EUROPEAN ACADEMIC RESEARCH, VOL. I, ISSUE 8/ NOVEMBER 2013
ISSN 2286-4822, www.euacademic.org
IMPACT FACTOR: 0.485 (GIF)
DRJI VALUE: 5.9 (B+)

Liquidity Risk in Albania

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Abstract:

Interbank markets play a crucial role in the financial system. They make possible to transfer liquidity in a timely manner by banks with surplus liquidity to those that face shortage. In the recent years many Central Banks in the world have implemented a monetary policy led by open market operations in order to control the interest rate in the interbank market for overnight loans. These interventions have a significant impact on the overall economy. Despite their importance, interbank markets are not adequately addressed in the economic literature. This lack of theoretical framework made that when banks faced liquidity shortages during the global economic crisis in August 2007, central banks were uncertain how to act concretely.

In this topic there will be addressed the liquidity risk with a special focus to the Albanian case. Liquidity risk management has become a vital responsibility to conduct the business of banks in particular and the economy in general. The technical side of managing balance sheet items, planning and realization of budgets, missmatches of maturities etc., have now a special importance in the activities of financial institutions in the world, but also in Albania, mainly in the banking system. In this context, it is worth mentioning that in recent years, liquidity risk has obtained a special importance in Albania. This is reflected in the strengthening of the regulatory requirements and increased reporting to the Bank of Albania, particularly in the context of recent developments in the global financial market.

Key words: Liquidity risk management, liquidity risk indicators, stress-testing, deposits withdrawal, crisis situation, regulatory framework in Albania.

1. Regulatory framework

Bank of Albania, following the latest developments in international and domestic market, and in accordance with the requirements of the Law "On Banks in the Republic of Albania", adopted Regulation no. 71 dated 14.10.2009 "On the management of liquidity risk", as amended.

Object of this regulation is to set minimum standards and requirements for an effective management of liquidity risk by the banks and branches of foreign banks, which carry out banking and financial activity in the Republic of Albania.

Article 4, paragraphs 2/a and 2/b of this regulation give respectively the definition of "liquidity shortfall" and definition of "liquidity risk", as follows:

> "Liquidity shortfall" shall mean each situation, where the bank:
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> i. does not own sufficient liquid assets or encounters difficulties to realise them in a market, with the purpose to meet obligations as they come due and to meet any unexpected demands for funds by its depositors or other creditors; or
>
> ii. is unable to fund increases in its assets;
>
> And
>
> "Liquidity risk" is the possibility of incurring a financial loss owing to the liquidity shortfall

For banks which exercise their activity in the Republic of Albania, the liquidity risk management system should include a strategy and policies for managing this kind of risk.

This strategy should include clear objectives and principles for liquidity risk management, the general methodology that the bank will have to implement to manage liquidity risk in the short and long term, the overall methodology and the vision of the bank to access markets and sources of funding as well as policies for managing liquidity risk.

On the other hand, these policies should include the identification of liquidity risk arising from new products and operations, liquidity risk measurement and periodic evaluation of the performance of markets where liquidity needs are met.

Following the above, it is very important to list some topics related to the successful management of liquidity risk by the bank's responsible structures:

1.1. Appropriate and dedicated organizational structure

The Bank has to create appropriate organizational structures to manage liquidity risk, and to clearly define the division of powers and responsibilities of units or functions of the bank that monitor and manage liquidity risk.

The Board of Directors or the competent body of the parent bank for the branch of a foreign bank, establishes the committees or structures for the management of different risks of the bank. These committees, in addition to other risks, are responsible even for the management of liquidity risk.

The Bank may establish a specific structure or function, which is responsible for implementing the operational risk management policy and control liquidity through daily monitoring of the liquidity risk.

1.2. Internal control system

Internal audit function for liquidity risk management includes the monitoring of compliance with the liquidity indicators as well as the reporting on potential excesses of these limits; regular control of deadlines, accuracy and completeness of the data and assumptions used for purposes of measuring and monitoring liquidity risk. It also includes the application of measures to correct identified weaknesses; continuous development of methods and methodologies for measuring and controlling liquidity risk, ensuring compliance with legal and regulatory framework of Bank of Albania, and the bank's internal rules.

1.3. Information management system

The bank creates an information system that provides in a timely and sustainable manner for the decision making process, all the data needed for measuring, monitoring, controlling and reporting of liquidity risk. The measuring and monitoring process should be done on a daily basis and clearly defined time period. The Bank shall have the appropriate software to perform stress tests of liquidity.

1.4. Contingency Plan

The banks should develop contingency plans for managing liquidity risk in exceptional circumstances, which should be tested periodically at least every 2 (two) years.

Contingency Plan is part of the risk management process and shall include a clear separation of duties, powers, responsibilities and decision-making regarding the implementation of the plan; early warning indicators used as signals for emergency conditions and determining the responsible persons within the bank to monitor and report on these indicators. In addition, the bank should determine the conditions under which the plan will be implemented; the activities to be undertaken, identifying possible sources of funding and the level of their advantages in use, as well as the time intervals within which these activities should be undertaken. Of great importance is even the communication with key depositors, business partners, other clients, public as well as contact details of responsible persons for implementing the plan.

1.5. Stress tests

"Stress-testing" risk management technique is used to assess the potential impact of one or more internal and external factors into the financial stability and / or liquidity of the bank. Stress tests can include scenario analysis or sensitivity analysis.

The bank manages liquidity not only under normal circumstances, but even under unusual circumstances. To avoid these situations, the bank performs periodic stress tests, to identify and measure its exposure to liquidity risk, under the daily activity conditions as well as in unusual situations. For this purpose the bank shall analyze the impact on cash flow and short and long term solvency. It has to be prepared for emergency situations and should assess its ability to increase assets through the identification of more favorable funding resources.

The stress tests results should be reviewed by the Board of Directors at least every 3 (three) months and used for:

i. improvement of strategies and policies on the management of liquidity risk;
ii. improvement of the regulatory framework necessary to resolve key issues related to the bank's liquidity position
iii. development of effective contingency plans.

Scenarios for conducting stress tests may include assumptions such as : What can happen if massive withdrawals of deposits occur; if there is a possible deterioration of borrowers' ability to repay their obligations, which means deterioration of the credit portfolio quality.

Stress test make assumptions about the impossibilities in converting easily and without significant loss assets in cash, the possibility of early repayment of the obligations in terms of contractual options that provide this settlement, operational risk and the extent of its impact on liquidity risk.

At the same time, special importance takes the fact how changes in economic conditions affect the sectors to which banks are exposed and the deterioration of the economy as a whole; a deterioration of the functioning of markets in which banks operates and a significantly reduced confidence in these markets; interest rate and exchange rate shock; the effect of significant changes in the value of banks assets or assets received as a collateral; limiting in partial or total the funding from the main sources, including the possibility of obtaining funding from parent banks as well as the impact of adverse economic developments in the region and in a global scale.

The key elements to be identified measured monitored and controlled by a bank with regard to its liquidity position, as defined by the Basel publications, are as follows:

i. future cash flows of assets and liabilities;
ii. sources of contingent liquidity demand and related triggers associated with off balance sheet items;
iii. sheet positions;
iv. currencies in which a bank is active; and
v. correspondent, custody and settlement activities.

The banks have to periodically monitor their funding sources in order to maintain diversified resources and identify potential concentrations. Concentrations should be further analyzed by source of funding, type of financing, by market, geographic concentration, by currency and by maturity.

2. Statistical data from the banking sector in Albania

Measuring liquidity is a very important issue, even in the Albanian money market. Although there are not significant volumes in the Albanian money market compared to other countries in Europe, the importance and assessment of the liquidity risk and its financing are in the focus of Albanian bankers.

Central Bank and commercial banks through open market operations, interbank market operations, customer deposits and other funding sources, provide the adequate liquidity to meet the demand for money. In the Albanian banking market operate 16 commercial banks, most of which are foreign owned.

Developments in 2008 presented a challenge in managing liquidity in the Albanian banking system in the conditions of a tense liquidity situation in global financial markets. For a good management of the situation, Bank of Albania asked banks for daily detailed reports with information regarding their liquidity situation, in particular their relationship with non-resident financial institutions and the daily performance of deposits.

According to Bank of Albania reports, the deposits withdrawal fenomena, which began in October 2008, was gradually softened during 2009, especially during the last two quarters. Only in the 4th quarter of 2008 the system's customer deposits dropped by ALL 49.1 billion (7.1%). At the end of December 2009, total deposits in the banking system presented ALL 694.3 billion posting a growth of ALL 49 billion (7%) for 2009. Despite this increase in the deposits level, the banking system had to recover ALL 21 billion still to reach the level of the third quarter of 2008.

During year 2009, the volume of banking activity was expected to shrink more. The increase in the deposits level depended significantly on the return of the public confidence in the health of the banking system, while the increase in the compensation level of deposits served as a driving factor to stabilize public finance. According to the Law no. 8873, dated 29.03.2002 "On Deposit Insurance" amended by the law no. 10101 dated 30.03.2009, it was increased the coverage amount for the insured deposit up to the amount of ALL 2.500.000 (two million five hundred thousand), for each depositor to each insured bank, from ALL 700.000 (seven hundred thousand) it was before. Based on the Albanian Deposit Insurance Agency information the impact of this amendment brought the number of the fully covered depositors, subject of this Law, to over 90% of the total number of depositors in the banking system.

As per end 2012, deposits amounted to ALL 991 billion, from ALL 924 billion in end 2011. This 7.3% growth is lower than in 2011, when customer deposits grew by 13%.

Even the performance of exchange rate against foreign currencies, especially against the Euro, has been a worrying sign regarding the deterioration of the borrower's financial conditions that have a loan in foreign currency. Therefore, deterioration in their capacity to repay the obligations related to loans obtained was an expectation not far from reality.

As mentioned above, even though in the last quarter of 2008, the Albanian banking market faced customer withdrawals of deposits, the liquidity indicators were not impacted significantly. During this period, the higher demand of the banking sector for short-term funding in domestic and foreign currency was met by the reduction of liquid investments, credit lines received from parent banks, as well as liquidity borrowed from Bank of Albania.

This high demand for short term funds, has limited the ability of the banking sector to lend to the economy. Indeed, referring to the Bank of Albania Annual reports the total loans grew by ALL 11.6 billion or 2 % in 2012 compared to ALL 75.3 billion, or about 15.3 % increase in 2011.

As a result of the liquidity situation in foreign currency, it is increased the dependence on the foreign credit lines, most of which obtained by parent banks. Despite the downward trend in the recent years, the share of liquid assets to the total assets of the banking sector continues to show high values. According to the data published by the Bank of Albania, at the end of 2008, the value of this indicator was 42.8 %, versus 49.8 % in late 2007. As at end of 2012, the ratio of liquid assets to short term liabilities stood at 36.7 %, from 33.1 % in 2011, above the minimum regulatory requirement.

According to the Bank of Albania annual report 2012, the deposits level remain the main source of financing and the most stable one, with a relatively low concentration at end-2012. Lek-denominated deposits have traditionally made up the largest share in customer deposits.

On the other hand, though parent-bank financing remains an important source for several banks, in 2012, the lines of credit dropped substantially on a year earlier. They accounted for about ALL 49 billion at end 2012, from ALL 63.4 billion a year earlier. According to the Supervision Annual Report 2012, from the prudential point of view, the lower use of credit lines from parent banks is considered a positive development. Banks can thus lower their exposure to a given source of funds and increase their reliance on stable funding sources, such as customer deposits.

Even though it seems that the level of the liquidity indicators is decreased, such a decrease is related with the entering into force of the new regulation "On liquidity risk management".

As mentioned in the first part above, the regulation introduced for the first time, beside other things, regulatory and more conservative limits for liquidity risk measurement purposes. According to the regulation the new regulatory limits are 20 % in total and 15 % calculated separately for local and foreign currency. About 55 % of the total liquid assets of the Albanian banking system are compounded by the Albanian Government securities, followed by transactions with financial institutions in the form of current accounts, placements or lending (31 %) etc..

Based on the above information, it seems that the situation in the Albanian banking system from the liquidity risk point of view is quite stable. The banking system is liquid and the liquidity indicators values are far from the regulatory limits set by regulation. On the other hand, the public confidence is more and more increased, reflected in the deposits base increase from 2009 and later.

Conclusion

The crisis of confidence that covered financial markets during 2008 caused a deep lack of liquidity in the financial markets, dried up the sources of financing of the banks and had a tremendous impact on those banks which relied for funding on the money market. The increased perception of risk between parties in the market led financial institutions to be more responsible and cautious. A lot of financial institutions faced difficulties in repaying their short term obligations.

Central banks in developed countries adopted several programs to ease the situation. They consisted of injecting liquidity into the market through repurchase agreements with extended terms, expanding the types and maturity of securities serving as collateral etc.

Considering liquidity risk as one of the two most relevant risks in the Albanian banking system, Bank of Albania approved a new regulation on liquidity risk management, by providing for the first time quantitative and qualitative requirements for banks in the Albanian environment.

Bank of Albania, through its regulatory framework, has set all the necessary prudential standards for the banks to be followed. With this regard, the main objective of liquidity risk assessment is to assure whether the banks have installed a control system, which can identify, measure, monitor and manage liquidity. On the other hand, from the regulatory perspective, liquidity risk assessment should be made in accordance with the standards set by the Basel Committee on Banking Supervision.

Identifying liquidity risk and its monitoring are two important steps. The control system of liquidity risk management should be efficient and accurate in order to reflect the current situation of the institution.

Psychological factor is very important to consider, due to public awareness on the financial developments in the country. It seems this is overpassed in the Albanian banking system, thanks to the supervisory measures and strong supervision of Bank of Albania, as well as to the changes in the deposit insurance law by increasing the level of insured deposits.

The crisis has provided many valuable lessons to different countries in the world, starting with the regulatory framework changes and adapting to the new environment created in the market.

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