

# SCIENTIFIC AND THEORETICAL FOUNDATIONS OF PROJECT FINANCING RISK MANAGEMENT IN COMMERCIAL BANKS

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**Abstract.** *The article examines the mechanisms, scientific-theoretical and practical aspects of risk management in project financing. The current state of risk management has been analyzed, and proposals and recommendations for further development in the practice of commercial banks have been developed.*

**Keywords:** *investment, project financing, risk, risk management, risk managing, quality indicators.*

## **Introduction**

Current socio-economic processes in the world, globalization of the world economy, as well as intensification of competition in international and local markets show the urgency of financing projects in commercial banks, existing problems, and improving the mechanisms used in risk management.

In order to effectively and timely implement the financing of investment projects aimed at ensuring the rapid development of economic sectors in our country, the new version of the Law of the Republic of Uzbekistan "On Investments and Investment Activities"[1], decrees of the President of the Republic of Uzbekistan "On the Development Strategy of the New Uzbekistan for 2022-2026" [2], "On measures of transition to a qualitatively new system of investment program formation and implementation of the Republic of Uzbekistan" [3] and resolution "On measures to improve the mechanism of management of investment projects with the participation of international financial institutions and donor countries" [4] ] were adopted and consistent measures are being taken to actively attract funds. Based on this, within the framework of these measures, a qualitatively new procedure for state programs and financing of the country's development has been introduced, with clearly defined sources of economically justified project financing.

It can be said that in recent years, we can see the growth of investment loans in the total loan portfolio of the banking system of our country. This creates the need and increases the relevance of commercial banks to improve risk management mechanisms in project financing.

In addition, it is worth noting that project financing is considered a high-risk activity of banks, and the management of this type of risk is a complex and multi-step process.

Based on this, it is important for commercial banks engaged in project financing to form their own scientific and theoretical foundations that help the process of "risk management" in order to manage risks.

## **Review of literature on the topic**

According to economist Ya.M. Mirkin, as the investment activities of commercial banks recognizes activities focused on "universal and specialized commercial banks financing investment projects on the basis of loans and shares, organizing and placing the issue of securities

on the primary market, managing assets, managing an investment company, carrying out transactions with real estate, consulting-analytical and broker-dealer operations» [5].

Also, in the research conducted by A.Naryana, it was mentioned that risk management processes in the investment activities of commercial banks are carried out in the following stages: that is, identification and analysis of the essence of risk; risk assessment and calculation of losses; development of risk management recommendations, risk reduction through the authority of officials involved in risk management; to control that the submitted reports on risk management are prepared in accordance with the established criteria and rules; earning income depending on the level of risk (high risk high income, low risk low income). Emphasis is placed on balancing risk and return[6].

In addition, P. Rose, one of the foreign economists, takes a broader approach to the concept of bank risk and emphasizes that it consists of 6 main types of risk, namely, credit risk, risk of non-profitability, liquidity risk, market risk, interest risk, and non-payment risk. At the same time, P. Rose considers the above six risks as very important, crucial risks in banking, and political risk and currency risk as secondary risks for the bank [7].

Foreign economist A. Shapkin describes the risk of loss equal to or more than the value of the borrower's property as an "extraordinary risk" arising in the investment activities of commercial banks. In his opinion, "emergency risk" usually leads to bankruptcy and complete insolvency of the enterprise, because in this case there is a risk of losing not only all the funds invested in the project, but also its property[8].

Sh.Abdullaeva, one of the economists from Uzbekistan, also researched the concept of bank risk, she claims that «banking risk is the possibility of losing part of the bank's funds in the process of carrying out banking activities, or carrying out bank operations (deposit, credit, investment, currency) hoping for a positive result in the absence of income»[9].

D. Ismailov in his research on the further improvement of investment financing methods of commercial banks by reducing risk claims that "since the implementation of high-tech projects based on scientific innovations and discoveries usually has a high level of risks, and also the demand for venture financing is high in our republic, and this risky investment method has not been developed, then it is necessary to actively attract foreign venture funds to positively solve the problem»[10].

Also, D. Nafasov proposed the following approach to the concept of bank risks: "In international banking practice, relations referred to risks mainly occur in the course of asset transactions. However, it should be noted that not all asset operations of commercial banks are associated with risk. In particular, it is appropriate to emphasize credit and investment operations as the main risk-related asset operations of commercial banks. We can see that it is recognized that banks generate their income through these operations because of the high level of risk involved in these asset transactions[11].

Bank risk, in particular, some aspects of bank risk arising in the financing of investment projects, have been researched by the aforementioned economists, and their author's approaches in this regard have been put forward. However, the improvement of risk management mechanisms in project financing and the factors affecting it have not been studied as a comprehensive research work. This determines the purpose and specific aspects of this research.

### **Research methodology**

Practical aspects of the article have been formed based on researching the approaches and views of foreign and domestic economists on the subject and expressing the author's attitude towards them, the scientific-theoretical methodological aspects of the article, as well as the improvement of risk management mechanisms that arise in project financing at the international and national level today, the analysis of priority aspects related to risk management in practice. As a research methodology, comparative literature analysis, logical and structural analysis, grouping and contrastive comparison, economic-statistical analysis and hypothesis substantiation methods have been used.

### **Analysis and results**

Investment projects are a system of organizational and economic decisions organized in order to effectively invest financial capital in order to achieve the goal set by the enterprise. The form and content of projects can be different - that is, from the construction of a new enterprise to the purchase of real estate, etc.

Today, trends formed at the international level provide new, modern and innovative opportunities for the banks of Uzbekistan, but also lead to the emergence of certain risks. The implementation of investment projects is associated with the possibility of risk factors, that is, the risk of not being able to fully or partially achieve the goals set for the project. In particular, the following are the main factors that have a negative impact on the development of investment lending practices:

- the insufficient ability of enterprises to repay the loan, which is often explained by the fact that the quality of the current management system is not up to the required level;
- current state of exchange rate policy in the country. The fact that the exchange rate regime is based on exchange rate formation based on supply and demand;
- shortcomings in the legal and regulatory documents that prevent the full consideration of the variability of the refinancing rate and other negative situations in order to ensure that the inflation rate in the country is within the target indicators;
- incompleteness of modern, international mechanisms for financing projects of enterprises in commercial banks;
- high level of risks in crediting investment projects in commercial banks;
- insufficient demand for goods and services produced by local enterprises.

The object of the bank's financing of investment projects is investment projects related to diversification or modernization of production, expansion of production or increase of production safety, as well as purchase of additional production capacities in enterprises of the real sector of the economy.

The following can be subjects of investment activity, i.e. investors and participants of investment activity:

- citizens of the Republic of Uzbekistan (natural persons);
- individual entrepreneurs and legal entities - residents;
- state administration bodies and local state authorities;
- foreign countries, administrative or territorial bodies of foreign countries, international organizations and foreign legal entities and citizens, as well as stateless persons.

In order to determine the specific characteristics of risks in lending investment projects, it is necessary to reveal the essence of the concept of bank risk more widely and to determine the specific characteristics of credit operations for real investment.

As we know, the practice of bank risk management in our country does not have a long history. Before the independence of our country, most of the commercial banks were organized on the basis of state property, as well as they carried out their activities mainly in cooperation with state enterprises and organizations, so the risk problem did not arise in banks. The formation of independent banking system of a modern banking, the establishment of private and joint-stock commercial banks in the banking system opened a wide way for the international integration of banking activities. This made it necessary to pay special attention to the factors that negatively affect the efficiency of bank operations and services, in particular, the factor of bank risks that arise in the financing of investment projects.

Modernization of the economy, technical and technological renewal, sharp increase of its competitiveness, increase of export potential, organization of new productions based on new innovative and energy-saving technologies, mastering the production of new types of goods that are in demand in the world market and thereby ensuring the financial and economic stability of our country investment policy are showing their effectiveness.

In particular, we will consider the analysis of investments in fixed capital in recent years by the composition of the main types of funds (Figure 1) [12].

Figure 1

Composition of investments in fixed capital by types of fixed funds

*billion soum*

Basic funds	2019 y.	2020 y.	2021 y.
Total	195927,3	210195,1	239552,6
Residential buildings	20621,9	23200,8	29851,0
Non-residential buildings	33408,1	38172,7	50894,5
Other structures	23148,7	27039,0	30290,6
Land improvement	127,3	285,9	277,1
Machinery and equipment, total :	107305,8	110493,8	113863,9
Transport equipment	16588,2	12415,2	14574,5
Information, computer and telecommunication (ICT) equipment	3194,8	7347,0	5325,6
Other machinery and equipment	87522,7	90731,6	93963,8
Animal resources that produce multiple products	2418,9	2843,0	3656,8
Multiple yielding trees, agricultural crops and seedlings resources	372,0	880,7	838,6
Costs associated with the transfer of ownership rights to non-producing assets	198,1	225,0	138,2

Computer software and databases	28,7	25,2	98,6
Original works of entertainment, literature and art	3,7	1,6	0,8
Scientific research and development	5,9	86,5	30,8
Exploration and evaluation of mineral reserves	763,7	26,7	96,4
Other intellectual property products	330,1	229,0	292,3

Analyzing the statistical data, machinery and equipment are leading in the composition of investments in fixed capital by types of fixed funds. In 2021, the total sources of financing in this type of main investment fund were 113,863.9 billion. soums or increased by several percent compared to previous years. Its composition as of 2021 consists of the following:

- 14,574.5 billion soum belongs to transport equipment; - 5,325.6 bln. soum to information, computer and telecommunication (ICT) equipment; - 93,963.8 bln. soum to other machines and equipment.

If we consider the share of investments in fixed capital by commercial banks by specific types of economic activity, it can be seen that the volume of investment funds allocated to industry and individuals has a high weight (Figure 2) [13].

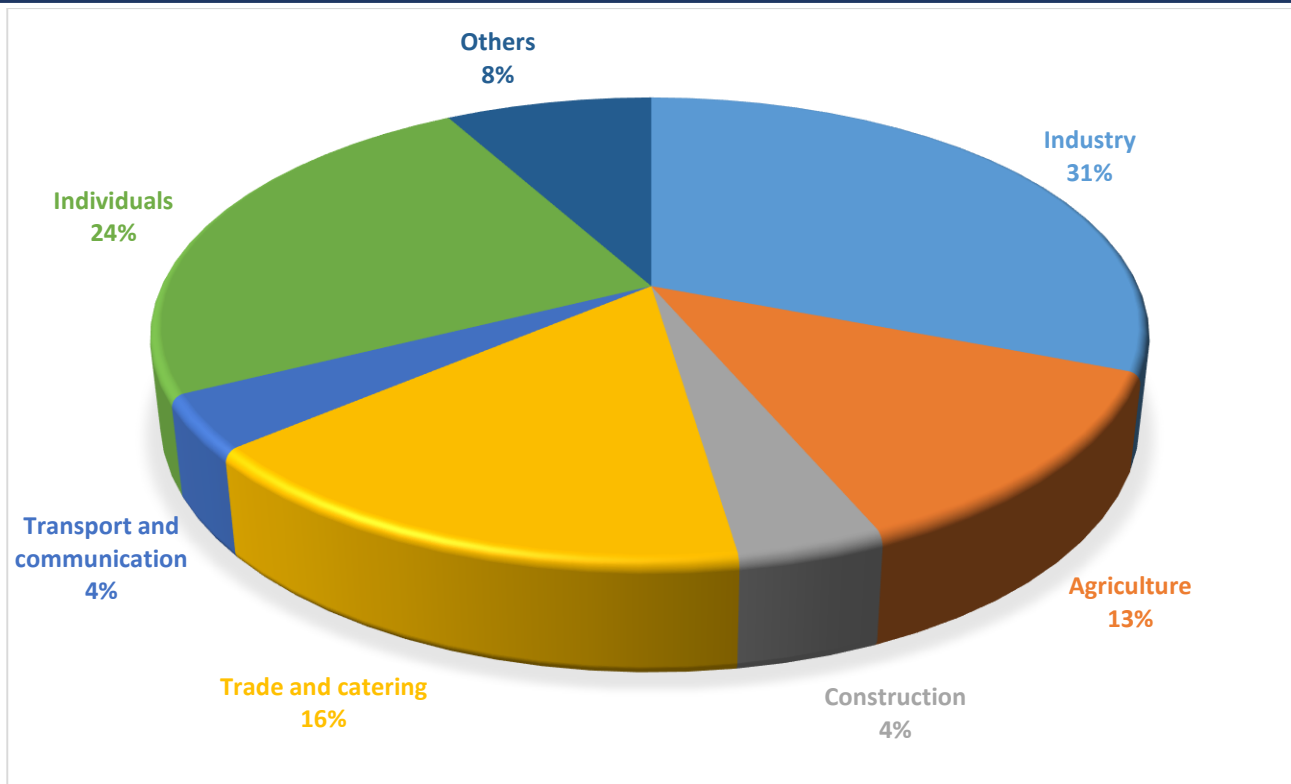
According to the data, 31 percent or 51.3 trillion soums of investments in fixed capital are directed to industry. In addition to other types of economic activity: the volume of investments allocated to individuals made up 24 percent of the total investments or 40.5 trillion soums.

At this point, in the financing of investment projects by commercial banks paying specific attention to the following quality indicators of the project, i.e. discount rate, payback period, discounted payback period, average rate of return, net income from the project, income index, internal rate of return and modified rate of return plays an important role in ensuring the viability of the project. That is, the high efficiency of the project quality indicators shows the quality of the investment projects under consideration.

Figure 2

**Distribution of investments made by commercial banks in basic capital by specific types of economic activity.**

**As of January 1, 2022, in percents**



Today, the following aspects are important in the further development and efficiency of the investment projects of commercial banks in the economic sectors:

- Activity and initiative of commercial banks of the Republic of Uzbekistan in the financing of annual investment programs and regional investment programs, including projects involving foreign investments, participation in the monitoring of post-financing processes, attracting funds aimed at foreign investments, loans and financial and technical assistance;

- expanding and stimulating the volume of investments in economic sectors and regions, further improvement of the investment environment in the republic, implementation of the policy of attracting foreign investments aimed at supporting the development of the activities of enterprises with the participation of foreign capital;

- systematic control of the implementation of investment projects, also, analysis of how investment obligations are fulfilled by investors, determining the factors and risks that prevent the timely and effective implementation of investment projects involving foreign investments and, on the basis of taking prompt measures to eliminate them, increasing the effectiveness of the use of foreign investments attracted to the economy of our country;

- it is considered appropriate to use risk-management widely in the management, monitoring and evaluation of project financing risks in commercial banks. Through risk management, banks constantly monitor the quality and composition of their assets, the current state of possible risks, and the prevention of losses that may occur as a result of risk is ensured.

### **Conclusions and recommendations**

In order to improve risk management mechanisms in project financing in commercial banks, it is advisable to implement the following measures:

1. Constantly analyzing and monitoring the purposeful use of financial funds allocated to investment projects, timely realization of income after the project is launched, taking measures to avoid overdue receivables and payables..



2. Correct and perfect implementation of initial control over the effective use of project financing, in this process, first of all, paying special attention to its current financial condition, knowledge and experience in this field, and the status of the project's quality indicator.

3. It is appropriate to consider the micro and macro level of risk management in project financing. The micro-level importance of bank risk management is ensuring the financial stability of commercial banks, enabling banks to fulfill their obligations to customers in full and on time, and to obtain the appropriate economic benefits.

4. As the importance of risk management at the macro level, we can mention such cases as ensuring the stability of the economy and the positive impact of the banking system on economic growth, strengthening the purchasing power of the national currency and ensuring the target indicators of inflation, creating a positive balance in the country's balance of payments.

In short, improving the mechanisms of risk and their management in the financing of investment projects is a multifaceted process, and the effective implementation of this process will ensure the efficiency of project financing financed by commercial banks, as a result of which it will be possible to increase the level of interest income of commercial banks.

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