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Existing Problems in Improving the Quality of Bank Assets and Opportunities to Reduce their Impact on the Activities of the Banking System of the Republic of Uzbekistan

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Abstract: Improving the quality of commercial banks' assets and managing them effectively is crucial for ensuring financial stability, strengthening the bank's financial position, and minimizing potential risks. This paper examines modern methods of managing commercial banks' assets, including investments, credit portfolio diversification, risk assessment, and strategies for effective risk management. Additionally, the article explores the internal and external factors influencing asset quality, legal and regulatory frameworks, as well as the role of innovative technologies. A clear and integrated approach to managing these factors enhances the efficiency of commercial bank operations and contributes to increasing credit potential.

Key words: Commercial banks, Asset quality, Asset management, Risk management, Credit portfolio, Risk assessment, Financial stability, Diversification, Regulatory framework, Innovative technologies, Financial position, Risk mitigation.

Introduction. Commercial banks are a crucial component of the economic system, playing an essential role in ensuring financial stability, providing credit resources, and contributing to economic development. The quality of a bank's assets directly determines its financial health and stability. Proper asset management and effective risk management help commercial banks achieve not only financial success but also maintain their stability in a volatile market environment.

Today, improving the quality of assets and managing them efficiently is influenced not only by internal factors but also by the external economic and regulatory environment. Therefore, this paper explores modern approaches to asset management in commercial banks, including diversification, risk assessment, and strategies to mitigate risks. The goal is to analyze the factors affecting the quality of commercial bank assets, the role of innovative technologies, and regulatory challenges, with the aim of enhancing the efficiency and stability of bank operations.

In 2023, macroprudential policy of the Central Bank of the Republic of Uzbekistan was directed to ensure financial stability of the banking system at an acceptable level amid ongoing uncertainties in the global economy. In order to minimize the negative effects of possible risks on capital and liquidity of banks, activities of banks were regularly analyzed in accordance with control indicators developed with the support of World Bank experts and Financial Soundness indicators of the IMF, and stress tests were conducted under various scenarios.

Based on the results of these stress-tests, measures were undertaken including, a true assessment of the quality of assets of commercial banks, formation of sufficient reserves against possible losses, monitoring financial condition of the largest customers of banks, improving collection system of problematic loans, writing-off non-banking assets, optimizing costs, forming capital and liquidity buffers in a timely manner.

Literature Review.

The literature on commercial bank asset management and quality highlights various approaches and methodologies that have evolved over time, focusing on risk management, portfolio diversification, and the role of technology in improving asset quality. Several key areas have been extensively studied in the field, and this review will summarize the most significant contributions.

1. Asset Quality and Risk Management

One of the central themes in the literature is the relationship between asset quality and risk management. According to Berger and DeYoung (1997), the quality of bank assets is a critical indicator of a bank's financial stability. They argue that effective risk management practices, such as credit risk assessment and capital adequacy management, are essential for maintaining high asset quality. Additionally, the work of Merton (1977) on the "option pricing theory" provided a foundational understanding of managing financial risk, which has been applied to assessing bank assets.

2. Credit Portfolio Diversification

Diversification of credit portfolios is another critical strategy for improving asset quality. According to Fama (1981), a diversified portfolio minimizes the risk of large losses by spreading risk across different sectors or geographic areas. This view has been expanded by more recent studies, such as those by Allen and Santomero (1997), who emphasize the importance of diversifying loan portfolios to mitigate the effects of economic shocks and sectoral downturns on banks' asset quality.

3. Regulatory Frameworks

Regulatory frameworks also play a crucial role in shaping banks' asset quality. The introduction of the Basel Accords (Basel I, II, and III) has provided banks with a set of international standards to ensure that they maintain sufficient capital to absorb potential losses. These regulations aim to reduce the risk of asset deterioration and provide guidelines for managing the quality of assets. Literature on the Basel framework (e.g., Borio, 2008) emphasizes that the implementation of stricter capital requirements has improved asset quality by encouraging banks to manage risks more prudently.

4. Technological Advancements

The role of technology in enhancing asset quality has become increasingly important in recent years. Digital banking, artificial intelligence, and machine learning algorithms allow for more accurate risk assessments and better forecasting of loan defaults. According to studies by Brynjolfsson and McAfee (2014), the use of big data and advanced analytics helps banks predict potential risks associated with their assets and improve decision-making processes related to asset management. Moreover, Fintech innovations provide banks with the tools to streamline their operations and enhance overall asset performance.

5. Internal Factors Affecting Asset Quality

Several studies have explored the internal factors that impact asset quality, such as governance, management practices, and the bank's corporate culture. According to Adams and Mehran (2003), strong governance structures and efficient management practices are essential for maintaining high asset quality. Banks with transparent decision-making processes and effective internal controls are less likely to suffer from deteriorating asset quality.

6. Economic Environment and External Factors

The economic environment and external factors also influence the quality of commercial bank assets. Research by Laeven and Levine (2009) highlights how macroeconomic factors, such as interest rates, inflation, and GDP growth, affect asset quality. Additionally, changes in the

regulatory environment, political instability, and global economic conditions can have significant impacts on the risk profile of bank assets.

7. Impact of Non-Performing Loans (NPLs)

A substantial body of literature focuses on the impact of non-performing loans (NPLs) on asset quality. Non-performing loans are a major indicator of asset deterioration, as they reduce the bank's overall asset base and increase the risk of insolvency. According to studies by Boudriga et al. (2009), the level of NPLs in a bank's portfolio is influenced by factors such as poor loan underwriting, inadequate risk management, and macroeconomic downturns. Reducing NPLs through better credit assessment practices and collection strategies is a critical component of improving asset quality.

In conclusion, the literature on commercial bank asset quality and management emphasizes the importance of effective risk management, regulatory compliance, portfolio diversification, and technological advancements in enhancing the quality of assets. The evolving economic and regulatory landscape requires banks to continuously adapt and innovate to ensure the stability and sustainability of their asset portfolios. This review provides a foundation for understanding the key factors that influence asset quality in commercial banks and sets the stage for further research and practical applications in asset management.

Analysis and results.

In 2023, as part of prudential control measures, significant efforts were made to improve the loan portfolio of the banking system and reduce the share of non- performing loans. Services were tailored to consider the debt burden of individuals, potential credit risks were mitigated through the analysis of the financial situation of large debtors, and access to financial services for self-employed individuals was expanded.

In particular, during 2023, to prevent the negative impact of non-performing loans on the financial stability of the banking system and reduce their weight, bank loan portfolios were regularly analyzed by banks, regions, and segments.

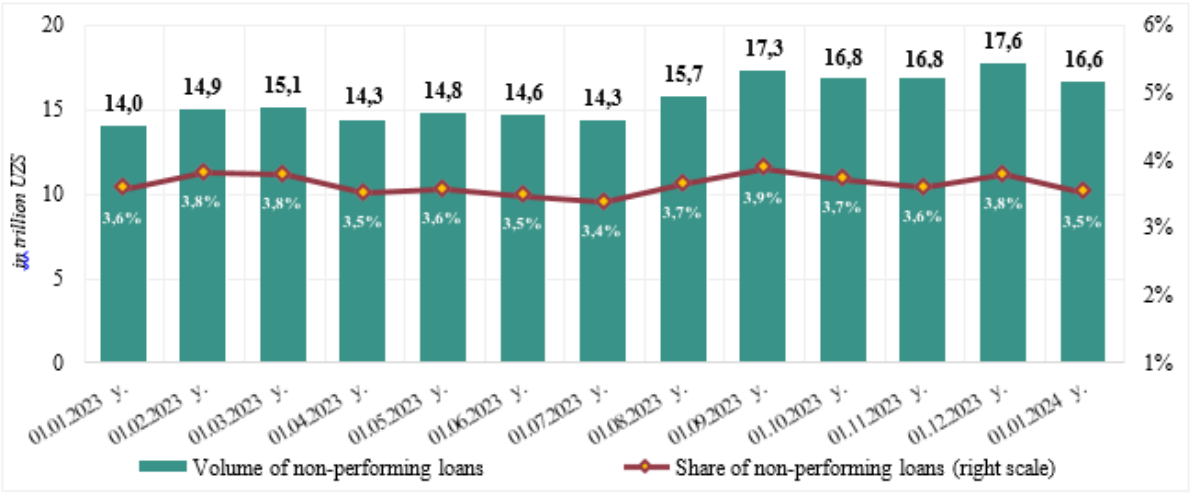
Based on the results of the analysis, the management of the relevant banks were given instructions to address shortcomings and existing vulnerabilities in the system.

In addition, to increase the efficiency of non-performing loans collection in the regions, working groups consisting of senior staff of commercial banks, led by deputy chairmen of the Central Bank, were established to study the state of non- performing loan collection locally. Furthermore, the Cabinet of Ministers, the General Prosecutor’s Office, the Central Bank, and the Accounts Chamber approved a package of joint instructions and created a vertical control system to organize, coordinate, and evaluate the activities of responsible officials in the regions.

At the end of 2023, the share of non-performing loans in the total volume of loans in the banking system decreased to 3,5% *(3,6% at the end of 2022).*

As of January 1, 2024, 80% of the loan portfolio of commercial banks is classified as “standard”, 16% as “substandard” and 3,5% as problematic *(1,5% as “unsatisfactory”, 1,1% as “doubtful” and 0,9% as “hopeless”).*

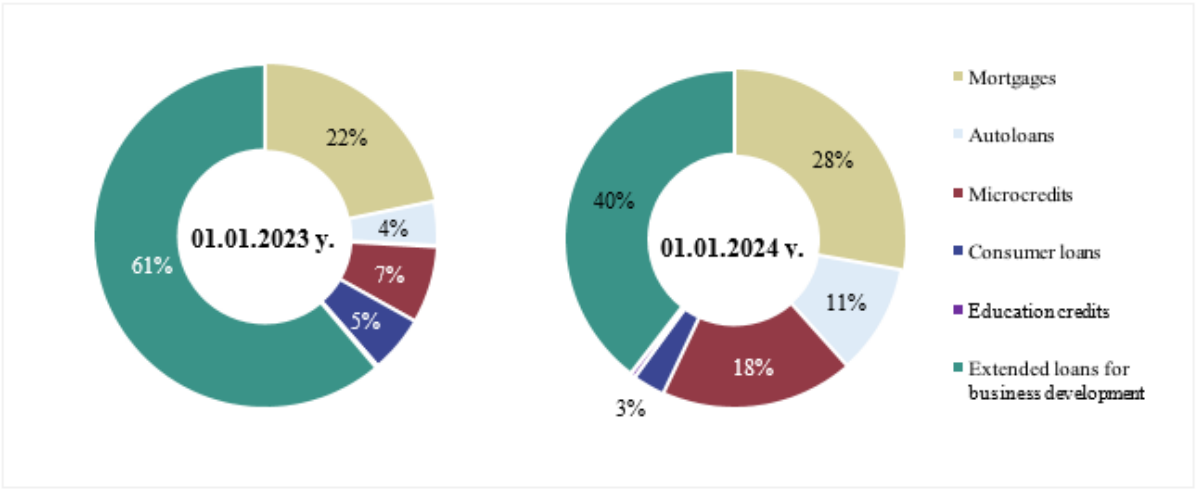
Figure 1 Dynamics of the share of non-performing loans in the total volume



In 2023, banks created additional reserves for assets (*excluding the "standard" loan portfolio*) amounting to 2,4 trillion UZS, and the coverage level of non-performing loans by reserves increased from 80% in the corresponding period of last year to 82% as of January 1, 2024.

85% *(14,1 trillion UZS)* non-performing loans belongs to business entities, while **15**% *(2,5 trillion UZS)* to individuals.

Figure 2 Non-performing loans of individuals



Source: Central Bank data

In the structure of non-performing loans of households, **1,0** trillion UZS *(40%)* were loans for the development of entrepreneurship, **709** billion UZS *(28%)* – mortgages, **470** billion UZS *(18%)* – microloans, **271** billion UZS *(11%)* – auto loans, and **89** billion UZS *(3%)* were classified as other consumer loans.

To mitigate the adverse effects of foreign economic risks on banking stability, the Central Bank conducted stress tests to assess the liquidity impact of risks related to the early fulfillment of financial obligations by commercial banks to foreign counterparts. Macroprudential measures were strengthened to ensure the diversification of banking assets and prevent an escalation in the debt burden of the population. In particular, to mitigate risks associated with the concentration of auto loans, a practice has been introduced to assess the risk level of auto loans based on the value of their collateral. As a result, while an average of 3,4 trillion UZS of auto loans were allocated

per month during the first 8 months of 2023, the monthly allocation decreased to 2,4 trillion UZS from September to December.

Additionally, it has been established that risk levels for issuing loans to individuals *(excluding those issued under family business development programs)* are assessed based on the loan-to-collateral ratio and the debt burden of households.

The introduction of this norm will further encourage accurate assessment of the creditworthiness of individuals by banks when providing loans, thereby helping to mitigate the risk of increasing the debt burden of individuals.

To effectively manage significant risks which is crucial for the banking system's operation and assess its efficiency, a methodology was introduced to analyze the financial condition of the top-50 debtors within the banking system's credit portfolio. This includes establishing risk levels, preparing individual information *(dashboard)* for each debtor, and studying their impact on the financial condition of banks.

As of January 1, 2024, according to preliminary analysis, loans extended by commercial banks to 50 large borrowers constituted 24% *(112 trillion UZS)* of the loan portfolio of the banking system, within this, 70% *(77 trillion UZS)* were attributed to state-owned enterprises and 30% *(35 trillion UZS)* to private enterprises.

Considering that 77% of these loans *(86 trillion UZS)* were allocated in foreign currency, and recognizing that currency depreciation can escalate the credit burden for borrowers and increase the risk of timely repayment, commercial banks have instituted a practice of regular monitoring for 20 largest borrowers.

In addition, the risk level for microfinance services provided to self-employed individuals and small businesses with regular income and turnover of funds in bank accounts for at least 6 months has been reduced from 100% to 75%.

This adjustment lays the groundwork for expanding bank lending opportunities to self-employed individuals and small businesses in the future.

Also, efforts are underway to align the methodology for calculating capital adequacy with the standards set by the Basel Committee:

- the requirements for determining the risk level of assets in banks have been revised, and specifically, the risk level of investments in the capital of business entities engaged in non-financial activities has been set at 200%;
- the distribution of shares of Tier I and II capital in the structure of regulatory capital of banks is now equal, with each comprising 50% *(previously, Tier II capital was limited to a maximum of 25% under the old requirement);*
- accounting for subordinated borrowed funds is now limited to an amount not exceeding 100% of Tier I capital after settlements.
- investments in the capital of business entities engaged in non-financial activities are now accounted for without deductions from regulatory capital.

In 2023, efforts continued as part of the banking system reform to enhance legislative acts aimed at transforming banks with state participation and implementing contemporary corporate governance practices within them. In particular, amendments had been made to the Law "On banks and banking activities", stipulating a gradual increase in the minimum authorized capital of a bank from 100 billion UZS to 500 billion UZS by January 1, 2025.

The introduction of this provision serves to enhance the capitalization and resource base of banks, align prudential standards for banks with international norms, and enhance opportunities for attracting foreign investment to the banking sector. In addition, in 2023, to reinforce financial stability, enhance investment attractiveness, operational efficiency, and prepare for the

privatization of state- owned enterprises, including commercial banks, as well as to attract strategic investors to the banking system, Resolution of the President of the Republic of Uzbekistan was adopted on additional measures to strengthen financial stability and accelerate the privatization process of JSCB "O'zsanoatqurilishbank".

The reduction of the state share in JSCIB "Ipoteka-bank", the increase in capitalization of commercial banks and the penetration of three new banks into the banking services market contributed to a decrease in the state share in total assets of the banking sector from 78% to 68% in 2022, and in total banking capital from 78% to 65%.

In 2023, Hungarian "OTP Bank" acquired 75% of the shares of JSCIB "Ipoteka-bank" from the Ministry of economy and finance of the Republic of Uzbekistan. In the reporting year, banks paid special attention to cooperating with international and foreign financial institutions. They collaborated with foreign experts to develop banking activities, focusing on improving corporate governance, risk management, retail services, information technology, and reducing operating expenses.

The National bank, in collaboration with major foreign banks, organized an international conference "Investor day", in which representatives from several foreign banks participated.

JSCB "Microcreditbank" cooperated with German banks such as "Raiffeisen bank" and "ODDO BHF" for conducting treasury operations. Additionally, in collaboration with international audit organization "PricewaterhouseCoopers (PwC)", "Financial management and treasury functions (CFO & Treasury)" of JSCB "Microcreditbank" were transformed based on international standards and practices.

In efforts to enhance operational efficiency at JSC "Asakabank", "KPMG Tax and Advisory" organization assessed effeciency of the bank's head office and several branches. Based on the assessment findings, JSC "Asakabank" revised its organizational structure accordingly.

Foreign practices for improving the quality of bank assets encompass various successful strategies and approaches implemented by financial institutions worldwide. These practices focus on risk management, credit quality, regulatory compliance, and governance, among other key areas. The following highlights several international practices that can enhance the quality of bank assets:

Solvency II: This is a European Union regulatory framework primarily for insurance companies, but it is also relevant for banks with significant insurance holdings. It aims to ensure that institutions hold enough capital to cover potential risks, including risks affecting asset quality. The framework encourages transparency in risk management and asset valuation, ensuring banks do not overestimate the value of their assets.

Risk-Based Pricing: In countries like Germany and Canada, banks use risk-based pricing for loans, adjusting interest rates according to the credit risk of borrowers. This helps mitigate the risk of loan defaults by charging higher rates for riskier borrowers, thus improving the overall quality of the loan portfolio.

Scenario Analysis: Banks in countries like Australia and Canada use scenario analysis to evaluate potential future economic conditions, such as changes in interest rates, inflation, or housing markets. This analysis helps identify risks to asset quality and allows banks to adjust their strategies to mitigate such risks.

Portfolio Diversification: Banks in countries such as Japan and Switzerland (e.g., UBS and Mitsubishi UFJ) diversify their asset portfolios across different sectors, geographic regions, and borrower types. This reduces the risk of significant asset depreciation during market downturns, thus improving the overall quality of the portfolio.

Transparency in Financial Reporting: The US Securities and Exchange Commission (SEC) requires banks to provide detailed, transparent reports on the quality of their assets, including non-

performing loans and impaired assets. This transparency ensures that investors, regulators, and other stakeholders have a clear understanding of a bank's asset quality and potential risks.

Blockchain for Transparency: In countries like Estonia and Switzerland, banks are exploring blockchain technology to improve transparency and efficiency in asset management. Blockchain provides a tamper-proof ledger of transactions, enhancing asset valuation accuracy and reducing the risk of fraudulent activities.

The foreign practices outlined above demonstrate the importance of adopting comprehensive risk management frameworks, enhancing credit risk assessment, leveraging technology, and ensuring strong corporate governance to improve the quality of bank assets. By learning from these practices, banks worldwide can strengthen their asset management strategies and build more resilient financial systems.

Conclusion. In conclusion, there are several critical factors that influence the quality of commercial bank assets and their effective management. These factors include efficient risk management, credit portfolio diversification, adherence to legal and regulatory requirements, as well as the implementation of innovative technologies. Analyzing, updating, and assessing risks using modern methods help achieve higher efficiency in bank operations. Additionally, internal management processes and changes in the economic environment significantly affect asset quality. For banks, applying proper approaches to asset quality, timely identification and mitigation of risks, and ensuring financial stability are essential for long-term development.

Several challenges are associated with improving the quality of bank assets, and addressing these issues is crucial for maintaining financial stability and ensuring sustainable growth. These challenges include:

1. Non-Performing Loans (NPLs)

Non-performing loans (NPLs) significantly impact the quality of bank assets. A high level of NPLs weakens a bank's financial position, as they reduce the ability to recover funds and deplete capital. The accumulation of NPLs requires banks to allocate more capital for asset repair and develop new strategies to improve credit assessment and risk management practices.

2. Inadequate Risk Assessment

Proper risk assessment is critical for banks in maintaining high-quality assets. If risks are not adequately evaluated, banks may make decisions that negatively affect asset quality, such as granting loans to high-risk borrowers or failing to foresee potential market downturns. This can lead to significant financial issues and poor asset performance.

3. Challenges in Compliance with Regulatory Frameworks

Regulatory requirements play a significant role in ensuring asset quality. However, banks often face challenges in complying with evolving regulations. For example, stricter capital requirements or new regulations regarding loan risk can impose operational constraints, making it difficult for banks to manage assets effectively while adhering to these new standards.

4. Internal Management Issues

Ineffective internal management systems can also hinder asset quality. Weak governance structures or inefficient decision-making processes within a bank can lead to poor asset management decisions, such as improper loan assessments, inadequate risk controls, or failure to take corrective actions when asset quality deteriorates.

5. Macroeconomic Risks

Macroeconomic factors, such as inflation, liquidity issues, or rising unemployment, can negatively affect the quality of bank assets. Economic instability or market volatility can increase credit risk and lead to higher default rates, making it challenging for banks to maintain a healthy asset portfolio.

To improve the quality of commercial bank assets and address the challenges discussed, the following recommendations can be considered:

1. Enhance Risk Assessment Practices

Banks should strengthen their risk assessment frameworks by utilizing advanced data analytics, machine learning, and AI tools. These technologies can help predict potential risks, identify high-risk loans, and enable more accurate decision-making. Regular stress testing and scenario analysis should also be implemented to better understand the potential impact of economic shocks.

2. Improve Credit Portfolio Diversification

Diversification of the credit portfolio is essential for mitigating risks. Banks should focus on broadening their loan portfolios by diversifying across sectors, geographic regions, and borrower types. This will help reduce the concentration of risk and improve the overall quality of the asset base.

3. Strengthen Governance and Internal Controls

Strong internal governance structures are crucial for maintaining asset quality. Banks should establish transparent decision-making processes, enforce robust internal controls, and ensure accountability at all levels. Regular audits and risk reviews should be conducted to detect any inefficiencies or weaknesses in the management of assets.

4. Adopt and Integrate Innovative Technologies

Leveraging technology is essential for improving asset management. Banks should invest in digital banking solutions, big data, and AI to enhance decision-making processes, automate risk assessments, and improve customer service. Additionally, blockchain technology can be explored to ensure transparency and security in asset management practices.

5. Focus on Non-Performing Loan (NPL) Reduction Banks should prioritize strategies to reduce the level of non-performing loans, such as improving credit risk management, enhancing loan underwriting standards, and offering restructuring options to borrowers facing financial difficulties. Regular monitoring of loan performance and early intervention can help prevent loans from becoming non-performing.

By implementing these recommendations, commercial banks can significantly enhance the quality of their assets, improve their risk management frameworks, and ensure long-term financial stability and growth.

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