

IMPROVING LOAN CLASSIFICATION TO ENSURE BANK PROFITABILITY IN UZBEKISTAN

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Abstract. Loan classification is one of the most decisive elements of modern bank management because it influences asset quality assessment, provisioning policy, capital efficiency, and the overall sustainability of profit generation. In Uzbekistan, this issue is especially important because credit operations remain the dominant source of bank income and a major component of bank assets. The national legal framework defines the institutional basis of banking activity, while the Central Bank's prudential rules require commercial banks to classify assets and form reserves for expected losses. However, a purely formal approach to classification does not fully reveal the real economic quality of a loan. A credit asset may appear profitable in nominal terms and still produce weak or unstable net returns once funding costs, monitoring costs, and expected losses are taken into account. This thesis argues that improving loan classification should be understood not only as a compliance requirement, but as a strategic instrument for protecting and increasing bank profitability. The paper uses official legal and statistical sources from Uzbekistan to show that more analytical and multi-layer classification improves the quality of profit, strengthens risk detection, and supports long-term portfolio efficiency.

Keywords: loan classification, bank profitability, credit portfolio, expected losses, provisions, non-performing loans, banking system, Uzbekistan.

Introduction.

In commercial banking, profitability is not determined by loan volume alone. It depends on the ability of a bank to distinguish between loans that generate sustainable income and loans that create hidden future losses. This distinction becomes critical in credit-based banking systems, where interest income occupies the largest share of total revenues. According to the Central Bank of Uzbekistan, the banking system's annual report for 2024 showed that interest income remained the key revenue source, while profitability indicators were under pressure, with return on assets at 1.4 percent and

return on equity at 6.6 percent by year-end. In the Financial Stability Report for the first half of 2025, those indicators improved to 2 percent for ROA and 10.8 percent for ROE, which suggests partial recovery, but also confirms that bank profitability is highly sensitive to asset quality and risk costs. This means that loan classification is not a secondary technical procedure. It is one of the central mechanisms through which banks recognize, price, and control the real profitability of their credit portfolios.

The legal basis for this issue is clear. The Law of the Republic of Uzbekistan “On Banks and Banking Activity” establishes the general legal framework for banking operations, prudential standards, and supervisory discipline. In addition, the regulation on asset quality classification and reserve formation in commercial banks defines how assets must be grouped and how expected losses must be covered through provisions. These rules are essential for financial stability. Yet they are not sufficient for internal profitability management unless banks transform prudential categories into analytical management tools. A bank may comply with regulation and still fail to identify which segments of its loan book are eroding value. Therefore, the practical problem is not whether classification exists, but whether it reflects the real economic behavior of the loan.

Materials and Methods.

This thesis is based on normative and statistical analysis. The legal foundation was examined through the Law “On Banks and Banking Activity” and the current regulation on classification of assets and formation of reserves in commercial banks. The empirical basis was drawn from the Central Bank’s Annual Report 2024, the Financial Stability Report for H1 2025, and official statistical releases on commercial bank loans, non-performing loans, sectoral loan distribution, and key banking indicators as of July 1, 2025. The method used is analytical interpretation of official data, combined with a comparative and structural approach. The analysis focuses on the relationship between loan classification, reserve burden, portfolio structure, and profitability indicators.

The conceptual assumption of the thesis is that a prudential category by itself does not fully explain economic profitability. For analytical purposes, loan quality should be interpreted through at least four dimensions: regulatory quality, borrower cash-flow stability, collateral coverage, and risk-adjusted return. The thesis therefore adopts a qualitative management perspective rather than a purely accounting perspective. This allows profitability to be interpreted as net value after expected losses and operational costs, not merely as gross interest income. That distinction is crucial in banking

systems where rapid credit growth may temporarily inflate income while simultaneously increasing future provisioning pressure.

Results and Discussion.

Official data confirm that the scale of credit activity in Uzbekistan makes loan classification a profitability issue, not only a risk issue. As of July 1, 2025, the banking system's total assets reached 852,195 billion UZS, while total loans amounted to 575,245 billion UZS. This means that loans represented the core earning asset of the banking system. The same official release shows that deposits stood at 355,621 billion UZS and total capital at 125,285 billion UZS, which underlines how strongly asset quality affects both funding sustainability and capital efficiency. When a system is this credit-intensive, even a modest deterioration in classification quality can produce significant effects through additional reserves, lower net interest income, and weakened returns on capital.

The composition of the portfolio also matters. By July 1, 2025, loans to individuals reached 196,890 billion UZS, while total loans rose by 16 percent year-on-year. Within retail lending, microloans grew by 73 percent compared with July 1, 2024, while mortgage lending grew by 18 percent. At the same time, the sectoral structure of lending showed that industry accounted for 27 percent of total loans, agriculture for 10 percent, construction for 3 percent, and trade and public service for 7 percent. These figures show that the loan portfolio is heterogeneous. Different sectors and borrower groups carry different repayment cycles, collateral structures, and sensitivity to macroeconomic shocks. A uniform classification logic cannot fully capture these differences. This is why a bank that classifies all substandard loans in the same managerial way may misjudge which segments remain salvageable and which ones threaten profitability.

The non-performing loan figures further support this argument. According to the Central Bank's release for July 1, 2025, non-performing loans amounted to 21,870 billion UZS, or 3.8 percent of total loans. This ratio is not catastrophic, but it is large enough in absolute value to influence reserve charges and earnings quality. The key issue is that the visible NPL share does not capture the full profitability risk embedded in loans that have not yet entered the non-performing stage. The most economically sensitive segment is often the layer immediately above formal problem status, where borrower stress is visible but not yet fully recognized in income statements. If classification remains purely formal, banks react too late. If classification is analytical and forward-looking, banks can identify cash-flow deterioration, weakened collateral, or behavioral warning signs before the loan fully migrates into the loss zone.

From a profitability perspective, the most important improvement is to connect classification with risk-adjusted return. A high-interest loan is not necessarily a profitable loan. Real profitability should be understood as interest income minus funding cost, operating cost, and expected credit loss. Once this logic is applied, some apparently attractive loans become economically weak, while some moderate-yield loans prove more efficient because of better repayment discipline and lower reserve burden. In practical terms, this means that banks in Uzbekistan need a multi-layer classification model. The first layer should remain regulatory and fully compliant with prudential norms. The second layer should segment loans by sector, region, currency, maturity, and collateral quality. The third layer should incorporate borrower behavior, including payment discipline, account turnover, and restructuring history. The fourth layer should evaluate the loan's risk-adjusted profitability. Only such a structure allows management to see which assets truly support sustainable profit.

This approach is especially relevant under changing banking conditions. The Financial Stability Report for H1 2025 notes that the banking system remained stable and that macrofinancial conditions eased during the period. Stability, however, should not be confused with immunity. A stable system can still suffer profitability deterioration if credit growth is not matched by stronger classification and monitoring practices. The purpose of improved classification is therefore not only to comply with supervision, but to protect future earnings. In this sense, better loan classification performs three functions simultaneously: it improves the accuracy of provisioning, strengthens early detection of portfolio deterioration, and supports more rational pricing of credit products.

Conclusion.

Improving loan classification is one of the most practical ways to ensure bank profitability in Uzbekistan. The official banking data show that loans dominate the asset structure of commercial banks and that profitability remains highly dependent on asset quality, provisioning costs, and risk control. A purely formal classification system may satisfy prudential reporting requirements, but it does not fully support internal profitability management. For that reason, banks should move from static classification toward analytical, multi-dimensional classification based on regulatory quality, sectoral risk, borrower behavior, collateral effectiveness, and risk-adjusted return. Such an approach makes loan classification a strategic management tool rather than a passive reporting obligation. In a banking system where the quality of income matters more than nominal growth, this shift is essential for achieving durable and economically sound profitability.

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