# *Bank risk management and Basel III*

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## *INTRODUCTION*

The Banking system in Albania represents a new system which is developed during the last 25 years (Meka and Kadareja, 2012) and has faced a rapid growth and changes since the last FGC in 2008 and latest digital tremendous boost. According to the Albanian Association of Banks (2012) the two-tier banking system in Albania was established in April 1992 and the first private Banks in Albania started to operate by the end of 1993. The state second tier bank under the name of Savings Bank was privatized by the Raiffeisen Group Zentralbank Österreich AG (RZB-Group) in 2004 finalizing a successful deal with a European notable banking group.
Albania has been considered as a developing country and still holds this status (World Population Review, 2020) because of a long transition period from dictatorship to democracy system manifesting unstable developing market, under which banks has faced a lot of challenges to adapt and maintain a soundness position and profitable results. Certainly, the latest changes and globalization have had their effects in the banking system in Albania, too, creating basis for regulatory authorities and rules establishment, adaption and implementation of new products and systems by the banks to meet customer needs and financial market restructuring.
So, Raiffeisen Bank Albania from an implementation of retail services with 19.6% of retail crediting services (280 million Euro) in banking sector by 2018 has raised to corporate and SME businesses services and integrated a successful digital system for online services with a notable increasing of 21% of individuals and 34% for micro entities holding the third position among 12 banking institutions after M&A processes in the banking market according to the latest Report of unaudited financial data of the first quarter of 2020 by the Albanian Association of Banks (14,9% of Total Assets).

## *Types of risks faced by Raiffeisen Bank Albania in the local market, how they have been managed during years.*

Financial sector in Albania plays a vital role in overall development functioning as a general motor for the progress of businesses and individuals through loans with an increase of credits to private sector and individuals by 8.8 times from 2004 to 2016, and an increase in bank assets that reach the value of 95 % of GDP, according to the latest report of Albanian Association of Banks (January, 2018) on Banking Sector Contribution in Albanian Economy and Society.
Crediting activity of banks in Albania represent the main factor in accelerating economic growth in last decade, but which actually is assessed to be under potential according to Bank of Albania (2018). The empirical assessments show that crediting is not any more efficient and this might come from the liquidity state of banks. A study of Suljoti et al. (2013) concludes that crediting standards by banks in Albania are becoming tighter because of the credit risk, market risk in individual sectors, bank capitalization and crediting lines by parent bank, since 90% of the banks operating in market are foreign-owned banks. In overall Albanian market manifests uncertainty and unstable development mostly because of unprofessional labour market evolution and economic growth.
In the last Financial Stability Report of Bank of Albania (2019, 2$^{nd}$ semi-annual), the main market risks emphasized are the exchange rate risk deriving from unprotected foreign currency loan segment. Other risks might come from low rate interests, which put under pressure the financial result of banks and creates impetus for changes on financing structure towards short-time assets and sources and the need for liquid assets. High dependency of accounts and transactions in foreign currency manifests hazard in administration of foreign currency liquidity risk. The Albanian market has always had a strong dependency and preferences for foreign currencies because of

remittances from emigrants and thus the local currency has the highest exchange rate comparing to the region according to Eurostat (April, 2020).

Based on the Decision of (Main) Bank of Albania No. 69, date 18.12.2014 For the Approval of Regulation “For Regulatory Capital of Bank”, which entered on force from 31.03.2015, Raiffeisen Bank has published Periodic Information on Risk for each quarterly period.

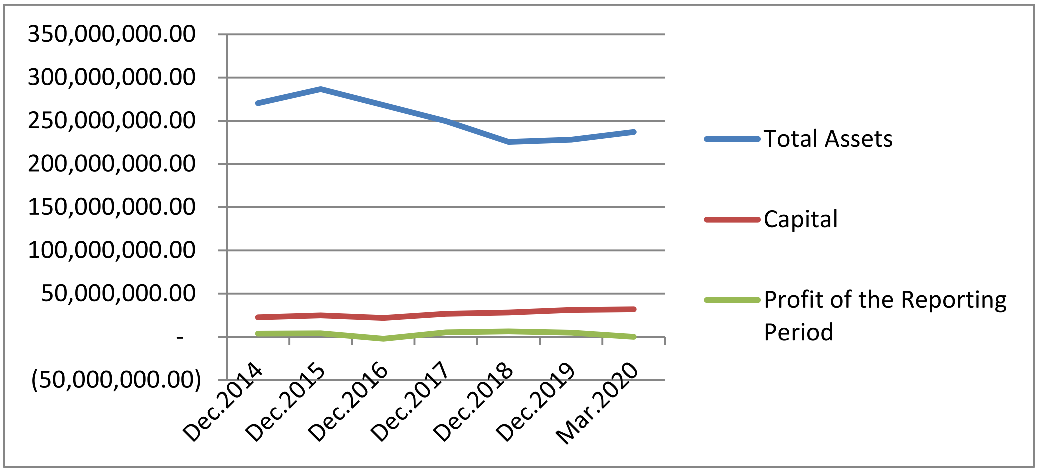


*Fig. 1 Financial Indicators of Raiffeisen Bank Albania Dec.2014 – March 2020 (Author)*

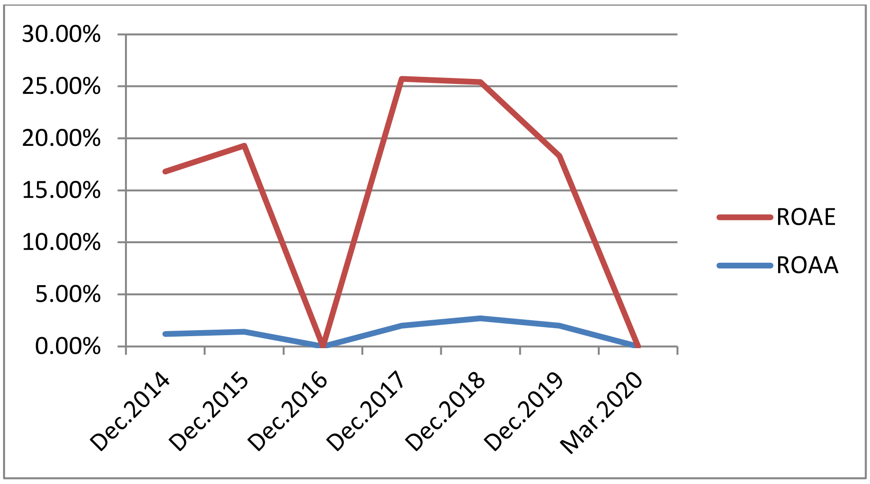


*Fig. 2 Rentability indicators of Raiffeisen Bank Albania Dec. 2014 – March 2020 (Author)*

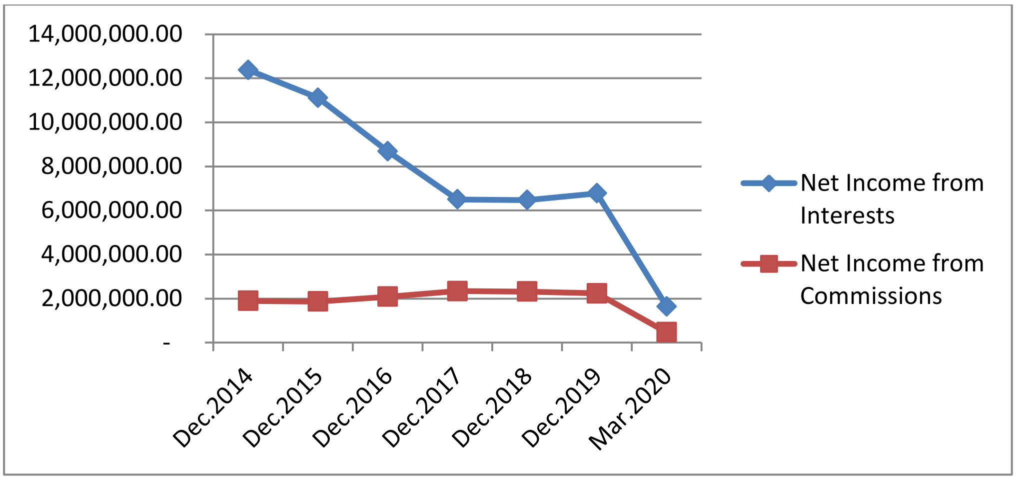


*Fig. 3 Income by category of Raiffeisen Bank Albania Dec. 2014 – March 2020 (Author)*

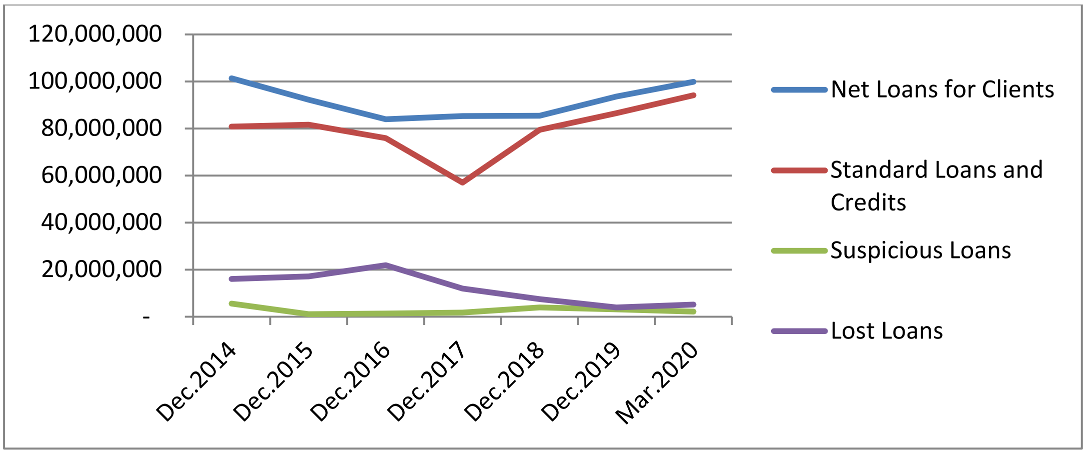


*Fig. 4 Loan amounts of Raiffeisen Bank Albania during Dec. 2014 – March 2020 (Author)*

The Albanian market, by surprise was not affected immediately by the GFC of 2008 because of the illegal markets and high level of corruption, but years later after reforms taken in justice and implementation of international standards and laws (such as Money Laundering Prevention, Income declaration and Control) constraints and money flow blocking appeared. The GFC of 2008 and the local effects appearing years later urged banks to fasten the crediting criteria and limit the amount of it.

As Bessis (2010, pg 5) state that mostly defaults on loan don't come right after inception, but in a later phase, when most of the amount is paid, it happened the same in Albanian market manifesting an increase in the "bad loans" figure as it is appeared in the Fig. 4 chart for the period of 2016-2017, especially for Raiffeisen Bank Albania.

Adaptation of Basel II regulation in the local legal framework by Bank of Albania has obliged the Banks to keep the standards and levels acquired for Capital adequacy and Liquidity percentages. Raiffeisen Bank Albania has assessed market risk and operational risk starting from the first report of 2015, while there is missing data for counterparty risk and risk of securitization.

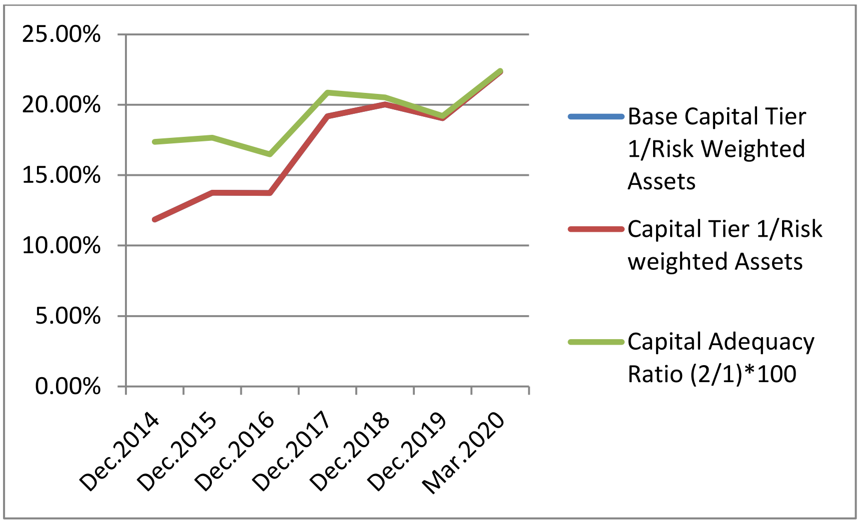


*Fig. 5 Capital Adequacy Ratio declared by Raiffeisen Bank Albania for the period of Dec. 2014 – March 2020 (Author)*

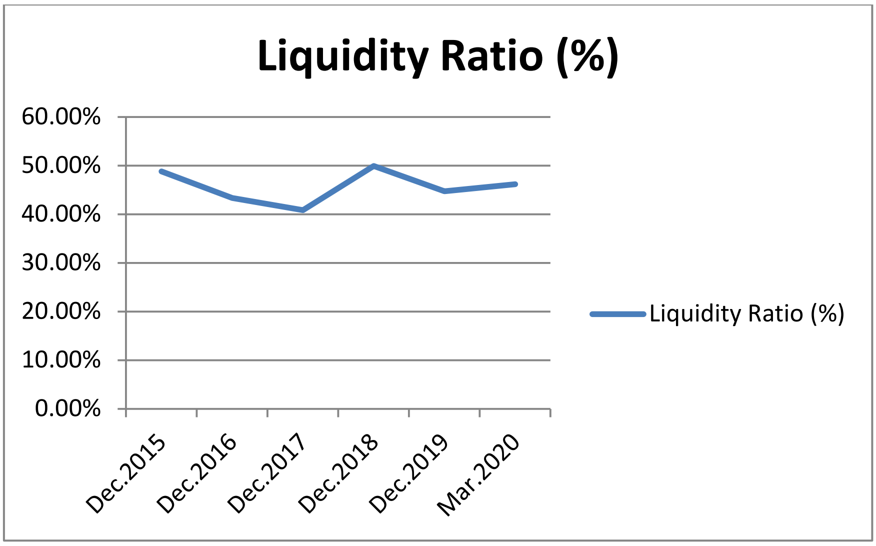


*Fig. 6 Liquidity Ratio declared by Raiffeisen Bank Albania for the period of Dec. 2015 – March 2020 (Author)*

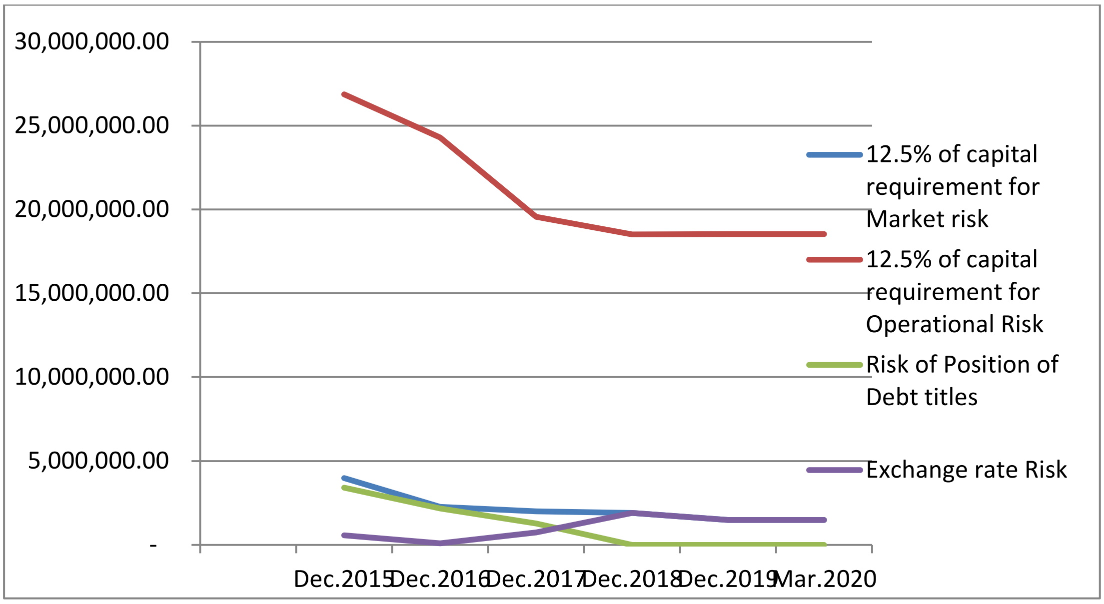


*Fig. 7 Risks assessed by Raiffeisen Bank Albania for the period of Dec. 2015 – March 2020 (Author)*

According to the last Annual Supervisory Report from Main Bank of Albania (2019, pp.40-45) the risks that local market delivers to banking system are: Market Risk; Operational Risk (indicating higher level from previous period because of increased gross losses) associated as well with robery of money in transportation in April 2019 of 3 banks, included high value from Raiffeisen Bank of Albania; Information Technology; and Reputation Risk.

While in its Periodic Risk Reports published on the website, Raiffeisen Bank Albania gives mostly information on capital ratio, liquidity ratio, market risk, exchange rate risk and operational risk. The bank declares that calculate monthly reserves funds based on two standards and regulations determined by Bank of Albania for Credit Risk management and International Financial Reporting Standards. So, according to IAS 39 and IFRS 9, the bank estimate two types of provisions: 1) Reserves fund for individual credit losses, and 2) Reserves fund for colective losses
In order to mitigate the credit risk, Raiffeisen Bank Albania uses several types of collateral, such as: financial collateral, real estates, receivable accounts, other physical collaterals, life insurances, guarantees. The Bank uses standard methods of calculating capital requirement for market risk and operational risk; risk of position for titles of debt calculated based on the method

of debt maturity; specific risk for debt titles calculated based on credit quality ratio; specific risk for trading book; concentration risk in the trading book; payment risk for the transactions DVP; exchange rate risk calculated in case the total net currency open position is higher than 2% of regulatory capital. For Operational risk, the bank uses Standard method for calculating the requests for capital and Risk Weighted Assets (Bank of Albania regulation, Act. 185, table 30), as well daily estimation, monitoring and report of Liquidity ratios.
The non-existence of a market for financial instruments issued in Albania forces the Raiffeisen Bank Albania to assess market risk based on judgments about future loss expectations, current economic conditions, risk characteristics of various financial instruments and other factors (RFAL, Periodic Risk Information – Q4 2019).

The financial data revealed by the FS of the bank show that the business risks have been inherent in the activity of bank, since there has been a significant decrease in asset values and reduction in the intrinsic value of bank from the data of FS 2012-2019. As well the risk management related to financial intermediaries has not been treated properly since the revenues from interests have had a significant decrease from 2014-2019 with 45%. In 2016, the Bank had a substantial loss and that was related with Losses from receivable accounts and expenses for reserves for suspicious accounts/loans, and that because of the default risk, which in fact had the origins from the initial years of banking sector in Albania with permissive crediting criteria and limits. The crediting upsurge of banks in their initial in Albanian market was combined with low quality credits (to high risk clients) and that is known that booming credits happen often in the developing countries, until the portfolios maturate and the bad credit rate gets unmanageable. As Kalluci (2018, p.86) states in her study, the increase of default risk in Albania might have been incurred from 2 situations: 1) exchange rate fluctuations since 50.3% of loans in currency were unprotected by exchange rate risk, and lead to unsolvency of borrowers, and 2) maturity period related to loans. Dushku (2018) remarks the correlation that the increased competition of banks related to loan market share has with the increased risk exposure of banks. Such situation explains the crediting sector in Albania, where for a population of 2,845,955 there have been operating in market a number of 17 banks by 2006 (Bank of Albania, 2020 Annual Supervisory Report of 2019. pp.71-72) and after challenges and M&A processes today are listed 12.
The Raiffeisen Bank Reports do not mention other risks that take importance in the latest market developments, such as: Cyber risk, considering the fact that the bank has increased the e-banking services and online applications; Reputational risk with the increasing sensibility of clients towards quality service, transparency and other security related issues. These issues must be addressed and go under a well-studied strategy and plan for assessment and management related risks.

## *How the regulatory relationship has influenced Raiffeisen Bank in Albania in risk management.*

Following the global progress and regulations to obtain the status of a European 'candidate', Albania has made a lot of progress and reforms in different sectors and regulatory framework to ensure a stable market for foreign investments, particularly. On the other hand, the international companies has put under pressure of international reporting standards the local framework and regulations. Adaption of the requirements of Basel I and Basel II in Albania started to be implemented later in years adjusted with the local market conditions and development, such as the minimal capital adequacy ratio resoluted in the level of 12%. Basel II was announced in 2004, but it took 10 years to be implemented in place, entering into force on 31 December 2014 with the Directives for capital request for credit risk, market risk and operational risk and the respective methods of assessment; obligation to create a proper assessment process for internal capital adequacy based in strategies for risks management (ICAAP), and requests for transparency. Chapter III of Regulatory framework implemented by Albania based on Basel II visualize the request for banks to assess the capital for the credit risk and counter-party credit risk according to Standard Method. For the first time, in regulatory framework is presented the concept of ECAI for credit risk rating and Titles.

The regulations approved by the Supervisory Board of Bank of Albania in years, concerning the Basel Requirements, published on its website are as follow:

- Regulation 27/2019 "For the ratio of liquidity coverage" effective from 01.03.2020

- Directive 60/2019 ''For Banks stress tests'' effective from 01.03.2020
- Directive 26/2017 ''For the internal assessment process of capital adequacy" effective from 31.12.2017
- Regulation 67/2015 ''For internal control system", integrated version, effective from 05.01.2018
- Regulation 69/2014 ''For regulatory capital'', integrated version, effective from 02.02.2019
- Regulation 10/2014 ''For the risk management of large banks exposures" integrated version, effective from 08.04.2020
- Regulation 48/2013 ''For capital adequacy ratio'', integrated version, effective from 01.06.2020
- Directive 33/2013 ''For interest rate risk management in trade book" effective from 08.07.2013
- Regulation 62/2011 ''For credit risk management from banks and branches of foreign banks" integrated version, effective from 28.05.2020
- Regulation 3/2011 ''For operational risk management" effective from 24.02.2011
- Regulation 48/2010 ''For open currency positions risk management" effective from 21.08.2010
- Regulation 71/2009 ''For liquidity risk management", integrated version, effective from 01.03.2018
- Regulation 44/2009 ''For money laundering and terrorism financing prevention", integrated version, effective from 08.01.2020
- Regulation 57/2007 ''For risk management in the activity of foreign banks branches", integrated version, effective from 01.10.2008

According to the Bank of Albania studies (2018), entries of foreign banks and new M&A banks increased competition in the banking sector, thus increasing financial intermediation and easement of crediting conditions as well a favorable economic climate in place. A higher rate of crediting has its costs and sooner or later it will present the respective risks, which in fact compromise the bigger risk for a bank since it is related with enourmous value. Kalluci (2018) notes that crediting enlargement in cases of considerable economic growth cause banks to take higher risks and if it happens that they are not well-diversified than it leads to a bank crash.
The Boom in banking sector and economic stability created a confidence and complacency in general, underestimating and turn a blind eye to procedures and risks related to default, exposure, etc. But, the pressure to adapt the international regulation and prevent crisis contagion has taken the governemental institutions to improve regulatory framework and increase supervisory role through new regulations and new supervisory boards. The Bank of Albania emphasizes that with the new developments there is a need for banks to undertake policies to improve costs efficiency, because empiric analysis evidence that banks with lower efficiency are less immune to the bank stability as well pursue controls on capital structure, since a higher ratio has a positive effect on banks stability.

## *With reference to both micro and macro prudential policy and regulation, critically analyse the impact of the Basel III Guidelines on this bank's risk management.*

The importance of financial market and its amplification in the micro and macro-economic environment of one country and globally are well observed through years (Andoni, 2015. pp. 15-18). Similarly, a sound economic growth wil be sustenanced by a robust and resilient banking system, as long as banks represent the main financing resource and are the centre of the credit intermediation process (Keefe and Pfleiderer, 2012).
Even though policymakers and governments have tried to anticipate different issues and scenarios and design provisions as well regulations to adjust in time deviations and deregulations, time has manifested that a persistent, stringent control and regulation must be taken to prevent losses and systemic risk. As Cabral stated in his article in 2013, financial international institutions and organizations had evaluated with favorable potential the economic prospect and financial stability in beginning of 2007, without considering of real importance the financial risks noted meantime. The financial reports of different banks by the end of 2006 disclosed pleasant figures of regulatory capital and buffers, liquid assets, mismatch disposal and risks calculations exceeding regulatory requirements disseminating confidence and certainty in risk management, but the crisis revealed the contrary (Bessis, 2010. pg. 8). Keefe and Pfleiderer (2012) note that

the onset of GFC brought to light the excessive off-balance sheet leverage, insufficient and poor capital, and liquidity of banks complying with the Basel requirements.
It was the shocking FGC and its contagion disaster of 2008 that highlighted the need of international restructuring of financial markets and revision of regulations aiming in strengthening capital requirements and liquidity standards with the new Basel Accord of 2010 known as Basel III. The new global regulatory framework's objective to provide more resilient banks and banking system is achieved through two goals: a) enhancement of capital adequacy and quality, and b) strengthening of liquidity standards (Berkowitz, 2011).
It is estimated that the Basel III impact will be spacious in the global economy with effects such as higher funding costs, decreasing of crediting amount, lower profitability in banking sector and higher implementation costs of new regulations, hence forcing banks to restructure and rethink of their strategies and business models (Stringa, 2012). Berkowitz (2011) emphasizes the above profound implications that Basel III will have for 'both sides of coin', banks and clients, too. In addition, the regulations will deepen the complexity of business sector.
The changes from new regulatory framework are evidenced as well in local banking system, relatively to Raiffeisen Bank which has faced a lower profit on 2019 comparing to previous period, lower revenues from interests, higher capital ratios and high liduidity ratios.
Albania has not yet included the standards of Basel III in its regulatory framework, but international banks operating in Albanian market have the pressure of following the parent-bank requests for reports with the same standards in order to avoid double reports and risk assessment. In fact, the Basel III capital ratio of 10.5% has been applying even higher (12%) in place, restricted by market conditions and growth, so it will not affect bank capital structure and meanwhile has provided the safety cushion for absorbing losses in financial stress periods. According to Bessis (2010, p.7), capital represents the foundation of regulation and the key for a strong credit standing and solvency of a bank. Basel III requirements may alterate a bank 'structural position' to prevent mismatch risk as well provide a pleasant profitability and liquidity. Liquidity issues are also planned to be secured with the countercyclic buffers (0%-2.5%) within capital ratio, thus eliminating the concern of new capital in disposal.

According to McKinsey (2010) Basel III will focus banking efforts, except the new ratios and risk management compliances, to balance-sheet restructuring and business-model adjustments to sustain the main objectives of profitability and survive in uncertain times. The latest global occurrence will soon deliver challenges to most of the financial market, which must be reconsidered and reformulated and additional interventions to be taken again.
As Ghosh (2012, pp.3-4) puts attention on the risks faced by banks such as business risks and control risks, the later take a significant role in mitigating the business risks, because the failure to control risks increases the loss if actions and adjustments are not taken in time to prevent them. Controlling can restrain the volume of business risk and proliferation of operational risk limiting the chances to fail, thus investing in effective internal controlling systems and processes will be a clever decision to banks.
As well noted by Bank of Albania, the control processes performed by Supervisory Board of Banks in different banks in place evidenced a lot of internal problems from the regulatory framework to the need of improving risk assessment reporting and internal processes and documentation. The immediate need for internal and external control processes and assessments rise for the moment when uncertain situations and unpredictable terms seem to come in 2020-2021. As mentioned by Ghosh (2012), the importance of control system detecting in time the irregularities is indisputable for preventing business risks.

## CONCLUSIONS

The Global Financial Crisis and the latest pandemic state showed that global financial market is vulnerable to risk exposure and that possibly new regulation and assessments must be considered. Banks complying Basel regulations appeared to be under-capitalized and unable to assess properly the risks of financial instruments during GFC, and currently the risks of default will still be impossible to quantify or new risks might show up because of the unprecedented global situation.

With the progress and new developments, it will not be far the day when Albania will be implementing the new regulations and guidelines related to financial market. For the moment, external and internal control processes are of high importance for the financial stability and banking sector. The regulations will keep a safer banking sector, but will increase the cost of implementation and increase lack of transparency from the part of banks.

New adjustments and regulations must be adapted related to Basel III, in order to offer the foreign bank branches operating in place to avoid double standards implementation and report. As well the definitions and models of Basel III will improve the risk assessments and thus models and strategies to mitigate such risks.

It is substantial for banks, especially Raiffeisen Bank Albania, which has increased the online services to consider new types of risks that come from the new model business and strategy, going under evolution conditioned by economic development, such as: model, cybersecurity and contagion risks. Immeasurable losses may result of a cyber attack and such issue is being discussed globally as the next ‘Modern Warfare’. The need for operational risk management may be exigent, in order to mitigate reputational risk which comes because of increased social sensitivity and awareness. Simultaneously, Basel III regulations create incentives related to enhancement of operational processes because of increased costs and controls, according to Andoni (2015). Related to market conditions, Raiffeisen Bank Albania must focus its efforts in assessing properly and managing risks related to interest rates, exchange rate and cyber risk, which can generate certain potential losses in business activity.

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