and other credit organizations may appear consortia, corporations, associations, etc.

The totality of the country's credit institutions, forms and methods of lending is a credit system. The credit system accumulates free cash and turns it into loan capital. Organization of the credit system (below the banking system) can be single-level and two-level. Banking systems of some countries have 3–4 levels, but, as a rule, these are subsystems of the first or second level. Modern banking systems, as a rule, two-level:

Level I - CB,

Level II - all types of CB and other credit organizations.

### Bank Disadvantages

Because of the job they play in the economy, banks are very directed. These guidelines limit the introduction to hazard that banks can take, which implies they aren't entirely adaptable in their loaning gauges or different arrangements. On the

off chance that you have poor credit, it tends to be elusive a bank willing to loan you cash, even at a high-financing cost.

Guideline additionally restrains what banks can do in different ways. Capital necessities limit the sum that banks can loan, which can particularly affect banks that work together abroad. A solid dollar in respect to outside monetary standards can put U.S. banks in a less aggressive position contrasted with remote counterparts. Banks have expanded their expenses after some time, both as far as the sum charged for explicit administrations and the circumstances that can lead them to charge clients. Bank guidelines can make constrained access your cash. On the off chance that you have a check from another establishment, for instance, you may need to trust that the assets will be made accessible to you after the check store.

## 2.2 Non-bank credit organizations and what do they perform.

At an essential dimension, a non-bank money related organization gives some financial administrations without gathering the lawful meanings of a bank, or budgetary establishments working without a permit. This can cover numerous structures, the same number of sorts of establishments offer some monetary administrations without qualifying as a bank. Non-banking organizations include various funds, unions, societies and other commercial organizations that perform certain banking operations on the financial market in accordance with the license received. Among the numerous kinds of organizations that may fill in as a non-bank money organization may be:

- Insurance firms
- Check-getting the money for administrations
- Pawn shops
- Hedge reserves
- Payday loan specialists
- Currency trades

Tasks of non-bank monetary establishments are regularly still secured under a nation's financial guidelines. Non-bank monetary organizations (NBFCs) offer many types of banking administrations, for example, private schooling subsidizing, retirement arranging, exchanging currency markets, guaranteeing stocks and shares, TFC (Term Finance Certificate) and different commitments. These foundations additionally give riches the board, for example, overseeing arrangement of stocks and offers, limiting administrations for example limiting of instruments and counsel on merger and securing exercises. The quantity of non-banking budgetary organizations has extended extraordinarily over the most recent quite a while as investment organizations, retail and mechanical organizations have entered the loaning business. Non-bank establishments additionally as often as possible help interests in property, market or industry thinks about for organizations. Anyway they are commonly not permitted to take stores from the overall population and need to discover different methods for subsidizing their tasks, for example, issuing obligation instruments.

Some non-banking money organizations may better serve clients who can't be served effectively by banks, or the individuals who banks don't look for as clients. For instance, a registration outlet can give low-salary clients a more affordable option than a bank, if the bank charges expenses for those unfit to keep up a base store. Other non-banking fund organizations serve the opposite end of the money related range. Multifaceted investments, for instance, pool cash from a gathering of speculators and put the assets in manners that stress potential returns over hazard. Their absence of guideline enables chiefs to choose openings that give a greater payout than anything a bank could offer – if the wager satisfies.

### Non-Bank Disadvantages

Because non-bank moneylenders will in general interpretation of more hazardous advances, their loan costs frequently are higher. You'll pay an expense to money a check at an independent registration store, for instance, yet an immediate store into a financial records shouldn't cost you a thing. Payday banks can charge triple-digit

financing costs for momentary credits, if state guidelines permit, since no government office is in charge of them. The absence of solid guideline builds dangers for the client, the loan specialist and now and again the economy. Bernie Madoff was the point of convergence of a money related embarrassment that broke in 2008, in light of the fact that his under-controlled store was producing numbers

### 2.3 Difference between bank and non-bank credit organization.

The distinction among banks and NBFCs is primarily in the idea of the liabilities of the two and, somewhat, in the structure of their advantages. While the liabilities of business banks more often than not comprise of interest and time stores, those of NBFCs don't conventionally incorporate interest stores, the shared advantage budgetary organizations, being prominent special cases. Since interest stores which are withdrawal with a money order are viewed as a part of 'cash', it is the level of cashness of the liabilities of the two sorts of organizations which comprises a noteworthy contrast between the two. From the perspective of advantages held, it might be said that business banks hold a wide assortment going from present moment and medium-term to long haul credits furthermore, they likewise utilize different credit instruments like overdrafts, money credits, bills, and so forth. On the other hand, the advantages of NBFCs are progressively particular. For example, contract buy fund organizations restrict their activities chiefly to the financing of transport tasks and buyer credit while lodging fund organizations make advances for lodging reason. It may, nonetheless, be expressed that the distinction in the idea of advantages held by business puts money on the one hand and those held by NBFCs on different does not unmistakably delineate the separate fields of the two since business banks are additionally, generally, making progresses in fields like transport and shopper credit, which were prior considered as out of their domain.

Credit organizations			
Banks		Non-bank financial organizations	
Emission	Non-emission	Specialized Credit and financial institutions	Post office savings organizations

CB	Universal banks	Specialized banks
RegionalCB		Functional
		Client

Table 2.1 Structure of credit system

Numerous exercises and elements of NBFC's are like those of banks. The refinement between them has turned out to be significantly obscured. The facts confirm that NBFCs, in contrast to banks, are still not a piece of installments instrument. They can't make cash yet in numerous other regards, they are substitution and correlative with banks. NBFCs are doing capacities much the same as that of banks; anyway there are a couple of contrasts:

- A NBFC can't recognize demand stores;
- A NBFC isn't a bit of the portion and settlement system and in this manner a NBFC can't issue check drawn on itself;
- Deposit security office of Deposit Insurance and Credit Guarantee Organization isn't accessible for NBFC contributors dissimilar to if there should be an occurrence of banks.

### 3 Risk management of credit institutions.

#### 3.1 The main risks facing credit institutions.

The most recent risks that bank faces are the followings:

1. Credit risk

2. Market risk

3. Operational risk

- Credit risk is the potential misfortune a bank would suffer if a bank borrower, otherwise called the counterparty, fails to meet its commitments—pay interest on the advance and reimburse the sum obtained—as per concurred terms. Credit chance is the single biggest risk most banks face and emerges from the likelihood that credits

or bonds held by a bank won't be reimbursed either somewhat or completely. Credit risk is regularly synonymous with default chance.

- Market risk is the danger of loss to the bank emerging from developments in market costs because of changes in loan rates, outside trade rates, and value and ware costs.
- Operational risk is the danger of loss coming about because of insufficient or wrong internal processes, persons and frameworks or from outside events. This definition incorporates legitimate risk, however, avoids strategic and reputational chance.

### Other Risk Types

Past the three primary types of risk—credit, market, and operational—there are different dangers banks face and should oversee appropriately. Here is a posting of some of them:

- Liquidity risk identifies with the bank's capacity to meet its keeping obligations, including financing its benefits.
- Business risk is the potential misfortune because of a reduction in the aggressive position of the bank and the possibility of the bank thriving in evolving markets.
- Reputational risk is the potential loss coming about because of a reducing in a bank's remaining in public opinion. Recouping from a notoriety issue, genuine or saw, isn't easy. Organizations have lost impressive business for no other explanation than loss of client certainty over an advertising issue, even with moderately strong frameworks, procedures, and funds set up.

Any exchange or undertaking with a component of vulnerability as to its future result conveys a component of risk: risk can be thought of as vulnerability. To relate specific resources, for example, values, securities or corporate money streams with kinds of risk, we have to characterize "chance" itself. It is helpful to characterize it

as far as a risk horizon, the time when a benefit will be acknowledged, or transformed into money. All market members, including examiners, have a horizon.

There are various meanings of risk. Every one of us has a meaning of what chance is, and we all perceive a wide scope of dangers. A portion of the more generally talked about meanings of risk incorporate the following:

- The probability an undesirable occasion will happen
- The extent of loss from a sudden occasion
- The likelihood that "things won't go right"
- The impacts of an adverse result

Basically, then the horizon is the timespan inside which risk is being considered. Once we have built up a thought of horizon, a working meaning of risk is the vulnerability of things to come absolute money estimation of a speculation on the financial specialist's viewpoint date. This vulnerability emerges from numerous sources.

For members in the financial markets risk is basically a proportion of the instability of benefit returns, despite the fact that it has a more extensive definition just like any sort of vulnerability as to future results.

Banks face a few sorts of risk. All coming up next are instances of the different danger's banks experience:

- Borrowers may submit installments late or flop by and large to make installments.
- Depositors may request the arrival of their cash at a quicker rate than the bank has held for.
- Market financing costs may change and damage the estimation of a bank's advances.
- Investments made by the bank in securities or privately owned businesses may lose esteem.



- Human info errors or extortion in PC frameworks can prompt misfortunes.

To monitor, oversee, and measure these dangers, banks are effectively occupied with risk management. In a bank, the risk the executives work adds to the administration of the dangers a bank faces by ceaselessly estimating the danger of its present arrangement of advantages and different exposures, conveying the risk profile of the bank to other bank capacities and by making strides either legitimately or as a team with other bank capacities to decrease the likelihood of misfortune or to relieve the measure of the potential misfortune.

From an administrative point of view, the size and danger of a bank's benefits are the most significant determinants of how much administrative save capital the bank is required to hold. A manage an account with high-risk resources faces the likelihood that those advantages could rapidly lose esteem. In the event that the market—contributors—sees that the bank is precarious and stores are in danger, at that point anxious investors may pull back their assets from the bank. On the off chance that an excessive number of contributors need to pull back their assets in the meantime, at that point dread that the bank will come up short on cash could break out. The bank might be compelled to sell its advantages under pressure. To dodge this, controllers would need a keep money with high-risk resources for have more holds available. Therefore, understanding financial guideline requires understanding financial risk management

### 3.2 Implying Basel pillars for preventing risks.

The Basel Committee is a gathering for administrative collaboration between its part nations on banking supervision-related issues. 2 Representatives of the national banks and banking managers are the council individuals. It's anything but a worldwide supervisory expert: Both the reports and proposals issued by the board of trustees need legitimate power. Rather, the panel figures expansive banking supervisory measures, (for example, the Basel Accords) creates rules for the two banks and controllers and prescribes explanations of best practice. The board of trustees energizes the improvement of normal banking administrative and

supervisory methodologies for globally dynamic banks. It looks to ingrain managing administrative standards without endeavoring to manage part nations' supervisory approaches. A general target of the board of trustees' work has been to close gaps in universal supervisory inclusion in quest for two fundamental standards:

1. Each universal bank ought to be liable to supervision.
2. The supervision ought to be sufficiently generous to guarantee consistence.

To accomplish this, the advisory group has issued a few thorough archives since 1975 that look to improve both administrative comprehension and the nature of banking supervision for worldwide banks. All the more as of late, it has gone about as a wellspring of residential enactment or banking supervision in the European Union (EU). In the EU, the Basel II Accord (clarified in further detail beneath) was embraced, to a great extent unaltered, as the reason for household banking and money related administrations supervisory enactment. This has driven an ever increasing number of nations outside the Group of 10 (known as the G10)<sup>3</sup> and EU nations <sup>4</sup> to either receive or consider embracing Basel II as a reason for their separate financial enactment and guidelines for residential and global banks.

The Basel Committee propelled two accords and one amendment. These reports are legitimately pertinent for directing the capital expected to adjust the dangers of universally dynamic banks. The accords are firmly identified with each other and mirror the advancement and expanded modernity of current-day money and banking. The board of trustees has additionally attempted consultative exercises.

#### The Basel I Accord

The Basel Committee perceived an abrogating need to reinforce the universal financial framework's capacity to withstand stuns. The board of trustees likewise tried to level the focused playing field by institutionalizing national capital necessities. Lower capital prerequisites, or higher influence, imply that the bank can utilize more obligation to finance the credits it makes, which decreases the expense of assets and builds benefit. At the time, worldwide banks in Japan were required to

keep up less capital or were permitted to work with more influence than banks domiciled in different nations, giving the Japanese banks an aggressive edge. In December 1987, the committee distributed a consultative report supporting a proposed framework for the estimation of capital. The record is regularly alluded to as the Basel I Accord. It was endorsed by the governors of the national banks of the G10 nations, Spain, and Luxembourg and was discharged to banks in July 1988.

The capital estimation framework accommodated the usage of a typical structure for capital appraisal as a component of the danger of assets. The Accord acquainted a framework with assistance banks better survey their dimension of risk over all assets. The framework built up risk weightings dependent on the apparent relative acknowledge chance related for every benefit class. The thought was to produce a risk recognizable proof framework to make it conceivable to look at changed sorts of banks and the distinctive kinds of advantages they held. To infer an accounting report weighted by risk factors, each instrument, loan, or obligation is gathered into four general classifications relying upon its apparent credit chance. By and by, banks had a multitude of various resources with various qualities, and the real loads utilized could differ as per the standards of the Accord and the circumspection of the financial manager. This framework enabled banks to consider all their resources, classify each, and after that ascertain their all-out risk weighted assets (RWA) as the whole of the outright estimation of every advantage increased by its risk weight. Risk weighted resources incorporate the bank's advances and securities recorded on the bank's monetary record and furthermore a few responsibilities not recorded on the bank's accounting report. For example, off-monetary record things would incorporate money related subsidiaries, reserve letters of credit, and other unforeseen liabilities that, if at any point activated, could open the bank to budgetary risk. What's more, the Accord made a system for the structure of bank capital, regularly called qualified capital. The Basel Committee considers value capital as the favored component of qualified capital for a bank. Be that as it may, for administrative capital purposes, most banks could hold capital in two levels:

- Tier 1, center capital, is fundamentally the bank's value.
- Tier 2, strengthening capital, for the most part incorporates holds and arrangements just as cross breed capital instruments and subjected obligation. Level 2 capital was limited to be at most half of all out administrative capital.

At long last, the Accord likewise set a base capital prerequisite of 8% for the proportion of RWA for administrative capital. The proportion of the RWA to the administrative capital of the bank is known as the capital proportion or capital standard.

Tier 1 capital is typically the value of the bank;

Tier 1 and Tier 2 capital, with certain changes, as a rule approaches the administrative capital.

The least capital standard of 8% was to be executed before the finish of 1993. Capital ampleness is accomplished when a foundation's capital proportion meets or surpasses the base capital standard. The Accord's regular structure for capital was dynamically presented in practically all nations with dynamic universal banks.

**Weaknesses of Bank Capital Requirements in Basel I Accord:**

The 1988 Accord was planned to advance after some time. In 1991, the Accord was changed to give a progressively exact meaning of general arrangements against terrible obligations that are incorporated into general credit misfortune holds. Since 1991, general credit misfortune holds have been incorporated as capital for reasons for figuring capital adequacy. However, as execution and utilization of the Accord advanced, it wound up clear that Basel I was too oversimplified to even think about addressing the exercises of complex banks. For example, as per Basel I, banks that loaned to organizations with an awesome credit standing were obliged to hold the very same measure of administrative capital as banks loaning to organizations with poor credit standing. Be that as it may, banks could charge higher enthusiasm on advances to organizations with poor credit standing. Accordingly, the Basel I Accord

gave banks—incidentally— with the spurring power to embrace advances to associations with lower credit ratings. These FICO scores are given by FICO assessment offices that routinely assess the financial soundness of a wide scope of borrowers. A higher FICO score, for example, an AAA rating, demonstrates a lower danger of default than a CCC-rating. Since AAA-appraised borrowers offer lower financing costs than CCC-evaluated borrowers, this structure gave banks less impetuses to endorse advances to organizations with great FICO scores. While the motivation behind the Accord was to diminish the general danger of globally dynamic banks, these impetuses really urged banks to guarantee less secure credits.

Another worry with Basel I was that it didn't perceive the advantages of credit alleviation techniques. Credit mitigation strategies help banks decrease the acknowledge risk related for advances using security and advance assurances. Albeit surely not the plan, the Accord did not give banks the fitting impetuses to utilize credit relief methods. Under the Accord, banks could utilize these systems however not get any capital help.

The Accord additionally did not perceive the advantages of expansion for credit risk decrease; a bank that loans to a similar sort of client in a similar district faces more prominent credit chance than a bank that loans to an assorted gathering of clients in the equivalent or distinctive locales of the world.

The council started the Basel II Accord trying to address the downsides and coincidental outcomes of the Basel I Accord.

### The Basel II Accord

In 1999, the board of trustees issued a plan for another capital structure to supplant the 1988 Accord. The new accord proposed to interface capital prerequisites more closely to the real dangers acquired by a bank. It likewise meant to expand the risks banks considered while figuring their base capital requirements. The new accord proposed approaches that would oblige banks' varying complexities in their tasks also, organizations. Above all, it tried to give motivating forces to banks to create

progressively complex internal risk managements frameworks that diminish non-fundamental risk in the financial framework. From an administrative viewpoint, the new accord would give banking bosses with upgraded forces to change shortcomings in individual banks.

In 2004, after long discussions, another capital system, Basel II, was presented. It consists of three pillars:

#### Pillar 1:

Sets least capital necessities intended to improve the institutionalized rules put forward in the 1988 Accord. These base administrative capital necessities ought to mirror the three main types of risk that a bank faces: credit risk, market risk, and operational risk. The approach in Basel II fixes a portion of the assertion or weaknesses in Basel I. Under Pillar 1, banks can look over distinctive options of fluctuating unpredictability to compute their base administrative capital necessities. Basel II additionally speaks to the primary endeavor to relegate an administrative capital charge to the administration of operational risk.

#### Pillar 1 risks:

- The formation of an administration structure inside the bank to guarantee internal supervision and oversight from the directorate and senior administration.
- The assessment, by the financial administrator of the bank's very own risk profile level furthermore, the procedures the bank used to discover that level

#### Pillar 2 risks:

Complements and strengthens Pillar 1 by setting up a prudential supervision process. It covers all the dangers in Pillar 1 and includes some contemplations:

- The computation by the bank of the measure of financial capital, the sum of capital a firm will require to handle amid times of trouble to cover

#### Pillar 3 risks:

Frameworks the successful utilization of market discipline as a switch to reinforce disclosure and empower sound financial practices. Market discipline is open revelation of a bank's money related condition to contributors and other invested individuals, permitting these to evaluate the state of the bank. It identifies with straightforwardness of the bank and its exercises. Divulgence, or straightforwardness, is how much a bank or on the other hand any organization uncovers its benefits, liabilities, as well as inward functions. Exposure bears the market—different banks, contributors, and borrowers—a superior picture of the bank's general risk position and permits the bank's counterparties to cost and bargain properly. The three columns are planned to fortify each other in a methodology intended to reinforce the security and soundness of the worldwide money related system. The complex administrative structure has two general goals:

1. Improve how administrative capital necessities reflect basic dangers
2. Address the impacts of monetary development that has happened.

At the point when a nation fuses the Basel Accord into its banking administrative and supervisory structure, it must do as such by modifying it to its own laws and guidelines. Most individuals from the Group of 10 (G10) have received the Accord by joining the prerequisites into their individual national laws and additionally guidelines with certain alterations what's more, adjustments. The Basel Committee worked intimately with the European Union in building up the new Accord. Obviously, unique nations will have diverse ways to deal with actualizing these Accords. The choice to actualize the Basel II Accord in a nation is persuaded by a few variables:

- The relative achievement being delighted in by banks that utilization risk-based capital
- The longing of many bank bosses over the world to advance toward risk-based guideline

- The craving of numerous nations to improve the notoriety of their financial framework Diverse nations have distinctive financial industry structures and explicit guidelines what's more, guidelines that oversee their business exercises.

The Basel II Accord takes these nation explicit contrasts into thought by permitting the national bank controllers what's more, chiefs in nations that receive the Accord to alter certain Basel definitions, methodologies, or limits that they intend to receive while executing the recommendations. Execution of principles and guidelines subject to a nation's choice are to be founded on household advertise practice and experience and predictable with the targets of the Basel II Accord and its standards.

### 3.3. Credit risk

Credit risk is the loss due to non-performance, untimely or incomplete use of the debtor's financial obligations to the credit institution in accordance with the terms of the contract.

Financial obligations may include these debtor's obligations:

received loans, including interbank loans (deposit there, loans), other funds placed, counting necessities for receipt of obligation securities, stocks and bills, paid under a credit understanding;

- Registered bills of exchange;
- Financing exchanges under the task of a fiscal case
- Acquired credit organization for the transaction (assignment of requirements) rights (requirements);
- Acquired by the credit institution in the secondary market of mortgages;
- Exchanges of offer (buy) of money related resources with conceded installment (delivery of financial assets);
- Letters of credit paid by the credit institution (including covered letters of credit);



- Return of funds (assets) in a transaction for the acquisition of financial assets with the obligation to re-alienate them requirements of the lessor on operations financial lease (leasing).

Credit operations of commercial banks are one of the most important types of banks; activities. In the financial market, lending maintains the position of the most income albeit the riskiest. Credit risk thus, was and remains the main type of banking risk. Credit risk is the risk of default on credit obligations to credit organization by a third party. The risk of this type of risk exists when carrying out loan and other operations equated to them, which are reflected in the balance, and can also be worn off-balance sheet These operations include:

- Granted and got credits (advances);
- Placed and pulled in stores;
- Other finances put, including prerequisites for accepting (returning) obligation securities, offers and bills gave under a credit understanding;
- Accounted bills;
- Payment by the credit establishment to the recipient under bank ensures;
- The money related necessities of the credit association for financing exchanges under the task fiscal prerequisites (calculating);
- The necessities of the credit association for the rights gained under the exchange (the task of the financial limits);
- The necessities of the credit organization for home loans gained in the auxiliary market;
- The prerequisites of the credit establishment for the deal (buy) exchanges of budgetary resources with conceded installment (conveyance of money related resources);

- The prerequisites of the credit association to the payers on the paid letters of credit (in bits of revealed fare and import letters of credit);
- Requirements for the counterparty to restore the assets for the second piece of the exchange procurement of securities or other money related resources with a commitment to invert them distance in the event that securities are unquoted;
- The prerequisites of the credit association to the tenant under the monetary renting.

The level of credit hazard relies upon the accompanying elements:

- monetary and political circumstance in the nation and the area, for example it is influenced full scale and microeconomic elements (the emergency condition of the progress economy period, inadequacy of the arrangement of the financial framework, and so forth.);
- the level of centralization of loaning exercises in specific enterprises, changes in the economy (i.e., a critical number of aggregates issued to a limited hover of businesses);
- reliability, notoriety and sorts of borrowers by kind of possession, capabilities and their associations with providers and different loan specialists;
- bankruptcy of the borrower;
- a huge extent of advances and other financial contracts falling on monetarily tested clients;
- convergence of the credit association's movement in the little-contemplated, new, non-territories of loaning (renting, calculating, and so on.);
- the extent of new and as of late pulled in clients, about which the bank isn't found peruses enough data;
- maltreatment by the borrower, misrepresentation;
- tolerating as a vow hard to acknowledge or expose to fast devaluation; separating values or the failure to acquire satisfactory security for a credit, loss of safeguard;

- expansion of the advance portfolio;
- the precision of the attainability investigation of the credit exchange and business or speculation venture;
- rolling out continuous improvements to the arrangement of a credit organization to give advances and the development of an arrangement of advances;

Since practically speaking these variables can act in inverse ways the impact of positive components levels the impact of negative, and on the off risk that they demonstration one way, at that point another is conceivable - the negative effect of one factor will expand the activity of another. The recorded credit risk elements can be gathered as outside and interior.

The gathering of outer elements incorporate state and prospects of financial improvement of the nation all in all; money related, remote and household approach of the state and the likelihood its progressions because of state guideline.

Outer credit dangers incorporate political, macroeconomic, social inflationary, sectoral, local, danger of authoritative changes (for instance measures, the production of administrative positive conditions for the arrangement of specific sorts of credit and different limitations), financing cost risk. Credit association can not precisely anticipate the dimension of intrigue, it can possibly think about while overseeing credit risks extra arrangements for potential misfortunes as immediate and covered up.

Interior variables can be related both with the exercises of the loaning bank and with the exercises of the borrower. The primary gathering of variables include:

- the executives level at all dimensions of the credit association;
- kind of market technique;
- capacity to create, offer and advance new credit items;

- the sufficiency of the decision of credit strategy;
- structure of the advance portfolio;
- transitory risk factors (with a long haul of a credit exchange, the likelihood of changes in intrigue, trade rates, pay from securities, intrigue edges, and so forth.);
- early withdrawal of the credit due to resistance with the terms of the advance understanding;
- staff capabilities;
- nature of innovation, and so forth.

It ought to be noticed that the above outer variables of credit risk have likewise related us with the exercises of the bank - they decide the states of its activity. However, these relations are different in nature: external factors do not depend on the activities of the bank, and internal - depend. As already mentioned, a group of factors associated with the activities of the borrower is highlighted or another counterparty of a credit operation. This includes the content of the borrower's business, creditworthiness, level of management, reputation, risk factors associated with the object of credit.

Factors that increase credit risk:

- concentration of credit risk, which is manifested in the provision large loans to an individual borrower or a group of related borrowers, as well as a result of the ownership of the debtors of the credit organization either to individual sectors of the economy or to a single geographical region or if there are a number of other obligations make them vulnerable to the same economic factors;
- large share of loans and other banking contracts falling on customers experiencing certain financial difficulties;
- the concentration of the bank's activities in the little-studied, new non-traditional areas;

- making frequent or significant changes to the bank's policy loans;
- a large proportion of new and recently attracted customers, about which the bank has insufficient information;
- Bank's liberal credit policy (granting loans without availability of necessary information, for example, complex analysis client's financial position);
- unsecured loans or low-liquid collateral pledging.

Risk assessment methods:

The amount of credit risk is measured by the amount that can be lost in case of non-payment or late payment of debt. Credit risk assessment of corporate borrowers can be carried out in two ways: qualitative and quantitative.

Qualitative assessment:

This method of risk assessment is a verbal description of it. Level by identifying negative information based on which the borrower's credit rating or consolidated risk level is determined. Based on the indicators for each loan recipient, you can determine the weighted average risk index for the loan portfolio as a whole. Methods of Russian banks for the qualitative assessment of credit risks in some parameters are similar. So, almost all banks consider indicators of financial stability, business activity, liquidity and profitability, as well as liquidity collateral. The difference is in the number of indicators corresponding to one indicator, and in the proportion of indicators in the formation of the overall assessment. It should be emphasized that each bank realizes its own understanding of risk based on knowledge of clientele's features, volume and price of credit resources and risk manager experience.

#### 3.4. Credit risk management of banks and non-bank credit organizations.

Bank risk management is one of the areas of financial administration in a commercial bank. Financial management in a commercial bank is a system of economic relations in the management of monetary resources held by a bank, in accordance with the concept of the bank.

The existing division of banking management is due to the peculiarities of the object's comrades, which are directed control actions. Thus, the management of economic the business of the bank has its constituent elements, i.e. financial directions management:

- formation of a commercial bank policy;
- equity management;
- liquidity management;
- marketing management;
- management of profitability, profitability;
- asset and liability management;
- credit portfolio management;
- bank risk management.

Each commercial bank chooses its own methods and methods of management. However, a necessary requirement for all of them is compliance with the financial the general concept of the development of the banking sector.

One of the features of financial management in commercial banks is the lack of a uniform technology for managing economic processes in credit institution within the existing banking system. Risk management is the process associated with identification, risk analysis and making decisions that include maximizing positive and minimizing negative consequences of risk events.

Risk management is a system of risk management and economic (financial) relations arising in the process of this management, including risk management strategy and tactics. The bank risk management system is a combination of techniques of the work of the bank's staff, allowing for a positive financial result in the presence of uncertainty in the conditions of activity, to predict the occurrence risk event and take measures to eliminate or reduce its negative consequences. This control system can

be described based on different criteria. Based on the types of banking risks in this system, you can select the blocks:

- credit risk management;
  - risk management of unbalanced liquidity;
  - interest rate risk management;
  - operational risk management;
  - loss of profitability;
- complex blocks associated with the risks arising in the process of individual directions activities of a credit institution.

With a different system of risk classification as independent blocks, subsystems are:

1) the control unit of individual (private) risks:

- credit risk management;
- risk management of other types of bank operations;

2) aggregate risk management unit:

- risk management of the loan portfolio of the bank;
- risk management of the bank's trading portfolio;
- risk management of the investment portfolio of the bank;
- risk management of attracted resources, etc.

There are features of risk management at different levels:

- Risk management subsystem at the bank level as a whole;
- Risk management subsystem at the level of financial responsibility centers (CFD);

- Risk management subsystem at the level of customer groups and banking products. Based on such criteria as risk management technology, the banking management system. These risks can be described as a combination of the following elements:

- the choice of a bank's business strategy that helps minimize risks;
- risk tracking system;
- a mechanism to protect the bank from risks.

The choice of a bank's strategy is based on a study of the banking market services and its individual segments. Among the riskiest strategies are well, the leader's strategy is a strategy related to the sale of new services in a new market.

The riskiness of these strategies is smoothed out if the bank in other market segments continues work with the old clientele, offering her a spent package of services. Regarding rice forged and a strategy for working with VIP-clients, involving the individualization of services.

The risk tracking system includes ways to identify (identify) the risk, risk assessment techniques, monitoring mechanism.

The mechanism of protection of the bank from the risk consists of:

- a) current risk management;
- b) methods to minimize it.

Under the current risk regulation refers to the tracking of critical indicators, the adoption on this basis of operational decisions on bank operations. In terms of the organization of the risk management process, the system under consideration is lays out the following controls:

- subjects of management;
- risk identification;
- risk assessment;



- risk monitoring.

All elements of this description of the bank risk management system represent a different combination of techniques, methods and methods of work of the bank staff. The subjects of bank risk management depend on the size and structure of the bank. But common to all banks is that they include:

- Bank management, responsible for the strategy and tactics of the bank, aimed at growth profits at acceptable risk levels;
- committees making decisions on the extent of certain types of fundamental the risks that the bank may assume;
- a bank unit engaged in the planning of its activities;
- functional units responsible for the commercial risks associated with the boards of these units;
- analytical units providing information for decision making on banking risks;
- the internal audit and control services that minimize the operational risks and the identification of critical indicators that signal the possibility of no risk situation;
- legal department controlling legal risks.

The world and domestic experience of commercial credit organizations allows for to mutate the principles of building an internal bank risk management system:

- 1) complexity, i.e. unified management system structure for all types of risk;
- 2) differentiation, i.e. content specifics of individual elements of the system in relation to types of banking risks;
- 3) the unity of the information base;
- 4) coordination of management of various types of risks.

To build an effective bank risk management system, you need:

- 1) considering the above principles of building a management system to include in the interbank documents the strategy and tasks of management;
- 2) to establish the principles of identification, assessment and diagnosis of risk as the basis in setting priority strategies and objectives and to ensure balanced protection;
- 3) use these principles as a basis for creating critical procedures management control, including when creating an organizational structure chart, preparation of documents on delegation of authority, as well as technical tasks;
- 4) define procedures for ensuring responsibility, self-assessment and evaluation of the results; activities in accordance with the principles of risk management and control systems, use these procedures as factors for improving the management process;
- 5) focusing on the above principles and procedures, a monitoring and feedback loop to ensure high quality procedures, assess and verify compliance.

Risk identification is to identify areas (zones) of risk.

In the context of a variety of banking products and services there is no single credit risk classification. Most often, credit risk is they qualify by repayment sources, by level and type of risk.

According to the source of the risk can be divided into external and internal:

External risk - the likelihood of loss as a result of non-solvency or default of the borrower under the negative influence of the external environment on its activities. External risks include risks that are not directly related to the activities of a bank or a specific customer. It is about political, social, economic, geophysical and other situations. Losses of the bank and its clients may arise as a result of the outbreak of war, revolution, political instability, nationalization, privatization, a ban on making payments abroad, debt consolidation, imposition of an embargo, cancellation of an

import license, aggravation of the country's economic crisis, natural disasters (earthquakes, floods, fires) and other external factors.

Internal risk - probability of loss as a result of insolvency or default of the borrower under the negative influence internal factors on its activity. Internal risks include risks directly related to the activities of the borrower: loss of counterparties, inefficient cost management, poor pay and credit policies of the borrower, deterioration of the organization's business reputation, etc.

By risk level, risk can be divided into:

moderate risk / risk below average / acceptable risk;

increased risk / medium risk;

high risk;

critical risk / very high risk / unacceptable risk

The basis for creating high-quality credit assets is the functioning in the bank of a credit risk management system based on following principles:

- the principle of quantitative assessment of risks taken;
- the principle of limiting the magnitude of unforeseen losses with a given probability for a certain period, covered by capital;
- the principle of funding the expected credit risk losses due to risky surcharges;
- the principle of continuous monitoring of accepted credit risk and control procedures used.

Risk management occurs on three levels:

1. Individual level:

Individual level of credit risk management implies analysis, assessment and reasonable reduction of risks for a particular transaction. Individual credit risk

management is generally carried out for transactions not falling under the aggregated level.

## 2. Aggregated level:

Aggregated credit risk management implies development of programs and development of criteria with which the transaction must meet, which allows to limit the amount taken by the bank risks. Credit risk management at the aggregated level is carried out, as a rule, for typical transactions with the amount of credit risk not exceeding the set value.

## 3. Portfolio level:

Managing credit risk at the portfolio level implies an assessment of total credit risk, its concentration, dynamics etc., as well as the development of proposals for the establishment of limits and management decisions in order to reduce risk.

Credit risk factors are the main criteria for its classification. Depending on the scope of the factors are allocated internal and external credit risks on the degree of connection of factors with the activities of the bank - credit risk, dependent or not dependent on the activities of the bank.

Credit risks dependent on the activities of the bank, taking into account its scale, are divided into fundamental (related to decision making by managers involved in managing active and passive operations); commercial (related to the direction of the number of CFDs); individual and cumulative (credit portfolio risk, risk of aggregate credit operations). Fundamental credit risks include standards related risks margin of collateral, making decisions on granting loans to borrowers who do not meet the standards bank, as well as resulting from the interest and currency risk of the bank, etc. Commercial risks are associated with small business credit policies, large and medium-sized clients - legal and natural persons, with separate directions of credit activities of the bank. Individual credit risks include the risk of a credit product, service, operation (transactions), as well as the risk of the borrower or other counterparty.

Risk factors for a credit product (service) are, firstly, its compliance needs of the borrower (especially in terms and amount); secondly, business risk factors, arising from the content of the credited event; thirdly, the reliability of sources for repayment; Fourthly, the adequacy and quality of security. In addition, the factors of risk may flow from operational risk, as in the process of creating a product and its varieties - services - technological and accounting may be allowed errors in the documents, as well as abuse.

Technology (mechanism) of providing a specific credit service that can be conditionally name of the loan. The type of loan also makes it possible to classify credit risks: credit risks overdraft, credit line, etc. For the types of credit is characterized by both general and specific manifestation of credit risks. For example, when lending overdraft there is a risk of non-authorized overdraft, the risk of violation of the order of payments in the overdraft, risk of continuity of overdraft loan debts and several others.

For investment loans, these are specific risks such as the risk of improper determining the client's need for lending, the risk of incorrect selection of a package of date, the risk of incomplete construction, the risk of obsolescence of the project, the risk of depreciation the risk of shortage of raw materials, the lack of a market for finished products, the risk of calculation of cash flow, the risk of revising ownership of a project, the risk insolvency of the guarantor, the risk of poor-quality investment memorandum.

Therefore, each type of loan is accompanied by different types of risks and factors, their which requires the development of various methodological support and applications implementation of various methods of credit risk management.

Borrower's credit risk factors are its reputation, including the level of non-performance, performance, industry, professionalism bank employees in assessing the borrower's creditworthiness, capital adequacy, the degree of balance sheet

liquidity, etc. Borrower's risks can be triggered by the most private organization because of the wrong choice of the type of loan and credit conditions

#### 4. Credit risk management experience of credit organizations in Azerbaijan and other countries

##### 4.1. In Azerbaijan

The development strategy of the banking sector in Azerbaijan for the period up to 2008 envisaged measures to increase the role of Azerbaijani credit institutions in the country's economic development, strengthen confidence in the banking system, enhance its transparency, and also increase the level of security of creditors and depositors of credit organizations. In 2005–

2008, favorable macroeconomic conditions developed. This circumstance and the high level of investment and consumer demand predetermined the growth in the volume of banking activity even in a period of turbulence in the global financial markets from mid-

2007 to autumn 2008. During this period, the Government and the Central Bank of the Republic of Azerbaijan carried out the main work on the implementation of measures for the implementation of the 2008 Strategy. The Bank is seriously worried about the risk of an excessive growth in the consumer credit market. But banks with a higher concentration of activity in the consumer lending sector (they account for 32% of banking sector loans to individuals) are at risk. While growth in the retail lending market as a whole slowed down, growth rates were reversed in these banks. Under such conditions, the profitability of most Azerbaijani enterprises remains relatively low, and it is more profitable for banks to issue loans not to them, but to the population, mainly due to a significant difference in interest rates, the Central Bank stresses. The Central Bank proposes to introduce a series of measures to reduce risks in consumer lending by introducing two new indicators for banks: the full cost of the loan and the ratio of the borrower's debt to its income (DTI),

We will analyze the state of credit risk in Azerbaijani commercial banks for the per

iod since 2004.

The structure of banks' credit risk for 2004-

2014 has not changed. Table 5 shows the risk structure in 2004-2014.

In the credit risk of banks in 2004, risks in other types of consumer lending prevailed: 86% - in 2004, in 2014 - 88.32%.

In 2004, mortgage loans ranked second by 1.19%, in 2014, car loans ranked second (7.73%)

Let us study the dynamics of loans with overdue loans.

Table 4.1 shows the chain indicators of changes in credit risk.

Table 4.1 Chain Debt Indicators

Period	Overdue debt	Absolute gain	Increase rate; %	Growth rate; %	Absolute content of 1% increase	Buildup rate; %
2004	2910.6		-	100	29.1	0
2005	2910.6	0.0	0	100	29.1	0
2006	4158.0	1247.4	42.86	142.86	29.1	42.86
2007	3433.5	-724.5	-17.42	82.58	41.6	-24.89
2008	3815.0	381.5	11.11	111.11	34.3	13.11
2009	7005.0	3190.0	83.62	183.62	38.1	109.6
2010	6766.7	-238.2	-3.4	96.6	70.0	-8.19
2011	6728.2	-38.5	-0.57	99.43	67.7	-1.32
2012	8132.2	1404.0	20.87	120.87	67.3	48.24
2013	12964.4	4832.2	59.42	159.42	81.3	166.02
2014	20292.8	7328.4	56.53	156.53	129.6	251.79
Total	79116.8					

In 2014 compared with 2013, arrears increased by 7,328.4 thousand man or by 56.53%. The maximum increase is observed in 2014 (7328.4 thousand man.)

The minimum increase was recorded in 2007 (-724.5 million man.) The rate of increase shows that the trend of a number is increasing, which indicates the acceleration of overdue debt

Table 4.2- Indicators of a number of dynamics

Period	Overdue debt	Absolute gain	Increase rate; %	Growth rate; %
2004	2910.6		-	100
2005	2910.6	0.0	0	100
2006	4158.0	1247.4	42.86	142.86
2007	3433.5	522.9	17.97	117.97
2008	3815.0	904.4	31.07	131.07
2009	7005.0	4094.4	140.67	240.67
2010	6766.7	3856.1	132.49	232.49
2011	6728.2	3817.6	131.16	231.16
2012	8132.2	5221.6	179.4	279.4
2013	12964.4	10053.8	345.42	445.42
2014	20292.8	17382.2	597.21	697.21
Total	79116.8			

In 2014, overdue indebtedness increased by 17,382.2 million man. or by 597.21%

It is worth noting that the current instability of the economy and the depreciation of manat caused an increase in overdue debts in 2014. The credit policy of all banks is aimed at reducing credit risk. There are several stop indicators for which banks were likely to refuse in 2004-2014. in lending:

- negative opinion of the economic security service;
- availability of claims to the borrower's settlement or currency account in the form of settlement documents not paid on time - availability of card file No. 2;
- the client has a net loss or uncovered loss on a cumulative total, not provided for by the investment program / income plan, for more than the last 2 reporting periods;
- the aggregate amount of commitments on loans and credits exceeds semi-annual revenue;
- a reduction in sales revenue for the last 2 reporting periods by more than 25% or more than 2.5 times compared to the same period last year;

The term of the borrower's activity is less than 6 months.



In this case, banks followed the basic principles:

In the case of a significant level of risk (with the probability of a loss from 50% to 100% of the loan size), it can be accepted only if it is possible to minimize it. As an additional measure of safety net, it is possible to consider a mandatory change in the terms of credit offered by the borrower or the credit unit, and only if the risk can be leveled this way.

In conclusion, we note that credit risk management would be impossible without the high level of qualifications and experience of bank employees, in which he must have the basics of quantitative financial analysis and, no matter how paradoxical, have good professional intuition.

The credit policy of the bank implies a set of basic tactical and strategic tasks on which employees of the institution must rely in the process of performing basic banking operations. Each credit institution independently develops such a policy depending on the objectives of the activity, as well as regional, political and social factors. It is aimed at improving organizational work, at achieving positive results of activities, at improving financial performance, and so on.

Commercial type credit organizations seek, on the one hand, to satisfy all the requirements and wishes of the client, and on the other hand, to increase the profitability of credit operations. As we know, the more profitable a deal is, the higher the risk of loss on lent amounts.

The bank's credit policy establishes a balance between these interrelated categories, that is, it determines the maximum level of risk for specific operations, which will not lead to bankruptcy. After developing the policy guidelines, the document is submitted for approval to all members of the Board of Directors. Accordingly, the responsibility for decisions taken lies with this management body. Moreover, Council members are also required to monitor the implementation of approved provisions in practice. In the modern world, many large banks have come to the conclusion that it is necessary to introduce common goals and objectives, as well as to develop co

common methods for achieving them. For this purpose, a special document is drawn up, called the “Memorandum on Credit Policy”. It indicates global goals, sets the maximum and minimum amount of borrowed funds, and also indicates certain types of loans that are considered the most risky, and therefore, their issuance is not recommended.

The credit policy of the bank includes calculations of the main financial indicators characterizing the success of the organization’s activities for the period of time under consideration. In this regard, one should take into account the amount of own funds, the availability of secondary reserves, for example, urgent deposit accounts, as well as the economic situation of the country at the moment.

The most significant in our region is considered to be the monetary policy of the bank, since not only the country's economy is built on it, but also the principles of the activities of credit institutions of a commercial type. This document includes the main provisions on which other credit organizations rely in developing their own policies. For example, the Central Bank sets the amount of required reserves, which directly affects the level of interest rates on all types of loans.

Currently, Azerbaijani banks lack their own system for developing and updating scoring models. The Bank uses the acquired scoring cards, which it embeds in the CFT software “Assessment of the creditworthiness of the borrower on the basis of scoring models”.

#### 4.2. In European Union

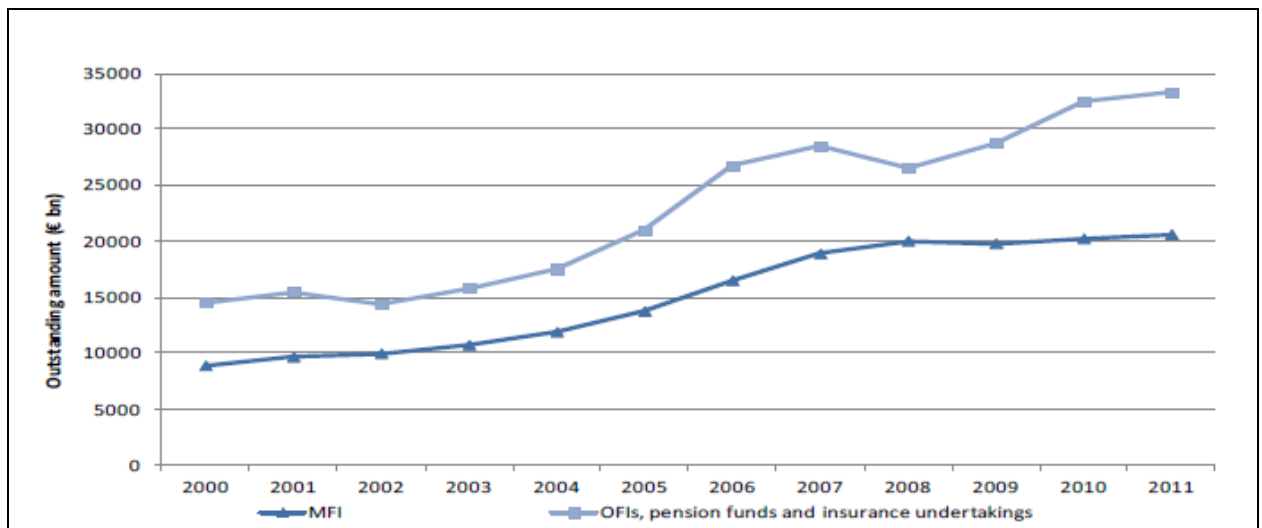
The non-bank financial sector has pulled in significant enthusiasm on the two sides of the Atlantic and in both the U.S. and Europe, various investigations have meant to measure the extent of the non-bank budgetary area, frequently alluding to the part as the shadow banking segment (for example, Noeth and Sengupta (2011), Pozsar and Singh (2011), Pozsar et al. (2012), Tobias and Shin (2009), for the investigations concentrating on the USA and Bouveret (2011) for studies concentrating on Europe). In expansion policymakers and controllers on the two sides of the Atlantic are checking on the most proficient method to fortify the oversight of the division and

lessen its murkiness (see, for instance, Financial Stability Board 2011a and 2011b and European Commission (2012)). Appraisals of the measure of the non-bank monetary division shift impressively, to some extent in view of various procedures (see table beneath) and the present report does not endeavor to put a figure to the general size of the part. In any case, it will consider insights all in all segment distributed by Eurostat and different sub-part insights distributed by Eurostat, the European Central Bank (ECB), business information suppliers and exchange affiliations.

Figure 4.1 demonstrates the advancement of benefits of the bank and non-bank money related segments. The non-bank monetary area has been reliably bigger than the financial division over the period 2000-2011 what's more, an increasingly point by point examination of the period 2000-2011 uncovers four unique stages concerning the relative execution of the two segments:

- The two segments extended at generally a similar pace from 2000 to 2004;
- From 2004 to 2006, in the run-up to the money related emergency, complete resources held by the non-bank monetary segment developed substantially more quickly than those held by the financial area
- During emergency, the non-bank monetary area encountered a substantially more articulated decay in all out resources than the financial segments
- Finally, during the post emergency time of 2009 to 2011, development of non-bank money related accounting reports came back to close the development experienced over the period 2002 to 2005 (before the sharp pre-emergency increasing speed) while resources of the financial division have scarcely developed since 2008

Figure 4.1



- While over the period 2000 to 2011, the estimation of benefits held by the MFIs and NBFIs have expanded by nearly a similar rate, the rate of development in the estimation of complete resources held by the MFIs is substantially less unpredictable than that of the NBFIs with the standard deviation of the yearly development rate of the previous remaining at 6.6 rate focuses while coming to 10.1 rate focuses for the NBFIs over the period 2000-2011.
- The distinction in instability is particularly evident in 2008 and amid the resulting years with all out resources of the NBFIs falling in 2008 and afterward developing again generously while resources of the MFIs have remained basically level from 2009 onwards.

As life insurance companies and pension funds have little obligation, the influence investigation underneath centers around an examination of obligation to-value proportions of MFIs and OFIs.

- As a group, OFIs are significantly less utilized than MFIs. Toward the finish of 2011, the MFI's influence proportion (characterized as the proportion of advances and obligation securities to shares and other value) remained at 2.8 while it was 1 for OFIs (Figure 5).

- While the high influence proportion of MFIs in 2011 reflects to a huge degree the effect of the monetary emergency, it ought to be noticed that, even before the emergency, the MFI's influence proportion vacillated in the scope of 1.6 to 2.0 while the OFIs influence proportion ascended from just shy of 0.5 to somewhat under 1 of every 2005 and surpassed 1 just once, in 2008 amid the stature of the money related emergency.

Besides developing impressively in size since 2000, the gathering of NBFIs has turned out to be likewise more associated with the financial segment. Connectedness is estimated from the viewpoint of the banking part and is proxied by the proportion of MFI asserts on NBFIs. The proportion of MFI guarantees on NBFIs altogether MFI claims expanded by somewhat over half over the period 2005– 2010 to 32.5% in the wake of having become without a doubt, in all respects possibly from 18.2% in 2000 to 21.4% in 2005. To put it plainly, the connectedness of the EU27 banking area to the NBFIs division expanded forcefully and this expansion happened on the whole during the money related emergency and post-emergency period.

Sub-sectors of the non-bank financial system: Money market funds; Private equity firms; Hedge funds; Pension funds; Insurance undertakings; Central counterparties

#### Money market funds

Money market funds (MMFs), or money market mutual funds, are a type of open-ended shared reserves that put resources into a broadened arrangement of currency advertise instruments that are ordinarily of short span. A 'prime MMF' puts resources into currency advertise instruments issued by prime banks, quite bank stores and business paper. A 'treasury MMF' puts resources into currency advertise instruments issued by governments. What's more, an 'administration MMF' puts resources into currency advertise instruments issued by government offices which appreciate fluctuating degrees of help from their administrations.

The goal of MMFs is to fulfill financial specialist interest for security of capital, liquidity and yield, the last mentioned (yield) regularly being dependent upon the

previous (security of capital and liquidity) for a few however not all MMFs (see exchange on 'upgraded' MMF underneath). Security of capital includes safeguarding what's more, bringing down unpredictability of capital (Macey, 2011). Liquidity includes furnishing financial specialists with same day or following day access to capital. What's more, given security of capital and liquidity, MMFs look to contribute in higher yielding currency advertise instruments, in spite of the fact that the effect of the budgetary emergency on cash markets has restricted respects a generally low and tight band.

### Private equity firms

Private equity firms moderate between financial specialists trying to contribute (indirectly) in organizations through private capital markets and organizations looking for outside finance. The financial elements of private equity firms are to embrace speculation screening, contracting also, observing exercises. Screening includes leading 'due industriousness' exercises, for example, gathering data about venture focuses on, the business sectors in which they work and supervisory crews. Based on due steadiness exercises, private value firms build up the terms on which private equity capital will be put resources into speculation targets, including value, division of proprietorship, security, prohibitive pledges, development, and so forth. Checking exercises are embraced so as to guarantee venture targets don't participate in exercises that misuse private value financial specialists, for example, the confusion of value capital. This is accomplished through surveying budgetary and consistence conditions inside the firm through cooperation in administrative basic leadership among others. Private equity ventures might be helpful because of proficiency picks up that speculation targets accomplish coming about because of the measure of the stake a private value firm takes in venture targets and assets contributed, especially prevalent administration mastery and corporate administration game plans. Private equity firms, through doing their capacity as money related middle people, might be helpful on the grounds that they make accessible a bigger pool of capital than would be accessible in their nonattendance.

Moreover, private equity firms may improve the proficiency of firms taking part in capital markets what's more, advantage other capital markets members. Private equity firms' inclusion with speculation targets as a rule includes a change of speculation targets' capital structures that diminishes the generally cost of capital. Private equity firms, through putting assets in organization valuation, moreover improve the value proficiency of capital markets.

### Hedge funds

Hedge funds are dynamic speculation vehicles that are daintily directed with extraordinary exchanging adaptability (Fung et al., 2008). They can attempt a more extensive scope of speculation and exchanging exercises than different assets and financial specialists in such assets are ordinarily high total assets people and a few institutional financial specialists.

A hedge fund investments is a reserve that can take both long and short positions, use exchange, purchase and sell underestimated securities, exchange alternatives or bonds, and put resources into practically any open door in any advertise. The essential point of most hedge fund investments is to decrease unpredictability and risk while endeavoring to safeguard capital and convey positive returns under all economic situations however their procedures fluctuate massively. For instance, speculative stock investments may take part in short (selling shares without owning them, wanting to repurchase them at a future date at a lower value), exchange, exchanging alternatives or subordinates, putting resources into expectation of a particular occasion (merger exchange, threatening takeover, spinoff and so forth.), putting resources into profoundly limited securities of organizations going to enter or exit money related pain or insolvency, regularly underneath liquidation esteem and so forth.

### Pension funds

The idea of the job of pension funds in money related intermediation has changed after some time. Generally, pension funds put long-term investment funds in long-

term resources. The idea of the pension funds may decide the risk it stances to money related solidness. Investment risk and portfolio management lays on the supporting manager (as in a characterized advantages plot), the representative (as in a characterized commitment plan) or a mix of the two. In the event that, for example, a characterized benefits plot faces a financing shortage in the midst of market pressure, the business is in charge of guaranteeing worker advantage commitments are met. Either bosses use organization income or businesses change venture and portfolio the executives choices to make-up the financing setback (or a blend of the two). The last alternative may include more serious hazard taking (European Commission, 2009).

What's more, pension funds are vast institutional financial specialists. This suggests the securities exchanges they attempt can possibly increment or lessening budgetary precariousness through the flame deal component. Pension funds are additionally buyers of fixed pay securities. Thusly, changes in the exchange examples of benefits assets can have critical ramifications for obligation backers. The above could be depicted as the customary job of annuity assets in budgetary intermediation. All the more as of late and non-customarily, annuity reserves have tried to build their general return by loaning out a portion of their long-term securities for an expense through securities loaning.

#### Insurance undertakings

Insurance undertakings assume a comparative job to benefits assets in money related intermediation, going about as huge institutional speculators and buyers of fixed pay securities. Be that as it may, as on account of annuity reserves, the nature of the job of insurance undertakings in money related intermediation has likewise changed after some time. Insurance undertakings have occupied with non-customary and non-protection exercises all the more as of late. Furthermore, with regards to the money related emergency, a portion of these were reasons for financial instability.

#### Central counterparties



The job of central counterparties (CCPs) in money related intermediation is inter alia to decrease counterparty dangers emerging in bilateral exchanges on OTC subsidiaries markets and, thusly, to decrease dangers to budgetary security originating from these counterparty dangers. CCPs do this work by going about as counterparty to each exchange among clearing individuals, performing multilateral netting and undertaking risk the executives exercises to guarantee that the disappointment of a clearing part does not influence different individuals (Duffie and Zhu, 2011).

Missing CCPs, gatherings to two-sided OTC subordinates contracts deal with the effect of counterparty risk using reciprocal netting understandings. These understandings total all exposures between two counterparties taking into account close-out netting in case of default by one or the other gathering. Close-out netting serves to counterbalance the subsidiary payables by the defaulting party against its subsidiary receivables versus the non-defaulting counterparty (Singh, 2010).

Outstanding exposures between counterparties are likewise now and again collateralised (after close-out netting between counterparties) to additionally diminish counterparty dangers. Nonetheless, contracts might be under-collateralised. Guarantee is normally posted by end-clients (non-vendors) to sellers however showcase practice does not include vendor to-seller security posting. Furthermore, vendors don't ask for security from end-clients, for example, sovereign elements and some corporates (IMF, 2010). Experimentally, 22% of OTC subordinate exchanges are uncollateralised; and of the 78% of notional sums that are collateralised, 16% are one-sided.

Counterparty risk is additionally overseen, somewhat, by multilateral pressure and tear-up tasks that look to dispose of excess contracts. For instance, if party A owes party B a total, state €100, and party B owes party C a similar sum, state €100, at that point party B can be dispensed with and party A will owe party C the €100. This abbreviates and improves between associations between bank furthermore, NBFIs with gainful implications for dangers to budgetary stability. CCPs enhance current

courses of action for overseeing counterparty chance. A reciprocal OTC subordinates contract is changed, through novation, into two new gets, each with the CCP. This, joined with higher multilateral netting among clearing individuals than if the CCP were missing, decrease the dimension of counterparty chance present inside the money related framework

The idea of the job of CCPs in monetary intermediation stretches out past overseeing counterparty risk. The security required to cover a lot of OTC subsidiaries contracts through a CCP is probably going to be lower than missing a CCP, all else equivalent. What's more, the capacity to exchange namelessly through a CCP may result in more prominent market interest. Decrease in counterparty risk joined with the previously mentioned elements is gainful to advertise results (e.g., liquidity) and at last serve to increment the conviction of and lessen the expense of capital (Singh, 2010).

#### 4.3. In Russia

The Bank of Russia, together with the Government of the Russian Federation, is developing and conducts a unified state monetary policy. The main objectives of monetary policy:

- achieving financial stabilization;
- decrease in inflation rates;
- strengthening the national currency;
- ensuring the sustainability of the country's balance of payments;
- creating conditions to stimulate economic growth.

Depending on the state of the economic situation, there are two main types of monetary policy, each of which is characterized by its own set of tools and a certain combination of economic and administrative methods of regulation.

Restriction monetary policy is directed to tighten the conditions and limit the volume of credit operations of commercial banks by raising the level of interest rates. Its implementation is usually accompanied by an increase in taxes, a reduction in

government spending, as well as other activities aimed at curbing inflation and improving the balance of payments. Restriction monetary policy can be used both to combat inflation, and in order to smooth cyclical fluctuations business activity. Expansionary monetary policy is accompanied, as a rule, by increasing the scale of lending, loosening control over the increase in the amount of money in circulation, reducing tax rates and lowering interest rates. The scale of the impact of monetary policy can be total and selective. With a total monetary credit policy measures of the Central Bank apply to all credit institutions, while selective - to individual credit institutions or their groups or on certain types of banking.

In accordance with the objectives and type of the Central Bank monetary policy determines specific methods and tools for its implementation. The main tools and methods of the monetary policy of the Bank of Russia:

- interest rates on Bank of Russia operations;
- standards of required reserves deposited with the Bank of Russia (reserve requirements);
- open market operations;
- refinancing of banks;
- currency regulation;
- setting benchmarks for the growth of the money supply;
- direct quantitative restrictions;
- deposit operations of the Bank of Russia.

The interest rates of the Bank of Russia are the minimum rates at which it carries out its operations (the refinancing rate, discount, deposit and lombard rates are known).

In the practice of the Bank of Russia, the refinancing rate plays a leading role.

Refinancing means lending by the Bank. For transactions with promissory notes can be set and self-rate - accounting. Lombard bet is interest rate on short-term loans to banks secured by government securities.

Since 1998, rates on deposit operations of the Central Bank of the Russian Federation at the end of 1999 have been widely used - 9 types of deposits, on which rates set daily based on market conditions. Interest rates on deposits of the Central Bank of the Russian Federation characterize the real price of money on money market. By adjusting the level of refinancing rates, the Central Bank influences the value of the money supply in the country contributes to the increase or reduce the demand for credit KB. Increase in official rates makes it difficult for the CB to get credit resources and, as a result, the ability to expand operations with clientele. Official interest rates have an indirect impact on market interest rates set by the CB independently in accordance with the conditions of the market of credit resources and not under the direct control of the Central Bank.

In Russia, in the face of rising inflation 1991–1993 the refinancing rate changed frequently, by 1999 it was accounted for 55%. During 2000, the refinancing rate decreased 5 times. In the following years, the rate reduction process continued (at the beginning of 2007 it was 10.5%). The Central Bank does not have to change according to the dynamics market interest rates of commercial banks: it may deviate from it in that or other side.

Since 2015, the consumer lending market in the Russian Federation is in a state of stagnation. So, if in 2012-2013 volumes issued loans increased, then in 2014-2015 growth rate of newly issued loans decreased, and in 2016 they decreased to the indicator of the beginning of 2012, which indicates a decline in consumer lending. With this in absolute figures, debt levels continued to be quite impressive until mid-2015, after which the growth in loans population has already changed.

In the conditions of deterioration of the situation with bank liquidity, credit organizations have tightened requirements for potential borrowers. In his turn Bank

of Russia as a regulator of commercial banks for minimizing banking risks and preventing the occurrence of credit "Bubbles" took a series of administrative measures to reduce growth consumer lending. Since 2013 they have been pursuing a policy high risk unsecured lending restriction: credit organizations are required to form reserves to cover possible losses on such doubled loans increased risk factors when calculating the capital adequacy ratio, and increased rates of minimum reserves for consumer loans.

Currently, there is a decrease in credit activity with part of the population. The reduction is due, firstly, to a decrease in real incomes of the population; secondly, with a decrease in consumer demand loans due to rising interest rates; thirdly with tightening requirements for potential borrowers; fourth, with the presentation increased requirements for collateral.

In accordance with the forecast of the Russian economy up to 2020, the Analytical credit rating agency (ACRA) real incomes of the population will be fall for another two and a half years, after which, in the absence of significant sources of economic growth, their stagnation is likely. If we consider that changes in income dynamics began to affect consumer markets already in 2013, the duration of the expected transformation is comparable to the crisis 90s. Under these conditions, the degree of rigidity of the balance of income and expenses population will increasingly depend on the dynamics of bank lending, and it, in turn, from the debt burden of individuals.

However, for the first time in six years, the debt burden of the population has become confidently decline, reaching the average level of developed countries. Intensive growth in lending to individuals in 2011-2014 supported the economic growth in Russia, and since 2013, has stimulated consumption in the conditions of lack of real income growth. Despite the fact that by 2016 the debt households reached only 13-14% of GDP, which is much lower than in the vast majority of countries with developed financial systems, debt population load is relatively high. Debt service ratio in Russia (i.e., the share of disposable income required to service interest payments and repayment of the short-term part of the debt), by the beginning of

2014. The city has reached the average value of developed countries-9%. Since, along with stricter regulation of the sector, a significant amount debt burden of individuals has a slowing effect on further lending dynamics.

In the absence of income growth, the resumption of increase debt load is fraught with a dangerous decrease in credit quality population: over the past three years, the share of loans with overdue more than three month payments doubled - from 5 to 10.8%. And the increase in this indicator slowed, but did not stop after termination of the loan portfolio growth, i.e. payment discipline is already on loans are deteriorating.

In view of the threat of a further decline in the creditworthiness of its population the debt load in the next two to three years, at worst, will continue on current level, but most likely will gradually decline due to a gradual “blurring” of the share of poorly serviced loans issued for the peak of the economic downturn. Often non-repayment of a loan can be associated with fraud borrower’s side. In accordance with the criminal code of the Russian Federation fraud in bank lending is theft cash borrower (a group of persons by prior agreement) by submitting to the bank false and (or) false information, as well as acts committed by persons using their official provisions. The scheme of crime in the field of lending to individuals is enough is simple. The fraudster submits fraudulent documents proving intent to return the loan to the bank. These may be fake documents about income and financial position of the borrower or false documents on property pledged. Also, in some cases may use corrupt connections in banks. Then the money received in loan form, just do not return. Security Attempts to foreclose about pledge are in vain, since the originally indicated collateral value is greatly overestimated, and so that the subject of the pledge is absent altogether.

Another type of bank fraud in lending population are crimes related to bank cards with the development of information and communication technologies appear all more sophisticated fraud schemes and many risks arises from cardholders. For scammers is not necessarily use the card physically as it happens when cash is stolen

money. To ensure their own security, a person needs to know what methods of fraud exist today.

Commercial banks in order to maintain competitive positions and protection of payment card users develop and apply complex measures aimed at minimizing the risks of using non-cash calculations. Among such measures are the following:

- SMS notifications of card holders about card requests;
- two-factor authentication, which implies, in addition to input standard login and password, an additional method of protection;
- use of 3-D Secure technology for payments on the Internet;
- use the procedure for issuing EMV-cards;
- the use of special software systems for fraud monitoring and transaction analysis.

Despite a number of these measures, not all online stores support various protection technologies. That is, making a payment can take place without authenticating via SMS or receiving a one-time password that is a security threat to the cardholder's cash. So thus, the owner must take care of the safety of card data, as any person who has seen and remembered the details may, without any confirmation, use the means to commit payment.

Of course, the client in case of loss, theft of the card or detection debiting without his knowledge can immediately apply to the bank in order to block the card. "On the National payment system "the bank is obliged to refund the amount of the transaction, but provided that the card holder applied to the bank no later than the day following the day receiving notice from him. In other words, the client must have time inform about the commission of an unauthorized operation with his in cash. The problem is that the population has a low financial literacy and often do not know what remedies cashless funds exist and what rights do they have when using. The next problem is the high cost of banking consumer loans. We illustrate this with mortgage rates loans. In advanced economies in which inflation low, this type of

lending is available to every citizen, since Mortgage interest rates do not exceed 3-4% per annum. For example, bets on mortgages in Germany are 2.73%, in the UK 3.12%, in the USA 3% etc.

According to the results presented by the research company Frank Research Group, average mortgage rate in Russia on 10/01/2016 amounted to 13.9% per annum, and the average rate on cash loans - 21.5%. The rate of inflation does not allow banks to lower interest rates. Another factor constraining the development of banking lending to the population is the monopolization of the banking market in Russia. Structural developments in the domestic banking system changes in the most general form describes the dynamics of the number of banks, functioning in the territory of the Russian Federation.

For the entire existence of the Russian banking system from 2506 closed banks, by force, that is, on the initiative of the regulator, 1969 banks ceased operations. Of these over the past 15 years, the Bank Russia withdrew licenses from 670 banks. It can be assumed, that the process of reducing the number of banks operating in the Russian Federation is the consequence of the Bank of Russia policy of reorganization of the banking sector and cleansing it from "weak" banks. At the same time, the withdrawal from the market of small and medium-sized banks or their forced merger with the largest banks cannot entail further development of concentration processes in the structure of the banking system and weakening competition. Despite assurances from the Bank of Russia that consolidation of the Russian banking sector is not its immediate task and the Bank of Russia will neither push nor slow. The indicated process, the actual, proves the opposite. Where in small and medium-sized banks represented primarily by regional banks, in this system act as a "weak link" and are doomed to care of the market. How the "cleaned up" banking system will work will show time, but while one thing is clear - in Russia there is a "washing out" of small and medium banks from the structure of the country's financial system and monopolization of the market large state-owned banks.



#### 4.4. In Turkey

##### The Banks Association of Turkey

The BAT was set up in 1958 under the system of banking law. Banks that work in Turkey are committed to move toward becoming members of the BAT, which is an expert association with the status of an open lawful substance.

The point of the Association is to protect the rights and the advantages of the banks, to do the contemplates on the development of the financial area, that break down factor facilitating, powerful working and the improvement of the financial calling, to fortify challenge control, to decide that will square out of line rivalry, and to execute and request the usage of these choices, in accordance with the guidelines, standards and principles of banking. (The Banks Association of Turkey)

The Association sets the moral expert standards and principles after getting the endorsement of the BRSA, just as checking the use of choices made by the BRSA. (5411 Banking Law: craftsmanship. 80) Additionally, the Association forces managerial fines on individuals who don't completely go along in a convenient way with the choices and measures made by affiliations. (5411 Banking Law: craftsmanship. 81)

##### The Central Bank of the Republic of Turkey

The intensity of the CBRT was built up Law in 1211, article 4. As indicated by this article, the Bank is approved to make guidelines relating to obligations and forces depended to it by the law and to oversee consistence with these guidelines. The CBRT is approved to issue banknotes, to control the volume of cash issued and the volume of acknowledge and, as the loan specialist of the final hotel, to stretch out credit to the banks. The CBRT must be autonomous to actualize money related arrangement. The CBRT is engaged to determine and manage the gold and money rates that are distanced to the CBRT by banks, just as the measure of gold and money that can be held by banks. What's more it can deal with the nation's remote trade

position and the components identified with fare and import. It can likewise ask for essential data from banks.

Risk is an occasion or circumstance that will influence an association's capacity to accomplish its targets. Risk the executives is a precise administration style that comprises of the particular and investigation of dangers that an association experience, the appraisal of the potential effects of dangers to the association and choices in regards to what move can be made to wipe out and lessen risk with inner control technicals.(Fikirkoça, 2003: p.25)

As per the Regulation on Internal System of Banks, the reason for the risk the board framework is the recognizable proof, estimation, observing and control of dangers through strategies, usage strategies and limits that are shaped to keep up control and, if essential, to change the risk/return structure of the bank's future income and accordingly, the quality and the degree of its exercises. (Guideline on Banks' Internal Systems,2006: art.35)

In light of this guideline, banks are obliged as far as possible to essential risk results related with their tasks and these limits must be endorsed by the top managerial staff. Risk limits are set by chiefs of related operational units, senior people in the risk the executives unit and the bank's general director.

A risk the executives framework must be free inside the authoritative structure. The obligation of observing and surveying of dangers is completed by the risk the board bunch which works under the risk the executives unit. During the time spent the recognizable proof, observing and assessment of dangers the inside control and risk the executives bunches must cooperate as indicated by the rule and systems shown by the governing body. On the off risk that essential, auditors will assess forte dangers, for example legitimate and operational dangers.

In banks, reserves got from different sources are apportioned between venture options. The criteria of risk portion are the risk evaluations and return measures of each option. Existing dangers inside the financial part can be gathered as inner and

outer dangers. While inner dangers result from the structure of the financial segment, outer dangers result from the occasions that happen outside of the part. The current dangers of the financial area can be recorded as operational risk, country risk, management risk, credit risk, interest risk, market risk, currency risk, liquidity risk and undercapitalisation risk

In asset management, banks must indicate existing danger definitely, and resources must be apportioned as per these particulars. Operational risk emerges from an absence of powerful internal controls what's more, evaluating methodology. Operational risk is the danger of disappointment of bank methodology whether from outside causes or because of mistake or extortion inside the establishment. As is known, there is a cozy connection among risk and return. At the point when risk builds, returns increment also. Banks keep money and snappy resources in their portfolios to lessen liquidity risk. Therefore, banks' benefit is influenced contrarily. In addition, if a loan fee is high, opportunity cost will be high too, due to the money kept in banks' portfolios to diminish liquidity risk. On the off risk that a bank does not screen or gauge the market improvements properly, it experiences liquidity risk. At that point, it can be constrained to assume an advance that involves surprising expenses or to loss sell its advantages for satisfy its commitment. In the event that different precautionary measures are not taken, a formal expert can close the bank or can combine the keep money with another institution.

Risk management is the procedure by which managers fulfill these requirements by distinguishing key dangers: getting predictable, justifiable, operational risk measures: choosing which risk to lessen and which to increase and by what implies: and building up strategies to screen the subsequent risk position. (Pyle, 1997: p.2) When the dangers are evaluated, all dangers that exist for banks must be taken into thought. To do the risk appraisal work viably, banks' top administrators must evaluate risk routinely and execute administrative measures as per changing conditions. Whenever the issues that lead banks to endure misfortunes are examined, the reason for these issues is resolved to be a lack of the internal audit framework.

The internal audit framework guarantees the location of issues that may cause misfortunes.

In 1998, Risk Management and Modeling Group, one of seven working gatherings of the Policy Advancement Group, the subcommittee of the Basel Committee on Banking Supervision, shaped standards with respect to powerful supervision and reviews in banking. As per these standards, banks' board of directors are the last specialist for the foundation and operation of a successful internal audit system. (Banking Regulation and Supervision Agency) The bank work force at any level that are in charge of internal audit produce data that contributes legitimately or by implication to internal audits. A full of feeling inside review framework requires the recognizable proof and assessment of material dangers that can anticipate the achievement of the bank's goals. Whenever the dangers are evaluated, all dangers that exist for banks must be thought about. All together for the risk appraisal capacity to be done adequately, banks' top directors must evaluate dangers routinely and take administrative measures as per shifting conditions. Autonomous and qualified reviewer should effectively and exhaustively control the internal audit framework. These controls are a significant piece of the internal audit framework and should be directly given an account of to the top managerial staff, inspection board and top administration.

Today, the nature of the Turkish financial division has risen a decent arrangement as far as both budgetary furthermore, institutional structure. Be that as it may, there are a few issues that are contrarily influencing the advancement of the Turkish financial part. Banks are establishments that need to work with high risk in view of the idea of banking. These dangers can exist in any nation and any period since dangers are the an integral part of budgetary markets. What is most significant is the exact ID and the board of dangers. Banks' top directors must accomplish sufficient and precise learning and should build up frameworks required for risk management. If this happens, the effect of risk and emergency stay at the very least.

The principle issues of the financial segment can be recorded as; staggering expense of money related assets, issues identified with expansion and adjustment programs, issues of value, issues identified with quick mechanical advancement, low asset cycle of business banks, issues related with banks' short position, insufficient review and oversight methodology and the issues coming about because of bunch banking. As a result of these issues, a powerful risk management framework is basic for banks. In an inflationist period, the financial area experiences a great deal of issues. During such a period, banks' income seem to increase nominally. Be that as it may, they decline in real terms, and the real measure of value decreases too. In an inflationist period, the cost of resources furthermore, their working costs increases, while venture choices that incur low risk decrease as a consequence of the expanded rate of credit interest. Moreover, during an inflationist period, dangerous credit issues increase, and this circumstance imperils banks' receivables. The most significant store wellspring of business banks is its stores. In spite of other subsidizing advancements that may emerge, stores stay significant, and there keeps on being a solid connection between store rates and expansion rates. In Turkey, entrance into the financial area was streamlined in the 1980s; be that as it may, lately, it has turned out to be confused by the open expert. Endeavors to defeat this imperative have made the quantity of venture bank increment lately. Leaving the segment isn't acknowledged as should be expected in light of the negative effect of such out of here attention. The trouble of passageway into and exit from the segment is a significant factor that exasperates the standards of impeccable challenge advertise. This circumstance diminishes the affectability to risk factors and prompts out of line rivalry. Another noteworthy issue in the Turkish financial segment is deficient value.

One of the fundamental issues in the Turkish financial division is an absence of powerful review methodology and oversight in the sector. The absence of a full of feeling framework to review and control the segment revealing lacks of the banks' interior review frameworks, has caused major issues. To give viable reviews in the

financial division, the quantity of evaluators must be adequate and they should have required specialized learning, the necessary database should likewise be accessible, political obstructions that can make evaluating insufficient must be separated and punishments to prevent misrepresentation must be utilized

## 5. Solutions

### 5.1. Providing effective credit risk management with using worldwide experience

For banks, lending is one of their most profitable types of activity, but at the same time high-risk. This obliges banks to carefully monitor compliance with the established principles of lending, as well as the targeted use of credit by credit borrowers and its efficiency in general. The bank should have timely and accurate information about the credit risks it currently faces.

In order to implement a credit risk management strategy in Russian practice, the following methods are commonly used: risk diversification, hedging, transferring losses to another person in case of non-repayment of a loan; insurance; credit limits.

Naturally, the state, represented by the Central Bank of the Republic of Azerbaijan, influences credit risks, acting as the supervisory authority for regulating the activities of commercial banks (through economic standards for credit risk, the Central Bank has an indirect effect on the concentration of loans and lending.

These issues should be considered with the identification of positive and negative aspects of the impact on the credit process and credit risks. We consider the following conclusions important: Compliance with these regulatory requirements, on the one hand, contributes to the creation of system conditions for the formation and functioning of an effective mechanism for managing bank lending and credit risks, and, on the other hand, increases the requirements for all participants in the credit process.

In this context, it is also essential to emphasize that the main task of risk management in general in the banking system is not to eliminate them initially. Such an approach

would be a certain measure of “administering” risks, which is contrary to the nature of banking risk activity. Most likely, we are talking about risk management of credit activities, and in proportion to this and all banking, from the standpoint of maintaining acceptable ratios of profitability with indicators of security and liquidity in the process of managing assets and liabilities of the bank, that is, minimizing bank losses.

Effective management of the level of credit risk should solve a number of problems - from tracking (monitoring) risk to its valuation and minimizing losses. Security and liquidity in the process of managing assets and liabilities of a bank, that is, minimizing bank losses.

Effective management of the level of credit risk should solve a number of problems - from tracking (monitoring) risk to its valuation and minimizing losses.

It should be more fully and timely (in the course of events) take into account that the level of credit risk associated with a particular event is constantly changing due to the dynamic nature of changes in external factors affecting the activities of banks.

This forces each individual bank to constantly clarify its position in the credit market, assess the credit risk of certain events, revise relations with customers and assess the quality of its own assets and liabilities, therefore, adjust its credit risk management policy (a comprehensive and permanent monitoring).

For the purposes of developing and implementing effective credit risk management techniques, a deep and diverse knowledge of credit risk factors and their systematic assessment is necessary. Note that credit risk factors require a special approach on the part of each bank according to the criterion for assessing the constraints that affect risks, the nature and impact of their impact. The methods of banking control and supervision set by the CBA cannot fully cover the banking business in regulating credit risks. If this practice is observed, then it is characterized by tough “compulsion” of risk control and inhibits (to a certain extent) the initiative of the

banks themselves in activating a diversified credit process and methods for its implementation.

The creation of reserves for possible losses on credit risks (loans) allows the bank to form a “margin of safety” in case of adverse changes in the activities of the borrower. At the same time, the main problem of the Azerbaijani banking practice is the inadequacy of the created reserves to the real risks that the instruments of the loan portfolio of commercial banks possess. At the same time, the formation of a reserve to cover losses makes it possible to cover the risk at the expense of the bank’s own funds, previously reserved.

For the effective application of this method, the bank must determine the optimal reserve amount, that is, such a value that would be minimal, but at the same time sufficient to cover potential losses.

Describing the above problems, it is necessary to clarify that the formation and efficient use of bank credit resources is the basis for conducting credit operations, taking into account credit risks.

This means that the formation of the bank’s own capital is not only a necessary but also an integral part of its financial resources in order to attract foreign capital: it is necessary to have adequate own capital so that creditors can be sure that at a critical moment they can count on it positions of potential credit risks and guarantees of returning the money invested as savings.

The structure of banks' own funds is heterogeneous in its qualitative composition and constantly changes depending on various factors: asset quality, use of its own profit, the bank’s pursued policy of ensuring the stability of its capital base. At the same time, the growth of banks' loan portfolios is dependent on the volume and structure of banks' own funds. However, the situation may develop in such a way that along with the growth of own funds, bank reserves will also grow. The reason for this phenomenon may be changing market conditions of banking activities,



which are formed under the influence of the generated own funds of banks and their loan portfolios, on the one hand, and increasing credit risks, on the other.

Thus, the development of global banking retail in recent years can be characterized by several turning points:

- this area has undergone significant financial stress due to marginal pressure, a sharp increase in reserves for problem loans, a decrease in assets, income and profits;
- there is a tendency of tightening the policy of regulators aimed at both reducing risks and increasing consumer protection;
- as a result of significant changes, the positions of many players in the banking retail market have changed (the banking landscape has changed);
- changed the behavior and expectations of customers, placing particular emphasis on reliability and trust;
- changing the role of products.

According to the analysis of approximately 140 of the world's leading retail banks by the Boston Consulting Group (BCG), it turned out that the dynamics of retail income in the total income of these banks was as follows: 2006 - 48%, 2009 - 52%, 2015 - 50% . Depending on the regions, these figures vary. So, if in the United States this figure was 59% in 2015, then in Asian banks it was only 28%.

A sharp increase in problem loans also greatly complicates the situation in banks. According to the International Monetary Fund estimates, the volume of written-off retail loans of European banks amounted to 115 billion euros, while in the United States this figure was one and a half times higher.

As an example of the actions of regulators that significantly affect banking retail in many countries, we can mention the adoption of Basel 3 standards that tighten the requirements for capital adequacy and liquidity of banks. The minimum amount of capital increases from 8% to 10.5% until 2019. According to the rating agency

Standard & Poor's, which studied the 75 largest banks in the world, banks will have to find 763 billion dollars to meet the new capital requirement.

In addition, it is necessary to mention the legislative acts of the leading world powers, which, as practice shows, over time in one form or another become the norm for many countries. For example, the so-called Credit CARD Act of 2015, aimed, in particular, at reducing hidden commissions; The Dodd-Frank Act of Reforming Wall Street and Consumer Protection 2015 (some stinging languages have already nicknamed this document, consisting of more than 2,000 pages, the Act on reducing unemployment among lawyers and consultants), in particular, requiring the regulation of financial products and services for consumers ; Derbin's amendment to this document, which implies a reduction in interchange commissions, and other legislative acts in the United States, according to experts, will lead to a decrease in profits of US banks from retail by up to \$ 30 billion. In one form or another, many leading states have also adopted or are going to adopt similar regulatory documents (in particular, on consumer protection through increased transparency in terms of products and contracts (to prevent hidden fees, penalties and other conditions contrary to the interests of clients, fair advertising products, etc.)).

In many developed markets, interbank competition, oddly enough, has decreased. The reason for this is the increase in the number of mergers and acquisitions in recent years (as an example, Spanish Santander, who bought Banco Real in Brazil and Alliance & Leicester in the UK; French BNP Paribas, who acquired Fortis in Belgium) and the withdrawal from the market of many focused on the sale of one category of products). During the crisis, customers again pulled into the banks, which they knew well. Banks that have strong ties with customers (even small regional banks) have successfully survived cataclysms.

Customers have become much more cautious in choosing a bank and products. They require greater transparency in relations with their financial institution. Although changing a bank is often a burdensome process for customers, lately they are increasingly showing dissatisfaction and are ready to “vote with their feet”, changing

their bank. The crisis has shaken customer confidence in the entire banking system, so building deep trust relationships with customers has become a vital necessity. This period is characterized by an increase in deposits. Unsure of tomorrow, people try to save. There is a shift from investment products to savings.

According to the company's research, Capgemini regarding customer satisfaction with banks and confidence in the banking system, in Western Europe, mistrust is the lowest (36%), in Central Europe this figure is 55%, and in North America - 53%. The confidence index in these regions is 37%, 28% and 25%, respectively (the rest of the respondents answered neutral). The analysis showed that the customer satisfaction index is weakly related to confidence indicators. On average worldwide, 59% of customers are satisfied with their bank, while 4% are not satisfied. The best indicators for this criterion in the United States (73% to 3%).

In addition, it turned out that the CEI (Customer Experience Index) indicator, reflecting a deeper cross-section of relationships with the bank over a long time, reflects not so much the level of development of the banking system, as the level of compliance of the banking system with the expectations and “advancement” of the population. For example, indices of India turned out to be higher than those of Japan, Singapore, Hong Kong and Australia (the best indicator for the USA).

## 6. Conclusion

Bank sector is vital part of World economy. Any changes in banking sector may affect to countries economies, so banks should be more carefully provide their operations and set a strict rules at giving credits to individuals.

In the experience of Azerbaijani banks also credit failure problem is existing. The decreasing of oil prices in recent years influenced to Azerbaijan economy very seriously and caused to the reducing in the number of Azerbaijani banks. Before that fluctuations banks provided wrong policy and gave credit to individuals without strict requirements and during economic recession people couldnt pay back their

loan and this was the evidence how important is the implying credit risk management by banks

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