MIDDLE EUROPEAN SCIENTIFIC

Volume 45, Issue 1 | 2025

https://cejsr.academicjournal.io/index.php/journal/

ISSN: 2694-9970

Article

The Economic Essence and Significance of Managing the Credit Portfolio of Commercial Banks

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Abstract: Commercial banks are one of the most important institutions of the economy, playing a crucial role in the efficient allocation of financial resources and attracting investments. Managing the credit portfolio is one of the central aspects of banking activities, directly affecting its financial stability, liquidity level, and profitability. The credit portfolio represents the overall structure of loans issued by a bank, consolidating all credits in one place. Effective management of the credit portfolio provides several advantages for commercial banks. Firstly, it helps minimize credit risks. Assessing and analyzing credit risks in advance reduces the bank's potential losses. Additionally, diversification prevents bank loans from being concentrated in a single segment, thereby enhancing financial stability. In conclusion, this article explores the concept of the credit portfolio, methods for its effective management, issues related to providing credit resources to various sectors of the economy, and opportunities for developing long-term and reliable cooperation with clients.

Keywords: commercial bank, loan portfolio, credit risk, risk management, bank liquidity, investments, diversification, financial stability.

Citation: F. Asqarov. The economic essence and significance of managing the credit portfolio of commercial banks Middle European Scientific Bulletin 2025, 45(1), 1-11.

Received: 10th Jan 2024
Revised: 11th Jan 2024
Accepted: 24th Jan 2024
Published: 15th Feb 2024

1. Introduction

Currently, commercial banks play a crucial role as a key component of the financial system in ensuring economic growth and stability. By providing loans, banks stimulate economic activity, contribute to business development, increase consumer demand, and expand investment flows. From this perspective, the issue of managing the credit portfolio of commercial banks is one of the most pressing topics today, as banks strive to minimize credit risks, maintain liquidity, and enhance profitability.

Commercial banks must adhere to several key principles when forming and managing their credit portfolios. In shaping their credit policies, banks should conduct an in-depth study of supply and demand in the credit market, assess customers' creditworthiness, analyze borrowers' payment capacity, and consider macroeconomic factors. Poorly managed credit portfolios can negatively impact a bank's financial stability and may even lead to bankruptcy.

In today's global financial environment, effective credit portfolio management is essential for ensuring the competitiveness of commercial banks. The rapid development of digital technologies, financial innovations, and big data analysis is providing new opportunities for shaping credit policies. For example, artificial intelligence and machine learning algorithms enable banks to accurately assess credit risks and analyze customers' payment capacity in advance. Additionally, continuous monitoring of the structure and quality of the credit portfolio is crucial. The repayment rate of loans, the share of overdue debts, and the quality of assets reflected on the bank's balance sheet are key indicators of the efficiency of the credit portfolio.

Therefore, commercial banks must enhance their risk management systems, improve credit analysis, and implement effective monitoring mechanisms to improve the quality of their credit portfolios. It is also important for commercial banks to develop and implement specific strategies for forming their credit portfolios. A bank's credit strategy should align with economic growth conditions and include coordinating short-term and long-term credit policies, diversification, and offering new financial products. In particular, banks can ensure the profitability of their credit portfolios by expanding loans to small and medium-sized businesses, increasing their share in the mortgage and consumer credit markets, and financing investment projects.

Macroeconomic factors also have a significant impact on the quality of the credit portfolio. Inflation rates, the central bank's interest rate policies, the stability of the national currency, and economic growth rates directly influence the formation of banks’ credit strategies. Therefore, when managing their credit portfolios, commercial banks must take into account not only microeconomic conditions but also macroeconomic factors.

2. Materials and Methods

The economic essence and importance of organizing credit portfolio management in commercial banks lie in its ability to balance risk and return, thereby ensuring the bank's profitability and stability. Effective credit portfolio management is crucial for maintaining a bank's competitive position in the financial market, especially in times of economic uncertainty. It involves a strategic approach to managing credit risks, optimizing the loan portfolio, and ensuring compliance with regulatory requirements, which collectively contribute to the bank's financial health and its role in stimulating economic growth.

Importance of Credit Portfolio Management

- Risk Management: Credit portfolio management is essential for mitigating credit risks, which are inherent in lending activities. By employing strategies such as diversification and risk assessment models, banks can minimize potential losses and enhance the quality of their loan portfolios (Kovalova & Iorgachova, 2024) (Marchenko et al., 2022).

- Profitability and Stability: The primary source of income for banks is the interest earned from loans. Effective management of the credit portfolio ensures that the bank can maximize its risk-adjusted returns, thereby maintaining profitability and financial stability (Marchenko et al., 2022) (Мягкова et al., 2021).

- Regulatory Compliance: Adhering to regulatory frameworks like Basel III is crucial for banks to manage their credit exposure and maintain adequate capital reserves. This compliance helps in reducing leverage and increasing liquidity, which are vital for the bank's long-term success (Malla, 2018).

Strategies for Effective Credit Portfolio Management

- Diversification: Diversifying the credit portfolio across different sectors and loan types helps in spreading risk and reducing the impact of defaults in any single sector(Мягкова et al., 2021) (Drobyazko et al., 2019).

- Credit Risk Assessment: Utilizing advanced models such as Value-at-Risk (VaR) and Monte Carlo simulations allows banks to assess and predict potential losses, enabling them to make informed lending decisions (Kochorba & Kolomiiets, 2024).

- Problem Asset Management: Developing strategies for managing non-performing assets is crucial for maintaining the quality of the credit portfolio. This includes regular monitoring and reporting to ensure timely interventions (Zharikova et al., 2023).

Economic Impact

- Stimulating Economic Growth: By efficiently managing their credit portfolios, banks can support investment activities and economic growth. Lending to non-financial corporations and households can drive economic development by providing the necessary capital for expansion and consumption (Kovalova & Iorgachova, 2024).
- Crisis Management: In times of financial crises, effective credit portfolio management becomes even more critical. It helps banks navigate economic downturns by stabilizing their portfolios and ensuring continued lending to key economic sectors (Zharikova et al., 2023) (Iskakova et al., 2023).

While credit portfolio management is vital for a bank's success, it also presents challenges. The complexity of managing diverse credit risks and the need for sophisticated risk assessment tools can be resource-intensive. Additionally, external factors such as economic sanctions or global financial crises can impact the effectiveness of credit portfolio strategies, requiring banks to continuously adapt and innovate their approaches (Iskakova et al., 2023) (Tokaev & Gokoev, 2023).

RESEARCH METHODOLOGY. Managing the credit portfolio of commercial banks is a process aimed at ensuring the bank's financial stability, minimizing credit risks, and increasing profitability. This process is economically significant as it helps maintain the quality and efficiency of bank assets. Effective credit portfolio management requires a comprehensive approach to risk management, liquidity maintenance, diversification, compliance with regulatory requirements, and profitability enhancement. Therefore, developing and implementing effective credit portfolio management strategies is crucial for commercial banks. The article emphasizes a systematic approach, economic-statistical analysis, and classification methods as the primary tools.

3. Results

The results of active operations are reflected in the asset side of the bank's balance sheet, providing an opportunity to assess the state of resources allocated by the bank over a given period. The largest share of active operations consists of loans issued to enterprises, organizations, and the population. This trend is also confirmed in the practices of commercial banks in our country. The dynamics and share of loans in balance sheet assets are shaped by various factors, including bank policy, as well as the economic and political conditions of the country.

Despite the Central Bank and government policies aimed at reducing inflation and the high efficiency of financial market operations, the low productivity of the manufacturing sector has had a decisive impact on the volume and nature of commercial banks' credit operations.

Active operations of commercial banks refer to activities related to generating income using own funds and attracted resources. In carrying out active operations, banks create various investments that generate income in the form of interest, dividends, or shares in joint ventures. In this process, compliance with liquidity indicators and rational risk distribution of responsible category investments is ensured.

The active operations of commercial banks can be classified into four groups:

- Credit operations that form the bank's credit portfolio;
- Investment operations that constitute the foundation of the investment portfolio;
- Cash and settlement services, which are one of the main service types provided to customers;

- Other active operations related to establishing a balanced infrastructure to ensure the successful execution of all banking services.

The loans provided by the bank can be categorized in the following manner (Figure 1):

Figure 1. Grouping procedure for effective management and analysis of a bank's loan portfolio

Source: Compiled by the author.

Despite the high efficiency of pure financial operations, the manufacturing sector remains low-income and constantly in need of additional resources. This situation limits the ability of commercial banks to allocate their resources to the manufacturing sector and forces them to direct their active operations primarily to the financial market. Even though the profitability level is low, commercial banks have continued to increase the volume of lending to the service sector of the production industry, albeit at a slower rate than the growth rate of financial market resources.

Commercial banks' credit activities include two types of operations:

- Providing cash funds on a repayable basis.

- Issuing guarantees and sureties, where the bank assumes the obligation to cover the loan in case of partial or complete default by the client.

Credit Functions

Economic literature offers different interpretations of credit functions. Some sources emphasize a single credit function, while others describe multiple functions, such as distribution, redistribution, cash substitution, and accumulation of funds. The seeming contradiction between these functions can be reconciled by considering their role in the overall production process or within an individual economic entity's financial cycle.

The concept of credit functions is derived from the dialectical relationship between generality and uniqueness. The general function of credit manifests in the process of social production turnover, while the unique function appears in the individual turnover process. Within the framework of national production, credit serves two primary functions:

- Ensuring monetary circulation in the national economy.
- Temporary transfer of idle monetary funds.

For the national economy to function properly, there must be an equivalent monetary mass sufficient for the volume of material goods in circulation. Thus, value simultaneously exists in both commodity and monetary forms. Based on their intended use, bank loans can be classified as monetary credit or capital credit.

From this perspective, it is important to note that some bank loans facilitate economic circulation by supporting the production of new material goods, while others contribute to expanding production assets and redistributing resources. The monetary equivalent of newly created gross domestic product serves as the material basis for the first type of credit, while the accumulated and redistributed part of the national gross product, concentrated within the credit system, forms the material basis for the second type.

Credit Resources and Their Mutual Interdependence

The issue of the mutual balance between credit disbursements and credit resources is a crucial consideration in the lending process. The issuance of credit and the formation of credit resources are interdependent and cannot exist separately. The link between credit resources and loans extended for material and commodity circulation lies in the fact that issuing credit leads to the creation of new resources.

Short-term and long-term loans for the development of production assets should be limited to the volume of credit resources accumulated by the bank. This suggests that lending in the sphere of circulation should not be strictly confined to bank resources, as each loan backed by material goods inherently contributes to the creation of new resources.

Lending for the formation of production assets requires the prior accumulation of resources. In both cases, credit resources take the form of monetary equivalents of material and commodity wealth:

- In the first case, these are funds entering the sphere of circulation.
- In the second case, these are funds exiting the sphere of circulation.

At present, commercial banks have defined key theoretical guidelines for forming their resources when providing specific types of loans. The described procedures indicate that while commercial banks issue loans, they simultaneously create credit resources backed by real material goods moving along the "producer consumer" path. Large banks issuing loans should ensure that the allocated funds continue to circulate within their clients' accounts. If these credit-based resources exit the bank system, it may create liquidity issues at the Central Bank's settlement accounts.

If the issuance of credit for settlements is delayed without economic justification, it may disrupt the continuous circulation of funds in individual organizations and, ultimately, negatively affect the overall production process. These disruptions often manifest as systematic payment delays.

The Redistribution Function of Credit

From the perspective of the reproduction process, the second function of credit is the redistribution of idle funds across industries and sectors of the economy.

Credit also plays an essential role in individual turnover cycles when it serves as a source for forming working capital. Economic funds, which are in constant motion during their circulation cycle, take three forms:

- Cash,
- Production assets,
- Finished products.

Thus, while part of an enterprise's funds remains engaged in production, another part participates in circulation.

During different periods of the turnover process, enterprises may experience both a need for additional funds and the presence of surplus funds. If organizations maintain working capital based on their maximum annual needs, a portion of these funds becomes excessive, reducing operational efficiency. Conversely, if they maintain working capital at the minimum required level, they may experience cash shortages at certain periods, negatively affecting their business operations.

If organizations form their working capital based on average needs, fluctuations will still arise, creating financial imbalances. Therefore, managing working capital requires maintaining proportionality in fund availability and needs, ensuring continuous production and sales processes. This balance is achieved by defining working capital sources as either internal or external (bank loans or credit from other lenders).

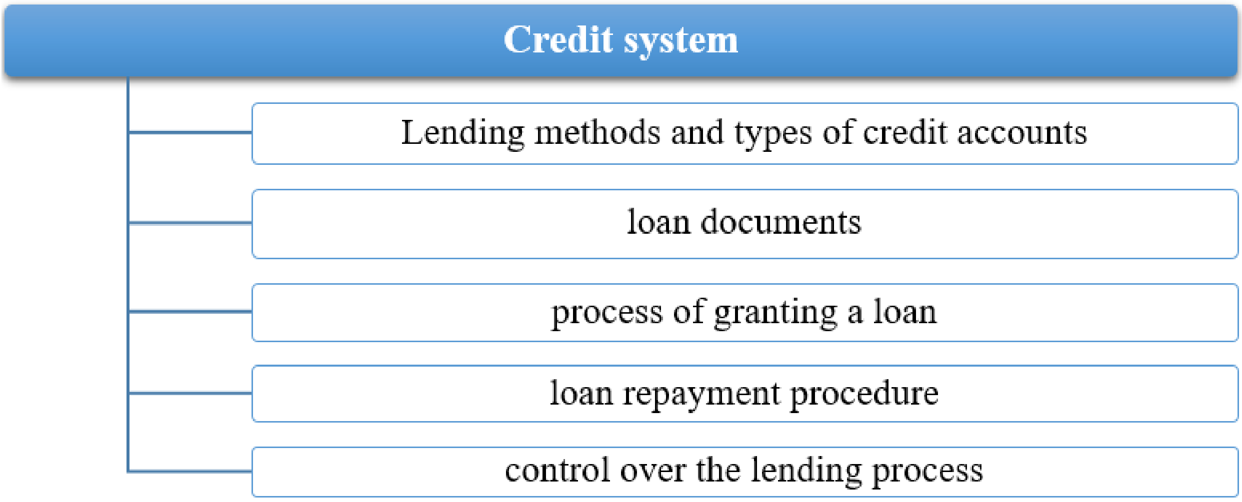

Figure 2. Lending system of commercial banks

Source: Compiled by the author.

Credit as a Necessity in the Reproduction Process

Fluctuations inherent in reproduction cycles and the resulting variable demand for production and working capital objectively necessitate credit. Credit helps resolve the contradiction between available funds and funding needs.

As a form of movement of loan capital, credit is used to satisfy the changing financial needs of enterprises that cannot fully meet them with their own funds. By providing working capital in the form of loans without altering a company's own capital, commercial banks enable enterprises to obtain financial resources in line with their actual credit needs.

Principles and Methods of Lending

Despite the diversity of lending objects and subjects, as well as the variety of loans granted to legal and physical entities, the lending system forms a unified structure that includes the following components (Figure 2).

Banks provide loans to legal and physical entities while adhering to the fundamental principles of lending. These principles are applied together and complement each other, forming the foundation of the lending process (Figure 3).

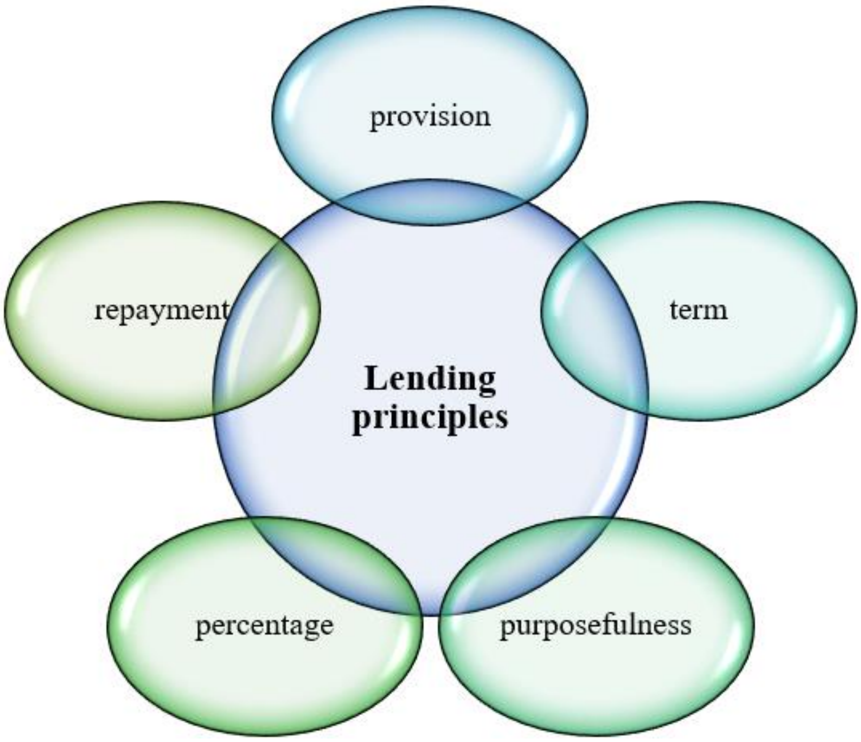

Figure 3. Basic principles applied by commercial banks in lending

Source: Compiled by the author.

Principles and Methods of Lending

The objects and subjects of lending can vary, and the types of loans provided to legal entities and individuals may differ. However, the lending system, in terms of its characteristics, constitutes a unified system that includes the components listed below (Figure 2).

Banks provide loans to legal and physical entities while adhering to the fundamental principles of lending. These principles, which are applied together and complement each other, form the basis of lending (Figure 3).

4. Discussion

Loan Security

Loan security means that the granted loan is guaranteed by specific material assets, financial documents, or the right to receive financial resources. In some cases, loans are granted to large, reliable borrowers based on their "corporate image" as collateral. However, even in such cases, the borrower's assets are still considered as a form of security for the granted loan.

The real aspect of loan security is reflected in the temporary transfer of ownership rights to a portion of the borrower's assets (which, in most cases, are acquired using the granted loan). These assets may include real estate documents, equipment, inventory, securities, goods, and other valuable items, which serve as collateral for the bank-lender.

Loan Repayment

Loan repayment refers not only to the return of the loan at the end of its term but also to the possibility of intermediate repayment as a result of completed operations (e.g., commercial transactions, production achievements, housing sales in the construction sector, etc.).

Loan repayment is not ensured in two cases:

1. If the loan is not used for its intended purpose.
2. If the transaction being financed has not been properly analyzed or if the bank has not adequately assessed the likelihood of loan repayment.

Loan Maturity

Loan maturity is closely related to its intended use and repayment. The bank grants loans for specific purposes with the condition of repayment, meaning that the loan should be automatically repaid as a result of the borrower's cash flow cycle.

The maturity of a transaction depends on the purpose for which the loan is used and the timing of cash flow release during the production or sales cycle.

Loan Purpose

The purpose of a loan refers to the borrower's activities, which are known and approved by the bank in advance. In some cases, this purpose is clearly defined (e.g., forming working capital, financing specific commercial transactions, etc.). In such cases, the bank can directly assess the feasibility and security of the specific operation being financed.

However, in some instances, loans may be provided for the general financing of a borrower’s operations. In these cases, the bank makes decisions based on available information about the firm and monitors the targeted use of the borrowed funds.

Lending Methods

A lending method can be determined based on the set of techniques banks use to provide and repay loans. There are three main methods of lending:

1. Turnover-based lending method
2. Balance-based lending method
3. Turnover-balance lending method

Turnover-Based Lending

In turnover-based lending, loan funds follow the movement and turnover of the lending object. The loan finances the borrower’s expenses when their own funds are insufficient. As the objective need for credit increases, the loan amount expands, and as the need decreases, the loan is repaid.

This method represents a continuous, self-renewing process, ensuring that credit moves in sync with changing needs.

Balance-Based Lending

In balance-based lending, the loan is directly linked to the stock of tangible assets and expenses that created the need for credit. In this case, an organization initially purchases the necessary assets using its own financial resources and then, by pledging these assets as collateral, applies for a loan from the bank.

The pledged stock of tangible assets ensures the loan's security, but the credit is provided not to finance purchases but to compensate for previous expenses. Compared to turnover-based lending, balance-based lending accounts for a smaller portion of the total loan volume.

Turnover-Balance Lending

In practice, turnover-based and balance-based lending methods can be combined, forming the turnover-balance lending method.

In the first stage, credit is provided when the need for funds arises. In the second stage, it is repaid according to a fixed schedule, although the volume of released resources may not always be sufficient.

In the first stage, credit is granted at the initial stage of the movement of tangible assets and expenses. In the second stage, the credit is repaid based on the borrower's outstanding obligations to the bank.

Loan Accounts

Loan transactions are recorded in credit accounts opened by the bank for the client. A credit account is an account where the borrower’s debt, loan disbursement, and repayment transactions are recorded.

All credit accounts follow a unified system:

- Loan disbursement is recorded on the debit side of the credit account.
- Loan repayment is recorded on the credit side of the credit account.
- The client’s outstanding debt to the bank is reflected on the debit side of the credit account.

Types of Credit Accounts

Although the scheme for recording loan disbursement, repayment, and debt remains unified, credit accounts can differ based on their purpose and the nature of cash flows.

Deposit-Credit Accounts

Credit accounts may be structured as deposit-credit accounts. In this case, the client is entitled to a loan only after exhausting their own funds deposited with the bank. This type of account is commonly used by individuals who save money in bank deposits and take out loans when necessary. When a debit balance appears in these accounts, they transition from deposit accounts to credit accounts.

Current Credit Accounts

Credit accounts linked to cash flow turnover are widely used in industries with seasonal production cycles, trade, agriculture, and procurement organizations, where goods and materials are supplied daily. One specific type of such an account is the contocorrent account.

A contocorrent account records all payments related to a company’s main activities, as well as expenses associated with expanding and modernizing fixed assets. This type of credit account is particularly convenient for clients with a high credit rating and strong financial stability.

Flexibility of Modern Lending Practices

Modern lending practices differ from a rigid, standardized approach. Instead, they offer multiple options based on the borrower’s needs. The bank’s client selects the most convenient lending method, the appropriate type of credit account, and a suitable loan repayment schedule.

5. Conclusion

The management of the credit portfolio of commercial banks is a crucial process aimed at ensuring financial stability, minimizing credit risk, and increasing profitability. Effective management not only helps maintain the bank’s liquidity and profitability but also contributes to economic growth. By diversifying the credit portfolio, optimizing risks, and complying with regulatory requirements, banks can provide high-quality services to their clients. Therefore, through strategic credit portfolio management, commercial banks not only strengthen their financial position but also contribute to the sustainable development of the economy.

The effective management of the credit portfolio of commercial banks positively impacts the bank's financial stability and economic development. Below are some scientific recommendations for improving this process:

- Enhancing the credit risk assessment system: It is necessary to implement artificial intelligence technologies to quickly determine customers' creditworthiness, predict credit risks in advance, and monitor them in real-time.
- Diversifying the credit portfolio: Distributing loans across various industries, customer segments, and credit types helps to reduce overall risks. In particular, it is advisable to expand retail lending rather than relying solely on large loans.
- Improving the bank's credit policy: Optimizing interest rates in accordance with market conditions and developing new financial instruments and innovative credit products is appropriate.
- Strengthening credit monitoring and control systems: Identifying problematic loans in advance, improving mechanisms for their repayment, and continuously analyzing credit portfolio quality indicators are essential.
- Integrating digital technologies and big data: The use of big data, blockchain technologies, and other digital tools in assessing customers' creditworthiness is required. Additionally, it is necessary to develop a fast credit issuance system through mobile applications and online platforms (Mamadiyarov, 2022).

The implementation of the above recommendations will enable commercial banks to improve the quality of their credit portfolios, increase profitability, and ensure the stability of the banking system.

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