OBJECTIVES OF THE PROVISION OF FINANCIAL STABILITY OF COMMERCIAL BANKS

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OBJECTIVES OF THE PROVISION OF FINANCIAL STABILITY OF COMMERCIAL BANKS

“Banks Are Where The Liquidity Is”

Oliver Hart

The article reviews the financial stability of commercial bank and objectives of its provision.

**Keywords:** commercial bank, banking sector, financial stability, liquidity, capital adequacy.

Maqolada tijorat banklarining moliyaviy barqarorligi va uni ta’minlash masalalari ko’rilgan.

**Kalit so’zlar:** tijorat banki, bank sektori, moliyaviy barqarorlik, likvidlilik, kapital yetarliligi.

From the first years of independence a great attention has been paid by our government to the development of the banking system, because banking sector is considered as an important aspect of financial stability of the country.

In general, for banking sector of the Republic of Uzbekistan, the last decade has been years of rapid growth and expansion of supplying banking services to the population and enterprises. As an Institution, banks play a major role in financial intermediary system in Uzbekistan, significantly surpassing other participants in financial markets in terms of economic potential.

The monetary policy of the Central Bank of the Republic of Uzbekistan was aimed at achieving forecast macroeconomic indicators for 2016, meeting the requirements of decrees and resolutions of the head of state on further reforming and enhancing the stability of banking system and achieving high international rating indicators.

In 2016, considerably work was carried out to increase the level of capitalization of the banking system, as well as, further strengthening its liquidity and sustainability. According to the results of the fourth quarter of 2016, the total capital
of commercial banks increased 1.2 times compared to the same period of the last year and reached more than 9.4 trillion soum. At the same time, the assets of commercial banks also increased 1.2 times and as of January 1, 2017 reached more than 80.4 trillion soum. As a result, the total volume of loans directed to the real sector of the economy increased by 1.3 times compared to the results of 2015 and at the beginning of the 2017 it reached more than 53.4 trillion soum. The level of capital adequacy of our banking system exceeds the three times the requirements established by The Basel Committee on Banking Supervision (8%) [1].

Financial stability is the most important characteristic of the commercial banks’ financial activity in a market economy. Its provision is one of the most acute problems in the activities of commercial banks. If a commercial bank is financially stable, it has competitive preferences over the other commercial banks, which is expressed in attracting additional resources, dominating in one or another segment of the market, increasing the population's deposits as the main source of banking resources and, accordingly, expanding the scope of investment, opportunities to absorb new non-traditional types of services, etc. In addition, a financially stable bank creates a favorable external environment, that is, does not enter into conflict relations with the state and society, as it pays taxes in full and on time to the budget and non-budget funds, wages to workers and employees, dividends to shareholders, and returns borrowed funds to its creditors.

Financial stability of banks is extremely important for the stable and progressive development of the economy. Financial stability is one of the main elements of the bank’s financial condition in modern society. Determining the level of stability and reliability of the bank requires an objective assessment of its financial condition. A systematic approach in diagnosing bank's financial position includes a balanced set of indicators, reflecting the level of reliability and efficiency of the bank's operations, as well as threats of bankruptcy.

The financial stability of commercial banks and the banking sector as a whole determines the stability of the entire economy of the country. This can be explained by the fact that a large share of cash flows is carried out through banking operations.
Traditionally, the assessment of financial stability of the bank involves the use of a certain set of indicators, which can be grouped as follows:

- Indicators of capital adequacy;
- Liquidity indicators;
- Indicators characterizing the quality of liabilities and assets;
- Indicators of profitability.

The capital (own funds) of a commercial bank performs several important functions in daily activities and ensure the bank's long-term viability. Additionally, the capital serves to protect against bankruptcy (“money for a rainy day”), supports the clients' trust in the bank and convinces the creditors of its financial strength. Capital must be large enough to ensure that borrowers are confident that the bank is able to meet their loan needs even if the economy is in decline.

Moreover, the capital provides funds for organizational growth, the provision of new services, the implementation of new programs and the purchase of equipment. During the growth period, the bank needs additional capital to support and protect against the risk associated with the provision of new services and the development of the bank (including the creation of branches).

According to the definition of Russian author Sviridov O. Yu., “the term of "capital adequacy" reflects the overall assessment of the bank's reliability, which determines the relationship between the amount of capital and the bank's exposure to risk” [3].

In order to estimate the stability of the bank we used the capital adequacy and liquidity ratios recommended by Basel Committee.

Below we review the capital adequacy requirements on the example of JSCMB “Ipoteka bank”:

### Table 1

**Information on the capital adequacy calculation of JSCMB “Ipoteka - bank” [4]**

<table>
<thead>
<tr>
<th>Indicators</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1 capital</td>
<td>150056,8</td>
<td>184316,2</td>
<td>230288,0</td>
<td>304950,1</td>
<td>381855,1</td>
</tr>
<tr>
<td>Tier 2 capital</td>
<td>39293,1</td>
<td>45734,3</td>
<td>53825,5</td>
<td>60956,4</td>
<td>77114,8</td>
</tr>
<tr>
<td>Total regulatory capital</td>
<td>182976,4</td>
<td>223964,6</td>
<td>278082,1</td>
<td>365906,5</td>
<td>458969,9</td>
</tr>
<tr>
<td>Risk weighted assets</td>
<td>1092396,2</td>
<td>1635972,0</td>
<td>2109878,0</td>
<td>3100902,5</td>
<td>3922819,6</td>
</tr>
</tbody>
</table>

Source: Created by author

It is obvious from the given table that, both tier 1 and 2 capital and risk weighted assets had upward trend with the passing of the years.
According to the recommendations of Basel III the capital adequacy is calculated as following [5]:

\[
Total \text{ capital adequacy} = \frac{Total \text{ regulatory capital}}{Risk \text{ weighted assets}} \geq 8\%
\]

\[
Tier 1 \text{ capital adequacy coefficient} = \frac{Tier 1 \text{ capital}}{Risk \text{ weighted assets}} \geq 6\%
\]

Picture 2. The capital adequacy level of JSCMB “Ipoteka-bank” [4]

Based on the analysis, the requirements on tier 1 capital and regulatory capital exceeds the standards. In spite of positive indicators a downward trend can be observed from year to year.

Banks should have available liquid assets that can easily be converted into cash, or the opportunity to increase their funds at the slightest hint of the requirement to fulfill its obligations.

Liquidity is one of the most important qualitative characteristics of the bank's activity, which indicates its reliability and stability.

The concept of liquidity which is given by Professor O. Lavrushin considered that "the liquidity of the bank is the ability to fulfill its obligations to depositors and creditors in a timely and lossless manner" [6].

Liquidity ratios track the adequacy of cash and other liquid assets to meet unforeseen cash demand, as well as the bank's ability to meet short-term obligations such as withdrawals from accounts by demand without experiencing liquidity problems.

There are different ways of calculating the bank’s liquidity in international experience. Below we calculate some of these indicators on the example of JSCMB “Ipoteka-bank”.

[Table and graph data]
Table 2
The method of calculating the level of liquidity of JSCMB “Ipoteka-bank” on the basis of international experience [4]

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia</td>
<td>High liquid assets/demand deposits</td>
<td>min 15 %</td>
<td>66.4</td>
<td>57.8</td>
<td>44.3</td>
<td>61.4</td>
<td>64.9</td>
</tr>
<tr>
<td></td>
<td>Liquid assets till 30days/ Demand deposits till 30days</td>
<td>min 50 %</td>
<td>52</td>
<td>63</td>
<td>43</td>
<td>69</td>
<td>53.9</td>
</tr>
<tr>
<td></td>
<td>Assets more than 1year / capital + liabilities more than 1year</td>
<td>max 120 %</td>
<td>172</td>
<td>127</td>
<td>146</td>
<td>122</td>
<td>130</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>Liquid assets till 30days/ Demand deposits till 30days</td>
<td>min 30 %</td>
<td>52</td>
<td>63</td>
<td>43</td>
<td>69</td>
<td>53.9</td>
</tr>
</tbody>
</table>

The CAMELS system uses a certain type of indicators to assess the liquidity:

1. Deposit stability. In order to find this ratio we should divide the stable deposits to total deposits and multiply it to 100%. In international practice it is considered to be a value of at least 75%.

Table 3
Deposit stability of JSCMB “Ipoteka-bank” [4]

<table>
<thead>
<tr>
<th>№</th>
<th>Indicators</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>Change of 2016 to 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>2014</td>
<td>2015</td>
<td>2016</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Stable deposits</td>
<td>517993</td>
<td>727794</td>
<td>847017</td>
<td>329024</td>
</tr>
<tr>
<td>2</td>
<td>Total deposits</td>
<td>1269187</td>
<td>1528000</td>
<td>1878875</td>
<td>609688</td>
</tr>
<tr>
<td>3</td>
<td>The share of stable deposits in total deposits (%)</td>
<td>41</td>
<td>48</td>
<td>46</td>
<td>5</td>
</tr>
</tbody>
</table>

Deposit stability of JSCMB “Ipoteka-bank” increased to 5 points in 2016 comparing to 2014, but as shown in the table, this ratio decreased to 2 points compared to 2015, accounting for 46 percent share of total deposits. The result is 29 points less compared to international standards. It can be explained due to the raise of budget funds’ share in bank deposits.

2. The ability of assets to exchange to cash quickly. It estimated by the dynamics of the following indicator: liquid assets divided to the sum of total (brutto) assets and the result multiplied by 100%.

3. The opportunity level of commercial bank to use the external sources.

In order to calculate this ratio we should divide the credits from other banks to the total attracted resources and multiply the results to 100%.

4. Compliance of the achieved indicators with the internal policy on maintenance of liquidity.
5. The effectiveness of the strategy of managing the asset and liabilities of the bank.

"Capital adequacy" and "liquidity of the bank" indicators are traditional and at the same time clear and comparable, which have become widespread in international financial practice.

Estimation of own capital is a priority in assessing the activity of the bank, because its volume determines the size, composition and structure of assets, and, consequently, the bank's income.

The essence of the liquidity problem is that the demand for liquid funds is rarely equal to their offer, therefore the bank constantly deals either with a deficit of liquid funds or with their excess.

Consequently, the general financial position of our commercial banks requires further refinement and improvement. At the same time, it is necessary to actively use foreign experience, taking into account the specifics of the conditions in which domestic commercial banks operate.

To improve the financial stability banks can carry out a set of the following activities:

- develop and implement an internal financial stability management system;
- develop stress testing system;
- implementation of Basel III elements in the management system of financial sustainability;
- managing banking risks, especially pay attention to the requirements for borrowers, improvement of the monitoring system for existing loan agreements;
- interaction of all branches of the bank to maintain financial stability of the bank;
- increase the stability of resources, in particular, increase the reserve fund, it is proposed to issue securities. The increase in equity capital contributes to the improvement of the bank's reliability.
- optimize the resource base of the bank

To increase the own capital of JSCMB “Ipoteca-bank” it is recommended to increase the authorized capital, increase profitability by reducing expenses and get a subordinated loan.

Thus, each commercial bank must independently ensure the maintenance of capital adequacy and liquidity at a given level on the basis of both an analysis of their developing condition for specific periods of time and forecasting the results of activities and subsequently carrying out scientifically sound economic policies in the formation of authorized capital, special funds and reserves, borrowing from outside organizations.
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