

## ECONOMICS

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### Features of credit risk assessment of borrowing banks in Ukraine

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**Abstract.** The work examines the methodological approach to assessment of financial condition of agency banks while laws and regulations are changing. It gives the list of necessary information and indicators that are basis for assessment of borrowing banks. It determines the advantages and disadvantages of expert opinion in bank analysing that will allow to solve the main problems of bank analysis in Ukraine.

**Keywords:** *financial condition, quantitative indicators, classes of agency banks, expert opinion, CAMELS rating.*

**Problem statement.** No country can develop successfully without credit relations and lending resource market with its major component which is the interbank lending market. Due to obtaining of interbank credits a bank may replenish its resources as well as having resource excess the bank may place it on the interbank market. The interbank lending market is an important component of the lending resource market.

Practice of banking business confirms the necessity of thorough investigation on credit risk assessment on the interbank lending market. Moreover the reliability of the banking business practice significantly influences the results of the definite credit agreements as well as the whole lending efficiency of the bank. The consequences of the permanent mistakes of credit risk assessment may lead to declining credit portfolio quality which make the bank increase its expenses on placing on hold. At best, this leads to worsening of financial condition of the banks. At worst, it brings the bank to bankruptcy.

Domestic scientists such as Halchynsky A.S., Dziubliuk O.V., Lukianenko D.G., Lysenkova U.M., Moroz A.M., Mozkovy O.M., Sokalsky V.V., Pukhovkina M.F., Peresada A.A, Savchuk M.I. examine thoroughly theoretical and practical aspects of interbank lending, its role on the macro- and microeconomic levels. But such issues like credit risk assessment according to the interbank credit transactions of the bank still require separate researches.

**The object of this article** is the research of methodological approach to credit risk assessment of borrowing banks that is widespread in Ukraine, and developing guidelines for its improving.

**Description of the basic information.** Researches on the contractors' credit risk assessment show that it comes to the financial condition assessment. Financial condition assessment of the contractor includes a row of analytic procedures such as calculation on the basis of the statistics reports and taking into account additional information of the borrower which result in forming propositions on rating (classing) of the contractor.

The procedure for determining the credit risk of the borrower including contractor banks, currently governed by the National Bank of Ukraine Regulation "On the procedure for the formation and use by banks of Ukraine the reserves for recovery of possible losses on active banking transactions" approved by the National Bank of Ukraine (NBU) of 25.01.2012 № 23. The Regulation contains a list of financial results that are to be calculated while evaluat-

ing the financial condition of contractor banks in order to adequately assess credit risks, as well as other requirements for credit risk evaluation.

According to the Regulation:

- the bank does a monthly assessment of financial condition of the borrowing bank during the term of the credit agreement on the basis of analysis of absolute and relative indicators of the current financial and statistical reports (horizontal analysis) in progress, as well as assets and liabilities by determining the proportion for individual items in the final data (vertical analysis) in progress;
- while analysing financial and statistical reports, the bank takes into account the following information: keeping the economic regulations and standard of compulsory funds reservation, performing by the bank its past liabilities concerning the provided and received interbank loans and the annual audit report;
- depending on the financial condition level the borrowing bank is assigned one of four classes: A, B, C or D [5].

Considering this we can claim that the bank independently determines and sets classes for contractor bank based on the analysis of the contractor bank financial condition and financial market situation. On the basis of financial condition assessment done and the class assigned, the bank determines the category of credit transaction quality and risk index.

The minimum set of input information used for borrowing banks assessment is as follows:

- calculation of indicators on the basis of statistical report file # 02 (the balance for the reporting period);
- analysis of keeping regulations and limits of open foreign currency position in the statement on keeping the economic regulations in the reporting period (form № 611);
- information on keeping liabilities by the contractor on previous credit transactions for 6 months.

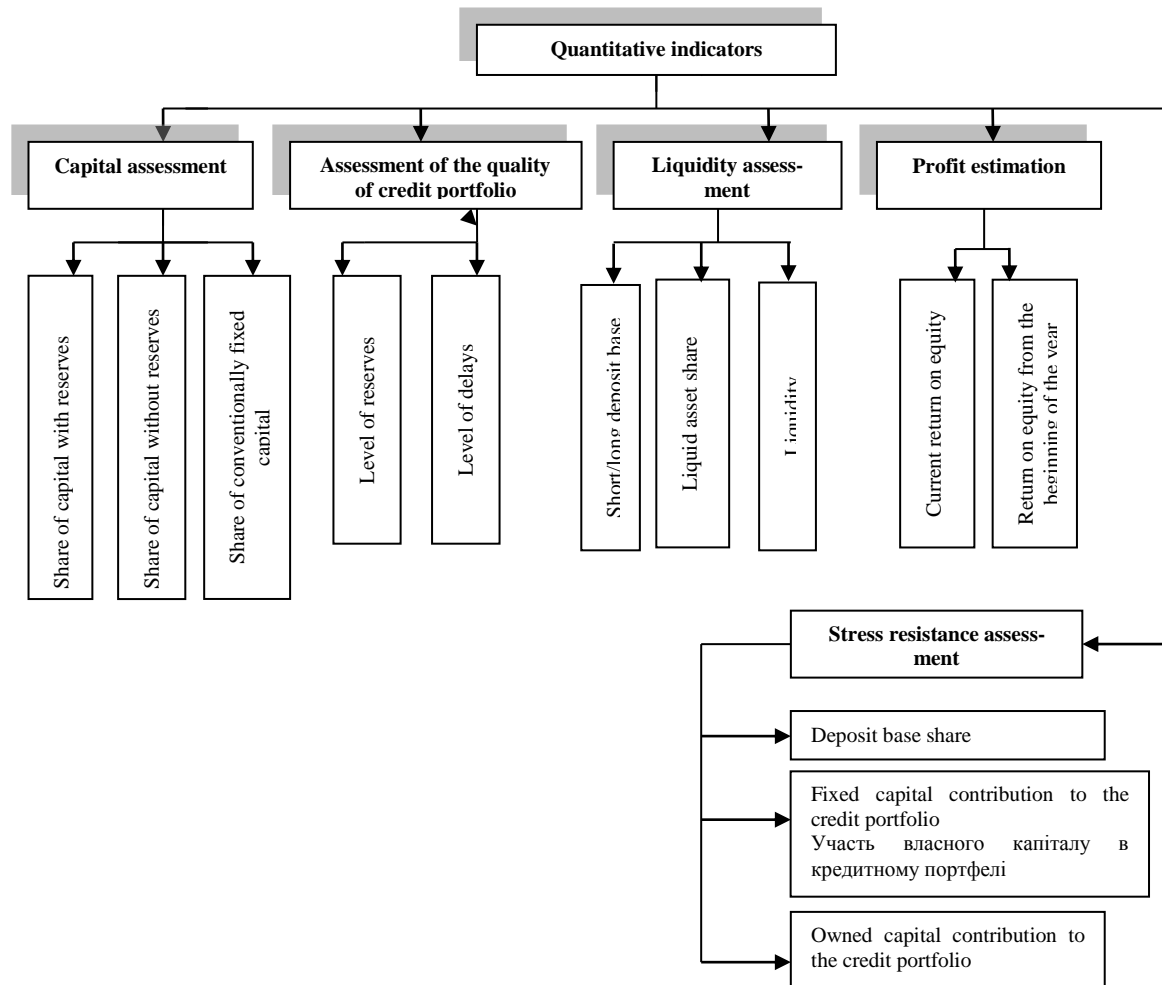
In addition, while assessing the financial condition the bank may take into account the following information became known from third parties:

- information on credit history quality, reputation at the interbank market and the cooperation period of the Bank with the relevant Contractor;
- information on participation in legal and arbitration cases;
- information on reputation of the founders, shareholders, relations with other organizations through the Contractor's participation in their capital, occurring of conflict and criminal situations and other aspects of Contractor's activities (through other organizational units of the Bank);
- information on directors' powers of the contractor bank;

Using collected data the bank evaluates the financial condition and defines classes for contractor bank making so-called "bank rating". Regularly, to define the class, the

banks do quantitative and qualitative evaluation. Picture 1 shows quantitative indicators commonly used in domestic

banking practice for assessing the financial condition of contractor banks.



Picture 1. Classification of quantitative indicators for the bank class determining

During the investigation it was determined that a qualitative assessment is carried out to take into account other parameters, and its result is an adjustment of general index, which was determined after calculation of quantitative indicators in such areas as financial status of shareholders, estimation of information from third parties, the evaluation of changes in the value of total index.

However, when assessing some "informal" aspects of the bank activities, they remain without due attention although they are crucially important. Such factors as management quality or personnel policy are difficult to formalize and regulate the extent of their impact on the overall condition of the bank as a part of the standard methods. This issue can be solved by drawing expert opinion or exactly methods of expert assessment. The expert, who may act as an officer who checks the bank, is able to identify and evaluate all essential aspects of its work. The only thing needs to be done after all is systematizing the results and getting the conclusion. And this is the case when methods of expert assessment analysing will help [1].

Using expert approach in bank analysing allows us to solve the basic problems of bank analysis. First, we consider significant individual characteristics of the bank and adequately describe them in the conclusion. Second, we consider not only quantitative indicators but also qualita-

tive information on the bank condition which is often more important.

Thus, the expert assessment is non-numeric in principle, and to analyse it we need relevant methods which allow to take into consideration their features. In banking practice, there are detailed theories that help to solve majority of standard problems, for instance the hierarchy analysis theory, non-numeric statistics, group analysis, etc. Unfortunately, in the domestic banking practice the methods of expert assessments analysis are not as widely used as in the Western Europe and the USA.

It is important to mention, that according to the hierarchy analysis, the problem should be divided into smaller components which in their turn are divided into even smaller ones and so on, which leads to the formation of the hierarchy. Thus, the upper levels of the hierarchy contain more general knowledge and rules than the lower ones [3].

According to the above concept a well-known CAM-ELS expert rating system seems to be suitable to use. This technique of hierarchical structure was designed in 1978 by the Federal Reserve System, Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC). It assesses each bank on the ground of documents that are submitted to the Bank Supervision Agency. The rating is calculated as the arithmetic mean

value of each component checked. Abbreviation CAMELS (first CAMEL) comes from the first letters of the components that are checked:

- (C) – Capital adequacy;
- (A) – Asset quality;
- (M) – Management;
- (E) – Earnings;
- (L) – Liquidity
- (S) – Sensitivity to risk.

Despite the prospects of such representation of banking analysis, CAMELS rating has obvious methodical shortcomings. First, it is not clearly formalized as an expert knowing the value of "small" components, should rate the major components. Second, it seems incorrect to get the final result of the bank reliability rate by simple summing up the rating points of reliability components. Points are of non-numeric nature therefore we cannot use them as ordinary numbers. It is better to use more appropriate methods including ones that consider different influence degrees of components to the overall rating of the bank [2].

However, the overall concept of CAMELS rating fits well the theory of hierarchy analysis where all those problems mentioned above are eliminated properly. Thus, there is a scientifically sound way of necessary improvement of the well-known methods. After relevant work is

done, it is possible to create a new rapid bank assessment method based on CAMELS rating which will allow to obtain general numerical evaluation of the bank reliability; get numerical evaluation of components of bank reliability; compare and classify banks according to their reliability level or similar aspects of their work.

This technique can be widely used for conducting various kinds of inspections of credit institutions. Improved methods of CAMELS rating will help to get not only a new effective method, but also on the ground of expert knowledge to find out the real influence degrees of certain aspects of the bank work to the overall reliability rate [4].

**Conclusions.** Thus, nowadays there is a situation in the domestic banking practice when banks assess the financial condition of contractor banks based on their own methods developed in accordance with the NBU requirements. For the more precise analysis of the bank work and reduction the credit risk of the interbank transactions, it is necessary to use formal methods based on bank reports and combine them successfully with the expert evaluation methods that are commonly used in the world. The example of such a method can be CAMELS rating, as far as officers examining bank papers, who are experts in their field, able to identify and evaluate all significant factors that impact the bank work, including informal factors.

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#### Семко В.Н. Особенности оценки кредитного риска банков-заемщиков в Украине

**Аннотация:** В статье рассмотрен методологический подход к оценке финансового состояния банков-контрагентов в условиях изменения нормативно-правовой базы. Определен перечень необходимой информации и показателей, на основе которых осуществляется оценка банков-заемщиков. Отмечено преимущества и недостатки использования экспертной оценки в анализе банковского учреждения, что позволит решить основные проблемы банковского анализа в Украине.

**Ключевые слова:** финансовое состояние, количественные показатели, классы банков-контрагентов, экспертная оценка, концепция CAMELS.