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Criteria for Determining the Financial Stability of Commercial Banks and Ways to Increase Them

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Abstract: This article explores the methodologies used to assess the financial stability of commercial banks. Financial stability is a critical aspect of the banking sector, ensuring the resilience of banks to withstand adverse shocks and maintain their functions within the financial system. The assessment of financial stability involves a multidimensional analysis, considering factors such as asset quality, capital adequacy, liquidity management, risk management practices, and macroeconomic conditions. Various quantitative and qualitative methods, including financial ratios, stress testing, and regulatory compliance assessments, are employed to evaluate banks' stability. The study also examines the implications of regulatory frameworks, such as Basel III, in enhancing the stability and soundness of the banking sector. By elucidating the key measures and indicators of financial stability, this article contributes to the scholarly understanding of banking stability and risk management practices.

Key words: Financial Stability, Commercial Banks, Assessment, Risk Management, Asset Quality, Capital Adequacy, Liquidity, Profitability, Regulatory Compliance, Basel III, Stress Testing, Prudential Regulation, Solvency, Banking Sector.

INTRODUCTION

Financial stability is a cornerstone of the banking sector, particularly for commercial banks, as they serve as the primary intermediaries in the financial system. This article delves into the scientific exploration of methods for assessing the financial stability of commercial banks, aiming to provide insights into the tools and frameworks used to evaluate their fiscal resilience.

Commercial banks, entrusted with the crucial task of mobilizing savings and allocating capital to productive investments, are exposed to various risks stemming from their lending and investment activities. The ability of these institutions to withstand adverse shocks and maintain solvency is paramount for the stability of the broader financial system.

The assessment of financial stability encompasses a multidimensional analysis that considers several key metrics and indicators. These include but are not limited to asset quality, capital adequacy, liquidity position, profitability, and risk management practices. Each of these aspects provides valuable insights into the overall health and resilience of a commercial bank.

Moreover, the evaluation of financial stability involves both quantitative and qualitative approaches. Quantitative methods typically involve the use of financial ratios, stress testing, and statistical models to assess the bank's exposure to various risks and its capacity to absorb potential losses. Qualitative analysis, on the other hand, focuses on governance structures, risk management frameworks, and regulatory compliance.

In recent years, the importance of assessing financial stability has been underscored by the global financial crisis and subsequent regulatory reforms aimed at strengthening the resilience of banks. Regulatory authorities and central banks have developed standardized frameworks, such as Basel III, to enhance the stability and soundness of the banking sector.

Against this backdrop, this article aims to explore the methodological underpinnings of assessing the financial stability of commercial banks. By examining the theoretical foundations, empirical evidence, and practical implications of various measurement tools and techniques, it seeks to contribute to the scholarly discourse on banking stability and risk management.

Literature Review:

Assessing the financial stability of commercial banks has been a subject of extensive research in the field of banking and finance. A comprehensive review of the literature reveals several key themes and contributions that have shaped our understanding of this important topic.

Scholars such as Altunbas, Gambacorta, and Marqués-Ibáñez (2010) have emphasized the significance of asset quality in determining banks' financial stability. Their research highlights the impact of non-performing loans and credit risk on bank stability, suggesting that banks with higher asset quality are better positioned to weather financial shocks.[1]

The importance of capital adequacy in ensuring bank stability has been extensively discussed in the literature. Studies by Demirgüç-Kunt and Huizinga (2010) have shown that well-capitalized banks are more resilient to adverse economic conditions, as they have a greater capacity to absorb losses without jeopardizing their solvency.[2]

Effective liquidity management is another critical aspect of bank stability. Researchers such as Allen and Gale (2007) have highlighted the role of liquidity risk in financial crises, underscoring the importance of banks maintaining sufficient liquidity buffers to meet short-term obligations and withstand funding disruptions.[3]

Scholars have examined various risk management practices adopted by banks to enhance their stability. Research by Berger and Bouwman (2013) explores the relationship between risk management efficiency and bank stability, suggesting that banks with robust risk management frameworks are better able to mitigate risks and preserve their financial health.[4]

According to the definition of Professor F.Kholmamatov (2020), "The stability of the banking system is the ability to achieve and maintain a balanced state that ensures the rapid and effective performance of its functions both in the current period and in the forecasted future".[5]

Overall, the literature review underscores the multidimensional nature of financial stability in commercial banks and the diverse factors that contribute to it. By synthesizing insights from various studies, this research aims to provide a comprehensive understanding of the mechanisms and determinants of bank stability, thereby informing policymakers, regulators, and practitioners in their efforts to promote a stable and resilient banking system.

Research methodology. Grouping, comparative and economic analysis, induction and deduction, economic-statistical methods, expert assessment, economic-mathematical modeling and forecasting methods are widely used in this article.

Analyzes and results

International Monetary Fund Requirements for Assessing the Financial Stability of Commercial Banks:

1. Capital:

- Commercial banks must maintain minimum capital levels to bolster their safety buffers and enhance their ability to absorb losses.

- The IMF specifies minimum capital requirements for banks, encouraging their reinforcement through retained earnings and increased tax obligations.

2. Assets and Liabilities:

- The IMF sets requirements for commercial banks to strengthen the prudential management of both their short-term and long-term assets and liabilities, thereby enhancing liquidity.

- Ensuring the quality and confidentiality of banks' assets and liabilities is crucial for maintaining financial stability, and the IMF provides legal frameworks for this purpose.

3. Risk Management:

- The IMF evaluates the robustness of banks' risk management systems, emphasizing the importance of identifying, assessing, and mitigating risks.

- To promote resilience, the IMF provides guidance on analyzing, defining, and mitigating risks effectively.

4. Transparency and Disclosures:

- The IMF encourages banks to enhance transparency and disclosures in their operations and interactions with stakeholders. This fosters confidence and understanding among other stakeholders, such as regulators and the public.

- Transparency measures, along with disclosures, facilitate information-sharing among banks and financial markets, bolstering stability.

5. Adaptation to Evolving Markets and Innovations:

- The IMF promotes the development of high-quality risk management models that enable banks to adapt to changes in market dynamics and financial innovations. This supports the development of banking services and customer-centric innovations.[6]

Banking system reforms in Uzbekistan have entered a decisive stage. On May 12, 2020, the Decree No. PF-5992 "On the strategy of reforming the banking system of the Republic of Uzbekistan for 2020-2025" was adopted. The main task set for commercial banks in the decree is to capitalize them and to privatize banks with a state share, first of all, to attract foreign investors.

Bank capital is the most important indicator of financial stability of banks, and its change directly affects the condition of banks.

Table 1 Analysis of banking system capital[1]

Indicators name	01.01.2019		01.01.2020		01.01.2021		01.01.2022		01.01.2023	
	billion soum	share, in percent	billion soum	share, in percent	billion soum	share, in percent	billion soum	share, in percent	billion soum	share, in percent
Tier I capital	**22146**	**91.40**	**43659**	**83.2**	**48140**	**82.8**	**58624**	**83.5**	**67793**	**81.3**
Basic capital	*22061*	*91.00*	*43622*	*83.1*	*48028*	*82.6*	*58429*	*83.2*	*67598*	*81.0*
Additional capital	*86*	*0.40*	*38*	*0.1*	*113*	*0.2*	*195*	*0.3*	*195*	*0.2*
Tier II capital	**2085**	**8.60**	**8808**	**16.8**	**10022**	**17.2**	**11567**	**16.5**	**15620**	**18.7**
Total regulatory capital	**24231**	**100**	**52467**	**100**	**58162**	**100**	**70191**	**100**	**83413**	**100**

The total regulatory capital of the banking system increased from 24.2 trillion soums in 2018 to 83.4 trillion soums by 2023. In this case, the I-level capital made up 81.3% of the total capital, while the II-level capital made up 18.7%. The absolute majority of Tier I capital corresponds to

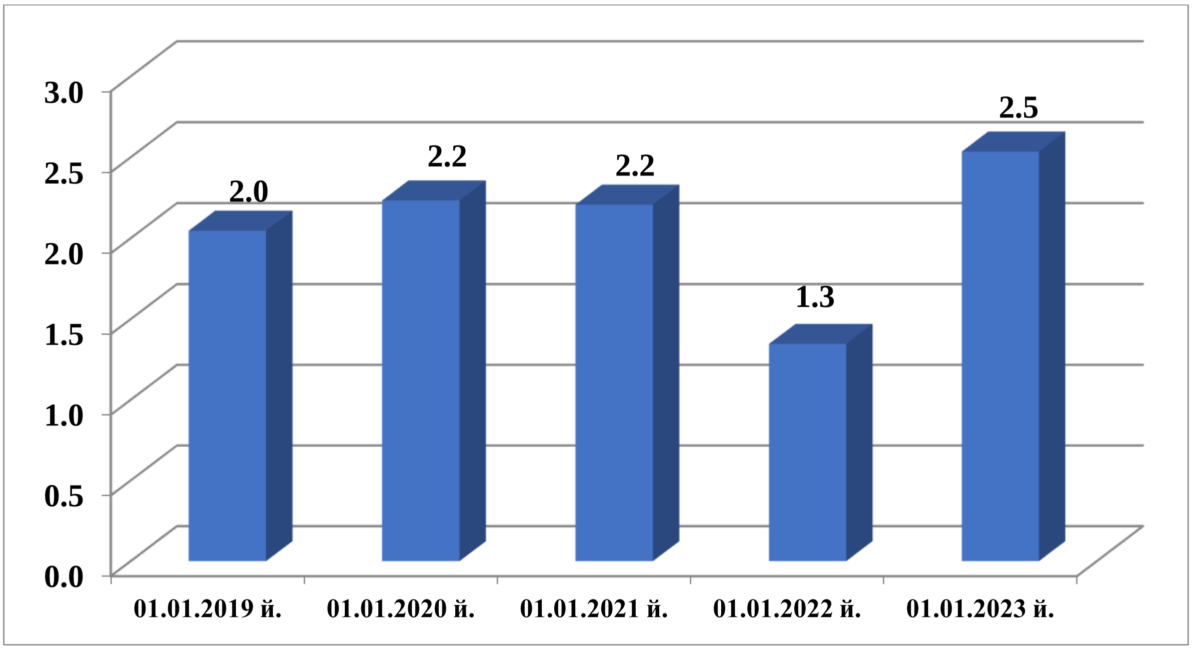
[1] Uzbekistan Republic President of the Statistics Agency initial information based on

the core capital contribution. In our opinion, the bank's capital consists of high-quality capital, which allows to reduce the impact of various negative situations on financial stability.

80 trillion soums by the end of the year, and the amount of authorized capital will increase by 9 % to 60 trillion soums. Also, by the end of 2022, the amount of regulatory capital in the banking system reached 83 trillion soums and risk-weighted assets reached 468 trillion soums, the capital adequacy ratio was 17.8 percent (minimum requirement 13 percent) and increased by 0.3 percentage points compared to the indicator in 2021.

The banking system will be able to avoid various shocks that may occur in the banking system if the liquidity indicators are at the same level and the minimum requirements are fully met.

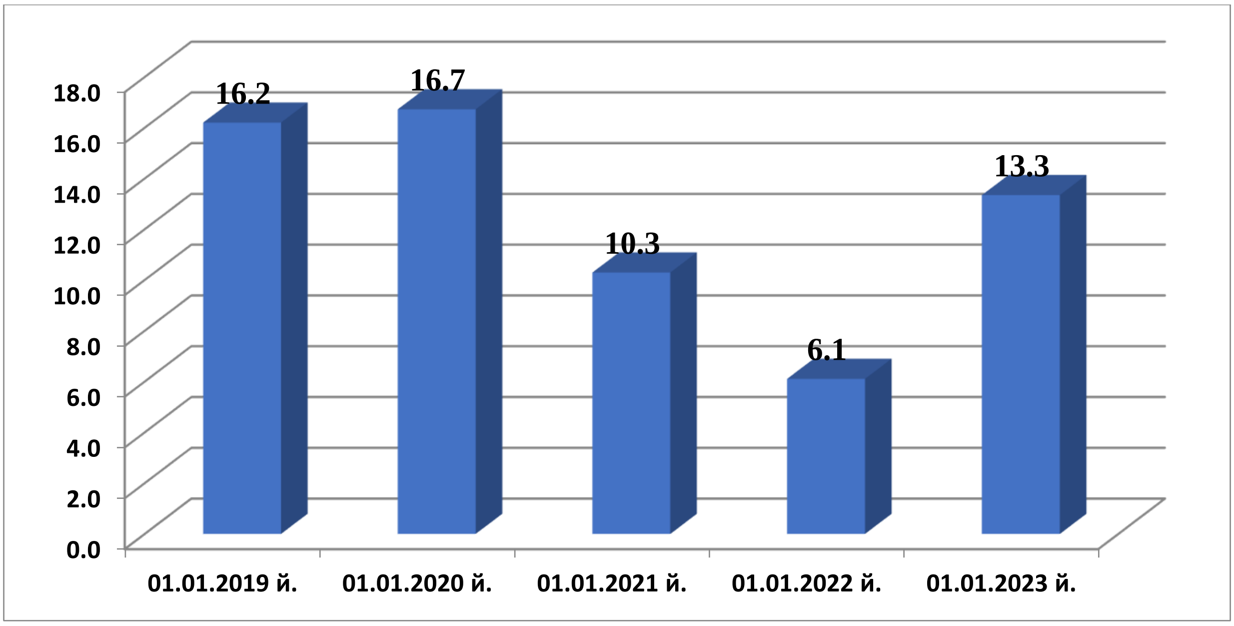
The increase in net interest income in the banking system is explained by the increase in the scope of commercial services, the decrease in the share of preferential and direct loans, and the improvement in the quality of assets.



Pic.-1. Banking system assets profitability (ROA) dynamics [2], in percent

The rate of return on bank assets is one of the main indicators of the stability of the banking system. The higher it is, the more efficiently it uses bank resources. The return on assets indicator, which assesses the efficiency of the use of assets by banks, has fallen to 1.3 percent by 2021, from 2.2 percent in 2020 . In 2019-2021, the rate of profitability was 2.0-2.2 percent. By the end of 2022, the profitability of banking system assets increased by almost 2 times compared to the beginning of the year, it was 2.5 percent, and the profitability of capital was 13.3 percent .

[2] Author's calculations based on the information of the Central Bank of the Republic of Uzbekistan



Pic.-2 . Banking system capital profitability (ROE) dynamics [3], in percent

The profitability of the banking system represents the extent to which the capital available in the banks has been used effectively. The return on capital is stable (16 percent) in 2019-2020, and has decreasing dynamics in 2021-2022. In 2022, it can be seen that it has increased dramatically. In this case, factors such as net interest margin (3.4 percent), ratio of non-interest income to assets (6 percent), leverage ratio (0.6 percent), reduction of tax burden on profit (0.8 percent) had a positive effect on the change of capital profitability., the growth of reserves (-2.5 percent) and the ratio of non-interest expenses to liabilities (-1.1 percent) had a negative impact. In our opinion, the main reason for this is the reduction of problem loans in banks, their removal from the balance sheet and the increase in bank profits.[7]

In order to ensure the stability of the banking system of Uzbekistan, the task "with the support of the International Monetary Fund, to identify possible risks in the economy, to develop stress-test models aimed at evaluating their impact on the stability of the banking system" has been set. In the strategy of reforming the country's banking system, "...improving the quality of the credit portfolio and risk management, following the moderate growth of lending volumes, maintaining a balanced macroeconomic policy, improving corporate governance and attracting managers with international practical experience, implementing technological solutions for assessing financial risks ensuring the financial stability of the banking system" is defined as one of the priorities. To ensure the performance of this task, ensure the continuous growth of lending activities of banks and increase the level of quality and diversification of the loan portfolio, develop and improve the effective risk management system in the banking system, strengthen the capital base of banks and adapt them to international standards, accelerate the process of transformation of commercial banks with a state share, One of the urgent issues of today is the implementation of an effective deposit protection system in order to increase the bank's resource base, to increase the share of long-term resources, to strengthen the measures of applying financial technologies to the banking system.[8]

Summary and Recommendations:

In summary, the assessment of financial stability in commercial banks involves a holistic analysis of various factors, including asset quality, capital adequacy, liquidity management, risk management practices, and macroeconomic conditions. This study employed a combination of quantitative and qualitative research methods to evaluate the stability of commercial banks and identify key determinants influencing their financial health.

[3] Author's calculations based on the information of the Central Bank of the Republic of Uzbekistan

The findings of this study indicate that asset quality, capital adequacy, and liquidity management are essential determinants of financial stability in commercial banks. Banks with higher asset quality, adequate capital buffers, and robust liquidity management practices are better positioned to withstand financial shocks and maintain their stability. Additionally, effective risk management frameworks and compliance with regulatory requirements play a crucial role in enhancing banks' resilience to adverse conditions.

Based on the findings, the following recommendations are proposed to strengthen the financial stability of commercial banks:

1. Enhanced Risk Management Practices:

- Commercial banks should continue to improve their risk management practices by adopting advanced methodologies for identifying, assessing, and mitigating various risks. This includes regular stress testing, scenario analysis, and robust internal controls to manage credit, market, and operational risks effectively.

2. Maintaining Adequate Capital Levels:

- Banks should ensure that they maintain sufficient capital buffers to absorb potential losses and meet regulatory requirements. This may involve retaining earnings, raising additional capital, or optimizing capital allocation to support business growth while preserving financial stability.

3. Optimizing Liquidity Management:

- Banks should prioritize liquidity management to ensure they have adequate funding sources to meet short-term obligations and withstand funding disruptions. This includes maintaining diversified funding sources, monitoring liquidity risk metrics, and developing contingency funding plans.

4. Adapting to Macroeconomic Conditions:

- Commercial banks should remain vigilant to changes in macroeconomic conditions and adjust their strategies and risk management practices accordingly. This may involve diversifying loan portfolios, adjusting interest rate risk exposure, and aligning business models with prevailing economic trends.

5. Strengthening Regulatory Compliance:

- Banks should continue to enhance their compliance with regulatory requirements and international standards, such as Basel III, to promote sound banking practices and maintain the confidence of regulators, investors, and depositors.

In conclusion, addressing the key determinants of financial stability outlined in this study is essential for ensuring the resilience and sustainability of commercial banks. By implementing the recommendations provided, banks can enhance their ability to withstand financial challenges and contribute to a stable and resilient banking system.

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