

Ajgul S. Jondelbayeva¹
VALUE OF EQUITY CAPITAL IN FINANCIAL
INSTITUTIONS OF KAZAKHSTAN

The recent financial crisis had consequences for the Republic of Kazakhstan. Among the major problems for second-level banks, in particular, were the lack of capital and ineffective risk management. Special importance is to be given to the equity of financial institutions. The Basel Committee has raised standards of capital ratios of banks in Kazakhstan, where afterwards a concept to harmonize domestic and international approaches to equity was developed. What should be the capitalization index, what is the effect of equity of financial institutions for its stability and the sustainability of the financial system as a whole, by the example of Kazakhstan's banks?

Keywords: accounting; capital; financial institutions.

Айгул С. Джондельбаева
ЗНАЧЕННЯ ВЛАСНОГО КАПІТАЛУ У ФІНАНСОВИХ
ОРГАНІЗАЦІЯХ РЕСПУБЛІКИ КАЗАХСТАН

У статті показано, що минула фінансова криза не пройшла без наслідків для Республіки Казахстан. Серед основних проблем діяльності банків другого рівня можна виділити недостатність капіталу та неефективність ризик-менеджменту. У зв'язку з цим особливе значення стало приділятися показнику власного капіталу фінансових організацій. На основі нових показників Базельського комітету в Казахстані було розроблено Концепцію з гармонізації внутрішніх і міжнародних підходів до власного капіталу. На прикладі казахстанських банків розглянуто такі питання: якою має бути показник капіталізації, як впливає розмір власного капіталу фінансових організацій на її стабільність і стабільність фінансової системи в цілому.

Ключові слова: облік; капітал; фінансові організації.

Форм. 1. Рис. 1. Літ. 18.

Айгул С. Джондельбаева
ЗНАЧЕНИЕ СОБСТВЕННОГО КАПИТАЛА В ФИНАНСОВЫХ
ОРГАНИЗАЦИЯХ РЕСПУБЛИКИ КАЗАХСТАН

В статье показано, что недавний финансовый кризис не остался без последствий для Республики Казахстан. Среди основных проблем деятельности банков второго уровня можно выделить недостаточность капитала и неэффективность риск-менеджмента. В связи с этим особое значение стало уделяться показателю собственного капитала финансовых организаций. На основе новых показателей Базельского комитета в Казахстане была выработана Концепция по гармонизации внутренних и международных подходов к собственному капиталу. На примере казахстанских банков рассмотрены следующие вопросы: каким должен быть показатель капитализации, как влияет размер собственного капитала финансовых организаций на ее стабильность и стабильность финансовой системы в целом.

Ключевые слова: учет; капитал; финансовые организации.

Introduction. At the present stage of the world economy development, changes are happening caused by the crisis in the US financial system. This factor has caused the need for critical analysis of global trends prevention and crisis management in the development of supranational mechanisms for financial markets regulation.

¹ T. Ryskulov Kazakh Economical University, Almaty, Kazakhstan.

One of these mechanisms is the requirement by the Basel Committee. Despite the critics by some economists Basel requirements have found no alternative so far. In their study, Gunnar Wahlstrom considered problematic issues of applying the requirements of the Basel Committee (Wahlstrom, 2008: 53). He explained the problems in the application of Basel by different goals of banking regulation.

Financial crises create requirements that will eventually lead to changes in regulation. The current situation in the global economy put heavy demands on the second tier banks and banking supervisors. In November 2010, the Seoul G20 summit endorsed the recommendations of the Basel Committee on Banking Supervision, as one of the measures to combat the global financial crisis. To bring the requirements on banks capitalization in accordance with Basel III at the 7th meeting of the Financial Stability and Development of the financial market of Kazakhstan, Kazakhstan approved the Concept on the harmonization of domestic and international approaches to equity ratio, which was published in January 2011. These events justified the regulatory standards for banks earlier introduced in Kazakhstan.

Problem statement. In today's economic crisis the problem of increasing the resource base of banks is of paramount importance. Efficient use and further capitalization is a crucial task for ensuring stability of the banking system. Strict requirements have led to an increase in the total capital of the banking system of the Republic of Kazakhstan, but the rate of capitalization of banks is clearly insufficient. What limits, in the post-crisis economy, the possibility of providing real sector lending resources? There was a need for new methods and systems of indicators that could form the basis for a balanced banking policy in management of assets and liabilities.

The reasons for this need are: the need to improve capital management, improved lending and investment, and as a result the growth of the real sector of the economy, and the lack of systemic studies on banks capital management.

Latest research and publications analysis. The issues of the adequacy and capital management of banks are present in the works of such economists as E. Altman (2008), I. Blank (2004), T. Copeland, E. Koller and J. Murrin (1990), Y. Maslennikov (1996), S. Penman (2007), A. Tavasiev (2006), V. Usoskin (1998), Y. Veshkin (2001) etc.

Despite the large amount of research in this area, some issues remain unstudied, such as the impact of bank capital in the investment and credit policy, and the role of equity capital to ensure the financial stability of the banking system.

Also, the use of the index's capitalization was not investigated as a tool for risk management in banking. These problems determine the structure of the work.

Subject the above, we have formulated the following objective: to study the influence of capital on the financial stability of a bank.

As a part of this goal, we formulated the following research objectives:

- to consider the role and function of equity in banking;
- to analyze different approaches to the assessment of capital adequacy based on international experience and to offer practical advice for Kazakh banks;
- to develop proposals to cap commercial banks;
- to develop scientifically sound practical advice on the system approach to capital management of the bank as the basis for its financial stability.

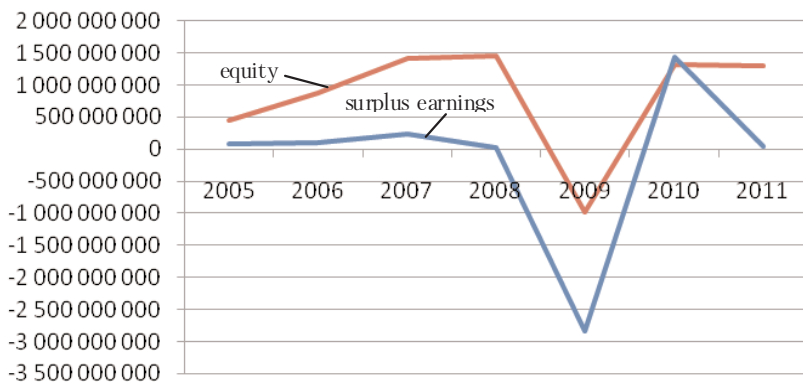
Key research findings. Bank capital of Kazakh banks, according to the specific features of formation and development of the market of the banking system of Kazakhstan is not yet able to exert a powerful influence on economic processes on the scale of the state, for the following reasons:

- first, bank capital was formed under the conditions of high inflation, and a sharp decline in the purchasing power of the national currency;
- second, banks' capital was formed under repetitive crises;
- third, banking capital of individual commercial banks was mainly speculated.

Adequate bank capital reduces operational problems by providing free access to financial markets. Capital gives a bank the ability to make loans from traditional sources at normal rates. More capital provides a stable reputation for a bank and depositors' confidence in it. Capital inhibits growth and reduces the risk of having new assets that the bank can purchase through financing debt. This function is closely related to the norm established by public authorities on capital to assets. So, if banks decide to increase the size of loans or buy other assets, they should support growth through additional equity financing. This prevents speculative asset growth, as banks must always remain within their means to provide successful asset management. These functions of bank capital suggest equity in commercial bank activities. It provides independence and ensures financial stability, offsetting the negative effects of various risks incurred by a bank (Lavrushina, 2001: 75).

The study shows that Kazakh banks have begun to increase their capital base. The dynamics of their own funds (capital) was as follows: January 1, 2009, the capital was negative, -981,797,669 ths KZT, which was caused by the crisis situation at the 3 largest banks of Republic: "BTA Bank", JSC "Alliance Bank", JSC "Temirbank". Other banks had a surplus of equity, and on January 1, 2010 equity capital amounted to 1,322,691,278 ths, and on January 1, 2012 1,305,476,015 KZT (Materials of the Annual General Meeting of Shareholders, 2011).

In general, the dynamics of the total equity capital and retained earnings of Kazakhstan banks for the past 7 years was as follows (Figure 1).



Source: Compiled by the author based on the data taken from the National Bank of Kazakhstan (in Kazakh).

Figure 1. The dynamics of the absolute size of equity capital and retained earnings of the commercial banks of the Republic of Kazakhstan, 1st January, 2006 to 1st January, 2012

Capital ratio of the banking sector to GDP in the same period, indicating a gradual decrease in the rate of capital growth, is compared with the growth of Kazakhstan's economy.

Kazakh banks capitalization problems are the a consequence of high risks and the imbalance of assets and liabilities. The main purpose of bankers in the first place was to get high profits, not win the trust of investors. World practice shows that the most important thing is to strictly observe the capital adequacy ratio, the level should be normalized and compliance should be monitored by supervisors. Whereas the number of the absolute level of capital does not guarantee the stability and reliability of banks as having a huge absolute level of capital may be risky and inefficient, further leading to bankruptcy.

The following factors influence the amount of equity capital:

- the minimum level of NBK capital commercial bank;
- the specificity of customers. A significant number of small depositors will have less equity than in the presence of large investors;
- nature of active operations. The presence of significant risk-taking requires a relatively larger equity.

At present, commercial banks have an important task – to choose an order for forming their own capital, which would at the minimum costs of establishment and operations provide for the payment of sufficient dividends to shareholders, thus creating the conditions for further development of a commercial bank.

The process of building equity at commercial banks can be implemented through two alternative sources of capital generalized, external and internal (Rose, 1997: 463). Kazakhstan's method of determining bank's capital and its adequacy calculation follows the recommendations of the Basel Committee, the calculation is made in accordance with the Board FSA "On Approval of the normative values and methods of calculation of prudential standards for banks" from September 30, 2005 #358 (Resolution of the Agency of the Republic of Kazakhstan on Regulation and Supervision of Financial Market and Financial Organizations, 2005).

According to this document, equity is calculated as the sum of Tier I capital and Tier II capital, capital of the second level is included in the amount not to exceed Tier I capital and the capital of the third level. The third level of capital is included in the amount not exceeding 250% of the capital of the first levels to cover market risk, net investment bank.

$$SC = (R1 + R2 + R3) - I. \quad (1)$$

Banks' investments represent investments in bank stocks (shares in authorized capital) of a legal entity, as well as subordinated debt of a legal entity, the aggregate amount of which exceeds 10% of Tier I capital and Tier II capital of a bank. Tier I capital is the sum of: paid-up equity capital less treasury shares, additional capital, undistributed net income of previous years; indefinite contracts, which resulted in the rise of financial assets of one entity and a financial liability or another financial instrument that evidences the share assets of a legal entity after deducting all of its liabilities, the other person; less: intangible assets, other than licensed software acquired for the purposes of main activities of a bank and the relevant International Financial Reporting Standard 38, "Intangible Assets", previous losses, the excess expense in the year of the income of the current year. Note that the share of perpetual financial

instruments included in Tier I capital should not exceed 15% of Tier I capital. The amount of perpetual financial instruments not included in Tier I capital, may be included in the calculation of Tier II capital (Resolution of the Agency of the Republic of Kazakhstan on Regulation and Supervision of Financial Market and Financial Organizations, 2005). In calculations equity includes the amount paid as perpetual financial instruments in the amount of money actually received by the bank.

Further, the capital of the second level is the sum of: the amount of excess income over expenditure of the year this year, on the size of the revaluation of fixed assets and securities, the size of reserves (provisions) for general banking risks in the amount not exceeding 1.25% of assets, weighted risk, not less invested balances taken under the custody contract, paid perpetual financial instruments not included in the calculation of Tier I capital, subordinated debt, the second level of the bank to be included in shareholders' equity, in the amount not exceeding 50% of Tier I capital net of treasury subordinated debt of the bank. Being specified that subordinated debt of the second level of the bank is unsecured obligations of the bank, the following conditions are:

- is not a contribution or commitment to bearer;
- is not pledged as security for bank's requirements or those affiliated with it;
- the liquidation of a bank is satisfied before the execution of bank liabilities for perpetual financial instruments in accordance with the order established by Article 74-2 of the Law of the Republic of Kazakhstan "On Banks and Banking Activities in the Republic of Kazakhstan" (Law of the Republic of Kazakhstan #2444, 1995);
- may be redeemed (in whole or in part) by the bank, including advance only at the initiative of the bank.

Subordinated debt is on the second level to be included in the equity – it has a term of attracting more than 5 years prior to maturity. Subordinated debt of the second level bank is included in the calculation of its own capital: during the period of more than 5 years before debt repayment in full amount, and in 5 years remaining until the maturity of the debt: 1st year – 100% of the subordinated debt, 2nd year – 80% of the amount of subordinated debt, 3rd year – 60%, 4th year – 40%, 5th year – 20%.

Capital in the third level is the third level of subordinated debt that meets the following conditions:

- does not have the security provided by a bank, a person associated with it has a special relationship or is an affiliate of a bank;
- is not a deposit or obligation of a bearer;
- can be repaid (in whole or in parts) by a bank, including early only at the initiative of a bank, provided that such redemption will not lead to non-compliance with prudential norms;
- has initial maturity of over 2 years.

The problem of determining the capital adequacy of a bank has always had special attention.

"Central bankers and financial supervisors can have conflicting goals. While monetary policymakers work to ensure sufficient lending activities as a foundation for high and stable economic growth, supervisors may limit banks' lending capacities in order to prevent excessive risk taking. But in theory, central bankers can avoid this

potential conflict by adopting an interest rate strategy that takes account of capital adequacy requirements" (Cecchetti and Lianfa, 2008).

On the one hand, we have banks, whose primary purpose is profit making, or minimizing costs and maximizing revenues. On the other hand, supervisors monitor the stability of banks and their timely fulfillment of obligations to depositors and other creditors. Capital for a bank in accordance with the spirit and to fulfill the functions of regulatory authorities, is a fundamental characteristic of a financial condition and an important indicator of its viability. In this case, capital is a tool for regulation for active and passive operations at a bank (through relations between its size and various articles of the assets or liabilities in a bank's balance).

What is meant under the capital adequacy? Some believe that capital adequacy "is a relative measure of the bank's activities in terms of its stability in the event of various risks on active operations of the bank" (Kosterina, 2009: 360).

In January 2011, the National Bank of the Republic of Kazakhstan adopted the concept for the standards for Basel III.

Minimum capital standards of Basel III in relation to capital adequacy ratio shall include the following:

- the minimum requirement for share capital will be increased from the current 2% to 4.5%, with the preservative buffer of 7%;
- the capital requirement of the first level will increase from 4% to 6%, with the preservative buffer of 8.5%;
- minimum capital requirements in view of conservation buffer will increase from 8% to 10.5%.

Countercyclical buffer size (from 0% to 2.5%) is determined by each country according to the stage of its economic cycle. Previously approved, but not yet started measures of NB RK to tighten requirements for banks capitalization, have been taken prior to the introduction of new recommendations of the Basel Committee, and generally reflect the need to increase capital requirements for the banking sector in the medium term by the average of 3 p.p., but with the alignment with Basel III increase will be adjusted by 2.5 p.p. Considering the new recommendations of the Basel Committee, in 2013, the National Bank provides for:

- the introduction of new capital adequacy, the value of which will be 4.5% in view of conservation buffer 7%;
- the value of capital adequacy C1–2 will be 6%, including 8.5% of conservation buffer;
- the value of capital adequacy C2 will be 8%, including 10.5% of conservation buffer;
- establishment of uniformity for all bank capital ratios, regardless the presence or absence of the major participant of the bank be a natural person, a holding company or a parent organization;
- the use of buffer capital (preservative – 2.5% countercyclical from 0% to 2.5%, the system – C2 +2%).

The capital adequacy ratio of the bank (C1–1) will be moved from the prudential norms in the early-response with the expected norm of 5%. Similar requirements for capital adequacy will be installed on the consolidated basis, i.e. for banking conglomerates.

The capital adequacy ratio may increase macroeconomic fluctuations (Blum and Hellwig, 1994), so the formation of a bank's equity of the second level is also important to take into account the characteristics of the economy and the financial market. Especially considering that the requirements for equity capital and authorized capital is one of the options, highly regulated by the National Bank. The size of capital ratios is a part of protective measures that reduce risks. Reduced levels of capital help to reduce the ratio between income and expenditure on risky operations and increase risks.

This approach is also present in Western countries, in which additional powers granted only to banks, net worth in excess of the specified minimum.

The final concentration of banking capital is the inevitable outcome that results from competition between banks in Kazakhstan. This will lead to the emergence and prosperity of monopolist banks and intense competition in all sectors of the banking market.

Of the entire range of methods, the main source of real growth in commercial banks' capital is a shareholding bank capital and an increasing the rate of return, which is levied to gain share, reserve and capital etc.

The main conditions for solving the capitalization problem of Kazakh banking system, in our opinion, are:

- Strengthening banking supervision, the purpose of which should be the identification of particular violations and punishment, and the complete and adequate assessment of the state of each bank and the banking system in general.
- Introduction of a legislative oversight body on the right judgments, accompanied by a sharp increase in skill and responsibility of supervisory personnel, would contribute to the elimination of formalism in oversight, preventing artificial inflation of capital individual banks.

We have developed new approaches to management of banks' capital and determined that the problem of effective management of bank capital is particularly relevant at this stage of banking activity in the country. Capital must be purposefully and actively controlled by a manager or a supervisor to ensure the bank's regulatory compliance with oversight bodies, as well as to maximize the market value of a bank.

Offered by a bank's capital management organization to create a management system that is an integrated set of interconnected functional units, organized and provided capital management process in order to optimize it, which includes: organs and controls, information management subsystem, the object management subsystem and controlling.

Also it is found that effective management of bank capital is realized through the solution of special problems, determined by the peculiarities arising from the functions and purpose of capital (equity capital) of the bank, and content management needs with the requirements of supervisory authorities and rating agencies. The main objectives of a bank's capital management are to ensure a bank's financial development, the definition of the rate of domestic capital formation, ensuring maximum profitability of bank capital at the prescribed level of financial risk and the optimization of capital sources, risk minimization in the use and allocation of capital, ensuring the requirements of supervisory authorities and rating agencies.

For a comprehensive evaluation and monitoring of all types of risks and forecasting, within the specified "risk capital" banks should be created a risk management

system with 2 vectors: micro and macro-risk management. The system of micro-management of risk is the system of risk management at the level of specific jobs: Macro-risk management is generally represented by integrated solutions for risk management at a bank as a whole.

Conclusions. During this study the following features in the planning of size and structure of capital at commercial banks were identified: refined stages of planning bank's capital and assessment methods for the strategy of capital formation. Proposed by the authors theoretical and practical recommendations and the developed methodological approach to banks' capital management can be used in practical work of banks and in education.

We have also developed an active asset management for banks: size control, capital structure and risk management of active operations or the combined method of money management are included with various elements of the first two methods. In order to determine the capital adequacy, in case of emergency it is recommended to hold stress-testing.

The study found that in order to counter a fictitious capital increase in a bank it is necessary to strengthen the oversight functions of the National Bank of the Republic of Kazakhstan.

National Bank may oppose the use of such schemes in two cases:

- at the stage of registration of reports on emissions or constituent documents;
- in the process of ongoing supervision.

In the first case, it can refuse banks to register due to the violation of the formation (increase) of the share capital requirement regulations.

In the second case it can bring credit institutions to be assessed on the provision for losses on additional assets formed on the balance sheet of fictitiously capitalized bank.

Practical implementation of the proposed ways of dealing with fictitious capital increase will improve the quality of capital in Kazakhstan.

The implementation of this the set of recommendations for the effective capital management will ensure sustainable operations and development, as well as the maximization of market value of banks and contribute to the effective functioning of the banking sector in the Republic of Kazakhstan.

References:

О банках и банковской деятельности в Республике Казахстан: Закон Республики Казахстан от 31.08.1995 №2444 // online.zakon.kz.

Об утверждении Инструкции о нормативных значениях и методике расчетов пруденциальных нормативов для банков второго уровня: Постановление Правления Агентства Республики Казахстан по регулированию и надзору финансового рынка и финансовых организаций от 30.09.2005 №358 // adilet.zan.kz.

Бланк И. Финансовый менеджмент. – К.: Ника-Центр, 2004. – 656 с.

Вешкин Ю. Международные валютно-кредитные отношения. – М.: Инфра-М, 2001. – 790 с.

Костерина Т. Банковское дело. – М.: ЕАОИ, 2009. – 360 с.

Лаврушин О. Банковское дело. – М.: Финансы и статистика, 2001. – 672 с.

Масленченков Ю. Финансовый менеджмент в коммерческом банке. Фундаментальный анализ. – М.: Перспектива, 1996. – 160 с.

Роуз П. С. Банковский менеджмент: предоставление финансовых услуг. – М.: Дело, 1997. – 743 с.

Тавасиев А. Антикризисное управление кредитными организациями. – М.: Юнити-Дана, 2006. – 543 с.

Уоскин В. Современный коммерческий банк: управление и операции. – 2-е изд. – М.: Антикор, 1998. – 320 с.

Altman, E. (2008). Managing Credit Risk. 2nd Edition. John Wiley and Sons.

Basel III: A global regulatory framework for more resilient banks and banking systems // www.bis.org.

Blum, J., Hellwig, M. (1994). The Macroeconomic Implications of Capital Adequacy Requirements for Banks. *European Economic Review*, 39(3): 739–749.

Cecchetti, S., Lianfa, L. (2008). Do Capital Adequacy Requirements Matter For Monetary Policy? *Economic Inquiry*, 46(4): 643–659.

Copeland, T.E., Koller, T., Murrin, J. (1990). Valuation: Measuring and Managing the Value of Companies. John Wiley & Sons.

Materials of the Annual General Meeting of BTA Bank Shareholders to be held on June 30, 2011 // bta.kz.

Penman, S. (2007). Financial Statement Analysis and Security Valuation, third edition. New York: McGraw Hill.

Wahlstrom, G. (2008). Risk management versus operational action: Basel II in a Swedish context. *Management Accounting Research*, 20(1): 53–68.

Стаття надійшла до редакції 16.09.2013.