Problems of Using Underwriting in Leasing Lending

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Abstract

This article highlights the importance, role and features of the underwriting service in lending leasing activities. The practice of crediting the subject in banks of different countries has been touched upon. The opinions expressed by local and foreign scholars on underwriting have been studied. In the process of crediting the lessee, the underwriters were approached as independent experts, with their participation, the issue of using the scoring model in the analysis of contracts and identifying unforeseen risks was discussed. The use of flexible models in the underwriting process for leasing contracts and the results achieved by this are briefly discussed.

Keywords: leasing, leasing lending, underwriting, scoring, financial indicators, rating model.

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Introduction

The high level of competition in the financial market, increasing the efficiency of credit agreements and the current financial situation create the need to reduce the costs of credit organizations. Standardization of lending stages in commercial banks is considered an important factor in solving the problems.

Therefore, in financing the activities of lessors through loans, commercial banks focus on the activity of the lessee as the last consumer of credit resources. Compliance with financial discipline of the lessee is not only an important category of credit quality, but also a factor that shows the quality of the provided service at a high level.

In practice, commercial banks may apply contractual limits related to lending to leasing companies. In particular, setting additional requirements for the structure of the contract and the lessee's financial condition, requiring additional security: collateral, surety, business risk insurance, etc. In order to standardize these processes, shorten the contract review period and reduce labor costs, it is proposed to introduce the underwriting process by commercial banks to make decisions on financing the activities of leasing companies. At the same time, the depth of the analysis and the measure of evaluation of the participants of the contract are determined based on the structure of the contract.

Literature analysis

The government has been paying special attention to increasing the efficiency of commercial banks in our country by reducing the risks encountered in their activities. In particular, in order to improve the quality of assessment of potential risks and optimize the decision-making process, the head of our state organized groups of highly qualified underwriters to improve lending mechanisms in state-owned banks, optimize service processes and introduce modular ("identical") credit products and their bank credit by increasing the share in the portfolio, expanding the types of fast and low-cost retail banking services and further improving the scoring systems of banks are also a task that needs to be solved [1].

The concept of underwriting was first used in writing in 1622 to mean "signing some kind of document". Initially, insurance contracts were concluded in London coffee shops. In this, merchants (at that time they were not called insurers) met with ship and cargo owners [2]. Similarly, V.A. According to Makarova, the term "underwriting" appeared during the formation of marine insurance, in which the merchant, as a third party, confirmed by signature that he assumed responsibility for covering possible risks [3].

N.I. Morozko, P.D. Burov highlighted the importance of underwriting in assessing the solvency of small businesses and entrepreneurial entities, and touched upon innovative ways of its development. According to them, underwriting activity in commercial banks serves to reduce the occurrence of problem loans as a risk analysis process [4].

According to M.S. Kudrenko, underwriting means the procedure for assessing the creditworthiness of a borrower (a legal entity and an individual). In other words, underwriting is an assessment of the probability of credit coverage of a potential borrower based on the procedure established by a commercial bank [5].

Different countries and different banks have different methods of risk assessment in the activities of potential borrowers and use different assessment systems. In particular, the practice of underwriting in the US banking sector is based on six "C" [6]:

1. Character – character;

2. Capacity – ability;

3. Cash – funds;

4. Collateral - provision;

5. Conditions - conditions;

6. Control - control.

In the US, special legislation has also been created to regulate the collection of information in risk assessment.

In Great Britain there is a practice of " PARTS " of risks [6]:

1. Purpose _

2. Amount – size;

3. Repayment - compensation;

4. Term - term;

5. Security - security.

A key difference from US practice is that lenders use their own criteria and benchmarks for risk assessment in the UK, rather than credit bureau ratings.

In our country, the underwriting service is approached as one of the advanced practices of banks in the field of banking services in the capital and securities markets, and opinions are given on its wide use in the lending practice of commercial banks [7].

A group of scientists under the leadership of I.I.Alimov approached the underwriting activity as an activity that provides services for the organization of the issue between the underwriter (underwriters) and the issuer under the conditions specified in the contract or the guaranteed placement of the issuer's securities, and focused on the importance of underwriters in the issuance of securities [8].

It can be seen that the issue of scientific study of underwriting activity in the activity of commercial banks and the use of foreign experience in creating a national underwriting system is of urgent importance today.

Analysis and results

The underwriting used in the credit process provides for a comprehensive independent analysis and examination of the risks related to the credit agreement (in our example, lending to the lessor) based on the methodology used in banking activity. As a result of the examination, the underwriter makes a decision on the possibilities of implementing a specific contract based on the specified conditions.

Different coefficients can be used in credit institutions to determine the solvency of a potential borrower. Below are the coefficients developed in the USA and European countries and used in the practice of most countries (Table 1).

Table 1 The main types of coefficients used in underwriting [9]

No	Coefficient	The content of the coefficient	The norm
1	Payment/Income	The ratio of loan payments in a certain period to the borrower's income in the same period	T/D≤40%
2	Liability/Income	The ratio of the borrower's liabilities to the total income	M/D≤60%
3	Loan/Collateral	The ratio of the amount of the requested loan to the value of the property to be purchased	**90%** ≤K/G≤30%
4	Loan/Termination Value	The ratio of the loan amount to the minimum value of real estate for sale	

Positive decisions include a number of mandatory conditions for the provision of financing, in particular, contract parameters: amount, term, commercial bank premium and collateral changes, as well as a number of proposals.

In such a case, the leasing company will be provided with a revised draft contract for making new decisions on the contract. At the end of the negotiations, a decision is made on the possibilities of implementing the contract.

The first step in the analysis of the credit agreement is the application of the scoring model, through which the quantitative and qualitative indicators of the lessor and the lessee are analyzed. On the basis of special computer programs created by the bank or external programmers, the contract participants are analyzed and evaluated on the basis of point-weighted indicators, and as a result, their credit rating is determined. As a rule, the credit rating obtained as a result of scoring reflects the default probability of the counterparty. The outcome of this assessment will be relied upon to determine further contractual action. If the rating of the lessor and (or) the lessee is assessed as low or the parameters of the contract indicate a high level of risk, then based on the risk management approaches of commercial banks, a more in-depth analysis of the assessment model and an increase in credit provision are envisaged.

Otherwise, funding decisions are made on the basis of an automated system without the participation of an independent expert.

The analysis of contracts requiring the participation of an independent expert - an underwriter in the control process allows to identify risks not foreseen in the scoring model, but it prolongs the decision-making period on the contract and increases the costs of banks. Therefore, when creating a system for analyzing credit products and risks, banks should carefully approach the creation of a rational decision-making system under the contract, which allows choosing standard terms of lending that does not require large labor costs.

The classic model of analysis of the credit agreement without applying underwriting measures envisages the analysis of the financial and economic activities of the lessor and the lessees. In this case, the financial and economic activity of the leasing entities is based on the analysis of important financial indicators of the counterparty's activity and in most cases involves the use of a scoring model to determine point-weighted indicators. As a result of the scoring model, they are presented with a credit rating.

The preparation of a credit summary for each contract is a complex and time-consuming process, and the final data obtained from the analysis, if the credit analyst is a person interested in the contract (as a result of the performance indicators of the employees set by the bank as a result of

KPI or due to personal relations with the contract participants), his subjective attitude may have been formed under the influence of The use of credit underwriting measures allows to reduce the types of risk due to the fact that the conclusion of the credit analyst is subject to additional scrutiny.

It is for this reason that the underwriting department should be free from the influence of other departments of the bank and be independent from the bank's business plan related to achieving the target amounts in terms of loan portfolio and income. In order to achieve such independence of the credit underwriting structure, it is required to form it as a separate department free from direct and indirect effects of other departments within the bank. In practice, there are cases of organizing underwriters in a separate building, city and even in a separate region according to the territorial designation.

The quality indicators obtained due to the application of scoring models to the process of rating evaluation and analysis of lessors and lessees are evaluated on the basis of economic-mathematical modeling methods, previously such analysis was carried out on the basis of expert opinions of credit analysts.

Point-weighted models used in rating programs are used to solve the following tasks:

➢ determining the level of influence of each factor being evaluated, which affects the level of credit risk;

➢ development of an economic-mathematical rating model.

The probability of default of the lessor and the lessee, as a result of which the risk of non-fulfillment of the obligations assumed can be estimated in the range of 0-100%. In the rating model, such estimates are divided into certain intervals, and a corresponding risk group is closed for each. Both banking and financial market statistics are used in the formation of the model. Depending on which risk group the loan agreement is qualitatively included in, the bank forms reserves for losses. For example, in banks in Russia, the amount of reserves for loan losses is set as follows: from 1 percent to 20 percent for non-standard loans; from 21 percent to 50 percent for doubtful loans; from 51 percent to 100 percent for problem loans; 100 percent for bad loans [10]. In our republic, the formation of reserves to commercial banks to cover possible losses on loans classified as "standard", "substandard", "unsatisfactory", "doubtful" and "hopeless" is defined based on the regulation developed by the Central Bank [11]. In particular, the norms of mandatory reserves for loan losses are as follows: for substandard loans in the amount of 10 percent of their outstanding principal (residual) amount; for unsatisfactory loans in the amount of 25 percent of their unpaid principal (residual) amount; for doubtful loans in the amount of 50 percent of their unpaid principal (residual) amount; for bad loans, it is necessary to form special reserves in the amount of 100 percent of their unpaid principal (residual) amount.

It is possible to distinguish a number of stages that serve as the basis for building the bank's business processes in the process of lending a lease agreement. These include:

1. Determination of the parameters related to the lessor's (sometimes the lessee's) application to the bank, the subject's application. At this stage, the following should be determined:

➢ loan amount and term;

➢ assessment of the provision of credit resources;

➢ presence/absence of additional security (collateral, guarantor);

➢ other important terms of the contract.

2. The employee of the front office (customer manager) who is involved in attracting customers to the bank must conduct a preliminary assessment of the lessor and lessee, the documents submitted by them, as well as perform an express analysis of the content of the contract to determine whether the contract is in line with the bank's interests.

3. The credit department analyst prepares a conclusion on the purposefulness of credit allocation and sends this information to the underwriter.

During the independent examination of risks under the contract, the underwriter checks the following:

➢ the reliability of the provided information;

➢ parameters of the loan agreement, i.e. compliance of profitability and security with the bank's internal regulatory documents;

➢ correctness and reasonableness of filling the parameters of the rating model.

In the event of a positive conclusion of the underwriter, a decision on the implementation of the contract will be issued by the bank's authorities. The rating of lessors and lessees is taken into account as the main indicator.

Quantitative and qualitative factors are also taken into account when calculating the rating [12].

Quantitative factors are evaluated based on the counterparty's accounting report. Quality factors include:

➢ branch in which the borrower operates;

➢ the position of the borrower in the market, its main competitors;

➢ negative opinions about the business owner(s) and the management process;

➢ diversification of contract portfolio, dependence on goods suppliers and buyers;

➢ positive credit history;

➢ financial and investment policy;

➢ existence of currency risks;

➢ transparency of the borrower's financial situation, etc.

As a result of the evaluation of the quality factors of the leasing company and the lessee's activities, the underwriter provides an expert opinion on the extent to which these factors may affect the non-fulfillment of obligations under the loan agreement being concluded.

Determining the rating of counterparties is carried out in several stages, and it is directly related to the composition of the methodology for determining the rating. Economic-mathematical analysis and modeling methods make it possible to determine the risk factors, the range of their influence on the non-return of the loan, and to assess the degree of probability of the debtor not fulfilling his obligations honestly. It is important to take into account additional risk factors that arise when determining the rating under the influence of quantitative and qualitative factors.

As we mentioned above, quantitative and qualitative factors determine the rating of the borrower. In turn, statistical analysis allows to determine the share (weight) of indicators in the

model. Modern credit institutions use one type of model to determine the borrower's rating. At this point, it should be noted that the formulas calculated on the basis of statistical analysis data used in the construction of the model may differ from each other. The fact that models can change (adapt) based on different conditions can also be the reason for their differences.

We can express the generalized formula of the economic-mathematical model used in determining the credit rating of the lessee as follows [13]:

$$R = UMo_u * \Sigma(Mo_u * Mo_q) + USo_u * \Sigma(So_u * So_q)$$

This where :

R – rating;

UMo_u is the total share of quantitative risk factors in the model;

Mo_u is the share of the quantitative factor in the model;

Mo_q is the value of the quantitative factor (point);

USo_u is the total share of quality factors of risk in the model;

So_u is the share of the quality factor in the model;

So_q is the value of the quality factor (point).

Currently, various intermediate scales are used to determine the counterparty's credit rating (R). Since the credit rating represents the default risk (DHR) of the lessee, it would be appropriate to choose a range of 0-100% to determine the rating. The lower the value of the counterparty rating, the lower the risk of default.

After that, the counterparties are divided into good, average and bad groups by the bank. Credit rating is not the only factor in determining credit risk. The determination of loss given default (DHY) is required to assess credit risk. DHY also has values ranging from 0-100%, the smaller the value of this factor, the more secure the lease contract is.

$$KY = DHY * DHX$$

The two multipliers in the formula are used to determine the expected loss (EL) under the contract, if the level of expected loss is not higher than the standard indicator set by the commercial bank, a positive decision is made.

The scoring model is developed based on previous credit performance. The effectiveness of this model directly depends on the adequacy of information. Although the amount of data depends on the specific models, in general they should meet the requirements of statistical significance and probability.

Summary

The introduction of the underwriting process into the credit policy of commercial banks allows for the unification of approaches to the evaluation of the borrower's activity and the standardization of processes.

The use of flexible models in the underwriting process for leasing contracts can affect the quality of the bank's loan portfolio, as well as the quality of the total loan portfolio of the banking system. This allows credit institutions to more accurately determine the level of credit risk, control the composition of the loan portfolio, and calculate profitability with high accuracy.

According to the analytical results of the current state of the banking sector and the prospects for its development, the growth rate of assets and capital will either decrease or remain at a very low level due to the growth of low-income assets and the decrease of the interest rate (margin) in banks in recent years. In this case, banks should increase the share of other sources of income that bring higher income compared to interest income.

Financing of leasing activities gives the commercial bank the opportunity to not only have a certain share in the leasing market and to attract them to the bank to serve important customers, but also to get a commission fee and an agency fee, to solve the tasks in a qualitative and effective manner.

The comparative analysis of financing models of leasing contracts by commercial banks shows that each of the studied models has its own set of advantages and disadvantages, that commercial banks can combine and use these advantages based on the terms and parameters of leasing contracts, as well as methods (schemes) of financing leasing activities commercial banks will have to choose independently.

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