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Risk Management of Financial Instruments in the Banking System in Albania

Gazmend Nure, Freie University Berlin, Germany
https://orcid.org/0000-0003-2195-3444

ABSTRACT

Albanian banks and finance, following the changes from the communist to the capitalist systems, in their current form, are a relatively new industry. The banking industry is the most important segment of the Albanian financial system and therefore requires more attention when it is about financial analysis. This paper theoretically and analytically deals with a brief presentation of the banking industry in general and the explanation of the primary risks associated with financial instruments. It will also mention the key challenges facing the banking industry and growth prospects.

KEYWORDS

Derivatives, Financial Constraints, Financial Institutions, Interest Rate Risk, Risk Management

1. INTRODUCTION

Due to the difficulties that financial markets have experienced, more attention has been paid to issues related to the security and stability of the financial system as a whole, and in particular the banking sector. Limited risk management leaves financial institutions more exposed to shocks than they may be and is probably a major factor in financial crises, so measures for stricter oversight and greater caution during risk performance analysis have increased. of banks. The financial value of financial institutions is a key determinant of their risk management. There is a statistically and economically significant positive relationship between risk management and net worth in both institutions and within institutions over time.

Financial institutions play a key role in macroeconomics and in the transmission of monetary policy. (Gertler and Kiyotaki, 2010). Understanding their exposure to interest rate shocks and experience-seeking contexts is thus essential to monetary and macro-prudential policy (Kashyap and Stein 2000; Jiménez et al.,2012). A dynamic model where financing and risk management are subject to the same financial constraints, that is, promises to both funders and hedging parties must be collateralized, both requiring net worth (Rampini and Viswanathan, 2010). Therefore, a dynamic trade-off between lending and risk management: institutions Limited financial institutions must share their limited net worth between them. The cost of earlier borrowing or shortening the credit lines of more borrowers is higher at the limit of such institutions. In addition, institutions that provide more financial protection also provide operational protection. Derivatives in financial markets as financial

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instruments have been promoted as risk management tools for hedging purposes, but these instruments can also be used for speculation and arbitration.

Finally, we understand that it is the net worth of financial institutions, that is, their economic value, which determines their hedging policy more than their regulatory capital. The lending policy of financial institutions which engage in derivatives hedging is less sensitive to interest rate spikes than that of non-user institutions (Purnanandam 2007). Inaccurate bright derivatives, the risks of managing the required use of indevetrate, however, are giving greater appreciation, giving great value to the benefit and central role of financial institutions in macro-financial linkage. This paper contributes to a better understanding of this market by documenting new empirical regularities in the cross section and time dimension.

1.1 Coordinated Risk Management

Credit risk is one of the main risks to which the Albanian banking system has been exposed. During the last decades, the main share of loans has been actively active and the credit portfolio quality has deteriorated significantly, implying the growth of bad loans. Measurement and management Risk is an added value for analyzing its performance over time, in the context of a country's financial viability. Risk management provides the elements needed to respond to the complexity of risk monitoring. The current literature on risk management demonstrates situations in which variance reduction is an activity of maximum value. Thus, the need for risk management aim to give the banking institution the opportunity to better meet its objectives and successful implementation of strategies (Ciuhureanu 2005).

The concept of risk management consists in preventing and minimizing the occurrence of certain events and also in their system of identification, valuation and quantification. In contrast to the predictions based on the one-dimensional notion of risk described in existing models, we are able to explain the optimal risk - borrowing or hedging certain risks even for institutions trying to increase the total risk of the institution. There are three reasons that financial institutions offer a good opportunity to test coordinated risk management. When a financial institution lends, whether financed by deposits or other debt, it is exposed to two sources of risk: (1) credit risk representing unexpected changes in defaulting fees and (2) interest rate risk representing unexpected changes in interest rates. Credit risk represents a hedged risk that is not easily synthetic hedged. Interest rate risk represents a hedged risk because derivatives with relatively low base rate risk are available due to the fungal nature of the cost of money. (Catherine and Unal 1995). The overall growth of risk management using interest rate derivatives, however, releases significantly small, given the size of this market and the central role of financial institutions in macro-financial links.

The risk of compensation is potentially diverse, however, diversification decisions simultaneously affect all risks associated with the risk asset. Over-the-counter instruments are always available at a price, but the costs of free instruments include a premium for liquidity and default risk. Furthermore, transaction costs are generally higher than those for traded instruments because of the costs associated with negotiation and personalization. Derivatives traded on the exchange are not available to offset hedging as successful derivative contracts typically require a homogeneous one the underlying asset. Any decision that changes the financial institution's exposure to hedged risk simultaneously affects its exposure to hedge risk. This risk (hedge risk) can be hedged (or increased) with derivative instruments traded on the exchange. If the risky asset were to be divisible across its overall risk components, the firm would not seek hedge risk and would only opt for offsetting risk.

2. LITERATURE REVIEW

Arguably, the leading rationale for risk management is that,business subject to financial constraints are effectively risk averse.For financial institutions, Purnanandam (2007) shows that users of derivatives are larger than non-users and Ellul and Yerramilli (2013) construct a risk management index to measure