Section 4. Finance, money circulation and credit

*Bezo Ardi, PhD candidate, lecturer,
Professional Business Academy, Tirana (Albania).*

E-mail: abezo@apb.edu.al

*Balili Lorena, PhD candidate, lecturer,
University of Tirana, Tirana (Albania).*

E-mail: lorena.balili@gmail.com

*Shehu Hidajet, Prof. PhD, Deputy Dean,
Agricultural University of Tirana (Albania).*

E-mail: hshehu@ubt.edu.al

Derivative contracts in commodity trading as a way to diversify the risk in case of Albania

Abstract: The use of derivative contracts has been spread worldwide due to its considerable benefits for the players in the market. The purpose of their creation was related to improving the efficiency of the system to bring economic benefits to their users. The main focus of this paper will be the possibility of using these derivative contracts in the oil commodity market in Albania, as an option to protect traders against from the exchange rate risk and price risk of buying wholesale items abroad.

Keywords: Derivatives contracts, Oil commodity, Commodity trading, Albania.

Introduction

Derivatives have a long history all around the world. A number of important changes in the global financial markets have strongly influenced the growth of derivative markets since the early 1970s. It can be said that during the last two decades, the use of derivative contracts is associated with a high number of events that affected corporate performance throughout the global financial markets. The trading of financial derivatives has received extensive attention and many authors have dealt with skepticism the use of these contracts in financial markets, playing an important role in stimulating the global financial collapse of large banks and corporations. We can mention the most critical that financial history has known in recent years, as the case of Barings Bank in 1995, Long-Term Capital Management in 1998, Enron in 2001, Lehman Brothers and American International Group (AIG) in 2008. The speed of their diffusion in financial markets is quite large, even in the current conditions of globalization their rate of expansion is expected to be even higher.

Based on these conditions and in past credit events which exposed many weaknesses in the organization of derivatives trading, the main challenges facing all coun-

tries is related to the design of new rules to minimize risk and to promote transparency. One of the major policy-makers challenges is to ensure that derivative transactions be traded properly and carefully supervised. Addressing the main constraints, the paper will serve as a theoretical instrument to further stimulate the use of these derivative contracts in Albanian oil market in defense of the main risks facing the market traders.

Derivative contracts: some basic concepts

Derivative contracts as a tool for risk management have an early origin, namely in the commodity markets. Later they were found useful as a hedging tool even in financial markets. Besides the different moment of their diffusion, the basic concept of a derivative contract remains the same whether the underlying happens to be a commodity or a financial asset. One of the most important elements that differentiate their use is that commodities require a special storage facility while financial assets do not needed to. Also an important issue to be managed is that in the case of commodities the quality of the asset underlying the contract can vary largely. While in the case of financial derivatives most of these contracts are cash settled and the underlying assets have similar qualities.

Primary assets are sometimes real assets (gold, oil, metals, land, machinery) and financial assets (bills, bonds, stocks, deposits, currencies). Financial asset markets deal with treasury bills, bonds, stocks and other claims on real assets. The owner of a primary asset has a direct claim on the benefits provided by an asset. Financial markets deal with primary assets and derivative assets. It can be said that derivative assets are assets whose values depend on (or are derived from) some primary assets. Also, derivative assets (positions in forwards, futures, options and swaps) derive values from changes in real assets or financial assets, and actually even other indices, for example temperature index. Derivatives represent indirect claims on real or financial underlying assets.

The main goals of the use of derivative contracts are related to hedging against fluctuations in exchange and interest rates, equity and commodity prices, as well as credit worthiness. Derivative contracts are widely used to speculate on future expectations or to reduce a security portfolio's risk. The most common positions held by participants in derivative markets are often classified as either "hedgers" or "speculators".

Derivative contracts are widely used to speculate on future expectations or to reduce a security portfolio's risk. Derivatives transactions are now common among a wide range of entities, including commercial banks, investment banks, central banks, fund managers, insurance companies and other non-financial corporations. Firms can use derivatives to hedge risk, but also derivatives bring additional benefits to the companies like minimizing earning volatilities or reduce tax liability (Stulz, 2005). The most common positions held by participants in derivative markets are often classified as either "hedgers" or "speculators". Hedgers take positions in financial derivatives to reduce their exposure against adverse changes in the values of their assets or liabilities. Many hedgers who maintain large portfolios of stocks or bonds take a futures position to hedge their risk. Speculators commonly attempts to profit by taking the opposite position and therefore serve as the counterparty on many futures transactions or by anticipating changes in market prices or rates or credit events. Based on the activity nature that speculators perform in derivative markets, it can be said that their operations are inherently more risky and should warrant close monitoring by financial regulators.

The most important types of derivatives:

This section discusses the basics concepts of four types of derivatives:

Forward Contract

A forward contract obliges its purchaser to buy a given amount of a specified asset at some stated time in the future at the forward price. Similarly, the seller of the contract is obliged to deliver the asset at the forward price. Non-delivery forwards (NDF) are settled at maturity and no delivery of primary assets is assumed.

Forward contracts are not traded on exchanges. They are over-the-counter (OTC) contracts. Forwards are privately negotiated between two parties and they are not liquid. Forward contracts are widely used in foreign exchange markets. The profit or loss from a forward contract depends on the difference between the forward price and the spot price of the asset on the day the forward contract matures. Forward contracts are settled only at maturity.

Futures Contracts

Futures contracts are created and traded on organized futures exchanges. Contracts are highly standardized in terms of the amount and type of the underlying asset involved and the available dates in which it can be delivered. The exchanges themselves provide assurances that contracts will be honored through clearinghouses. One of the primary roles of the Corporate Finance clearinghouse is to be the opposite party to all trades. Buyers and sellers of future contracts do not deal directly with each other but with a clearinghouse.

Options

An option is a derivative security that gives the buyer (holder) the right, but not the obligation, to buy or sell a specified quantity of a specified asset within a specified time period. An option contract differs from the futures contract in that the option contract gives the buyer the right, but not the obligation, to purchase or sell a security at a later date at a specified price. One way of creating options is through single contracts that are individually negotiated between parties, usually firms and their banks (OTC options). Organized option exchanges Corporate Finance provide the advantages of liquidity, low transaction costs, and safety through the standardization of the assets on which the contracts are based and of the contract sizes and maturity dates.

Swaps

Swaps are considered to be interest rate risk management tools because they give an efficient means of adjusting the interest rate exposure of a company's assets and liabilities. It should be noted that other financial instruments, such as exchange-traded interest rate futures and option contracts, are often capable of achieving the similar results. Swaps are long-term OTC instruments.

Some basics of commodity trading

Commodity markets came into focus in 1948 when the US increased uncertainty in trade between farmers and merchants. Just thought it was an important moment of the origins of the use of prior agreements between farmers and merchants. It's supposed to be this important moment of the beginning of the first use of agreements between farmers and merchants which was further refined in derivative contracts. The commodities' market was one of the first to begin the use of the derivatives as a hedging instrument (Chance, undated). Consequently, it can be found a lot of literature including studies of commodities derivatives. There are also several empirical evidence regarding the stock and currency derivatives market. In the past years this kind of instruments has been the most popular amongst the investors. In addition, we will not break away the importance of commodities derivatives provided especially in commodity trading, being the primary focus of our paper.

Virtually all agricultural, energy, and industrial commodities must undergo a variety of processes to transform them into things that we can actually consume. These transformations can be roughly grouped into three categories: transformations in space, transformations in time, and transformations in form.

Given that the place of commodity production and consumption are not connected, it shows that the time of commodity production and consumption is often unbound. This feature becomes more present for agricultural commodities, which in one side are often produced periodically (with a crop being harvested once a year for some commodities) but in the other side are consumed continuously throughout the year. Time discrepancies in production and consumption are present even in other products without being limited only to agricultural products. Commodity demand can also fluctuate due to macroeconomic events, such as extraordinary political events or financial crisis which cause a deterioration of the overall economy. For example, wells produce natural gas at a relatively steady rate over time, but there can be extreme fluctuations in the demand to consume gas due to random changes in the weather, with demand spiking during cold snaps and falling when winter weather turns unseasonably warm. In the other side, supply can also experience random changes, due to for example: a strike at a mine, or a hurricane that disrupts oil and gas production.

Derivative contracts approach in the near future commodity trading in Albania

Trying to expand the investigation about the topic, this research is focused on a specific derivatives market: oil commodity.

Trying to expand the investigation about the topic, this research is focused on a specific derivatives market: oil commodity. The vast majority of the Albanian market consists of trade. In trade sector are operating 42.7 percent of enterprises which make up 50.0 percent of net sales by all together companies. Inside trading companies, for some years on top list of most profitable companies are oil trading companies. As a result, is viewed with interest the possibility of using derivative contracts in this market, as an option to protect traders against from the exchange rate risk and price risk of buying wholesale items abroad. Our case study will focus on one of the largest distributor companies in Albania, "Kastrati group" being an elite company in the distribution of commodity oil in Albania and Kosovo. "Kastrati group" has a diversified investment portfolio almost even in alternative investment. We will take the case of one of its investments such as the trade of oil.

As all know oil prices are sensitive and exposed to the oil volatility of commodity prices, but also are exposed to foreign exchange rate risk during the trading time. Having such situations we try to convey through this theoretical study the use of derivative contracts to the possible potential investors. Albania is still a country with underdeveloped capital market, and therefore there is a very great lack of information regarding their use. Employees who are linked directly with the oil trading in the company have not yet know-how about the dimension uses of derivatives contracts. Supervisory authorities in our country still do not possess the necessary legislation to make available to potential investors these forms of contracts in order to protect against these risks giving rise to significant damage to high-value transactions.

Conclusions

Commodity trading are essentially in the business of transforming commodities in space (logistics), in time (storage), and in form (processing). Their basic function is to perform physical "arbitrages" which enhance value through these various transformations. Commodity trading firms provide various forms of financing and risk management services to their customers. Offering these services to customers exploits trading firms' expertise in merchandising and risk management, utilizes the information commodity trading firms have, and provides better incentives to customers and themselves. The private ownership model is well-adapted to traditional, "asset light" transformation activities, but as economic forces are leading to increasing investments in physical assets by all types of trading firms. Commodity trading firms exhibit considerable diversity in their in-

vestments in physical assets, with some firms being relatively asset intensive, and others being very asset light.

These firms or companies also exhibit diverse trends in asset intensity.

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*Veizi Zamira, University of Gjirokastra,
PhD Candidate in Finance
E-mail: veizizamira@yahoo.com*

The impact of credit risk management on the banking profitability: A Survey of the Theoretical and Empirical Literature

Abstract: Banks as financial intermediation institutions are defined as businesses that receive and manage various risks. Among numerous banking risks, credit risk is identified by most researchers as the greatest risk affecting the performance of the bank. On the other hand, banking sector profitability has received great attention in recent years. The purpose of this paper is to recognize us with theoretical and empirical literature about the relationship that exists between credit management risk and banking profitability indicators. The most studies in this field have concluded that credit risk management is the primary contributor on the profitability of commercial banks. But there are and those studies that have proved that the impact of credit risk management on banking profitability is negligible.

Keywords: credit risk management, banking profitability, indicators of profitability, indicators of management credit risk

1. Review of theoretical literature

1.1. Risk management in banks

The management of bank risks is the most important factor for financial stability and economic growth in the developed economies, Ferguson [1]. Van Gestel and Baensens [2] say that an appropriate procedure for risk management is the identification of risk, risk measurement and then developing strategies to manage risk. According to Adeusi et al [3], risk management issues in the banking sector have not significant impact only in the performance of the bank, but also in national economic growth and in the development of the business climate. Credit risk is considered as greater risk from all other risks affecting in the financial performance of a bank. Giesecke [4] said that the credit risk is the most important risk that are facing banks, where their success depends on accurate measurement and efficient management of this risk, in a greater extent than any other risk. Lopez [5] expressed that the credit risk is the risk of reducing of the value of the loan due to a change in the ability of borrowers to perform payment.

Chen and Pan [6] said that the credit risk is the degree of volatility of the value of debt instruments or their derivatives due to changes in the credit quality of borrowers and parties related to them. Hosna et al [7], stated that the credit risk is the most important risk that are facing commercial banks due to his connection with possible losses. According to Charles [8], risk management is essential for the survival of a bank and this enables the management to allocate resources for the risk units based on a compromise between risk and potential return. Banks that are primarily exposed to credit risk, result in the reduction of their profitability. Shelagh Heffernan [9] expressed that five main ways that a bank can minimize credit risk are: accurate determination of the price of credit, credit limits, the use of collateral, diversification of credit and "Securitisation" and/or the use of credit derivatives. Sinkey [10] singled out what he calls "**Five C**" to be used in a qualitative assessment of credit risk:

1. *Character:* A borrower is ready to repay the loan?
2. *Cash flow:* Has borrower reasonable liquidity?