

## The Management of Credit Risk in the Banking System during a Period of 5 Years (2009-2014)

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### Abstract

The discussion about risk management in the banking system, we should to understand that the goal of banks is to take over the risk and the goal of surveillance is not to eliminate or reduce takes over the risk. Instead, the goal of surveillance is to participate and lead the risk management process. The agreements of Basel have more influence, this agreements are often very detailed and technically easily accessible by policy makers or researchers interested. This article to fill this gap try to detail the origin, regulation, implementation, reviews and results of Basel I and Basel II as well as the transition to Basel III. The main questions of this paper are: (1) What were the reasons for international cooperation for effective supervision, so why was created Basel I? (2) Where are the problems of Basel I and why we passed to Basel II? (3) The transition to Basel III. Does Basel III justify high costs of implementation of this agreement?

**Keywords:** Banking credit risk, Basel I + II + III, Supervisors, Banking system

### 1. Introduction

Banking financial risk<sup>1</sup> is perceived and conceived as a negative impact on the profitability of the bank due to some uncertainties with financial character. Though young, the financial market in our country has already first experiences related to the financial risk. Pyramid schemes, significant devaluation of vouchers privatization and exchange rate fluctuations were the first phenomena, which made us aware that in addition to the hoped return rate of investment, there is also an important element: The risk of losing one part or the entire investment.

Based on the terminology, the risk of loss is called "risk" and according to JORIO it comes from Latin and was used for the first time by the ancient mariners who sailed near the Mediterranean coast and beware of the parts of the rock "risk" that threaten to harm or to sink their ship. The event is defined as "Risk Management"<sup>2</sup>, which includes in itself a series of stages, starting with the recognition and classification of risk, to measuring and reporting beyond their control and management. Risk management profession has experienced a qualitative development in the last decade, which has brought with it a new dimension of the terms and the introduction of new methodologies.

Classifications and definitions most commonly used are those of RiskMetrics Group, one of the leaders in the field of risk management and financial risk management manual published for the first time by GARP which is comprised of the most prominent managers of banking risk.

In the regulation classification of the Bank of Albania<sup>3</sup> "On internal control in banks and branches of foreign banks", there are identified nine types of risks: credit, liquidity, market, interest rates, exchange rates, operational, the disregard of rules, strategic and reputational risk. In this regulation, the first seven risks are considered directly and the last two indirectly. So one of the main and important risks, is credit risk.

### 2. Credit risk

Credit risk or risk of failure is the main risk for the importance and size of the losses that causes the bank. Credit risk is the risk that the borrower fail to meet its obligations to serve the debt taken. Failure leads to loss of partial or total data

<sup>1</sup> Risk Management [www.adb.org/documents/reports/consultant/.../42096-reg-tacr.pdf](http://www.adb.org/documents/reports/consultant/.../42096-reg-tacr.pdf)

<sup>2</sup> Risk Management [www.rabobank.com/ir](http://www.rabobank.com/ir)

<sup>3</sup> Risk Management Guidelines for Commercial Banks & DFIs [www.sbp.org.pk/riskmgm.pdf](http://www.sbp.org.pk/riskmgm.pdf)

amounts owed. But also credit risk is the risk of deteriorating financial position of the borrower. Failure deterioration is not in the true sense of the word but greatly increases the probability of failure. Credit risk in banks is divided into:

- Risk banking loan portfolio.
- Risk commercial loan portfolio.

*Credit risk<sup>4</sup> is defined simply as the possibility that a borrower of a bank will fail to discharge its obligations to the bank under the terms set in the contract jointly between the two sides.* The goal of credit risk management is to maximize the rate of return to the bank to adjust the risk, taking a credit risk exposure to acceptable parameters. Banks need to manage overall credit risk that has to do with their own nature as a whole as institutions that accept deposits and make loans, that includes their portfolio, and also special credit risk.

The main directions in which banks need support to achieve the necessary results in credit risk management<sup>5</sup> are:

1. *Creation of an enabling environment to protect against credit risk.*
2. *Maintaining a stable lending activity.*
3. *Creating a continuous process and adequate credit management, risk measurement and monitoring.*
4. *Ensuring appropriate and sufficient controls on credit risk.*

It is widely accepted that the business performance of the credit in the bank is the basic factor of success or failure of the bank. Savings bank cessation of lending at the beginning of 1998 is an exception to this general rule.

### 2.1 The tendency of increasing credit risk

Borrowing appetite has become a global goal for the world economy. Besides the number of borrowers that is increasing nowadays, government debt are part of the expansion of credit. In some countries like Singapore and Israel government credit plays an important role in the economy. Another trend in developed countries and developing countries is the privatization. Traditionally infrastructure projects such as construction of roads, bridges, etc. are funded by the state.

Many things are being changed nowadays. For example in the United Kingdom many important projects even those dealing with protection activities are performed by private business under the auspices of "Private Finance Initiative". Credit risk, as the risk of fully default or partial credit, is not only the oldest form of financial risk but also a serious challenge for the economy, banking and financial business.

## 3. Banking risk and the treatment of Basel

Basel agreement<sup>6</sup> is one of the most influential agreements and worst treated in the modern international finance sector. Forgotten since in 1988 until 2004, Basel I and II have led to a new era of international banking cooperation. Through quantitative and technical standards, both agreements have helped in the harmonization of banking monitoring processes, regulation and capital adequacy standards among the 11 countries of the Group of Basel and many other emerging economies.

On the other hand the real strength of two agreements - quantitative focus and techno- limits understanding of these two agreements within political circles, causing misinterpretation and misuse in many of the economies of the world.

### 3.1 Basel I (Basel Capital Accord)

In the mid 80s, as a result of fierce competition, many of the largest banks in the world suffered a dramatic decline in the capital ratio, so the Basel Committee<sup>7</sup> was forced to act by issuing recommendations regarding the capital adequacy. Consequently, in 1988 it was created the Basel Capital Agreement, which later became known as Basel I, which was originally applied to the G - 10 countries. This system was a milestone in terms of harmonization at the international level for regulatory capital requirements.

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<sup>4</sup> Risk Management Guidelines for Commercial Banks & DFIs [www.sbp.org.pk/riskmgm.pdf](http://www.sbp.org.pk/riskmgm.pdf)

<sup>5</sup> Risk Management Guidelines for Commercial Banks & DFIs [www.sbp.org.pk/riskmgm.pdf](http://www.sbp.org.pk/riskmgm.pdf)

<sup>6</sup> Balin ,Bryan J.Basel I,Basel II,and Emerging Markets:A Nontechnical Analysis.Washington DC,USA:The Johns Hopkins University School of Advanced International Studies (SAIS),May 2010

<sup>7</sup> Basel Committee on Banking Supervision,Recognizing the risk-mitigating impact of insurance in operational risk modeling.Oct.2010,[www.bis.org](http://www.bis.org)

Shortly after Basel I, its flaws become more visible, especially that regulatory capital reflects not enough the risk. The main problems of Basel I can be summarized as follows:

- 1) insufficient differentiation of credit risk
- 2) limited recognition of collateral
- 3) Failure to consider the operational risks and requirements for disclosure
- 4) etc.

Finally, Basel I is focused on the risk at the institutional level and not on the system risk.

### 3.2 Access to Basel II

In June 1999, the Basel Committee on Banking Supervision<sup>8</sup>, began the process of replacing 11-year agreement with a broader context and naturally most updated and published the First Consultation Document. The new most important part of this document was the presentation for the first time of a capital requirement for "new risks", except that of credit. The obvious shortcomings of the first accord, prompted the Basel Committee to apply the methodology of risk-based regulations considering operational and credit risk.

### 3.3 Basel II

The basic feature of Basel II is the connection of banking supervision and risk management by banks. Because of this connection, the new framework provides clear and stronger incentives for banks to provide risk management systems and the use of instruments and modern techniques of risk management. In the center of Basel II process is the notion of regulatory treatment of individual banks, which exhibit risk. This means that high risk banks must hold a higher capital level and perhaps, should be subjected to prudential supervision.

### 3.4 The implementation and current status

Some of the basic news brought Basel II are as follows:

- 1) A system with more weight to risk sensitivity for determining regulatory capital calculations, based on the bank's own measure of risk
- 2) An extensive introduction of emollient credit risk instruments
- 3) More capital for operational risk
- 4) A wider role for supervisory authorities
- 5) Detection / contemporary publication of the data and methodology used by the bank.

The main purpose of financial regulation is financial stability, which means the early prevention of excessive risk of the system and further episodes of system risk. But Basel II fails in the pursuit of this goal, ignoring the risk of liquidity, which is the most systematic by risk categories.

### 3.5 Towards Basel III

In November of 2010, banking regulators concluded an agreement which aims to show how strong should be the banks. The agreement, known as "Basel III", as it is the third version of these rules will have a major effect on the financial system and the world economy.

The banking industry argues that Basel III<sup>9</sup> will seriously damage the economy. For example, the Institute of International Finance estimated that the economies of the United States and Europe will be increased 3% after 5 years compared with those economies if Basel III is not adopted. But there are others who think that these costs will not be at such a level and even be compensated by gains on security.

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<sup>8</sup> Basel Committee (2002). Basel Committee reaches agreement on New Capital Accord issues. Basel Committee on Banking Supervision, 10 July 2002 edition

<sup>9</sup> Asgerir Jonsson: Banka Kaupthing. [www.riskresearch.org](http://www.riskresearch.org)

### 3.6 Proposed changes

The core of Basel rules shows that the level of capital needed depends mainly on the risk assets of banks. Given that the capital is to hedge against risk, it is clear that more is needed when the bank takes big risks. The attention is focused on assets because generally obligations are recognized as correctly imposed for the fact that a deposit or a bond must be paid under the terms of the contract. Unlike bank liabilities, its assets may decline, or can rise in value. In addition, the loans cannot be paid and the securities may fail or may be required to sell at a time when their market values have fallen. The financial crisis brought to light a number of areas of weakness of the rules of Basel II.

These problems<sup>10</sup> led to many changes proposed under Basel III, including the following changes:

- 1) Higher capital reports. Advisory document does not specify numbers, but made clear that the minimum capital received in Pillar 1 and Pillar 2 will increase. This will have considerable effects. After Basel III agreement we can conclude that:
  - Basel II: Under Basel II, banks are currently required to have a capital rate of the first category 4%, with 2% of the core capital ratio of the first category. The difference between the total capital and first capital category results in the capital of the second category.
  - Basel III: Under Basel III, the rate of capital Pillar 1 is located 6% with a 4.5% core capital. The implementation will begin in the year when the core capital will increase by 2% to 4.5%, curbing announced in July to reduce the taxes and utility rights of "mortgage" in the first category of capital will give its full effect in January 2018.
- 2) Using the leverage ratio as a security tool. The crisis highlighted the problems of calculating risk-weighted assets, which directly, are based on past experience, in the case of the estimates used by big banks, or indirectly, in the case of risk weights set by Basel Committee. The value of many assets fell more and more quickly than was suggested by past the experience. In some cases, even to the fact that there was no qualitative data for a number of years only reflecting favorable market conditions encountered in recent times. In this context, the Basel III rules proposed inclusion of a lever ratio as an additional test for capital adequacy, thus serving as a "safety net" to protect against problems with risk weights.
- 3) Tougher risk weights for trading assets. Another problem occurred as a result of the crisis was that risk weights for trading assets were set too low, again based on the history of the town with favorable market conditions. This was due to a number of changes that were taken into consideration for Basel III. It looks like capital requirements in these areas have doubled, on average, compared with the old methodology.
- 4) The exclusion of certain items from equity balance. Following the same logic, the Basel Committee decided that some balance sheet items should be excluded from capital as they are not able to absorb the loss actually during the crisis. "Interests minority" would also not be considered as capital items. In addition another category is "deferred tax assets" which represents a value of past losses, since it depends on future profits, it was decided to exempt from Basel III.
- 5) Capital requirements<sup>11</sup> against - cyclical. Basel III also suggested that capital requirements should be higher in good times and somewhat lower in hard times. This would achieve the goal of "going in opposition to the wind", the slowdown in banking when he walks quickly and lending encouragement in difficult times. Yet it is not clear how to apply something like this and the level of freedom that will have national regulators.

## 4. Implementation and possible effects of Basel III

The implementation of Basel III by the end of 2012, it seems clear that there will be transitional periods and observation periods for several important requirements. There are many disputes about the effects that will have Basel III. It seems that everyone accepts that the banks and the financial system will be more secure after these changes, but it would have cost as slowing economic growth for many years as a result of higher costs of lending. However, the degree of impact cannot yet be said with certainty. This is a very big impact and leaders of the G - 20 probably would object Basel III if they believe these figures.

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<sup>10</sup> Montes-Negret, Fernando .Risk Management Challenges .The World Bank. Tirane , April 2010

<sup>11</sup> Wikipedia.org/wiki/Basel III,http://www.iif.com,http://www.pwc.com

## 5. Conclusions

Currently in Albania there is a situation where the credit risk for banks is still in progress and controllable. One reason why credit risk still cannot be considered very serious in Albania is that the banks in our country yet can be called new.

Banks in Albania generally do not have a proper system for risk management. They are used those methods used in the bank, but also new modern methods. One of the traditional methods is to estimate the "gap" interests (for calculation of the percentage risk of interest rates), the measurement of exchange rate risk by the method of "Value at Risk". More or less, the same is being implemented for credit risk.

Regulatory requirements of the Bank of Albania can be considered conservative, given the level of provision of credit, regulatory capital requirement (10% versus 8% in other countries) or the level of reserve requirement. However, these requirements have not yet been an obstacle to the development of the banks, because we are dealing with a banking system in the first steps of its development. So the level of risk assumed is still low.

There are required investments in technology, which are very expensive. To provide a risk management system should be spend, at least a million dollars. This is a costly process, but also necessary.

Measurement and management of credit risk is certainly one of the challenges relative to the banking system in our country. In recent years we have witnessed a substantial increase in lending by the banks. But in terms of a smaller market and less access to major financial markets credit risk accompanied as usual with liquidity can result to be significantly above what the bank are reported nowadays. Creating a database on borrowers is a necessity for our banking system.

Systems and procedures relating to credit risk should emphasize the following: (1) An analysis of the reliability of the borrower; (2) the evaluation of collateral; (3) the decision of granting the loan; and (4) systematization for analyzing and monitoring credit quality after approval. Using the techniques and tools of protection from credit risk is favorable.

Success in bank lending process depends not only on effective systems for measuring credit risk, but also the human potential support.

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