Albania’s Banking Sector Reforms and Developments during the past decade

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1. Introduction

This paper dwells upon developments the Albanian banking system has undergone in the last decade covering in particular:

- stages of developments and reforms implemented by the central bank and other authorities with the support of foreign donors;
- current features of the system (size and structure, banking performance and comparisons with SEE and EU standards);
- credit developments and portfolio quality;
- payment system and bank supervision reforms;
- challenges that lie ahead to further the reforms and achieve integration of banking system towards the EU standards;
- a special section thoroughly depicts the Albanian Banking System shocks, background, causes and consequences and lessons of experience;
- final conclusions.

2. Macroeconomic environment

Below we describe the macroeconomic setting and fundamentals, which analysis is essential to understand the development of the banking sector:

The broad framework of Albania’s economic policy in the past 14 years has been set forth by government’s agreements with the IMF and the World Bank. With its impressive macroeconomic performance and successful stabilization programs coupled with market-liberalizing reforms, Albania’s case has been contemplated by these organizations as one of the most remarkable growth examples (annual average real GDP of 6.2 %) among transition economies during the past decade. Most of this growth has stemmed from a conducive environment to growth, driven by improving economic stabilizers and implementation of structural reforms among which:

- implementation of a prudent monetary policy as evidenced by subdued inflation pressures, stable inflation expectations (2–4 %) and strong confidence in domestic currency, reflected in its steady appreciation. Year-end 2004 annual inflation figure was 2.2 %, while the annual average CPI rate was 2.9 %;
privatization of the majority of economic activity and conspicuous private sector contribution to country’s GDP by slightly less than 80 %;

fiscal consolidation contributing to decreasing the government deficit to 4.9 % of GDP in 2004;

decrease of public debt-to-GDP ratio from 76 % at end-1998 to a forecasted 55 % at end-2004;

substantial increase of foreign exchange reserves to more than USD 1.2 billion and a comfortable level of reserve coverage (5.2 months);

full liberalization of trade activity.

Another important factor explaining this sound performance has been the noteworthy improvements in total factor productivity, resulting in a shift of resources from low to high productivity sectors, i.e. from agriculture to construction and services. Additionally, growth was triggered by high net transfers of private remittances from Albanians living abroad, though this item has been demonstrating a decelerating pattern. Finally, an apparently large presence of illegal activities and informal economy, accounting officially for some 30 % of formal sector (Instat) has further fueled the growth.

Yet, regardless of its impressive macroeconomic performance, Albania has been struck by several social and macroeconomic weaknesses and structural challenges the country needs to address on a timely and adequate manner, in order to sustain its long-term economic development and improve its prospects for the EU integration. Thus, with a GDP per capita of about USD 2,400 in 2004 and almost one-quarter of the population living below the poverty line, Albania is ranked among the poorest countries in Europe. Unemployment remains pervasive, especially in rural areas. Albania’s external position outlook poses threats particularly in the mid to long term. Current account deficit was 5.3 % of GDP in 2004 with trade deficit reaching 21 % of GDP. While FDI level, though growing with the sale of Savings Bank last year, is the lowest in the SEE countries. Due to ineffective tax administration and widely accepted high level of corruption, tax revenue collection against GDP (23.7 % in 2004) is almost half of that of other SEE countries. Country’s export capacities are generally weak – one fourth of import levels – and moreover, export competitiveness has been also impaired by local currency appreciation in the recent years. Government is being largely criticized by international community for highly increasing corruption levels, soaring cases of “state capture”, substantial decrease of transparency, effectiveness and rule of law. Administrative barriers to businesses in terms of customs and tax procedures, licensing and business regulations, land property claims and dispute resolution, as well as creation of politically-supported monopolies in certain sectors, create an impediment to the process of attracting FDIs.
Albania’s long-term success will greatly depend on meeting the following prerequisites to sustainable growth:

i) maintaining macroeconomic stability; ii) continuing the remaining structural reforms; iii) continuing observance of fiscal discipline by improving public expenditure management and further reducing the budget deficit, by broadening and securing the revenue base and avoiding the use of preferential practices; iv) improving country’s public infrastructure, education and health systems; v) enhancing institutional quality and governance; vi) raising the rate of capital accumulation; vii) strengthening government’s fight against tax evasion, smuggling, trafficking and fraud.

3. The development of the Albanian banking system since 1990

Over the past 14 years, the Albanian banking system has witnessed continual changes, adopting the model of a two-tier banking system with the Bank of Albania (BoA) positioned at the center of the system, aiming at maintaining price stability and safeguarding the financial system. From end-1993 to the beginning of 1997, state owned banks prevailed in the market, with Savings Bank (SB) being the exclusive collector of household savings. By 1993, besides the three state-held banks, two joint venture banks brought the total number of banks to five, although being unable to challenge the role of the state-owned banks. The latter accounted for 95.6 % of all banking assets at year-end 1995. Over those years, the Albanian banking system was vigorously financing the fiscal deficit by purchasing high-yield (9–13 %) treasury bills. The percentage of banking assets held in government securities rose to 57.7 % in 1995. In the same year, banking assets to GDP had fallen to 39.2 % vs. 61.4 % in 1993, bank loans to GDP had also declined to 4.8 % from 5.6 % in 1993, while individual deposits had reached 15.8 % of GDP: The “Ponzi Schemes” had already come into scene.

3.1 Banking Reform: Bank Restructuring and Privatization

Following the passage in Parliament of the amendments made to law “On the Bank of Albania” in 1996, new clauses were incorporated aiming at strengthening the independence of Bank of Albania and its supervisory power.

Until 1997, the banking system was virtually insolvent from bad loans to dilapidated enterprises and adverse selection of entrepreneurs. Private sector lending was seriously constrained by: improper legal framework and poor law enforcement, particularly with respect to lenders’ protection; the inability of banks to assume secured lending, execute collateral and take control of assets through bankruptcy procedures, double standard financial reporting of businesses for tax authorities; lack of business credit history and the absence of credit information bureaus.
In order to improve performance, solvency, corporate governance, and promote foreign investments, the government in 1995 prepared the draft on the pre-privatization policy of two state owned banks, National Commercial Bank (NCB) and Rural Commercial Bank of Albania (RCBA). The new policy envisioned complete institutional restructuring and recapitalization of these banks by the expertise of foreign banks and identification of strategic investors to transfer the majority of the banks’ ownership by summer of 1997. The collapse of pyramid schemes in the early 1997 wreaked havoc throughout the country, damaging severely the whole process of bank privatization.

Because of negative impacts observed in the implementation of the stabilization program, since the end of 1997, the government and BoA pursued a financial sector policy designed to boost public and investors’ confidence in the banking sector. This included:

- Finalizing the restructuring process of the two banks pending privatization:
  a) The RCBA was liquidated in 1998 with most of its deposits being transferred to SB and its large bad debt book placed in the newly established Bad Asset Re-structuring Agency (BART).
  b) The NCB, the second largest bank in Albania after the SB, was 100 % privatized with the main strategic buyer (60 % of shares) a Turkish Bank and the EBRD and IFC owning circa 20 % of shares each. The entire loan portfolio of NCB was transferred to BART.

- Increasing competition by licensing foreign private bank entrance in the banking sector:

At the end of 2000, 13 banks were operating in Albania, with many foreign-financed banks licensed after 1997. Among the foreign banks, the Greek banks were by far the most active in the market. The SB remained the only state-owned bank, still dominating the sector by holding 64.8 % of total bank assets in Albania vs. 33 % controlled by foreigners. With the new entrants, the financial intermediation improved and lending to the private sector increased at a healthy rate, with a low level of non-performing loans. The new banks not only contributed to the system with “know-how”, better corporate governance, new products and services, but also remained immune of political interferences relative to state-held banks. Even though the foreign banks extended almost 64 % of total loans in the system, the level of financial intermediation was minimal, as their time deposits made up just a small share of the banking system (12.1 % in 2000), as compared to the monopoly held by SB (80 %). Some of these banks such as ProCredit used inter-alias their long-term concessional financing to grant credits and not the deposit sources. The interbank market that could have enabled the exchange of fund flows from SB to these small banks was in its nascent stages with an insignificant volume of transactions.
Improving the asset quality of the system:

Until 2004, the SB continued to enjoy the dominant position in the Albanian banking sector in terms of total assets (67% of the banking sector in 1999), though this supremacy fell down gradually, but not sufficiently, to 52% by end of 2003. In an attempt to restrain the potential growth of non-performing loans, due to political pressures and improper corporate governance in the two state-held banks, BoA imposed a ban by the end of 1997 on lending activities of the two remaining state banks (NCB and SB), until their effective privatization took place respectively in 2000 and at the end of 2003. At the time of ban, SB accounted for over 47% of all lending vs. 1% in 2003. Partly because of this seven-year moratorium on lending, total outstanding loan stock in Albania accounted for only 6–7% of projected GDP until the end of 2003, vis-à-vis over 80% in most Western European countries. The low degree of bank intermediation is explained primarily by the cautious behavior of foreign banks vis-à-vis clients lacking appropriate risk-return profile, weak enforcement for creditor rights protections, the lack of long-term funding, etc.

Modernization of financial sector and fostering bank intermediation:

From 2001 until 2003, SB went through a World Bank-assisted restructuring process and a speedy recapitalization. Following several attempts to privatize the SB by a strategic investor, through an international tender procedure, RZB Austria took official control of the 100% ownership of SB in April 2004, by paying USD 126 million in cash. Soon after the takeover of SB’s management by the new owner, the BoA lifted the prohibition on SB granting fresh loans. With this privatization, Albania now boasts a healthy, 100% privately owned, competitive banking sector.

The forthcoming privatization of the largest bank in the country prompted the existing banks during 2002 and 2003 to pursue aggressive policies including inter alia geographical expansion within and outside the Albanian territory, technology improvements and feverish attempts to increase their deposit market share by offering attractive deposit rates and preferential commissions to major corporate clients. Lending stepped up with the launching by banks of new retail products such as car, health, education and home loans. Three banks became leaders in introducing the ATM, overdraft facilities, debit and credit card services in both local and major foreign currencies, while efforts are still underway to embark on internet banking. Many banks reorganized themselves in a way to give more emphasis to customer service and bank-customer relationship by establishing separate Marketing Departments.

The recent sale of SB will certainly spur competition among banks and increase the level of financial intermediation in the economy through increased and cheaper lending to the corporate and retail sector. RZB has committed to pioneer new products in the Albanian banking market and to resume lending...
gradually, which will lead to a reduction of their T-bill stock over the coming year. Since RZB holds almost 80% of Lek deposits in the banking sector, the bank is expected to continue to wield considerable influence over T-bill yields and may have the power to even set the market interest rate practically. Much of RZB’s initial lending is likely to be in foreign currency, in line with the existing market trends. Though RZB officials have been very optimistic in recommencing lending and promising to deliver about €100m fresh credits in the second half of 2004, until recently, their loan portfolio amounted to only €30m, due to internal restructuring and management problems, which proved to be more difficult and take longer to tackle than initially anticipated. RZB plans to issue also some 120,000 Visa Electron debit cards by the end of 2005.

In addition, 7 non-bank financial institutions operate in the market. In 2003 and 2004 two private, 100% Albanian-owned banks joined the market by further diversifying its composition.

- Banking System Shocks:

Banks play a critical role in ensuring a stable and healthy financial system. A non-properly functioning and non-efficient banking sector can lead to banking crises and increase asymmetric information problems. Additionally, problems in the banking sector amplify the chances of a foreign exchange crisis occurrence, which, in turn, could set off a full-blown financial crisis.

3.2 Pyramid Schemes – Macroeconomic Setting

Albania’s macroeconomic indicators were hitting new records during 1993–1995. Notwithstanding, in 1996, the favorable macroeconomic performance was reversed due to mounting political tensions and rising government’s expenditure prior to general elections. The situation deteriorated rapidly with a domestically financed deficit increasing by over 4 percentage points, and inflation tripling to more than 17%. This was also associated with a sharp decline in revenue collection. The banking system at the end of 1996 was confronted with several major problems, among which the most striking were:

1. Significant sector concentration with three major state-owned banks dominating the entire system by holding 97% of total deposits and 88% of total lending, while the remaining three small foreign and joint-venture banks held a negligible 4.4% of total banking assets.

2. Substantial operating losses and insolvency could crisply describe the financial state of the three state-held banks, suffering from very poor quality of bank’s lending portfolios. According to Jarvis (2000), bad loans made up one-third of the banks’ total lending and 80% of their NPLs. In similar way, the level of financial intermediation by the three state banks to the economy,
illustrated by the ratio of loans to deposits (11%) and credit to private sector as percentage of GDP (one-digit figure) were very low.

3. The payment system was by large inefficient, mostly cash-based. The average duration for payment transactions between accounts at different branches of the same-owned bank was 11 days. (Cani, 1995)

As a result of these problems and a general distrust to the banks, the public preferred to hold an unusually high amount of their financial assets in cash, outside the banking channels, and was seeking for alternative investment opportunities, such as the very lucrative returns provided by non legitimate and not legally supervised, non-bank financial intermediaries.

Pyramid schemes have generally thrived in almost all the transitional economies, notwithstanding, the magnitude, the duration and the political and social consequences of this phenomenon in Albania were unparalleled. Their geographical distribution covered the entire country and lasted for a relatively long time, compensating for the lack and inefficiency of proper financial institutions in Albania. The escalation of the whole process was certainly prompted, at a large extent, by the lack or delay of structural banking system reforms and more specifically of state bank restructuring and privatization.

3.3 Pyramid Schemes vs. Banking System

Since financial intermediation was limited and banks were practically unable to meet the growing demand for credit of the private sector, an informal credit market emerged based on funding sources generated from friends and relatives, as well as by remittances of Albanian emigrants. These schemes were out of the control of the authorities. Initially, government and the central bank did not take notice of the informal borrowing companies and international financial institutions were not able to anticipate the extent of the forthcoming crisis and therefore alert the authorities in time to take corrective actions right away.

The inceptions of the schemes and the first signs of massive public investments in these companies dated back as early as 1994. Though many investors were conscious of the mediocre management and the mystery encircling the money-making process of these companies, they still believed that the then existing government was staying behind or supporting these schemes and the funds were coming from illegal activities that secured huge profits. The latter were, in their opinion, sufficient to substantiate the excessively high interest rates that were 6 to 8 times higher than the rates offered by commercial banks. On the other hand, policies pursued by the government were misleading. Some top government officials benefited personally and/or supported openly some of the major schemes, as they contributed to the ruling party’s campaign. These companies were allowed to continuously advertise in the written and electronic media.
According to Gomel (May 2002), at their peak, the nominal value of the pyramid scheme liabilities came close to half of country’s GDP. By 1995, banking assets to GDP had fallen to 39.2% vs. 61.4% in 1993. Consequently, the central bank’s monetary policy became less effective. There were these companies that were later transformed into pyramid schemes, which, based upon some indirect and approximate calculations absorbed as much as USD 200–300 million from the population in 1995 (Cani, 1995) and over USD 1 billion by the end of 1996. These companies were never able to receive a license to collect deposits and nobody knew whether they were ever solvent. Besides, legal structures available to the authorities to fight the pyramid schemes were entirely inadequate. Since 1995, the central bank warned persistently the Government, though not openly, that borrowing companies were violating the law on banking system and of the danger that could possibly derive from such schemes. But, the competent authorities had the opinion that the law was not applicable to the borrowing companies (Jarvis, 2000). Hence, though with some delay in recognizing the situation, it is important to underline that central and commercial banks neither supported, nor did they justify the schemes.

The fall of pyramid schemes, where thousands of Albanians lost their lifetime savings, was deep and associated with seriously adverse political and social impacts. The country plunged into anarchy, as state institutions went into total collapse, and mass civil rioting exacerbated to near civil war. Economic activity was virtually disrupted and demand was severely reduced, causing a drop in tax collection and thus aggravating the already high fiscal deficit. “The Lek depreciated by more than 40% during the first half of the year 1997, as remittances from abroad declined markedly ...” (Jarvis 1999). As a result, Albania experienced serious external imbalances and annual inflation rose again to 42% at the end of 1997.

### 3.4 Bank Deposit Bleedings – March 2002

#### Introduction – Macroeconomic Conditions

The black shadow of 1997 (pyramid schemes) resurfaced in March/April 2002, but this time panic gripped the banking system. Fears on deposit safety pertaining to privatization of the major state-owned bank brought about vast deposit withdrawals from the banking system. The episode was located in the southern cities of Albania, which were the most severely hit by the ’97 pyramid schemes. The most affected groups were depositors from the rural areas and Albanian emigrants living in Greece. Surprisingly enough, the bank panic occurred at a time when the financial performance of the banking system was evaluated to be at its best in the last ten years. The panic was rather perceived as a confidence crisis following the privatization process of the state-owned bank (SB). The un-
founded fears of a possible bankruptcy of the largest bank spilled over to other commercial banks, resulting in significant deposit outflows (8%) within a very short span of time.

**Banking Sector Performance: the Need for Reforms**

While macroeconomic stability is a prerequisite for banking soundness, the March/April 2002 threatening to the banking sector has shown that delays in banking reforms might have serious negative implications in economy, even when the banking system parameters are solid. The following analysis on banking system key indicators: asset quality, liquidity, earnings, bank capital will shed some light to this conclusion.

a. The ratio of NPLs to total loans in the overall banking system has been relatively high (about 11.6% in December 2001), however, it posed no threats of insolvency due to the small share of total system loans relative to total assets. Particularly, if we examine the Savings Bank and NCB – the two largest banks that suffered mostly from the deposit outflows in March and April – their combined loan portfolios represented less than 0.5% of the total assets at the end of 2001. Most of these bank’s investments in the asset side were concentrated in T-bills. In other words, asset quality was not a concern and the banks were not exposed to any major credit risk.

b. Additionally, the relative liquidity of overall system seems to substantiate the above argument. Two months before the vast deposit outflows, liquid assets in the banking system made up nearly 90% of the total assets, where more than half of them were invested in treasury bills. Also, the short-term liabilities accounted for about 95% of total liabilities, and the ratio of liquid assets to total short-term liabilities was over 98%. Besides, all the assets of the Savings Bank were practically liquid and there were no reasons rather than speculations to believe it would have been insolvent.

c. Two years after consecutive huge losses in the years preceding 1999, the Albanian banking system has been finally showing profits. The total system ROA was 2.1% and 1.5% respectively in December 2000 and 2001. The same argument goes to the return on equity, where the private banks recorded their best result in the past two years.

d. Declining capital adequacy of financial institutions has been found as one of the features in 14 out of 22 studied international financial episodes (Davis E P, 1999) and this could serve as one of the indicators serving as a predictor of crises. Commercial banks in Albania have been characterized all the time, due to very low risk profile of bank investments, by very high capital ratios –
well-above the minimum required rate of 12%. Hence, in terms of this indicator, the banking system can be discerned as safe and not likely to fail.

However, although asset quality and financial performance of Albanian banks has improved significantly over the recent years, the country’s banking sector was nevertheless faced with a number of actual and potential challenges. First, the NCB was in the process of a slow recovery and rehabilitation after its privatization in 2000, yet suffering from the collapse of its major shareholder in Turkey, whereas Savings Bank privatization was at a standstill, due to lacking of bank recapitalization and restructuring activities to make it attractive to foreign investors. In spite of a relatively large number of banks in Albania, the market continued to be characterized with a high degree of concentration and insufficient competition (at the end of 2001, the top two banks accounted for slightly less than 70% of total banking sector assets). The range of services rendered to corporate clients were confined to basic classical banking services.

Causes and Consequences of Deposit Outflows: The Confidence Crisis

Alarming deposit outflows in March and April may just be another example of the irrationality that can sometimes grip the Albanian financial market, even when the fundamentals are stubborn. Bank panic, due to pure political speculations and depositors’ lack of proper knowledge about the banking system proved once again, how susceptible and unprotected the financial sector is against the speculative externalities and how skeptical the public is about government’s commitments.

Nonetheless, economic fundamentals were being overrun by a host of political uncertainties such as: i) the process of passing in the Parliament the new law “On deposit Insurance”, ii) the amendment of the law “On compensation of proprietors”, iii) the opening of SB privatization process right before the approval of the law on deposit insurance, iv) an exacerbated political situation during the first quarter of 2002, v) a government reshuffle, vi) a weak public culture about commercial banks, vii) a sluggish economic performance with some volatile indicators. All these factors resulted in a lack of confidence.

The consequences of rapid deposit leakages in March 2002 were the reduction of money supply by Lek4.5 billions, the increase of currency held outside the banks by more than Lek10 billions, liquidity shortages for commercial banks, which were immediately eased by the central bank’s actions. The latter was forced to shift the course of its monetary operations and turn into a liquidity injector to the market. The strategy of the Bank of Albania during the crisis consisted of making several daily assessments of the liquidity in the system and particularly of the two affected banks, evaluating the performance of the sector, lobbying to the politicians and media, keeping an eye on the exchange rate, and ensuring calmly the depositors for the safety of their deposits. Conclusively, the
situation was very well contained and remained under control of the central bank.

There are several causes behind the mini-run on deposits. Although the new law on deposit insurance aimed at protecting depositors in all of the domestically operating banks, the allegations made by some politicians seem to have given confusing signals to the depositors. Politicians in search of gaining political advantage with the case of the privatization of SB, doubted and misinterpreted the law. In addition, Albanians have long been viewing with full skepticism the promises and commitments of their government. Efforts at fighting corruption by government – in part pressured by international agencies – are still adversely affected by some political involvement in shady dealings. Likewise, frequent elections and aggravated political situation have kept away foreign investors and hindered privatization of Savings Bank and other strategic state-owned enterprises.

4. On the current state of the Albanian banking sector

4.1 Product and Services Offered

The range and quality of financial services provided by banks to their clients although improved in the last years is still limited as compared to their European peers. The east northern part of the country and rural population is under served. Domestic and international money transfers are expensive, whereas “e-banking” has a long way to go. Service delivery is slow and cumbersome; sometimes the clients have to go to the bank for obtaining their account history or balance confirmation. The availability, terms and stringent selection requirements of SME finance, mortgage loans and other consumer finance make the services accessible to only a small fraction of the population. Leasing has not taken off yet in the country. With the passage of respective Law in the Parliament in 2003, the first Leasing Company has been set up as a subsidiary of a foreign bank.

4.2 Size and Structure of the Banking System

In 2000, the ratio of banking assets to GDP had risen to 51.8 % (higher than SEE countries – 40 %, but lower than the EU – 280 %). Bank loans accounted for slightly lower than 4.5 % of GDP. Thus, banks have chosen comfortable ways to make profits, while minimizing the risks. The large share of T-bill investments shows that most of bank deposits used as primary source of funding are destined to finance fiscal budget rather than investing in the economy or SMEs. The primary explanation for this phenomenon is that SB, the largest bank by far in Albania, operated for 7 years as a simple savings bank with over 70 %
of its assets held in T-bills and only 4% of its assets extended as loans and so did NCB until 2000.

At the end of 2004, there were 16 banks operating in Albania, out of which 12 foreign-owned private banks (94%), two private Albanian banks (1.7%) and two joint-ventures (5.3% of total assets). Recent developments in the banking sector have positively influenced the asset structure of banks with respect to their investment diversification. Balance sheet of banks at 31 December 2004 was composed by: investments in risk-free or low risk government’s treasury bills (46%), short-term interbank placements (15.6%) and loans (16%) of total assets. On the liabilities side, deposits represent the main funding source (87% of total assets of banking system), reflecting a growing public confidence in banks. Total deposit base is composed by a high share of household’s savings (84%) with many upside potential for mobilizing the private sector deposits. The absolute figure of household deposits has grown by almost 8 times from 1996. Deposit share as percentage of GDP has risen from 42% at the end of 2002 to 45% by the end of 2004, higher than SEE level of 30%, but below the EU standards (100%). From this analysis, we can see that banks invest heavily on treasury bills, but their weight has declined from 57.7% in 2000 to 46% in 2004. While the share of loans extended to private sector and individuals almost doubled from 8.6% in 2000 to 16% in 2004.

The deposit share of SB alone has decreased from 75% at year-end 1999 to 56% at the end of 2003. Despite these developments, the sector continues to remain highly concentrated with the five largest banks holding almost 70% of total assets in March 2004, higher than the EU standard (the market share of top 5 largest banks amounts to 53% of total bank assets at the end of 2003).

4.3 Credit Developments and Portfolio Quality

High rates of lending growth to economy have consolidated an increasing trend of the banking system in the past four years. To further stimulate a friendly-credit environment for business and households alike, BoA has consistently pursued an easing monetary policy in the recent years. In 2004, BoA slashed the base repo rates five times (1.25 basis points) hitting a decade record low of 5.25%. As a result, credit to economy has been growing by 34% on average during the last two years. The credit/deposit ratio (18%) and credit to private sector/GDP (8.1%), two indicators highlighting the degree of financial deepening on economic development, are steadily growing (compared respectively with 13.5% and 5.7% at the end of 2002). Still the current bank credit to private sector/GDP level lags behind the EU (130%) and the average SEE standards (23%), whereas loan to deposit ratio is much lower than the EU (143%) and SEE (64%). The gap between Albanian banks and those in other EU and SEE countries implies that Albanian economy is still underbanked and there is a
lot of catch up potential for bank developments toward EU convergence. Notwithstanding, the BoA’s transmission mechanism has not been properly understood and effectively conveyed to commercial banks lending rates due to high level of dollarization in the economy, large proportion of loans in foreign currency and the low degree of credit.

Loan book mix by maturity has improved due to bank’s lengthening of their repayment periods in favor of medium to long term loans. Short-term loans mostly granted for trade and working capital requirements constituted 26.7% of total lending portfolio at the end of 2004 vs. 47% at the end of 2002. The gradual shift of new credits towards longer tenors indicates that banks are extending more loans for investment projects, moving away from trade activities to construction, processing industry, tourism and agro processing. With respect to currency mix, hard currency loans continue to prevail, making up 81% of total lending figure in 2004, creating a mismatch with deposits held in foreign currency (31%) and raising concerns for potential foreign exchange risk in case of a rapid depreciation of local currency.

Excluding two joint-venture banks, which share of non-performing loans and bad loans, was respectively 18.3% and 12% of the system at year-end 2004, the NPL ratio vs. gross outstanding loans for private banks stood at the level of 2.6% at December end 2004. Total system figure was 4.2% at the end of 2004, down two basis points from 2003 and below the slightly less than 7% average in the SEE region. This indicates that lending expansion in Albania and foreign bank ownership have contributed to better handling of credit risk and a more risk-averse behavior of private banks compared to the region standards. Problems will arise on the quality of lending and bank abilities to control these assets in the future as banks try to increase their profits by growing rapidly their lending to more than 50% of balance sheet and offer credit card, other consumer loan products and SME credits classified as much riskier than the existing bank products.

4.4 Banking Performance

After consecutive loss-making activities, the Albanian banking system turned out profitable for the first time in year 1999 with USD 8.25 million. The system has been showing increasing profits over the past five years amounting to USD 52 million in 2004 (circa 0.6% of GDP). Most banks are showing increased profits. Profitability ratios of the banking system, ROA and ROE were respectively 1.3% and 21.4% during 2004, indicating a growing trend in years as compared to 0.5% and 15.7% during 1999. These figures are higher than in the EU (ROA = 0.5%, ROE = 11%) and comparable to the SEE (ROA = 2%, ROE = 18%). Despite considerable progress made, high interest margins between lending and deposit rates are the main determinants of the system profi-
tability. As competition toughens, spreads will go downward and banks will face difficulties in sustaining these profitability levels. Therefore, they have to look intensively for alternative riskier investments and spend more money in technology, new product introduction and modernization.

Capital Adequacy Ratio (CAR) of the banking system, though edging down steadily during the past four years and currently standing at 21.6 %, is much higher than the required rate of 12 % due to low risk exposure of bank investments. CAR levels are higher than the EU (11 %) and lower than the SEE (25 %). This implies high liquidity in the system: currently, the share of risk-free, liquid assets against the total is over 27 %. The actual decrease of CAR is explained by a faster growing trend of risk-weighted assets than that of regulatory capital, particularly reflected with the increase of long-term credits in foreign currency as share of total assets, overdraft facilities and investments in foreign sovereign securities by some large banks.

4.5 Payment System Reform: BoA’s Anti-Cash Program

Albania’s economy is primarily cash-based. Custom duties, taxes, utilities, public and private sector salaries are generally paid in cash. According to BoA, 33 % of the money in circulation is held outside the banking system, as against an average of 10 % in the other CEE countries. Reflecting this status, even the banking payment system is not efficient. The latter has been largely featured by physical cash transfers, relatively long delays in processing and high risks to both customers and the banks. The most widespread instrument, in terms of both volume and value, is the payment order used by businesses. Cheque use is relatively limited and direct debits to effect recurring payments remain low. ATM and electronic card transactions were insignificant to nonexistent until 2003. Debit cards, credit cards like Visa and MasterCard have been issued just recently, though at a limited scale, by several commercial banks.

As the main responsible body for the operational management of Interbank Payment System and the Clearing House, BoA has taken important steps in the recent years to modernize and increase the efficiency of the payment system. The new interbank Real Time Gross Settlement (AIPS) system for large payments became operational since January 2004 and a fully automated bulk clearing system (ACH) for low value transactions is scheduled to complete by mid-2005.

In 2003, the Bank of Albania launched a new pilot campaign on increasing the use of the banking system in the regular conduct of business in Albania. Calling upon the responsiveness of the Albanian government and after wide consultation with all stakeholders: the Ministry of Finance and Economy, commercial banks, the Bankers’ Association, tax authorities, utility companies, pri-
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vate sector, etc., BoA outlined in June 2004 the following agenda for all the parties involved in discussion that included:

- Execution of all payments and revenues for or in favor of state budget through bank transfers.
- Payment of all civil servant salaries and other supplementary bonuses by bank accounts.
- Distribution of pensions and other social contributions through banking system.
- Pressures by tax and custom authorities on large and small-to medium size businesses to open bank accounts and conduct their operations through the banking system.
- Identification of needs for improvements in the current legislative and regulatory framework.
- The use of direct debits to pay utility bills of corporate and household clients.
- Interbank agreements to sidestep double charges for domestic payments.
- Extended hours of bank operations and installation of the Automatic Teller Machines (ATM).
- Elimination of charges for on-line branch-to-branch transactions to encourage intensive use of banks by businesses.

The campaign, though still underway, recognized its first successes: The Ministry of Finance fully liberalized in 2004 the transactions of budget accounts, formerly a monopoly of SB, to the entire banking sector; BoA and Ministry of Finance began delivering on the same year the salaries of all their staff through the banking system, a practice that would be later followed by approximately 120,000 civil servants of public administration; Commercial banks increased media advertising to create general public awareness; Significant technology investments were made by banks to install/increase the number of ATMs and POS, introduce debit and credit cards; Competition intensified as banks began offering attractive packages (preferential corporate and household loans, preferential exchange rate transactions, etc.) to businesses that would open bank accounts to their employees, resulting in cheaper lending products and other banking transactions.

4.6 Bank Supervision

Banks are among the most heavily regulated financial institutions in the country. Following the collapse of the pyramid schemes in 1997, supervision of the financial sector has significantly improved to promote the enforcement of international codes, rules and good practices and the development of industry standards with the purpose of enhancing the efficiency and soundness of the financial system. More specifically, BoA has pressed ahead with significant structural re-
forms aimed at strengthening substantially its supervisory and analytical capacity through the implementation of a more risk-based supervision process and improving the deficient areas in the regulations such as capital adequacy and the use of international accounting standards. The Law on Deposit Insurance was passed successfully by the Parliament in 2002 and the respective Deposit Insurance Agency has been established and is functioning properly. This scheme guarantees to depositors 100 percent coverage of their deposits up to the amount of about USD 3,600 and 85 % on the second lot of circa USD 3,600. A collateral registry for movable property has been functioning well for over three years. To strengthen the legal framework on insolvency and bankruptcy procedures, the law on bankruptcy was recently approved by the Parliament, and if enforced properly, it would be the instrument that the banks can use to exert pressure on borrowers and to protect themselves from bad loans. Efforts are underway with the assistance from international donors to developing the technical expertise and legal framework to combat more successfully money laundering and terrorism financing.

5. Additional challenges for future banking systems reforms

Regardless of substantial progress that Albanian financial sector has achieved in the recent years more challenges lie ahead to complete the banking sector reforms. Key objective of these reforms is to increase international competitiveness of the sector to a level that will allow its successful financial integration not only into the regional financial services market, but also into the EU. The EU accession requirements in banking are an important impetus towards convergence reforms of Albanian banks to the Western standards and practices.

Policy actions to achieve the stated objectives in the banking sector can be classified in the following clusters:

(i) Internal restructuring and competition: this encompasses the successful sale of the state 40 % stake in the two joint-venture banks, generally characterized by operational inefficiencies, inadequate corporate governance and poor loan quality; and internal restructuring of all the banks with the view to reduce their operating costs and to expand the range of their services in a more competitive market.

(ii) Banking regulation and supervision: to improve its supervisory capacity, the BoA has been setting some targets such as improving corporate governance, strengthening banking supervision, encouraging a sound-banking environment and designing strategies to prevent and settle the crises.

The foreign-based ownership of the majority of the banking sector, the provision of a range of new financial services by commercial banks and the engagement of banks in high risk-taking activities call for:
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- drafting new regulations on credit cards, e-banking and other new products;
- further strengthening of supervision techniques;
- advancement of modern risk management skills and techniques at the commercial bank and supervisory level;
- design of disaster recovery and liquidity contingency plans;
- consolidated cross-border supervision by BoA;
- creation of a credit information bureau;
- adoption of international reporting standards;
- gradual implementation of Basel II Accord.

(iii) Increase public financial literacy: the recent experience confirms once more the population’s unfamiliarity with market institutions and the strong need to educate the Albanian public with economic and financial issues in order to reduce the effects of them falling prey to future market speculations. Unable to distinguish between accountable bank managers or outright crooks and to read behind the bank financial statements, depositors would be reluctant to put money in the bank, thus making banking institutions less viable or even worse, leading to bank panic with harmful consequences for the economy. Education of businesses with financial terminology and instruments will assist them to make informed decisions, get easy access to bank products and SME loans. Likewise, consumers will achieve maximum returns from their investments and benefit from more competitive loan products and bank services.

(iv) Legal approximation to EU legislation: although the Banking Law is an important step forward, there is a need for a further approximation to the EU banking legislation. To become a member of the EU it is required that the candidate countries align their national legal systems with the existing EU legislation in all areas. Achieving this means, above all, that Albania should do more than just ticking off the boxes on the “acquis communautaire”.

6. Conclusions

1. In most cases, enjoying positive macroeconomic indicators for a certain period of time does not prevent from eruption of financial crises. The most important thing that contributes to the long-term financial stability is ensuring that these parameters are strictly maintained, and carefully watched for any potential volatility that might arise. The Albanian economy and particularly the financial market have undergone two shocks: the pyramid schemes of 1997 and the mini deposit run in 2002. The detailed analysis we conducted in this paper demonstrates that various factors, often disregarded, underestimated or misused by authorities, stand behind the crisis: a) political manipulations; b) illegal and
criminal activities to which authorities have not been watchful, but instead permissive; c) government corruption; d) low confidence of the public in politics; e) procrastination in privatization and especially in financial sector reforms and bank restructuring; f) finally, the low level of consumers’ financial literacy. Even today, a major part of these factors are still present and therefore they should not be neglected, but included as a top priority on the country authorities’ agenda.

2. When financial crises originate from unstable political situations, the timely and successful resolution of the crisis will be highly conditioned by the willingness and coordination efforts of all the political powers. This reminds us that market psychology can sometimes be more important than positive fundamentals. Accountability is very central as the public reaction can sometimes make things get worse before they get better. Besides, the time that elapses from symptom identification until corrective interventions taken by the Government and regulators should be short to minimize the negative effects of the crisis. At a time of shaken public confidence, transparency, independence and image restoring by the central bank are paramount.

3. The main features of Albanian banking system are: a) very high degree of concentration (the three largest banks account for almost 70 % of total bank market share); b) over 95 % of bank assets are foreign-owned; c) low level of financial depth with corporate, SMEs and household financing needs poorly and insufficiently served by the banking sector; d) high asset quality due to low NPLs/gross loans, low risk investments and high balance sheet liquidity; e) better profitability ratios than EU and SEE; f) capital adequacy ratios well above the required minimum. All these features combined demonstrate Albania’s high potential for banking sector growth and developments.

4. The Central Bank has achieved substantial progress in reaching its goals: Inflation has remained under control, within the forecasted range of 2–4 %, the exchange rate has been relatively stable with a confirmed trend of appreciation and bank supervision has significantly improved and strengthened toward meeting the international standards. Since Albania’s banking system is characterized predominantly by a high degree of foreign ownership (96 %), either at branch or at subsidiary level, the top priority of Albania’s central bank remains strengthening and synchronizing the prudential cross-border supervision techniques and procedures with home country authorities to enable the information-sharing, facilitate the process of effective consolidated supervision with home regulators and prevent the “spill-over” effects in case of a crisis. Although the prevailing bank regulations have been amended to accord with core interna-
tional principles, there are several loopholes and deficiencies that have to be rectified especially in the area of capital adequacy, use of international accounting standards, and use of consolidated comprehensive supervision.

5. A critical challenge the financial system might have to contend with in the short run is concentrating the supervision of financial market operators (banks, financial companies, investment funds, pension funds, insurance companies, etc.) in just one hand, either under the Central Bank’s or an independent agency jurisdiction, outside the Bank of Albania. The only properly supervised financial institutions in Albania are banks, the rest of financial market players operate in a market with lax regulations and liberal oversight, leading sometimes to their engagement in suspicious or even criminal-type activities, as is the case with certain insurance companies. If one of these companies defaults, the contagious effect might be spread also in the banking system due to large exposure of bank credits to personal and property insurance policies.

Capital markets in Albania are still in an embryonic stage and not capable of fulfilling their functions. A modern financial market should be a diversified one. The major providers of financial services in the country are banks, whereas non-bank financial institutions are insignificant, with respect to their role and size. If anything happens in the banking sector, due to its underdevelopment stage, the other financial market participants are unable to compensate or help diversify the risk or play a significant role in safeguarding financial stability. Hence, the authorities should encourage the creation of a deep and complex financial sector including all non-bank participants.

6. Foreign currency loans account for over 80% of the banking system stock of outstanding loans, while most of bank deposits are held in local currency, creating a currency mismatch between investment and funding sources. Albania’s balance of payment is fuelled at a large extent by emigrants’ remittances, illegal and criminal activities and somehow by donor’s funds. As the majority of these sources will shrink in the long run, the sustainability of our balance of payments is questionable. Given also the fact that our exports represent just 1/4th of our imports and the other facts above, our external position might be seriously exposed and therefore affected by a potentially material risk of sudden exchange rate fall.

7. Financial deepening, expressed by the ratio of credits to economy is still at low levels (8% of GDP), yet recognizing over the recent years a growth of 34% p. a. The former Savings Bank, holding a 50% market share, was not allowed, for the past seven years, to extend any loans until the bank privatization in 2004. The imminent resumption of lending by RZB, which plans to enter the corporate and retail market aggressively by
the second half of the year 2005, will result in doubling the total credit figure in the system. Besides the increase of financial intermediacy, the repayment of credits in foreign currency and negative influence in the balance of payments might be some of the most obvious side effects.

a) As the banking system grows and competition intensifies, the banks will engage into riskier transactions that provide higher margins, such as SME, mortgage and consumer lending, etc. Under these new conditions, also taking into account the absence of a long-term tradition in lending, the next immediate challenge for banks will be emphasis on risk management, especially on credit risk. The establishment of credit bureaus, where the banks can track the information on creditworthiness of their prospective borrowers becomes a necessity to streamline the process of credit evaluation and approval and increase the chances of granting good loans since the inception.

b) Banks in Europe and the CEE countries play an essential role in financing the segments of population that do not have easy access to bank financing: the SMEs and consumers. In Albania, only 2% of SMEs use bank financing, despite the growing lending from microfinance institutions and savings and credit associations that operate in the country. Expanding finance to the underserved market segments is one of the major challenges the banks will have to confront with in the near future.

8. The Albanian Bankers’ Association (ABA) is very fragile and its role in being a real partner in the public and private sector dialogue is insufficient. As representatives of market associations, the members of ABA might have the will and ability to identify problems, but they often fail to implement changes or make viable recommendations to the authorities due to lack of expertise, organization, experience, forward-thinking approach, understaffing, etc.

9. Commercial banks should step up their efforts in increasing the transparency on corporate governance issues, such as collective responsibility of board members, accountability, responsibility and fair treatment of shareholders, etc. and include them as part of their regulatory framework.

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