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# SPECIFIC FEATURES OF ASSESSING PAYMENT ABILITY BY COMMERCIAL BANKS

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**Abstract**:
The article presents research devoted to theoretical and methodological issues of determining the solvency of business entities, the economic content of the concepts of solvency and creditworthiness, the relationship of solvency with other economic indicators and the conclusions drawn on their basis.

**Keywords**: Solvency, bank, credit, security, liquidity ratio, funds.

## Introduction

Payment ability is a broad concept, and creditworthiness is a part of it, reflecting the ability of business entities to repay loans obtained from commercial banks. Therefore, we found it necessary to study the procedures for determining the creditworthiness of business entities by commercial banks and to draw relevant conclusions based on this study. In particular, "Mikrokreditbank" JSC has developed its own methodology for assessing the creditworthiness of business entities and implements its credit policy based on this methodology.

According to the credit policy of "Mikrokreditbank" JSC, creditworthiness is the assessment of the financial condition of business entities and their ability to repay loans on time and in full. The creditworthiness of business entities is characterized by a number of indicators. The number of indicators is not limited and is independently determined by each commercial bank based on the specific features of the activities of the clients it serves.

## LITERATURE REVIEW

Several theorists have studied the concepts of liquidity and payment ability. In particular, the theory of the variability of bank liquidity regarding commercial banks

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was proposed by H.G. Moulton, who emphasized that "if commercial banks maintain a large volume of assets that can be converted into cash without material losses when necessary, then there will be no losses."

According to S.O. Udoka and R. Anyingan, "a perfectly marketable asset must be convertible immediately into capital without loss when liquidity is required. According to this theory, regardless of the nature of the assets, banks must possess assets that can be easily transferred into cash at satisfactory prices when funds are needed in order to be considered liquid."

N.R. Emmanuel, in the theory of "Commercial Credit or Real Bills Doctrine," indicates that a commercial bank should issue only short-term, self-liquidating, and productive loans to business entities. Loans intended to finance the production, storage, transportation, and distribution of goods through sequential stages are considered self-liquidating loans. This theory also emphasizes that when commercial banks issue short-term, self-liquidating productive loans, the central bank should accept such short-term loans as collateral. This principle ensures an appropriate level of liquidity for each bank and an adequate money supply for the entire economy.

Unlike the commercial credit theory, the Expected Income Theory was developed based on the practice of U.S. commercial banks extending term loans. According to this theory, regardless of the nature and character of the borrower's business, the bank plans to repay the term loan from the borrower's expected income. In issuing such a loan, the bank imposes restrictions on the borrower’s financial activities. In lending, the bank considers not only the collateral but also the borrower's expected earnings.

While the commercial credit theory focuses on short-term assets, the expected income theory is oriented toward long-term assets, and the variability theory focuses on the ability of assets to be converted into cash regardless of their nature. The liability management theory is also based on similar principles.

The methodology identifies the necessary compulsory indicators of creditworthiness, such as the loan coverage ratio, liquidity, and equity ratio (independence coefficient), as well as dynamics of the availability of own working capital, outstanding debts, profitable activity, and the turnover of working capital.

The main indicators of creditworthiness consist of the following ratios: coverage, liquidity, and equity provision (independence coefficient).

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## RESEARCH METHODOLOGY

In the process of organizing and conducting the research, methods based on accounting techniques were used, including expert evaluation, comparative analysis, content and event analysis, as well as systematic and factor analysis.

## ANALYSIS AND DISCUSSION OF RESULTS

Liquidity indicators are used to assess the ratio between the most liquid elements of a company's balance sheet and its short-term liabilities. The higher the coverage of these liabilities through quickly realizable assets, the stronger the company's financial position and the greater its opportunity to obtain credit from banks.

The balance sheet coverage ratio is calculated as the ratio of current assets (after deducting future period expenses, deferred expenses, and overdue accounts receivable) to current liabilities. A higher coverage ratio indicates a more stable financial standing, enhancing the company's creditworthiness and its attractiveness to financial institutions.

$$Q_k = \frac{Current\ Assets - Future\ Period\ Expenses\ and\ Deferred\ Expenses - Overdue\ Accounts\ Receivable}{Current\ Liabilities} (1)$$

If the liquid assets exceed short-term liabilities by at least two times, the financial condition of the economic entity can be considered good. This threshold represents the upper limit of the criterion. When an economic entity possesses liquid assets equal to the amount of its short-term liabilities, it is accepted as the lower limit of this criterion.

The liquidity ratio reflects how quickly an economic entity can meet its payment obligations, indicating the extent to which current liabilities can be covered by the most liquid assets (excluding inventory and other assets requiring a longer time to be converted into cash).

This ratio provides information about the degree to which current liabilities can be covered by available cash, revenue expected from the sale of excess products, completed work, rendered services, the sale of securities, and amounts collectible from debtors within the near future.

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The liquidity ratio is calculated as the ratio of the sum of cash, short-term investments, and receivables (excluding overdue receivables) to current liabilities — in other words, it considers only truly liquid assets, without including inventory.

$$L_K \frac{\text{Cash+Short−term Investments+Accounts Receivable−Overdue Accounts Receivableari}}{\text{Current Liabilities}} (2)$$

The equity ratio (also referred to as the financial independence ratio) is calculated by dividing the total amount of equity by the total liabilities (passive side) of the company's balance sheet.

This ratio reflects the degree of the company's independence from borrowed sources of financing.

The equity ratio is determined using the following formula:

$$M_k = \frac{\text{Equity}}{\text{BTotal Liabilities}} * 100\% (2)$$

The value of this indicator should not fall below 30%.

Depending on the level of current asset turnover and the nature of the entity's operations, the acceptable threshold for this indicator may be slightly lower.

If, after calculating the three main solvency indicators, the total score is less than 9 points, the enterprise should not be granted a loan.

If the total score ranges from 9 to 19 points, the enterprise is considered to have insufficient repayment capacity and may be granted a loan only under exceptional circumstances, provided that it is secured by highly liquid assets.

Even when the equity ratio is high, a substantial portion of the company's equity may be invested in long-term assets, making it insufficiently involved in the formation of current assets such as inventories and production costs.

Therefore, when assessing the creditworthiness of an enterprise, it is necessary to also evaluate the availability of its own working capital.

The availability of working capital (Net Working Capital, NWC) is calculated as:

Working Capital (NWC) = Equity Capital + Long-Term Loans and Borrowings – Long-Term Assets

Additional indicators of creditworthiness include the following:

Turnover ratio of working capital and turnover time,

Turnover ratio of accounts receivable and turnover time,

Turnover ratio of accounts payable and turnover time,

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Profitability ratios,
And other relevant indicators.
These additional creditworthiness indicators complement the main ratios and provide a more solid basis for drawing conclusions.

$$Turnover\ coefficient: = \frac{\text{Revenue from product sales}}{\text{Average balance of working capital}} (3)$$

Inventory turnover period (days):

$$\text{Turnover } time\ = \frac{\text{Average balance of working capital}}{\text{Revenue from product sales}} * 365\ (4)$$

The liquidity ratio of receivables:

$$K = \frac{\text{Revenue from product sales}}{Average\ accounts\ receivable\ amount} (5)$$

The turnover period of receivables (in days)

$$K = \frac{\text{The average amount of receivables}}{\text{Revenue from sales of goods}} * 365\ (6)$$

The liquidity ratio of payables:

$$K = \frac{\text{Sotilgan mahsulot tannarxi}}{\text{Kreditorlik qarz o‘rtacha summasi}} (7)$$

The turnover period of payables (in days)

$$K = \frac{\text{Kreditorlik qarz o‘rtacha summasi}}{\text{Sotilgan mahsulot tannarxi}} * 365\ (8)$$

Rentabellik koeffitsientlari:

Aktivlar rentabelligi koeffitsienti:

$$K_{AR} = \frac{\text{Aktivlar qoldiq qiymati}}{\text{Mahsulot sotishdan tushgan tuShum}} (9)$$

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Sof foyda rentabelligi:

$$K_{SfR} = \frac{\text{Sof foyda}}{\text{Mahsulot sotishdan tushgan tuShum}} (10)$$

The share of the borrower's own funds in the total value of the project (maximum score 5):

| | |
|---|---|
| a) more than 50% | 5 |
| b) from 30% to 50% | 3 |
| v) from 20% to 29% | 1 |
| g) less than 20 % | 0 |

The financial condition of a company is often directly related to its actual cash flow. Cash flows through the company's accounts, including those of settlements and other financial records, are referred to as cash flow.

The amount of cash flow from the debtor determines the company's ability to repay loans and ensure working capital. For a thorough analysis, it is essential to have data on the cash flow from previous and projected periods, the sources of funds, and how these funds are used.

If a company is conducting its primary activities, it must ensure that, during the investment period, it has enough cash flow to cover interest payments. To assess this, it is necessary to consider the following indicator, especially when conducting credit monitoring:

Debt Service Coverage Ratio (DSCR): This ratio shows how much the company's operating income (before paying interest) exceeds the annual debt repayments, including principal and interest. Monitoring the debt service coverage ratio provides insight into how the funds obtained from debt are being used to expand operations.

$$KOD\ (QXKK) = \frac{\text{Earnings Before Interest and Taxes}}{\text{Interest and Current Principal Debt Expenses}} (11)$$

One of the methods to protect against the risk of loan repayment is to attract sufficient collateral to secure the loan. This method guarantees the repayment of the loan and interest payments. When collateral is provided for a loan, it is important not only to cover the amount of the loan itself but also the interest payments.

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The following table outlines the recommended principles for assessing the collateral object and determining the loan amount relative to the market value and appraised value of the collateral. These guidelines help ensure that the collateral sufficiently covers both the principal and interest amounts of the loan.

**Table 1 Recommended Principles for Collateral Valuation are as follows:**

| **Types of Collateral** | **Valuation or Market Value** | **Credit Amount in Relation to Market Value** |
|---|---|---|
| Bank Guarantee (According to the decision of the central bank's credit committee, the guarantee of insurance companies) | Financial Reporting in Terms of Taxation: | Up to 100% |
| Movable Property (such as retail stores, hotels, factories, office buildings, etc.) | a) Market value assessed by the valuation organization. | If the property has been appraised by both the property appraisal organization and another organization, the minimum value should be taken from both appraisals, up to 80%. |
| Machinery and Equipment (Cranes, excavators, helicopters, KamAZ trucks, other cargo vehicles, motor graders, and others): | b) Valuation committee's assessment agreed upon between the bank, | |
| Produced from 1997 to 2013 | Depreciated market value refers to the market value of an asset after accounting for its depreciation | Up to 70 % |
| Accounting Technology and Devices (Computers and others) (Based on the decision of the central bank's credit committee). | Depreciated Market Value | Up to 60 % |
| Equipment | Market value after depreciation | Up to 60 % |
| Transport Vehicles: | the borrower, and the pledge holder. | |
| Produced from 1997 to 2013. | Market value after depreciation | Up to 70 % |
| Goods in Stock<br>(Based on the decision of the central bank's credit committee). | Market value. If the item is a highly demanded liquid asset, it is based on the condition that the quantity of the item in stock is not significantly reduced. | Up to 50% |
| Jewelry Items | This is based on the valuation of a licensed appraisal organization. | Up to 80% |

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When analyzing the factors affecting the borrower, it is necessary to also consider various industry and market indicators. These include general economic conditions, the overall state of the industry, competition in the market, the stages of development of the product market produced by the enterprise, the level of marketing development within the enterprise, the existence and size of the sales market for the product being produced. The following Table 16 presents the criteria for evaluating the creditworthiness of legal entities using the scoring method.

In evaluating the creditworthiness of legal entities using the scoring method, the "Credit Information" criterion involves assessing the enterprise's credit history, as outlined in the following table.

The final evaluation consists of four categories: the first category determines high-quality credit levels, the second category identifies acceptable credits with some drawbacks that require monitoring, the third category identifies credits that could have problems, and the fourth category identifies credits with a high likelihood of serious issues. This approach provides crucial information and data to assess the potential issues that may arise with credits.

**Table 2 The procedure for assessing a company's credit history is as follows:**

| **Indicator names** | **Score** |
|---|---|
| a) The company has been a client of the bank for more than 3 years. It has used bank loans multiple times and has repaid the principal amount and interest on time. | 4 |
| b) The company has been a client of the bank for 1.5 to 3 years. It has used bank loans and repaid the principal and interest on time. | 3 |
| v) The company has been a client of the bank for more than 1.5 years, has good working capital, but has not used any bank loans. | 1 |
| g) The company has been a client of the bank for less than 1.5 years or has used loans in the past but failed to repay them on time. | 0 |

It is necessary to give special attention to the last two categories when conducting credit monitoring because these indicators show whether there are issues with the repayment of loans or the client's activities, and such loans may be classified as problematic. Therefore, each of these categories is divided into two additional parameters to determine the adequacy of reserves for covering potential losses from

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such loans. This evaluation should require necessary measures to be taken quickly to reduce losses and take corrective actions.

From the above, we can see that this commercial bank uses a system of specific indicators to make calculations when deciding on credit allocation as part of its credit policy. However, in our opinion, it would be appropriate for the bank to take several factors into account:

Firstly, if the company's operating period is less than 1 year, it should be given 0 points, or if the company has been operating for 1-3 years, only one point should be given. This would limit the ability of newly established and financially unstable entities to obtain credit.

**Table 3 System for Assessing the Creditworthiness of Clients**

| Class | Description | Overall |
|---|---|---|
| Class 1 | Even in the worst-case scenario, significant losses are unlikely. Credit is provided to private entrepreneurs with a good reputation and financial standing, whose situation is very unlikely to deteriorate sharply. The collateral for the credit meets the necessary requirements. They are presented as reliable customers. These customers are generally eligible for loans. It is also possible to provide them with loans on preferential terms. It is recommended to carry out standard monthly monitoring. | 85-100 |
| Class 2 | Credit is provided to quite well-known borrowers who demonstrate a sufficient level of financial stability. The client has the necessary financial resources, but for one reason or another... | 55–84 |
| Class 3 | The client's financial situation is unstable. An unfavorable market situation has emerged, and the possibility of further deterioration increases the likelihood of losses. These clients are considered unfit for credit, and loans can only be granted if high-liquidity collateral is provided or based on the decision of the Bank's credit committee, with one of the alternative types of collateral. It is recommended to conduct monthly checks on the client in the future. Special attention should be paid to the client's financial situation, monitoring their accounts, and maintaining regular meetings and communication with the client. | 23–54 |
| Class 4 | These clients should not be granted credit (except in exceptional cases). | 0–22 |

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## CONCLUSION AND RECOMMENDATIONS

In our opinion, this clause should be excluded from the credit granting process, or a score should be given as follows: 5 points for clients who have had a reliable and stable business operation for more than 5 years, and 3 points for those with less than 5 years of stable operations. If a company has been operating for more than 5 years but instability is observed, 3 points should be awarded; if a company has been operating for less than 5 years with observed instability, 1 point should be given.

If the subject shows a downward trend in its activity, regardless of whether the activity lasts more or less than 5 years, it would be appropriate to assign 0 points.

Additionally, if the subject is a corporate client and shows stable development indicators, even if they have not used bank credits before, a score of 4 points should be awarded based on their credit history.

It is also recommended to leverage interbank relationships for effective benefits. That is, even if the client is not a customer of the current bank, but has received loans from other banks and has a positive credit history, relevant information should be obtained, and opportunities should be created to benefit from their credit history in the proper manner.

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