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A THEORETICAL AND INSTITUTIONAL FRAMEWORK FOR ASSESSING THE FINANCIAL STABILITY OF COMMERCIAL BANKS: EVIDENCE FROM UZBEKISTAN'S BANKING SECTOR REFORMS

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Abstract

This thesis develops an integrated theoretical and institutional framework for assessing the financial stability of commercial banks in transition and circular-economy conditions, using Uzbekistan's 2020-2025 banking sector reforms as an empirical setting. Building on the theories of Mishkin, Diamond and Dybvig, Stiglitz and Weiss, Lavrushin, Schinasi, and Akimov and Dollery, the study proposes an original definition of financial stability integrating operational, capital, and adaptive stability; systematizes the factors affecting bank stability into five groups - macroeconomic, legal-regulatory, institutional-political, socio-demographic, and internal; and develops a five-tier institutional model linking international standards, state policy, central bank supervision, bank-level risk management, and system-wide stability. It concludes that bank stability indicators in transition economies are shaped as much by external structural conditions as by internal management, and that a hierarchy-based model better explains observed divergences than single-indicator approaches such as CAMELS.



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Ensuring the financial stability of commercial banks has become one of the fundamental conditions for the sustainable development of national economies and global macroeconomic stability. According to the International Monetary Fund's 2025 Financial Sector Assessment Program (FSAP), the stable functioning of the banking system determines more than 60% of a country's economic growth [9]. Consequently, the Basel III capital and liquidity standards, the IMF's Financial Soundness Indicators (FSI) methodology, and the CAMELS rating framework have become the generally accepted international benchmarks for assessing bank stability [7].

Uzbekistan's banking sector has undergone rapid reform over the past five years. According to the Central Bank of the Republic of Uzbekistan, banking system assets grew from 200 to 863 trillion soum between 2020 and 2025, the state's share in bank assets fell from 84% to 64.53%, and the level of financial inclusion rose from 23% to 60% [10]. By the first half of 2025, system-wide prudential indicators - a capital adequacy ratio (CAR) of 17.4%, a liquidity coverage ratio (LCR) of 195%, a net stable funding ratio (NSFR) of 117%, and a non-performing loan (NPL) share of 3.8% - remained above the thresholds set by Basel III and the Central Bank. Yet bank-level analysis reveals considerable divergence: the cost-to-income ratio (CIR) ranges from 29.7% to 85% across banks, and the loan-to-deposit ratio (LDR) reaches 220-440%, well above the international norm of 80-100%. This divergence between system-wide soundness and bank-level heterogeneity signals the need for a new, integrated theoretical-methodological approach to assessing financial stability.



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The theoretical foundations of bank financial stability have been examined from several distinct angles in the economic literature. Mishkin treats commercial banks as institutions that resolve the problem of asymmetric information, evaluating the effectiveness of financial intermediation through the principles of capital balance and risk diversification [1]. Diamond and Dybvig's classical model explains banks' function of liquidity creation and their capacity to manage random depositor demand, providing the theoretical basis for deposit insurance [2]. Stiglitz and Weiss demonstrate how imperfect information leads to credit rationing, a mechanism directly relevant to asset quality and NPL dynamics [6]. Lavrushin defines banking principles as a system of rules grounded in the objective economic laws of credit relations and treats their observance as a necessary condition for financial stability [3]. Schinasi conceptualizes financial stability as the capacity of a financial system to efficiently allocate resources, assess and manage risk, and absorb shocks without disrupting the real economy [5]. Akimov and Dollery, examining Uzbekistan specifically, emphasize that commercial banks in transition economies are not only centers of monetary and credit relations but are also structurally shaped by the legacy of state ownership and gradual institutional reform [4]. Each of these approaches captures a partial dimension of stability - solvency, liquidity, information efficiency, or institutional context without offering a single operational definition suited to transition and circular-economy conditions.

Building on this literature, the study proposes an original definition of financial stability as a dynamic, multi-factor capacity of a bank to meet its obligations in a timely manner, maintain adequate capital and profitability, withstand external shocks, and restore its strategic development trajectory. This definition integrates three components: operational stability, reflecting the efficiency of current operations; capital stability, reflecting long-term solvency; and adaptive stability,



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reflecting resilience to external shocks. Unlike single-dimension definitions grounded solely in solvency or liquidity, this composite definition allows financial stability to be assessed as a coherent system rather than a set of disconnected indicators.

The factors shaping bank financial stability indicators are systematized, for the first time in an integrated form, into five groups. Macroeconomic factors - inflation, GDP growth, the exchange rate, interest rates, and the business cycle - define the economic environment in which the banking system operates: inflation directly affects deposit and lending rates, GDP growth shapes credit demand, and exchange-rate movements affect banks' open currency positions. Legal-regulatory factors comprise the prudential norms set by the Central Bank - CAR, LCR, and NPL ceilings - together with Basel III international standards, licensing procedures, and stress-testing requirements [7]; these constitute the principal mechanism for safeguarding bank soundness.

Institutional-political factors encompass state economic policy toward the banking sector, privatization strategy, state ownership share, and geopolitical risk; in Uzbekistan's context, the reduction of the state's share in bank assets is the dominant factor in this group. Socio-demographic factors - population income, financial literacy, and demand for banking services - shape the size of the deposit base, lending activity, and financial inclusion; according to the World Bank's Global Findex database, the share of Uzbekistan's adult population with access to financial services rose from 23% in 2014 to 60% in 2025 [10]. Internal factors, under the direct control of bank management, comprise capital adequacy, asset quality (NPL), liquidity (LCR), profitability (ROA), cost-to-income efficiency (CIR), and the quality of risk management systems. Taken together, this five-factor classification demonstrates that bank stability indicators in transition economies are shaped not only by internal management decisions but



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also by macroeconomic, legal-regulatory, institutional-political, and socio-demographic conditions beyond a bank's direct control.

On this basis, the study develops a five-tier institutional model of financial stability assurance: (1) international standards and recommendations, including Basel III, IFRS, and IMF/World Bank guidance [7][9]; (2) state policy and the legislative framework; (3) Central Bank prudential supervision; (4) commercial banks' internal risk management systems; and (5) the overall stability of the banking system. Each tier transmits requirements and feedback to the tier below and above it, forming a coherent regulatory chain comparable, in structural terms, to the way Basel Committee standards are transmitted through national regulators - the Federal Reserve, the European Central Bank, or the Bank of Russia - down to individual banks in other emerging and transition economies. The model is empirically grounded in the context of Uzbekistan's 2020-2025 banking sector reforms, with the function of each tier explicitly defined.

The explanatory power of this framework is illustrated by the study's empirical findings. Using the Altman Z-score model adapted for banking [8], the financial stability of three systemically important Uzbek banks - JSC “National Bank of Uzbekistan,” JSCB “SQB,” and JSCB “Asakabank” - was assessed for 2021-2025, yielding Z-scores in the range of 27.35-66.58, confirming that all three banks remain in the stable zone ($Z > 2.6$) with no systemic bankruptcy risk. At the same time, the wide dispersion in CIR (29.7-85%) and LDR (220-440%) across these three banks, despite comparable system-wide prudential ratios, is consistent with the five-factor classification: it reflects differences in internal governance and digital transformation (internal factors) as well as differences in state ownership and financing structure (institutional-political factors), rather than differences in the legal-regulatory environment, which is uniform across all three banks.



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CONCLUSION

The proposed theoretical and institutional framework addresses a gap between the partial, single-dimension definitions of financial stability found in the existing literature and the practical need for an integrated assessment methodology suited to transition and circular-economy conditions. The composite definition, the five-factor classification of influencing conditions, and the five-tier institutional model together provide a replicable, hierarchy-based methodology that extends beyond single-indicator approaches such as CAMELS. Applied to Uzbekistan's 2020-2025 banking sector reforms, the framework explains both the system's aggregate soundness and the considerable heterogeneity observed at the level of individual banks, offering researchers, regulators, and practitioners in other transition economies a methodological basis for further empirical assessment.

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