Current Analysis and Current Issues of Ensuring the Financial Stability of the Banking System in Uzbekistan

Kholmamatov Farkhodjon Kubayevich
DSc, Professor of Tashkent Institute of Finance

Abstract: This paper provides a current analysis of the financial stability of the banking system in Uzbekistan, focusing on recent issues and challenges. With the ongoing economic reforms and liberalization efforts in Uzbekistan, the banking sector plays a crucial role in supporting economic growth and development. However, several factors pose risks to the stability of the banking system. These include asset quality deterioration, liquidity constraints, inadequate risk management practices, and external shocks such as the COVID-19 pandemic. The paper reviews recent regulatory and supervisory measures implemented by the government and the Central Bank of Uzbekistan to address these challenges and strengthen the resilience of the banking sector. Additionally, it discusses ongoing initiatives to enhance financial inclusion, promote digitalization, and improve corporate governance within banks. Despite progress made, the paper identifies areas requiring further attention, such as enhancing transparency, addressing legacy issues, and fostering a culture of compliance and risk awareness. Overall, the analysis underscores the importance of continuous monitoring, proactive regulation, and prudent risk management practices in ensuring the long-term stability and sustainability of Uzbekistan's banking system amid evolving domestic and global dynamics.

Key words: Banking Regulation, Financial Stability, Banking Sector Reform, Asset Quality, Capital Adequacy, Liquidity Management, Non-Performing Loans (NPLs), Credit Risk, Macroeconomic Environment, Governance and Transparency, Regulatory Compliance, Risk Management Framework, Supervision and Oversight, Digital Transformation, Financial Inclusion, Interest Rate Policy, Exchange Rate Policy, Cross-Border Banking Risks, Economic Diversification.

Introduction:

Financial stability is the ability of a financial system, i.e., financial institutions, markets, and market infrastructure, to withstand possible shocks and imbalances, thus reducing the likelihood of disruption of financial intermediation functions. The goal of financial stability is not the stability of a single financial institution but the stability of the entire financial system. Financial stability is a cornerstone for the sustainable development of an economy.

A financial system is considered stable when banks, other lenders, and financial markets can provide households and businesses with the financing they need to invest, grow, and participate in a well-functioning economy—and can do so without making the system more vulnerable to sharp downturns. In contrast, in an unstable system, an economic shock is likely to adversely impact the real economy, disrupting the flow of credit and leading to larger-than-expected declines in employment and economic activity.

In the event of financial instability, the financial system cannot provide the financial services that are crucial to the economy. Financial instability may occur if, for example, a large institution experiences difficulties. In addition, problems in a single institution can spread to the rest of the system because the institutions are closely interconnected via interbank exposures. Financial instability may also occur even though the individual institutions seem robust. The reason is that the overall behavior of the institutions can pose a risk to the entire financial system, i.e., a systemic risk.

Literature Review:

The role of financial stability considerations in monetary policy can be roughly divided in two separate views: The first view, which is often labeled the conventional or reactive view, is represented for example by Bernanke (2002) and Posen (2006). According to this view, the best a central bank can do is to focus on price stability and output stability. In this way, they already react to ‘all relevant information’.

Authors such as Issing (2011), White (2009) and Woodford (2012) argue that the pre-crisis consensus, dominated by the conventional or reactive view, seems to be eroded. Since the U.S. subprime crisis and the European sovereign debt crisis, the proactive view of monetary policy and financial stability has gained many proponents. Thus, it seems clear to many authors that if central banks care about financial stability more than already mirrored in output and inflation, then simple policy rules might no longer suffice.

According to Goodhart (2006), financial stability has proved difficult to comprehend, mainly because there is no one accepted definition of what financial stability means. However, a vast national study by the United Way Worldwide identified two critical components that must exist in order for families to attain financial stability: stable adequate income and stable adequate financial resources (Valley of the Sun United Way, n.d.). Moreover, a report from the Corporation for a Skilled Workforce and United Way Worldwide (2011) stated that financial stability is achieved when families obtain sufficient resources via jobs that render enough income to sustain their daily necessities.

In particular, low-income people may have a lack of awareness about or distrust in banks and other financial institutions (Birkenmaier and Curley 2009). Therefore, communicating to them the advantages of using traditional banking versus using alternative banking services may help them to understand how to more effectively meet their banking needs (Robbins, 2013). Since many low income persons live paycheck to paycheck, acquiring a checking account could be an investment towards financial stability.

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.

Financial stability and its analysis are among the main tasks of central banks and financial sector regulators. The banking sector is the most important part of the financial system of Uzbekistan. For this reason, maintaining banking system stability is one of the main tasks of the Central Bank of Uzbekistan (CBU). The CBU monitors and assesses developments in the banking system and adopts measures to reduce the build-up of systemic risk and enhance the banking system’s resilience. The CBU publishes a Financial Stability Report twice a year, which analyzes and assesses the banking system’s stability and macro-financial vulnerabilities and risks. By publishing this report, the CBU intends to promote public awareness and increase the transparency and accountability of the CBU in this area.

Analyzes and results

In H1 2023, the banking system in Uzbekistan maintained financial stability despite slightly tighter financial conditions. The period witnessed a stagnant money market and significant volatility in the foreign exchange market, contributing to heightened uncertainty in the banking sector. Although there was a decline in capital adequacy and liquidity metrics, these indicators stayed well above regulatory minimums. The banking sector saw an improvement in profitability despite a reduction in the share of highly liquid assets in total assets. The ratio of non-performing loans (NPLs) to total loans was low, and there was an increase in provisions to offset potential loan losses.

The population's debt burden significantly increased. Uzbekistan's retail lending sector saw a notable surge in H1 2023, leading to a rise in the population's debt burden on gross and mortgage loans. This surge has led to a higher credit-to-GDP ratio over recent years. The accelerated growth in the balance of loans issued to the population could escalate credit risk. Individuals with lower incomes may particularly struggle to fulfill their loan obligations. Despite a relatively low debt service ratio (DSR) for total loans, indicating manageable debt levels among the population, there is an evident trend of high growth. An increase in indebtedness levels among the population could render borrowers more vulnerable and lenders more exposed to shocks, potentially destabilizing the financial system.

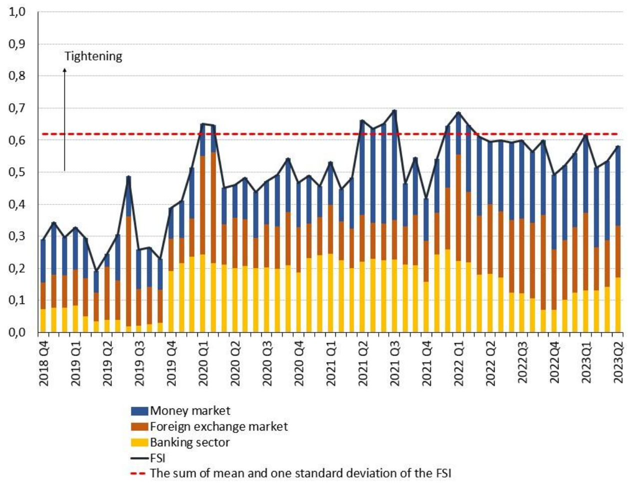
The housing market in Uzbekistan is currently experiencing overvaluation, with market prices significantly outpacing fundamental values. As of H1 2023, housing prices were, on average, 36 percent higher than their fundamental prices. Although housing price indices have climbed since 2022, a continuous upward trajectory might precipitate a market correction during economic downturns. The persistent demand for housing, outstripping supply, is expected to exacerbate the supply-demand imbalance in the real estate market. A sudden decline in the prices of houses used as loan collateral could amplify loan losses for banks.

In recent years, car loan growth has notably outpaced other loan categories, including mortgages and microloans. This has led to a higher concentration of car loans, increasing banks' vulnerability to economic shocks. Poor repayment discipline and significant loan losses are potential outcomes during economic downturns or car value depreciation. The surge in car loans is attributed to more lenient lending standards by banks, which, in turn, has stimulated demand in the automotive market. The combination of limited local supply and high import duties on cars has driven up prices, making vehicles one of the primary investment assets. Consequently, speculative activities in the car market are on the rise, bolstered by the growing investment appeal of automobiles.

According to macro stress testing, Uzbekistan's banking system has demonstrated resilience against shocks under both baseline and adverse scenarios. The total capital adequacy ratio (CAR) surpasses the Central Bank's minimum requirements in both scenarios. In the adverse scenario, even in the face of significant loan, equity, and housing losses, alongside an increase in risk-weighted assets (RWA), robust net interest and non-interest income are expected to maintain the CAR above the minimum requirement at 13.6 percent, by the end of 2025.

During H1 2023, Uzbekistan's Financial Stress Index (FSI)[1] was lower than its average plus one standard deviation, despite significant volatility. The money market remained stagnant during this period, but high volatility in the foreign exchange market and slightly increased uncertainty in the banking sector led to a slight tightening of financial conditions.

Figure 1. Uzbekistan's Financial Stress Index



[1] The FSI methodology is presented in the Financial Stability Report for 2022.

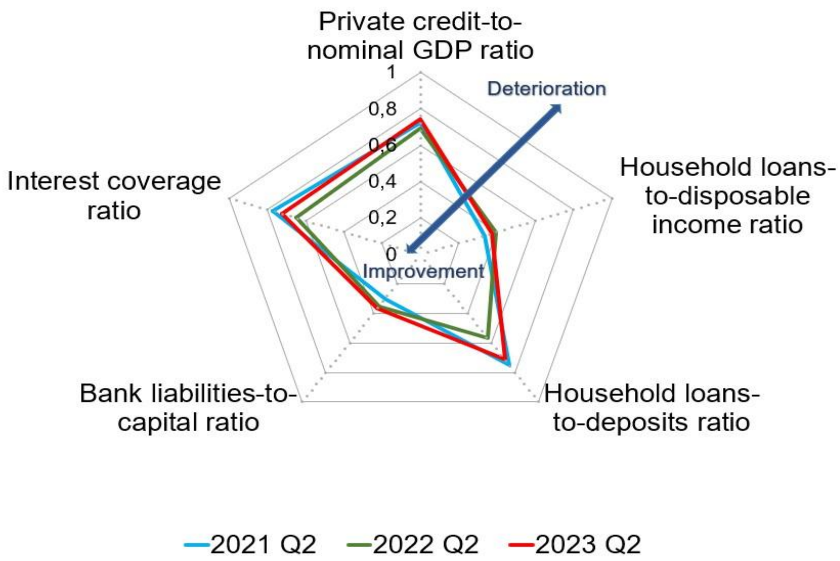
Source: CBU staff calculations.

Note: The FSI value close to 1 indicates a high level of stress, while a value near 0 indicates a low level of stress.

The ongoing external geopolitical tensions caused an external trade deficit to increase (in H1 2023, it amounted to –4.9 billion USD, which is 4.4 percent higher than in H1 2022), resulting in a high domestic demand for foreign currency. This and other factors caused volatility in the domestic foreign exchange market in H1 2023. As of July 1, 2023, total deposits decreased by 6.4 percent[2] from the beginning of the year due to the reduction of foreign currency deposits.

According to the credit market risk map[3], the household loans-to-deposits and interest coverage ratios deteriorated. As of July 1, 2023, the household loans-to-deposits ratio increased by 20 percent compared to the same period in 2022.

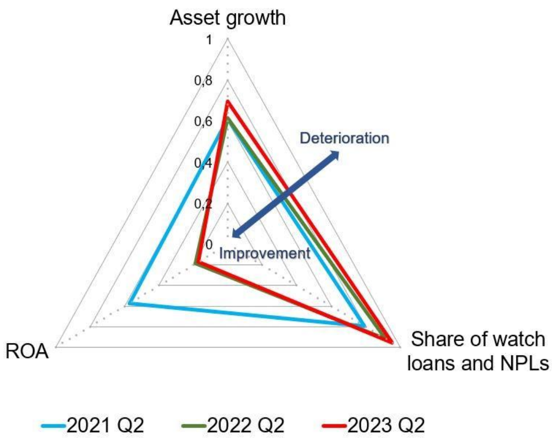
Figure 2. Credit Market Conditions



Sources: Statistics Agency and CBU staff calculations.

The interest coverage ratio also decreased by 4 percentage points compared to the corresponding period of 2022, indicating that banks' ability to cover interest payments on loans from bank profit decreased. However, there was a positive change in the household loans-to-disposable income ratio at the end of H1 2023 compared to the same period in 2022.

Figure 3. Financial Soundness Conditions



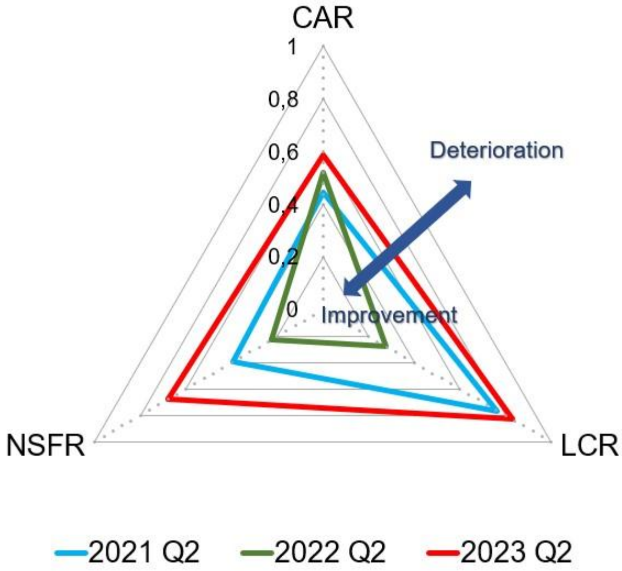
Source: CBU staff calculations

[2] https://cbu.uz/en/financial-stability/about/

[3] The risk map methodology is presented in the Financial Stability Report for H1 2022.

According to the map of financial soundness conditions in the banking system, there has been a slight increase in risks associated with the slowdown in asset growth and the increase in the volume of assets with overdue payments for more than 31 days. Specifically, in H1 2023, the growth rate of bank assets dropped by 8 percentage points compared to the same period in 2022. Additionally, the share of substandard and NPLs increased by 2 percentage points by the end of H1 2023 compared to the same period in 2022. However, bank profitability in terms of return on assets (ROA) has remained positive at a steady 2.7 percent for the past two years.

Figure 4. Banking System Resilience



Source: CBU staff calculations.

A decline in capital adequacy and liquidity indicators negatively affected the banking sector's resilience, making it more vulnerable to potential shocks. As of July 1, 2023, the capital adequacy ratio (CAR) fell by 0.6 percentage points compared to the same period in 2022. The liquidity coverage ratio (LCR) and net stable funding ratio (NSFR)— indicators of banks' liquidity position—also decreased.

In H1 2023, the banking system's capital adequacy remained above the minimum requirements. This provides a cushion against potential losses even under unfavorable macroeconomic and external conditions. As of July 1, 2023, the total regulatory capital of banks increased by 14 percent compared to the same period in 2022, reaching 88.7 trillion UZS. Approximately 85 percent of this capital is considered high-quality Tier 1 capital.

In Uzbekistan, the share of NPLs in total loans has decreased and is approaching the 25th percentile boundary for Central Asian and the Caucasian countries. As of July 1, 2023, the share of NPLs in Uzbekistan was 3.4 percent, the median indicator for this region. Furthermore, by the end of 2022, nominal wage growth was higher than the inflation rate in Central Asian and the Caucasian countries, including Armenia, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, and Uzbekistan. A recovery in economic activity and rising real wages in the region made it easier for borrowers to repay their debts. As a result, there was an improvement in the loan portfolio quality of banks in Central Asian and the Caucasian countries in H1 2023.

Figure 5. CAR in Banking Sector, %

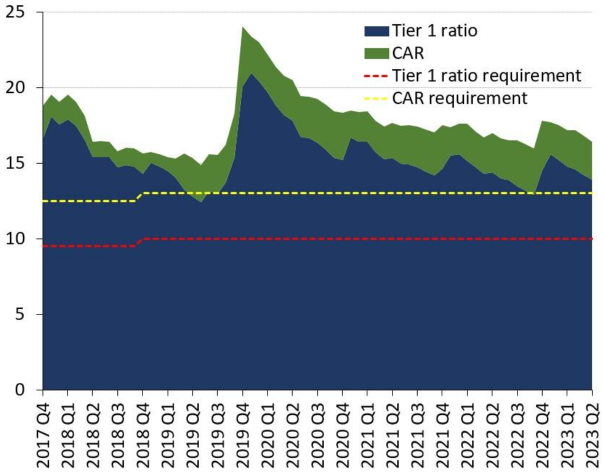
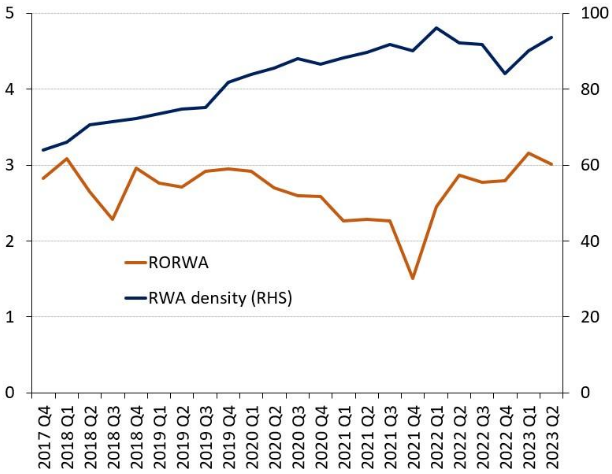


Figure 6. RWA Density[4] and Return *on RWA (RORWA), %*



Source: CBU staff calculations.

As of July 1, 2023, the total CAR[5] and Tier 1 capital ratio[6] were 16.4 and 13.9 percent, respectively. Compared to the same period in 2022, the ratios decreased by 0.6 and 0.5 percentage points, respectively. The CAR for systemically important banks (SIBs) was 16.6 percent, which is 0.4 percentage points higher than that of other banks.

In H1 2023, the return on RWA (RORWA) was approximately 3 percent. The RWA density for the banking system saw an increase and was at 94 percent as of July 1, 2023. This rise in the RWA density indicates that banks' risk appetite is increasing. It also suggests that bank returns on increasingly riskier assets are not increasing commensurately.

As of July 1, 2023, the CET1 capital decreased by 0.5 percentage points compared to the same period in 2022. However, it remains significantly higher than the required minimum for this capital. Changes in banks' total assets and the RWA density were the primary reasons for the annual decrease in CET1.

The banking system's profitability remained stable, with the return on equity (ROE) increasing by 1.6 percentage points as of July 1, 2023, compared to the same period in 2022. However, the ROA remained nearly unchanged. Furthermore, banks' net profit increased by 28 percent in H1 2023 compared to the same period in 2022. The high profitability of banks helped in their capital growth, which acts as an essential buffer against potential shocks and ensures their resilience.

Summary and Recommendations:

Here's an outline for summarizing the current analysis and issues related to ensuring the financial stability of the banking system in Uzbekistan, along with recommendations:

1. Overview of the Banking System in Uzbekistan:
➢ Provide a brief overview of the banking sector in Uzbekistan, including its structure, key players, and regulatory framework.

2. Financial Stability Indicators:

➢ Discuss key indicators used to assess the financial stability of the banking system, such as capital adequacy ratios, asset quality, liquidity, and profitability.

[4] To calculate the RWA density, the amount of RWA is divided by total assets. The RWA density provides a measure of riskiness of assets. An increase in the RWA density indicates a deterioration in overall risk profile of bank assets, while a decrease in the RWA density indicates an improvement in risk quality of assets.
[5] The ratio of total regulatory capital to RWA.
[6] The ratio of Tier 1 capital to RWA.

3. Current State of Financial Stability:

- Evaluate the current state of financial stability in the Uzbek banking system based on the identified indicators.
- Highlight strengths and weaknesses, including any vulnerabilities or risks.

4. Regulatory and Supervisory Framework:

- Review the existing regulatory and supervisory framework governing the banking sector in Uzbekistan.
- Assess the effectiveness of regulatory measures in maintaining financial stability.

Recommendations:

1. Enhanced Risk Management Practices:

- Encourage banks to improve risk management frameworks, including credit risk assessment, monitoring, and mitigation.
- Provide training and capacity-building initiatives to enhance risk management capabilities.

2. Addressing Non-Performing Loans:

- Implement strategies to address non-performing loans, such as loan restructuring programs, asset quality reviews, and strengthened loan recovery mechanisms.
- Enhance credit risk assessment procedures to prevent the accumulation of new NPLs.

3. Strengthening Regulatory Oversight:

- Enhance regulatory oversight and supervision to ensure compliance with prudential regulations and standards.
- Conduct regular stress tests and scenario analyses to assess the resilience of banks to potential risks.

4. Improving Governance and Transparency:

- Promote good governance practices within banks, including transparency, accountability, and effective board oversight.
- Enhance disclosure requirements to improve market transparency and investor confidence.

5. Investing in Financial Infrastructure:

- Invest in financial infrastructure, including payment systems and credit information sharing mechanisms, to support the stability and efficiency of the banking sector.

6. Promoting Financial Inclusion:

- Promote financial inclusion initiatives to expand access to banking services, particularly in underserved areas.
- Enhance financial literacy programs to improve the understanding of financial products and risks among the population.

By addressing these recommendations, Uzbekistan can work towards strengthening the financial stability of its banking system and promoting sustainable economic growth.

References:

1. Beck, Thorsten, Asli Demirgüç-Kunt, and Ross Levine. 2007. "Finance, Inequality and the Poor," Journal of Economic Growth 12(1): 27–49.
2. Boyd, John, and David Runkle. 1993. “Size and Performance of Banking Firms: Testing the Predictions of Theory,” Journal of Monetary Economics 31: 47–67.

3. Čihák, Martin. 2007. “Systemic Loss: A Measure of Financial Stability” Czech Journal of Economics and Finance, 57 (1-2): 5-26.
4. Freixas, X., Laeven, L., & Peydró, J. L. (Eds.). (2015). "Systemic Risk, Crises, and Macroprudential Policy." MIT Press.
5. Kashyap, A. K., Rajan, R. G., & Stein, J. C. (Eds.). (2012). "Dodd-Frank: One Year On." Center for Economic Policy Research.
6. Mishkin, F. S. (2010). "The Economics of Money, Banking, and Financial Markets." Pearson Education.
7. Allen, F., & Carletti, E. (Eds.). (2013). "Systemic Risk, Crises, and Macroprudential Regulation." MIT Press.
8. Demirgüç-Kunt, Asli, Enrica Detragiache, and Thierry Tressel. 2008. "Banking on the Principles: Compliance with Basel Core Principles and Bank Soundness," Journal of Financial Intermediation 17(4): 511–42.
9. Kaminsky, Graciela, and Carmen Reinhart, 1999, “The Twin Crises: The Causes of Banking and Balance of Payments Problems,” The American Economic Review 89 (3): 473–500.
10. Laeven, Luc and Ross Levine, 2009, “Bank Governance, Regulation, and Risk Taking” Journal of Financial Economics 93(2): 259–275.
11. Uralovich, K. S., Toshmamatovich, T. U., Kubayevich, K. F., Sapaev, I. B., Saylaubaevna, S. S., Beknazarova, Z. F., & Khurramov, A. (2023). A primary factor in sustainable development and environmental sustainability is environmental education. Caspian Journal of Environmental Sciences, 21(4), 965-975. DOI: 10.22124/CJES.2023.7155
12. Холмаматов, Ф. К. (2021). РЕСПУБЛИКАМИЗ БАНК ТИЗИМИДА МУАММОЛИ КРЕДИТЛАРНИНГ АМАЛИЙ ҲОЛАТИ ВА УЛАРНИ КАМАЙТИРИШ ЙЎЛЛАРИ. Scientific progress, 2(2), 488-495.
13. Kholmamatov, F., Khannaev, S., & Ruzimoratov, O. (2021). Assessment Of The Competitive Environment In The Bank Market Of Uzbekistan Through" Bun" Indicator. Turkish Online Journal of Qualitative Inquiry, 12(7).
14. Kubaevich, K. F., Abdullayevna, Q. Z., Axmadjanovna, S. G., & Makhmudovna, K. R. (2020). The modern state of crediting practices of commercial banks of the republic of Uzbekistan. Journal of Critical Reviews, 7(7), 387-390.
15. Chartayev Asqar, & Xolmamatov Farhod. (2022). THE PROFITABILITY INDICATORS OF COMMERCIAL BANKS IN THE REPUBLIC OF UZBEKISTAN AND THEIR MODERN STATE. World Economics and Finance Bulletin, 8, 141-148. Retrieved from https://www.scholarexpress.net/index.php/wefb/article/view/710
16. Kholmamatov, F. (2023). The Importance and Role of Bank Capital in Ensuring the Stability of the Banking System. https://doi.org/10.5281/zenodo.10825377
17. www.cbu.uz- Official website of the Central Bank of Uzbekistan