

LECTURE 10. PASSIVE AND ACTIVE BANK OPERATIONS

Agenda:

1. Passive operations
2. Active operations

1. Passive operations

The commercial banks refer to a special category of business enterprises called financial intermediaries. They attract capitals, savings of population and other monetary means released in the process of business activity and present them for temporary use to other economic agents which need an additional capital.

The financial intermediaries perform in such a manner an important social economic function providing society with a mechanism of interindustrial and transregional distribution of monetary capital.

The bank determination as an institution which accumulates the available monetary means and place them on a repayable basis allows to distinguish in its activity passive and active operations.

The passive operations characterize the sources of means and nature of commercial banks' links. These are they exactly widely predetermine the conditions, forms and directions of bank resources usage, i.e. the composition and structure of active operations.

These operations were considered in depth already in a quality of credit fund sources in the theme "The origin of loan resources forming". That's why this paragraph concerns only generalized moments regarding the meaning of passive operations.

Passive are the operations by means of which the bank resources are formed. As was mentioned before their main sources are deposit operations.

The deposit operations of commercial banks are the operations of attraction of the legal entities' and private persons' means to deposits for a specified term or on demand and also remaining balances on the clients' operating accounts for their usage in a quality of credit resources and in the investments.

The deposit is the monetary means (in cash and non-cash forms, in national or foreign currency) placed in bank by their owners for holding on certain conditions.

The deposit operations is a wide meaning because it includes all the bank activity connected to the means attraction for deposits. The peculiarity of this passive operations group is that the bank has a comparatively lax control over the volume of these operations because the initiative of their placement on to the deposits goes from the depositors themselves.

Whereby as practice shows the depositor is interested not only in paid to him interests but also the safety of relied to bank means keeping.

The organization of deposit operations should be performed under the set of principles:

- getting a current profit and creation of conditions for its getting in future;
- flexible policy under the deposit operations management for the bank operative liquidity supporting;
- concurrency between the deposit policy and assets profitability;
- development of banking services for clients' attraction.

For commercial banks the deposits are the main and the cheapest type of resources. The increase of this element part in the resources base decreases the interest costs however their high part weakens the bank's liquidity.

The clients' means attracted by bank are placed on current, deposit and saving accounts. Their remaining balances summarize and are shown in balance by a single index. Under the analysis the attracted deposit means group according to urgency.

The fixed-term deposits are considered to be the most stable part of attracting resources. The increase of fixed-term deposits' part in the resources base promotes bank stability growth, allows to perform an effective management of bank liquidity and solvency.

Under the means attraction from the client a deposit agreement should be concluded with him. The banks develop the form of deposit agreement independently which bears on every separate type of deposit a typical feature. The agreement is issued in two copies: one copy for the depositor, the other for bank which is kept in credit or deposit department (depending on the fact to whom in bank this work was put).

The agreement stipulates the sum of deposit, term of its validity, interests which the depositor will get after the agreement termination, liabilities and rights of the depositor and bank, parties' responsibility for the agreement terms performance, dispute settlement procedure.

For the deposit operations register the following are applied: current account, savings book, checklist, pay and cheque books, alphabetic card, operational journal, receipts, cash receipt notes, depositor's commission of sum writing down, notification to a follow-up control, application for deposit transfer, schedule of applications record, record book of lost savings books.

The deposit placing in cash could be performed only by private persons. From legal entities the deposit placing are accepted only in cashless form.

Under the deposit closure the client should present to bank a deposit agreement and paying-in book which should be paid off. The bank offers client to register a cash payment voucher on an amount of deposit and interests of it.

The economic work of bank with client covers all the spheres of bank activity – from client's attraction to different bank operations performance according to his accounts.

The clients' attraction requires from banks the definite works conduction – advertisement, development of the new types of services introduction, negotiation, preliminary analysis of the financial condition, preparation and conclusion of different agreements, etc. All these works are closely connected to the bank's activity of its assets and liabilities management.

The work with clients is based on different agreements conclusion: for settlement, cash and credit services of joint activity, opening and conduction of deposit accounts, etc.

The client's current and operating accounts opening and conduction of operations according to them is performed on the grounds of agreements for settlement and cash management services.

In an agreement for settlement services the terms of settlement and current accounts opening and operations conduction according to it are stipulated. Besides there the order of cash operations conduction is stipulated either. The order of settlements should provide the documents passing guarantee in due time.

2. Active operations

Under *the active operations* are considered the monetary means placement for the purposes of maximum profitability getting under the statutory compliance and the required liquidity level and assets soundness supporting. Such approach stipulates the compliant rules of active operations classification according to basic groups. According to the most general classification there are:

- 1) cash operations;
- 2) credit and other operations having a credit nature (including leasing and its types, factoring, discount operations with bills, etc.);
- 3) investments into the paper holdings;
- 4) the other active operations.

All the active operations could be conditionally divided on the operations which have a purpose of the bank liquidity supporting on this or that level and operations directed on profit getting. Between these types of operations a correlation exists which is required for the bank's

activity supporting on a qualitative level. To the deposits which are oriented on the bank's activity supporting the cash and bank balances in NB RK, investments into the quick-selling consolidated stocks, means on accounts and deposits in other banks are correlated.

Whereby though some of listed deposits bring definite revenue, the main reason of their existence is a necessity of the bank's general liquidity supporting on an adequate level, while their profit serves though as significant but accessory factor.

The cash operations. The commercial banks at any time and on first client's demand are obliged to pay him fully or partially the deposits which are kept on call accounts. In accordance with this the cash department should constantly contain a definite quantity of cash money.

The cash balance is the notes and coins which are kept in cash department and bank cash boxes and providing its daily requirement in money for cash payments: money withdrawal from accounts, cashing, granting loans in cash form, payment of bank expenses, workers' salary payment, etc. Whereby the bank should have the source of notes and coins of different nomination in order to satisfy the requirements of clients.

Theoretically it is unlikely that all the bank's clients will request their deposits for withdrawal in cash simultaneously but practically all could be. That's why it is necessary to choose the required part of means which is necessary for such payments correctly while considering the cash balance which doesn't receive any profit.

Besides the cash the commercial banks should support the definite remaining balance on their accounts in NB RK (correspondent account) for provision of daily balancing of clearing settlements with other banks. The similar accounts are used by the commercial banks for settlements with treasuries on a cash basis of notes and coins received from them through NB RK for cash refill.

The total sum of current account balance of the commercial banks in the correspondent banks or NB RK doesn't receive them profit and together with cash and cheques being at a process of encashment are in some manner "frozen" in noninterest deposits. That is the reason why the commercial banks aspire to get a maximum possible profit on the remaining part of their resources. Considering that NB RK takes measures for normal diversion of funds of the commercial banks on the accounts of "mandatory reserves" it forces banks to decrease their credit operations.

The credit operations are the relations between creditor and borrower of a monetary means definite sum granting under the conditions of term, payment and recovery.

Let's consider the active loan operations of the bank. Granting the loans to their clients the banks perform the role of financial intermediaries accepting the monetary means from depositors and granting them to borrowers. This bank activity is profitable for all the participants of credit relations (creditor, borrower and bank). These relations contain a mutual interest: each satisfies its own requirements.

Under the direct bank crediting the creditors grant the loan directly to borrower. The creditor is the bank and the borrower is a business entity. the credit operations of the commercial bank could be classified by different features:

- by terms – short-term (to 1 year), medium-term (from 1 to 5 years), long-term (more than 5 years);
- by types of security – unsecured (blank based on reliance to the borrower) and secured;
- by types of borrowers – loans for enterprises, government authorities, banks, population;
- by the field of borrower – loans for industry, transport, construction, business, trade;
- by methods of redemption – to redeem coincidentally and partially.

In order to grant loans to the clients the bank opens loan accounts where the loan records of each crediting object are maintained. In accordance with clients' requirements and the bank's interest in every particular case the client could be provided with a simple loan account or with special.

A special loan account differs from simple by the fact that the loan granting every time is not registered documentary and is executed on the basis of statement of obligation which is

presented by borrower to the bank at the special loan account opening. The loan is granted also from a transactional account. It is a special type of account where from the one side the receipts are reflected and from the other – loans and payments.

A credit line is an agreement between the bank and borrower for the loan granting on a maximum sum which the last can use within a determined term and under the certain conditions observance.

To the operations which have a credit nature the *leasing, factoring, forfeiting, discount operations with bills* refer.

The leasing operations. The term “Leasing” means “renting, demising”. Under the leasing a renting of durable subjects (building, machinery, equipment, automobile, etc.) is understood.

Nowadays the leasing operations in Kazakhstan didn't receive a mass distribution; however the perspectives of their rampant development are practically assured.

The leasing performs several functions. First of all it is a form of means investment to the key assets, i.e. financing. A lessee has a possibility to use the required for him property without a nonrecurrent funds raising and loans attraction. He is out of onetime payment of the property's price. For the second it is one of the most progressive forms of material and technical production support by new equipment, modern machinery.

There are three participants in a leasing dealing the relations of which are documented by an agreement:

- the first is a property owner (lessor);
- the second is a property user (lessee);
- the third is a property seller (provider).

Their relations are built on the following scheme: the future lessee refers to lessor who has the required funds to participate in dealing, i.e. he should buy the required property for lessee from provider (a property seller) with its following transfer to lessee for lease on the terms of payment.

The commercial banks participate in this dealing as property owners: they receive the property for ownership and pass it to lessee thus opening for him a financial service. In principle they grant credit of this property (machinery, equipment, etc.), i.e. the credit relations appear. Here all the principles of crediting present: term, payment and recovery.

Under the termination of an agreement the lessee returns the property to its owner and pays the service – makes rent payments. On the form this credit is not monetary but productive, commodity credit to key assets.

There are the following types of leasing:

1. the operative leasing is granted for shorter term. Its objects are the machinery and equipment with high rates of functional depreciation.
2. the financial leasing on more longer term which matches with the term of machinery and equipment amortization. Here a possibility of leased property purchase by lessee is provided.
3. the leasing of depreciated cost is applied for already used equipment that's why the leasing object is appreciated not according to initial cost but to depreciated.

For leasing business development special leasing companies are created which act as lessors. Their main source of funds for the machinery and equipment purchase is bank credits.

In comparison with creating leasing companies the commercial banks have such main advantage that they are already institutionalized; for leasing operations conduction they form special departments or groups. The leasing operation conduction is profitable: it is highly remunerative with low risk and has a real material security.

The next comparatively new type of active operations of the commercial banks is *factoring*. It is a reassignment of unpaid by client active debts (commercial invoices and bills) appearing before supplier for goods and services to the factoring company or bank with all the consequences (with risk). The meaning of factoring is that the banks purchase from their clients the payment documents (their debts receivable) with getting interests for service. Such dealing is formed by an agreement where the sum of purchased debt and definite interest are stipulated

noting what part of debts receivable sum of separate entity will be rendered to bank in the form of service payment.

Initially the banks began to render the factoring services to their clients in 1990. In particular the systems of Promstroybank of USSR performed them. The factoring services are most efficient for separate entities which often suffer from the financial embarrassment.

The operations of factoring include three participants: client factor – the first creditor and debtor which gets from client goods on a deferred-payment basis. In other words the participants of this operation are supplier, factoring company and buyer.

The supplier sales its active debt to the factoring company or bank which perform the factoring operations and which pay to a supplier as a rule 80% of commercial invoices cost by deducting fees payment for rendered services. The rest sum of the cost will be paid after the debtor's payment.

Whereby the factoring company or bank lead all the accounting, undertake the requirements encashment, all risks connected to full and due time payments receipt. The expenses of supplier constitute of fees payment for an accounting leading and factor's fees which are composed of interests granted for an advance and profit of the factoring company or bank.

The forfaiting transactions. The forfaiting is the bank's purchase of payment obligations usually rendered in the form of bills without recourse to buyer. These transactions are one of the most widely spread in the world practice of short- and medium-term credit forms of international trade transactions basically connected to the machinery and equipment supplies.

The appearance of "a-forfe" operations relates to the period of significant changes in the structure and conjuncture of the international trade in the end of 50s – beginning of 60s of the last century when the conditions of the machinery and equipment realization gradually from the market of seller transformed to the market of buyer. In such a manner in the beginning of 60s a phenomenon of "forfeiting crediting" appeared as one of the ways of the heightened needs in the international credit satisfaction.

The seller of forfeiting payment obligations usually is an exporter which accepted the bills for the supplied goods cost payment; thus the seller gets free of all risks connected to payment receipt of transferred bills.

The buyer (forfeiter) purchasing the payment obligations denies its right to place counter demands to any of preceding owners of the obligations which serve as dealing objects. In a bill's endorsement the notices are placed like "without recourse to me", "without a counter demand". In such a manner the buyer undertakes all the risks of the purchased obligations payment.

For the forfeiter an important meaning has an additional security getting according to granted credits excluding the obligations of debtor. Such additional security is bank guarantee or aval – the obligation to pay the sums due time in case of nonpayment from the side of main debtor.

The forfeiting debt obligations are purchased on a discount basis, i.e. by means of their accounting. The discounting is performed according to the fixed accounting rate within advanced interest collection means for the whole period of credit dispose. Thus the exporter immediately gets a cash sum which is equal to the issued bills' nominal by deducting a discount amount. The bills are issued in hard currency as a rule in USD or EURO.

The next active operation with bills of the commercial banks is the discount bill of exchange transactions or *bill discounting* by banks.

The bill discounting is what a bill holder passes the bills to bank under the endorsement before their maturity and gets for it a principal amount decreased on a certain interest which is called interest rate or discount rate.

The discount operations with bills and loans granting on security of bills will be examined in the next chapter.

The presence of leasing, factoring, forfeiting and discount transactions in the range of bank services first of all is connected to the bank's intention to render for its clients the maximum full range of financial services and widen its influence on chosen fields of market.

The investment activity of the commercial banks. In banking under the investments the commitments to paper holdings on a relatively significant period of time are usually understood. The portfolio investments are performed in the form of paper holding purchase (securities portfolio) or rendering the long-term bank loans (loan portfolio).

The purpose of investment activity of the commercial bank is to provide safeguard of assets, diversification, profit and liquidity.

The investment transactions of the commercial banks are performed at the expense of:

- own resources;
- external funds.

As a rule the basic field of the bank's investments are the commitments into the fixed-interests paper holdings which represent one of the forms of bank's liquid reserves that's why under their chose for investment a special attention is paid to their reliability.

The banks' investments into the fixed-interests paper holdings intensity depends on the bank clients' requirements in credit resources and the strategic vision of interest rates' dynamics on credit market.

If the decrease of interest rates are expected thus for banks will be more rational to invest the funds into the fixed-interests paper holdings. And conversely if there is a possibility of interest rates raise thus the bank should refrain from their further purchase and try to sell the available on balance.

The bank acts as an independent merchant purchasing the paper holdings for its own portfolio or selling them. The main purpose which is pursued by the banks performing trade operations is an income extraction from the rates difference on one and the same paper holdings on different share markets. Because these operations should be performed quickly thus eventually they promote the paper holdings' rates equalization.

From the point of view of emitter's legal status, degree of investment and credit risks, guaranty of investors' interests' protection, etc. the stock securities are divided into two basic groups: non-state and state.

The non-state securities are represented by:

- shares;
- debt obligations of enterprises, organizations and banks (bonds, short-term obligations, certificate deposits, etc.).

The most wide spread are shares and bonds.

The government securities are the securities where the emitter, i.e. entity which issued them and is liable according to them is government. Usually they are issued in non-documentary form. Their initial placement on the basis of an agreement with the Ministry of Finance the general financial agent performs in the quality of which acts as a rule the National Bank of RK.

The bigger part of the commercial banks' investments fall at a part of valuable governmental papers and also of the local government authorities.

There is a significant difference in terms of volume of investment in government and corporate securities in the activity of our banks which prefer to invest monetary means into the operations with government securities which under the inappreciable risks provide a good profitability.

The other active operations of the second-tier banks. To them the operations with foreign currency, precious metals, loans and monetary means granted to banks, trust, agent, etc. refer.

The economic substance of listed operations is differential. In one cases (purchase and sale of foreign currency and precious metals) the assets' volume and structure change occurs which could be used for claims satisfaction of the bank's creditors; in other (trust transactions) the bank acts as an authorised delegate in regard to property placed to it in management; in third (agent's operations) the bank acts as an intermediary performing the settlement operations by order of its clients.

From the above mentioned operations the most significant among them for the second-tier banks are foreign currency operations, so let's examine them.

Of course in modern conditions the commercial banks' activity is inconceivable without constant presence on the internal and international exchange markets and performance of dealing operations on them. The essence of active operations performed by banks on exchange markets is in purchase and sale of currencies. Within the whole working day the bank intends to purchase the foreign currency at a more favorable from its opinion correlation of rates for its further realization for the purposes of profit getting.

Initially the Kazakh banks' activity resolved mainly to the operations "Kazakh tenge – US dollar". This situation was the result of the fact that in the process of Kazakh exchange market development when the constant fluctuations of tenge – US dollar rates occurred the significant activity of banks was observed on an internal interbank exchange market because there was a daily possibility to perform the operations of speculative character.

As was mentioned before the purpose of the commercial banks activity is a profit getting what forces them to show flexibility in the correlations with clients and entrepreneurial attitude in the active operations conduction.

The commercial status gives bank a significant independence in purposes, conditions and terms of crediting, level of interest rates, development of different new forms of bank activity determination. The execution of its all should correspond to the legislation of the Republic and regulations of the National Bank of the country.

It is necessary to note either that besides the reasons of profitability and liquidity of active operations a significant meaning for their execution has a question of investment risks. If the resources placement into the cash, remain balances in NB RK, government securities (and in slightly different terms to the securities of local government authorities) are considered to have practically a zero risk degree and in the means placement in other banks – assets with minimum risk degree, thus the credits to different firms, private persons, investments into the corporate securities and operations on exchange markets are connected to the most significant risk the degree of which changes in accordance with the type and conditions of the conducted operations.

In this connection under the conduction of such active operations for banks a big significance has a question about the risks distribution and disallowance of their excess concentration on some one type. Indeed it is obvious that the risks minimization appearing in the process of crediting is not only one of the most important directions of the active operations efficiency development of the commercial banks but either the main factor of the real productive sector condition improvement and consequently of the all Kazakh economy.

Comprehension questions

- 1. What active operations of the commercial banks do you know?*
- 2. From what sources the credit resources of the commercial banks are forming?*
- 3. How do the commercial banks participate in an interactive business?*