Eugen Fomenko*

FORMING PORTFOLIO OF INTERNATIONAL BANKING SERVICES UNDER CONDITIONS OF STRENGTHENING COMPETITION BETWEEN FINANCIAL INSTITUTIONS

Strategic approaches to portfolio construction of services of the commercial banks are opened, allowing to raise efficiency of its activity on international financial market, in the conditions of competition strengthening in spheres of functioning of polytypic credit and financial institutes.

Keywords: financial market, the market of financial services, financial service, banking activity, bank assets, bank liabilities, bank strategy, a portfolio of financial services.

Розкрито стратегічні підходи до формування портфеля послуг комерційних банків, що дозволить підвищити ефективність його діяльності на міжнародному фінансовому ринку в умовах посилення конкуренції у сферах діяльності різнотипних кредитно-фінансових інститутів.

Ключові слова: фінансовий ринок, ринок фінансових послуг, фінансова послуга, банківська діяльність, активи банку, пасиви банку, банківська стратегія, портфель банківських послуг.

For years of concurrence banking market became not just competition for resources but struggle of strategies which resulted that commercial banks pay special attention to the spheres which provides greatest competitive advantage. In this context, it is very important for commercial banks' to be in time to change its strategy, update structure and key business processes to challenge environmental changes.

All indicated challenges leads to structural changes in the banking sector of the financial market. New trends of improving efficiency of the banking sector leads to shifting strategy from mass-selling banking products and services to deployment and creation of individual portfolios aimed to satisfy specific consumer demands. Such restructuring brings creation of new products in portfolios of banking groups. Therefore, in modern condition the problem of forming and managing portfolio of commercial banks services is actual as never before.

Theoretical approaches on improvement management of commercial banks services most fully represented in works of foreign experts, such as Brue S.L., Van-Huza D.D., Velfelya Ch., Dolana Z., Kotler F., Murphy N.B., Miller R.L., Rose P., S. Sealy and other. Mostly in this works, the process of forming commercial bank services based on the classic segmentation approaches.

The works of Ukrainian scientists, such as A.Galchynsky, I.Burakovsky, Z.Lutsyshyn, A.Moroz, M.Savluk, V.Sutormina, V.Fyedosov focused on formalization of national priorities of banking business. The more vide view of strategic analysis are described in the works of A.Kredisov, D.Lukyanenko, Y.Panchenko, O.Plotnikov, A.Poruchnik, O. Rogach, A.Rumyantsev, A.Filippenko.

* Postgraduate the Department of World Economy and International Economic Relations, Institute of International Relations, Kiev National Taras Shevchenko University

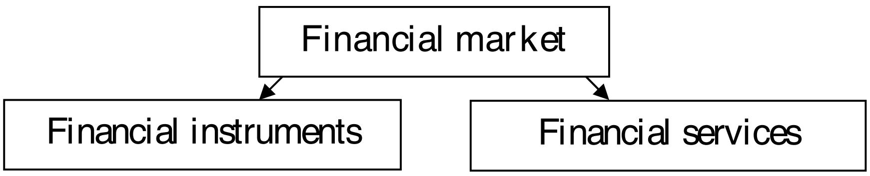
© Eugen Fomenko, 2012

For a long time in the economic literature was expressed only the concept of financial markets, thus limiting understanding of the processes associated with money transferring. Complications of forms and methods of money allocation leading to emerging new specific professional activities aimed to serve owners of capital and the emergence of a new category - "financial service".

In connection with the above mentioned it is becoming increasingly important to study banking services and to identify factors that affect the bank's decision to include services to the portfolio.

The development of the financial market is characterized by the number of financial agents and variety of financial services that they provide. Financial services market is the market, where the object of sale is the various financial instruments and financial services [4]. Specificity and mechanism of financial services which are being provided are determined by the specificity and degree of financial market development and regulatory regulation of financial institutions. (Pic. 1).

Financial instrument it is a commitment that express from the one side contractual obligation to transfer funds or other financial asset and from another side contractual obligation to exchange financial instruments under potentially favorable condition. These include: securities, monetary obligations, futures, options, etc. In other words on the financial market is realized financial relationships through the provision of financial services by means of financial instruments, the number and types of which are set by the government.



Pic 1. The interconnection of the financial market and market of financial services.

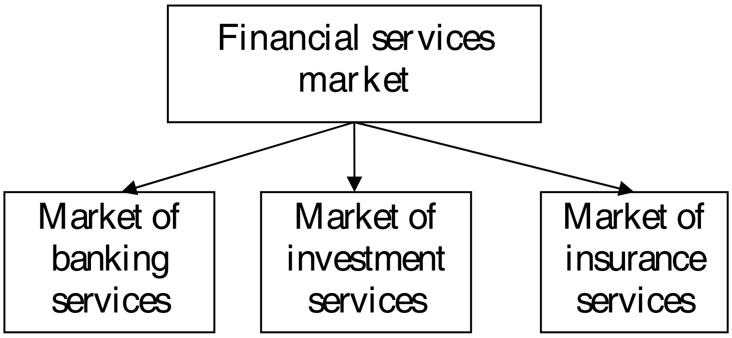
Financial service is a social-economic category associated with the transformation of money into the cash funds of legal entities or private individuals though the banking, insurance and investment markets and also other financial services.

The general services provided by financial agents on the primary market are allocation of funds in the form of deposits and loans granting though commercial banks in the loans market. Such service also can be consider underwriting or help to issuers in organizing and conducting emission of financial assets that resulted placement of issued assets in the market.

On the secondary market, financial agents provide stable functioning of the market and profit for legal entities and private individual during investing in financial assets. Different market institutions are not only meet the needs of investors on buying-selling financial assets on a regular basis and at market price, but also provide information, consulting and management services [6].

In general approach, the structure of financial services market can be regarded as the market of banking services that corresponds to credit market, foreign exchange and precious metals market, the market of investment services, including the stock market. On the financial services market can be separated insurance market, which is connected with all financial markets within the structure of financial markets (Pic. 2).

Banking services market is a specific sphere of market relations, which provides supply and demand for the banking services; sphere aimed to stimulation of banking operations that meets customer needs. The scope of banking market is not only central and commercial banks, but also commercial companies, investment funds, consulting companies, offshore areas etc [3]. In other words, the subjects of banking services is not only commercial banks but also non-banking financial institutions and non-financial enterprises, which formally are not banks, but their activity is directly related with provision of financial services similar to a bank (consulting firms, investment funds, factoring and forfeiting companies) [3]



Pic 2. Structure of the financial services market.

At the present stage of development, commercial banks are moving to a new level of service, transforming it into "firms which provides financial services, financial supermarkets" that propose wide range of banking products to the consumers.

Banking activity involves creating portfolio of services, organization of the market and sales of these services to the final consumer. Portfolio of banking services is a set of services that clearly connected with banking operations in a specific area of banking activity [9].

Increasing sales of goods, services, technologies and intellectual property in developed countries has caused a direct impact on the development of banking services. Currently, growing importance of services for foreign trade; enlarging volume of investment, consulting, information services; growing role of services in financial advisory, asset management; great role plays information technology banking services with usage of Internet. A typical portfolio of banking services includes correspondent banking relations, risk management, customers with foreign economic activity and also international investment services [2].

At the same time, managing of financial flows on the different countries under different conditions of external business environment without a clear decision-making principles regarding allocation of assets and resources is almost impossible. We can therefore conclude that the effectiveness of the bank is determined by one factor that is the quality of loan and deposit portfolios, because otherwise the poor quality of the portfolio directly leads to bank bankruptcy.

Factors that determine the principles and process of forming portfolios are conditions which are affecting the decision to include specific services in the portfolio, level of service sales, sales market and it cost [7]. The main factors are following:

1. The cost of service. Cost of service which is developing by a commercial bank, is one of the most important factors for consideration to include specific services in the portfolio for a particular consumers group. Depending on the needs and financial capacity of consumers and the availability of the resources to provide service, bank is determining service cost, which becomes part of the tariff policy. The service cost is the main factor among others. However, availability of resources, service lifetime, opportunity to conquer new market niches must be also considered. Service quality plays not the last role during portfolio forming.

2. Market share. Market share is usually achieved mainly through the duplication of portfolios and expanding the list of proposals to consumers and increasing flexibility of tariffs, and also allocating additional resources. The most popular services are being defined during portfolio formation.

3. Indicators of quantity and quality of services for evaluation the portfolio. Often exists situation when the same service is provided by various banks, which differs time on the market. Depending on this, the volume of information about service parameters in the bank may be dif-

ferent. The shorter period of service, the more different parameters may be offered to consumers in assessing service quality. Quantity and quality indicators are also depending on growing rate of specific service. Thus to determine the set of parameters for assessing the effectiveness of a particular portfolio may require additional data concerning not only the same service, but also market conditions.

4. Availability of resources to provide service. Significant impact on the process of forming portfolio of services affects availability of resources of the bank, which are detached to provide specific services. Amount of resources allows to range portfolio, create database of consumers and to ensure the regularity of result. Thus, the availability of resources proves universalization of the banking portfolio and increases efficiency of the bank on the market. This approach allows to develop more clearly portfolio strategy of the bank.

5. The attractiveness of service for a specific group of consumers. It is important for consumer to get a quality service for short period of time. To improve efficiency of the portfolio, services can be divided between various portfolios and responsible departments, whose duty is to provide various services to specific customers. Thus, the attractiveness of the services depends on available of resources, terms and quality.

6. Specialization. It is supposed that specialization in a particular service brings main income of the bank which is formed by providing a small but quality list of services. Thus, some banks may form single portfolio that includes all services with a high degree of specialization.

7. The cost of entry for the bank to the market of specific services. During forming portfolio of services periodically arise necessity to change the list of services according to change of consumer requirements. In these conditions, one of the factors for inclusion service in the portfolio is the cost of entry to a particular market. The higher cost of entry is the more complex decision to include services to the portfolio.

8. The relative effectiveness of service comparing to other bank services. To determine priority of service portfolios often use its comparative effectiveness. It is needed to evaluate quantity of services and its relative effectiveness before decision include or not specific services to the portfolio. Effective portfolio must be formed in the way that average performance of the portfolio corresponds to the requirements of the bank's strategy and meet the liquidity requirements.

9. Life-cycle of the service. Significant impact to the process of forming portfolio of services makes a life-cycle of the service. If the service is on the stage of initiation, it is necessary to use one structure of the portfolio and the result of the formation may be the answer to the question of economic utility or market potential of the portfolio composed from different services with different stages of the life cycle. If the service is under development, forming of the service portfolio is the subject to analyses about adequacy of tariffs and consumer demand, as well as the opportunities for closer interaction with the market. At the stage of stagnation main purpose of the portfolio is to prolong stable sales of the services in the market as long as possible. Recession stage requires answer to question about the painless exit of the market. Thus forming the portfolio, determination of the life cycle stage gives more precise expectations of the portfolio that can clearly justify the choice of specific services.

10. Bank's position on the market. The more stable position of the bank on the market, the more full information about the market it has. Volume and existing information allow to spend fund on services rather than the formation of new portfolios. This situation can improve the quality and quantity of services under creating and to take more informed decisions about forming portfolio. Depending on the bank's position on the market volume of efficient solutions concerning portfolio creation are increasing [10].

Based on consideration of factors that makes significant influence for the formation of the portfolio of services, we can conclude that the critical factors during forming list of services for inclusion in the portfolio are financial factors, because most of these factors influence performance of the bank.

The main objective of any commercial bank is allocation of funds in various active operations, without reducing profitability and liquidity. Besides, commercial banks may guide such methods of allocation as a method of general fund, which is based on the idea of unification of all resources. Total capital is distributed between the types of assets that are considered effective. In the model of the general fund capital detached to a particular active transaction, no matter from what source received funds, while their detachment contributes to the goals set by the bank. [5]:

1. The allocated funds are placed in active operations, which are allowing to fulfill liquidity and profitability parameters. According to that it is being determined which share of each dollar (or UAH), allocated in the bank, should be sent to the reserves of the first or second stage and which share should be used for other earning profit operations.

Provision of the first stage includes two groups: reserves required to serve collateral for liabilities on deposits and cash balances, the amount which is sufficient to serve everyday payments. In practice, the amount of funds of primary reserves is being determined based on the average share of total assets and deposits. This share almost the same for all banks.

The main purpose of second stage reserves is to serve the primary source of supplement of first stage reserves. In second stage reserves are included assets as usual portfolio of securities and in some cases loan fund on accounts.

Once the bank has determined the size of primary and secondary reserves, it can start to determine composition of the portfolio of banking services. For example funds remained after repayment of the loans and may be invested into relatively long-term first-rate securities. Purpose of investment portfolio is to generate income and serve as a reserve of second stage [10].

Using the “general fund” method bank can choose from great selection of categories of active operations. This method sets the priorities, although not always solves the dilemma of "Liquidity - profitability".

2. The method of distribution of assets, also known as a conversion method, allows to remove the limitations of general fund method. This method attempts to classify funds source in accordance with required reserves and according to speed of funds turnover.

For example, deposits on demand requires high rate of mandatory reserves comparing with savings and time deposits and the turnover rate is usually higher than in other types of deposits. Therefore, large proportion of each dollar of deposit on demand should be contained in primary and secondary reserves and a smaller part - in other investments. This model assumes creation multiple "profit centers" (or "liquidity centers") inside the bank used for allocation of funds mobilized by banks from different sources.

Having distributed funds to different centers basing on its liquidity and profitability, the Bank's management determines order of allocation fund by each center.

The main advantage of the considered method is reduction share of liquid assets and investments of additional funds into loans and investments that is increasing profit margins. Although the basis of different "profit centers" is deviation in fund turnover but there can not be a close link between the turnover of fund of some group and fluctuations in the total contributions of this group.

Another drawback of this method is that it assumes independence of the sources of funds from the ways of it usage. For example, practicing bankers trying to allocate more funds from business firms because these firms, as usual, borrow money in the same bank where they have opened accounts. So, allocation of new funds, simultaneous means obligation of the bank to provide loans for new depositors. This means that part of the new fund should be directed to credit the owners of these funds.

These two methods should be appraised not as a set of standards that provides the basis for decision making but as general framework within which the bank's management can determine the approach to asset management solution. Usage each of these methods involves the ability of the competent managers to explore the whole range of relationships to take decisions that meets specific condition of the bank.

The purpose of the bank as a commercial organization is maximizing net interest income, i.e. the spread between interest income and interest expense taking into account acceptable levels of risk. Bank expands range of services to attract new customers on deposit and credit market. However, cash flows in different markets may change over time under the influence of sudden changes in profitability or risk. Therefore, the distribution of investment terms ambiguous and should be taken into account during forming strategy of creation portfolio, such as ladder or spaced maturity policy, short-term or long-term focus, "bar", interest expectations [8].

3. The ladder, spaced maturity policy. One of the simple and popular approaches how to solve problems of dynamics, especially among smaller financial institutions. The most appropriate term is being selected, for example year as planning horizon. Within the chosen horizon executing distribution of investment capital among all appropriate financial instruments in equal proportions depending of terms of funds allocation. This strategy does not maximize income from investment, but has the advantage of minimizing the deviation of income in one or another side.

The policy of short-term focus (Front-end load maturity policy), according to which all capital is invested in short-term securities, thus only a short investment horizon is being selected. This strategy strengthens the position of the bank in liquidity, but short-term financial instruments usually have a poor yield [2].

Long-term policy focus (Back-end load maturity policy). This is the opposite to the previous strategy according to which all capital is being invested in long-term securities with maturity from 5 to 10 years. Thus this strategy worsens the liquidity balance, however, increases the profitability of assets. Problems of liquidity arising according to this strategy can be covered by short-term borrowing.

Strategy "bar". Investment portfolio consists of short-term and long-term financial instruments in equal proportions, medium-term investments is absent or takes a small part of the portfolio. It should be noted that this strategy does not require significant management decisions and is often used by investment funds. The choice of strategy in this case depends on the propensity to take risks and choice of investors.

Immunization strategy. For the bank profitability and risk of the portfolio is not less important characteristics as liquidity, payments flow and security of portfolio from interest rate risk. To control abovementioned factors the key information for the investment bankers is the level of assets income (sum and term) and the level of expenditures to serve liabilities [1].

Desire to get more profitable portfolio is always in contradiction with the desire to provide safe portfolio (with lowest limited risk). The risk is managing through diversification. Obviously, the optimal portfolio risk increases with increasing the required expecting effectiveness. If the capital borrowed, it is possible to form portfolio with variable expected efficiency, but the risk will grow indefinitely. Risky assets may be more reliable in diversified portfolio.

So, the main question for banking managers to choose the optimal portfolio, i.e. forming set of assets with the highest yield at the lowest or indicated level of investment risk, taking into account mutual correlations between assets income, that allows to conduct effective diversification of banking services portfolio.

SOURCES:

1. Андросова О.Ф. Зростання рівня капіталізації банківської системи як перспектива її надійності/ О.Ф. Андосова// Економічний простір. – 2008. – №15. – [Електронний ресурс:] – Режим доступу до журн: www.bis.org
2. Дослідження ефективності діяльності комерційних банків /О. Гриценко, О. Іщенко //Банківська справа. – 2010. – №5. – С.197.
3. Банківські операції: Підручник. – 3-тє вид., перероб. і доп./ [А.М. Мороз, М.І. Савлук, М.Ф. Пуховкіна та ін.]; За заг. ред. А. М. Мороза. — К.: КНЕУ, 2008. — 608 с.
4. Ольхова Р.Г. Банковское дело: управление в современном банке. – М.: Кнорус, 2008 – 246 с .
5. Ковалев М.М., Осмоловкий А.Д. Диагностика банка // Финансовый анализ. № 9 – 10, 2007. [Електронний ресурс] – Режим доступу до журн.: http://www.economy.bsu.by/library
6. Подкатилова Е.В. Рынок финансовых услуг и его место в структуре финансового рынка //Нефтегазовое дело – 2006.- №3 [Електронний ресурс]– Режим доступу до журн.: http://www.ogbus.ru
7. Цисарь И. Ф., Чистов В. П., Лукьянов А. И. Оптимизация финансовых портфелей банков, страховых компаний, пенсионных фондов. М.: Дело, 2008 – 384 с.
8. Markowitz H. M. Mean-Variance Analysis in Portfolio Choice and Capital Markets. Blackwell Publishers. 1987.
9. Sengupta R. Foreign Entry and Bank Competition: Research Division // Working Paper Series. 2006-043A. - Federal Reserve Bank of St. Louis. - July 2006. – 33 p.
10. Vaughan E.J., Vaughan T.M. Fundamentals of Risk and Insurance. -John Wiley & Sons Inc.. 2002. - 704 p.