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Analysis of Banking Investment under Unstable National Economy

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ABSTRACT

The banking sector is one of the most important building blocks of the modern economy. In many respects, the banking sector determines the level of economic development of the country as well as affects economic growth through investments in various sectors of the economy. Russian law provides commercial banks with the opportunity to control their funds and income, so the banks carry out investment activities for profit, along with the main types of banking activities. The efficiency of a commercial bank's investment into the stock market instruments is determined by the degree of national economy stability, by the legal system of the state, by the level of development of credit and financial system, by the development of the securities market, by the presence of high-quality securities on the market, by the securities' term of maturity. This paper presents findings on the quality of credit institutions' investment processes during the financial crisis 2014-2015. It features a comparative analysis of the indicators characterizing the structure of the banking sector assets, grouped by areas of investments, resulting in the development of the practical applications that ensure effective selection of capital market instruments for their inclusion into the investment portfolio of credit organizations in the conditions of high volatility and instability of the financial market.

JEL Classification: G21, E01, F52, K22.

Keywords: Volatility, banking sector, financial crisis, stock market, securities.

1. INTRODUCTION

In the structure of banking sector active operations, the major role is given to the investment activity, through which banks act as institutional investors, forming trade and investment portfolios. The investment activity of commercial banks involves investing of own means as well as borrowings into securities in order to generate income or obtain rights to participate in the financial and business activities of other economic

entities. Investment operations of financial and credit institutions in Russia have a wide range of applications due to the fact that commercial banks work according to the European model, which, unlike the US model, enables commercial banks to actively operate on the securities market and portfolio investments. The main factors that determine the effectiveness of banks' portfolio investments are: receiving interest yields, improving profitability and ensuring the liquidity of a certain group of assets, as well as the growth of the standard of capital adequacy (capital).

Profitability of banks' investment operations is affected by a number of factors. The key factors are: the level of the national and global economy; the structure of the national credit and financial system; the degree of development of the securities market infrastructure; the legislative framework regulating the issue and circulation of securities; professional participants of the stock market; the structure of investment and trading securities portfolio, which in its turn depends on the dividend changes on shares, interest on bonds and notes.

Consequently, the key features of banking investment activities are the following:

1. Either own or attracted resources can be the sources of investment banking.
2. Bank investing tools are limited by law in view of reducing the risks of large-scale failure of credit and financial institutions.
3. The economic benefit for the bank consists in making a profit from the investment.

2. LITERATURE REVIEW

Many domestic and foreign economists have been studying the problems of banks investment activity under economic instability and financial market volatility. In Russia, among them are economists A.V. Ulyukayev, K.V. Burachki, N.L. Marenkov, V.D. Milovidov, J.M. Mirkin, M.V. Petrov, B.B. Rubtsov, O.V. Khmyz, etc., and among foreign economists D.V. Bailey, M. Baker, P. Krugman et. al., must be mentioned. Analysis of published works on the banks investment activity shows that the state and prospects of the control system have been studied quite extensively. However, the bulk of the research concerns only the general questions on the investment activity of the banking sector stimulating; additionally, there is a need of investigation the problems of adaptive mechanisms that ensure high banks investment activity under unstable financial markets.

3. OBJECTIVES, METHODOLOGY AND RESEARCH DESIGN

The aim of the research is to analyze the current structure of the Russian banking sector assets in the directions of investments and to develop effective measures of its optimization; these would allow to carry out the investment activity in the conditions of the financial market instability.

The methodological basis for the study is represented by both theoretical and empirical methods, including theoretical analysis, synthesis, analogy, scientific generalization, assessment of the results of the banking sector investment activity.

4. THE RESEARCH INCLUDES TWO MAIN STAGES

The first stage consists in a theoretical overview of the economic, normative, educational, literary sources on issues related to investment banking activities. There are determined the purpose, tasks, object, subject of study as well as general direction of the analytical work.

The second stage comprises analysis of the results acquired, including analysis of the structure of assets of credit institutions in areas of activity, structure and dynamics of the banking sector investments in securities, the volume and structure of its debt issuance, the effectiveness of bank investments. This stage also includes developments that are assumed to optimize the structure of the credit institutions' investment portfolio and provide them with a stable yield combined with an acceptable investment risk value in order to maintain a high investment activity in the financial market volatility.

5. DISCUSSION OF THE RESEARCH OUTCOMES

In 2014 the characteristic features of the national financial market environment were as follows: increasing economic and geopolitical instability, difficulties in foreign trade, reduced investment activity and the Bank of Russia's policy in the area of interest and exchange rate policies.

In addition, the introduction of anti-Russian sanctions, the decline in world energy prices, the weakening of the national currency and high interest rates on money market have led to a significant increase of volatility and uncertainty of quotations of corporate securities of domestic companies (Rulinskaya & Kalinichev, 2015).

On the domestic stock market in the segment of equity securities stock market indicators MICEX and RTS exceeded their maximal declines. The RTS Index, which is calculated on the basis of prices of national companies equities denominated in foreign currency, by the end of 2014 decreased by 45.2%, in comparison to the end of 2013, approaching the minimum values of the most acute phase of the economy's stagnation in 2008-2009 global financial and economic crisis of 2008-2009 (*"The official website of the Moscow Stock Exchange"*).

The beginning of 2015 saw a strengthening of financial and economic crisis, which led to a decrease in activity of a large number of the national economy sectors, including the banking sector, which was on the verge of full-scale system slowdown. The main negative trends were shaped by a number of political and economic factors, both internal and external, and their amplification could be observed throughout 2014. The general deterioration of the dynamics of micro-economic indicators, falling incomes of wide economic agents range, institutional and private investors had a negative impact on the resource base of the banking sector, and the quality of bank assets.

In late 2014 the situation worsened in all segments of financial markets, particularly in capital market and money market, which was reflected, above all, in a sharp drop of representativeness and exchange rate decline of the national currency against foreign one, and in a sharp increase in demand for foreign currency assets, that caused problems with the bank's liquidity. Tightening of the Bank of Russia's interest policy in December 2014 led to a decrease in the efficiency of banking credit operations and, consequently, to a deterioration of asset structure and quality. Increased risks on active operations of commercial banks did not affect the final statements of banks for 2014 (Nikonets & Mandron, 2014).

In 2014 nominal growth of banking sector assets significantly increased in comparison to previous periods; this was due to the revaluation of foreign currency assets of the bank. The nominal value of the total assets of banks increased almost by 30% per year. With the removal of the revaluation effect of the foreign currency to the rouble, the growth rate of bank assets in 2014 remained at the previous year's level, i.e. about 15% (*"The official website of Bank of Russia"*).

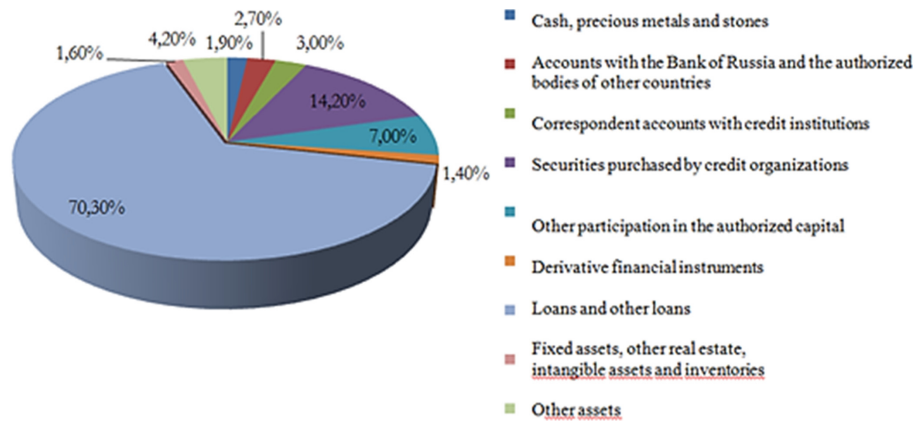


Figure 1: Structure of the assets of credit organizations in Russia, grouped by areas of investment (as % of assets), for 2015

The reduction of investments in foreign assets served as an additional resource for banks in 2014-2015. We can say that all the repayment of external debt of banks was achieved at the expense of the reduction of this category of bank assets.

2014 saw a significant increase in portfolio investments of credit organizations. Hence, based on accounting data of financial and credit institutions, the growth of the securities portfolio amounted 24.3%, the increase was up to 9.7 trillion rubles. In 2013, the increase was 11.2%, while its share in assets reduced from 13.6 to 12.5%.

The use of securities by financial and credit institutions in order to provide for refinancing operations of the Central Bank of Russia is an important source for the growth of liquidity in the banking sector. In 2013-2014 the activity in the formation of the commercial banks' investments in debt was one of the key factors in preserving liquidity.

The banking sector investments into debt securities increased by 24.2% in 2014 and by 17.1% in 2013, with total volume of 7.7 trillion rubles, and more than a half of them were transferred without derecognition, which means their temporary assignment within the framework of repo transactions. The participation of banks in the subsidiaries and dependent joint stock companies is increasing; so in 2014 an increase of this indicator was 2.3 times, that is to 1.4 trillion rubles. Investments in equity securities decreased by 38.2% during the reporting period (per 2013 - 0.2%), to 489 billion rubles, and their share was 5.0% of the securities portfolio at the end of 2014 (as compared to 10.1% at 01.01.2014) (*"The official website of Bank of Russia"*).

Under the stability and growth of the national and world economy, specific investments ratio of the banking sector in market instruments securities are the follows:

- 5% - futures, options, and other derivatives;
- 10% - corporate securities;
- 10% - promissory notes;
- 25% - certificates of deposit;
- 50% - state and municipal bonds.

The structure of credit organizations investments in securities in Russia (Table 1) shows the continuous growth of the banking sector investments in securities. Thus, in 2014-2015 investments in securities increased from 7.5482 billion rubles on 01.01.2014 up to 9.5061 billion rubles on 01.01.2015; during 2015 the growth continued, so on 1.12.2015 rates reached 11 058.7 billion rubles.

In the overall structure of banking investments in the securities market instruments available-for-sale securities dominate; their share was 51.1% on January 1, 2014. Next come securities designated at fair value, with shares of 29, 3%, and the share of securities held to maturity is 11.6%. In 2015 there was a trend of financial organizations' investment growth in securities, and on December 1, 2015, the total investments amounted to 11 058.7 billion rubles compared to 7.5482 billion rubles on January 1, 2014.

The volume of emission of debt instruments issued by the banking sector at the beginning of 2015 increased by 4.67% and amounted to 2692.0 bln. rub, compared to 2.5724 trillion. rub. in 2014 (Figure 2). In 2014 all groups of credit and financial institutions suffered losses due to transactions with securities, estimated in the statement of income as 155 billion rubles and resulting from the negative revaluation of securities. The share of losses amounted to 4.3% in the structure of profit reduction factors (in 2013 it was 0.2%). The largest share of net loss on operations with securities in the structure of the profit reduction factors was observed in the major private banks (*"The official website of Bank of Russia"*).

Table 1
Structure and dynamics of the Russian banking investments in securities

<i>Indicators</i>	<i>1.01.2014</i>		<i>1.01.2015</i>		<i>1.07.2015</i>		<i>1.09.2015</i>		<i>1.12.2015</i>	
	<i>bn. rub.</i>	<i>% to total</i>	<i>bn. rub.</i>	<i>% to total</i>	<i>bn. rub.</i>	<i>% to total</i>	<i>bn. rub.</i>	<i>% to total</i>	<i>bn. rub.</i>	<i>% to total</i>
Investment volume										
– total number	7548,2	100,0	9506,1	100,0	9523,5	100,0	10603,0	100,0	11058,7	100,00
– in rubles	6031,2	79,9	6721,7	70,7	6769,4	71,1	7202,5	67,9	7319,5	66,2
– in foreign currency	1517,0	20,1	2784,4	29,3	2754,1	28,9	3400,5	32,1	3739,2	33,8
Among them:										
Securities designated at fair value through profit or loss	2214,2	29,3	1700,5	17,9	1415,2	14,9	1632,3	15,4	1722,3	15,6
– in rubles	1897,5	25,1	1089,0	11,5	872,4	9,2	931,1	8,8	1031,5	9,3
– in foreign currency	316,6	4,2	611,5	6,4	542,7	5,7	701,2	6,6	690,8	6,2
Securities available for sale	3856,4	51,1	4210,4	44,3	4173,9	43,8	4645,1	43,8	4719,7	42,7
– in rubles	3024,5	40,1	2751,2	28,9	2934,0	30,8	3168,8	29,9	2912,6	26,3
– in foreign currency	831,9	11,0	1459,2	15,4	1239,9	13,0	1476,3	13,9	1806,8	16,3
Securities held to maturity	876,4	11,6	2224,1	23,4	2441,5	25,6	2821,2	26,6	3012,9	27,2
– in rubles	800,0	10,6	1512,5	15,9	1472,0	15,5	1600,2	15,1	1774,9	16,0
– in foreign currency	76,4	1,0	711,6	7,5	969,6	10,2	1221,1	11,5	1238,1	11,2
Portfolios of subsidiaries and dependent joint-stock companies	594,9	7,9	1365,9	14,4	1488,1	15,6	1498,5	14,1	1596,7	14,4
– in rubles	304,0	4,0	1365,2	14,4	1487,4	15,6	1497,8	14,1	1596,0	14,4
– in foreign currency	290,9	3,9	0,7	0,0	0,7	0,0	0,7	0,0	0,7	0,0

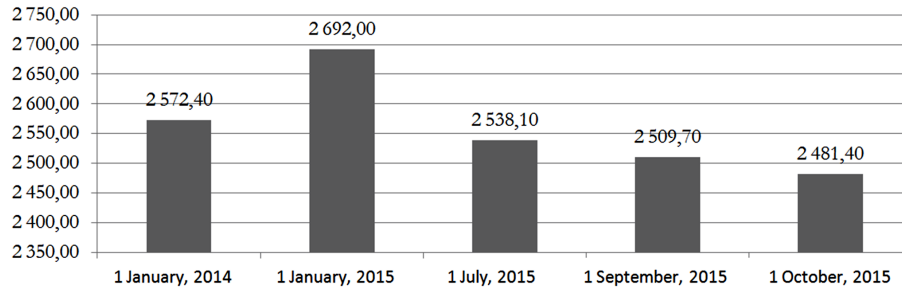


Figure 2: The total volume of banking debt issuance in the Russian Federation (billion rubles)

2014 saw the decrease of the banking investments into promissory notes. Bill market is one of the most robust segments of the securities market. Hence, over 2014 the investments in the bill market decreased by 20.5% to 218 billion rubles (per 2013 - 31.3%). This fact caused promissory notes decrease in the securities portfolio that constituted 3.5% (2014) to 2.2% (2015). In the bill portfolio, promissory notes of Russian banks formed 155 billion rubles (or 71.1%). The share of discounted notes of other Russian organizations increased from 17.8 up to 27.3% over the year.

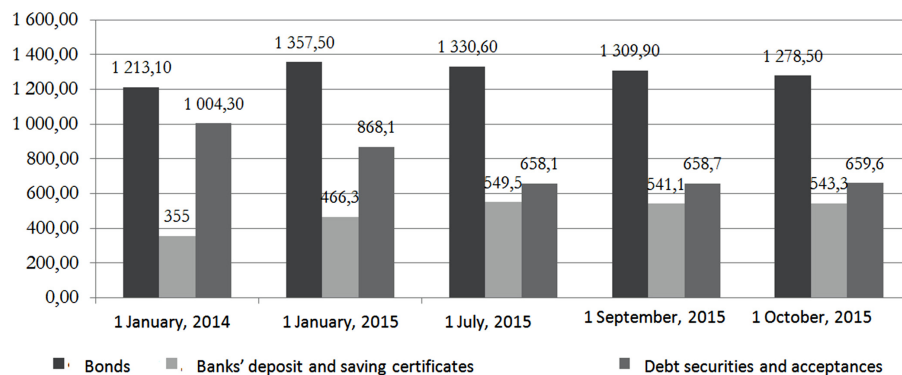


Figure 3: The volume of banking debt issuance in the Russian Federation (billion rubles)

The formation of the investment policy of the bank is the key part of the investment process in financial and credit institutions.

While developing an effective investment policy ensuring profitable banking resources investment in order to guarantee both short- and long-term financial stability, it is necessary to observe a number of general principles:

- the investment policy must be focused on the realization of the institution's strategic plans.
- when determining the profitability of the banking investments and instruments the inflation level must be borne in mind.
- economic efficiency of banking investment must be substantiated.
- the investment portfolio must be formed considering conditions of the national and global economy.
- projects and investments must be estimated according to their relevance and predictions on their efficiency (Kharitonova & Shadoba, 2016).

Among the sources and methods of the financing for the investment, the most reliable and cheaper ones shall be chosen.

The investment policy of the banking sector should include the following points:

- the main objectives of the investment policy;
- the structure of the investment portfolio;
- security limits (by type, maturity, and issuers):
- requirements for diversification of investment portfolio structure;
- methods of adjustment of the composition of the investment portfolio;
- insurance mechanism;
- calculation of potential gains and losses on investments (Kharitonova & Shadoba, 2016);
- computer software development.

Under the national and global economy crisis the need for banks to focus on the analysis of appropriate securities market instruments' selection increases. It determines the range and the combination of instruments that could be included in the investment and trading portfolio, and that do not violate the restrictions of the banking investment policy (Dmitriev et. al., 2016).

Thus, the process of structuring of the investment securities portfolio is constituted in terms of maximizing the potential income through the list of profitable, secure and liquid financial instruments under minimizing the risk (Nikonets, Mandron & Savinova, 2015).

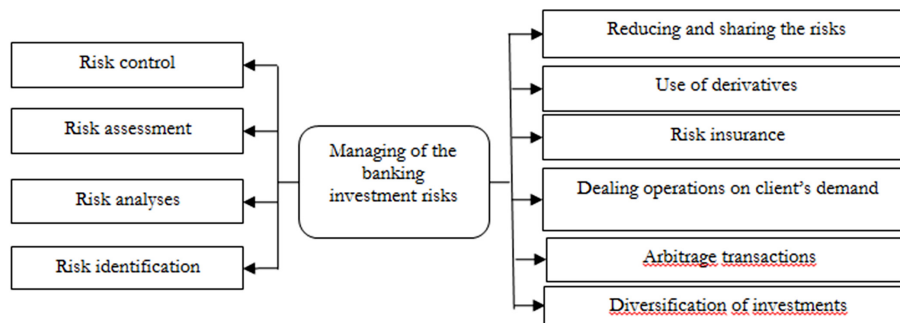


Figure 4: Diagram of investment risk management in the bank

The major role in the investment portfolio formation is given to determining criterion of the optimality of the stock instrument acceptable to the bank at the ratio of profitability and the value of the risk.

As an example, there is represented the comparative analysis of corporate bonds of the leading industries - telecommunication and metallurgical ones (Table 2) (“*The official website of the Moscow Stock Exchange*”).

Proceeding from this data we can make the following conclusions: The debt market instruments have the same maturity, but the yield of the bonds of OJSC “MTS” is 10% higher than the bond yield of OJSC “MMC” Norilsk Nickel “. Bonds of the telecommunication company have a lower credit rating on the corporate securities market, which moves the securities of the issuer into the high-risk zone, unlike those of metallurgical company. This fact leads to a significantly greater amount of equity capital of a credit institution, which is required for the acquisition of securities in the investment portfolio (“*The official website of the Moscow Stock Exchange*”). Return on equity securities of the metallurgical corporation is 25% higher than that of “MTS” bonds.

Table 2
Comparative analysis of the investment parameters of the corporate sector bonds

No. П/П	Indicators of investment instruments	"Mobile TeleSystems"	"MMC" Norilsk Nickel
1	Registration number	4-08-04715-A	4B02-01-40155-F
2	Bond yields	8,75 %	7,9 %
3	Maturity	2 года	2 года
4	Minimum discount rate on repo transactions CBR	12,5 %	7,5 %
5	The interest rate on repo transactions CBR	7,5 %	
6	Credit rating	Ba2/BB	Baaa2/BBB-
7	Risk Group in accordance with the Regulation number 387-P CBR	High risk	Low risk
8	The total interest rate risk	1,25 %	1,25 %
9	Special interest rate risk	12 %	1,6 %
10	Interest risk	13,25 %	2,85 %
11	Market risk	165,625	35,625
12	Capital adequacy ratio (N1)		10 %
13	Additional capital (in% of the required funds) needed to acquire an asset	16,5 %	3,5 %
14	Additional funds needed	0 %	4 %
15	The cost of additional funds	0 %	8 %
16	Yield of the asset	15 %	20 %

6. CONCLUSION

The authors believe that the key criteria for the selection of the securities and their inclusion in the investment portfolio should be their maturity, discount on repurchase transactions established by the Bank of Russia for a particular issuer and the risks identified in accordance with the current banking investment policy. Nowadays nominal yield plays a significantly smaller role due to its inability to fully take into account the estimated risk value.

Taking these factors into account will enable banks to rely on an effective mechanism for selection of financial instruments that will ensure the formation of the optimal investment and trading portfolio that would meet the requirements of the current investment policy and would allow obtaining maximum revenue with minimal risk. It will consequently ensure the banking system reliability, the stability of investments in the real sector of the Russian economy as well as allow getting out of the protracted financial crisis in the near future and achieving the stable growth rates.

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