



Theoretical Foundations of the Banking System and Priority Areas of Its Practical Activities

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Abstract: This article comprehensively analyzes the theoretical foundations and practical aspects of the banking system, a vital component of the modern economic system. The banking system is characterized as a set of financial institutions and is considered the primary mechanism for regulating financial flows and ensuring the efficient allocation of capital in the national economy. The intermediary role of commercial banks is emphasized, as is their special importance in ensuring liquidity and financial stability in economic activity by attracting deposits and providing loans. The study examines the essence of the banking system within the framework of a systems approach and substantiates that it is a multi-level, open, dynamic, and self-developing system. These characteristics enhance the adaptability of the banking sector to economic and technological change. In particular, digital transformation, online banking, and the use of artificial intelligence are identified as key factors in improving banking efficiency. The article provides a comparative analysis of two main strategic models of commercial banks – foreign market and domestic market. While the first model is more focused on low-risk foreign assets, the second stimulates lending to the real sector and the development of the domestic economy. Both strategies yield different results depending on the banks' resource base and the economic environment. At the same time, the role of systemically important banks in ensuring economic stability, the associated risks, and the need for regulation are examined. As a result, the effective functioning of the banking system is directly linked to institutional stability, sound governance, risk management, and innovative approaches.

Keywords: banking system, foreign market, governance, depositors and borrowers.

Introduction

The banking system is a set of financial institutions that carry out banking activities and regulate financial flows in the national economy. The main goal of the banking system is to ensure the most efficient redistribution of capital and other financial resources. A commercial bank is a financial intermediary between depositors and borrowers. Its activities ensure the security of financial transactions and increase liquidity. The bank accepts deposits and extends loans to clients, and also provides other financial services (transactions, guarantees, etc.). The main source of income for a commercial bank is the interest margin. This is the difference between the interest rates on loans provided and deposits received. Depositors' funds are held at a low interest rate, and the bank lends a portion of these funds at a higher interest rate [1]. The difference between the amount of loans provided and the amount of deposits received constitutes the commercial bank's reserves. The ratio of reserves to deposits is the reserve ratio.

Currently, the banking sector is undergoing profound structural changes associated with the need to adapt to digital technologies that meet the demands of modern clients. At the same time, issues of effective management continue to play a key role in ensuring the competitiveness of banks and the stability of the banking system as a whole [2], [3].

The Concept of the Banking System and Its Essence.

The term "system" is widely used in academic circles and is employed by modern scholars and practitioners to express a variety of concepts. A systems approach is considered one of the main areas of scientific research into various economic entities, including banking institutions.

There is no single, standard definition of the concept of "system" in science, and at the same time, the concept of "banking system" also requires further clarification. According to the most common approach, a system is a set of interconnected and connected elements that form a specific whole. This approach is not arbitrary, as "system" (Greek: *systeme*) denotes a whole consisting of parts and a unified structure [4]. Other definitions of this concept are found in modern academic literature, but they do not provide a clear understanding of the essence of the problem. For example, in a recent work on systems theory, the concept of "system" is defined as "a special organization of specialized elements united into a single whole to solve a specific problem." The main characteristic of this organization—namely, integrity—is expressed in the principle of "non-derivability of the properties of a system to the properties of its elements and vice versa."

Analyzing the differences between existing approaches, I. V. Blauberg, V. N. Sadovsky, and E. G. Yudin concluded that attempts to provide a unified, standardized definition of the concept of "system" have not yet been successful, and, most likely, this task is fundamentally insoluble at a strictly formal level [5], [6].

Methodology

N. E. Egorova and A. M. Smulov distinguish two main types of definitions of this concept:

1. Definitions aimed at ontological universality.
2. The main goal of these definitions is to define the attributive and identification characteristics of objects so that they can be perceived as systems. These definitions are not strictly formal, but are general in nature and serve as an introduction to the systems approach.
3. Definitions aimed at epistemological universality.
4. These definitions are more precise and formal and allow for formal detailing of objects.

The first type of definition is more suitable for a systematic analysis of the banking sector, as this approach allows for a meaningful explanation of the system through a specific sequence of characteristics. Analysis of each subsequent characteristic narrows the scope of objects, but at the same time characterizes them more precisely.

According to the above classification of systems, the banking system is characterized as follows:

- It is an artificial system created by human activity;
- It is a large-scale system that unites a large number of elements. This set is not a random collection of elements;
- It is impossible to automatically include entities that act randomly in the market but are subordinated to other goals;

It is a complex system with numerous connections and interactions. These connections are so numerous that it is impossible to identify, track, and, above all, describe them all. An example is the use of the modern banking system for money laundering and terrorist financing, but identifying such activity is very difficult, if not impossible. Moreover, the value of a complex system significantly exceeds the value of its individual elements. If one element fails, the system quickly recovers and compensates for the losses. Theoretically, it can be assumed that even if the first tier of the banking system—the central bank—disappears, the system will not collapse immediately, as other banks will be able to process the money supply in circulation, issue loans, and perform other banking operations for some time. Historically, securities issuance operations have been entrusted not only to the central bank but also to commercial banks in some countries.

This is a controlled system, as the Central Bank conducts independent monetary policy, performs a supervisory function, and is accountable to parliament or the executive branch. Commercial banks, as legal entities, operate in accordance with general and special banking legislation, and their activities are regulated by economic rules established by the Central Bank.

This is a hierarchical or multi-tiered system, meaning it consists of two levels: the Central Bank is on the first level, and the commercial banks and other credit and financial institutions that do not have bank status are on the second.

Result and Discussion

It is a dynamic, self-developing, and goal-oriented system, as the banking system is not static but constantly changes and develops. In this regard, two factors stand out. First, the system as a whole is in flux and is constantly being supplemented and improved by new elements. For example, mortgage banks previously did not exist in Russia, but now they have been established in a number of large cities. Second, new connections are constantly being established within the system: there are relationships between the Central Bank and credit institutions, as well as between the banks themselves [7]. Banks participate in the interbank credit market, engage in long-term and short-term foreign exchange trading, exchange financial resources and provide other services, participate in joint financial projects, and form associations and alliances. The banking system, like the modern economic system, is self-developing and self-organizing, since changes in the economic or political situation automatically entail changes in the policies of both the Central Bank and credit institutions. During periods of economic crisis and political instability, the banking system reduces long-term investments in the real sector and loan repayment terms, increasing its income primarily through auxiliary activities [8], [9]. Conversely, in stable economic and political conditions, banks generate profits primarily from traditional interest income and expand lending to the real sector. Banks that fail to respond quickly to changes experience difficulties, lose clients, and, consequently, cease operations.

Banking strategy

In countries with well-developed banking systems, established standards for successful performance have long existed, influencing the practices and policies of leading global banks. For example, S. Davis, in his book "Great Banks," mentions the following standards:

1. A strong emphasis on interpersonal relationships, which form the basis for sound decision-making [10]. He believes that making good decisions depends more on careful deliberation and rational thinking than on speed;
2. The presence of shared values is the core of organizational culture. The best way to achieve this is to develop managerial talent within the organization;
3. An emphasis on intangible value. Although profitability is the primary goal of every commercial bank, factors such as high service quality and encouraging innovation among employees also play a crucial role;
4. A desire to earn customer trust. Successful banks help customers solve problems by implementing a "customer-centric" policy [11]. To overcome the above-mentioned problems, commercial banks are advised to develop short- and medium-term development strategies. Currently, many banks prefer one of two main strategies, which differently define their market position and role in the economy.

The first strategy is the external strategy.

The essence of this strategy is to concentrate low-cost resources from the corporate sector (primarily export-oriented enterprises) and invest them in relatively low-risk foreign assets (deposits, loans, government securities, etc.).

The main features of this strategy are:

1. The predominance of export-oriented enterprises among clients (a high share of foreign currency in accounts is noted – from 55% to 100%);
2. A developed international correspondent network and competitive advantages in foreign operations;
3. Low management costs (less than 2% of assets).

"The banking system is the main financial intermediary, ensuring the efficient allocation of resources in the economy, and its stable functioning determines the continuity of investment flows" [12].

This strategy is primarily implemented by large banks and foreign-controlled banks. These banks often face the problem of "excess resources" and invest their funds in foreign assets. As a result, the asset structure is characterized by a high share of low-yielding but liquid assets. These banks are more focused on external financing than on the domestic economy.

The second strategy is a domestically oriented strategy.

This strategy is based on the active expansion of lending to domestic borrowers. Resources are raised primarily within the country.

The main features of this strategy are:

1. a predominance of domestically oriented companies among clients (low share of foreign currency funds – from 0% to 45%);
2. easier access to household funds;
3. high management costs (more than 2% of assets).

This strategy is primarily implemented by banks with an extensive branch network. These banks are the main financial intermediaries providing loans to the real sector. The share of loans in their assets is high (about 42%), and total operating assets reach 65%.

Organization and priorities of the banking system

As the banking system has developed and matured, banks have emerged whose activities have a significant impact both on the banking sector as a whole and on its role as the primary financial intermediary in the economy. These banks are expected to contribute to the country's economic growth, requiring timely adjustments to their strategies and operational tactics in the banking market. At the same time, any problems that may arise in these banks' operations could destabilize the economy and increase systemic risks, requiring regulation through specialized supervisory mechanisms and increased attention to risk management.

One of the main factors complicating the development of regulatory measures for their activities is that the moral hazard problem applied to systemically important banks differs from traditional moral hazard models. Therefore, the liquidation of these banks' assets could lead to a serious financial crisis. For example, the assets of the Swiss banks UBS and Credit Suisse significantly exceed Switzerland's GDP, and financial problems arising at either bank could seriously impact the country's economy. A similar situation was observed in the Russian Central Bank's decisions regarding the restructuring of Otkritie Bank. Furthermore, because systemically important banks are large and complex organizations, the problem of information asymmetry is exacerbated, potentially leading to conflicts of interest between shareholders and management.

There are various approaches to defining systemically important economic institutions. On the one hand, financial companies are considered systemically important if their bankruptcy or serious failure could have widespread negative consequences for the financial system. For example, the European Central Bank's 2006 Financial Stability Report emphasized the particular importance of supervising banking groups, as their failure could seriously disrupt the functioning of the financial and credit system.

Some researchers point to the close interactions of credit institutions with other organizations as a key indicator of systemic importance, as their exit from the market could seriously harm the economy as a whole.

The quantitative approach utilizes indicator methods, network analysis, and an assessment of the contribution to systemic risk. The European Banking Authority (ESRB) recommends using additional indicators to identify systemically important banks: the number of payment systems, transaction volume, clearing share, number of clients, non-interest income, etc. The development strategy of the banking system of Azerbaijan is one of the most important and integral components of the overall socio-economic strategy of the state. The structural features of the national economy determine the main directions of development of the banking sector. These structural features include the following:

- The oil sector remains the cornerstone of the country's economy, but significant efforts are being made to develop the non-resource sector, particularly in the non-resource industry. According to 2019 data, the non-resource sector grew by 3.5%, industrial production increased by 1.5%, and industrial production in the non-resource sector increased by 14% [13].
- Azerbaijan's economy has sufficient domestic raw material resources and an adequate energy base, and maintains close trade and economic ties with many countries.

Based on these characteristics, the following priority development areas can be identified:

- Ensuring the reliability of the banking sector, continuously improving supervision and regulation, and developing the legislative framework for banking activities;
- Maintaining and developing favorable conditions for attracting foreign investment in the national economy, particularly in the banking sector [14]
- Creating an adequate stock market regulation system;
- Expanding international cooperation in banking regulation and supervision.

These goals will be achieved through the introduction of innovations. For a long time, the banking market believed that innovation in the banking sector was not always appropriate, as managing large financial resources requires a high level of responsibility, and any changes could lead to significant losses for banks and their clients. However, globalization has not bypassed this area, demonstrating its influence [15]

Currently, mobile banking, online banking, and remote account management using bank cards are becoming increasingly widespread in the country and are no longer perceived as innovations, but as a necessity. Banks' primary goal has become not only profitability but also cost reduction. At the same time, increasing attention is being paid to the application of artificial intelligence technologies in the banking sector, and although

this process is still in its early stages, these innovations are expected to be widely adopted in the near future.

Conclusion

Theoretical and empirical analysis demonstrates that the banking system is one of the key structural elements of the modern economy and plays a crucial role in the efficient allocation of financial resources. The banking system is not limited to attracting deposits and issuing loans, but also performs complex and multifaceted tasks, such as maintaining economic stability, providing liquidity, stimulating investment flows, and managing financial risks. In this regard, banks act as intermediary and regulatory institutions within the economic system.

The study's results demonstrate that the essence of the banking system is determined by its multi-tiered, open, dynamic, and self-developing nature. These characteristics enhance the banking sector's ability to adapt to changing economic conditions and ensure its long-term sustainability. In particular, in the modern era, digitalization, the development of financial technologies, and global economic integration have had a significant impact on the structure of the banking system. The introduction of mobile banking, online banking, and artificial intelligence-based services not only improves banking efficiency but also creates the conditions for the development of a customer-centric service model. An analysis of banks' operating strategies reveals that commercial banks operate primarily according to two strategic models: a foreign-market-oriented strategy and a domestic-market-based strategy. The foreign-market-oriented strategy involves investing resources in foreign financial markets, with an emphasis on low-risk, highly liquid assets. In this model, banks have extensive international connections, but their role in financing the real sector is relatively limited. The domestic-market-oriented strategy serves to expand domestic lending, strengthen financial support for the real sector, and stimulate economic growth.

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