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THE ESSENCE OF FORMING PROVISIONS FOR PROBABLE CREDIT LOSSES

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Abstract

This article examines the economic essence of forming provisions for probable credit losses, their importance in the banking system, and their role in credit risk management. The creation of reserves is a key instrument for ensuring the quality and stability of commercial banks’ loan portfolios. The study also analyzes methods for assessing probable losses and highlights the relationship between international standards and national practices.

Keywords

credit, credit risk, probable losses, provisions, banking system, financial stability, loan portfolio

Introduction

Nowadays, the banking system represents a crucial component of the economy, and its stable operation determines the financial stability of the country. The core activity of commercial banks is lending, which is inherently associated with various risks, particularly credit risks. The emergence of credit risk increases the probability of financial losses for banks. Therefore, it is essential to assess potential losses in advance and establish mechanisms to cover them. The formation of provisions for probable credit losses plays a vital role in ensuring the financial stability of banks, controlling the quality of their loan portfolios, and minimizing unexpected losses. These provisions are allocated based on the likelihood of loan defaults, thereby reducing the level of risk in banking activities. In modern banking practice, determining expected credit losses and forming provisions in accordance with international financial reporting standards (IFRS) is particularly relevant. The main objective of this article is to reveal the essence of forming provisions for probable credit losses, analyze their role and significance in the banking system, and highlight directions for improving this process.

Main Body

The formation of provisions for probable credit losses is an integral part of banking activities and serves as an effective mechanism for managing credit risk. Loans issued by banks always carry the possibility of default or delayed repayment. Therefore, assessing potential losses in advance and creating appropriate provisions is a key factor in ensuring the financial stability of banks. Provisions for probable losses represent financial resources allocated by banks to cover potential losses within their loan portfolios. These provisions are formed based on the quality of loans. Typically, loans are classified into several categories: standard

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(performing), substandard, doubtful, and loss (non-performing) loans. Since each category has a different probability of default, the level of provisioning also varies accordingly. For example, standard loans require minimal provisions, whereas doubtful or loss loans require significantly higher provisioning. In modern banking practice, international financial reporting standards, particularly IFRS 9, play a crucial role in determining expected credit losses. According to this standard, credit losses are assessed using the Expected Credit Loss (ECL) model. This model requires banks to estimate potential losses over the entire life of a financial asset, rather than only when a loss event occurs. This forward-looking approach enables banks to assess risks more accurately and take timely preventive measures. The assessment of expected losses is based on several key indicators, including the borrower's creditworthiness, credit history, financial condition, quality of collateral, and macroeconomic factors. In addition, banks utilize statistical models and historical data to evaluate credit risk. Alongside human judgment, automated systems and advanced analytical tools are increasingly used in this process. Moreover, the formation of provisions is regulated not only by internal bank policies but also by the requirements set by central banks and regulatory authorities. This ensures a unified approach within the banking system and strengthens overall financial stability. Insufficient provisioning can negatively impact a bank's financial performance and may lead to liquidity problems. Thus, the formation of provisions for probable credit losses is a critical element of banking operations, contributing to risk mitigation, prevention of financial losses, and the overall stability of the banking system.

Loan Classification and Provisioning Table:

Loan Category	Description	Risk Level	Provision Rate (%)
Standard	Borrower makes payments on time	Low	1–2%
Substandard	Minor delays in payments	Medium	5–10%
Doubtful	регуляр delays, high probability of default	High	25–50%
Loss	Loan is unlikely to be repaid	Very High	100%

IFRS 9 ECL Model Table:

Stage	Description	Type of Loss Recognition	Key Indicators (PD, LGD, EAD)	Provision Level
Stage 1	Performing assets with no significant increase in credit risk	12-month Expected Credit Loss	Low PD, Low LGD	Low
Stage 2	Significant increase in credit risk (early signs of payment delays)	Lifetime Expected Credit Loss	Medium PD, Medium LGD	Medium
Stage 3	Credit-impaired assets (default or serious payment delays)	Lifetime Expected Credit Loss	High PD, High LGD	High

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Problems

The process of forming provisions for probable credit losses is associated with several challenges that directly affect the efficiency of the banking system. First, accurately assessing credit risk is a complex task, as the financial condition of borrowers is constantly changing, making precise forecasting difficult. In particular, macroeconomic factors such as inflation, exchange rate fluctuations, and overall economic instability significantly influence the probability of loan default. In addition, the implementation of the IFRS 9 standard and the ECL model requires banks to collect and analyze large volumes of data. However, many banks face difficulties due to the lack of high-quality and comprehensive historical data, which limits the accuracy of risk assessment models. Furthermore, determining key indicators such as PD, LGD, and EAD often involves estimation and assumptions, which may lead to inaccuracies. Another important issue is the insufficient implementation of modern technologies and automated systems in some banks. This can slow down the calculation process and increase the likelihood of human errors. Moreover, the shortage of qualified specialists in risk management and financial analysis also hinders the effective application of the ECL model. Additionally, allocating large amounts of provisions can reduce banks' profitability, which may create incentives to underestimate provisions. This, in turn, can reduce the reliability and transparency of financial statements, potentially misleading investors and regulatory authorities. Overall, these challenges highlight the need for improved methodologies, advanced technologies, and full compliance with international standards in the process of provisioning for credit losses.

Recommendations and Solutions

To address the existing challenges in forming provisions for probable credit losses, banks should adopt a comprehensive and systematic approach. First, it is essential to implement modern digital technologies and advanced analytical systems for more accurate credit risk assessment. The use of big data and artificial intelligence can significantly improve the evaluation of borrowers' creditworthiness and enhance the accuracy of the ECL model. Furthermore, banks should prioritize the development of high-quality and comprehensive historical data systems. Improving data collection, storage, and processing will allow for more precise calculation of PD, LGD, and EAD indicators. At the same time, adopting international best practices and ensuring full compliance with IFRS 9 standards is crucial. Enhancing human capital is another key solution. Banks should organize regular training programs, professional development courses, and international certification opportunities for their employees. This will improve expertise in risk management and reduce errors associated with human factors. In addition, strengthening internal control systems and improving audit processes are essential. Ensuring transparency in provisioning practices and preventing intentional underestimation of reserves will increase the reliability of financial reporting. Regulatory authorities, including central banks, should also enhance supervision and establish stricter compliance requirements. In general, improving the system of provisioning for probable credit losses will contribute to strengthening financial stability, enhancing risk management, and increasing trust in the banking system.

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Conclusion

In conclusion, the formation of provisions for probable credit losses is a crucial mechanism for ensuring the stability and sustainability of the banking system. It enables banks to assess credit risks in advance, cover potential financial losses, and maintain the quality of their loan portfolios. In particular, the application of the Expected Credit Loss (ECL) model under IFRS 9 allows for a more accurate and forward-looking approach to risk management. At the same time, several challenges remain, including data limitations, methodological complexity, technological gaps, and a lack of qualified specialists. These issues require banks to adopt more advanced approaches, implement modern technologies, and fully align with international standards. In the future, improving the provisioning system for credit losses will enhance the financial stability of banks, strengthen risk management practices, and support sustainable economic development. Therefore, ongoing reforms and practical measures in this area will play a significant role in increasing the reliability and efficiency of the banking sector.

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