THE ROLE OF THE BANKING SYSTEM IN MARKET RISK MANAGEMENT

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Abstract. During their activity, commercial banks are constantly faced with different types and groups of risks, some of which accompany banks throughout their lives and some others appear temporarily, only in certain moments and circumstances. For a bank, high risk exposure often means a greater chance of losing money. The history of the banking system is replete with cases where banks, even if financially strong, have found themselves in the face of difficulties and have even risked bankruptcy due to poor risk management.

Today, in the conditions of an increasingly competitive environment, the problem of risk management is considered of vital importance for every bank. This paper focuses precisely on market risk management. It describes the main methods used by banks to analyze this risk, policies and strategies that design them for a more effective management of the main problems that arise to them during this process. The paper is treated in two planes: first in a general theoretical plan, which describes how banks operate in the world and second in a somewhat more concrete plan, regarding the policies, methods and rules followed by banks operating in our country..

Keywords: banking system, market risk, management, analyse.

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Introduction

By market risk we mean the risk of losing a position in the off-balance sheet as a result of price changes in the financial market. Unlike the usual credit risk, the risk faced by banks does not result from the non-appearance of the issuer or seller of the financial instrument. It belongs to the category of speculative risk, where price fluctuations can result in losses or gains. This risk appears not only due to market changes, but also due to actions taken by traders, who can accept or avoid these risks. The bank's growing exposure to market risk has come as a result of the change in the trend of this business, from the traditional function of intermediation, to trading and investing in financial products. These provide a greater potential for capital gain, but expose the bank to a higher risk.

Market risk results from changes in:

a) the price of the instruments'value

b) the price of amenities,

c) income derived from the instruments (interest rate)

d) price (exchange rate) of currencies.

Therefore, the main components of this risk are:

1. value risk
2. the risk of amenities
3. interest rate risk
4. currency risk.

Each component of risk includes a general aspect of risk and a specific aspect of risk, which begins in the specific structure of a bank's portfolio.

Market risk accompanies not only standard instruments, but in particular derivative instruments (derivatives) such as options, value derivatives, currency derivatives, interest rate derivatives, etc

The price volatility of many assets held in the tradable and investment portfolio is often very significant. It also exists in mature markets, however it is much higher in emerging or liquid markets. The presence of large institutional investors, such as pension funds, insurance companies or investment funds, has also had a major impact on market structure and market risk. Institutional investors regulate their large investments and trading portfolio by trading at a high rate: in rising price markets, high buying tends to push prices up, on the contrary, downward markets become more fluctuating when large packages of financial instruments are sold by these institutional investors. Eventually, this leads to an expansion of the amplitude of the price change and consequently to an increase in market risk.

Literature Review

Market risk is the risk of loss that arises as a result of opposite developments in market price fluctuations, which may appear in interest rates, foreign exchange markets, stocks and commodities. It is caused as a result of commercial activities and management of the bank's Assets / Liabilities. Furthermore, market risk may arise from other positions taken by the bank, such as in the trading portfolio.

By its very nature, market risk requires a great deal of attention during management, as well as performing appropriate analyzes. A prudent manager should be fully aware of how closely related a bank's market risk exposure is to its equity. Aware of the growing exposure of this exposure and of benefiting from disciplines that normally impose capital requirements, in January 1996 the Basel Committee amended the 1988 Capital Agreement by imposing specific capital additions to market risk. These capital risk standards for the market were implemented by the G 10 countries at the end of 1997.

Methods

At the bank, the organization of the investment, trading and risk management function should follow a more or less standardized form. Necessary projections and quantitative and qualitative analyzes of the economy, including all economic sectors of interest to a bank, and the money and capital markets, are carried out internally by economists and financial analysts and externally by market experts and industry. This information is communicated to the bank through the reports and brochures of analysts, who are responsible for government securities or for a group of securities in one or more sectors of the economy. If a bank has a large trading or investment portfolio, then traders / analysts of these securities groups can report to a portfolio manager who is responsible for certain types of securities. Operational responsibility for managing a bank's trading and investment portfolio rests primarily with the investment committee or treasury group.

Results

Market risk management policies should reflect in particular the bank's objectives as well as related policy directives, designed to protect capital from the negative impact of adverse market price movements. Policy lines must be drafted within the limits set by the applicable legal and political framework. While market risk policies may vary from bank to bank, some types of policies are present in all banks. These include:

Market valuation.

This refers to the valuation of a bank's portfolio to reflect changes in asset prices, which have come as a result of fluctuations in market prices. This policy allows assets to be revalued at their current market price (accounting policies may require that these assets be

presented at a lower cost or at market value). The volume and nature of the activities in which a bank engages generally determine the density of the revaluation process. For a bank, it is considered appropriate to evaluate and revaluate positions related to its investment portfolio, at least on a monthly basis. Whereas, regarding the activities of the tradable portfolio, since they are sold and bought on a continuous basis, it is necessary for the bank to evaluate the market at least once a day. The reports prepared during this process should be sent for review to the bank's senior managers, who are responsible for the bank's investments.

For assets / liabilities and risk management.

Other issues that need to be included in the market valuation policy are valuation responsibility and the methods used by the bank to determine the new market price for an asset. Some jurisdictions have sanctioned in more detail legal arrangements that specifically cover the process of valuing a bank's assets by market. The Bank should consistently obtain the latest price and use this information from external sources when revaluing its investment portfolio assets.

Position limits.

A market risk management policy should set limits on long-term, short-term and net position, taking into account the liquidity risk that may arise from the execution of outstanding transactions such as open contracts or buy and sell commitments. securities (for example, option contracts or repurchase agreements). Long position means the position in the purchase of a security, while the short position (Short), means the position in its sale. The difference between a long and a short position in a certain title, constitutes the net position of this title. The net position can be in buying (when long position> short position), it can be for sale (long position <short position) or zero (long position = short position).

Banks, especially those with a large investment and / or trading portfolio, often set limits on the positions held by securities dealers / traders operating on the stock exchange on behalf of the bank. The establishment of these boundaries is related to various factors, including the specific organization of investment and trading functions and the level of technical skills of "traders" and "dealers". The level of sophistication and quality of analytical support provided to dealers can often play as important a role as the specific characteristics of a bank's tradable and investment portfolio. Or the level and quality of its capital. This indicates the limits of its control.

Provisions for loss prevention.

Market risk management policy should also include taking measures to prevent losses from various positions in securities. These measures relate to predetermined limits of exposure to loss. These limits should be set in accordance with the capital structure of a bank and its profit trend, as well as in accordance with the overall risk profile. When losses in bank positions reach unacceptable levels, ie exceed the set limits, these positions should be closed automatically or consultations with risk managers and the assets / liabilities committee should be initiated to review or confirm the loss prevention strategy.

Concentration.

It involves holding a large number of securities of a single issuer or affiliated group of issuers, or holding securities in the same market, region or economic sector. Concentration increases price risk directly or because of the higher transaction cost (transaction cost increases when the amount of securities to be bought or sold, at a given point in time, is so large that it affects the price market equilibrium). A bank's investment and trading policies should normally set boundaries regarding different concentrations. Counterparty boundaries are also included in this category, which are often set to avoid overexposure to market

participants. A prudent bank should have these limits in the piazza, in case the process of placing them in the respective place takes time or is of a risky nature. If a bank decides to adopt a liberal concentration policy, it should be regularly monitored and reviewed by a relatively high level of management.

Limits to new market presence.

New financial products or as they are otherwise called new market presence, provide profits that are much higher than those of standard instruments. In a highly competitive market environment, these products put pressure on competitors to enter new businesses in order to gain more or not lose a market advantage. However, these new products involve a special risk undertaking, which means that a bank is willing to invest or trade in a new instrument even though its return and variance have not yet been tested in the market, or suitable market may not yet exist.

A bank should have risk management policies that describe its presence in emerging markets. Limits associated with new market presence need to be reviewed and adjusted from time to time. Since the rapid spread that initially occurs in new market segments attracts competitors, these markets can rise rapidly. Increasing the use of a new instrument also helps to increase the breadth and depth of secondary markets, as well as increasing their liquidity. Once a market stabilizes and has sufficient liquidity, the bank must restore it to applicable levels in mature markets.

Conclusion

The tendency of banks to extend their activity beyond the traditional financial intermediation activity has increased worldwide. More and more they are emerging as active participants in the financial markets through investing and trading in securities. Such an activity, properly managed, provides the bank with large profits, but at the same time exposes it to the so-called market risk.

- Market risk is the risk of losing positions in the off-balance sheet of a bank, as a result of unfavorable price fluctuations in the financial market. It is present whenever there are changes in: the price of financial instruments, interest rates, exchange rates and the price of "amenities". It follows that its main components are: 1. Securities price risk, 2. Interest rate risk, 3. Currency risk and 4. Commodity risk.
- It is important for the bank to properly analyze, measure, and manage this risk, in order to take advantage of favorable market price fluctuations and minimize its exposure to losses.
- The senior management levels of the bank should engage in the design of appropriate policies to achieve the most effective management of market risk. These policies are designed in line with the main objectives of the bank and are a reflection of its attitude towards risk in general. Although each bank may have its own specifics regarding market risk management, there are some moments that constitute the skeleton of an effective management and that is felt by almost all banks. These are: market valuation, positioning margins, loss prevention provisions, concentration, margins on new products in the market and credit risk assessment.
- In the context of market risk management, it is important for banks to pay due attention to the selection and management of their tradable and investment portfolio. In many countries the composition and size of the portfolio is subject to legal regulation, but within these general limits each bank can set its own specific limits.
- In our country, market risk management is even more in theoretical terms and few banks pay due attention. This is because, at the moment, the activity of investing and trading in securities still does not occupy a very important place in the life of Albanian

banks. The lack of a secondary market in the country makes their tradable portfolio very limited (Treasury Bills and Repo with the Bank of Albania) while the investment portfolio is poor.

- The bank's capital can be considered as a protection zone against losses related to market risk. Its calculation should be subject to legal regulations. Banks in our country determine the Request for Regulatory Capital for market risk coverage, based on the Regulation of the Bank of Albania.

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