DEVELOPMENT OF CAPITAL RAISING TECHNIQUES THROUGH FINANCIAL SECURITIES IN COMMERCIAL BANKS

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Аннотация: *В этой статье открыта тема несколько видов увеличения капитала в коммерческих банках и показано в текущем примере международных коммерческих банков и банков Узбекистана.*

Аннотация: *Ушбу мақола тижорат банкларининг капиталини бир неча хил йўллар орқали кўпайтириш усуллари ва уларнинг амалдаги холатини халқаро ва Ўзбекистон тижорат банклари мисолида кўрсатилган.*

Abstract: *The multiple ways of increasing capital of commercial banks and their experience in both international and Uzbekistans' commercial banks have been discussed in the article.*

Introduction

Today, mainly commercial banks sustain the financial stability of the government by both providing various services to clients and collecting money through the services offered to people.However, banks must generate income on its own without the supply from central banks that is government. So, how do they make money? Actually, banks are profit organization; id est. the single service can make huge revenue for them. Although it is not enough in today's economy where high demand and low supply exist.

Literature review

Problems related to financial securities were clearly identified and solved in the foreign economists' scientific novels like Bagehot, Walter. (1873). *Lombard Street: A Description of the Money Market*. Henry S. King, Third Edition, Calomiris, Charles W., and Andrew Powell. (2001). "Can Emerging Market Bank Regulators Establish Credible Discipline? The Case of Argentina, 1992-99" in Frederic S. Mishkin, (ed.), *Prudential Supervision: What Works and What Doesn't*. University of Chicago Press, Chou, Yuan K., and Martin S. Chin. (2004). Financial Innovations and Technological Innovations as Twin Engines of Economic Growth. *Mimeo*, University of Melbourne, January, Flannery, Mark. (2005). "No Pain, No Gain? Effecting Market Discipline via Reverse Convertible Debentures" in Hal S. Scott (ed.), *Capital Adequacy beyond Basel: Banking, Securities and Insurance*, Chapter 5, Oxford University Press, Frederic S. Mishkin and Stanley G. Eakins. (2009). *Financial Markets and Institutions*, Pearson, Sixth Edition, Greenspan, Alan. (2009). The Fed Didn't Cause the Housing Bubble. *Wall Street Journal*, March 11, Miller, Merton H. (1991). *Financial Innovation and Market Volatility.* Blackwell Publishing, Rajan, Raghuram. (2009). "Too Systemic to Fail: Consequences and Potential Remedies," presented at the *Proceedings of a Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago, May and many others.

By investigating a number of researches done by above-mentioned works, the article uses appropriate models and techniques where they are needed.

What are the financial securities?

Financial securities are the type of financial instruments and called simply as securities. The key features of securities are negotiability and financial worth. Most importantly, securities form high income above face value and both issuer and holder of security can gain maximum profit. They have different forms such as debt securities that include banknotes, bonds, debentures or equity securities that form stocks and etc.

Financial securities may be issued by various financial organizations as a mean to raise capital or finance any other projects. Commercial institutions like international banks can also issue one type of financial security. Usually, companies issue different securities to attract new investors and receive considerable investments from them. However, securities such stocks entail some risks which need to be eliminated.

The need for recalling financial securities is the encouragement for commercial banks to raise capital significantly. Nevertheless, it is important to identify how actually depository institutions like commercial banks generate income.

The way commercial banks make money in general.

The initial service or purpose of banks are lending and saving money securely. Through opening up bank accounts one can transfer the sum of money from one place to another so easily. But these services are not free of charge indeed managers charge some amount to fulfill the service.

There are various forms of loans that banks offer and each loan has different interest charge by banks according to their risk involved. The riskier the loan is the higher the interest rate is. This is the main profit oriented service for the banks.

Besides above mentioned duties banks offer other feeble option like providing cheques, ATM access, and checking. Credit cards sustain banks with high income since it follows more risk and requires being more risk tolerant. Such cards may give a rise to credit risk because customer may not fulfill its obligation at the maturity date.

Securities and investment projects in commercial banks.

Banks play a considerable role in issuing securities or investment. They as an agent have a right to underwrite on behalf of customers. Actually, Investment banks are designed to maintain individuals, corporations and government via underwriting issue of shares, stock, bonds or other securities. However, commercial banks can also have department that promotes underwriting services for clients or government. This encouragement creates better reputation between bank customers and also entails a huge amount of profit.

Along with financial securities like stocks, bonds, shares; other types of securities exist for commercial banks to be used as a profitable tool for the institution. This tool, so called derivative instruments, that is form of off-balance sheet transactions that can be used by banks to gain maximum profit.

Derivative instruments.

As the term explains, derivative instruments derive its value from underlying asset or index. However, the way it obtains value differs from nonderivative instruments, because they are highly dependent on current stock market prices. The prediction made today should match future condition. In that way, derivatives make a huge profit by encouraging the economy as a whole as well. If the future condition occurs reversely to the expectation, a considerable loss influences not only a trader itself but the economy too. Nevertheless, in every contract traded there is a winner and loser. So the economy may offset its losses with another gain.

The financial profitability of derivatives.

There are various approaches, which facilitate financial institutions with profitability in trading derivatives. Let's take banks as an example. Banks as dealers can raise capital through 5 distinctive ways in OTC markets.

1. Volume. The larger is the capital involved in the contract the higher is the opportunity to gain the profit if it is professionally worked out contract. It means that by betting large sums of money one can make huge money but, surely, with experienced skills.

2. Economies of scale. The gradual flow in operations, systems, or counterparty credit management illustrates that there is an economies of scale in order for traders or dealers to take advantage. As the industry is in process and market share increases, dealers realize the opportunity to make considerable money.

3. Proprietary trading. While trying to speculate on various risks existing in OTC markets, dealers notice the flow in profitable markets as well as creating market itself. However, it is impossible to separate this action from market making.

4. Complexity. Derivatives business prefers complexity. In turn, it establishes sophisticated risk profiles to meet client needs. Moreover, this process requires high margin trades and the trade is structured and negotiated in nature. More complexity allows buyers to become beware.

5. Cheating. Often dealers suggest clients to go for trades that they do not know how to price fairly. This is called either direct lying or misleading the buyer. It means that dealers sell clients contracts that ultimately make buyers be in a risky position. Additionally, this action is not illegal but it is considered as being unethical.

To evaluate the profitability of each above-mentioned approach in percentage, I would asses them 30%, 20%, 25%, 20%, 5% respectively. However, this is my critical view and it is hard to find banks or other financial institutions operating profit like this.

The flow of securities in Uzbekistan.

There are 28 commercial banks in Uzbekistan. Each bank has its own well worked out goal to achieve and every year they implement different projects that are goal-oriented. Although, special banks so called Investments Banks do not exist in Uzbekistan, however, commercial banks deal with operations with financial securities besides their main services.

Unfortunately, not all banks are experienced in this field and therefore, these financial institutions still lack in achieving international standards with securities.

It is important to mention that Asaka Bank is getting priority over other commercial banks in securities market in Uzbekistan. It issues the shares which are purchased by large investors like The Ministry of Finance, “O’zavtosanoat” Co., and The Fund for Establishment and Development of the Republic of Uzbekistan. Since 1996, Asaka Bank has been sustaining its capital through diversified services including operations with securities.

Nevertheless, not all commercial banks develop such strategies within internal and external system. For example, Agro Bank, maintaining clients in agriculture industry, fails to promote different techniques for raising capital efficiently enough. To maintain customers it must sufficient amount. Financial securities whether purchased or sold can lead to that amount if the operation is done thoroughly and accurately. For example, underwriting issue of shares, issue bonds, stocks, commercial paper can be engaged in either in international or local financial securities market so that issued financial tools entail huge amount of profit.

Recommendations

OFF BALANCE SHEET activities have being used by most of the banks to enhance the profitability and liquidity. These are the financial products that do not appear on the typical bank balance sheet but introduce income high enough and by this feature OBS are preferred in the majority of critical situations of banks. Off balance sheet products include credit cards, letters of credit, acceptances, operations of deposit box facilities and many others. Moreover, derivatives, as it has been mentioned above, and securitization have being used often for more than 20 years.

Securitization

Issuing bonds, commercial paper and the sale of asset backed securities are the type of securitization. By using the means of securitization banks play an indirect role unless the core banking activity that is intermediation is required.

Large financial institutions purchase loans from banks and finance companies, and then gather together pools of loans with similar characteristics, such as mortgage loans to people with certain credit scores. These securitizers then issue securities that entitle the owner to a share of the payments on the pool of loans. The securities are bought by financial institutions such as commercial banks, investment banks, pension funds, and mutual funds, and then often trade in secondary markets.

Banks want to sell loans and securitization provides a way for them to do so. The benefit for banks when they sell mortgage loans is they eliminate the default risk that such loans entail. Banks still perform the basic function of reducing asymmetric information because in initially lending the money, they screen borrowers and design loan covenants. Due to this work, banks can sell the loan for more than the amount originally given to the borrower. Thus, banks earn profits on the sale and avoid the default risk associated with holding loans. Many banks sell mortgage loans and purchase mortgage-backed securities, effectively swapping relatively few loans for small parts of many loans. This provides diversification to banks, reducing their risk, and it also increases liquidity since mortgage-backed securities are easier to sell than individual mortgages. Demand for mortgage-backed securities from Fannie Mae and Freddie Mac comes from many financial institutions. These include mutual funds and pension funds, along with banks. Fannie’s and Freddie’s securities are an attractive

alternative to bonds because they are very liquid and are considered very safe, as a result of being backed only by prime mortgages and having an implicit government guarantee. And they pay a bit more interest than other safe assets like Treasury bonds. Securities backed by subprime mortgages are very different and were purchased by institutions such as investment banks and hedge funds prior to the financial crisis.

Commercial paper, as the Goldman Sachs case study shows, dates back to the 1800s. Corporations issue a promissory note, which agrees to repay the bearer at some specified date in the future. The USA has outstanding commercial paper issues of more than $1 trillion, but they have only been issued in European countries since the 1980s, and the size of the market is much smaller, amounting to about $17 billion in the UK.

Asset backed securities

The issue of asset backed securities is the process whereby traditional bank assets (for example, mortgages) are sold by a bank to a trust or corporation, which in turn sells the assets as securities. The bank could issue a bond with the pooled assets acting as collateral, but the credit rating of the bank is assigned to the new security, the proceeds of the bond are subject to reserve requirements, and the assets are included in any computation of the bank’s capital ratio.

The bank can avoid these constraints if a separate entity is established (special purpose vehicle, SPV, or trust). The bank sells the asset pool to the SPV, which pays for the assets from the proceeds of the sale of securities. Effectively, while the process commences in an informal market (the bank locates borrowers and makes the loans), asset backed securitization means a large number of homogeneous loans (in terms of income streams, maturity, credit and interest rate risks) are bundled together and sold as securities on a formal market.

Collateralized bond obligations

Collateralised bond obligations (CBOs), consisting of collateralized bonds and collateralised loan obligations (CLOs), which involve collateralised pools of corporate loans or other credit facilities. After being pooled and turned into a security, they are split into different investment classes or security tranches. The bank loans used as collateral for CLOs are typically at investment grade level, whereas the CBOs are usually a mix of investment grade and sub-investment grade, but collateralised by higher yielding securities. CLOs originated in the 1990s and consist of a pool of investment grade revolving/term loans, standby letters of credit and even derivatives. Unlike the original ABS/MBS, the components of the pool can be quite diversified, and the originator remains the owner of the underlying portfolio.

For the bank arranging them, CDOs offer a number of benefits:

- release of core capital and thus increased efficiency of the capital allocation;
- illiquid loans become liquid, tradable securities;
- investors are attracted to the bank because they can have a choice of different tranches

to meet their risk/return needs.

Commercial banks in Uzbekistan like international banks can use or introduce new financial securities to the system so that the profitability of banks could grow

significantly than expected. Certificates of deposits or repurchase agreements can on the best examples for such financial institutions to get recording results in their financial statements.

It is true that some commercial banks in Uzbekistan are using CDs and repos but the result does not catch the pick the hill. Hedging in exchange markets and underwriting issues, attracting more preferred shareholders than common shareholders (Asaka bank) also contribute to the capital growth.

Moreover, there is a term used comparative advantage which means the basic principle behind the international trade of goods and services. If a good/service is produced in one country *relatively* more efficiently than elsewhere in the world, then free trade would imply that, in the absence of trade barriers, the home country exports the good/service and the COUNTRY gains from trade. Firms engage in international trade because of ***competitive advantage***. They exploit arbitrage opportunities. If a firm is the most efficient world producer of a good or service, and there are no barriers to trade, transport costs, etc., this firm will export the good from one country and sell it in another, to profit from arbitrage. The FIRM is said to have a competitive advantage in the production of that good or service. If certain commercial banks of Uzbekistan trade in international banking services, it is best explained by appealing to the principle of competitive advantage. Banks are exploiting opportunities for competitive advantage if they offer their customers a global portfolio diversification service and/or global credit risk assessment. The same can be said for the provision of international money transmission facilities, such as global currency/debit/credit facilities. Global systems/markets that facilitate trade in international banking services are discussed below.

Conclusion

By engaging in asset transformation, the bank hopes to profit by charging a higher interest rate on its assets than it must pay on its liabilities.

Thus, a bank manager must be concerned with both asset management (acquiring assets with the highest return and the lowest risk) and liability management (acquiring funds at the lowest cost).

But a bank manager has to additional concerns as well:

Liquidity management = making sure that the bank has enough cash to cover deposit outflows (hold some excess reserves, even though they do not pay interest).

Capital adequacy management = maintaining sufficient capital as a cushion against a decline in the value of the bank’s assets, while still providing a decent return to the bank’s shareholders.

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