

STABILITY OF THE BANKING SYSTEM OF UZBEKISTAN: ANALYTICAL REVIEW OF LARGE BANKS

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This article studies issues of providing financial stability of commercial banks. There is reviewed a new Single supervisory mechanism of EU for banks. We analyzed main indicators of financial stability of the banking system Uzbekistan on example of nine large banks. As an instrument of analyses we used stress-testing. Quality of assets and capital adequacy were chosen as factors to assess the banking sector. We concluded that the asset quality of large banks of Uzbekistan can be evaluated on an acceptable level.

Key words: Banking, financial stability, capital, assets, profitability, stress-testing.

INTRODUCTION

The efficient functioning of any modern economy mainly depends on how successfully commercial banks are managing risks (Kallaur, 2008). With increasing importance of the financial sector to the economy, risks began to make a significant impact on the macroeconomic stability in general. Taking into consideration this factor, ensuring financial stability, that is, the optimization or minimization of risks in commercial banks has become one of the main activities of the Central Bank and management of the commercial banks all over the world. Unstable volatility in the financial and economic world justifies the importance and need for financial stability also in the banks of Uzbekistan.

The reason for we have selected banks as object of our research is that the share of banks accounts for over 90% of all assets of the financial sector in Uzbekistan (CBU stat for 2015). In

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the analysis we used major tools of stress-testing to check the data of nine large banks of Uzbekistan: Uzpromstroybank, Asakabank, Ipotekabank, Qishloqqurilishbank, People's Bank, Agrobank, Hamkorbank, Kapitalbank, and Korean Development Bank Uzbekistan. Basel Committee on Bank Supervision was one of the first to note the significance of stress testing: "Banks that use the internal modeling approach for compliance with the capital requirements in respect of market risks should have a programme for rigorous and comprehensive stress-testing" (Basel, 1996).

THEORETICAL REVIEW ON BANKING SUPERVISION

Financial stability is such a condition of commercial banks when they will be able to resist risks without development of cumulative processes that disrupt the transformation of savings into investments and payment transactions in the economy (Olsen, 2005). Therefore, to prevent it, Bezdudniy and others (Bezdudniy et. al, 2012) have noted the importance of stress testing in the following cases:

- to assess the exposure of banks to risks in stress conditions, which enables to develop or choose appropriate strategies to overcome these risks;
- for diagnosis and better understanding of the bank's own level and structure of risks;
- as means of assessing the ability of the credit institution to withstand stressful situations in terms of profitability and capital adequacy;
- to determine expected losses that banks are willing to incur in case of the situation on the particular scenario, and as a consequence, setting limits on operations.

In this article we are interested in the above-mentioned third paragraph, what will happen to the major banks in Uzbekistan, if any negative shock happens. The main types of risks have to be chosen for conducting stress-testing. The impact of the risk should be strong, however, to ensure significance of the results, it should not be beyond credibility. Moreover, according to the English practice, it is impossible to assess the impact of simultaneous default by all banks as it is

considered to be inappropriate (Bank of England, 2005). So it is necessary to focus on the most important aspects of the activity.

Central Bank of Uzbekistan and National Rating Agency “Ahbor-Rating” encourage commercial banks to actively use instruments of international organizations when developing their own stress tests (of such organizations as Basel, CEBS, IIF,FSB). It should be noted that after stress-testing, international rating agency “Moody’s” assigned rating to the banking system of Uzbekistan as “a stable” even to case of shocks.

When choosing stress factors current approach of Central Bank of Uzbekistan is based on statistics of banks with the account of current trends. These factors directly determine the effect of stress on the most risks which are more significant to banking business. In the framework of stress scenarios, these following negative changes are supposed to occur: (1) in case of growth of the share of bad loans in the credit portfolio of banks and non-performing loans, and (2) in case of outflow of deposits and funds of legal entities off the accounts of legal entities.

Realizing the need to develop new mechanisms for enhanced control over unexpected situations, the European Union in October 2013 adopted a Resolution which was devoted to the development the new Single Supervisory mechanism for banks. The document sets objectives and policies of the ECB in the preparation and putting into operation this supervision mechanism.

This document notes that despite some progress in harmonization of activities of national banking supervisory authorities of the countries of EU zone “crisis has shown that a simple coordination is not enough, especially in the presence of the countries with the single currency” (EU, 2013). As a priority, tasks aimed at formation of the structure of the public administration of the new supervisory body, development of legal and operational procedures and solutions of other issues necessary for commencing of its activity. In the framework of new powers it was expected that the ECB will have the right to have a direct supervision over 130 of the largest and most important banks in 18 Eurozone countries with assets of 22 billion Euros. Five main

directions of the preparatory activities for the single supervisory mechanism have been supposed to be implemented (Usoskin, 2015).

The first direction is development of principles of selecting of the most important credit institutions which are subject to direct supervision by the ECB. The reason for selection was based on the following criteria:

- total amount of assets exceeds 30 billion Euro;
- ratio of the institution's assets to GDP of the appropriate country exceeds 20%;
- the institution is included in top three main important credit institutions of the country.

The second direction is development of legal documentation of the supervisory activities. This involves a wide range of issues, starting with determining the status of importance of banks and ending with the distribution of responsibilities and arrangements for coordinating the activities of ECB and bank institutions certain countries within the framework of single supervisory mechanism.

The third direction is creation of elements of the organizational structure of single supervisory mechanism. This direction is focused on the establishment of a network of joint supervisory groups, which responsibilities include daily monitoring over activities of certain major lending institutions, preparation of images and other analytical materials about their financial condition, as well as smoothening of the system of risk assessment.

The fourth area is creation of the system of collecting statistical data necessary for the effective functioning of new supervisory mechanism. First and foremost, this system is determined by the needs of the programme of risk assessment. Information is distributed by categories depending on the risk profile of the analyzed banks.

The fifth direction is preparation for the implementation of the programme for a comprehensive assessment of bank's balances and their adjustments before the introduction of single supervisory mechanism. This programme includes two interrelated elements:

- assessing the quality of assets of bank balance;

- stress-testing, using and supplementing results of the first element and aimed at assessing the ability of banks to overcome shocks of unfavourable changes in financial market conditions.

As it was noted by Constancio (Constancio, 2015), having improved the quality and coordination of the supervisory authorities of the Eurozone countries, this reform promotes elimination of high systemic risk in the financial sector of European Union.

Briefly cite other important academic literary sources by foreign authors and scientists from the CIS countries. The focus of scientific publications by Bystritskaya (2010) and Kramarenko (2008) is done on the distant supervision as an important component of the banking supervision. Estrella et. al (2010) in their research investigated methodology for the calculation of capital ratios and their relationship with the possibility of the bank default. Research of Tatom et. al. (2011) is devoted to the generalization of existing methods of bank insolvency forecasting.

Taking into consideration conclusions presented in scientific literary sources and practices of international financial institutions on supervisory activities, the next section is dedicated to the analysis of banking system of Uzbekistan for 2015, as well as stress-testing nine major banks of Uzbekistan.

ANALYSIS AND STRESS-TEST OF TOP UZBEK BANKS

In 2015, banking system of Uzbekistan experienced high growth rates. This section of the article presents analysis of 9 major banks of Uzbekistan which have been chosen by the indicator of the volume of total bank assets. The largest bank in Uzbekistan is the National bank for foreign economic activities hasn't been included in the group of analyzed banks because the share of its assets is much bigger than others. It should be noted that the share of National bank in 2015 accounted for 21.58%. We suppose that including of National bank in the analysis would lead to the distortion of the results by large banks. 8 of 9 being analyzed banks are joint-stock commercial banks and 1 bank is a bank with participation of foreign capital (>30%). All statistical data for analysis were taken from 42nd Analytic report of National rating agency "Ahbor-rating" for 2015.

By the end of 2015, total assets of banks increased by 26.3% in comparison with 2014. The concentration of assets in banks has been remaining constant during last several years which justifies a stable rise of the banks' activity. Banks render lending and leasing services to manufacturing enterprises by the refinancing rate (9%) of the Central Bank. Loan and liquid assets prevail in the assets' structure of banks and the share of these assets accounts for 61.2% and 26.9% correspondingly (See Table 1).

Table 1. Indicators of financial stability of the analyzed banks

| Liquidity | 2014 | 2015 |
|---|-------------|-------------|
| Ratio of high-liquidity assets to the total assets | 13.32% | 15.39% |
| Ratio of liquid assets to the total assets | 21.20% | 20.56% |
| Relation of high-liquidity assets to demand obligations | 47.52% | 57.92% |
| Relation of liquid assets to short-term obligations | 62.67% | 63.40% |
| Relation of clients' deposits to the total loans | 75.98% | 80.09% |

Source: 42nd Analytic report of National rating agency "Ahbor-rating" for 2015.

On the results of 2015 liquid assets of being reviewed banks increased by 28% in comparison with 2014 and accounted for 73.9% of total liquid assets. In 2015 average terms of banks were mainly of a short-term nature. Due to the potential growth of the volume of financing of strategic branches of the economy by banks, we positively assess the perspective of growing of the share of assets with the term over 1 year in assets structure of banks. Therefore, it should be noted that currently obtained a capital adequacy ratio exceeds requirements of international standards established by the Basel Committee (See Table 2).

Table 2. Indicators of financial stability of the analyzed banks

| Capital adequacy | 2014 | 2015 |
|--|-------------|-------------|
| Capital adequacy of level 1 | 14.19% | 11.58% |
| Adequacy of the fixed capital | 15.41% | 13.11% |
| Ratio of assets weight by the degree of risk to total assets | 9.56% | 8.63% |

Source: 42nd Analytic report of National rating agency "Ahbor-rating" for 2015.

Constantly, increasing competition in financial markets and the pursuit of universalization of the banking business force domestic commercial banks to be more deeply involved in processes of

investment provision of innovation development of key enterprises in various sectors of the economy. In this regard, it should be noted that in recent years government has greatly increased its stake in these banks, due to the fact that most of these banks have a strategic importance for the domestic banking system and the economy as a whole.

Nowadays, as international experience shows, the enhanced development tools in retail lending in the banking market always contributes to a significant expansion of banking services among the population, as well as increasing the diversification of the loan portfolio of commercial banks. According to the data of Central Bank, at the end of 2015, over 90% of all loans extended by banks are referred to the group of banks considered in the article.

The measures undertaken to expand resource base through further increase of bank capitalization accompanied by attracting private capital in this sector there is the tendency of the gradual growth of deposits. It should be noted that due to the provided benefits and privileges at the end of 2015, there was a significant growth of time deposits which accounted for 37.0% which for the analyzed period amounted to the share 78.6% of the total deposits of banks. By the end of 2015, total revenue of the considered banks increased by 21.9% compared to 2014 year and amounted to 74.6% of total income of all banks. In the structure of sources of income generation of the analyzed banks, interest income on loan operations plays a predominant role. Their share accounts for 42% of total revenues. The share of other interest income in total revenue increased by 17.1% in comparison with the same period of previous year.

In the structure of non-interest income of banks, receipts coming from the commission are considered to be the main source. According to the results of 2015, bank profit from the operations in forex increased by 125.5% in comparison with 2014, and other sources of non-interest income such as profit from operations with securities also rose by 34.5% compared to 2014. Other non-interest income grew by 22.3%.

Thus, according to the results of 2015, net bank profit increased by 31.5% in comparison with 2014. So ROA of banks illustrated insignificant increase from 1.39% in 2014 to 1.45% in 2015.

In addition, ROE indicator of banks demonstrated a rise from 12.37% to 13.50%. The results of the analysis of the banks' profitability are demonstrated in the following table.

Table 3. Indicators of efficiency and profitability of analyzed banks

| Indicators | 2014 | 2015 |
|---|--------|--------|
| ROA | 1.39% | 1.45% |
| ROE | 12.37% | 13.50% |
| Net interest margin | 4.30% | 4.02% |
| Interest spread | 4.34% | 4.33% |
| Interest income / income bearing assets | 10.14% | 9.73% |
| Interest expenses / Interest expenses bearing liabilities | 5.80% | 5.40% |

Source: 42nd Analytic report of National rating agency "Ahbor-rating" for 2015.

In their activities on the internal audit banks use main directions of stress-testing developed by the international banking practice, sensitivity analysis and scenario analysis. Sensitivity analysis is used to assess the impact of change of one factor on the financial condition of a bank. Analysis in the scenario conditions assumes the use of interconnected combination of several risk factors as a stress case.

Such factors as the quality of assets and capital adequacy are considered to assess a banking sector of Uzbekistan. Real level of non-performing loans is higher than it is reflected in the reporting and accounts for 5% from the total amount of loans extended and may result in losses in the amount of 5% of the total amount of losses extended within 12-18 months.

Capitalization level has been adjusted towards the reduction for taking into account non-profile investments in financially-unstable manufacturing enterprises. Losses have been admitted in the amount of 10% from investment funds. Bank's consolidated assets which are subject to risk will increase by 20-25%. After stress-testing the capital adequacy of the 1-st level will account for 11.56%. Total capital adequacy after stress-testing will make 12.30%.

According to the results of stress-testing, the capital adequacy ratio is slightly decreasing by 0.02%. Moreover, according to the bank reporting, in 2015 non-performing loans amounted to

3.24% of the total credit portfolio of banks. Banks have to accrue reserves on loans by 3.80% from the total volume of the credit portfolio. As results of stress-testing demonstrate, the quality of assets of analyzed banks can be estimated on the appropriate level.

In conclusion, it should be noted that currently commercial banks of Uzbekistan maintain relatively stable position from the point of view of capital reserves and can successfully withstand a moderate stress.

CONCLUSION

In general, the analysis has demonstrated that the banking system of Uzbekistan is characterized by high growth rates in recent years. Total assets of banks increased considerably. The capital adequacy ratio of banks far exceeds the requirements of international standards. Net profit of the banks demonstrates a relatively high growth and ROA of the banks shows a slight increase. The ROE of the banks indicated an increase from 12.37% to 13.50%. According to the results of stress test, the value of the capital adequacy ratio for analyzed banks slightly reduced. According to the results of the stress test, we can make a conclusion that the asset quality of large banks of Uzbekistan can be evaluated on an acceptable level.

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