

THE ROLE OF CREDIT MARKET IN FINANCING THE ECONOMY

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Abstract

The Albanian Government is not credit provider in the Albanian Market. It just draws funds through emission of treasury funds and treasury bonds recently. Investing in Treasury bills from commercial banks is a significant part of the investment portfolio. Purchase of treasury bills by commercial banks represents a good investment option that competes lending. In order to achieve its final objective Bank of Albania sets the operational framework of monetary policy instruments used to intervene in the money market. The instruments employed for such a purpose include: the instruments used in the open market operations, standing facilities and other liquidity providing instruments. Open market operations are conducted through the purchase or sale of securities by the Bank of Albania. These transactions play the main role in the transmission of monetary policy in the banking system. Ensuring financial system stability is not the exclusivity of a public authority but it requires cooperation among relevant public authorities at home and abroad, and regular communication with the financial industry. The purpose of this study is to determine the monetary policy pursued by the Bank of Albania and the impact of Credit risk in Albania.

Keyword: Credit Market, Bank, Government, Money, Monetary Policy

INTRODUCTION

The Albanian Situation

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.

As in all countries with developed market economy banks finance the majority of credit needs. In Albania, it is supposed that banks finance 90% of needs for loan, a high figure in comparison with developed countries where financing through the banking system ranges from 65-75% for credit needs. "Albanian businesses were faced with "mandatory" acceptance of tightened conditions, offered in a concerted way by all banks, as well as the limited bank loan offer, throughout 2009-2010 and even during 2011.

"Therefore, businesses had no way out to raise capital and liquidity from sources, different in type and origin, with bank loans, which could have relaxed the impact of bank loans' tightened conditions and global financial crisis shockwaves on financial system and real economy, too" (Meka, E. & Filipi, Gj, 2010)

Banking financial risk is perceived and conceived as a negative impact on bank profitability due to some uncertainties in financial nature.(Crockford, Neil, 1986) Though young, the financial market in our country has already first experiences about financial risk. Pyramid schemes, depreciation of privatization bonds and exchange rate fluctuations, were the first phenomenon which aware us was that except the interest rate in return from investment there is also a very important component: The risk of losing a part or all investment.

The unbalanced financial system poses many risks, not only to the system itself, but also to a country's economic development. Theoretical and practical evidence show that, "the existence of several large financial institutions, within financial system is fairly counterproductive and leads to a non-competitive financial system (Sudweeks, B.L, 1989).

Repurchase Agreements

Repurchase agreements are instruments of the open market operations by means of which Bank of Albania sells securities, to commercial banks, committing to repurchase them respecting the predetermined conditions. The aim of this instruments is to temporary reduce liquidity in the banking system. While the reverse repurchase agreements consist in open market operations by means of which Bank of Albania buys securities from commercial banks committing to resell them under the predetermined conditions (Bank of Albania, 2006).The instrument is used in order to temporary inject liquidity in the banking system(Krishnamurthy, Arvind, Stefan Nagel, and Dmitry Orlov, 2014).

The minimal requested amount to transact through (reserve) repurchase agreement is 10 (ten) millions Lek and could be raised only by multiples of the same amount.

The main open market operation is realized through a seven days maturity (reverse) repurchase agreement which is the main instrument for the implementation of monetary policy by Bank of Albania. The main features of the (reverse) repurchase agreements can be summarized as follows:

- They are executed through multiple price tenders with fixed offers amount or through fixed price tenders.
- The tenders for these types of agreements are held weekly as standard type tenders.
- The interest rate is fixed by Bank of Albania's Supervisory Council. This rate acts as a floor (reserve repurchased agreements) or ceiling (repurchase agreements) rate for multiple price tenders.
- The maturity of this instrument is seven days.

Structural Operations

The instrument used to conduct structural operations consists in the outright transactions. The purpose of using these operations is to adjust the market liquidity structure.

Outright Transactions

The outright transactions refer to the operations where Bank of Albania buys or sells securities outright in the market. Such operations are not reversible and have permanent effect in the money market liquidity. They are employed in the structural operations.

Standing Facilities

Standing facilities are instruments available to banks at their own initiative without restriction under normal circumstances. They consist of instruments providing and absorbing overnight liquidity. The interest rates on these instruments provide the corridor in which the money market interest rates can fluctuate.

Overnight Loan

Type of Instrument

The overnight loan is a short-term debt instrument available to the commercial banks. It is a fully collateralized loan, which is used to satisfy commercial banks overnight liquidity needs. Under normal circumstances, the interest rate on the loan facility provides a ceiling for the overnight market interest rate (Siklos, Pierre, 2001).

The Role of Other Credit Institutions in Financing the Economy

Except banks there are also some others microcredit -institutions which offers loans mainly in rural areas or small towns.

Besa Fund j.s.c mission is to contribute to the country economic growth in the urban and semi urban areas, by promoting and financing the small and medium enterprises sector in Albania.

Clients of Besa Fund j.s.c are people from all socio-economic layers, including unemployed and start up businesses.

Foundation "BESA" provides small loans usually up to 3,000,000 for maximum term to seven years (84 months). The value of the collateral must be 150% of the amount of loan. The amount of loan of this institution has increased year after year and in 2013 it was 5,180,446,599 ALL.

Funding for mountain areas that provides loans to individuals and SME in these areas as its mission is to reduce poverty in mountain areas. Loan amounts are offered from 150,000-200,000 ALL with maturity 3-5 years. Value of collateral should be 150-200% of the loan amount.

Albanian Partner in Micro, an Albanian American company that provides loans for developing Albanian businesses. Gives small loans 10,000-150,000 ALL with short maturity 4-10 months.

Foundation to the future, a nonprofit organization that aims socio-economic development of rural areas with small loans up to one million ALL with maturity up to 5 years.

Albanian Savings and Credit Union, is a voluntary union of individual Savings and Credit Associations. The amount of loans is 500,000 ALL in the village, and 1,000,000 ALL in the city. The maturity does not last more than three years.

Informal Loans (Fajdet)

A phenomenon that cannot be deny in the credit system is also the loan through so called "usurer" (fajdexhinj) who finance businesses with a high level of guarantee, but do not fulfill the requirements of lending by the banking system. Generally this form of lending is more popular in rural areas. A business to take a loan does not present financial statement or reports profitability but are personal connections between lenders and borrowers that provide a high level of guarantee. Generally the maturity of this kind of loan is very short, and interest rate is monthly. This kind of business in Albania is not known only for loans but also for deposits. These deposits are with high rate of interest, but with a very high risk.

Financial Stability and Banking Supervision

A financial system is assessed as stable, if it is able to withstand various shocks to its activity and meet economic agents' needs for financing and other financial services.

The definition reveals clearly the need for identifying, preventing and managing risks to the financial system, particularly the systemically important ones (Systemic risk is defined as the risk of collapse of financial services due to the partial or total damage of the financial system and that may provide seriously negative consequences to the real economy. Systemic risks are divided into cyclical and structural risks (Berger, A.N., Hancock, D., and Humphrey, D.B. 1993). The cyclical dimension relates to the way the risk develops over time, in the conditions of interplay between financial agents or financial system and the real economy (Altman, A., Resti, A., and Sironi, A. 2005). The structural dimension, also known as the inter-sector dimension, is related to the way the risk is concentrated or extended to financial system infrastructure, at a certain period, potentially bringing a significant negative impact on financial system stability.

The latter accompany the financial system activity and reflect not only the complexity of activity but also its extension to various jurisdictions and the real-economy interplay. Ensuring financial system stability is not the exclusivity of a public authority but it requires cooperation among relevant public authorities at home and abroad, and regular communication with the financial industry.

The Law "On the Bank of Albania" and the Law "On Banks in the Republic of Albania" regulate Bank of Albania's role in maintaining financial stability. Besides the objective of maintaining price stability through monetary policy implementation, the Bank of Albania has other objectives as well, including regulating the banking activity and developing the payment systems (Bank of Albania 2002). These objectives shall be achieved by licensing, regulating and supervising the banking activity, as well as by monitoring and implementing initiatives to technologically improve the payment systems, in line with the best international standards. Furthermore, the legal framework also defines the Bank of Albania's responsibility for communicating its assessment on financial stability to the public.

In the banking sector despite the fragile situation of the Albanian economy and increased vulnerabilities in the financial system, the key financial strength indicators improved in 2013. The positive profit increased. The levels of liquidity and capitalization were adequate.

The Importance of Measuring Credit Risk

It should be accepted that methods used by larger institutions and the most advanced in this field, are not always applicable to the practice of our financial system (Baestaens, D.E. 1999). Also a problem is the dualism between internal models (the banks themselves) for the

measurement and reporting of risks and reporting models, defined by banking supervisory authority, which in this case is the Bank of Albania.

Credit risk has become a real challenge for risk management in general, in the late 1990s. Globally, all financial institutions are taking more and more risk upon themselves. Adding credit exposure has increased the need for a management with more sophisticated techniques for credit risk (Altman, A., Resti, A., and Sironi, A. 2005). Credit is definitely one of the core businesses of commercial banks and in most cases constitutes over 50% of assets.

Credit risk measurement is important to assess income from credit, to determine the extent of provisions and to determine credit limits for particular clients. Generally models focus on calculating the probability of bankruptcy of the customer and their classification into risk categories (Allen, L. and Saunders, A. 2004). In fact there are some very practical reasons why there should be a calculation of credit risk (Baesens, B., Setiono, R., Mues, C. and Vanthienen, J. 2003):

- Financial products have become more complex. Increased activity of futures contracts has created a very dynamic and uncertain counterparty exposure that is a challenge plus, together with the simpler exposures calculation such as exposure to more traditional instruments for example loans and bonds.
- Expansion mechanisms to improve credit; Guarantees issued by third parties, available collateral, etc... Make necessary assessment of credit risk at the portfolio level as in exposure to individuals.
- Improved liquidity in secondary markets and emergency for future credit contracts make necessary a more active management of credit risk. Not only this but also the universally established standards that require the measurement of the existing risks before protecting and maneuvering with them.
- New improvement instruments of loans require the measurement of correlations that exist in a loan portfolio.
- Four-eye principle which requires the approval of loans made by at least two persons from independent instances of each other.

CONCLUSIONS AND RECOMMENDATIONS

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.

The behaviour of individuals seems to be affected by uncertainties about the future of their finances, in terms of slowdown of real disposable income.

Families continue to reflect this uncertainty in maintaining their tendency to save, which is reflected in the steady growth of deposits and other savings investments.

Credit risk in Albania has become a real challenge for risk management in general, in the late 1990s. Globally, all financial institutions are taking more and more risk upon themselves. Adding credit exposure has increased the need for a management with more sophisticated techniques for credit risk.

The global financial crisis, as in many countries, even in Albania, gave a significant impact on the banking system's role as financial intermediaries.

Credit risk measurement is important to assess income from credit, to determine the extent of provisions and to determine credit limits for particular clients.

The Bank of Albania has objectives as well, including regulating the banking activity and developing the payment systems. These objectives shall be achieved by licensing, regulating and supervising the banking activity, as well as by monitoring and implementing initiatives to technologically improve the payment systems, in line with the best international standards.

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