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BANKING FIRM, LIQUIDITY DILEMMA AND THE WAYS OF ITS MANAGEMENT

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Abstract: Indirect financing is realized through many main financial methods and techniques. Among them, an important place is occupied by banking firms. It carries out the bulk of the indirect financing transactions. On the other hand, the monetary policy implementation mechanism is closely related to the functioning of the banking system. This is why in this paper we will analyze and focus our attention on banking firms as representatives of financial intermediaries and ways of managing the liquidity dilemma, a phenomenon everyway found in the banking system. To face this dilemma, there are several ways and techniques of managing it. Also, to better understand the functioning of the banking firm, we will first analyze a general instrument of control and management, which is the balance sheet of the firm. Then we will analyze the way the bank manages its assets and loans, two main activities on which the banking firm bases its activity.

Keywords: banking firm, liquidity dilemma, balance sheet, indirect financing

For the banker, the customer is not just a number,n an account surplus, a series of economic or financial transactions, but his most important wealth. He should be the center of attention of the banker, in order the bank well organize its activity.

I. Balance sheet and basic elements of a bank activity.

The balance sheet of a banking firm consists of two parts: assets and liabilities. Its main feature is the equalization of both sides of the balance sheet, as in the case with other economic firms.

Assets = Liabilities + Capital. This reconciliation means that if we deduct from the assets the liabilities of thefirm, we get the net assets of the bank or in other words its capital.

ASSETS	LIABILITIES
I. Fully liquid assets (primary reserves)	***I. Deposits***
A. Cash money	A. First accounts (notable)
1.Cash in national currency	1. Interest free accounts
2. Cash in foreign currency	2. Interest accounts
B. Deposits with the Central Bank	B. Accounts receivable
II. Accounts receivable (secondary reserves)	1. Saving deposits
A. Government security bills	2. Time saving deposits
1. Government	3. Monetary market deposit
2. Local entities	***II. Debts (Borrowings)***
B. Loans to other banks	A. Borrowings from the Central Bank
III. Other assets	B. Borrowings from the other banks
A. Deposits in other banks	C. Eurodollars
B. Interests to be collected	D. Long term debts
IV. Credits (Lendings)	***III. Other liabilities***
A. Bussines	A. Taxes to be paid
B. Mortgage	B. Interests to be paid
C. Personal	C. Reserves for credit losses
D. Agricultural	***IV. Capital***
V. Fixed assets	A. Paid-in capital
A. Buildings	B. Remaining profits
B. Equipment and Machinery	C. Provisions
C. Others (compensatory surplus)	D. others

Assets

I. Fully liquid assets or primary reserves. This includes all types of reserves held by the bank in its cash, as well as deposits with the Central Bank. Their specific weight that they occupy to the total assets of the bank is very small. In Albania, due to the tight monetary policy and the low effectiveness of the banking system, this item is about 14.5%. Although the reserve bank does not receive any interest, it holds a portion of its assets in this form for two reasons:

1. To supplement the reserves required by the regulatory authority, the Central Bank, according to a rate for each deposit unit, which are called required reserves. Currently, in our country a rate of 10% is applied for all types of deposits.

2. In case of direct withdrawal of deposits or payment of checks, to meet its liquidity needs, the bank also maintains excess reserves.

II. Liquid assets or secondary reserves. These constitute an important item of the bank's assets because they meet two important conditions

1. Bring income (interest is paid on them)

2. Being tradable in the secondary market, they have a high degree of liquidity, therefore they are called secondary reserves. In Albania this item reaches 50% of assets. In our country there is a feature which derives from the transition. Due to the initial level of development of the capital market, initially this item included the necessary financing of government debt by the bank, which has been high and has been declining after the transition to debt financing with treasury bills.This item includes interbank loans which are short-term loans (24 hours) to meet liquidity needs, they are liquid and represent one of the most useful ways to manage risk.

III. Other assets. Banks can also hold deposits in other banks. Mostly small banks hold deposits in large banks to provide certain services at low cost. Our banks hold deposits with foreign banks to provide customer service for international import transactions and as a profitable investment. In Albania this indicator reaches the figure of 21%, which is an indicator of the creditworthiness of the banking system.

IV. Loans are the main asset of the bank. In our country they occupy about 8.2% of the bank's assets. The low level of credit is based on the restrictive credit policy adopted by the Bank of Albania, as well as on the insufficient development of the banking system to finance the needs of the economy through credit.

Loans represent one of the traditional assets of commercial banks. Through them they provide the vast majority of profits, because the interest rates applied to them are higher compared to other assets. They have a higher degree of risk and a lower level of liquidity. They cannot be returned before maturity and depending on the economic situation of the entity receiving them, there is a degree of risk of non-return.

Bank liabilities

I. Deposits. They represent the main source of financial resources for the bank, occupying the main part of liabilities. In Albania they account for about 83% of total liabilities. Deposits are tangible and intangible.

The notable deposits represent bank accounts which entitle their holder to issue checks to third parties. These deposits can be interest-bearing first deposits and significant interest-bearing deposits such as NOW accounts and money market deposit accounts (MMDAs).

The mentioned deposits represent asource with low cost for the bank, because the depositors
give up interest to ensure high liquidity. Their cost includes both the low interest paid on some tangible deposits and the costs of the service such as filling and storing checks, preparing and sending the monthly notice, cashier payments, advertising costs, employee salaries, etc.

Non-refundable deposit accountsrepresent the main source of bank funds. Their main feature is that they bring high interest, but the issuance of checks is not allowed. These deposits are mainly presented as savings deposits and time deposits.

Savings deposits are the typical form of transferable deposits in which deposits can be made and withdrawn at any time. Withdrawal period can be from one day to one month, however the bank is interested in serving customers in the minimum possible time.

Term deposits have different maturities that can be monthly or several years and in case of early withdrawal, the bank penalizes the customer with debt interest.

II. Debts (Borrowings)

This item of liabilities represents the receipt of loans by the Central Bank in the form of discounted loans, when the bank needs financial resources. An interest known as the discount rate is paid on these loans. This rate also serves the Central Bank as an instrument of monetary policy, to encourage or limit borrowing from it.

Interbank loans are short-term loans that banks give to each other for liquidity needs at a certain interest rate, which is important because it also determines the movement of other interest rates.

III. The bank's equity represents the difference between the bank's assets and liabilities or internal resources. The capital serves as a guarantee of the bank against possible declines in the value of its assets. This is the reason why regulatory agencies set by law a capital adequacy ratio that the bank is obliged to meet. Periodic audits by supervisors help to understand whether the bank is complying with restrictions on its capital and assets. The controllers define for the bank a CAMEL classification, which is related to:

capital adequacy **C**
quality of assets **A**
bank management **M**
income **E**
liquidity**L**
market risk sensitivity.

II. Basic elements of a bank's activity and liquidity dilemma.

The bank represents a business firm with specific features. It sells "money" goods. Like any business firm, it relies on the basic motive of profit maximization. The bank also has specific features, because it does not produce goods and services, but offers financial services. The bank secures its profits through the basic activity of accepting deposits from providers of foreign funds and lending to applicants for foreign funds. The difference between the interest that the bank receives for the loans it gives (debit interest) and the interest it pays on the deposits it receives (credit interest) is the source of its profit (debtor balance). In addition to this basic activity, the bank offers a series of financial services such as: receipt and settlement of checks, payment through checks, bank receipts, transfers inside and outside the country, e-banking, etc.

On the other hand, the peculiarities of its activity put the bank in front of a fundamental dilemma that it has to solve - the dilemma of liquidity to profit.

Most of the bank's financial resources are deposits. Their owners want to be able to withdraw them at any time and in this regard,it is better for them that the bank keeps their money at any time as a reserve, in order to have the opportunity to withdraw when they want.

So, on the one hand, the bank must provide the greatest possible liquidity to withstand this pressure of depositors. On the other hand, banks carry out the activity to secure the largest possible profits. These profits are secured by keeping as few reserves as possible and by giving as many loans which bring interest.

As it can be seen, it is quite clear that the liquidity criterion conflicts with the profit criterion.
This is a Shakespearean dilemma for the good management of a bank.

The solution of this dilemma is achieved by the bank itself by optimizing the level of reserves with that of loans.

This is why banks are very careful in their pursuit of profits. They do not aim for very high profits, but profits harmonized with meeting liquidity needs.

The solution to this basic dilemma, the bank provides through banking management that includes the following main components:

a) liquidity management
b) the management of assets
c) loan management.

III. Liquidity Management

In terms of liquidity, we mean the ability of the bank to meet the requirements of depositors at any time they wish to withdraw their deposits or make payments through the issuance of checks. The realization of this mission is not very easy as it seems at first sight, because it conflicts with the interests of the bank for greater profits. The Bank relies on a well-known empirical principle, according to which, the fulfillment of the average needs for withdrawal of deposits is realized by keeping only a part of the deposits as a reserve, while the rest can be lent. The problem is that the amount of deposit withdrawals can fluctuate from the average and reach high figures. If the bank does not meet the withdrawal requirements, this can turn into a banking panic, which leads to the bank's bankruptcy. Therefore, banks are very sensitive to the level of trust that depositors have in them. The bank uses several techniques to manage liquidity.

1. The Bank holds a portion of its assets in the form of primary reserves which may be required and excess. The bank keeps the excess reserves precisely to ensure a high degree of liquidity at the lowest possible cost.
2.Credit reduction. The Bank may not renew a short-term loan whose maturity has expired when it needs liquidity, thus increasing its primary reserves. This method provides the bank with additional liquidity, but has a cost that is represented not only by the interest lost on the loan it does not provide, but also by the potential loss of the clientele.
3. Sale of existing loans to other banks. The bank can provide additional income by selling outstanding loans to other banks. This sale is realized with a discount which is conditioned by the fact that the banks that buy these loans have very little information about the borrower and as a result, are not very willing to become creditors of customers who do not know them. This is offset by the high discount on the loan being sold, which represents a loss for the bank that sells it.
4.The Bank holds liquid assets in the form of secondary reserves. It can meet the needs for additional reserves by selling these liquid assets on the secondary market. This technique also has its cost due to the fluctuation of the price of securities in the secondary market. In this banking activity, we mention the low transaction cost. Loss of interest and the loss that may come from lowering the price in the market.
5. The bank can provide financial means through discount loans received from the Central Bank. These loans are taken according to a certain procedure and have a cost that depends on the discount rate that represents the interest rate that the bank pays for these loans. Also, the Central Bank itself is careful in granting these loans by not looking "favorably" at the bank that often requests loans.
6.Another technique for liquidity management has to do with interbank loans. The bank can provide the liquidity it needs by borrowing in the interbank market from banks that have excess liquidity. This technique also has its cost that is represented by the interest rate paid on these loans. When the demand for liquidity is high, the interest rate is also high and vice versa.
As it can be seen, all the possible techniques that the bank can use have a cost. It is clear that the bank chooses the alternative with the lowest possible cost. In these conditions, depending on the cost of other alternatives, the bank determines the optimal level of excess reserves that it holds for liquidity purposes by maximizing the difference between the benefits of non-payment of potential interest, when using one of the above techniques, at the cost represented by interest lost on non-lending credits.

IV. Management of bank assets.

Asset management focuses on **defining an asset portfolio that ensures a maximum profit with a minimum risk**. Asset management is related to the realization of the main goal of the banking firm, profit maximization. Asset management is realized through several main techniques:

- Securing or finding suitable borrowers who pay higher interest rates and have a lower risk of default. For this purpose, the bank uses specialized employees and studied procedures that assess the degree of credibility of the borrower. Banks also use advertising to attract credible, low-risk borrowers. They are very conservative in their lending policy.
- Banks intend to use part of their reserves to buy securities, mainly government securities that provide relatively high income and have a low risk of default and liquidity.
- Banks diversify their asset portfolio to avoid default risk and liquidity risk. In this context, banks buy different types of short-term and long-term assets, such as different consumer and commercial loans with different maturities, treasury bills, bonds. Those banks that do not diversify their portfolio are highly exposed to the risk of non-return. For example, in the 1980s, banks that specialized in lending to energy companies or farmers suffered heavy losses due to the energy crisis and agricultural products in this period.
- The bank should also manage the liquidity of its assets by supplementing the required reserves at the lowest possible cost. It must hold securities that have high liquidity and why they bring a lower interest rate than other assets.

So, the bank manages its assets in such a way as to provide the required liquidity, but not to be too conservative and to ensure a normal profit.

V. Principles of loan management

Loans occupy a large share of the bank's asset portfolio. The bank must lend successfully in order to achieve its goal of high profits. In defining the main principles that the bank follows in lending: it has in mind two important concepts which are bad choice and conscience risk.

Bad lending choices exist because those who are at higher risk for non-repayment of loans are more likely to insist on borrowing. In short, the bank is more likely to decide to lend to those who are most likely not to repay them.
Conscious risk in the loan market exists because borrowers tend to take actions that are undesirable to the lender. When he borrows, he is more likely to invest in high-risk activities, which when successful bring high profits, but, on the contrary, which is entirely possible, he will not be able to return it.
Therefore, in order to limit these two negative phenomena, the bank applies the following principles of loan management:
a) Performs detailed analysis of information (screening) and banking supervision. Often one party to a lending transaction has more information than the other. This inequality can have major consequences for the bank.
b) Specialization in lending. On the one hand, this seems like an unfair move because it does not diversify the loan portfolio, but on the other hand it provides a specialization which allows the bank to provide detailed information to local firms. In this way the bank correctly determines the "level of reliability" and makes accurate decisions about lending.

VI. Conclusions and recommendations

We noted above that the bank reduces bad choice and conscience risk by analyzing detailed information and monitoring. But as long as these activities are costly for the bank, there is a possibility that the bank will not undertake them by violating the interests of depositors. They want the opposite, in order for the bank to guarantee them the interest and services promised.
This is ensured when the bank holds a sufficient amount of capital, which does not allow the bank to go bankrupt, because it is a costly process for it.
Sufficient capital realizes the compatibility of the interests of depositors and the bank by encouraging both parties to behave in the same way.
On the other hand, banks try to diversify their portfolio, in order to avoid high risk, to have sufficient capital and to know how to manage their liquidity in the real situations they face.
In conclusion, state regulation is also necessary to increase the compatibility of bank interests with those of depositors. This is ensured through the requirements set by the government for the level of capital adequacy and restrictions to promote portfolio diversification and the establishment of the level of liquidity in various banking situations.

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