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Methodological Aspects and Specific Features of the Insurance Mechanism in Improving the Efficiency of Credit Risk Management in Commercial Banks

Yusupov Ruslan Mukhtarovich

Independent Researcher at the Tashkent State University of Economics

In modern financial systems, commercial banks play a crucial role in supporting economic development by providing credit to businesses and individuals¹. However, lending activities are always associated with various types of risks, among which credit risk is considered one of the most significant. Credit risk arises when borrowers fail to fulfill their financial obligations in accordance with the agreed terms². Ineffective management of this risk can lead to serious financial losses, reduced liquidity, and instability within the banking sector.

The growing complexity of financial markets and increasing uncertainty in economic conditions require banks to adopt more effective and innovative approaches to credit risk management. One of the important mechanisms used to mitigate credit risk is the insurance mechanism. Insurance allows banks to transfer a portion of the credit risk to insurance companies, thereby reducing potential financial losses and improving the stability of their lending operations.

The use of insurance mechanisms in credit risk management not only protects banks against borrower default but also contributes to improving the quality of loan portfolios, enhancing financial sustainability, and strengthening trust in the banking system. In many countries, credit

1 Mishkin, F. S. (2019). *The Economics of Money, Banking and Financial Markets*.

2 Saunders, A., & Cornett, M. (2018). *Financial Institutions Management: A Risk Management Approach*.

insurance, loan guarantee schemes, and other risk-sharing instruments have become important tools for managing credit risk in commercial banks.

The effectiveness of this mechanism depends on several methodological aspects, including risk assessment procedures, contractual arrangements between banks and insurance companies, regulatory requirements, and the overall structure of the financial market³. Understanding the methodological foundations and specific characteristics of insurance mechanisms is therefore essential for improving credit risk management practices in commercial banks.

This study aims to analyze the methodological aspects and specific features of the insurance mechanism used to improve the efficiency of credit risk management in commercial banks. The research also examines the role of insurance in minimizing credit losses, enhancing financial stability, and supporting sustainable banking operations.

The analysis of credit risk management practices in commercial banks shows that the insurance mechanism plays a significant role in reducing potential financial losses arising from borrower default. In the traditional credit risk management framework, banks rely mainly on borrower screening, collateral requirements, credit scoring, and portfolio diversification. However, these methods alone are not always sufficient, especially under conditions of economic instability, rising non-performing loans, and increased uncertainty in financial markets. In such circumstances, the insurance mechanism serves as an additional protective tool that strengthens the overall credit risk management system.

The study indicates that the application of insurance in lending operations improves the quality of banks' loan portfolios. By transferring part of the credit risk to insurance institutions, banks are able to reduce exposure to unexpected losses. This is particularly important in sectors characterized by high default probability, such as small business lending, agricultural finance, and consumer credit. The results show that insured loans generally demonstrate a lower effective loss rate compared to uninsured loans, because part of the losses is compensated through insurance coverage.

Another important result of the analysis is that the insurance mechanism contributes to improving the financial stability of commercial banks. When credit losses are partially covered by insurance companies, banks can maintain a more stable level of capital adequacy, liquidity, and profitability. This reduces the negative effect of problem loans on bank performance and allows institutions to continue lending activities more confidently. As a result, insurance not only protects individual banks but also supports the stability of the banking sector as a whole.

The research also reveals that the effectiveness of the insurance mechanism depends on several methodological factors. These include the accuracy of credit risk assessment, proper selection of insurable risks, clear contractual terms between banks and insurers, and compliance with prudential regulations. Where these conditions are met, the insurance mechanism functions efficiently as part of the credit risk mitigation strategy. On the other hand, weak risk evaluation, excessive dependence on insurance, or poorly designed insurance contracts may reduce its effectiveness.

³ Basel Committee on Banking Supervision (2017)

In addition, the results suggest that the integration of insurance mechanisms into credit risk management enhances decision-making in commercial banks. It encourages banks to adopt a more structured approach to risk classification, pricing of loans, and monitoring of borrower behavior. This leads to better coordination between banks and insurance companies and improves the institutional framework for managing credit-related losses.

Overall, the findings confirm that the insurance mechanism is an effective supplementary instrument for improving the efficiency of credit risk management in commercial banks. Its main advantages include risk sharing, reduction of credit losses, improvement of loan portfolio quality, and support for financial sustainability. Therefore, broader and more methodologically grounded use of insurance mechanisms can significantly enhance the resilience and performance of commercial banks in modern financial conditions.

Table 1

Main Credit Risk Management Methods Used by Commercial Banks⁴

| No | Credit Risk Management Method | Description | Expected Effect |
|-----------|--------------------------------------|--|---|
| 1 | Borrower creditworthiness assessment | Analysis of the borrower's financial condition, repayment capacity, and credit history | Reduces the probability of default |
| 2 | Collateral requirement | Securing loans with assets pledged by the borrower | Minimizes losses in case of non-payment |
| 3 | Credit portfolio diversification | Distribution of loans across different sectors and borrower groups | Reduces concentration risk |
| 4 | Credit insurance | Transfer of part of the credit risk to an insurance company | Compensates losses caused by borrower default |
| 5 | Continuous monitoring | Regular supervision of borrowers' financial performance and repayment discipline | Ensures early detection of problem loans |

The table presents key credit risk management methods used by financial institutions to minimize potential losses and ensure stable lending operations. These methods include assessing borrower creditworthiness, requiring collateral, diversifying the credit portfolio, using credit insurance, and

⁴ Source: Basel Committee on Banking Supervision (BCBS), *Principles for the Management of Credit Risk*, Bank for International Settlements.

continuously monitoring borrowers' financial performance. Together, these approaches help banks reduce the probability of default, manage exposure to risk, and maintain financial stability.

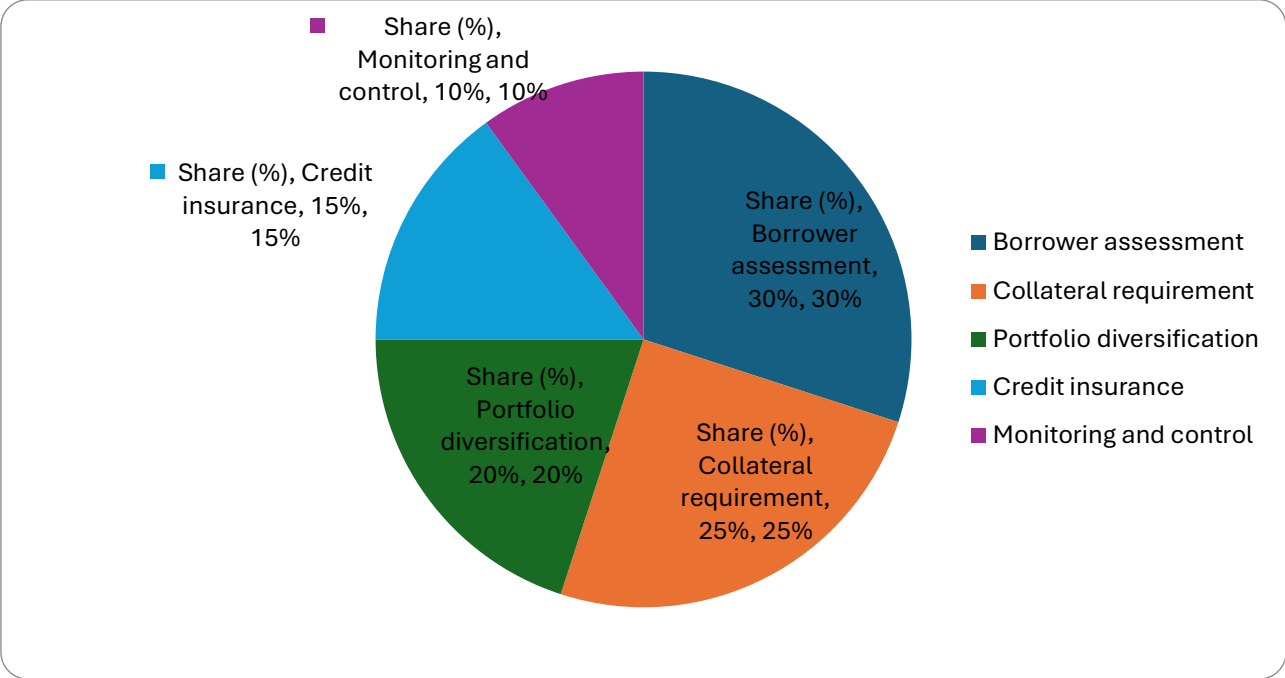


Figure 1. Credit Risk Management Instruments⁵

The chart illustrates the distribution of major credit risk management instruments used by financial institutions. Borrower assessment accounts for the largest share (30%), followed by collateral requirements (25%) and portfolio diversification (20%). Credit insurance represents 15%, while monitoring and control make up 10%. These instruments help banks reduce default risk, protect financial assets, and ensure effective credit risk management.

⁵ Author's compilation based on Basel Committee on Banking Supervision (BCBS), *Principles for the Management of Credit Risk*, Bank for International Settlements.

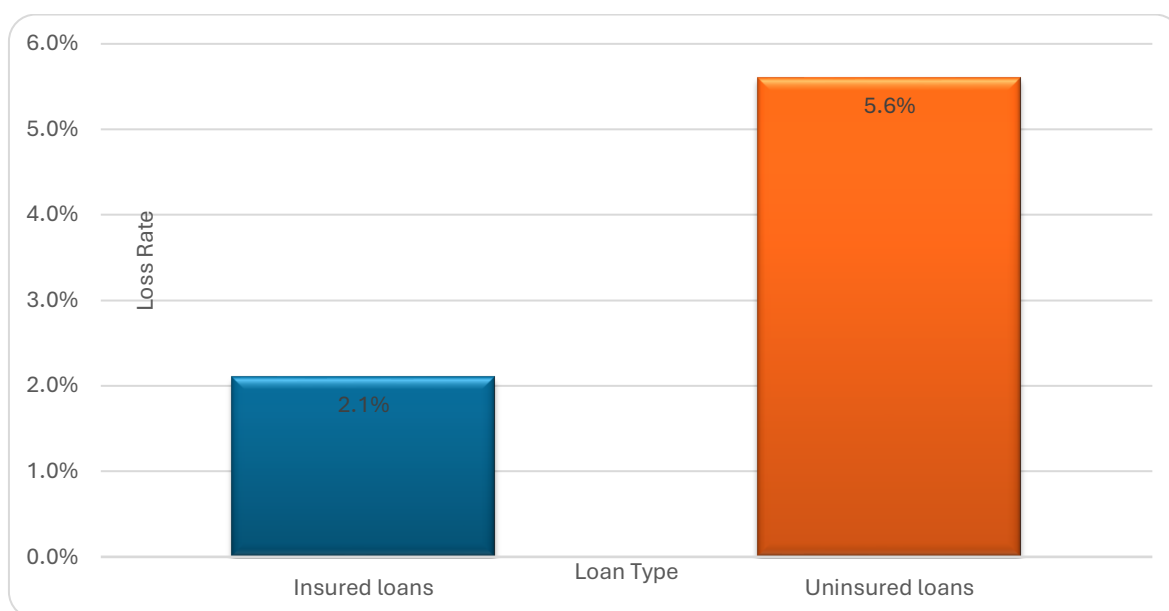


Figure 2. Comparison of Loss Rates for Insured and Uninsured Loans⁶

The chart compares the loss rates between insured and uninsured loans. The loss rate for insured loans is significantly lower (2.1%) compared to uninsured loans (5.6%). This difference demonstrates the effectiveness of credit insurance as a risk mitigation tool, helping financial institutions reduce potential losses associated with borrower defaults and improve overall credit risk management.

Table 2

Comparative Efficiency of Insured and Uninsured Loans⁷

| Indicators | Insured Loans | Uninsured Loans |
|----------------------------|---------------------------------|--------------------------|
| Average default rate | 4.2% | 7.8% |
| Average loss rate | 2.1% | 5.6% |
| Portfolio quality level | High | Medium |
| Risk coverage | Partial compensation by insurer | No external compensation |
| Financial stability impact | Positive | Moderate |

⁶ Author's compilation based on credit risk management studies and banking risk analysis reports.

⁷ Author's compilation based on banking risk management studies and Basel Committee on Banking Supervision (BCBS) principles.

The table presents a comparison of key risk indicators between insured and uninsured loans. Insured loans demonstrate lower default and loss rates (4.2% and 2.1%) compared to uninsured loans (7.8% and 5.6%). In addition, insured loans contribute to higher portfolio quality and provide partial risk coverage through insurance mechanisms. As a result, credit insurance positively affects the financial stability of lending institutions, while uninsured loans expose banks to higher levels of credit risk.

The conducted research confirms that the insurance mechanism plays an important role in improving the efficiency of credit risk management in commercial banks. Traditional risk management tools such as borrower creditworthiness assessment, collateral requirements, credit portfolio diversification, and continuous monitoring remain essential components of the credit risk management framework. However, the results of the analysis demonstrate that these methods can be significantly strengthened through the integration of credit insurance mechanisms.

The findings show that insured loans have lower default and loss rates compared to uninsured loans. The comparative analysis indicates that the average loss rate for insured loans is considerably lower, which proves that insurance mechanisms effectively reduce financial losses caused by borrower defaults. In addition, credit insurance contributes to improving the quality of loan portfolios and enhances the financial stability of commercial banks.

Another important conclusion is that the insurance mechanism supports better risk distribution between banks and insurance institutions. By transferring part of the credit risk to insurers, banks are able to maintain more stable levels of liquidity, capital adequacy, and profitability. This allows financial institutions to continue their lending activities with greater confidence even in conditions of economic uncertainty.

Based on the results of the research, several practical recommendations can be proposed. First, commercial banks should expand the use of credit insurance mechanisms, particularly in sectors characterized by higher credit risk. Second, banks should improve their methodologies for evaluating insurable credit risks and strengthen cooperation with insurance companies. Third, regulatory authorities should develop clearer guidelines and standards for the application of insurance mechanisms in banking risk management.

In conclusion, the broader and more systematic use of insurance mechanisms can significantly improve the resilience of commercial banks and strengthen the stability of the banking sector. Therefore, integrating credit insurance into the overall credit risk management strategy should be considered an important direction for the future development of modern banking systems.

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