

THE CREDIT ACTIVITIES OF THE BANK AND THE FORMATION OF INTEREST RATES

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Volvenkova M. M. The Credit Activities of the Bank and the Formation of Interest Rates

The paper reveals the essence of the interest rate, which is a certain amount paid to the creditor (the banking institution) by the borrower for the temporary use of credit resources. There have been identified and summarizes the main types of interest rates on credits used in banking practice. In the course of the study it was determined that the formation of the interest rate is a multi-factorial process. It is demonstrated that the given process is defined by a number of factors, which can be arbitrarily divided into two groups: macro- and microeconomic. It has been proved that the main factor affecting the level of the interest rate is the cost of attracting by the bank credit funds (usually the amounts of deposit rates). On the basis of the conducted research there has been proposed a number of directions to improve the process of crediting the bank borrowers in view of existing risks.

Keywords: interest rate, interest, credit, bank, economy.

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Воленкова М. М. Кредитна діяльність банку та формування відсоткової ставки

У роботі окреслено сутність відсоткової ставки, яка являє собою певну плату кредитору (банківській установі) від позичальника за тимчасове користування кредитними ресурсами. Визначено та узагальнено основні види відсоткових ставок за кредитами, що використовуються в банківській практиці. Установлено, що формування відсоткової ставки являє собою багатофакторний процес. Показано, що даний процес визначається великою кількістю чинників, які умовно можна розподілити на дві групи: макро- та мікроекономічні. Доведено, що головним чинником, що впливає на рівень відсоткової ставки, є ціна залучення банком кредитних коштів (зазвичай це розміри ставок за депозитами). На основі проведеного дослідження запропоновано низку напрямків з удосконалення процесу кредитування позичальників банку з урахуванням існуючих ризиків.

Ключові слова: відсоткова ставка, відсоток, кредит, банк, економіка.

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Воленкова М. Н. Кредитная деятельность банка и формирование процентной ставки

В работе раскрыта сущность процентной ставки, которая представляет собой определенную плату кредитору (банковскому учреждению) от заемщика за временное пользование кредитными ресурсами. Определены и обобщены основные виды процентных ставок по кредитам, используемых в банковской практике. Установлено, что формирование процентной ставки представляет собой многофакторный процесс. Показано, что данный процесс определяется множеством факторов, которые условно можно разделить на две группы: макро- и микроэкономические. Доказано, что главным фактором, оказывающим влияние на уровень процентной ставки, является цена привлечения банком кредитных средств (обычно это размеры ставок по депозитам). На основе проведенного исследования предложен ряд направлений по совершенствованию процесса кредитования заемщиков банка с учетом существующих рисков.

Ключевые слова: процентная ставка, процент, кредит, банк, экономика.

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Under conditions of market economy the stability of the banking system has a key significance because it affects the development and efficient operation of all economic agents.

The demand for bank credits is to a great extent determined by the development level of economic and business activity of business entities. Among other factors that shape the demand for credit resources it is worth emphasizing the level of interest rates, i.e. the charge that the bank must receive from the borrower for using the borrowed funds.

In the banking practice there used several types of interest rates. The type and level of interest rates are specified and predefined at concluding the credit agreement. Interest rates are affected by a number of factors, which require a thorough studying. It is this fact that determines the relevance of the chosen topic.

The aim of the article is to identify the types of interest rates used in banking practice and study the factors influencing their level.

One of the main elements of the financial and credit system is the credit market, i. e., the sphere of circulation of

borrowed funds. Interest is the main indicator in financial calculations. It is the absolute value of revenues from money lent in any form. According to the principle of payment, the bank credit envisages that to use credit funds the borrower shall pay a certain amount specified by the bank credit committee. This payment should include at least two components:

- ✦ interest on the credit;
- ✦ commission charge.

The interest rate provides coverage of expenditures on attracting resources for performing credit operations. In turn the commission charge provides the covering of general banking overheads and transaction expenditures on crediting activities. It is also worth noting that the commission charge is set as [1]:

- ✦ one-time charge, denominated in the national currency;
- ✦ one-time charge, in percentage of the credit amount;
- ✦ fixed charge, denominated in the national currency;
- ✦ fixed charge, in percentage of the credit amount.

The cost of credit is such an interest rate that is envisaged in the credit agreement taking into account the credit

term, degree of the credit project risk and ensuring the timely payments of the borrower on previous credits [2].

The interest rate is a relative indicator of the credit cost, which is used in the calculation of interests from the amount of credit and shows the ratio of the sum of the interest paid to the credit value.

In the process of crediting the banking institution shall inform the client about the total cost of the credit, which consists of the interest rate, commission charge and services related to credit operations [2].

The bank may change the interest rate only at the happening of such an event, which has a direct impact on the cost of the credit resources of the banking institutions regardless of the parties' will. It should also be noted that the bank has no right to change the interest rate on the credit at will of any of the parties [1].

There are a lot of types of interest rates in the banking practice (Fig. 1).

Types of interest rates	Fixed interest rate – is fixed in the credit agreement at the moment of its conclusion and remains unchanged throughout the entire credit term
	Floating interest rate – may be changed by the bank under the terms of the credit agreement with mandatory notification of the borrower
	Simple interest rate – the charging of interests is carried out only on the amount of the credit granted (the initial debt amount)
	The compound interest rate – the interest charged on the principal amount of debt and interest on successive increments of the interest earned in prior periods (based on the amount increments for the previous period)
	Nominal interest rate – annual interest rate declared by the bank
	Effective interest rate – the charging of interests is performed several times a year
	Decursive interest rate – the charging of interests is performed at the end of the period of using funds.
	Discount interest rate – the charging of interests is performed in advance at the start of the crediting period on the final amount of debt and is charged by the bank when granting a credit by subtracting the accrued interest from the total debt amount
	Market interest rate – is established in the market of credit resources under the influence of supply and demand
	Real interest rate – takes into account the influence of inflation and all costs of the bank on the attracted resources

Fig. 1. Types of interest rates [2]

In the banking practice there exist a lot of types of interest rates, which shall be paid by the borrower. There are also a great number of factors, which influence the level of the interest rate. Some of them are presented in Fig. 2 [3].

All the above listed factors have their own impact on the interest rate of a particular credit. The higher the level of the credit risk, the higher the rate on the credit, and in turn,

providing security (the collateral in the material form) – reduces the credit risk. However, it is with the lodging of collateral that costs of the bank increase. It is related to the fact that it is necessary to monitor the condition of the property. Therefore, such costs should be taken into account when establishing the credit rate.

Macroeconomic factors	<i>The relationship of supply of the borrowed capital and demand for it</i> – the more the demand for the credit, the higher the interest rate
	<i>Inflation rate</i> – acceleration of the inflation rate causes an increase in the interest rate, which serves as means of protection against the depreciation of capital
	<i>The level of the Central Bank discount rate</i> – when determining the interest rate banks take as the basis the discount rate of the Central Bank, which, in turn, depends on the type of the monetary policy (restrictive or expansive), interest rates in the international debt capital market, state of the balance of payments of the country, national currency
Microeconomic factors	<i>Term of the loan</i> – the level of the interest rate is directly dependent on the term of the credit: the longer the credit the higher the interest rate because the risk of the credit default and depreciation of the borrowed funds increases with the growth of the inflation rate
	<i>Loan amount</i> – usually the interest rate on large loans should be more than on small ones
	<i>Risk</i> – In granting loans commercial banks face a credit risk (losses from non-repayment of the debt principal) and interest rate risk (losses from non-repayment of the interest paid by the borrower for the use of capital), so the higher the bank evaluates these risks the higher will be the interest rate
	<i>The nature of the security</i> – the security quality is directly related to its liquidity, because the higher the liquidity of assets, which are furnished as security for the credit, the lower the interest rate

Fig. 2. The factors, which influence the interest rate level [3]

In today's competitive environment it is important to set an interest rate reasonable for the borrower and the bank, which would help to reduce the risks and increase the level of the bank profitability as well as contribute to a more effective use and implementation of the credit project, lead to the development of the borrower's activity.

Presently the use of monetary policy in most developed countries is based on management of the short-term interest rate in the money market. However, despite the very limited range of standard tools (refinancing, reserve requirements, open market operations) the peculiarities of their use and building of the monetary system vary widely in different countries. But at the same time a common feature of all the systems is maintaining due to operations by the Central Bank the short-term interbank market rates at a certain level, close to the official rate of the Central Bank [8].

For example, let us consider the US Federal Reserve System. The monetary policy of the FRS of the USA is based on the maintenance of the rate on Federal Funds at the level close to the target rate set by the Federal Open Market Committee due to performing operations in the open market.

The FRS rate is an interest rate used as a basic one by US banks when they grant credits on their excess funds to other banks. The refinancing rate (FRS rate) is a tool in solving issues of the monetary policy.

With the help of the Federal Reserve discount rate the Central Bank affects the rate of the interbank market as well as the credit and deposit rates for legal and natural persons. The level of interest rates of the US and Ukraine in recent years is presented in Fig. 3.

Operation principles: the FRS reserve level is determined by the amount of assets and liabilities of the depository institution and this level can be set individually by the FRS. If this level falls below the normal value the bank reserves should be increased to match the requirements of the regulator (FRS).

To lower interest rates, the Federal Open Market Committee (FOMC) increases the money supply by buying government bonds. If the FOMC wants, on the contrary, to increase the interest rate, it withdraws money from circulation by selling government bonds. In today's economy there exist a lot of different interest rates, such as the interest rate of the Central Bank, credit interest, interbank rates, deposit interest rates, etc. During the recession, when organizations reduce investment in the production development, interest rates are falling.

In turn, it is low interest rates that stimulate investments. Considering interest rates in the US and other developed countries of Europe there emerges the question: Why are the interest rates so high in Ukraine? The analysis of theory and practice of the banking activity indicates that the main factors in the formation of interest rates, such as inflation, risks, money supply and demand have the greatest impact on their level.

The directions for improving the processes of crediting legal and natural persons are presented in Fig. 4.

So, all the abovementioned actions can positively affect the credit activity of any banking institution and allow to adequately compete in the banking market under complicated economic conditions that will positively influence both the banking sector and the economy in general.

The normative and legal support in the field of credit relations in Ukraine is based on the main law of our country – the Constitution.

The legal basis for activities of domestic banks is the procedure of the establishment and major principles of their activities, which are prescribed by the Law of Ukraine “On Banks and Banking Activity”. The law states that the main function of the bank is granting credits to economic entities and citizens at the expense of the funds attracted from organizations, enterprises, institutions and other credit resources, cash and settlement services of the economy, implementation of foreign exchange and other banking transactions envisaged by this Law [4].

To protect the interests of creditors and clients of the bank, granting credits is implemented under the current laws of Ukraine.

The NBU sets economic norms for the regulation of activity of commercial banks [7]:

- ✦ the minimum volume of the authorized capital must be EUR 1 million;
- ✦ the bank's capital must be not less than the amount equivalent to at least EUR 3 million;
- ✦ the solvency is calculated as a ratio of the bank's capital to the total amount of assets of the bank with respect to risk;
- ✦ the instant liquidity is defined as the ratio of the amount of funds on the correspondent account and in cash to the settlement and current liabilities;
- ✦ the total liquidity is defined as the ratio of total assets to total liabilities;
- ✦ the ratio of highly liquid assets to operating assets of the bank characterizes the share of highly liquid assets in operating assets.

Ukraine banking institutions provide credits to customers in compliance with the following main principles:

- ✦ repayment;
- ✦ security;
- ✦ maturity;
- ✦ interest payment;
- ✦ purpose-orientation.

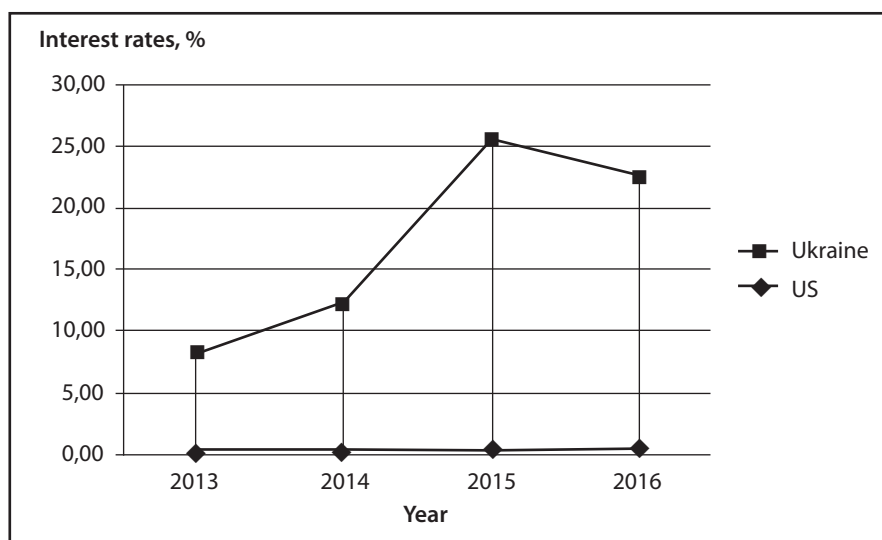


Fig. 3. The level of interest rates in the USA and Ukraine for 2013–2016 [5]

Measures	Results	Risks
Introduction of new credit products for legal persons	The use of an individual approach to each borrower in evaluating its financial condition, working capital, scale of production and business activities, reputation when introducing the revolve and current account credits	The risk associated with the lack of stable and creditworthy clients, who would be satisfied with the credit terms
Introduction of new credit products for natural persons	Development of optimal terms of crediting for the most vulnerable population groups (students, pensioners, disabled people) using more diminished requirements to the borrower	The risk of non-payment on the credit
Creation of seed capital credit programs	A detailed assessment of the business project taking into account all aspects related to risks, payback period and possible profits from crediting of the business entity	The risk associated with the lack of successful projects
Creation of a positive image of the commercial bank	The conducting of systematic promotional activities through the media and the Internet, press conferences, distribution of promotional leaflets, providing additional information on bank statements, encouraging existing clients and motivation of the personnel for attracting new clients, conducting charitable events	The risk of not covering expenditures aimed at implementing all measures
Expansion of the set of financial coefficients	Selection and development of financial coefficients for comprehensive analysis of the future borrower, taking into account not only the financial performance of its operations, but also other aspects such as business reputation, marital status, etc.	The risk associated with the absence of a considerable number of clients, who must comply with all the established evaluation parameters
Collection of bad debts	Individual approach when collecting bad debts, taking into account each individual case and optimization of the process to speed up the considerations	The risk associated with impossibility of disposal of the mortgaged property of the borrower

Fig. 4. The directions for improving the processes of crediting legal and natural persons [6]

The activities of the domestic banking system are aimed at improving the servicing of economy. At the same time, the country faces a banking crisis, which is caused among many other reasons by inconsiderate credit policy of banks due to the fact that the banking system of Ukraine has hardly fulfilled one of its main objectives – the support and ensuring of the development of economic sectors.

CONCLUSINS

Today the banking system of Ukraine is compelled to operate in a very complex and unstable environment. This further exacerbates the problem of finding reliable sources of investment of resources attracted by the bank. The further development of the banks' credit activity is influenced, in addition to external factors, by a number of internal ones, among which the leading role is played by the level of interest rates on credits. In turn, the formation of the bank inter-

est rate also depends on a number of factors that can be arbitrarily divided into macro and microeconomic ones. The first group includes the inflation rate, discount rate of the NBU and ratio between the supply of borrowed capital and demand for it. The second one includes the size and terms of granting the credit, nature of the collateral and credit risks.

In view of the conducted study, which considered the types of interest rates, factors that influence their formation, the paper suggests ways to improve processes of crediting borrowers (legal and natural persons), who are able to accelerate the pace of the development of bank crediting. ■

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