

Fatos Ibrahimi: The banking system situation and the future challenges

Address by Mr Fatos Ibrahimi, Deputy Governor of the Bank of Albania, at the European Finance Convention, Tirana, 14-15 September 2007.

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Dear participants,

It is a pleasure to participate in this summit and to outline some of the main developments in one of the key areas of the Albanian economy, that of the banking system.

In my following discussion, I will dwell on two main issues:

First, the key steps in the banking reforms, with special focus on the issues related to commercial banks and the system's financial developments in the recent years.

Second, the aspirations of the Albanian economy to absorb foreign direct investments, their importance to our financial system and the FDI growth implications in the future.

1) The performance of the Albanian banking system

Reform in banking was part of the structural reforms undertaken by the Albanian authorities after 1992. In addition to the macroeconomic stability, these reforms aimed to transform the Albanian economy into a market economy, through its privatization and the establishment of financial institutions and institutions of social protection.

Albania has been going through a constant process of banking system consolidation since the transition into a market economy. In most of the 90s, this process was relatively sluggish as a result of the informal financial markets which had held the country's economic and financial development back. The high interest rates offered by these markets kept the efficiency of monetary policy in steering the interest rate pending. In addition, other issues, such as the high concentration of deposits and loans in three state-owned banks, their operational losses as a result of the increase in non-performing loans' portfolio, the undeveloped and incoherent regulatory framework in supervision had become an impediment to the expansion of reforms in the banking sector.

Following this period, the banking system consolidation process began to progress. This period is characterized by the reduction in the share of state-owned banks, their gradual privatization and the considerable increase in the number of private banks from 4 operating in 1997 to 17 banks in 2006. In this context, the central bank has been extremely prudent in selecting and licensing the private banks, where only three of them licensed the recent years are of entirely Albanian capital.

Despite the increase in the number of domestic commercial banks, the expansion of the banking activity until 2003 was a prudent one, being in line with the country's economic development. During 1998-2003, the banking system's total assets grew by an average of 13 per cent a year, consistent with the nominal GDP growth during this period. Nonetheless, there has been a swift growth in banking assets by 67 per cent in the last three years, which is 2-3 times higher than the cumulative growth of nominal GDP. As a result of the enhanced confidence in the domestic banking system, the share of assets to the GDP increased in 2006 to the peak level of 70 per cent, which is comparable to that of the Central and East-European countries.

The performance of commercial loan to private sector and to households is also satisfactory. Its growth rate has been constantly exceeding the expansion rate of banking assets. Over the last years, private loan has improved considerably; for 2005-2006 it recorded a cumulative growth of 175 per cent, which is the highest growth recorded in the region and the

Central and East-European countries. Another characteristic in support of foreign crediting institutions is the free choice of currency, where almost 3/4 (three-fourth) of total loan was extended in foreign currency.

Thus far we may say that credit supply is in prudent levels, since non-performing loans' portfolio, though increased moderately to 3.1 per cent of gross loans in 2006, provides evidence for a limited exposure of the banking sector to non-settlement risk. However, despite the considerable improvement in the assets quality and the commercial banks' financial performance, the growth of lending to the private sector and to households remains low as a share to the GDP – about 21.3 per cent in 2006, compared to 49 per cent in Central and East-European countries – providing evidence for other non-utilized banking services capacities in the Albanian economy.

2) Banking law

Many amendments to the law on the financial system have been made over these years. These amendments resulted from the need of adopting the European Directives in this area and the Basel core principles for an effective banking supervision. This process was successfully finalized upon the approval of Law No. 9662 “On Banks in the Republic of Albania” by the Parliament. Compared with the previous law, the new law is more complete and more accurate in some parts of it. It has integrated some new concepts which are in full compliance with the European Directive 83/349 and other important directives. It stipulates changes in the licensing of activities by level of capital, in consolidated supervision, etc. In addition, “risk management”, which previously was provided for in specific regulations, has been now summarized in a specific chapter of this law.

3) Foreign direct investments and the Albanian financial system

Foreign direct investments have been assessed as very important for developing countries, since they have a positive impact on the macroeconomic, technological and institutional performance of recipient countries. The wide experience over the last decades indicates that the presence of the financial FDIs improves the soundness of the domestic financial system, through a better management of portfolio risk and a more efficient allocation of credit funds. In addition, the technological innovations deriving from the FDI inflows affect the enhancement of the banking system competition and efficiency, through the increase in the variety of products and services provided. Despite these positive effects, the presence of foreign banks in the country instigates improvements in the institutional framework, by pushing the application of international accounting, reporting and supervision standards, which does not only help the commercial banks' decision-making process but also the central bank's.

Therefore, the FDIs are expected not only to promote the production activity in the country, but also to have a direct and indirect impact on the Albanian financial system. Foreign production companies will directly need financial transfers and services (channel payrolls through the ATMs, POS), which will be executed through the domestic financial system. The international companies investing in the country will make use of commercial banks' funding sources in order to prevent exchange rate and interest rate risk.

There have been many property-related developments in the Albanian banking system. Since its establishment, the domination of state-owned banks has been reducing and today, foreign commercial banks' assets account for over 90 per cent of the banking system.

The increase in the number of foreign banks in the system has been also favoured by the fact that such investments have not been penalized in Albania; the requirements for establishing a bank are similar for both domestic and foreign-owned banks.

The current ownership is diverse; there are foreign investors from Austria, Italy, Greece, USA, Turkey, Germany, Bulgaria, Malaysia and some Arab countries. Greek banks have been present in the market since 1996; the German and Italian investment has been present for quite a long time as well, while the latter has grown substantially and has become one of the market's key actors. Austrian investments may be considered as the most dominant ones. Their ownership has resulted from the acquisition of the largest domestic state-owned bank.

The long presence of foreign banks in the Albanian banking system has influenced the establishment of a stable banking system and its stable growth. Despite the financial collapse of 1997 or the panic crisis in 2002, in none of the cases was the system's performance a source of crisis or instability. Previously, foreign banks were more conservative in terms of expanding their geographical activity; however, the entry of Raiffeisen Bank into the market pushed them to be more active. This fact may be evidenced by the variety of products provided in the market, the growth of lending and the employment of clear strategies to increase or maintain their market share.

However, the economic benefits deriving from the presence of foreign banks have not reached the proper levels yet. The enhancement of the quality of information provided to the public at large and to the central bank, the lowering of the intermediation cost, the further improvement of risk management, and the standardization of the accounting and financial reporting systems are not in the desired levels yet.

Now let us now turn briefly to the possible financial relationship between the Albanian banking system and the production foreign investments flow. Undoubtedly, the positive influence foreign direct investments have on economic growth depends largely on their recipient countries' circumstances. It requires a substantial level of financial system development as a crucial precondition. A developed financial system improves the efficiency in allocating the resources and it further enhances the country's capacity to absorb the FDI.

The entry of new investors will orient the concentration of market segments to large-size businesses. Their impact, along with the lending capacity of our banking market, are believed to be the crucial proof for their success in Albania.

In more concrete terms, the circumstances in Albania are such that there is an asymmetrical distribution of total assets between banks in the market. The reference is only to banks, since in terms of total assets, the banking system shares more than 90 per cent. Other non-bank financial institutions play a more insignificant role than the commercial banks. As far as the latter is concerned, there are many qualitative banks in the market, whose presence is an attractive factor for absorbing the FDI.

On the other hand, the concentration of assets and banking loans in a few commercial banks bears the risk of creating an oligopolistic environment where only a few banks establish the terms for new loans. Such a situation would increase the investment cost in the public and private sector and in households, as well. Though thus far there have not been any cases of prices manipulation or banks exercising a dominant position in the market, I deem as necessary the promotion and vitalization of other financial market segments in general. This market requires real commitment in the efficient intermediation of financial resources in all its segments. Non-bank financial institutions need to become more active by expanding their activity in the market segments they operate in. With regard to the banking system, the Bank of Albania deems the revitalization of certain institutions, whose activity shares a small part of the banking market, as crucial. These institutions need to become more active, by taking more responsibility consistent with their business plans and they need to find new ways of organization and co-operation between them in order to enhance competition and provide a more symmetrical re-distribution of banking activity in our market.

4) The system's future challenges

Some sectors of economy, such as agriculture, continue to be credited at low levels or are not credited at all. The contribution of banking loans to production investments is still low. Moreover, considering the high share of loans for commercial purposes, it may be concluded that the largest share of loans is used to finance imports. The level of public accessing the banking system is not in the parameters set in the country's economic development objectives. Furthermore, the level of cash in economy is extremely high. All these phenomena push the borders of informality further and reduce the monetary policy efficiency. It is the financial system's duty and responsibility to make all its efforts in co-operation with the Bank of Albania and other Government authorities to find the solution to these problems.

In conclusion I would like to say that as a result of the reforms undertaken, the Albanian banking system, being the most dynamic part of the financial system, has made significant progress during the last years. This progress results from the clear visions and seriousness shown by the Albanian authorities in reforming the banking sector, the fruitful co-operation these authorities have had with the international financial institutions such as the IMF and the World Bank for designing medium-term strategies and developing this sector further. This progress is also a result of the numerous challenges the Albanian banking system has been faced with over the recent years.

It may be concluded that the Albanian banking system is presented safe, sound, under a constant reformation and consolidation process. It is going through a new stage, which will provide to the business and the banking clients modern banking services, aiming to reach the western banks' standards. "

With regard to the aspirations of the Albanian economy and strategies to be employed for its further opening to foreign investors, we believe that these undertakings will have a positive impact on the country's macroeconomic, technological and institutional area.

The banking system's stage of development and the FDI flows in economy have mutual influences on each other. Hence, if Albania attracts stable and long-term FDI flows in the following years, their impact on the further development of the financial system will be considerable. Furthermore, the demand for banking products both from domestic and foreign companies will grow.