

Fatos Ibrahimi: Banking system reforms, accomplishments and challenges in Albania

Speech by Mr Fatos Ibrahimi, Deputy Governor of the Bank of Albania, at the Ninth CEI Summit Economic Forum “Fostering reforms and innovations for sustainable growth”, a Ministry of Economy, Trade and Energy, Central European Initiative, Tirana, 23 November 2006.

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Distinguished participants,

Allow me to express my pleasure for participating in this forum and for the opportunity to present some of the main developments that have taken place in one of the most important fields of the Albanian economy, the banking system. My presentation will focus on two issues:

First, the main steps followed by the reform in the banking area, presenting the problems related to commercial banks, omitting monetary aspects.

Secondly, the current situation of the banking system and some of the main problems it is faced with, which need solution over the short-term and medium-term period.

The banking system reform was part of the structural reforms undertaken by the Albanian authorities after 1992, which aimed at macroeconomic stability and Albanian economy transformation into a market economy, by privatizing the economy and creating financial and social protection institutions.

The banking system transformation in Albania followed the same path as in other former socialist countries.

The first important phase started with the passing from the one-tier banking system into a two-tier system, in which the former Albanian State Bank was divided into two banks, with a qualitatively distinguished activity from each-other. The Bank of Albania was given the conventional functions of central banks, such as: monetary policy, currency issuing, foreign exchange market; while the National Commercial Bank, together with other banks, were given the conventional banking functions, such as accepting deposits, extending loans and other banking services.

The Laws “On the Bank of Albania” and “On the Albanian banking system” adopted in 1992 constituted the grounds needed for this transformation.

It is worth mentioning that one of the fundamental elements of the Law “On the Bank of Albania” of 1992 was the granting of a relatively high degree of independence to the central bank, as a legal, institutional, financial and personal independence. This independence has been increasing constantly throughout these years, not only as a legal and institutional independence, by amendments made to the Law in 1996 -1997 and after the approval of the Constitution, but also as an independence in the real aspect.

Under the Law of 1992, the dependence of the Central Bank passed from the Government to the Parliament, being given simultaneously the functions of determining the volume of credit, issuing, banking interest rate, the payment system, etc. At that time, the reform in second-tier banks was focused on three main directions:

1. Introduction of a new regulatory and supervisory framework;
2. Institutional policies in treating the non-performing loans;
3. Plans related to the privatization of state-owned banks.

Notwithstanding the measures taken for the banking system transformation till 1997, when the collapse of pyramid schemes reached the climax, the banking system was not able to operate effectively in carrying out its intermediation function. Private banks, which consisted of small foreign banks or joint-stock banks and which did not have any subsidiaries, hesitated to extend loans and were focussed on foreign exchange transactions and trade financing.

The state-owned banks were engaged in domestic lending, but they operated as government agencies, with soft restrictions in funds management and failed to apply the lending practices in compliance with international standards. Also, the Central Bank’s supervisory capacities of that time

were limited. Some data indicate that the level of non-performing loans at end of 1996 reached to 60% of the total loan portfolio.

Besides the weak performance in credit intermediation, the range of services provided to the public was also limited. Many of financial activities in the economy were carried out outside the licensed financial institutions. The financial infrastructure, including the payment system of accounting and audit was also rather weak.

Lack of a formal operational banking system, associated with an insufficient structure of regulations and supervision, contributed to the flourishing of pyramid schemes. The 1997 events served as an encouraging element for deeper reforms in the banking sector.

The government of that time, in cooperation with the International Community and the Bank of Albania, affirmed the commitment to implementing a full program of reforms needed for the banking system. The government' commitment to carry out a full program of structural reforms in banking sector served as an instrument for re-establishing the public confidence in financial institutions and services.

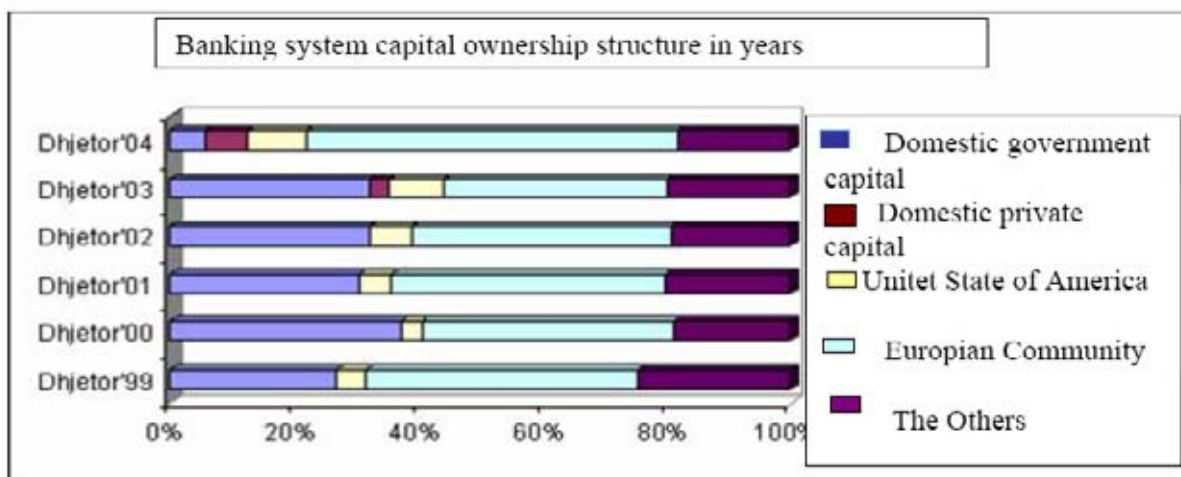
The program of that period was focussed on four main objectives:

- Improving the legal and regulatory infrastructure;
- Building sound and reliable institutions;
- Strengthening the financial infrastructure; and
- Liquidating or privatising the state-owned banks.

Besides the adoption of new laws on the Bank of Albania, on the banking system, on bankruptcy, and on safe transactions, of importance was the program for a rapid change of the state-owned banks' ownership, which led to the liquidation of the ANB and the establishment of the Bad Assets Resolution Trust. The NCB was recapitalised and privatised in 2000. During 2004, the privatization process of the Savings Bank was finalized, being purchased by the Raiffeisen International Bank Holding, thus recording the transfer of 94% of the banking capital to private ownership.

Currently the Albanian banking system is composed of 17 banks, 14 of which are of foreign capital. The capital source is from different places, such as Greece, Italy, Austria, Germany, United States of America, etc. After the privatization process of the former Savings Bank was over and a 100% of its stock was transferred to the Raiffeisen International Bank Holding AG in August, the capital ownership structure during that period underwent significant changes, having the share of "domestic government capital" estimated at 6% from 32.1% at end of 2003, and the "domestic capital" at 12.75 from 35.15% it was in the same period of the previous year.

Figure1: Banking system capital ownership structure in years¹



Recently, the improved climate for the development of business and the economy, the Savings Bank's privatization from the Raiffeisen Bank, the macroeconomic stability, and the low inflation, have all led to rapid development of the banking system. Hence, we can highlight that:

- During 2005 and onwards, considerable developments have occurred. The system was more oriented towards the lending activity. The latter one constituted 26% of the portfolio, from 16% in the same previous year period. In 2005, the outstanding credit of the banking system increased by ALL 57.6 billion² or 82%, from ALL 19.3 billion or 38% in the previous year. In the meantime, the significant growth rate of the outstanding credit compared to end of 2004 has been reflected even in the changed credit structure by terms. It comes out of the analysis that the short-term credit has maintained the same growth rate, while a shifting of the mid-term credit to long-term credit is noticed, particularly when the comparison is made with year-end 2004. Banking system assets of the nine-month period of 2006 increased by ALL 71 billion or 14% more than at year-end 2005, maintaining almost the same growth rate with the previous year. The downward trend of the large banks' contribution to the growth of the system indicates a reduction of the overall banking activity concentration. Meanwhile, the banking system assets performance in years, but particularly in 2005, expressed as a share of GDP, shows increased depth of the banking system intermediation. The ratio under discussion is estimated at about 59.3% for year-end 2005, versus around 52% at end of 2004 and 60.4 % at end of the nine-month period of 2006.

¹ Though in 2000, the National Commercial Bank was privatized, the increased weight of the domestic government capital in comparison to 1999 is explained with the growth of the size of the shareholders' equity of the Savings Bank to ALL 5 billion, from ALL -9.3 billion at end of '99 (it is evidenced with a negative value because of the accumulated losses of the SB).

At end of '99, the weight of the paid-in domestic government capital accounts for 41.7 percent, from 27 percent of the weight of the domestic government equity capital

² While the credit outstanding in ALL is increased by ALL 17.5 billion or 128 percent, the one in foreign currency is increased by ALL 40.1 billion, or 71 percent.

Indicators	2000	2001	2002	2003	2004	2005	9M/2006
Number of Banks,(from which with foreign capitals)	13 (12)	13 (12)	13 (12)	15(13)	15(14)	17(14)	17(14)
Total assets of the banking system	270,851	310,457	339,333	373,635	426,440	496,561	567,743
Total Loans (year-end)	28,213	28,277	38,941	50,824	70,148	127,056	171,484
Total deposits (year-end)	233,087	277,810	289,006	331,426	375,843	432,960	489,693
Total equity	18254	18760	21620	21985	25,949	26,993	39,883
The ratio of credit to GDP - se (In%)	5.3	4.8	6	7.3	8.9	15	≈ 18
The ratio of total deposits to GDP (in%)	43.9	47.1	45.8	48	48	52	≈ 56

Indicator in %	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04	Dec-05	9M/06
Capital adequacy	41.80	35.30	31.60	28.51	21.63	18.60	18.27
Non-performing loans minus provisions on equity	2.00	5.80	4.80	3.94	3.80	3.64	6.29
Non-performing loans to total loans	42.90	6.90	5.60	4.65	4.20	2.33	3.20
ROA	2.10	1.50	1.20	1.24	1.28	1.40	1.28
ROE	21.10	21.60	19.10	19.53	21.10	22.24	19.17
Interest income to gross income	67.70	83.70	87.00	89.63	80.32	83.97	95.58
Liquid assets to total assets	80.40	81.30	77.90	73.57	71.10	62.62	58.73

Compared to end of 2004, the banking system appears with an increasing level of profit, to ALL 6.1 billion. Return on equity resulted to 22.24% at end of 2005 and 19.2 % at end of the nine-month period of 2006, while the credit quality denominated as a ratio of the net non-performing loans to total loan portfolio is at 2.3%, from 4.2% at end of 2004. However, it is still soon to judge about the credit quality, because credits are still new and their quality has to be monitored prudentially.

- Year 2005 recorded ALL 33 billion of the shareholders' equity of the system, or about ALL 7 billion higher compared to 2004, and 19% of the capital adequacy indicator or about 3 percentage points lower than in the same previous year period, whereas for the nine-month period of 2006 these indicators are respectively: shareholders' equity of the banking system reached ALL 39.8 billion, being increased by ALL 6.8 billion compared to year-end 2005, and the capital adequacy indicator was 18.3 % or 0.3 percentage point lower than in the same previous year period.
- Another welcomed development of the banking system belongs to the customer service, which through electronic terminals, has been naturally associated with the increased number of electronic cards in circulation. Presently, banks provide debit and credit cards, in cooperation with the international companies of Visa and MasterCard, Diners Club. Nine banks provide the ATM service and the number of the latter ones at end of December 2005 was 205, while in August of this year it has reached to 266. In the meantime, the number of the points of sale has reached to 1073, of debit cards to about 70,176 and of credit cards to 4,245.
- Undoubtedly, the further expansion and strengthening of the banking system is an important aspect. The geographic extension of covering the territory with banking business, the increased competition, the introduction of many new products and the new recent developments constitute an additional argument for the vital role played by the banking system. The map of covering the country with banking business was further expanded, including new regions uncovered previously. Thirty new branches and agencies were opened during 2004, while in 2005 their number became 48, making the total number of branches at end of 2005 reach 127 and that of agencies reach 113.

- The positive developments in the banking sector and the increased number of subsidiaries and agencies have brought about a considerable increase in the number of employees. So, at year-end 2004, 3491 persons were employed at the Albanian banking system, from 2816 persons in the previous year. This constitutes a growth of 24% per year and expresses clearly the priority the banks are giving to the enhancement of human resources, as a necessary condition for growing the activity in the future.
- These developments indicate an improved perception, not only by banks but also by businesses and households for the investing environment in Albania, encouraged even by the sustainable macroeconomic environment. The annual increase of the number of employees that work at the banking industry by about 24%, versus 26% of the previous year is a logical outcome of the positive developments in the banking sector.

An important role in these developments has been played by the Bank of Albania, in terms of creating a favourable climate for the development of business and the economy. We may highlight here:

- The monetary policy followed in the recent years has always aimed at cutting the interest rates, with a slight change in 2006, intending to keep inflation rate under control. This has impacted on the establishment of a stable business climate, where the business plans and decisions are not jeopardised by the insecurity of inflationary erosion.
- Since some years the Bank of Albania has been committed to create an updated payment infrastructure, so that the banking system is open and closer to customer relations. Hence, after putting into operation the real time gross settlement system and the automated electronic clearing house system, the establishment of a loans register is presently aimed at. After the completion of the automated electronic clearing house system, another possibility is created not only for the banking system but also for the business of services of a periodic nature, so as to enhance its economic efficiency.
- The Bank of Albania deems that a banking system helps the economic growth if it is sound financially, since the developing economies, such as our economy, are generally characterised by a fragile stability. Therefore the Bank of Albania has taken a number of measures, aimed at enhancing its supervisory abilities, with the purpose to have a strong, sound and efficient banking system.

Regardless of the positive developments, still much has to be done. The degree of financial intermediation continues to be relatively low.

Some economy sectors, such as agriculture, continue to be slightly credited or not credited at all. The banking credit contribution to productive investments is still low, and moreover, given the high weight of lending to support the trade activity, the conclusion drawn is that the majority of loans go for financing the imports. Also, the degree of using the banking system is not in the required parameters, and moreover, the degree of using cash is still high.

During the current year, it has been worked for improving the existing Law "On Banks in the Republic of Albania". These improvements are being driven by the need for adopting the European directives in this area, and by the Basle principles for an effective supervision. Compared to the existing law, the new draft is aimed at being more complete, more accurate in some of its elements, including new concepts in compliance with the European directive 83/349 and other important directives. Amendments are envisaged in the way of licensing activities according to capital level, in the consolidated supervision, etc. Many provisions are planned to be introduced in the law, as concerns to risk management, which so far has been covered by some regulations. The draft-law, for which international financial institutions have also given their assistance, has been subject to a large discussion with the banking industry and is currently submitted to the Parliament for passing it.

In conclusion, I would say that:

As a result of reforms undertaken, the Albanian banking system, as the most dynamic part of the financial system, has recorded a constant progress in the recent years. This process is the fruit of clear visions and earnestness with which the Albanian authorities have treated the banking sector reformation, fruitful collaboration these authorities have had with international financial institutions, such as the IMF, the WB, for drafting the medium-term strategies and beyond, for the development of this sector as a vital sector of the market economy and the numerous challenges it has been faced with throughout these years.

Hence, the Albanian banking system is presented as safe, sound, under a constant reformation and consolidation process, passing into a qualitatively new stage, which will provide the business and bank customers with a modern banking service that aims at achieving the levels and standards of Western banks.