TRANSFORMATION OF THE FUNCTIONS OF BANK CAPITAL IN CONTEMPORARY ECONOMIC SYSTEM

© 2010 I.V. Volkov*

Keywords: economic relations, banking capital, operation, development and control-regulatory functions of bank capital, government regulation of bank capital.

On the basis of theoretical economic approach to bank capital the author considers the transformation of its functions, analyzes operation, development and control-regulatory functions of bank capital and defines the features of their implementation depending on economic dynamics.

The vast majority of scientists consider three main functions that bank capital performs - operational function, protective function and regulatory function. The operational function is manifested in the fact that the bank capital is financing the own development of the bank at the initial stage of its activities. The protective function, the major one, as a rule, is described by the fact that bank capital protects the bank in case of banking panic and may be used to meet the creditors and depositors's demands. The regulating function can be expressed in the fact that by means of regulating the size and order of capital functioning, governing authorities try to ensure the banking system stability as a condition of the normal development of the economy.

However, in modern terms, these approaches, based essentially on stock capital of commercial banks require some refinement. Bank capital, as a special system of economic relations, is based upon the monetary resources (equity and debt, centralized and decentralized) of the whole economic system, which are accumulated by banking organizations. On this basis we can distinguish operation, development and control-regulatory functions of bank capital.

The operation and development function of bank capital is implemented at the expense of various attracted resources, when current banking operations are constantly funded and reproduced. The role of initial capital provided by the owners of bank's foundation in this sense has a limited importance. Moreover, the conception of banks as financial intermediaries, issuing loans at the expense of attracted deposits (transformation of savings into investments), and profiting at the expense of the interest margin, is somewhat simplistic. As we know, banks have a unique opportunity to increase the money supply exceeding the original attracted deposits (multiplier of bank capital), which creates prerequisites for expanded reproduction of monetary and real productive resources.

It should be noted that the protective function of bank capital is fairly conventional. In addition, in the modern fractional reserve banking system credit institutions try to minimize the accumulation of unproductive assets. Bank capital, including equities and debts, is involved in the financing of risky operations. In other words, we can review the protective function of bank capital, in conditions where share capital is a kind of collateral, allowing to smooth out the adverse selection and moral hazard under conditions of asymmetry of information, or when equity is an additional mechanism for delegated monitoring to lenders because the owners' investments into stocks absorb losses first.

Protective function of bank capital in contemporary economic system is closely related to the regulatory function; therefore it is appropriate to review them as a single control-regulatory function. Regulatory authorities depart from the value of own funds of banks in determining the maximum risk, which can be taken by the banks. Therefore, capital adequacy regulation is the display of, perhaps, more protective than the regulatory function of bank capital. Herewith, bank capital does not regulate anything directly, only administrative restrictions based on capital requirements have the regulatory effects. Bank capital is regulated not by itself, but merely as a mean to achieve financial stability.

According to capital adequacy requirements, for example, the value of loans, which can be issued by the bank as a highly leveraged firm with limited liability, depends on the value of its equity. The last one is not chosen by acci-

* Ilya V. Volkov, post-graduate student of Kostoma State University of Technology. E-mail: volkovvit@ya.ru.

dent: the idea is to increase the responsibility of the shareholders for the risk, not allowing them to assign a portion of the earnings of investors from riskier projects, reducing the possibility of leverage and credit multiplier. Capital adequacy requirements are the powerful obstacle to the spread of moral hazard, protecting the economy from excessive expansion of credit and money supply, since the shareholders at the same risk of losing investment can reap the potentially large profits, exposing the economy to the possibility of devastating banking crisis. Such requirements associated primarily with the stability of the banking system, and unrelated to the direct control of money supply and tools of "fine tuning", ultimately affect the value of money capital circulating in the economy (bank capital channel of the monetary transmission). In this case, it is not quite right to criticize the central banking system.

In fact, the regulating function of bank capital is more important than people think, not only because of the financial system, but the entire economy depends on the banking capital. Since bank interest (its relation with the level of inflation, the rate of profit) is a kind of universal catalyst for the quality of business processes within any economic system. A variety of banking transactions, characterized by one or another level of speculation, importance and priority for the entire state economy, the depth of attention to specific interests of certain industries, enterprises and to preferences of the population, their innovation and investment degree, high-tech component, their integrated, strategic and social oriented character, give evidence about nature of the regulatory effect of bank capital, which can be both positive and negative. That is why market processes of the banking capital functioning are the subject of special state regulation and control that are implemented by using a centralized subsystem of bank capital - capital of central banks, for example, in the form of monetary policy. In the modern economic system the regulating function of bank capital can not be separated from state regulation of capital movements and money supply in order to smooth out economic cycles, low~~er~~ inflation, reduce unemployment and stimulate economic growth.

In conclusion, it is worth to note that various functions of bank capital are in constant motion. So, depending on the economic dynamics, some changes are going in the value of certain functions of bank capital. For example, in times of economic crisis, operation and development function, which played an important role in the recovery period, fades into the background, giving place to control- regulatory function. This trend is clearly manifested in the situation of the current global financial crisis.

Received for publication on 08.06.2010