

Impact of Credit Risk Management on the Soundness of Commercial Banks

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Abstract—This study examines credit risk management in commercial banks, with particular attention to the Indian banking system during 2015–2026. Credit risk—the risk of loss arising from borrower default—remains the single largest source of risk in bank balance sheets, and its management determines banking soundness, profitability and financial stability. The paper uses an evidence-synthesis methodology built on Reserve Bank of India (RBI) Financial Stability Reports, Basel Committee frameworks, IMF and World Bank assessments, and published academic research. The study traces the full asset-quality cycle of Indian scheduled commercial banks: a recognition-driven peak in stressed assets around 2017–18, followed by a sustained clean-up supported by the Insolvency and Bankruptcy Code (IBC), recapitalisation, tighter provisioning and improved underwriting. System-level gross non-performing assets (GNPA) declined from about 11 per cent of advances in March 2018 to roughly 2.4 per cent by March 2025, while capital adequacy strengthened well above the 9 per cent regulatory minimum. The paper then presents the four-stage credit risk management cycle—identification, measurement, mitigation and monitoring—and the quantitative toolkit used by modern banks, including credit scoring, rating-based probability of default (PD), loss-given-default (LGD), expected loss ($EL = PD \times LGD \times EAD$), risk-adjusted return on capital (RAROC), stress testing and early-warning systems. It also maps the regulatory architecture of Basel III, the Prompt Corrective Action (PCA) framework, prudential provisioning norms and the IBC. The evidence shows that credit risk cannot be eliminated, only priced, provisioned, diversified and managed. Banks that combine robust underwriting culture, data-driven models, sectoral diversification and strong recovery infrastructure demonstrate lower slippage, higher provision coverage and more stable returns. The study concludes that effective credit risk management is not merely a compliance exercise but the core discipline that converts credit intermediation into durable shareholder value and systemic stability.

Keywords—credit risk, commercial banks, non-performing assets, Basel III, expected loss, RAROC, provisioning, IBC, PCA framework, India

I. INTRODUCTION

Banks are in the business of taking risk. Of all the risks embedded in a banking book—market risk, operational risk, liquidity risk and reputational risk—credit risk is historically the most important, because lending is the primary activity of commercial banks and loan losses are the most common cause of bank failures. Credit risk is commonly defined as the risk of loss arising from the failure of a borrower, counterparty or obligor to meet contractual obligations on time, and it also includes the risk of losses caused by migration in the credit quality of exposures and the associated reduction in portfolio value [1].

Credit risk management (CRM) is therefore the central discipline of banking. It encompasses the policies, processes, models and governance structures through which a bank decides whom to lend to, at what price, under what covenants, with what collateral, and how the resulting exposures are monitored, provisioned and recovered. The objective is not to avoid credit risk—an impossible task for an institution whose business is lending—but to ensure that risk is consciously assumed, adequately priced, sufficiently provisioned and

held within the risk appetite approved by the board.

The Indian experience provides an unusually instructive natural laboratory for studying credit risk management. During the second half of the 2010s, Indian banks underwent an Asset Quality Review (AQR) and related recognition exercise that exposed a large stock of hidden stressed assets. System-level GNPA climbed to roughly 11 per cent of advances by March 2018, and several public sector banks were placed under the RBI's Prompt Corrective Action framework. The subsequent recovery—driven by the Insolvency and Bankruptcy Code 2016, front-loaded recapitalisation, higher provisioning coverage, write-offs and materially improved underwriting—brought system GNPA down to about 2.8 per cent by March 2024 and roughly 2.4 per cent by March 2025, while capital adequacy ratios strengthened to historically high levels [2], [3], [4].

At the same time, new pockets of risk are emerging. Rapid growth in unsecured retail credit, microfinance and lending to non-banking financial companies during 2022–2024 prompted the RBI to raise risk weights on consumer credit and bank credit to NBFCs, an explicit macroprudential response to potential credit-risk build-up [5]. This demonstrates that credit risk management is a continuous process rather than a problem that is solved once: every phase of the credit cycle generates a new configuration of risk that must be identified, measured and managed afresh.

This paper therefore combines the conceptual foundations of credit risk with the practical frameworks used by commercial banks and with Indian empirical evidence. The focus is threefold: how banks organise the management of credit risk, the quantitative and regulatory tools through which it is controlled, and the lessons embedded in India's asset-quality cycle between 2015 and 2026.

II. OBJECTIVES AND RESEARCH QUESTIONS

The objectives of the study are: (1) to explain the concept, sources and economic significance of credit risk in commercial banking; (2) to describe the credit risk management cycle—identification, measurement, mitigation and monitoring—used by modern banks; (3) to present the principal quantitative tools of credit risk assessment, including credit scoring, rating-based models, expected loss and RAROC; (4) to map the regulatory framework governing credit risk in India, including Basel III, prudential provisioning norms, the PCA framework and the IBC; (5) to analyse the Indian asset-quality cycle of 2015–2026 using RBI and international data; and (6) to derive managerial implications for bank boards, credit officers and risk functions.

The study addresses three research questions: (a) what organisational and quantitative mechanisms allow commercial banks to manage credit risk effectively? (b) how did Indian banks rebuild balance-sheet soundness after the 2015–2018 asset-quality stress? and (c) what emerging credit risks require attention in the current phase of the credit cycle?

III. LITERATURE REVIEW

A. The Concept and Economics of Credit Risk

The modern analytical treatment of credit risk begins with Merton's [6] structural model, which views a firm's equity as a call option on its assets and default as the event in which asset value falls below the face value of debt. This insight underlies much of today's portfolio credit-risk modelling, including the credit-metrics and credit-portfolio approaches that estimate loss distributions from rating migration and default correlations. Altman's [7] Z-score model demonstrated that multivariate discriminant analysis of accounting ratios can predict corporate bankruptcy with meaningful accuracy, and it remains the prototype of credit-scoring systems used in retail and SME lending.

Basel Committee literature formalises credit risk as the driver of regulatory capital. Under the internal-ratings-based (IRB) approach, the expected loss on an exposure is given by Eq. (1), where PD is the probability of default within a one-year horizon, LGD the share of exposure lost in default and EAD the

exposure amount at default [1].

$$EL = PD \times LGD \times EAD \quad (1)$$

Unexpected loss—the volatility of credit losses around the expected level—is covered by capital, while expected loss is covered by provisions and pricing. This separation is the intellectual foundation of modern CRM: banks must hold both provisions and capital, and must price loans so that the interest margin compensates for expected loss plus a return on the capital absorbed by unexpected loss.

B. Credit Risk Management as an Organisational Discipline

The banking literature emphasises that credit risk management is as much organisational as it is mathematical. Saunders and Cornett [8] describe credit analysis, underwriting standards, loan monitoring and problem-loan management as the core functions of bank credit administration, while Berger and DeYoung [9] provide classic evidence that cost and profit efficiency are causally linked to problem-loan management: efficient banks manage credit problems faster and at lower cost. The “three lines of defence” model has become the standard governance template: business lines own the risk, an independent risk-management function measures and challenges it, and internal audit provides assurance. Credit culture—shared standards of underwriting discipline that survive credit-boom incentives—is repeatedly identified as the decisive variable separating sound banks from chronic underperformers [10].

C. The Indian Asset-Quality Cycle

Indian banking scholarship and official reports document a distinctive credit cycle. An investment-led credit boom of the late 2000s, followed by stalled infrastructure projects, governance weaknesses and evergreening of stressed loans, produced a large stock of restructured and non-performing assets by the mid-2010s. The RBI’s AQR from 2015 forced uniform recognition, pushing system GNPA to a peak around 11 per cent in March 2018 [2], [4]. The policy response was multi-pronged: the IBC created a time-bound resolution mechanism, government recapitalisation restored capital buffers, the PCA framework restrained weak banks, and provisioning norms were tightened. IMF and World Bank assessments subsequently documented a remarkable clean-up, with system GNPA falling to about 5.8 per cent by March 2022 and about 2.8 per cent by March 2024, accompanied by record profitability and double-digit capital adequacy [3], [4], [11].

Recent RBI analysis, however, flags renewed pockets of vulnerability in unsecured retail credit and NBFC exposure, prompting macroprudential tightening of risk weights in late 2023 and 2024 [5]. The IMF’s 2025 Article IV consultation similarly notes that declining aggregate NPA ratios coexist with rising slippages in unsecured personal loans among private sector banks [12]. The lesson of the cycle is therefore not that Indian banks have “solved” credit risk, but that its locus migrates—across sectors, products and borrower classes—as credit conditions change.

D. Research Gap

Much applied writing on credit risk treats either the conceptual framework or the regulatory framework in isolation, and often relies on pre-2018 NPA data that no longer describe the system. This paper addresses that gap by integrating three layers—concept and measurement, bank-level CRM practice, and the post-AQR Indian evidence base—into a single analytical narrative that is current through the 2025–2026 phase of the credit cycle.

IV. RESEARCH METHODOLOGY

The study adopts a descriptive-analytical and evidence-synthesis design. The primary data sources are the RBI Financial Stability Reports, RBI reports on Trend and Progress of Banking in India, Basel Committee publications, IMF Article IV consultations and Financial Sector Assessment Program reports, World Bank analyses, and peer-reviewed academic research. The observation window is FY2015–FY2026.

For banking soundness, the analysis uses standard indicators: the gross NPA ratio (GNPA/advances), net NPA ratio, provision coverage ratio (PCR), capital to risk-weighted assets ratio (CRAR), return on assets (RoA) and net interest margin (NIM). Credit risk at portfolio level is expressed through the Basel identity $EL = PD \times LGD \times EAD$ and through $RAROC = \text{risk-adjusted return} / \text{economic capital}$. Sectoral evidence is drawn from RBI sectoral deployment of credit data and supervisory commentary.

The analytical logic is directional rather than a new econometric estimate. In simplified form, bank soundness can be represented as $\text{Soundness} = f(\text{Underwriting Quality, Provisioning Adequacy, Capital Buffers, Recovery Infrastructure, Diversification, Credit-Cycle Phase})$. A limitation of this methodology is important for interpretation: this paper synthesises published evidence and ratio mechanics rather than estimating a new firm- or bank-level causal model. Findings should therefore be read as evidence-based analytical conclusions, not as new causal coefficients.

V. ASSET-QUALITY AND SOUNDNESS DATA OF INDIAN SCHEDULED COMMERCIAL BANKS

Table I summarises the broad asset-quality cycle of Indian scheduled commercial banks. The series shows the post-AQR deterioration, the peak around 2018, and the sustained improvement through the recovery phase.

TABLE I.
ASSET QUALITY AND CAPITAL ADEQUACY OF INDIAN SCBS, 2018–2025 (INDICATIVE SYSTEM-LEVEL VALUES)

Period	GNPA ratio	NNPA ratio	CRAR (system)	Phase of the credit cycle
March 2018	~11.2%	~6.0%	~13–14%	Post-AQR peak stress
March 2019	9.1%	3.7%	14.3%	Recognition and resolution under IBC
March 2020	8.2%	2.8%	14.8%	Clean-up; recapitalisation; higher provisioning
March 2021	7.3%	2.4%	16.3%	COVID-era moratorium; restructuring window
March 2022	5.8%	1.7%	16.9%	Steady decline in stressed assets [4]
March 2024	~2.8%	~0.6%	~16–17%	Multi-decade low GNPA; record profits [11]
March 2025	~2.4%	~0.5%	~17%	Soundness consolidated; retail risk flagged [5], [12]

Figure 1 plots the GNPA and NNPA ratios over the period. GNPA fell from about 11.2 per cent in March 2018 to about 2.4 per cent in March 2025, while NNPA fell from about 6.0 per cent to about 0.5 per cent. The narrowing gap between the two series reflects the rise in provisioning, and Figure 2 shows the same fall in side-by-side form. (The table gives no March 2023 value, so that year is omitted from the figures.)

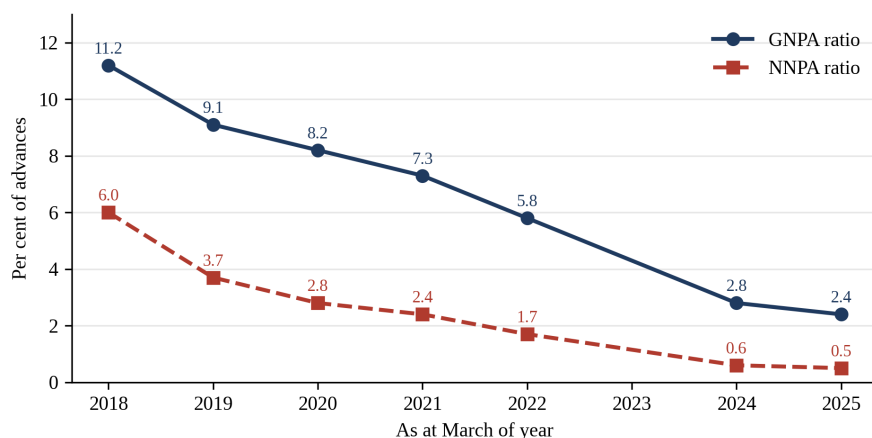


Fig. 1. Trend in GNPA and NNPA ratios of Indian scheduled commercial banks, March 2018–March 2025 (data from Table I).

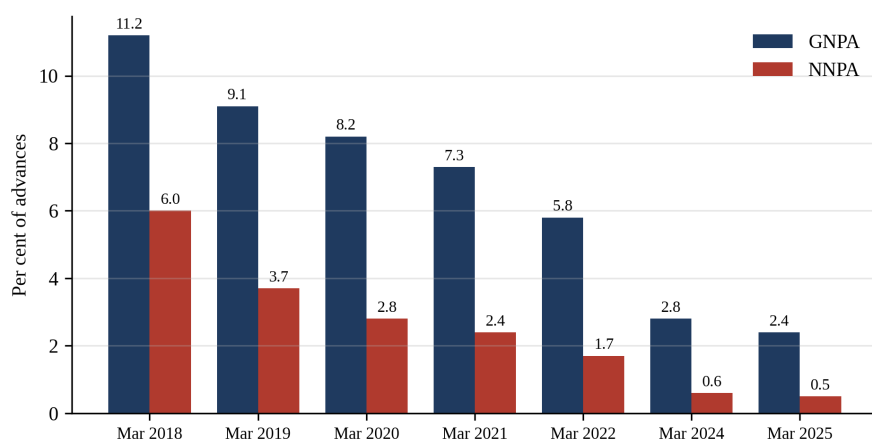


Fig. 2. Year-wise comparison of GNPA and NNPA ratios (data from Table I).

Figure 3 shows system capital adequacy over the same period. CRAR rose from about 13–14 per cent to about 17 per cent and stayed well above the 9 per cent regulatory minimum throughout, so the asset-quality clean-up was accompanied by stronger capital buffers.

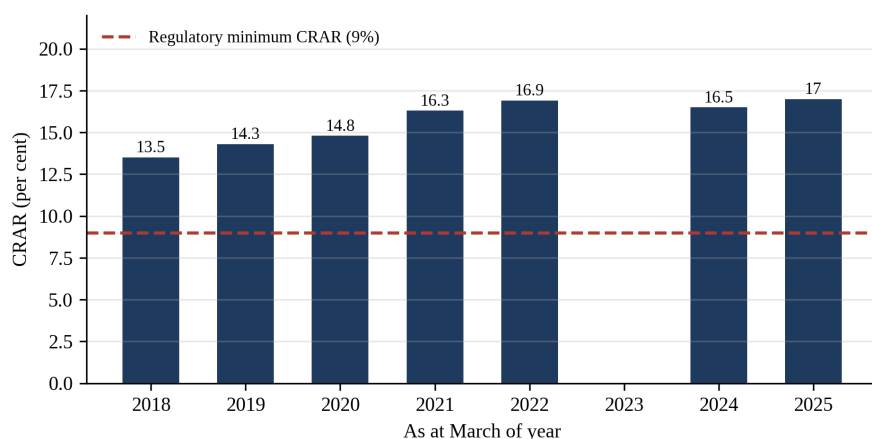


Fig. 3. System CRAR of Indian scheduled commercial banks against the 9% regulatory minimum (data from Table I; the 2018 bar uses the midpoint of the reported ~13–14% range and the 2024 bar the midpoint of ~16–17%).

Three features of this cycle deserve emphasis. First, the improvement was policy-engineered rather than a cyclical accident: the IBC created credible recovery threat, recapitalisation restored lending capacity, and

front-loaded provisioning raised PCR above 70–90 per cent at many banks, allowing genuine balance-sheet repair. Second, improvement in public-sector banks was the steepest precisely because their starting point was the weakest—several PSBs exited the PCA framework between 2019 and 2022 as capital, return on assets and asset-quality triggers were restored. Third, the State Bank of India—the system’s largest lender—illustrates the full arc: its GNPA fell from 10.91 per cent in FY2018 to about 1.5 per cent by FY2026, with provision coverage above 90 per cent [13]. Micro-level data of this kind confirm that the aggregate improvement reflects genuine credit-discipline gains, not merely write-off-driven cosmetic decline.

VI. THE CREDIT RISK MANAGEMENT CYCLE IN COMMERCIAL BANKS

Credit risk management in a commercial bank is organised as a continuous cycle with four interlocking stages: identification, measurement, mitigation and monitoring (Table II). Weakness at any stage contaminates the entire system—accurate measurement cannot rescue poor initial selection, and strong collateral cannot substitute for continuous monitoring of borrower cash flows.

TABLE II.
THE FOUR-STAGE CREDIT RISK MANAGEMENT CYCLE

Stage	Core activities	Key tools / outputs
1. Identification	Credit origination, borrower assessment, sector and product risk analysis	Credit policy, risk appetite statement, 5Cs/5Ps framework, sector caps
2. Measurement	Quantification of default risk and expected loss for each exposure	Rating models, PD/LGD/EAD estimates, scorecards, RAROC pricing
3. Mitigation	Structural reduction of loss severity and concentration	Collateral and guarantees, covenants, syndication, diversification, credit limits, CDS (limited in India)
4. Monitoring	Early detection of deterioration; provisioning and recovery	Early-warning systems, SMA/NSR classification, stress testing, review of watchlist accounts

A. Identification: Selection Under a Credit Culture

Identification begins with a board-approved credit policy and risk-appetite statement that define target segments, prohibited exposures, single-obligor and group concentration limits, and delegation of sanctioning authority. At transaction level, banks apply structured borrower appraisal—traditionally the 5Cs (character, capacity, capital, collateral, conditions) or 5Ps (person, purpose, payment, protection, perspective)—combined with cash-flow-based viability analysis for project and corporate loans. The quality of this stage is decisive: most loan losses are made at origination, not during monitoring.

B. Measurement: From Judgement to Models

Measurement converts judgement into quantified risk. Internal rating models assign obligors to rating grades with associated PDs; LGD is estimated from recovery experience on collateral and seniority; EAD captures likely exposure at default including undrawn commitments. Retail portfolios typically use application and behavioural scorecards estimated on large default datasets; corporate and SME portfolios use expert-validated rating models. Outputs feed pricing (RAROC), capital calculation (IRB or standardised approach), provisioning (expected-credit-loss models under Ind AS 109) and portfolio reporting.

C. Mitigation: Structuring the Exposure

Mitigation reduces either the probability of loss (guarantees, covenants, staged disbursement against milestones) or its severity (collateral, cash margin, credit insurance). Concentration risk—single names, groups, sectors and geographies—is managed through limits calibrated to capital. Syndication and loan participation distribute large exposures; securitisation transfers risk where markets are deep. In India, collateral enforcement is supported by the SARFAESI Act 2002, which allows secured creditors to recover dues without court intervention, materially improving effective LGD for secured lending.

D. Monitoring and Recovery

Monitoring converts static sanctioning into dynamic risk control. Early-warning indicators—account conduct, delays, covenant breaches, sector stress signals—trigger account-level reviews and, where warranted, classification as special-mention or stressed. Deteriorating exposures are managed through rectification, restructuring under prudential frameworks, sale to asset reconstruction companies, or resolution under the IBC. Effective recovery infrastructure is itself a credit-risk tool: banks with professional stressed-asset verticals recover more and provision less, as the SBI stressed-assets management structure illustrates [13].

VII. QUANTITATIVE TOOLS OF CREDIT RISK MANAGEMENT

The quantitative toolkit of modern CRM has five pillars. First, credit scoring and rating systems convert borrower attributes into ordinal or cardinal measures of default risk, enabling consistent, auditable decisions and large-volume retail underwriting. Second, portfolio models—Merton-type structural models and reduced-form intensity models—estimate PDs and migration matrices, allowing banks to compute expected loss, unexpected loss and economic capital for the whole book [1], [6]. Third, risk-adjusted performance measurement: RAROC divides risk-adjusted profit by economic capital, aligning the incentive of lending officers with the true cost of risk and preventing growth-at-any-price lending. Fourth, stress testing and scenario analysis—mandatory under ICAAP—estimate losses under adverse macro scenarios; the RBI's periodic stress tests in the Financial Stability Report, for example, assess whether banks' capital would remain adequate under severe credit shocks [2]. Fifth, machine-learning methods increasingly complement traditional scorecards in fraud detection, early-warning analytics and alternative-data underwriting, though model risk and explainability require strong governance.

The unifying logic of these tools is the Basel identity: pricing must cover expected loss (provisions) plus a hurdle return on capital absorbed by unexpected loss. A loan priced below this level destroys value even if it never defaults, because it fails to compensate the bank for the risk it carries.

VIII. THE REGULATORY FRAMEWORK IN INDIA

Credit risk management in Indian commercial banks operates within one of the most comprehensive regulatory architectures in the world. Its pillars are summarised in Table III.

TABLE III.
KEY ELEMENTS OF THE INDIAN CREDIT-RISK REGULATORY ARCHITECTURE

Pillar	Instrument	Purpose
Capital adequacy	Basel III: minimum CRAR 9% (Tier-1 $\geq$ 7%, CET1 $\geq$ 5.5%) plus capital conservation buffer 2.5%	Absorb unexpected credit losses [1], [14]
Early intervention	Prompt Corrective Action (PCA) framework	Triggers on capital, asset quality, leverage, profitability; forces corrective action before failure [15]
Asset classification	Prudential norms on NPA classification (sub-standard, doubtful, loss) and provisioning	Time-bound recognition and adequate provisions
Resolution	SARFAESI Act 2002; IBC 2016; ARC mechanism	Enforcement and time-bound insolvency resolution
Liquidity	Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)	Prevent liquidity stress from crystallising credit losses
Macroprudential	Risk-weight tightening on consumer credit and NBFC exposure (2023–24)	Contain build-up of systemic credit risk [5]

This architecture has proven consequential. The PCA framework forced eleven weak banks to shrink and repair between 2017 and 2021, with all of them subsequently exiting; the IBC altered debtor-creditor dynamics by introducing a credible threat of change of control; and macroprudential risk-weight actions

demonstrated that the regulator treats credit-risk build-up as a systemic phenomenon even when headline NPA ratios are low [2], [12], [15].

IX. SECTOR-WISE CREDIT RISK EXPOSURE

TABLE IV.
SECTOR-WISE CREDIT RISK MAP FOR INDIAN COMMERCIAL BANKS

Segment	Risk level	Main credit-risk drivers	Principal mitigants
Infrastructure and project finance	High	Long gestation, regulatory risk, leverage	Escrow structures, consortium discipline, staged disbursement
MSME	High	Information asymmetry, cash-flow volatility	Cash-flow lending, CGTMSE guarantees, digital data trails
Unsecured retail / credit cards / microfinance	Medium–High	No collateral, cyclical defaults, over-indebtedness	Scorecards, risk-based pricing, exposure caps, collection analytics
Agriculture and priority sector	Medium	Weather, price risk, waivers	Interest subvention, insurance (PMFBY), gold collateral
Housing (secured retail)	Low–Medium	LGD-linked risk via property cycles	Mortgage collateral, moderate LTV norms, stable demand
NBFC lending / interbank	Medium	Contagion and concentration risk	Risk weights, single/group exposure limits

The current phase of the credit cycle is defined precisely by migration of risk toward the segments in the upper rows of Table IV: as corporate balance sheets deleveraged and infrastructure stress receded, competitive lending migrated to unsecured retail and NBFC segments, where growth outpaced risk infrastructure at several banks—exactly the pattern the RBI’s risk-weight measures of 2023–24 were designed to restrain [5], [12].

X. FINDINGS AND DISCUSSION

Finding 1: Credit risk is the dominant risk of commercial banking, and it is irreducible but manageable. The Indian evidence confirms that lending losses, not trading losses, drive bank stress; equally, the post-2018 recovery shows that the same risk, well managed, is the source of record profitability.

Finding 2: Recognition is the precondition of management. The AQR episode demonstrates that suppressed or evergreened stress compounds silently until recognition is forced; banks with cultures of early, honest classification recovered faster than those that delayed.

Finding 3: Recovery infrastructure is a first-order CRM asset. The IBC, SARFAESI enforcement, ARC sales and professional stressed-assets verticals improved effective recoveries and thereby lowered LGD across the system; recovery capability shapes both provisioning needs and ex-ante lending appetite.

Finding 4: Capital and provisioning are complements, not substitutes. System CRAR above 16–17 per cent alongside PCR above 70 per cent created the resilience that allowed Indian banks to absorb the COVID shock and the 2022–2024 tightening cycle without renewed systemic stress [2], [11].

Finding 5: Credit risk migrates across segments as the cycle turns. The shift from corporate/NPA stress (2015–2019) to unsecured-retail vigilance (2023–2025) shows that a bank’s risk map must be redrawn every credit cycle; yesterday’s safe segment can become tomorrow’s problem book.

Finding 6: Quantitative tools work only inside strong governance. Scorecards, IRB models and RAROC discipline fail when overridden by relationship pressure or growth targets; conversely, even simple tools outperform sophisticated models that lack credit-culture enforcement.

XI. MANAGERIAL IMPLICATIONS

First, boards should treat the risk-appetite statement as an operating constraint, not a document: exposure caps, target segments and prohibited-lending lists must bite on actual sanction decisions. Second, credit pricing must be explicitly risk-adjusted: every sanction note should show expected loss, capital consumption and RAROC, so that officers cannot book value-destroying growth. Third, early-warning systems deserve investment ahead of models: detecting deterioration at SMA-1/SMA-2 stages is far cheaper than resolving a defaulted account. Fourth, concentration management must be dynamic—limits should tighten automatically as segments show rapid growth, falling spreads or rising slippages, as the unsecured-retail episode illustrates. Fifth, recovery capability should be treated as a strategic asset with dedicated senior leadership, sector-wise resolution expertise and incentives aligned to cash recovery rather than balance-sheet cosmetics.

XII. LIMITATIONS

The study has five principal limitations. First, it does not estimate a new econometric model of bank-level credit risk using proprietary loan-level data; conclusions rest on published evidence and ratio analysis. Second, system-level NPA aggregates conceal significant heterogeneity across public, private and foreign banks and across segments. Third, figures for the most recent quarters are indicative and subject to revision in subsequent RBI publications. Fourth, credit risk interacts with macroeconomic, liquidity and operational risks in ways a single-risk framework cannot fully capture. Fifth, the rapid adoption of machine-learning credit models is evolving faster than the published evidence base, limiting definitive conclusions about their long-run performance.

XIII. CONCLUSION

Credit risk is the defining risk of commercial banking: the failure to select, price, monitor and recover loans has destroyed more banks than every other risk combined, while disciplined credit origination remains the foundation of bank profitability. This study has presented the full architecture of credit risk management—conceptual foundations in default-risk theory, the four-stage management cycle, the quantitative toolkit from scorecards to stress testing, and the Indian regulatory superstructure of Basel III, PCA, prudential provisioning and the IBC.

The Indian experience of 2015–2026 demonstrates both the cost of neglect and the payoff of discipline. A recognition-driven crisis that pushed system GNPA to around 11 per cent was resolved through credible resolution law, recapitalisation, provisioning and underwriting reform into a system with GNPA near 2.4 per cent, record profitability and capital ratios well above regulatory floors [2], [4], [11]. Yet the simultaneous emergence of risk in unsecured retail segments confirms that credit risk never disappears; it migrates. For bank managers, the enduring lesson is that credit risk management is not a compliance function bolted onto lending but the very mechanism by which lending creates durable value. Banks that institutionalise credit culture, price risk honestly, detect deterioration early and recover decisively will remain sound in every phase of the credit cycle; those that treat the last cycle's lesson as permanent will meet the next one unprepared.

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