Science Arena Publications
International journal of Business Management
Available online at www.sciarena.com
2016, Vol, 1 (2): 1-8

THE RISK OF CREDIT MARKET IN ALBANIA

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Abstract: In countries with a developing economy like Albania based on the use of cash and the total credit available to the general public it is limited. The opportunity of credit impact to increase the demand for goods and services, thus increasing the living standards and economic stability.

Significant exposures to market and liquidity establish special challenges to the process of bank lending. Sensitive exposures to the market include exchange with foreign currencies and financial derivatives contracts. Random and uncertain nature of exposure of these instruments requires that banks have the ability to assess the probability distribution of exposure size in the future. It is also important its impact on the degree of financial leverage, the same for the bank and the borrower.

During the development of the business strategies, many banks face a natural dilemma between choosing to specialize in key areas with the purpose to achieve a leadership position in the market, or diversifying their flowing income. This happens specifically when the banks are involved in some unstable segments of market. This dilemma has been aggravated by the intensification of competition between banks and non-banks but realize some lending activities, which are a bank feature, like lending corporate credit for investment.

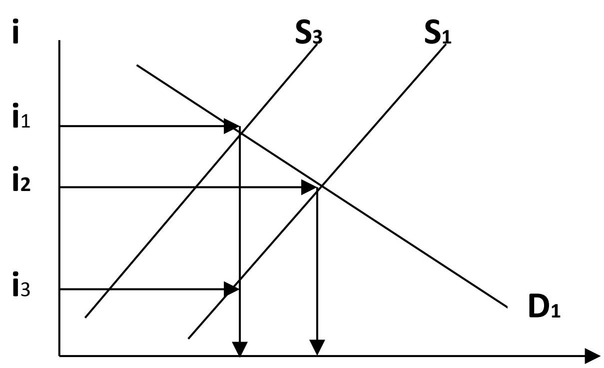
Keywords: credit, risk, market, loans, collateral

Introduction

1. The situation of credit risk in Albanian Market

Credit risk can be defined as the potential that a contractual party will fail to meet its obligations in accordance with the agreed terms (Ken Brown Peter Moles., 2014: I/2).

The chart below is a simple model of the credit market. On the vertical axis is the interest rate and the horizontal axis is the volume of deposits / loans. The curve of supply of deposits is S3. The curve of supply of credit is S1 which shows that the bank will offer more loans to increase interest (Fama, E. F., and K. R. French. 1995: 136, 136). D1 curve represents the application for the loan which decreases with increasing interest. In equilibrium bank pays a rate interest deposits i3 and the borrower has an interest rate i1. The amount of deposits and loans is OT. Marginal interest equals i1 - i3 and should cover the capital costs, the price of risk that is added to the loan, payments tax, and institution profit. While i2 is the pure interest rate market.



There are three characteristics that define

credit risk (Ken Brown Peter Moles., 2014: I/2):

1. Exposure

2.The likelihood that this party will default on its obligations

3. The recovery rate

Increase of credit has made banks more conscious of credit risk. What is seen from the specialists of the loan is that the aggressive policies of banks that want to save and expand their market share can lead to lend more money unstudied. Difficulties that banks face while giving a loan are (Bruno, Michael, 1992: 745):

1. Presentation of unrealistic balance sheet by businesses

2. Gaps in business plans

3. Specialists think that businesses in Albania suffer from lack of managerial skills to successfully manage their activities.

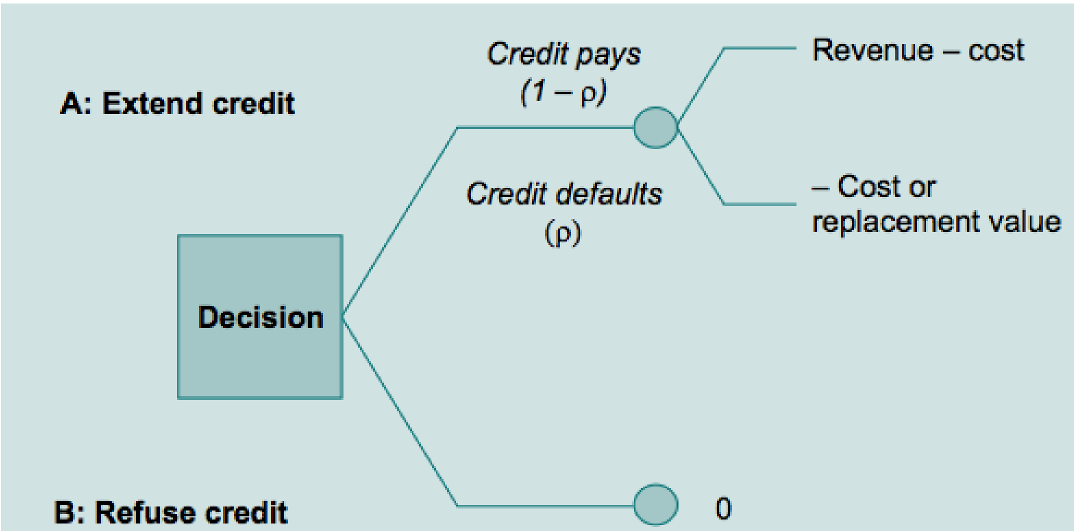
4. The problem in evaluating the collateral.

What banks require are not only sufficient finances but also fulfillment of collateral or guarantee. Even though the client may have a job that is well paid confidence procedures are more important than the amount of money an individual earns. Creating the database where banks can be informed about their uncertain clients (Hasen, L. P., and R. Jagannathan., 1991: 226), has led to lowering of lending to households and increased somehow credit quality. In some banks client may take a loan if an old customer bank guarantee for him.

Another problem is the quality of the collateral provided by customers. Often, collateral valuation is done by the method of the market, for example: is seen the price of a certain number apartments and then based on the average of this price is determined the value of collateral held as a security for loan. Market method requires extensive experience in determining the appropriate comparisons for prices and to valuate type of property (Howells P.; Bain K., 2004: 125). Often the desire of banks to increase lending and increase their market share is associated with tolerate by the part of banks in terms of quality of collateral (Mehra, R. and Prescott E., 1985: 150). About 80% of the collateral registered in the banks in Albania consists of estate assets which do not always provide the necessary qualities to be liquidated quickly in case of loan default.

What is most preferred today is the consumer credit which has higher interests that banks apply. This is the favorite loan for all those customers who have a stated salary. But this loan has its risks here and in Albania where the job contracts are not always given, so employees do not have the opportunity to prove their salary (Haderi S., 2003:).

Figure 1: The decision of bank for credit



Source: Ken Brown, Peter Moles (2014)

Credit risk or otherwise risk failure is the risk that the borrower might fail to meet its obligations to the bank, under the terms established in the contract between two parts. Failure leads to loss partial or total amounts lent. But also credit risk is the risk of deteriorating financial position of the borrower[1]. Deterioration is not failure in the true sense of the word but greatly increases the probability of failure.

Credit risk in banks is divided into:

-Risk Loan from banking portfolio.

-Risk Loan from commercial portfolio.

Financial institutions are faced with difficulties for many different reasons. But the main cause of the most serious problems of the banking sector continues to be directly connected to the careless credit standards for borrowers. Also poor management of portfolio risk or lack of attention to economic changes or other circumstances may lead to a deterioration of the sustainability of lending by banks.

Banks need to manage overall credit risk that has to do with their nature as a whole as institutions that accept deposits and make loans, and that includes their entire portfolio. Banks should also take into account the connection between the credit risk and the other risks. Effective management of credit risk is an integral part of the whole and the most important of risk management and is essential to the long term success of any banking institution[2]. For most banks, loans are the largest and clearer sources of credit risk. However there are other sources of credit risk throughout the bank activity. These sources are included in banks and trading accounts, even they include in the balance sheet or not. Banks are facing credit risk more and more in various

[1] https://www.capgemini.com/resource-file access/resource/pdf/Credit_Risk_Management__Trends_and_Opportunities.pdf

financial instruments except loans. For example bank acceptances, interbank transactions, trade financing, foreign exchange transactions, future financial contracts, bonds, and the expansion of involvement etc…

A further particular instance of credit risk relates to the process of settling financial transactions. If one side of a transaction is settled but the other fails, also if one party is simply late in settling, then the other party may incur a loss relating to missed investment opportunities. The level of risk is determined by the particular arrangements for settlement. Factors in such arrangements that have a bearing on credit risk include: the timing of the exchange of value; payment/settlement finality; and the role of intermediaries and clearing houses[3].

Important is encourage of supervisors to promote sustainable practices for managing credit risk. Although the basic principles of effective management of this risk are clearly applicable in the business of lending, they should apply to all activities where credit risk is present.

The main directions in which banks should be supported to achieve the right results in the management of credit risk are:

1 Creating an appropriate environment to protect against the credit risk.

2 Maintain a stable lending activity.

3 Create a continuous and appropriate process of credit administration, measurement and monitoring the risk.

4 Ensure adequate and sufficient controls.

Although management practices of specific credit risk change between banks on the nature and complexity of their lending activity, a general program of credit risk management will be addressed in these four directions. These practices should also be applied together with other sustainable practices related with accurate valuation of asset quality, adequacy of provisions and reserves and credit risk invent.

Exact actions chosen by different supervisors depend on many factors. They also change depending in facts if there are internal or external supervision techniques, and how many external auditors are included in the supervisors function.
Bank must use the tests to examine the damage if there is high risk. The other element is the risk caused from changes in basic financial variables as a% base interest or exchange rate.

- *Market risks*

The Bank of Albania deems that the banking sector is exposed to interest-rate and exchange-rate fluctuations. In both cases, the market risk is indirect and relates mainly to difficulties that a swift and considerable increase in interest rate and/or exchange rate would pose to borrowers[4].

- *Liquidity risk*

The Bank of Albania deems that the banking sector exposure to liquidity risk is low, against the backdrop of adequate liquidity condition. Liquidity indicators, both in lek and foreign currency, are above the minimum required threshold.

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[3] See in particular Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions (September 2000), in which the annotated bibliography provides a list of publications related to various settlement risks.
[4] https://www.bankofalbania.org/web/pub/ndermjetesimi_financiar_t2_14_6810_1.pdf

- *Risk of foreign shocks spillover*

The latest financial crisis highlighted the need for monitoring international market developments to assess their impact on the value of the banking sector investments. The Bank of Albania conducts this assessment periodically, as part of the stress-testing exercise[5]

- *Systemic risk*

Assessment of each risk and the overall analysis of the economy and the financial system provide us with an assessment of the systemic risk situation and performance. Therefore, the Bank of Albania focuses on:

a. Developing methodologies and techniques to assess the systemic risk in its both dimensions;

b. Conceiving and establishing the framework for macro prudential policies;

c. Developing inter-institutional cooperation and preparing in advance for:

    i. Preventing systemic-risk situations;

    ii. Managing systemic-risk situations.

To assess the systemic risk according to its cyclical dimension, the Bank of Albania has applied several methodologies and techniques, which include indices for assessing the banking sector's financial position and the financial stress level. Assessing the systemic risk according to its structural dimension, the Bank of Albania has developed a methodology that identifies banks' contribution to systemic risk and determines the systemically important banks[6].

2. Bad Loans

Loans are classified as problematic when banks have difficulty in collecting them. They are categorized in several ways depending on the degree of problems they manifest:

- Standard loans are also called as regular loans, because they show no problem in time and amount of repayment;

[5] https://www.bankofalbania.org/web/pub/chapter_1_6630_1.pdf
[6] https://www.bankofalbania.org/web/pub/chapter_1_6630_1.pdf

- Loans in collection represent the loans that show the first signs of delays in repayment and are under the supervision of the bank, but not yet classified as problematic loans;
- Sub-standard loans are called the loans that are not classified as standard loans, due to delays in repaying , and are classified as problematic;
- Past due loans are called the loans that have significant delays in their payment, but the bank still has hope in their collection and are classified as problematic loans;
- Written off Loans, are called the loans that can not be collected on the bank and are classified as problematic loans.

Monitoring

Monitoring is the maturity of the credit control of customer of colateral of life insurance to the loan closing. Monitoring can compare with the control that people have to make to the doctor every six months to have the opportunity to capture the disease in a timely manner. Monitoring has more phases[7], but the more importante are four phases:

1. Monitoring of the loan maturity

2. Customer Monitoring

3. Collateral Monitoring

4. Monitoring of the life and Collateral Security

3. Money Market

The economy of Albania is facing cyclical weakness. In response to weak demand, the Albanian economy is growing below potential; Low inflation appears; public and private balance sheets present difficulty; while the banking system is facing increasing bad loans (Sudweeks, B.L., 1989:5). This problem is detected in time by the Bank of Albania. However, the transmission of monetary policy to the real sector of the economy has not been complete.

The focus is the need to improve the quality of assets and maintaining ongoing financial soundness indicators (Meka, E. & Filipi, Gj., 2010: 85). Bank of Albania will support this process through cooperation with the banking industry and improving the regulatory and supervisory framework. It is recommended to improve the legal infrastructure, operational and institutional cooperation.

Most of the loans given in Albania for commercial banks is guaranteed by estate assets. This is a loan guarantee for the fact that banks do not finance more than 70% of the property value. But here is a potential risk due to the fact that the mortgage loan is generally long. But there is a risk of a possible collapse of the estate assets market which would transfer an added risk for banks that would own as collateral: houses, shops etc. with a value less than the value of given loan.

[7] https://www.frbatlanta.org/media/Documents/banking/publications/components-of-a-sound-credit-risk-management-program.pdf

Conclusions and Recommendations

Albanian banks do not have management department of risk because it is increase the cost of labor, it also required a qualified staff.

Credit Risks are approved by the Credit Committee of the Bank which operates under procedures and delegations set Credit Committee and approved by the Board of Directors in June 2004. Furthermore the management of credit risk is done through regular analysis of clients and their classification set by the carried risk.

Credit to the economy is recording lower rates of growth in the last decade, impacting negatively on the revival of Albanian weak economy. According to the study, developments in credit performance reflected other macroeconomic developments in the country. The slowdown in aggregate demand is associated with a decreased demand for loans from businesses as well as individuals.

The share of problematic loans and those in collection loans to total loans has been increasing in recent years in Albania. There has been an important increase in written-off loans, this means that the quality of loans has been decreasing and these loans can not be collected by the banks, but instead the collateral has to be executed.

The main factors identified by the banks to the decline in demand for loans to individuals are situations in the estate assets market and the presence of other sources (informal) funding. Meanwhile, positive impact on the demand for loans provided the policies pursued by the Bank of Albania, especially the reduction of the interest rate and ensuring price stability, as an anchor of stability in the economy.

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