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FOREIGN BANK ENTRY ON BANKING SECTOR IN TRANSITION ECONOMIES: THE CASE OF ALBANIA

Leon PETANI

Danışman
Prof. Dr. Tülay YÜCEL

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ABSTRACT

Master Thesis

Foreign Bank Entry on Banking Sector in Transition Economies: the Case of Albania

Leon PETANI

Dokuz Eylül University

Institute of Social Sciences

Department of Business Administration

Finance Program

The high share of foreign banks in Eastern European countries has become a key feature of financial development. At present foreign banks own more than 50 percent of banking assets in almost all of the CEE and SEE and in some countries the share of foreign-owned bank assets is as high as 80-90% , making this region' banking systems among the most open in the world.

Despite mixed evidence in the literature as to the effects of foreign bank entry, the benefits foreign banks can offer are now much more widely recognised. Most transition economies now increasingly look to foreign banks to provide the capital, technology and know-how needed in banking. Nevertheless recent rapid credit growth leaded by foreign banks in transition countries has been the subject of much criticism because of the potential risks it poses to the financial sector and macroeconomic stability.

Albania joined the group of countries experiencing a credit boom in 2004-2005, after the privatization of the state-owned Savings Bank, with credit growth rates as high as 75% per year. In 2007 foreign banks' assets in Albania accounted for more than 94 percent of total assets in the banking system.

The aim of this work is to give a thorough presentation of the foreign bank entry and its effects in the Albanian banking sector, together with the potential risks and challenges to the financial stability. Even why for some objective reasons it is almost impossible to compare the performance of foreign banks vis-a-vis domestic banks, the impact of foreign bank entry on the sector as a whole is analyzed in detail, with important results and inferences for the future.

Key Words: Transition Countries, Foreign Banks, Albania, Banking Sector, Credit Growth.

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ABBREVIATIONS

ALL	Albanian Lek
BART	Bank Asset Resolution Trust
BCPS	Bank Credit to Private Sector
BIS	Bank for International Settlements
BoA	Central Bank of Albania
CEB	Central Eastern Europe and Baltic States
CEE	Central Eastern Europe
CPE	Centrally Planned Economy
EBRD	European Bank for Reconstruction and Development
EME	Emerging Market Economy
EU	European Union
FDI	Foreign Direct Investment
FSFDI	Financial Sector Foreign Direct Investment
FYROM	Former Yugoslav Republic of Macedonia
IFC	International Financial Corporation
IMF	International Monetary Fund
IPO	Initial Public Offering
M&A	Merger and Acquisition
MFI	Microcredit Finance Institution
NBFI	Non-Bank Financial Institution
NIM	Net Interest Margin
NPL	Non-Performing Loans
ROA	Return on Assets
ROE	Return on Equity
SEE	South Eastern Europe
SME	Small and Medium Enterprise
SOB	State-Owned Bank
SOCB	State-Owned Commercial Bank
SOE	State-Owned Enterprise

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INTRODUCTION

The importance of a sound financial system to economy as a whole has been the subject of much research. In the recent years an increasing number of studies have presented empirical evidence that show a strong positive relation between financial system development and long-run economic growth. In this aspect, the understanding of the mechanism, the players and functions of the novel and many times fragile financial systems in transition economies becomes essential for the macroeconomic stabilisation and growth policies.

At the end of the 1990's the banking industry world wide was being transformed. The global forces for change included technological innovation, the deregulation of financial services at the national level and opening-up to international competition. In Europe the introduction of the euro and the globalization of financial markets shaped the future of the banking industry

The transformation of the banking systems in emerging countries had also been pressured by the banking crises in Asia, Russia and Latin America. The banking industries in transition countries had mainly been transformed as a result of privatizations of state-owned banks that had dominated their banking systems in the past.

The emergence of foreign banks as major players in these countries, either through the acquisition of existing banking assets or as new entrants, has been a striking occurrence. Indeed, the entry of foreign banks in the transition region is unique in both its scale and coverage.

At the international level, the easing of restrictions on foreign entry and the search by global institutions for profit opportunities in the emerging economies have led to a growing presence of foreign-owned financial institutions in domestic banking systems. As a result, most emerging economies now increasingly look to foreign banks to provide the capital, technology and know-how needed in banking (Hawkins and Mihaljek, 2000:4). At the same time there has been a strategic shift by foreign banks away from pursuing internationally active corporate clients towards the exploration of business opportunities in the domestic market (Moreno and Villar, 2005:9).

Banking sectors in transition economies have been in the focus of interest for the foreign investors, here banks, and banking groups. Over the last decade the

financial sector in transition countries has converged towards a universal bank-based system, which is largely foreign-owned. Regional consolidation is driven by EU banks, mainly from Austria, Italy, France and Greece, which have created wide banking networks, particularly in the SEE region.

Extensive literature on the subject offers different conclusions as to the positive effects of such foreign entries in the banking sectors in transition countries. The fact that foreign banks are diversified across different countries could well change the cyclical behaviour of the host country financial system since foreign banks are less sensitive to host country economic conditions. On the other hand a large foreign bank presence can expose a country to shocks due to purely external events, such as those affecting the parent bank.

Following a period of privatization and restructuring, commercial banks in Central and Eastern Europe and, more recently, in the Balkans have rapidly expanded their lending to the private sector. While such credit expansion fuels economic growth it also might create serious risks to the economies. At the same time access to finance for small businesses, a crucial engine of growth in the transition economies is still lower than expected. There is a concern that foreign banks lack local market knowledge and are reluctant to lend to small businesses (EBRD, 2006:7).

Albania joined the group of countries experiencing a credit boom in 2004-2005, after the privatization of the state-owned Savings Bank, with credit growth rates as high as 75% per year. Together with positive implications for economic growth rapidly increasing credit might cause financial sector instability and macroeconomic imbalances that when coupled represent great risks to the economy. These include deteriorating quality of loans, currecy mismatch, inflationary pressures, current account vullnerability etc.

There have been many developments in the ownership status of the banking system in Albania. Since its establishment, the domination of state-owned banks has been decreasing and by end 2007, foreign commercial banks' assets accounted for more than 94 per cent of total assets in the banking system.

The aim of this work is to give a thorough presentation of the foreign bank entry and its effects in the Albanian banking system, together with the potential risks and challenges in the financial sector that have to be handled carefully by authorities. Even why for some objective reasons it is almost impossible to compare the performance of foreign banks vis-a-vis domestic banks, the impact of the foreign

bank entry on the banking sector as a whole is analyzed in detail, with important results and inferences for future performance. We will also try to identify the potential risks posed to the financial sector by the rapid credit expansion that has brought more dynamics in the banking activity.

The effect of the foreign bank entry on the Albanian banking sector has not been studied in a detailed way up to date, and considering that by the time this work was completed more than 94% of the assets of the banking sector in Albania was owned by foreign banks we hope that this work will be helpful to other researchers and policy makers.

Throughout this work European transition countries, particularly SEE countries where Albania is included will be in focus. Other transition and emerging countries will be used for comparative purposes. The closest group of countries in similarity of economy, political and structural reforms and geographical proximity are the CEE countries. Moreover these countries were among the more successful both in terms of system change and in terms of achieving economic and political stability, and they were the first transition economies to become members of the European Union. Thus these countries set a standard of perhaps the best that economies in transition could hope to achieve.The remaining group of the transition countries, the CIS countries by contrast, bear very different political and economic conditions, and thus are not used as a close comparative group.

This study is organized as follows: in the first chapter an overview of the financial system, financial intermediaries and their essential role in the economy as a whole and economic growth in particular is presented. Following the importance of the banking system and commercial banks that is stressed out in the first chapter, the second chapter gives a thorough insight into foreign ownership in the banking sector in transition economies, the main frame subject of this study. The financial system in Albania is presented in the third chapter, with an emphasis on the banking sector, which represents more than 95 percent of the financial system assets. Foreign ownership in the banking sector in Albania is examined in the fourth chapter where a structural dynamic analysis of the banking sector is carried out. The fifth and final chapter presents an empirical model for estimating bank credit to private sector in Albania, one of the most prominent effects of the foreign bank entry in the banking sector. The results of this analysis together with inferences, challenges and proposed strategies for the Albanian banking sector conclude this work.

CHAPTER 1

AN OVERVIEW OF FINANCIAL INTERMEDIARIES AND THE CHALLENGE OF TRANSITION COUNTRIES TO BUILD A SOUND FINANCIAL SYSTEM

Financial markets and financial intermediaries (banks, insurance companies, pension funds, etc.) have the basic function of moving funds from those who have a surplus to those who have a shortage of funds. A healthy and vibrant economy requires a financial system that moves funds from lender-savers mainly households, to borrower-spenders, mainly businesses and the government, who have the best profitable investment opportunities. The financial intermediaries rank investment projects by risk and return, monitor the uses to which borrowed funds are put, and sanction managers who fail to maximize shareholder value. By doing so, the financial intermediaries contribute to higher production and efficiency in the overall economy (Mishkin, 1998:35).

In market economies the intermediation of resources between different agents is a process mainly carried out by the financial system. The state acts as a regulator providing supervision of the financial intermediaries and compliance with regulations, while acting as an agent during the realization of its fiscal policies. The function and features of a financial system in a centrally planned economy are completely different. The allocation of resources in planned economies is guided by central authorities, making the financial system a mere passive means of payments and transfers between the state-owned enterprises (SOE). Poor financial systems consisting of a single level banking and some specialized banks serve this purpose. The scarce need for a disciplining market and competitive dynamics makes all other features and structures of more developed financial systems superfluous and a one-bank financial system prevails.

1.1. FINANCIAL INTERMEDIARIES

The process of indirect finance using financial intermediaries, called financial intermediation, is the primary route for moving funds from lenders to borrowers. Studies of the major developed countries, including the USA, Canada, UK, Japan, Italy, Germany and France show that businesses finance their activities mainly through financial intermediaries rather than from securities markets.

Banks have played a dominant role among financial institutions in the early stages of development in virtually all market economies. The legal and institutional prerequisites for efficiently functioning securities markets are more demanding. That is one of the reasons why banks took a leading role in the restructuring of financial systems in the transition economies in the early 1990s (EBRD, 1998:93).

The importance of financial intermediaries is explained by the existence of *transaction costs* and *information costs* in financial markets. Transaction costs are costs associated with financial transactions when buying or selling financial assets in the financial markets. Financial intermediaries can substantially reduce transaction costs because they have developed expertise in lowering them and because their large size allows them to take advantage of economies of scale. An additional reason that highlights the central role of the financial intermediaries is *asymmetric information* (Fabozzi and Modigliani, 1992:19-21).

Asymmetric Information: one party's having insufficient knowledge about the other party involved in a transaction, to make accurate decisions. The presence of asymmetric information creates problems in the financial system before the transaction is entered into and after. Asymmetric information can take the form of *adverse selection* or *moral hazard*.

Adverse Selection: is the problem created by asymmetric information before the transaction occurs. Adverse selection in financial markets occurs when the potential borrowers who are the most likely to produce the bad credit risks are the ones who most actively seek out a loan and are thus most likely to be selected.

Moral Hazard: is the problem created by asymmetric information after the financial transaction occurs. Moral hazard in financial markets is the risk that the borrower might engage in activities that are undesirable from the lender's point of view because they make it less likely that the loan will be paid back. Because moral hazard lowers the probability that the loan will be repaid, lenders may decide that they would rather not make a loan. The problems created by adverse selection and moral hazard are an important impediment to well-functioning financial markets, and financial intermediaries can alleviate these problems.

Types of Financial Intermediaries

Several types of financial intermediaries have evolved in the search for minimizing transaction costs and asymmetric information. We must stress here that

commercial banks are the most prominent of all financial intermediaries. Commercial banks have the most important role in financing business activities throughout the world. In developing countries banks play an even more important role in the financial system then they do in industrialized countries, due to greater asymmetric information problems in the developing countries. Let us have a look at the principal financial intermediaries and how they perform the intermediation function.

Depository Institutions: are financial intermediaries that accept deposits from individuals and institutions and make loans. These include:

Commercial Banks: raise funds primarily by collecting savings from households through checkable deposits, savings deposits and time deposits. Then these funds are used to make commercial, consumer and mortgage loans and to buy government securities.

Savings and Loan Institutions: obtain funds primarily through savings deposits and time and checkable deposits. The acquired funds have traditionally been used to make mortgage loans.

Mutual Savings Banks: very similar to SL's their corporate structure is different from that of SL's in that they are structured as mutual entities or cooperatives. The depositors own the bank.

Credit Unions: are very small cooperative lending institutions organized around a particular group: union members, employees of a particular firm etc. They acquire funds from deposits called shares and primarily make consumer loans.

Contractual Savings Institutions: such as insurance companies and pension funds are financial intermediaries that acquire funds at periodic intervals on a contractual basis. Because they can predict with reasonable accuracy how much they will have to pay out in benefits in the coming years, the liquidity of assets is not as important a consideration for them as it is for depository institutions. Contractual savings institutions tend to invest their funds primarily in long-term securities.

Life Insurance Companies: sell policies that insure people against financial hazards following a death or illness, and provide annual income payments upon retirement. They acquire funds from the premiums that people pay to keep their policies in force and use them mainly to buy securities and mortgages.

Property and Casualty Insurance Companies: insure their policyholders against loss from theft, fire, and accidents. They also receive funds through premiums for their policies, but having a greater possibility of loss of funds if major disasters occur. For this reason their funds are placed in more liquid assets then life insurance companies.

Pension Funds: private pension funds and state and local retirement funds provide retirement income in the form of annuities to employees who are covered by a pension plan. Funds are acquired by contributions from employers or from employees, who either have a contribution automatically deducted from their paychecks or contribute voluntarily.

Investment Intermediaries:

Mutual Funds: acquire funds by selling shares to many individuals and use the proceeds to purchase diversified portfolios of stocks or bonds. Mutual funds allow shareholders to pool their resources so that they can take advantage of lower transaction costs when buying large blocks of securities. In addition, shareholders can hold more diversified portfolios then they otherwise would.

Money Market Mutual Funds: have similar characteristics as mutual funds but they also function as a depository institution because they offer deposit-type accounts. They sell shares to acquire funds that are then used to buy money market instruments that are both safe and very liquid. The interest on these assets is then paid out to the shareholders. Shares in a money market mutual fund function like checking account deposits that pay interest.

Finance Companies: raise funds by selling commercial paper and by issuing stocks and bonds. They lend these funds to consumers, who make purchases of such items as furniture and automobiles, and to small businesses. Some finance companies are organized by a parent corporation to help sell its product.

1.2. FUNCTIONS OF THE FINANCIAL SYSTEM AND ECONOMIC GROWTH

Extensive study has been done on the subject of finance, growth and the relation between the two. Even though economists often disagree about the exact role of the financial sector in economic growth, a growing body of empirical analyses, including firm-level studies, industry-level studies, individual country-studies, and broad cross-country comparisons, demonstrate a strong positive link

between the functioning of the financial system and long-run economic growth. The conclusion generally drawn from these studies is that well-functioning financial intermediaries and markets promote long-run economic growth (Levine, Loayza and Beck, 2000:7). But how does financial development promote growth? Once we consider some of the main sources of growth, such as productivity improvement, physical and human capital accumulation, investment and savings, then the relation between financial development and economic growth can be understood better.

The basic functions provided by a financial system can be grouped in many ways; here we will employ the one presented by Levine (2004:5). Five broad functions provided by the financial system and financial intermediaries are:

- Produce information in advance about possible investments and allocate capital
- Monitor investments and exert corporate governance after providing finance
- Facilitate the trading, diversification, and management of risk
- Mobilize and pool savings
- Ease the exchange of goods and services

In an intuitive way an inference can be drawn, on the possible mechanism of how financial development may feed the sources of growth and foster economic growth. Now let us consider shortly how each of these financial functions can influence savings and investment decisions and hence economic growth.

Production of information about possible investments

Investment decisions often require developing evaluation skills, thus long and expensive research beforehand. During the evaluation process large costs are incurred to assess firms, managers, and market conditions before making investment decisions. Individual savers ability to collect, process, and produce information on possible investments is limited. These high information processing costs will eventually discourage individual investors from investing in unknown projects, which in turn may harm the efficient allocation of capital. Moreover large contracting costs are associated with most forms of investments, these are the costs of writing contracts between parties. Because of the amount of funds managed by financial intermediaries, economies of scale can be realized in contracting and processing information about possible investments (Fabozzi and Modigliani,

1992:21). By improving information on firms, managers, and economic conditions, and by minimizing the information costs incurred by the individual investor, financial intermediaries can promote the capital allocation efficiency and accelerate economic growth.

Monitoring of investments and corporate governance

Being the basic cells of the economy corporates and businesses are crucial to understanding economic growth. The subject of corporate governance is of growing importance nowadays with the wide expansion of globalized multinational companies. Effective monitoring of the capital use is a great challenge to financial intermediaries. In fact investment decisions and capital allocation depends on the ability of financial intermediaries to monitor and influence the firms activities after funding. Thus, the effectiveness of corporate governance may improve the intermediation process having positive effects on growth rates. Examples of this strategy in practice are the "*keiretsu"* or "industrial group" in Japan and industry – banking relations in Germany. Both these arrangements consists of groups formed of banks and other financial intermediaries together with industrial firms which are banks' clients, holding equity shares of each-other, thus giving banks voting rights in the industrial firms governance (Mishkin, 1998:214).

Diversification and Management of Risk

Together with information and transaction costs, financial risk keeps individual investors from transferring their savings to profitable projects. Diversification of risk is a main service provided by the financial system that influences greatly the allocation of capital and thus economic growth. This function of financial intermediaries is basically transforming more risky assets into less risky ones. By risk pooling saving and investment decisions in an economy are shaped and inferences for the growth rates follow. Studies show that financial systems that allow agents to hold a diversified portfolio of risky projects foster a reallocation of savings toward high-return projects with positive implications on growth.

Mobilization and Pooling of Savings

Mobilization of savings is the process of agglomerating capital from disparate savers for investment. Mobilizing savings involves: overcoming the transaction costs associated with collecting savings from different individuals and overcoming the

informational asymmetries associated with making savers feel comfortable in giving up control of their savings. Financial systems that are more effective at pooling the savings of individuals can profoundly affect economic development by increasing savings, exploiting economies of scale, and overcoming investment indivisibilities. Large, indivisible projects, financial arrangements that mobilize savings from many diverse individuals and invest in a diversified portfolio of risky projects facilitate a reallocation of investment toward higher return activities.

Exchange of Goods and Services

The ability to make quick payments without using cash is critical for the functioning of the financial system and the economy as a whole. Financial arrangements that lower transaction costs can promote specialization, technological innovation and growth. Financial intermediaries provide cost effective methods for making payments such as: checks, credit and debit cards, electronic transfer of funds etc. Promoting exchange in the markets results in productivity gains. There may also be feedback from these productivity gains to financial market development. If there are fixed costs associated with establishing markets, then higher income per capita implies that these fixed costs are less burdensome as a share of per capita income. Thus, economic development can spur the development of financial markets (Levine, 2004:24).

An important reason why many developing countries experience very low rates of growth is that their financial systems are underdeveloped, a situation referred to as financial repression. The financial systems in developing countries face several difficulties that keep them from operating efficiently. Two important tools used to overcome adverse selection and moral hazard problems in credit markets are collateral and restrictive covenants. In many developing countries, the legal system functions poorly, making it hard to make effective use of these two tools (Mishkin, 1998:219). The institutional environment of a poor legal system, weak accounting standards, inadequate government regulations, and government intervention through directed credit programs and nationalization of banks are all factors that may hinder economic growth in developing countries.

1.3. REGULATION OF THE FINANCIAL SYSTEM

The asymmetric information problem of adverse selection in financial markets helps explain why financial markets are among the most heavily regulated sectors in the economy. The fact that different parties in a financial contract do not have the same information, leads to adverse selection and moral hazard problems that have an important impact on the financial system. The financial system tends to be one of the most heavily regulated sectors of the economy, and banks are among the most heavily regulated of financial institutions. The principal reasons banks are subject to government regulation are: to increase the information available to investors, to ensure the soundness of the financial system, and to improve control of monetary policy. Let us examine shortly these reasons for regulation in the financial system.

Increasing Information Available to Investors: Asymmetric information in financial markets means that investors may be subject to adverse selection and moral hazard problems that may hinder the efficient operation of financial markets. Government regulation can reduce these problems in the financial markets, promote the public confidence in the financial system and increase its efficiency by increasing the amount of information available to investors. As an example corporations issuing securities are required to disclose information about their sales, assets, liabilities and earnings to the public.

Ensuring the Soundness of Financial Intermediaries: Asymmetric information can also lead to widespread collapse of financial intermediaries referred to as a financial panic. Because providers of funds to financial intermediaries may not be able to assess whether the institutions holding their funds are sound or not, if they have doubts about the overall health of financial intermediaries, they may want to pull their funds out of both sound and unsound institutions. The possible outcome is a financial panic that produces large losses for the public and causes serious damage to the economy. To protect the public and the economy from financial panics, the governments issue certain laws and tight regulations.

Improving Control of Monetary Policy: Banks play a very important role in determining the supply of money that in turn affects many aspects of the economy. Much regulation of these financial intermediaries is intended to improve control over the money supply. One such regulation is reserve requirements, which make it obligatory for all depository institutions to keep a certain fraction of their deposits in

accounts with the central banks. Reserve requirements for banks are a principal channel for governments' economic policies to stabilize the economy (Rose, 1995:130). The following tools for regulating the financial system are all designed to prevent the potential problems that may arise and to ensure a healthy banking system.

Bank Supervision: Chartering and Assessment of Risk Management

Setting up a bank or financial institutions is subject to chartering or licensing. Good credentials and large amount of initial capital are prerequisites for founding a bank. Overseeing who operates banks and how they are operated, referred to as prudential supervision, is an important method for reducing adverse selection and moral hazard in the banking business. Chartering banks is one method for preventing unqualified entrepreneurs who could engage in speculative activities, from controlling a bank. Regular on-site bank examinations, which allow regulators to monitor whether the bank is complying with capital requirements and restrictions on asset holdings, also function to limit moral hazard. However the change in the financial environment for banking institutions has resulted in a major shift in the supervisory process throughout the world. Bank examiners are now placing far greater emphasis on evaluating the soundness of a bank's management procedures with regard to controlling risk. Examiners give a separate risk management rating from 1 to 5 that feeds into the overall management rating as part of the *CAMEL* system. The *CAMEL* rating (that stands for: capital adequacy, asset quality, management, earnings and liquidity) given to banks by examiners provides information about banks activities and risk exposure, that regulators can use to enforce regulations that can affect the bank's behaviour and its risk taking attitude.

Once a bank has been chartered, it is required to file periodic reports that reveal the bank's assets and liabilities, income and dividends, ownership, foreign exchange operations and other details. The bank is also subject to examination by the bank regulatory agencies to ascertain its financial condition.

Deposit Insurance*:* The governments can insure people providing funds to a financial intermediary from any financial loss if the financial intermediary should fail. All the financial intermediaries make contributions to the insurance fund.

A bank failure is a situation in which a bank is unable to meet its obligations to pay its depositors and other creditors and so must go out of business. In the

absence of a deposit insurance, depositors faced with a bank failure would have to wait to get their deposit funds until the bank was liquidated and be paid only a fraction of the value of their deposits. Unable to monitor the risk taken by a bank's managers depositors would be reluctant to put money in any bank, following a bank failure, thus making the banking business less viable. Moreover, the depositors' lack of information about the quality of the overall bank assets in the system can lead to bank panics, which can have serious harmful consequences for the economy. A deposit insurance can short-circuit runs on a banks and bank panics, and by providing protection for the depositors, it can overcome reluctance to put funds in the banking system. With fully insured deposits, depositors don't need to run to the bank to make withdrawals, even if they are worried about the bank's health.

The most serious drawback of the deposit insurance practices stems from moral hazard, which is an important concern in insurance arrangements in general, because the existence of insurance provides increased incentives for taking risks that might result in a payoff. Because with a deposit insurance depositors know that they will not suffer losses if a bank fails, they do not impose discipline on banks by withdrawing deposits when they suspect that the bank is taking on too much risk. Consequently, banks having a deposit insurance arrangement have an incentive to take on greater risks then they otherwise would (Mishkin, 1998:83)

The moral hazard created by a deposit insurance and the desire to prevent bank failures have presented bank regulators with a particular dilemma. Because the failure of a very large bank could lead to a major financial disruption, bank regulators are naturally reluctant to allow a big bank to fail and cause losses to its depositors. A too-big-to-fail problem may, in turn, increase moral hazard incentives: knowing the existence of an implicit safety net, big banks may be less careful in allocating credit and screening potential borrowers, take on even greater risks, and make bank failures more likely (Agenor, 2001:19).

Bank Capital Requirements and Restrictions on Asset Holdings*:* There are restrictions on what activities financial intermediaries are allowed to engage in and what assets they can hold. Financial intermediaries are particularly restricted from investing in certain risky activities. As an example in the United States commercial banks and other depository institutions are allowed only to hold

securities and stock solely for the account of customers and in no case for their own account, because stock prices experience substantial fluctuations.

Bank regulations that restrict asset holdings and bank capital requirements are directed at minimizing the moral hazard problem which stems out from banks' excessive risk taking. Due to the nature of their business banks tend to engage in risky activities, that may provide the bank with higher earnings when they pay off; but if they do not pay off the bank may become insolvent and fail at the depositors' cost. Acquiring information on a bank's activities to learn how much risk the bank is taking can be a difficult process for the individual depositor. Hence most depositors are incapable of imposing discipline that might prevent banks from engaging in risky activities. Bank regulations also promote diversification, which reduces risk by limiting the amount of loans in particular categories or to individual borrowers (Fabozzi and Modigliani, 1992:25-26).

Requirements that banks have sufficient bank capital are another way to change the bank's incentives to take on less risk. When a bank is forced to hold a large amount of equity capital, the bank has more to lose if it fails and is thus more likely to pursue less risky activities. To be classified as well capitalized, a bank's leverage ratio (the amount of capital divided by the bank's total assets) must exceed 5 percent; a lower leverage ratio triggers increased regulatory restrictions on the bank.

In the wake of globalization of financial activity and financial innovation an additional concern was that the amount of equity capital was even less adequate because of potential liabilities that do not appear on the banks' balance sheet. These so-called "off-balance sheet" activities include commitments such as letters of credit, interest-rate swaps, futures and options and expose the banks to high risks. These concerns for capital adequacy led to an agreement among banking officials from industrialized countries who met under the auspices of the Bank for International Settlements in Basel, Switzerland in 1988.

Disclosure Requirements*:* To ensure that there is better information for depositors and the marketplace, regulators can require that banks adhere to certain standard accounting principles and disclose a wide range of information that helps the market assess the quality of a banks' portfolio and the amount of the banks' exposure to risk. More public information about the risks incurred by banks and the quality of their portfolio can better enable stockholders, creditors and depositors to

evaluate and monitor banks and so act as a deterrent to excessive risk taking. Estimates of financial risk generated by banks' own internal risk management systems can also be adapted for public disclosure purposes. Such information would supplement disclosures based on traditional practices by providing information about risk exposure and risk management that is not normally included in balance sheet and income statement reports. The disclosure procedures that are oriented toward consumer protection include the public disclosure of information about the cost of borrowing, and the total finance charges on loans. There are stringent reporting requirements for financial intermediaries. Their bookkeeping must follow certain strict principles and their books are subject to periodic inspection (Rose, 1995:57).

Restrictions on Competition*:* Increased competition can also increase moral hazard incentives for banks to take on more risk. Declining profitability as a result of increased competition could push the incentives of bankers toward assuming greater risk in an effort to maintain former profit levels. Thus governments in many countries have created regulations to protect banks from competition. The most prominent practice has been the preventing of non-bank institutions from competing with banks by engaging in banking business. However restricting competition can have serious disadvantages. It can lead to higher charges to consumers and can decrease the efficiency of banking institutions. This downside has provided a more cautious approach to restricting competition in the banking sector in industrialized countries in recent years. Different restrictions have been put traditionally that inhibit competition in the banking system. This stems from the belief that free competition among financial intermediaries promotes failures that will harm the public. Examples include limits on interest rates, credits, branching etc.

1.3.1. The Basel Accord on Risk-Based Capital Requirements

The increased integration of financial markets across countries and the need to make comparable regulations for banks from different countries led to the June 1988, Basel Accord to standardize bank capital requirements internationally. This accord represents a milestone in the international harmonization of supervisory regulations. With this agreement the base rate of capital adequacy was fixed at 8% and calculated as a ratio of capital to risk-weighted assets.

The stated purposes of the agreement were:

- To promote world financial stability by coordinating supervisory definitions of capital, risk assessment and standards for capital adequacy across countries.
- To link a bank's capital requirements systematically to the riskiness of its activities, including various off-balance sheet forms of risk exposure.

The Basel capital requirements works by assigning a different risk weight to all the assets and off-balance sheet activities which are allocated into four categories, to reflect the degree of credit risk associated with that group of assets. The lowest risk category includes items that have no default risk, such as reserves and government securities. The highest risk category includes all other securities such as commercial paper, loans and fixed assets. Off-balance sheet activities are treated in a similar manner by assigning a credit-equivalent percentage that converts them to on-balance sheet items, and then the appropriate risk weight applies.

Once all the bank's assets and off-balance sheet items have been assigned to a risk category, and are weighted by the corresponding risk factor they are added up to compute the total "risk-adjusted assets." The bank must then meet two capital requirements: It must have "core 1" or Tier 1 capital of at least 4 percent of total risk-adjusted assets, and total capital (Tier 1 capital plus Tier 2 capital, which is made up of loan loss reserves and subordinated debt) must come to 8 percent of total risk-adjusted assets. For regulators to classify a bank as well capitalized, it must meet an even more stringent total-capital requirement of 10 percent of risk-adjusted assets and Tier 1 capital of 6 percent of risk-adjusted assets.

The effect of this agreement was instantaneous. Although the Basel Accord was initially directed only at internationally operating banks, it has now become the globally recognized capital standard for banks. The growing complexity of banks activities and securities trading activities made possible to amend the capital accord in 1996, by incorporating also the capital requirements to cover market risk. The Core Principles for Effective Banking Supervision of the Basel Committee were published in September 1997. Despite its positive aspects the 1988 Basel Accord has come under increasing criticism over the past few years, due to the fact that:

• The institutions risks are captured only very roughly and thus imprecisely;

• New financial instruments such as credit derivatives, netting agreements for balance-sheet position, the global use of collateral, and credit risk models have been virtually ignored;

• The gearing of the capital requirements solely to credit and market risk does not correspond to the overall risk profile of a bank.

1.3.2. Basel II

The Basel Committee on Banking Supervision revised the agreement of the year 1988. By revising the Accord, the Basle Committee put itself the objective of eliminating shortcoming of prudential credit risk measures and of bringing the modern measurement of credit risks in the capital adequacy regulations into line with the credit institutions risk management methods. The Basel II Framework describes a more comprehensive measure and minimum standard for capital adequacy that national supervisory authorities are now working to implement through domestic rule-making and adoption procedures. It seeks to improve on the existing rules by aligning regulatory capital requirements more closely to the underlying risks that banks face. The efforts of the Basel Committee on Banking Supervision to revise the standards governing the capital adequacy of internationally active banks achieved a critical milestone in the publication of an agreed text in June 2004 (BIS, 2004:1-7). The New Basel Capital Accord is based in three main pillars:

Pillar I. Minimum capital requirements

Pillar II. Supervisory review process

Pillar III. Enhanced disclosure and market discipline

Pillar I. Compliance with the capital requirement of Basel II is measured, as before, using the capital ratio, which must be no lower than 8%. In the new Accord, the *operational risk* has now been added in determining capital adequacy to the existing risk types namely *credit risk* and *market risk*. Operational risk is defined as the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events. Operational risks have become important because of the fact that banking operations are becoming more

dependent on information technology and electronic banking. The Basel Committee on Banking Supervision has specified three methodologies for measuring operational risk:

- The basic indicator approach is a less sophisticated procedure using general indicators, for example gross income.
- The standardized approach uses an indicator that reflects the volume of the banks activities within each business line.
- Internal measurement approach takes account of the institutions' individual experience of operational losses.

The overall capital requirement is then calculated by multiplying these expected losses by a capital factor specified by the supervisors.

Pillar II. The Supervisory Review Process represents a major innovation in the revision of the Basel Capital Accord and is based on:

- Continuous improvements to banks internal procedures for assessing their institution-specific risk profile and capital requirements.
- The capture of external factors such as the influence of the business cycle, as well as other risk areas (e.g. interest rate risks, statistical uncertainties in measuring operational risks) when calculating the minimum capital requirements.
- The dialogue between banks and supervisors about institutions own procedures to measure and monitor their risk.
- The supervisory authority ability to require, to identify and take action requiring higher regulatory capital ratios as necessary for an institution.

Pillar III. Enhanced disclosure is based on the expectation that well informed market players would reward credit institutions with risk-aware business management and or penalize riskier behavior. The purpose is to complement the minimum capital requirements and the supervisory review process. This aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution. Supervisors have different powers available to them to achieve the disclosure requirements. Market discipline can contribute to a

safe and sound banking environment, and supervisors could require banks to disclose information under safety and soundness grounds. Alternatively, supervisors have the authority to require banks to provide information in regulatory reports which at the same time can be publicly available (BIS, 2004:175).

Being implemented in the EU as of January 2007, Basel II is expected to provide a strong encouragement for enhancing banking supervision, in the developing countries, while the banks themselves are going to be more sophisticated in risk management. In the EU another important effort to establish a common regulatory framework for the financial systems was the Financial Services Action Plan (FSAP). It comprises 42 directives targeted at a wide range of financial activities and it is now almost fully implemented in the EU countries.

1.4. THE CHALLENGE OF THE TRANSITION COUNTRIES: BUILDING A FUNCTIONING FINANCIAL SYSTEM AND INTERMEDIARIES

The transition from a centrally planned to a market economy requires that prices, as well as trade, are liberalized and that an enforceable legal system, including property right is in place. The performance of a market economy is enhanced by the consensus about economic policies by the macroeconomic stability and the absence of any significant barriers to market entry and exit. But a successful transition requires in the first place the building of a sound market-oriented financial system. Financial institutions, banks in particular play a central role in the allocation of resources in all market economies and provide a payments system that substantially lowers the cost of market transactions. The efficiency with which financial markets and institutions carry out these tasks is a crucial determinant of economic performance.

The transition economies inherited few of the relevant financial institutions from the era of central planning, where the financial system was little more than a bookkeeping mechanism for the central authorities' decisions about the resources to be allocated to different enterprises and sectors. Since there was no demand for banks to carry out the tasks of financial intermediation they developed little capacity to do so. Today banking sectors in transition economies are different from their counterparts in either developed or developing countries due to the legacies of the monobank system and culture (EBRD, 1998:92).

1.4.1. Legacies of the Centrally Planned Economies

Banking sectors in all transition economies during the 1990s were underdeveloped due primarily to the legacies of the pre-transition planned economy. In the centrally planned economy (CPE), money served as a unit of account and played only a limited role as a medium of exchange. The payment system consisted of a cash circuit for households and commercial transfers among enterprises handled by the central bank. In most CPE's, specialty banks existed separately from the central bank and performed specific functions according to the economic sectors they served. A state *savings bank* with an extensive branch network was responsible for collecting household deposits. A *foreign trade bank* handled all transactions involving foreign currency. An *agricultural bank* provided short-term financing to the agricultural sector. A *construction bank* funded long-term capital projects and infrastructure development. The existence of these specialty banks was only due to the structural nature of the CPE, and their main function was to serve the central planning (Fries, 2005:6).

There was no need for the supervision and prudential regulation of the financial activities beyond that inherent in the direct control of these accounting activities by government. The intermediation process was wholly controlled by the state and the credits extended to the investment and budget needs of the state-owned enterprises (SOE) were granted on a political and strategic, rather than on an economic basis with scant regard for repayment capacity. These practices lead to a lack of credit analysis and risk assessment skills that would be engaged only in the first years of transition by the foreign or emerging private banks. The challenge for the transition economies was thus to create a functioning financial system that had not existed before.

In doing so, they were encumbered by an inheritance of state banks that inevitably formed the foundation of the nascent financial system. The portfolios of these banks were dominated by non-performing loans, and their personnel possessed few of the capabilities expected of financiers in market economies. Building a functioning financial system around the vestige of the old one was a difficult task. At the same time, the state inherited little capacity from central planning to regulate effectively a decentralized banking system (EBRD, 1998:92).

Hence, structural segmentation, state-ownership of a significant proportion of banking assets, and a large number of bad loans were the main legacies of the CPE for banking sectors in most transition economies (Bonin, 2001:3).

Notwithstanding the similarities between different transition countries with regard to their primitive financial systems and the scarce presence of functioning financial intermediaries, the degree of economic development and financial depth in some of the countries was markedly greater. The potential to build functional and credible financial systems was obviously higher in some of the transition countries in CEE. That is why the starting conditions and the subsequent reforms at the beginning of transition were particularly significant for the challenge of transforming the old system.

1.4.2. Starting Conditions and Reforms

A transition economy's appeal depends not only on measures taken to reform and liberalize the economy; it also depends on the starting conditions from which policy makers begin the transition process. Starting conditions consist of the measures that had been taken to implement transition in advance as well as the state of the economy, as measured by monetary imbalances and distortions in the structure of production that existed prior to transition (Brada, Kutan and Yigit, 2004:21).

In the early days of transition the question of macroeconomic stabilization stood out among all reform priorities in transition countries. Many, but not all, of the transition economies had pursued a policy of aggressive price liberalization followed by high rates of inflation. These countries' economies were characterized by large and persistent fiscal imbalances that reflected underlying structural weakness, including soft budget constraints for loss-making enterprises, opaque tax systems, and inefficient tax administration. Unquestionably, the countries that achieved stabilization by a steady monetary policy, mostly CEB countries, succeeded in restarting the growth process and keeping inflation under control, while elsewhere monetary instability was accompanied by a protracted slump (Carare, Claessens and Perotti, 1999:5).

The degree of macroeconomic instability had a significant influence on the scale of development of banking sector as well. Developing vibrant financial sectors in transition economies was inevitably going to be a long and difficult task. Evidence

reveals that not only was banking underdeveloped relative to the situation in other emerging market economies at comparable stages of development (as measured by GDP per capita) but securities markets were even more severely deficient. In 1993, for example, average bank assets per capita in the transition countries were below 1,300 US Dollars, lower than other developing countries (above 1500 USD), while bank assets in many developed European countries at the time surpassed 40,000 US Dollars per capita (Gianneti and Ongena, 2004:5).

The first step in banking sector reform in most of the transition countries was structural and involved the creation of a two-tier system with commercial and retail activities carved out of the portfolio of the mono-central bank (Bonin, 2001:3). An important policy decision was how to sequence or link financial sector reform and enterprise restructuring. To meet the challenge of building stable market-oriented financial systems, it was necessary to develop the skills and practices both in financial institutions and markets. In addition to this process of learning-by-doing, several factors were likely to shape the further expansion of finance. Governments had to put into place the kind of prudential regulations and supervisions, disclosure and reporting requirements, auditing and accounting, and corporate governance practices that promote development of active and efficient banks and securities markets. This required real competition among prudent and well-managed financial institutions, together with their private ownership and effective corporate governance (EBRD, 1998:93).

Table 1: Banking System Characteristics in Early Transition in Some CEE and SEE countries

REFORMS	Hungary	Poland	Czech Rep	Bulgaria	Romania	Albania
Establishment of two-tier Banking System	1987	1989	1990	1989	1990	1992
Number of State-Owned Commercial Banks	4	9	2	59	4	3
Number of Foreign Commercial Banks	2	5	0	0	2	0
Specialized Banks	10	1	1	8	2	0
Banks Specialized for Foreign Transactions	1	1	2	1	1	1
Savings Banks	1	1	2	1	1	1

Source: Ibrahimi and Salko, 2001:196; Bonin, 2001

Nonetheless, many transition economies had major shortcomings in the way to fulfilling these goals, such as: the lack of capital, the lack of commercial banking skills and an inefficient banking structure. These and other factors which created a need for foreign bank participation, would lead to wide-scale bank privatizations in the transition countries. The length of the privatization process varied from country to country. The mono-bank system had been abolished or significantly weakened prior to 1989 in the former Yugoslavia, Hungary and Poland. This early start allowed the two later countries to privatize at least some state banks relatively early in the transition and to allow relatively free foreign participation compared with other parts of Eastern Europe.

The main reason for privatization of the state-owned banks was their poor performance and frequent costly bailouts, resulting from inadequate systems of governance under state ownership. A second reason was a widely held perception that the presence of state-owned banks tends to hold back the development of the financial sector. Several empirical studies have indeed established that the presence of state-owned banks generally is associated with a lower level of financial development. The most successful method for privatization of state-owned commercial banks in recent years appears to have been the sale to strategic partners, usually reputable foreign banks (Hawkins and Mihaljek, 2001:11).

In central and eastern Europe, bank reforms did not focus on privatization in the early stages of the transition. Pressing issues at the time were the resolution of a large stock of inherited bad debts and recapitalization of the financially very weak state-owned banks. There is evidence that after the early stage of collective bailouts ended in early 1993, banks at first acted as a channel to support insolvent firms. In the first years of transition SEE countries started a collective bailout of firm arrears funded with monetary emissions (Romania 1991-1993, Bulgaria 1994). The immediate inflationary impact and strong IMF pressure convinced the governments to stop such measures. In conclusion, the evidence suggested that bank credit in 1993-1994 replaced state subsidies of 1990 and direct bailouts of trade arrears of 1991-1992 (Carare, Claessens and Perotti, 1999:6). These practices ultimately culminated in banking crises in both countries that eventually helped to spur a stronger pace of reform (Fries and Taci, 2002: 6).

Poor lending was a serious concern for comparable emerging economies as well. There were many banking crises in emerging countries during the 1990s, often occurring shortly after the external and banking systems were deregulated. Banking

crises, in which a large number of banks failed, occurred in the transition region also. They have been prevalent in countries at relatively advanced stages of transition where the financial environment had been liberalised but the regulatory framework had not been developed sufficiently to contain the additional risk. Banking crisis were experienced by Estonia in 1992 and by Latvia and Lithuania in 1995. The Czech Republic saw the failure of several medium-sized and large local banks in 1996 and Bulgaria a full-fledged banking crises that same year. In Estonia, insolvent banks accounted for more than 40% of the assets of the financial system. In Bulgaria's banking panic more than a third of all banks were placed under administrative control or entered bankruptcy proceedings (EBRD, 1998:100). Experience suggests that financial crises tend to occur when the financial sector develops too quickly and branches out into new activities following financial liberalization.

Toward the end of the 1990s most transition countries' financial sectors remained underdeveloped, burdened by the legacies of central planning and structural and macroeconomic upheavals early in the transition. Financial sectors were small and heavily bank-based. Banking systems were relatively underdeveloped in most countries, characterized by a lack of financial intermediation, continuing bad loan problems and weak central bank supervision. Lending to the private sector was very low by any standard (EBRD, 1998:93).

Almost nowhere were the differences between economic systems more manifest than in the financial sector. Whereas in market economies the financial sector plays a key role in the resource allocation and risk pricing processes, under central planning it had been merely responsible for passively accommodating and monitoring the payment flows between enterprises. Financial intermediaries were almost non existent in most CPE's in the eve of transition, thus making the transformation of the old financial system into a two-tier modern system one of the first reforms to be carried out.

Despite considerable variation in the approaches to financial sector reform, the key driving forces across the transition region have been broad changes in the institutional environment, privatization and market entry by foreign banks. These changes have increasingly been associated not only with improvements in bank performance but also with widening access to banking services and greater diversity in the types of services being offered to customers.

The increasing availability of finance for the private sector in transition economies raises the obvious issue of its impact on growth. This relationship has been widely studied, with very mixed results. Evidence from the 1990s suggested that the link between financial development and economic growth was not strong in the first decade of transition. This link appears to have strengthened as the general institutional framework has improved. Nevertheless most countries, even the advanced countries of CEE and the Baltic countries, have lower levels of financial development than their levels of income would imply (EBRD, 2004:28). This suggests that financial systems in transition countries must develop further before the full growth potential of these economies can be exploited.

CHAPTER 2

FOREIGN BANKING IN TRANSITION[1] ECONOMIES

During the 1990s, the presence of foreign-owned banks in developing and transition economies increased dramatically. In Central Europe, the proportion of total bank assets controlled by foreign-owned banks rose sharply from 8 percent in 1994 to 56 percent in 1999 making these countries banking systems among the most open in the world (Agenor, 2001:26). At present this level is more than 50 percent in almost all of the CEE and SEE and in some countries the share of foreign-owned bank assets is as high as 80-90%.

Banking crises, deregulation and globalization of financial services led to this dramatic increase in the presence of foreign banks in the emerging economies, while assets of foreign bank branches and subsidiaries remained virtually constant in all western European countries during the last few decades and never exceeded more than 15% of total bank assets in France, Germany, Italy, the Netherlands, Spain, and Sweden (Giannetti and Ongena, 2004:9; ECB, 2007:51-63).

As seen from Table 1, foreign ownership of the banking sector is substantially higher in Latin America and CEE than in Asia. In some countries foreign banks now control more than 50% of total banking assets. The share of foreign banks (50% or more foreign ownership) in total assets of the banking sector ranged from 68% to 90% in Poland, the Czech Republic and Hungary. While banking systems in some smaller economies such as the Baltic States are almost entirely foreign-owned. (BIS Quarterly, 2005:73).

Some of the recent evidence on the effects of foreign bank penetration in emerging countries appears to support the view that the competitive pressures that it creates have led to improvements in the efficiency of domestic banks and financial intermediation in general in terms of lower operating costs and reduced net interest margins. On the other hand, the risk that foreign banks may lead to credit rationing to small firms and greater concentration in the allocation of credit, with adverse effects on the distribution of income, must be taken seriously (Cottarelli, Dell'Ariccia and Vladkova-Hollar, 2003).

[1] Even though most of the European countries that underwent a transformation of their economy from central planning to market economy are now EU members and thus the transition process is considered to be completed, throughout this work we will regard these as transition countries.

Table 2: Change in the Share of Foreign Bank Assets in Selected Transition and Emerging Countries

	1990	2004	% GDP	bn. USD
CEE				
Bulgaria	0	80	49	13
Czech Republic	10	96	92	99
Estonia	...	97	89	11
Hungary	10	83	67	68
Poland	3	68	43	105
EMERGING ASIA				
China	0	2	4	71
India	5	8	6	36
Korea	4	8	10	65
Singapore	89	76	148	159
Thailand	5	18	20	32
LATIN AMERICA				
Argentina	10	48	20	31
Brazil	6	27	18	107
Chile	19	42	37	35
Mexico	2	82	51	342

Source: BIS Quarterly Review, 2005:72

The rapid credit expansion by foreign banks in the transition countries also raises financial stability issues for host country authorities. Lending to households has been a particular concern in European transition countries, where household credit increased by an annual average of 17% between 2000 and 2004. Some of this growth is the result of the aggressive expansion by foreign banks due to much higher spreads in these markets. Nevertheless, household credit growth is occurring from a low base and in rapidly growing economies, so the debt burden is still relatively low (BIS Quarterly Review, 2005:78).

In the remainder of this chapter I consider the surge in international financial integration in the last two decades, the foreign expansion of banks during this period and their motivations to go abroad. Next, the possible benefits and drawbacks of foreign bank entry are highlighted concluding with the evaluation of the present situation of foreign banking in European transition economies.

2.1. INTERNATIONAL FINANCIAL INTEGRATION AND FOREIGN DIRECT INVESTMENTS IN TRANSITION ECONOMES

The degree of integration of financial markets around the world increased significantly during the late 1980s and 1990s. A key factor underlying this process

has been the increased globalization of investments seeking higher rates of return and the opportunity to diversify risk internationally. At the same time, many countries encouraged inflows of capital by dismantling restrictions, deregulating domestic financial markets, and improving their economic environment and prospects through the introduction of market-oriented reforms.

In particular, many developing and transition economies in East Asia, Latin America, and Eastern Europe removed restrictions on international financial transactions, at the same time that they were relaxing regulations on the operation of domestic financial markets and moving away from regimes of financial repression. Policies aimed at increasing the openness of domestic financial markets to foreign investors have included the removal of controls on capital outflows and the liberalization of restrictions on foreign direct investment (Agenor, 2001:3).

The results of these transformations in the form of FDI's entering the financial sectors of these countries have been substantial. Between 1991 and 2005, transactions targeting banks in emerging market economies accounted for $121 billion. Of these, cross-border merger and acquisitions targeting banks in CEE was $20 billion (17% of total Mergers & Acquisitions). Latin America leaded followed by emerging Asia with respectively $58 and $43 billion (BIS Quarterly, 2005:70-71).

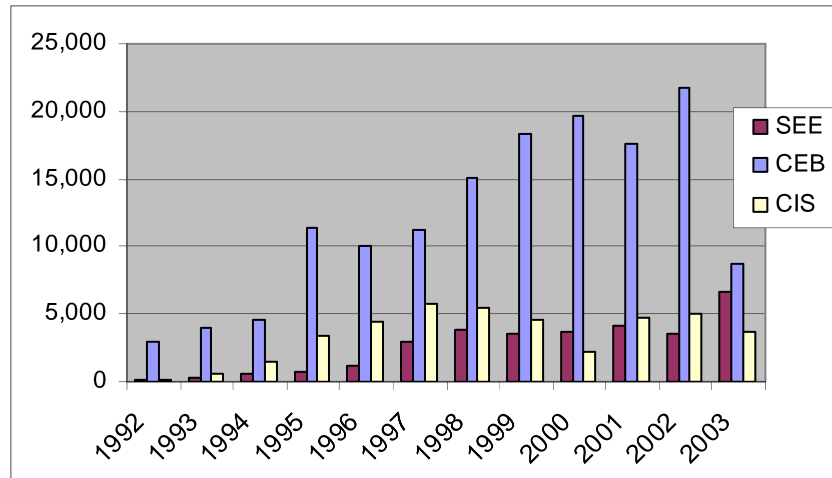
Transition economies' FDI inflows differ from those of other emerging economies due to the effects of transition. The actual FDI inflows thus depend both on macroeconomic and structural characteristics captured by and on the pace and success of transition. Political and economic stability in the host as well as trade links between home and host countries have been important factors that explain the degree of foreign interest in investing in the financial sectors. The establishment of the rule of law also played an important part in investors' considerations, because the security of the investment was likely an important selective consideration (Brada, Kutan and Yigit, 2004:20).

The transition economies of Eastern Europe received an impressive amount of FDI's during the past decade. These FDI inflows have been dramatic both because of their dynamism, as these countries began the 1990s with practically no stock of FDI, and because FDI had important consequences for the transition process and for these countries' economic performance. (EBRD, 2006:7)

In Figure 1 we can see the annual overall FDI's in the economies of the three groups of transition countries for the period between 1992 and 2003. The CEE

countries clearly outpaced the two other groups and FDI inflows into the SEE region are considerably low.

Figure 1: FDI in Transition Countries, 1992-2003 (mill. USD)



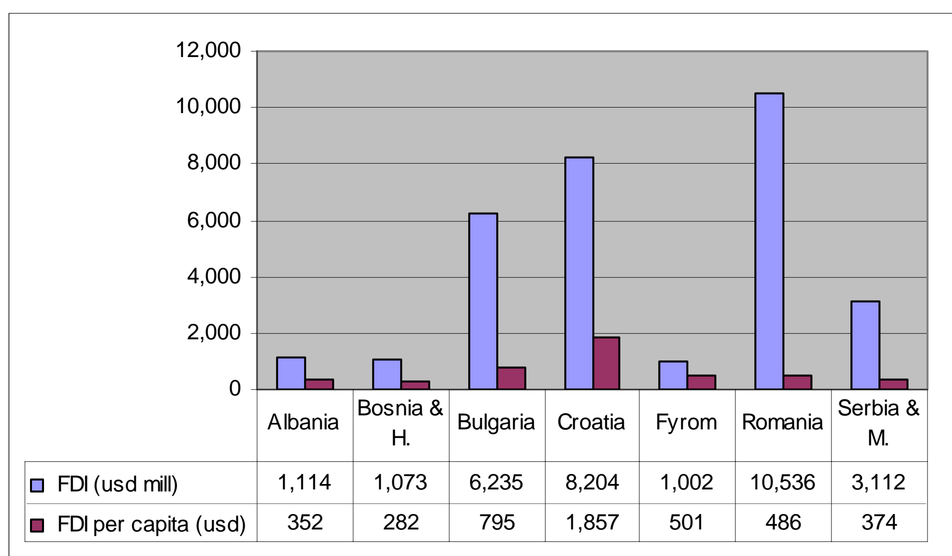
Source: EBRD Transition Report, 2004:27

Furthermore, as Figure 2 shows, there are greater inter-country differences in the SEE group in terms of the volume of FDI inflows. Romania, Bulgaria and Croatia emerged as significant host countries for FDI in the second half of the decade. Progress with economic stabilization and economic and political reform no doubt played a role in this trend.

The causes of the Balkan countries shortfall in attracting FDIs are manifold. Some of the Balkan countries are small by any standard, which may limit FDI inflows relative to countries that can offer a large domestic market. Many, although by no means all, Balkan countries have been unable to implement or sustain cohesive reform strategies, and political instability in the region has affected the decisions of potential foreign investors. For example, FDI inflows to Albania dropped sharply in 1997-1999 as a reaction to the crisis caused by the collapse of the financial pyramid schemes in 1997 and the Kosovo crisis of 1999 (Brada, Kutan and Yigit, 2004:25).

Another important source of variability is the major changes in privatization policy, which occurred in the Balkans during the late-1990s, not at the beginning of the decade as in the CEE countries.

Figure 2: Cumulative FDI and FDI per capita in SEE Countries, 1992-2003.



	Albania	Bosnia & H.	Bulgaria	Croatia	Fyrom	Romania	Serbia & M.
FDI (usd mill)	1,114	1,073	6,235	8,204	1,002	10,536	3,112
FDI per capita (usd)	352	282	795	1,857	501	486	374

Source: EBRD Transition Report, 2004:28

Among the SEE countries, Romania, Bulgaria and Croatia particularly have received the biggest piece from the pie of FDI's, in contrast to the rest of the countries referred to as the Western Balkans. Considering the low savings rates in many of the transition countries, particularly SEE countries, FDI inflows have made an important contribution to economic growth.

Along with huge benefits brought by FDIs there are also several potential costs associated with the global financial integration.

Potential Benefits:

FDI can serve as a supplement to domestic savings

Improve domestic investment and growth

Enhance macroeconomic discipline

Increase banking system efficiency and financial stability

Bring new technology and managerial skills

Potential Costs:

Domestic misallocation of capital flows

Loss of macroeconomic stability

Pro-cyclicality of short-term flows (portfolio investments)

Herding, contagion, and volatility of capital flows

The experience of the early to mid-1990s revealed that several large recipients of capital inflows suffered from some, or a combination of some, of the potential problems namely, a rapid increase in liquidity, inflationary pressures, real exchange rate appreciation, and growing external imbalances. This implies that, sustained inflows of capital may lead to large macroeconomic and financial imbalances, which may be compounded by a weak banking system, particularly under a regime of pegged exchange rates (Agenor, 2001:26). As with the Southeast Asian countries, volatility in capital inflows has tended to translate into exchange rate instability and large fluctuations in official reserves depending on the exchange rate regime, sometimes resulting in currency and banking system crises.

Faced with FDI inflows equivalent to 20% of GDP in the first nine months of 2002 the Slovak government and central bank agreed to sterilize all capital inflows associated with privatization in order to prevent volatility in the inner markets, and to use the proceeds only for public debt repayment and pension reform (BIS, 2003:53).

Notwithstanding, given that FDI is an activity based on investors' expectations regarding future returns, and thus is a signal of confidence in the reforms and the prospect of economic growth in the host countries, FDI's has been and will continue to be an important factor of development in the economies of European transition countries.

2.2. MOTIVATION AND REASONS WHY BANKS GO ABROAD

While the Centrally Planned Economies where about to enter a long and painful transition period, financial institutions in the developed western countries were undergoing a major change. The increasing global competition, rapid inflation, unstable currency prices, changing regulation and a volatile global economy together with technological innovation and deregulation of the banking industry in stimulated more aggressive expansion and growth strategies (Rose, 1995:48).

The factors determining the patterns of bank internationalization considered in the literature can be broadly classified into three major groups. The first one relates to the degree of integration between the country of origin and that of destination of the investment, consistent with the hypothesis that banks follow their clients into foreign markets, to defend their existing client relationships. The second group of factors relates to profit opportunities: as profit maximizing institutions, banks should be attracted by locations where they expect to have a larger stream of

future cash flows. This approach reflects the need for new expansion and new target markets for the banks. Finally, there is a broad consensus that institutional barriers play an important role in shaping the patterns of cross-border activities (Focarelli and Pozzolo, 2002:3).

Size of the foreign markets, trade relations, the presence of non-financial firms on the market, and the presence of entry restrictions and other regulations affects the banks' decisions to expand abroad. As international trade has grown international banking has grown with it. The desire to escape domestic burdensome regulations has been another important factor that has developed international banking (Buch, 1999:8). Adopting a liberal approach to foreign bank entry has also been laid down by international trade agreements (WTO, NAFTA) or has been a condition of membership of the OECD or the European Union, or is part of reciprocity requirements for domestic banks to expand abroad[2].

2.2.1. Banks Following their Clients

The spectacular growth in international banking can be explained by many factors. The first wave of foreign banking was associated with the rapid growth in international trade and multinational corporations that has occurred since 1960s. When firms work abroad they need banking services in foreign countries to help finance international trade. Although these firms could use foreign banks to provide them with international banking services, many prefer to do business with their domestic banks which they have established long-term relationships and which understand the firm's business customs and practices (Mishkin, 1998:195).

Traditionally, foreign banks focused primarily on the provision of financial services to their international corporate clients. Previous empirical work on the foreign activities of commercial banks from US or Japanese banks has shown that FDI of banks from both countries was positively related to FDI in the non-financial sector. Foreign activities of German banks also are found to be positively related to demand conditions on the local market, foreign activities of German firms, and the presence of financial centers (Buch, 1999:29). These findings support the hypothesis that banks follow their customers abroad.

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[2] Both Copenhagen criteria for accession (European Council meeting in June 1993 and article 1 of the EBRD agreement call for the creation of open, competitive market economies and democratic institutions (EBRD, 1998).

The early literature concludes that foreign banks have traditionally followed their customers who had already established a position in the host country through foreign direct investment. However, recent evidence indicates that foreign banks are now entering host countries in a more aggressive manner attempting to acquire domestic clients and to take market share away from domestic banks (Bonin and Abel, 2000:8). This trend began in the 1990s, with foreign investments increasingly being driven by more general profit opportunities in local markets.

2.2.2. Banks Looking for New Markets

As investment opportunities and risks in Emerging Market Economies changed, heightened competition in the traditional markets of major international banks increased the pressure on them to find new areas of growth. The range of foreign bank activity in EME's has also broadened considerably. Expanding into EME's has allowed the global banks to further exploit economies of scale, for instance in product development, transaction processing, and risk management (BIS Quarterly, 2005:73).

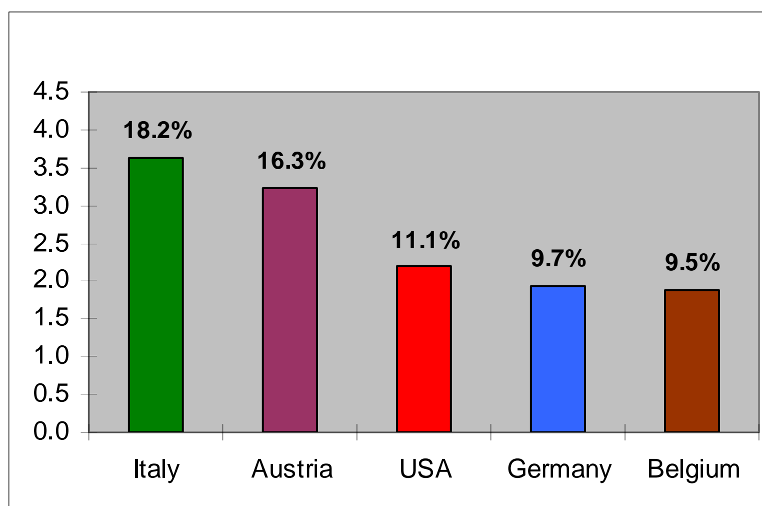
The trend of financial FDI's was particularly strong in European transition countries and even traditional financial centers lost ground to them. For example the share of outward FDI's of German banks in Luxembourg declined from 35.1 % of total in 1991 to 22.2% in 1997. In the same period German banks' FDIs to transition countries in Europe increased from 0.1% to 3.4% of the total outward FDIs. (Buch, 1999:16)

In fact transition countries in Central and Eastern Europe (CEE) and South Eastern Europe (SEE) presented very suitable conditions to foreign bank entry throughout all the period from the early 1990s up to date. Empirical work shows that measures of the potential profit opportunities in the destination markets are the key factor in determining the choice of banks on where to expand. In particular, banks are more likely to enter host countries where the expected rate of economic growth is higher and the banking system is on average less efficient. Similarly important are the regulatory environment and the characteristics of the banking sector in the country of destination of the investment. Foreign banks prefer to enter in markets that are less concentrated and where regulatory restrictions on banking activities are less stringent (Focarelli and Pozzolo, 2002:4). Many of these characteristics were inherent to the transition countries in Europe.

The degree of economic integration between home and destination countries is measured by: geographical distance, the volume of bilateral trade flows, and the value of bilateral foreign direct investment which is central to the banks decision to go abroad. As regard to non-economic integration, differences in language, culture and legal systems have been considered as factors reducing the degree of integration among countries, by making it more difficult for a bank to operate in a foreign country. In this context it is understandable that the major FDI's in the financial sectors of transition countries originated from banks and financial institutions in the more developed neighbouring countries.

European commercial banks have been particularly active to expand abroad with a regional focus, since the 1990s. This phenomenon probably reflects both economy of scale considerations and a lack of opportunities to expand in home markets. In CEE countries, banks with a regional strategy, mainly domiciled in western Europe, account for about 70% of FSFDI. (BIS Quarterly, 2005:74)

Figure 3: Regional Composition of Foreign Bank Ownership in Eastern European Countries[3]



Source: BIS, 2005:75

Typically, market size and foreign trade links exert a positive impact on the foreign direct investment of banks. Entry regulations have the expected negative impact together with exchange rate volatility on FDI of banks. The fact that financial

[3] Share in % of the total cumulative value of M&A deals targeting the region and value in USD bn. shown on the y-axes.

centers more than proportionally attract foreign banking can be interpreted as evidence for a positive impact of a liberal regulatory regime on foreign activities of banks (Buch, 1999:11).

2.3. ADVANTAGES AND DISADVANTAGES OF FOREIGN BANK ENTRY

As with other FDI's there are arguments for and against the entry of foreign banks. Another concern that will be discussed in the following sections is the impact of foreign entry on the performance of the domestic banking industry and particularly on the credit growth.

2.3.1. Advantages of Foreign Bank Entry

There is widespread agreement on the benefits of foreign bank participation for the emerging economies. Foreign banks, are familiar with sophisticated financial instruments and techniques, and have faster and cheaper access to international capital markets and liquid funds. This may represent an invaluable source of capital for firms in transition countries where equity markets are underdeveloped. Foreign bank presence may also encourage other foreign firms to invest in the domestic economy (Giannetti and Ongena, 2004:20).

The focus on the domestic market has also broadened the transfer of resources. In addition to the transfer of human capital usually associated with FDI, acquired institutions benefit from the adoption of the parent's infrastructure, such as back office routines or credit control systems. Complementary to this, decision-making and risk management of the local operation are integrated into those of the parent. Moreover, the acquisition of domestic banks often involves the transfer of reputation as the acquired banks frequently operate under the parent's brand name.

Foreign banks have become heavily involved in lending through domestic affiliates since the mid-1990s. Growing foreign bank participation has exposed EMEs to three underlying trends in the global financial system: consolidation, capital allocation based on risk-adjusted profitability and corporate governance based on widely dispersed ownership by private shareholders at the parent level. The benefits of this kind of financial globalization in the form of heightened financial sector efficiency, improved pricing and better risk management are widely acknowledged. (BIS Quarterly, 2005:79)

Moreover, foreign banks are better placed to ride out domestic recessions because they can more readily access international financial markets or draw on credit lines from their parents. Foreign banks have better diversified balance sheets and may help reduce resident capital outflows during crises because they are usually perceived as safer. Evidence from CEE, SEE, and Latin America shows foreign banks have been willing to lend in cyclical downturns, thus playing an important role in dampening macroeconomic fluctuations during the entry and expansion period (Kraft, 2004:4).

Finally, as the likelihood of being bailed out is lower foreign banks have an incentive to be more prudent in their loan policy. This comes on top of the fact that foreign owned banks are more likely to avoid making the bad loans in the first place. In practice this might be the case because they will be less subject to domestic political pressures. There seems to be evidence that testify to this fact as there have been no large scale bail outs involving foreign banks (Gros, 2003:12).

2.3.2. Disadvantages of Foreign Bank Entry

Although foreign bank penetration can yield several types of benefits, as discussed above, it also has some potential drawbacks as well.

Credit rationing to small firms: Foreign banks may ration credit to small firms to a larger extent than domestic banks, and concentrate instead on the most creditworthy corporations so their presence will be less likely to contribute to an overall increase in efficiency in the financial sector. By leading to a higher degree of credit rationing to small firms, foreign bank entry may have an adverse effect on output, employment, and income distribution.

Lack of information for local firms: Foreign banks may lack the local information that is particularly important for lending in countries where asymmetric information problems are severe and legal enforcement is weak. Additionally, foreign banks are often large organizations themselves that are reluctant or unable to effectively use soft information, often the only information available on small and young firms or potential entrepreneurs (Giannetti and Ongena, 2004:27).

Cutting credit to domestic borrowers during crises: Foreign bank entry may not lead to enhanced stability of the domestic banking system, because their presence per se does not make systemic banking crises less likely to occur, as may happen if the economy undergoes a deep and prolonged recession, leading to a

massive increase in default rates and a subsequent growth in nonperforming loans. It is believed they foreign banks have a tendency to “cut and run” during a crisis, or during recessions cutting lines of credit to domestic borrowers. (Agenor, 2001:19)

Discount sale of domestic banks: A common argument against selling banks to foreign owners is the populist objection that domestic savings will be used to fund projects in foreign countries. Political sensitivities may be particularly acute if foreign banks are perceived to be buying local banks at a discount, especially if taxpayers' money has been used to clean up the banks' balance sheets ahead of privatization. As a result, political resistance to the entry of foreign banks has often had to be overcome gradually, for example as in Poland. In some cases, only a failure of domestically-led privatization and restructuring has persuaded the authorities to allow foreign bank entry (for ex. in the Czech Republic see Hawkins and Mihaljek, 2001:28).

No domestic commitment: Domestic banks are more committed to the domestic economy, in the sense of having both longer-term business relationships with customers and a patriotic affinity with the national interest. Foreign banks, by contrast, are said to look at lending opportunities around the world and may neglect the development of the economy where they have invested if its prospects deteriorate or if prospects improve in other countries. There are concerns that foreign banks might gather deposits in the host country and make loans in the home country (Galac and Kraft, 2000:2).

Exposure to home country risks: The behavior of foreign banks may also be driven by events at their home base. One example is the pullback of Japanese banks from lending in Asia when they faced difficulties in the Japanese market. In addition, changes in strategy of global banks taken at headquarters can have a major impact on markets where these banks have a presence (Hawkins and Mihaljek, 2001:27).

Complex supervision: Foreign ownership can also pose challenges to supervisory authorities because of the migration of decision-making and the incongruence of foreign-owned banks' organizational structures and host country legal and regulatory systems (BIS, 2005:55). In the worst case the home countries might have a weak supervising authority resulting into a poor monitoring of a part of the banking system and consequently leading to unsound banking activity.

There are a few special cases where the State-Owned Banks are seen as advantageous over foreign banks. In large countries (Russia, Brazil, Argentina), only state-owned banks are willing to serve customers in remote areas. Some countries, instead including Poland and China, see cooperative banks and credit unions as a better alternative to banks in serving customers in remote areas. In some less developed countries the lack of basic market and legal infrastructure may be so severe as to make market failure pervasive and the SOB's the only viable alternative. In Russia, private banks are financially weak and small, so only state-owned banks are in a position to provide loans of meaningful size and offer security for household deposits. This function can be comparable to the existence of state-owned investment banks in some countries.

Moreover several emerging countries have tried to contain the sale of their banks to foreigners: the authorities in Singapore stated explicitly that they wanted local banks to retain at least half the market. Another example is the Philippines, where existing law provides that the market share of foreign-majority owned banks shall not exceed 30% of the banking industry. The government of Mexico also restricted foreign ownership to 30% when it first started selling off the SOCB's in the early 1990s; however, these restrictions were later relaxed and eventually removed. Mexico used to limit also foreign ownership in domestic banks with a substantial market share. Authorities in China have ensured that banks have more familiarity with the local market by requiring them to have a representative office for two years before commencing banking operations (Hawkins and Mihaljek, 2001:29).

2.4. BANK PRIVATIZATION IN TRANSITION ECONOMIES

A large number of factors were important to defining the context of bank privatization and system restructuring in the transition countries. These included: the health of the economy measured by unemployment and growth; the level and volatility of inflation; exchange rate convertibility and volatility; interest rates and spreads; fiscal issues (tax rates, budget deficits); political risk and conditions. Many of these factors particularly inflation, budget deficit and political instability made bank privatization in transitional economies a difficult process (Kormendi and Snyder, 1996:9).

While most of SOB's were being privatized in Eastern Europe in the mid-1990s, economic growth remained fairly modest, with inflation at rather high levels

due in part to the decontrol of previously administered prices. At the same time high unemployment levels constituted a continuous drain on public finances (BIS, 1998:51). In this background successful bank privatization was a must for transition countries economies.

The process of bank privatization is a part of the restructuring of the banking system that generally involves the following phases in a consecutive order (EBRD, 1998:97).

- Carving out and privatizing the parts of the old system
- Determining the method of privatizing the carved out entities
- Establishing the regulatory system
- Determining the rights to establish and operate new banks and foreign-owned banks
- Determining the structure and methods of dealing with the troubled banking assets
- Structuring the payments system

To the extent that the bank entity to be privatized has positive future value, with an expectation of future profitability, the question is who will receive the revenues from sale or the rights to the profit stream from ownership. In principle, the government can market the entity and sell it to third party investors using any method and retain the revenues from sale as a means of financing the activities of government. The privatization methods used generally in the transition countries include:

The voucher mechanism: The government can give away ownership rights to its citizens, thereby distributing the rights to the future profits stream. This can be accomplished through a voucher mechanism but could be accomplished by a direct distribution of ownership shares, the two being the same often. In theory, this method provides a speedy transfer of ownership using an egalitarian process that does not favor any particular interest groups. In the Czech Republic voucher privatization of banks resulted in the transfer of less than fifty percent of the bank shares to individual and investment funds with no dominant strategic owner emerging from the process (Bonin and Wachtel, 1999:3).

The Initial Public Offering (IPO): Is the offering of equity shares in the new bank entity to the domestic investor market. Because most transitional economies have only poorly capitalized stock markets that lack the depth, width and liquidity, an IPO could have been a risky strategy, both in terms of revenues generated (bank IPO's in a transition economies may be prone to market manipulation) and even ultimate success. Moreover IPO privatizations usually resulted in only partial government divestiture of state ownership and in dispersed ownership. Hence it failed to create an environment for the development of a modern, independent banking sector.

The strategic foreign investors: One issue central to the mechanism chosen for privatization was whether to allow foreign ownership and control of the bank. This was often viewed positively, as a means of increasing the realizable sale value and the capitalization of the bank. Examples of sales to strategic foreign investors include: ING-Bank Slanski, BLB-MKB, GE Capital-Budapest bank. Two direct benefits are derived from allowing and even encouraging strategic foreign investors. First the price received for the bank will generally be greater, due to the fact that the foreign investors often have the financial and operational expertise to realize greater returns from transitioning to modern efficient banks as well as the capital to support such movement. Such a transfer of ownership and control facilitates necessary changes in management, often transfers knowledge of modern banking techniques, and promises much needed capital injections. However setting a price for the transfer can be difficult and sometimes delicate in the political front. There may be significant political resistance to foreign ownership of the domestic banking system (Bonin and Wachtel, 1999:5).

The management led recapitalization: In Russia, Czech Republic and Hungary existing management has been a driving force behind the method of privatization and recapitalization. Often management wanted a privatization process that would enhance their control position in the bank. This can be done either through diffuse ownership with IPO!s or vouchers, or through passive friendly investors, who after buying part of the SOB decided not to interfere with management decisions.

SOB privatization in transition countries has been carried out using any of these methods or a combination of them. Komercni Bank in the Czech Republic was by and large a voucher privatization. Bank Slanski in Poland involved an IPO, but also a large foreign investor. MKB in Hungary is often pointed to as a strategic

foreign investor model. The privatization of Mosbusinessbank in Russia has the character of a management led recapitalization. In reality, almost any case involves a mixture of some or all of the methods. In fact there is no one best way to achieve privatization. Each of the above mechanisms achieves different goals towards the ultimate goal of bringing together the necessary elements for a successful privatization (Kormendi and Snyder 1996:17).

Hungary has been one particular transition country that had a successful bank privatization. Even thought the SOB privatization process began relatively late, in 1994, over the subsequent three years, all five state-owned banks were privatized. By the end of 1997, foreigners owned 62% up from 12% in 1994 and the banking sector in Hungary had been fully restructured and recapitalized. With a banking sector substantially privatized and mostly in foreign hands, the non-performing loan ratio was down to 8% in 1997 from 30% in 1993 and provisioning was full (EBRD, 1998:128).

Three basic lessons for promoting healthy and financially stable banking sectors in any small open economy can be drawn from the experiences of bank privatization in the fast-track transition economies, namely Poland, the Czech Republic and Hungary.

1) Bank restructuring and privatization must be sequenced carefully to create the appropriate incentives for lending on a commercial basis only.

2) Privatization requires a credible transfer of control from the state and often a change in the current management of the bank.

3) The proper corporate culture is most easily established by attracting a strategic investor who is more likely than not going to be a foreign financial institution (Bonin and Wachtel, 1999: 19-20).

SOB privatizations through a foreign strategic investor have in the first place, enhanced stability in the host country. Failures of banks sold to reputable foreign partners have been almost unknown. Some exit has occurred in cases where the foreigners changed their business strategy, or where the CEE / SEE ventures proved disappointing. But overall, the overwhelming majority of the banks bought by foreign investors have earned substantial profits, grown solidly, and provided stability (Kraft, 2004:4).

2.5. FOREIGN BANK ENTRY AND CREDIT GROWTH IN EUROPEAN TRANSITION COUNTRIES

Foreign bank entry has been one of the most striking features of the development of the banking system in the European transition economies. From the early 1990s, privatizations in transition countries ended the system of state-owned banks which used to lend exclusively to governments and public enterprises. Promoting private ownership was key to banking expansion: fostered competition and improved management and productivity of the banks and leaded to a hardening of budget constraints to SOE's.

New banks also started to enter the market throughout the region. By the mid-1990s, basic regulatory and supervisory frameworks were in place, allowing a steady increase in the availability of finance, particularly in CEE and the Baltic States. At the end of the decade more than half of the banks in the region were foreign-owned, accounting for two thirds of total bank assets, however, growth in bank credit mostly involved lending to large enterprises and in a significant number of countries, particularly in SEE, the financial sector continued to be underdeveloped (EBRD, 1998; Naaborg et al., 2001:6).

Table 3: Foreign Bank Assets as a % of Total Bank Assets in CEE Countries, 1994-2000

	1994	1995	1996	1997	1998	1999	2000
Czech Rep.	11	17	20	24	27	40	66
Estonia		2	2	2	90	90	97
Hungary	14	19	46	62	61	66	67
Latvia	36	53	72	81	76	78	…
Lithuania	0	0	28	41	52	38	57
Poland	3	4	14	15	17	47	69
Slovak Rep.	12	19	23	30	30	31	43
Slovenia	3	4	5	5	5	11	15

Source: EBRD Transition Reports, 1998-2004

Countries in CEE became major recipients of Financial Sector FDI when the privatization of their banking systems and preparations for EU membership took place in the second half of the 1990s. In some instances the unsatisfactory results of early domestic privatization schemes led the authorities to rely on foreign resources to recapitalize their banking sector and permit foreign ownership. Poland and the Czech Republic experienced the largest FDI inflows with 38% and 28%,

respectively, of the total volume of M&A's targeting the region from 1991–2005. In the recent years, FSFDI has focused on countries that were scheduled to join the European Union at a later stage, such as Bulgaria, Romania and Croatia. Overall, however, FSFDI flows to CEE have decelerated, possibly indicating certain saturation. (BIS, 2005:71).

It can be seen from Table 3 that in 1996, foreign bank penetration in the former Communist countries of central and southeast Europe was minimal. Foreign ownership as measured by the share of foreign-owned banks in the total assets of the banking system remained low (below or near 20% in most countries by end 1996), with Latvia and Hungary, that had quick bank privatization processes, as exceptions. Until the end of 2000, the general level of financial development, the level of bank credit as a percentage of GDP, increased only moderately, and public credit of foreign banks exceeded private credit (Fries and Taci, 2002: 3-9). In countries where the infrastructure for delivering household credit was not well developed, such credit was still in effect rationed, with only a small, high-income, segment of the population having access to credit, and often prohibitively high interest rates (BIS, 2004:48; Naaborg et al., 2001:5).

By 2004 instead, foreign banks held majority shares, and often overwhelmingly large shares, in 13 of the 15 countries of CEE and SEE. Among SEE countries, Albania, Bosnia-Herzegovina, Bulgaria, Croatia and Romania had foreign majority ownership with Macedonia very close to 50% (Kraft, 2004:2).

Table 4: Foreign Bank Assets as a % of Total Bank Assets in SEE Transition Countries, 2001-2006

	2001	2002	2003	2004	2005	2006
Albania	40.8	45.9	48.1	97.1	93.5	95.1
Bulgaria	74.0	75.0	75.0	76.5	78.2	81.6
Croatia	89.3	90.2	91.0	91.3	91.3	90.8
Fyrom	44.0	44.0	44.0	47.3	51.3	53.2
Romania	55.2	56.4	58.2	62.1	62.2	85.8
Montenegro	n/a	15.1	17.0	35.0	88.0	92.0

Source: National Central Banks' Reports

As we can see from Table 3 and 4 foreign banks entered the SEE markets relatively later than in CEE where foreign banks held dominant shares in the banking systems of most countries as soon as 2000. The reason for this has been a high country risk perception by foreign investors and relatively problematic domestic

banks. The presence of foreign banks, as well as other foreign direct investment remained limited as foreign banks were reluctant to buy stakes in weak institutions (Berglof and Bolton, 2001:15).

Most of the foreign banks entered the markets in transition countries through the acquisition of local banks rather than the more costly establishment of greenfield operations. Even the wholly owned acquisitions are often kept as local subsidiaries [4] rather than as branches of the parent. The restructuring of banks and subsequent privatization provided incentives for the establishment of subsidiaries (Hawkins and Mihaljek, 2001:26). In CEE, by the end of 2003 more than 85% of foreign bank operations were run as subsidiaries, which also accounted for about 95% of total foreign bank assets. Almost all the foreign banks operating in SEE countries are operating as subsidiaries (BIS Quarterly, 2005:75).

Table 5: Presence of Foreign Banking Groups in CEE end-2003

	Baltic States	Czech Rep	Hungary	Poland	Slovakia	Total
No of subsidiaries	15	18	28	45	16	122
No of branches	5	9	0	1	3	18
Total	20	27	28	46	19	140
Assets of subsidiaries	14.2	62.3	33.7	74.7	19.8	204.8
Assets of branches	1.5	7.6	0.0	0.7	3.0	12.8
Total Assets (bn eur)	15.7	69.9	33.7	75.4	22.8	217.6

Source: BIS Quarterly Review, 2005:76

In SEE countries the entry of foreign banks has been part of a general consolidation of the banking sectors. After a period of very easy entry in the early 1990's, failures and acquisitions during and after banking crises brought substantial decreases in numbers of banks. For example, Croatia had 61 banks and 36 savings banks in 1997, but by 2003 it had a mere 40 banks and no more savings banks overall. Bosnia and Herzegovina had 61 banks in 1999 and only 37 in 2003 (Kraft, 2004:9). In the past few years, the number of financial institutions has continuously declined in Macedonia as well (NBRM, 2006:6). This trend of market consolidation of the banking sector also appears in CEE countries, primarily as a result of the increased competition in banking, after the completion of the processes of integration of these countries in the European Union. The process of restructuring and market consolidation of the banking system should lead to further deepening of

[4] Institutions that are incorporated separately from the parent bank and whose financial commitment consists of the capital invested.

the financial intermediation and especially to improving the amount and the quality of financial services the banks offer.

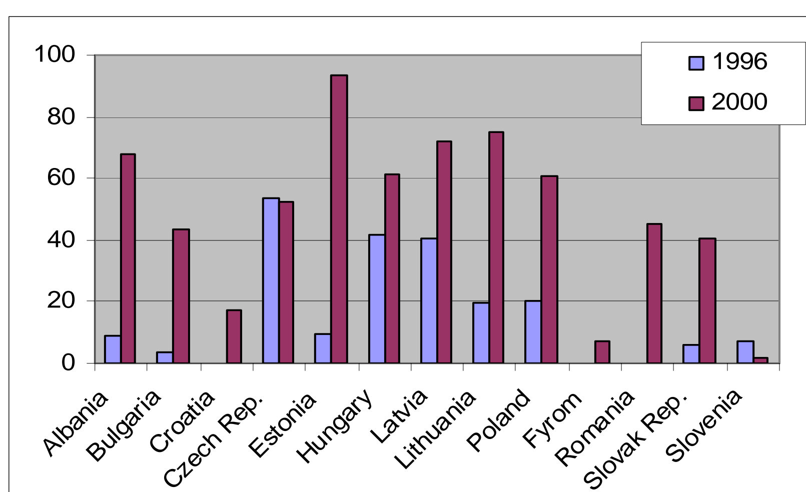
Table 6: Number of Mergers and Acquisitions in Several Transition Countries, 2001-2006

	2001	2002	2003	2004	2005	2006	Total
Czech Rep.	2	2	2	3	1	0	10
Hungary	4	0	4	2	0	3	13
Latvia	1	2	1	2	3	2	11
Poland	9	8	2	7	3	0	29
Slovenia	2	3	1	1	1	1	9
Estonia	0	2	0	0	3	0	5
Macedonia	3	0	0	0	1	2	6

Source: ECB, 2007; NBRM, 2007

Together with foreign bank entry another prominent feature of most transition economies, particularly those of CEE, has been the strong growth in bank credit to the private sector since the second half of the 1990s. Evidence suggests that in the context of increased overall financial deepening: privatization, public sector reduction, overall progress towards market institutions and the quality of legislation to protect creditors' rights have been key factors behind rising BCPS ratios. Rapid credit growth in a later stage in some of the transition countries has been driven by successful macroeconomic stabilization, robust growth, and capital inflows (Cottarelli, Dell'Ariccia and Vladkova-Hollar, 2003:23; Duenwald, Gueorguiev and Schaechter, 2005:12).

Figure 4: Foreign Bank Lending as a % of Total Bank Loans in Several Transition Countries



By looking at Figure 4, we can see how foreign bank lending evolved rapidly during the second half of the 1990s and by end-2000 made up the greatest part of total bank lending in many transition economies. Thus we can say that foreign banks have been an important generator of BCPS growth in transition countries. A similar inference can be done for Turkey, a comparable emerging country; where household credit as a % of GDP more than doubled in 2 years from 2003-2005, while foreign-owned bank lending increased from a mere 4.1 % in 2003 to 15% of the total system loans in 2006 (Yucel, 2007:50).

In CEE countries household credit as a percentage of GDP increased considerably over the 2001-2005 period. Starting from nearly 8 percent of GDP in 2001, by 2005 the average ratio of household credit was 14 percent of GDP; higher than most of the other emerging economies such as Turkey with 9.5 %, Russia 5.5% and Latin America countries with 8% (BIS, 2005:78).

Bank Credit to Private Sector has accelerated in some Balkan countries where the transition process was considered to be less advanced. Romania and Bulgaria have experienced, in the last years a high credit growth which has provoked specific reactions from the central banks of the two countries. Domestic credit as % of GDP in Bulgaria increased from 11.8% in 2000 to 36% in 2004; in Romania from 7.2% in 2000 to 15% in 2004 (Figuet and Nenovsky, 2006:2).

Table 7: Bank Credit to Private Sector as a % of GDP in Several Transition Countries, 1994 -2006

Country	1994	1996	1998	2000	2002	2003	2006
Albania	3.8	3.9	2.9	4.1	6.1	7.3	22.0
Bulgaria	3.1	19.0	11.4	11.6	18.0	25.8	49.0
Romania	-	-	9.0	7.8	8.3	9.5	28.0
Croatia	-	-	22.1	27.8	44.0	48.5	74.0
Slovenia	23.1	28.8	30.6	38.5	40.3	43.3	53.0
Hungary	24.7	20.8	22.7	30.1	34.5	42.3	55.0
Poland	10.5	13.0	17.4	18.1	17.6	17.8	27.0
Estonia	11.1	15.1	24.3	24.0	27.5	33.7	85.0
Latvia	14.7	7.0	12.3	18.1	30.5	38.8	89.0

Source: EBRD Transition Reports (1998-2004)

The strong growth of personal incomes, accompanied by lower interest rates and greater competitive pressures, encouraged banks in Bulgaria, Croatia, the Czech Republic, Hungary and Romania to expand their lending to households at

annual rates ranging from 20 to 60% between 2001-2003 (BIS, 2003:55). This high growth partly reflected the low initial share of household lending in bank credit hence an expansion of consumer credit seems natural from this perspective.

There are additional reasons for the rapid growth in consumer loans. Wholesale lending relies much more than retail on a strong legal system to enforce contracts, size collateral and provide smooth and effective bankruptcy procedures. While it is true that home mortgage lending does rely heavily on the legal system, repayment rates on home mortgages are generally higher than on corporate loans, so that the legal system risk is somewhat compensated for by lower repayment risk (Kraft, 2004:9).

Along with structural reasons there are some practical reasons for the growth of consumer lending. To consider a comprehensive example, in 2003 the central bank of Croatia imposed a penalty on rapid loan growth. Banks whose loan portfolio grew faster than 4% per quarter were required to buy low-yield central bank securities twice the amount of excess growth. Banks responded by limiting lending, cutting back on corporate loans and focusing on more profitable retail business (Sosic, 2003:3).

Table 8: Household Loans as a % of Total Loans in SEE Countries, 1997-2003

Country	1998	1999	2000	2001	2002	2003	2006
Albania	5.1	48.1	36.2	14.3	18.3	23.1	33.7
Bosnia & H.	8.8	9.8	12.9	20.6	34.5	38.2	-
Bulgaria	20.1	18.2	17.6	19.4	19.4	22.6	36.0
Croatia	32.5	37.9	42.3	43.8	47.5	52.7	-
Macedonia	7.3	9.9	7.6	7.4	10.7	20.7	34.4
Romania	4.9	4.5	4.7	5.6	8.5	17.2	37.0

Source: Kraft, 2004:8; Countries' Central Bank Reports

The rapid growth on consumer credit, increased banks' exposure to significant credit risk, as most household lending is not properly secured due to deficiencies in legislation governing the use of collateral. In some of the countries, there are special concerns because household borrowing is in large part denominated in foreign currency, this being the case for Albania also where 72 % of the total loans where in foreign currency by end 2007. To complicate things further, although the share of non-performing loans ratio is still low in many countries it is

extremely hard to determine the real quality of the banking assets during periods of lending boom.

Moreover the sharp increase in private sector consumption and investment caused by credit growth over the past years have contributed importantly to widening macroeconomic imbalances and heightened external vulnerability in countries such as Romania and Bulgaria (Duenwald, Gueorguiev, and Schaechter, 2005:3). The lending boom initiated by commercial banks in Croatia in 2001 boosted consumption and investment, but it also significantly increased imports so current account deficit almost doubled in 2002, reaching 7.1% of GDP. The use of foreign sources of capital for financing domestic lending increased external debt, which reached 68% of GDP at the end of 2002, an increase of about 10 percentage points over the previous year (Sosic, 2003:2).

Since the rapid credit growth to the private sector and particularly to households is a relatively new occurrence for some of the transition countries, authorities might have not been prepared to use policies aiming at limiting the negative effects of the credit boom on macroeconomic stability. Policy responses have included attempts to both control credit growth and offset its impact on domestic demand, with mixed outcomes thus far. For example after a period of credit boom in Albania, when BCPS jumped from 9.2 % of GDP in 2004 to 29 % of GDP in 2007, the central bank increased its core interest rate three times during 2007 to contain high inflation that is thought to has been caused at least partly by the credit expansion to households. To our opinion, an ex-ante policy controlling the commercial banks' credit granting procedures, or reducing loan-to-value ratios would had been more appropriate. In fact as of March, 2008 annual inflation in Albania at 4.6% got out of the targeted 2-4 % interval.

The macroeconomic and macroprudential implications of strong credit growth in non-European emerging economies have attracted considerable attention, particularly after the Asian crisis of the late 1990s. A number of countries have used prudential measures to dampen rapid growth in credit to households and address sectoral or financial stability concerns. For example, to curb speculation in property markets in Korea, a government panel in 2003 proposed sharp increases in capital gains taxes on property sales by owners of three or more residential properties. To reduce the vulnerability of the financial sector, ceilings on loan-to-value ratios on mortgage lending have been imposed in both Korea and Thailand. The use of targeted regulatory restrictions may be warranted because of market imperfections;

for example, in a number of emerging economies, property markets are thought to be vulnerable to speculators. Similar restrictions still exist in a number of advanced economies and were widespread a few decades ago (BIS, 2004:50). In India risk weights were raised for housing loans (from 50% to 75%), commercial real estate (from 100% to 150%) and consumer credit (from 100% to 125%). The general provisioning requirement for loans in specific sectors was also raised (BIS, 2007:42).

Bank credit to the private sector is likely to continue rising faster than GDP in the next years throughout the region, picking up also in countries where so far it has been stalled. Although this growth should be regarded as a structural and positive development, policymakers will have to evaluate carefully its implications for macroeconomic developments and financial stability (Cottarelli, Dell'Ariccia and Vladkova-Hollar, 2003).

The dramatic increase in the presence of foreign banks, has deeply transformed the financial systems of the transition countries; foreign owned bank assets in some transition economies are now over 90% (ECB, 2007:51-63). The literature on international financial integration and foreign banking is mixed about the effects of the FDI inflows and foreign bank entry but evidence shows that capital flows into transition economies have made a significant contribution to realizing the regions growth potential, fill the savings investment gap and transfer business practices and technology (EBRD, 2004:28). The attitude of transition countries toward foreign bank entry has generally been liberal, and these countries have benefited in terms of modernization of their financial systems and banking products.

The high share of foreign owned bank assets in CEE and Latin America raises worries that foreign banks might have focused only on a small group of highly creditworthy customers. There are concerns that small and medium-sized enterprises often have difficulties in obtaining credit from foreign banks, which are more dependent on standardized credit evaluation. In fact, lending to SME's from foreign banks depends on the availability of reliable accounts, and transparent procedures for posting collateral and foreclosure in these countries. Nevertheless, recent research generally does not provide evidence of foreign banks "cherry picking" a selective group of highly rated clients (BIS, 2005:77). Moreover, as a result of strong competition and significant penetration, foreign banks in central Europe are increasingly focusing on lending to SME's and households.

Spurred by competition and financial innovations credit to households (mortgage lending and/or consumer credit, including credit card loans) has expanded rapidly in CEE as well as in other transition countries. The striking growth in credit, with rates sometimes as high as 81%, (between 2000 and 2003 in Hungary, see BIS, 2004:47), creates risks which may not be well managed. Households could become overextended and might then be unable to service their debt. Such difficulties would of course be accentuated should a housing market bubble develop and then collapse.

Foreign bank entry raises some other issues also. Financial FDI's in the form of foreign bank entry in European transition countries has mainly originated from banking groups in their western more developed neighbors. Governments should be reluctant to have their domestic banking systems dominated by banks from a single country, in case these banks suddenly cut their activities when faced with problems at home or are able to exert political pressure for favourable treatment. For this reason, the emerging economies may seek to diversify foreign owners.

As a conclusion, a growing role has been played by foreign banks in transition countries in Europe. In addition to stimulating competition more generally, foreign banks also play an active role in introducing innovations into emerging markets, many of which help improve risk management procedures. They can also be a source of financial support to the banking system since they are less vulnerable to country-specific, systemic risk, less sensitive to host country cycles, and can also obtain foreign currency liquidity during episodes of financial stress.

CHAPTER 3

FINANCIAL AND BANKING SYSTEM IN ALBANIA

With the fall of the Berlin Wall by the end of 1989 and after major political changes overwhelmed the ex-communist countries in the early 1990's, Albania, too, embarked on the road to transition towards a democratic society and a free market economy. Supported by the international community, in the first years Albania seemed to make substantial progress and the economic indicators were promising. However, this performance was not build on solid foundations. The lack of strong institutions, incomplete financial reforms and an undeveloped banking sector led the development of fraudulent pyramid schemes, where most of the Albanians had invested their savings. The subsequent collapse of these schemes in 1997, precipitated into severe civil disorders.

During the central planning the financial sector was primitive, intermediation between savers and borrowers was internalized within the state banking apparatus basically through a system of directed credits to state-owned enterprises for both investment needs and budget allocations for working capital, necessary to meet the output plan. The banking system provided an accounting service to all production units and carried out all payments and transfers between them. Credit evaluation and risk management were irrelevant hence these skills were never developed domestically. Of all the SEE countries, Albania suffered from the most serious distortions from the Centrally Planned Economy monobank legacies (Bonin, 2001:40). The insufficient knowledge on modern banking inherited from the centralized economy, continued to burden the sector for most of the 1990s.

At present the Albanian financial system offers a wide range of financial services and products to the private sector. The non-bank financial industry still remains underdeveloped. The stock exchange is non-functional despite plans to revive its activity in the near future. The securities market is wholly comprised of government bills and bonds with short and medium maturities. The industry still lacks mutual and investment funds, as well as investment banking services.

The banking sector has grown to be one of the most important sectors of the Albanian economy. Total assets represented more than 75% of GDP and credit to private sector was 29% of GDP as of end 2007. During the last 5 years the banking sector in Albania has experienced rapid growth, total assets of the sector have

increased by 17% on average while total loans extended to the economy increased by 50% annually on average between 2003 and 2007. The loan/assets ratio of the system was 39% at end 2007, rising from only 13.6 % at end 2003.

Today Albania is a member of the IMF, the World Bank, the European Bank for Reconstruction and Development, the World Trade Organization, the Black Sea Economic Initiative and recently was invited to join the NATO. In 2006 Albania signed the Stability and Association Agreement with the European Union and is looking forward an invitation for membership.

The aim of this chapter is to outline the main developments in the Albanian banking system against a historical background, and developments in other comparable transition countries. The key steps in the banking reforms through all the difficult transition period, the banking system privatization and its efficiency in performing the financial intermediation, with special focus on the developments in the recent years will be presented. In the last part an overview of Non-Bank Financial Institutions in Albania will be presented.

3.1. HISTORICAL BACKGROUND OF THE ALBANIAN ECONOMY AND FINANCIAL SYSTEM

3.1.1. The Central Planning Period and its Legacies

For about 45 years Albania was under the rule of the most totalitarian regime in Eastern Europe. From 1944 to 1991 Albania was the antithesis of a market economy. Private ownership was completely forbidden and all economic activity was controlled by the state without exception. For much of this period, Albania's economic, political and cultural ties with the rest of the world were reduced to an absolute minimum. Albania's case was unique in terms of the intensity of the economic centralization and isolation (Ibrahimi and Salko, 2001:190). Foreign economic aid was not accepted and the country's Constitution banned receiving loans from capitalist countries. These caused the 1980's decade to start under conditions of a drastic decline in the standart of living. At the eve of great transformations, political, economic and cultural isolation of the country reached the highest peak (Bezemer, 2001:2).

Albania was the latest communist country that entered the road of economic transformation. The fall of the communist regime left Albania in a political vacuum

and in a state of total economic collapse and massive unemployment, with a destructive impact on household incomes and living standards. The country inherited sharp poverty, an inefficient industrial sector, and serious deficiencies in administration and institutions. When transition eventually began in 1991 the vast bulk of the population was completely unfamiliar with market institutions or practices (Jarvis, 1999:4).

The initial impact of this transition caused severe macroeconomic problems. GDP decreased by 13 % in 1990 and 27.7 % in 1991, a decrease that had started to be felt since mid of 1980s. The current account was worsened apparently due to drastic reduction of exports and significant increase of imports specifically for consumer goods. The trade deficit reached the level of USD 150 million in 1990 and USD 208 million in 1991. The budgetary deficit in 1990-91 reached respectively 15% and 31 % of GDP. The monetary expansion went out of control as the Central Bank issued money without restriction because of the governing pressure for crediting the enterprises with losses. In the same time this impacted significantly on the stock of inherited bad loans in the banking system after the starting of reforms in 1992 (Cani and Haderi, 2002:4). From 1992 to 1996, with the assistance of the World Bank, the IMF and other donor organizations, Albania began to implement a stabilizing economic program and actions were taken in order to control further deterioration of the economy.

The financial sector in Albania was underdeveloped as in other transition economies. During socialism banking system was completely centralized and until 1976 "The Bank of State" that operated both as a monetary authority and a crediting institution was the only existing bank in the country. The banks' role as a financial intermediary was hugely limited, as both monetary policy and loans distribution were designed by a centralized plan. Its main functions were to issue currency, adopt the monetary policy, perform budget expenditures and payments with foreign parties as well as accommodate the credit needs of state enterprises (Cani and Haderi, 2002:4).

In 1977 the Agricultural Bank was established as a separate bank, through the separation of one section of the Albanian Bank of State. This new bank covered the supply of agricultural sector funds and its main functions included short-term crediting of agricultural enterprises, and agricultural cooperatives. The Agricultural Bank was not functioning independently from the Bank of the State, but it was rather

a supplement of the latter and credit granting was strictly supervised and it was part of the state crediting plan (Ibrahimi and Salko, 2001:193).

Apart from these two financial institutions in 1990, the Department of Foreign Relations of the Albanian State Bank served as a basis for founding the Albanian Commercial Bank that was responsible for performing payments with foreign entities, financing and encouraging the exports and held the accounts of foreign trade enterprises.

Along with the State Bank, in 1949 the Directory of Savings Desk had been established. Its main function was to collect savings from households. In 1953 these savings desks were used to perform the state insurance of property as well, and consequently the Savings and Insurance Desk Institute was established. This institute continued its activity until 1991 and after its dissolution the Savings Bank was established and started its activity in 1992.

In the beginning of the 1990's two financial circuits existed in Albania, the deposit side consisted of individual savings on the "Savings Agencies" and the credit side consisted of the State Owned Enterprises and cooperatives that extensively used bank loans attained from the "Bank of State" to finance their production activities and even pay salaries. However it should be noticed that this semi-intermediation process was far from economically motivated, since interest rates charged on loans were often very low and the SOE's would continue to roll over their debts, with support from the government.

With a problematic structure and lack of market experience the Albanian banking system was completely inadequate with respect to the new requirements presented by the transformation into a market economy. The banking system's role in the financial intermediation process was limited because of the out of date if not totally missing; lending evaluation, risk management and accounting practices.

The Savings Bank that was created by the government in 1992 after merging the Savings Agencies was the only entity with an extensive branch network throughout the country and, as such, held a virtual monopoly over primary deposit collection (EBRD, 1998:149). Securities markets were absent since the authorities created no marketable financial instruments. These were serious unfavorable conditions at the start of the transition process for the country since an underdeveloped financial system could not contribute efficiently to a reallocation of the property rights over the factors of production.

3.1.2. Transition Toward the Market Economy in the 1990's: First Reforms and Macroeconomic Stabilization

Albania started the process of changing from a central economy of Eastern type to a market economy of Western type following the same scheme applied by other transition countries. This scheme, first of all underlined the achievement of economic stability through monetary and fiscal policies sustained by structural reforms. Economic reform started in July 1992, when the governmental program was supported by a stand-by agreement from IMF. At the core of this reform there were three main principles: macroeconomic stabilization that aimed at the reduction of budget deficit, inflation control and the liberalization of prices. The restructuring of state-owned sector that aimed at the elimination of government subsidies, the establishment of free competition and the reorganization of public sector and the banking system. Privatization of the economy including industry, agriculture and public services were priorities as well (Ibrahimi and Salko, 2001:190-1).

Table 9: Albania Macroeconomic Indicators, 1991-1996

	1991	1992	1993	1994	1995	1996
Real GDP growth	-27.7	-7.2	9.6	9.4	8.9	9.1
Nominal GDP (USD mill.)	1,139	700	1,200	2,000	2,400	2,700
GDP per cap. (USD)	346	222	388	620	745	890
Private sector share % of GDP	5	10	40	50	60	75
Inflation (CPI change %)	35.5	236.6	30.9	15.8	6.0	17.4
Unemployment rate %	8.9	27.9	21.7	19.5	16.9	12.4
Fiscal deficit (% GDP)	31	20.3	14.4	12.4	10.3	11.7
Exports (USD mill.)	73.0	70.0	112.0	141.0	205.0	229.0
Imports (USD mill.)	281.0	524.0	602.0	601.0	679.0	921.0
Trade balance (% GDP)	-18.0	-65.0	-41.0	-23.0	-20.0	-26.0
Current Acc. Balance (% GDP)	-21.6	-61.1	-29.7	-14.1	-7.3	-8.9
Exchange rate Lek/USD	25.0	98.7	100.9	95.0	94.5	103.7
Emigrant remittances (USD mill.)	n/a	150.0	274.8	377.9	384.6	499.6
FDI (USD mill.)	0	32.0	45.0	65.0	89.0	97.0
Urban population % total	37	37	41	42	43	44

Source: IMF Albania Statistical Appendix, 2000:3-5

The Albanian reform could be characterized as quick and liberal. The price and trade liberalization, the cut of subsidies happened in a few months and the economic policy became very orthodox according to IMF recommendations. Notwithstanding the swift changes hit the economy very hard, industrial production fell by 60 % in 1992 and by 10 % in 1993 and real wages fell 30 % between 1990 and 1993. The authorities arranged a last drastic step devaluation of the Lek on the 1st July 1992, allowing it to float at a rate of around 100 Lek to the USD (Bezemer, 2001:3). Unemployment jumped officially to 27.9 % at the end of 1992, and in cities the global unemployment was at least twice as high. An enormous budget deficit as high as 31% of GDP in 1991 and 20% of GDP in 1992 brought on in part by huge government subsidies to loss-generating state enterprises during a period of almost complete breakdown in production, led to triple-digit inflation with rates as high as 237 % in 1992.

But already in 1993, GDP bounced back: growth was led by agriculture, construction, and by small private services. To decrease inflation, the government promised to cut its budget and eliminate price supports and subsidies to the state enterprises. Another feature of transformation was high current deficits, consumption was much higher than production and the deficit was funded by outside sources, by private transfers and emigration. Aid was equivalent to 40% of GDP in 1992, 20 % in 1993 and 12 % in 1994. Remittances from about 400,000 emigrants working in Greece and Italy were on average 350 million USD per year, 20% of the GDP between 1993 and 1996. Through a tight monetary policy and fiscal measures the GDP increased with an annual rate of approximately 9%, unemployment stopped at 12.4 % of the labour force, and the inflation rate reached 6% in 1995. However, the macroeconomic policies were not backed by institutional reforms. The state institutions remained weak and the financial sector did not develop efficiently thus allowing growth of an informal economy.

Reforms in the Banking Sector

The passage from a CPE to a market economy necessitated the development of new financial intermediaries and instruments, as the functions added to the financial system were expected to increase. The law "On Bank of Albania" was approved in April, 1992 replacing the previous law "On the Bank of Albanian State". The new law delegated to the central bank responsibilities previously enjoyed by government such as: determining the amount of credit,

issuance of currency, banking interest rates, payment system, etc. Now central bank would report to parliament rather than to government. Moreover on the basis of these laws, the central bank was given the responsibility of regulating the banking system and licensing the new private banks.

Albania created a two-tier banking system in 1992. The Bank of Albania was created as a first tier bank, the country's central bank, while the three other banks: the Savings Bank, the National Commercial Bank, and the Rural Commercial Bank, constituted the second tier of the banking system. The National Commercial Bank (NCB) was created by merging the commercial business of the Bank of Albania with the short-lived Albanian Commercial Bank. Basically, the NCB performed the tasks of a foreign trade bank and an industrial bank. Rural accounts were held at the Rural Commercial Bank of Albania (RCBA) and the state Savings Bank (SB) was a monopoly collector of household deposits. In 1993, banking assets to GDP was nearly 50%; however, total bank loans amounted to only 5.6% of GDP while individual deposits were 11.3% of GDP and non-performing loans were calculated to be 12.5% of total loans (Bonin, 2001:25).

The under development of banking infrastructure such as out of date and inadequate payment systems and the absence of capital markets, limited the potential and functional instruments of monetary policy. Upper limits on the granted credits were one of the most notable instruments in the central bank's hand. These pressures on the banks to ration the amount of credits given, together with the large holdings of government bonds, thus indirectly financing the budget deficits, lowered the efficiency of the banking sector in the first years of transition. Being controlled by the state these banks mostly did not have their own strategies on credit and investments.

By 1993 two other banks with joint capital (foreign capital and Albanian Government capital) were present in the system: The Italian Albanian Bank and Arabic-Albanian Islamic Bank. In 1996 two banks with Greek capital were licensed: Tirana Bank and the branch of National Bank of Greece. During these years, the State Owned Banks dominated the banking sector that was characterized by a limited intermediation process. This was in part because of the inefficiency of the SOB's and the inability of the newly emerging private banks that were too small to perform accordingly to the need of the economy (Cani and Haderi, 2002:6). Nevertheless a tendency of banking system activity growth can be noticed during this period. Both assets and deposits increased substantially even why the growth

did not keep in pace with the output growth in the economy, actually this is evidence of the disintermediation of the formal financial system in Albania in the period 1992-1997. Another important development is the increase in household deposits that increased steadily up to 25.7% of GDP after the crisis in 1997.

Table 10: Albanian Banking System, 1992-1997 (amounts in ALL mill.)

	1992	1993	1994	1995	1996	1997
No. Banks in the System	3	6	6	6	8	8
Foreign Banks	0	3	3	3	5	6
Banking Sys. Assets		61,360	70,850	90,010	128,714	167,310
BS Assets as % of GDP		49.0	37.7	40.1	45.8	49.0
System Deposits	18,874	32,200	42,500	65,500	106,740	124,646
Deposits / Assets		52.5	60.0	72.8	82.9	74.5
Deposits as % of GDP	35.5	25.7	22.6	29.1	38.0	36.5
Household Dep. % GDP	12.8	11.5	12.3	16.2	14.1	25.7
FX Deposits % total	36.3	31.8	30.8	30.6	31.8	28.3
System Loans	3,918	7,000	9,686	10,940	13,790	16,396
Loans / Deposits %	20.8	21.7	22.8	16.7	12.9	13.2
Loans / Assets %		11.4	13.7	12.2	10.7	9.8
Non-Performing Loans % of Total		12.5	28.6	34.9	40.1	91.3
Bank Credit to Private Sector as % of GDP	2.2	3.4	3.8	3.7	3.9	3.8
Gov. Securities/Assets %		7.6	11.5	23.6	38.9	41.3

Source: IMF Albania Statistical Appendix, 2000; BoA Supervision Report, 1998.

Aside from the poor performance in credit intermediation, the provision of other financial services to the public was also very scarce. Most financial activities in the economy took place outside the licensed financial institutions, in the informal financial market. The financial infrastructure, including the payment system, accounting and audit was particularly insufficient. The absence of a functioning formal banking system, combined with an inadequate regulatory and supervisory framework, contributed to the mushrooming of informal financial schemes. These included the pyramid schemes the collapse of which resulted in the civil crisis in early 1997, which eroded many of the achievements made during the early years of transition. However the events triggered by the collapse of the pyramid schemes may have represented a turning point for the reform of the banking sector (Aghadey, 2001:218).

3.1.3. Informal Economy, the Pyramid Schemes and the 2002 Deposit Withdrawal Crisis

As a foreign analyst put it following the collapse of the pyramid schemes and the precipitation of the civil order in Albania in 1997: "It is not true that development is a problem of institutions in the first place; it is a problem of institutions in the first place, the second and the third" (Elbirt, 1997:4);

The rise and fall of the pyramid schemes was by far and large the major financial environmental event of the decade in Albania and it spurred discussions in the financial literature worldwide. Similar schemes had flourished in other transition countries as well, most prominently 'Caritas' in Romania and 'MMM' in Russia both of which had collapsed in 1994. The pyramid scheme phenomenon in Albania attracted attention because of its unprecedented scale relative to the size of the economy and the subsequent profound political and social consequences (Bezemer, 2001:16; Jarvis, 2001:4).

The collapse of these schemes had a measurable effect on the structure of the banking sector even if banks were not directly involved in the schemes activity. On the other hand financial disintermediation and a passive banking system had its own role in the preparation of the crises along with scarce supervision by the respective authorities and institutions' inefficiency to take preventive measures. To better understand the environment of the banking sector on the threshold of the pyramid schemes collapse let us consider some details.

In 1996, one-year prior to the crisis, the three state-owned banks maintained virtual control of the Albanian banking system even though five foreign banks were operating at the time. The three SOB's held nearly 94% of banking assets and made 91.3% of all loans, with each one having around 30% of this market. Deposit collection was even more concentrated than lending with the top three banks holding 96.8% of both total and household deposits (Bonin, 2001:41).

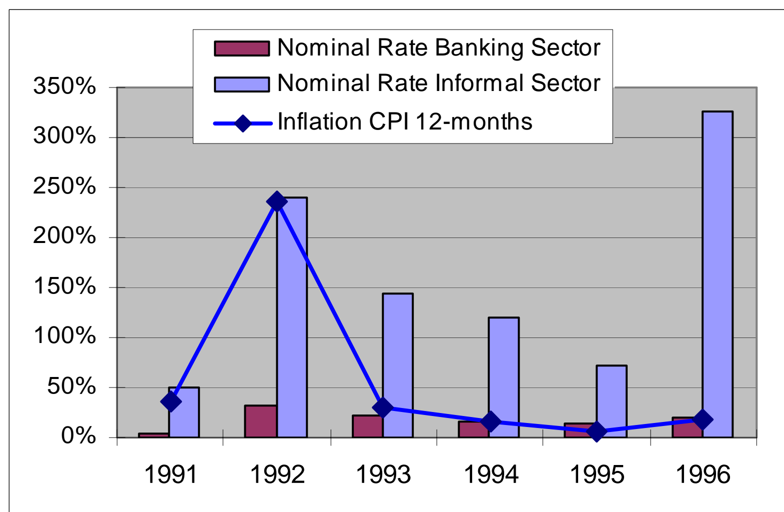
Although lending was more equally divided among the three banks and Savings Bank had lost some of its monopoly over individual deposits to National Commercial Bank, the Albanian banking sector was still severely segmented in 1996. The same year, banking assets as a share of GDP had climbed back to 45.8% but investment in government securities had taken an even more important place on the balance sheets of Albanian banks accounting for 38.9% of all banking assets (Bonin, 2001:42). In the same time bank loans were still at a very low level,

only 4.9% of GDP, thus suggesting for a crowding out of the private sector. Of the total bank loans extended, 40% was classified as non-performing in 1996.

Private banks which consisted of five small foreign or joint-venture banks without branch networks, were reluctant to lend and focused mainly on foreign exchange transactions and trade financing. State-owned banks were engaged in domestic lending but they operated as state agencies with soft budget constraints and failed to implement prudent lending practices. As a result of this in 1997 non-performing loans of SOB's represented more than 80% of their total loan portfolio (Aghadey, 2001:218).

The absence of a regulatory and supervisory system as well as the absence of tradition for loan repayment, influenced on increasing the level of bad loans. The supervisory authority and the experience of the central bank was rather limited and this resulted in a poor monitoring process (Cani and Haderi, 2002:6). Both the defective payment system and the 'bad loan' problem left commercial banks with too little liquidity for adequate lending, while the control of interest rates on deposits imposed by the central bank made bank deposit accounts less attractive to the population.

Figure 5: Annual Nominal Interest Rates on Deposits in the Formal and Informal Financial Sector in Albania, 1991-1996



Source: Calculations on data from EBRD Transition Report, 2004; Bezemer, 2001:39

In the same time the demand for financial intermediaries was especially large because of a considerable cash flow to the population in the transition years, mainly from three sources: remittances, financial aid and informal economy. These circumstances drove first business people, later many more non-entrepreneur citizens to the informal markets, where Ponzi[1]-like firms and foundations had started to operate (Bezemer, 2001:7).

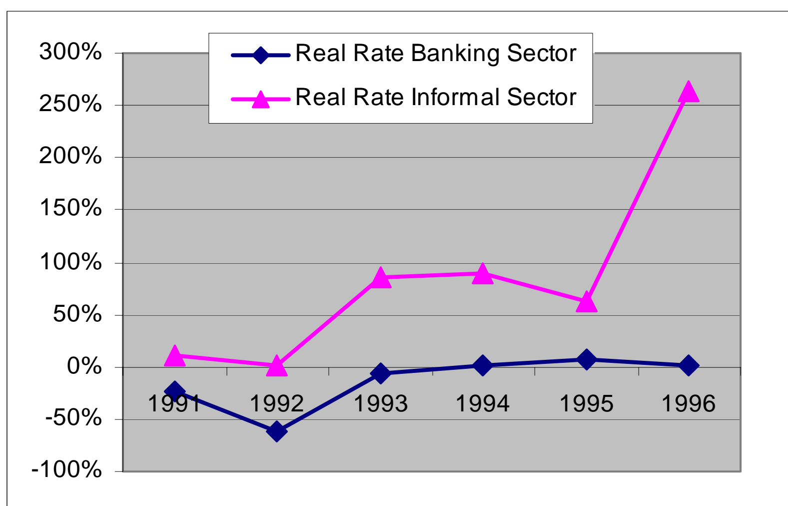
Albanian economy had showed a remarkable performance during the 1992-1996 period. Following its profound economic reforms in 1992, the country had been celebrated in much of the literature on the economics of transition as the classic example of sound post-socialist economic policy in line with the 'Washington Consensus'. During the period of 1992-1996 the developments in the real sector were characterized by a significant economic growth of 9% per year on average, a decline of inflation to 6% in 1995 and a significant improvement of the current account and fiscal deficit, which however, remained in high levels. The domestic currency was stable and foreign investment had started to pick up significantly. The progress in the macroeconomic stabilization had its basis on the implementation of tightening monetary and fiscal policies and on the rapid-paced privatization in agriculture, wholesale and retail market and SME's, which enlivened the economic growth (Cani and Haderi, 2002; Elbirt, 1997:4).

Even why we can not blame on the country's macroeconomic situation a number of other factors including insufficient legal framework and weak institutions, an under-developed banking system and the emerging informal credit market led to the development and collapse of pyramid schemes. The informal loan market had been in move since the beginning of transition. This market developed as a result of the tolerance of state authorities and the absence of the legal framework to prevent such deposit taking and lending activities. The banking system's inefficiency to perform the financial intermediation made room for pyramid schemes to absorb the growing savings of the population fueled especially by the emigrants' remittances. The monetary policy employed by the central bank during this period was based on the control of money growth through direct instruments such as loan ceilings and control of interest rates on deposits, which obviously distorted the market. In fact

[1] Fraudulent borrowing schemes linked to Charles Ponzi who in 1920 in Boston had collected $9.5 million from 10,000 investors by selling promissory notes with the pledge of paying a 50 percent profit in 45 days. As Ponzi paid the matured notes held by early investors, word of enormous profits spread throughout the community, pushing greedy and credulous investors into a fury. But there was no profit: earlier notes were paid at maturity from the proceeds of later ones.

official nominal interest on deposits remained far below inflation levels until 1995. That means deposits in commercial banks during this period yielded negative real return rates.

Figure 6: Annual Real Interest Rates on Deposits in the Formal and Informal Financial Sector in Albania, 1991-1996



Meanwhile interest rates offered by the ponzi schemes for the deposits were rather high and moved from 8%-12% monthly offered by the more conservative companies up to 40%-50% monthly for different short-maturity deposits offered by some smaller schemes, much higher then the rates offered by banks. (Bezemer, 2001:10-11). As a result, by the last quarter of 1996, the schemes had accumulated more than USD 250 million in their accounts, a sum representing only 40% of their liabilities. By early 1997 before the crisis exploded, the total value of deposits that the 16 pyramid schemes reached was USD 1.2 billion, or nearly 50% of GDP, excluding accrued interest at the time of estimation, roughly equal to total remittances from emigrants in the 1993-1996 period (Elbirt, 1997:2).

The collapse of pyramid schemes at the beginning of 1997 lead to an overall crisis, which started as a financial crisis. The country passed through a total anarchy, the revolts were turned into an armed uprising and the government lost the control of the territory (Jarvis, 2001:4). The financial system was heavily hit and the macroeconomic indicators deteriorated. Inflation jumped to more than 40 %, GDP dropped by 10%, unemployment reached 14.9 % and the Lek depreciated quickly by nearly 50%. Nevertheless the crisis' macroeconomic effect did not last long and by end-1998 indicators were back to reasonable levels. In 1998 output grew by 12.7%,

inflation dropped to 8.7% and the Lek recovered from its earlier depreciation. The current account deficit decreased to some 7.1% of GDP due to private transfers and lower-than-expected increases in imports. This improvement of macroeconomic indicators made it possible to lower interest rates, even though real interest rates were still high in the first half of 1999. The crisis impacted obviously on the public confidence loss in the banking system and the direct consequences of that were experienced during the bank run in 2002.

Table 11: Albania Main Macroeconomic Indicators, 1997-2002

	1997	1998	1999	2000	2001	2002
Real GDP growth	-10.2	12.7	10.1	7.8	6.5	5.2
Nominal GDP (USD mill.)	2,300	2,842	3,548	3,836	4,114	4,695
GDP per cap. (USD)	790	880	970	1,150	1,320	1,420
Inflation (CPI change %)	42.1	8.7	-1.0	4.2	3.5	1.7
Unemployment rate	14.9	17.8	18.4	16.8	14.5	15.8
Fiscal Deficit % GDP	12.6	10.4	9.4	8.2	7.9	6.6
FDI (USD mill.)	42	45	51	143	204	135
Current Account % GDP	-12.2	-7.1	-7.9	-7.4	-6.4	-9.7

Source: IMF Statistical Appendix, 2003; BoA, 2004.

To prevent the crisis effects on the banking system and to stabilize the macroeconomic indicators, the central bank suspended the lending activity for banks which had the level of bad loans over 20% and increased the minimum annual interest rates on deposits at about 30 %. Consequently, all three state-owned banks suspended their credits and succumbed to a deep reforming process (Ibrahimi and Salko, 2001:208). These measures restrained the extension of risky loans, improved the banks' portfolio and made possible that the deposits level be increased again. This increase, which reflected a growth of confidence in banks, ensured the possibility for the banks to have sufficient liquidity, which was mainly used for the purchase of treasury bills and for increasing the credit to the private sector (Cani and Haderi, 2002:11).

Having fallen in real terms in 1996, individual deposits grew by 68% to become 25.7% of GDP in 1997, as a result of the flight to security by households in the wake of the pyramid scheme collapse. Due to the increase in its deposit base the Savings Bank emerged from the crisis as the system's largest bank with a market share in assets of 66.2% more than double its share in 1996. By 1997, SB

was holding 51.8% of its assets in government securities operating basically as a narrow savings bank providing a safe investment for individual depositors.

On the other side of the balance sheets of banks, qualified loans increased to 90% of total bank loans in 1997 or about 4.3% of GDP. Already in serious financial trouble, Rural Commercial Bank of Albania was downsized by reducing its assets and loans and increasing the percentage of assets held in government securities at 42.2% to cover all of its household deposits. Finally RCBA was closed in 1998 leaving only SB and NCB as the only two state-owned banks in Albania from the beginning of 1999.

Table 12: Concentration in the Albanian Banking System end-2000

	Savings Bank	3 Largest Banks	Next 3 Banks	Rest
Assets %	64.8	79.6	12.4	8
Loans %	32.3	74.3	21.3	4.4
Tot. Deposits %	70.8	85.3	10.1	4.6
Ind. Deposits %	77.1	88.2	8.6	3.2

Source: Bonin, 2001:62

Legacies of the former economic system were still present in the structure of banking systems in the SEE countries after almost ten years in 2000. As the least developed of the region countries at the end of the decade, Albania's banking sector suffered the most severe segmentation (Bonin, 2001:53). After the privatization of NCB in June 2000, SB was left as the only state-owned bank dominating the banking sector in Albania. The largest bank in the system, SB accounted for almost two-thirds of all banking assets and collected nearly 70% of all deposits. The loan market was the least concentrated. By that time, SB had decreased its lending in real terms from a market share as high as 59.7% in 1997 to only 32% by end-2000. Much of the bank lending in Albania was performed by the small foreign banks using sources other than individual deposits to finance their activities. Hence, intermediation was still in its primitive stages in Albania despite the fact that bank deposits were a relatively high 42.6% of GDP.

By 1999 the central bank had ceased using ceilings on loans as an instrument of monetary policy, and started to employ an indirect instrument, the interest rate of repurchase agreements. While the interest rate of deposits for state-owned banks continued to be managed by the central bank until end-2000.

Table 13: Banking System Indicators, 1998-2002 (amounts in ALL mill.)

	1998	1999	2000	2001	2002
No Banks in the System	10	13	13	13	14
Foreign Banks	8	11	12	12	13
Banking System Assets	206,032	250,740	270,834	318,457	339,300
Assets as % of GDP	44.7	49.5	50.2	53.9	53.7
Banking System Deposits	171,006	207,863	229,667	277,818	289,006
Deposits as % of GDP	37.1	41.1	42.6	47.1	45.8
FX Deposits % Total	24	26.3	29.1	32.0	31.8
System Loans	15,864	18,587	23,243	27,942	38,652
Loans / Deposits %	9.3	8.9	10.1	10.1	13.4
Loans / Assets %	7.7	7.4	8.6	8.8	11.4
Non-Performing Loans % of Total	59.8	35.4	33.4	6.9	5.6
FX Loans % Total	39.7	49.9	63.8	81.7	79.0
Gov. Bonds / Assets %	45.2	51.4	57.7	53.5	54.5
Bank Credit to Private Sector as % of GDP	3.2	3.3	4.1	4.6	6.1

Source: Calculations on data from BoA Supervision Reports 1998-2003

In this setting when macroeconomic indicators and the banking performance indicators were improving the banking system was faced with the panic of deposits in March 2002, a pure banking sector event. The dynamic of deposit withdrawal between February and July 2002 presented in Table 14 reflects the starting and intensity of the bank run. The panic started and was extended mainly in the Savings Bank, which was on the eve of privatization and occupied the largest part of the banking system and less in the National Commercial Bank the second largest bank in the country. The deposit outflow from these two banks reached to Leke 12 billion in March and Leke 9.4 billion in April, while the withdrawals from the Savings Bank occupied 96.3 % of the total. Bank of Albania intervened effectively to inject liquidity in the market using overnight loans and reverse repos, and the panic was overcome in a short period.

The lack of information and its asymmetry had a significant impact on forming non-accurate public expectations. It is not accidental that the deposits withdrawal started and got extended initially in the rural areas, where the knowledge on the banking system was rather limited (Cani and Haderi, 2002:17). The run on the Savings Bank was linked to the newly introduced deposit insurance law while anecdotal evidence has it that this happened after speculations by foreign media

that banks in Albania were not safe. Other factors believed to have triggered the bank panic include the offering of the Savings Bank for privatization and political factors that shocked the public confidence in banks.

On the other hand, the deposits crisis had consequences even on the real economy, since the deposits withdrawal was associated with the increase of currency out of banks, increasing inflationary pressures and creating liquidity problems for the banking sector.

Table 14: Deposits at Savings Bank and National Commercial Bank During the Panic in 2002 (Amounts in ALL mill.)

	Dec-01	Feb-02	Mar-02	Apr-02	May-02	Jun-02	Jul-02
SB	176,980	180,407	167,425	157,925	156,700	157,525	158,097
% change		1.9%	-7.2%	-5.7%	-0.8%	0.5%	0.4%
NCB	28,500	28,517	26,124	25,985	25,856	26,077	26,561
% change		0.1%	-8.4%	-0.5%	-0.5%	0.9%	1.9%
Total BS	277,818	285,545	270,700	261,873	263,310	265,082	268,309
% change		2.8%	-5.2%	-3.3%	0.5%	0.7%	1.2%

Source: BoA, 2003:16

After more than one decade in transition the Albanian economy featured a fragile macroeconomic equilibrium, with external and fiscal imbalances, one of the lowest income per capita in Europe, relatively high poverty and relatively weak institutions. Estimated value of informal economy in 2002 was 27.5% of GDP (IMF, 2005). While the financial system continued to be in low development levels, the financial crises had appeared in settings that entered the literature as the “Albanian paradox”. The crisis that associated the collapse of the pyramid schemes erupted when Albania had displayed an impressive macroeconomic performance between 1992 and 1996 and was considered as successful in implementing the reforms, whereas the deposits withdrawal crisis occurred at the moment when the banking system was in better performance levels than ever before (Cani and Haderi, 2002:3; Bezemer, 2001:16).

As a conclusion we can point to some factors for the fragility of the Albanian financial system during the evaluated period. These are: the legacies of the socialist system, the slow reform developments during the transition period, the asymmetric information and lack of information on modern finance and banking practices, unstable macroeconomic and political developments together with institutional backwardness.

3.2. PRIVATIZATION OF THE BANKING SECTOR IN ALBANIA

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 at transforming the Albanian economy into a market economy, through its privatization the establishment of financial institutions and institutions of social protection.

The process of banking system consolidation during most of the 1990's, was relatively slow as a result of the presence of informal financial markets which had hampered the country's economic and financial development. In addition, other issues such as the high concentration of deposits and loans in the state-owned banks, their operational losses as a result of the increase in Non-Performing Loan portfolio, the underdeveloped and ineffective regulatory framework in supervision had become an impediment to the expansion of reforms in the banking sector (Ibrahimi, 2007:1).

The privatisation process started in 1995 when the law "On transforming state-owned banks into trade companies and allowing their privatisation" was approved. Other legal acts and decrees followed this law. The inefficiency of the SOBs especially in relation to crediting the economy in a safe manner showed that the first steps of restructuring the system were inadequate. Following the law on bank privatization, and the aggravated situation caused by the pyramid schemes crisis the Rural Commercial Bank (RCB) was liquidated in January 1998, with most of its assets being transferred to the Savings Bank (SB), while bad loans were transferred to the Bank Asset Resolution Trust (BART). The BART was established by the Government in 1998, as an agency for the resolution of bad loan portfolios of the state-owned banks. This process helped to speed up the privatisation process of the other two banks which had already started based on the existing legal grounds (Ibrahimi and Salko, 2001:200).

The liquidation of Rural Commercial Bank left the sector with 10 banks, 8 of which were foreign owned, by end-1998. In June 2000, NCB was recapitalized and privatized when Kent Bank of Turkey bought 60% of the shares and EBRD and IFC took 20% each. Prior to privatization, the entire loan book of NCB considered to be non-performing was transferred to the credit-restructuring agency (Aghadey, 2001:219-220). In November 2000, the new shareholders invested USD 10 million, resulting in a strong capitalization of the bank. During 2001, Kent Bank ownership

was transferred to the Savings Deposit Insurance Fund (SDIF) in Turkey and in 2006 the Bank of Albania approved the transfer of 60% of the NCB shares possessed by Kent Bank in favor of Calik-Seker Consortium A.S.

At the end of 2000, 13 banks were operating in Albania and after the privatization of NCB, the Savings Bank was the only remaining state-owned bank. However, SB accounted for 64.9% of all bank assets in Albania; hence, the percentage of assets controlled by foreigners was only 35%. The strategy for the eventual privatization of the dominant bank, SB, and the development of the interbank market was a crucial determinant for the future effectiveness of the banking system in terms of financial intermediation, competition, new technology and services (Bonin, 2001:5).

The privatization of SB was planned for 2001 and prior to offering it for sale, the government cleaned up SB's loan book in a manner similar to the action taken for the privatization of NCB. All of the loans at SB in 2000 were transferred to the BART, and the total recapitalization amounted to slightly less than 1.4% of GDP. This not only recapitalized the bank and improved all capital related ratios, but it also improved financial ratios for the entire banking system. Following this, the government signed a contract with the bank, providing all new loans had to be approved by foreign advisers. In practice, the Savings Bank investment activities were mainly restricted to purchasing treasury bills and its privatization was postponed for 2002. (Aghadey, 2001:219-220).

The decision to push ahead with the privatization of SB increased the interest of foreign investors. The fact that SB recapitalization was carried out before its privatization, unlike NCB that was recapitalized the moment it was privatized, was considered an advantage and made the bank more attractive for sale. Moreover the bank continued to have a monopoly over household deposits with a network of 37 branches and 70 agencies spread all over the country by end-2001. National Commercial Bank operated with ten branches at the time of its privatisation.

A further plan for the SB restructuring was prepared for the period December 2002-September 2003. This plan consisted in further IT developments, personnel reduction and professional promotion, banking network restructuring, payment system improvement, decrease of bank's dominance and marketing (BoA, 2003:8).

Finally the SB was privatized in April 2004 when Austria's Raiffeisen Zentralbank, bought 100% of its shares for USD 126 million in a tender offer. At the time the Savings Bank had the largest branch network in the country with 92 outlets,

and 1000 employees. With its privatization, the state presence was completely removed from the banking business, except for partial ownership in two joint-venture banks, the Italian-Albanian Bank (IAB) and the Arab-Albanian Islamic Bank (AAIB) where the government held 40% stakes.

The Albanian Ministry of Finance 40% share in the IAB was transferred in December 2005 after an agreement with Italian banking group Sanpaolo IMI spa. Capitalia being the owner of another 40% share of IAB sold its take too and the total deal for 80% of the shares of IAB was worth Euro 40.8 million. The change in shareholders structure was completed in May 2006. Early in 2008 the IAB was merged by acquisition with the American Bank of Albania that had been also purchased by Sanpaolo in June 2007.

Both SB renamed Raiffeisen Bank of Albania (RBA) after privatization and NCB are the largest bank of the system and operate extensive branch networks, offer diverse banking products and services, develop banking infrastructure, create innovative technology and foster competition. As in many other transition countries sale to strategic foreign investors has proved to be a successful privatisation strategy in Albania.

At present the Albanian banking system is entirely privately-owned except for some minor shareholdings of the government, which are scheduled to be sold within 2008.

3.3. PRESENT SITUATION OF THE BANKING SYSTEM IN ALBANIA

For most of the last decade the Albanian banking system remained underdeveloped with loans in very low levels, 8.8% of banking assets and a still lower 4.7% of GDP in 2001, even though the ratio of banking assets to GDP had risen to 54%. Investments were limited to Albanian treasury bills and the percentage of banking assets held in government debt securities was as high as 57%. The primary explanation for this phenomenon has been the dominance of the Savings Bank, the largest state-owned bank in Albania, that was operated at the time as a narrow savings bank by the government with the majority of its assets held in government securities (Bonin, 2001:26). Although during 1993-1999 the Central Bank of Albania had established limitations on lending from banking system, the banks never needed to meet these limits and thus, this instrument did not prevented them from crediting the economy (Ibrahimi and Salko, 2001:207). At the end of 2000

the central bank removed limitations on credit and started to monitor the crediting activity based on supervisory indicators. This decision allowed commercial banks to increase the amount of lending to the economy. The same year commercial banks introduced consumer loans for the first time.

Following this period, the banking system entered a period of consolidation. The share of state-owned banks decreased gradually due to their subsequent privatization and the considerable increase in the number of private banks from 6 operating in 1997 to 17 banks in 2007 three of which are banks established with domestic capital.

The growth of the banking sector during 2004-2007 has been sizable, with assets growing at an average rate of nearly 20% per year resulting in a cumulative growth of 98.8% for the period. In the same period banking assets growth in more developed CEE countries was 22% per year on average, and 35% per year in Bulgaria and Romania (ECB, 2007:52). Growth in the banking system was reflected in increased lending, and in particular in mid-term and long-term loans. Supported by a rise in banking activity and products, lending to the private sector has increased with an average rate of 50% annually between 2003 and 2007 more than almost any other country in the region (WB, 2007:34). Growth rates have been as high as 75%, 58% and 50% in 2005, 2006 and 2007 respectively. Bank credit to private sector (BCPS) as a percentage of GDP increased from 7.3% in 2003 to 29.2% in 2007. However, despite the considerable improvement in the asset quality and the commercial banks' financial performance, the growth of lending to the private sector and to households remained low as a share of GDP compared to region countries such as Bulgaria and Croatia, providing evidence for other non-utilized banking services capacities in the Albanian economy (see Tazble 16). Notwithstanding we should recognize that the intermediation process in the banking system started from negligible levels.

As a result of the enhanced confidence in the domestic banking system, the share of assets to the GDP increased in 2007 to the level of 76%, which is comparable to that of the region countries. The privatization of the Savings Bank in 2004, macroeconomic stability and low inflation together have contributed to the rapid growth of the banking system.

The number of banks and non-bank financial institutions (NBFI) operating in Albania appears to be high, considering the still-limited economic activity in the country and the size of the overall economy. Further consolidation of the banking

system would help achieve economies of scale and avoid unsound credit practices in the drive to attract clients (WB, 2007:17).

Table 15: Number of Financial Institutions in Albania

Subjects	2002	2003	2004	2005	2006	2007
Commercial Banks	14	15	16	17	17	17
Non-bank Financial Institutions	5	7	7	7	5	6
Savings and Loan Association	113	131	130	131	125	129
Insurance Companies	5	5	10	10	10	10
Pension Funds	1	1	1	4	4	4
Leasing Companies	1	1	1	2	3	3

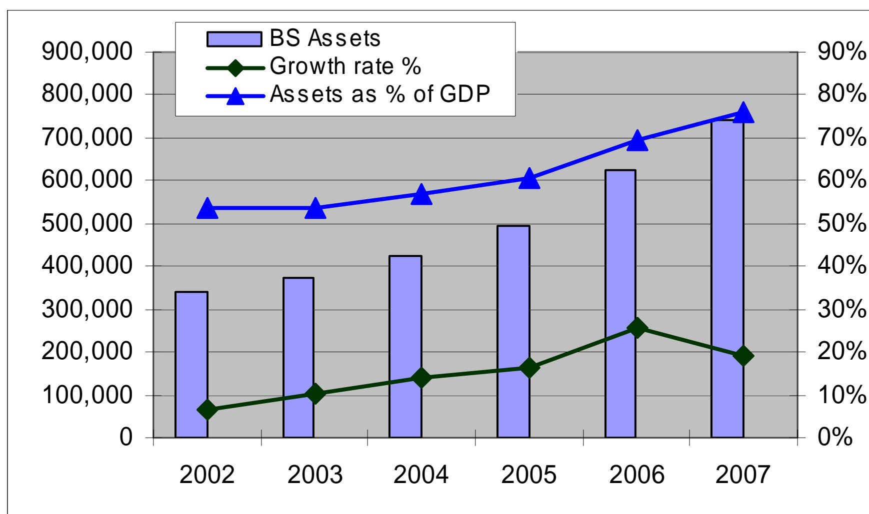
Source: BoA, 2006:32, AMF:2006

As of January 2008 there are 16 commercial banks operating in Albania. The commercial banks operate in accordance with the universal banking principle; banks are allowed to engage both in core activities such as deposit taking and lending and in other activities such as investment banking, securities intermediation etc. They offer a wide range of services and products such as: money transfers, deposits, different kind of loans, card services, bank guarantees etc. Notwithstanding apart from these traditional banking products sophisticated products are not yet present in the banking system. By the end of 2007 the Albanian banking network had more than 390 branches and agencies and 5,200 employees. Commercial banks dominate the financial system with nearly 97% of the total assets and 95% of the total credit granted to the private sector. The banking sector is regarded as the most developed sector of the Albanian economy and is currently experiencing a rapid and continuous growth.

Banking System Assets

The banking system assets have increased considerably in the last 4 years with an average growth rate of almost 20% per year. This growth has been fueled primarily by the increase in the deposits, which during this period have represented on average 86% of total assets. The capitalization of banks has also been increased necessitated by the expansion of banks' lending activities. Equity capital accounted for 7.7% of total assets in 2007 up from 5.8% in 2003.

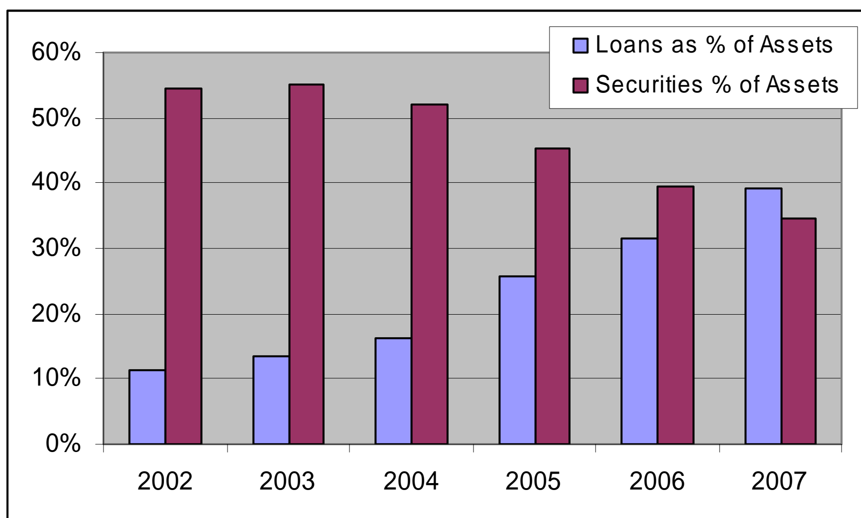
Figure 7: Banking System Assets in Albania, 2002-2007 (Amounts in ALL)



Source: Calculations on data from the BoA Supervision Reports

The ratio of banking system assets to GDP has increased substantially during the past years suggesting for an improved level of financial intermediation in Albania. This ratio has grown from 53.6% in 2003 to 75.9% in 2007. Yet this is at relatively low levels compared to an average assets-to-GDP ratio of 102% for CEE countries or 300% of GDP for Eurozone countries in 2006.

Figure 8: Asset Structure of the Banking System, 2002-2007



Source: BoA Supervision Reports, 2003-2007

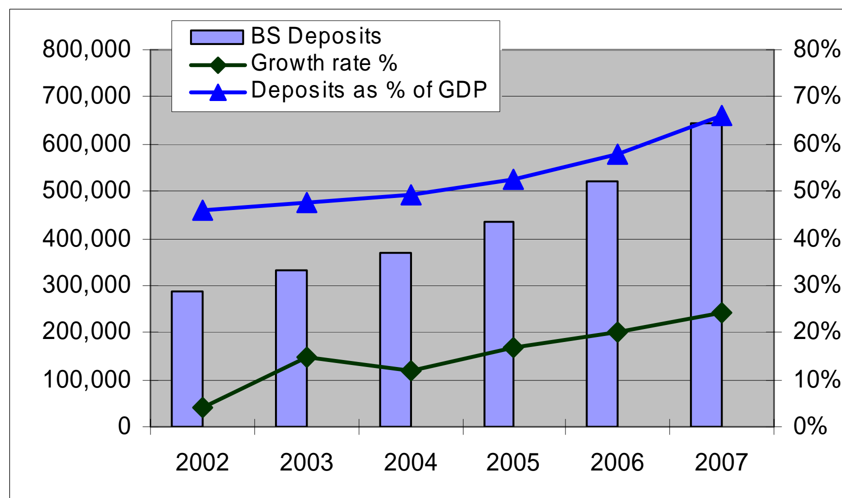
The structure of assets has changed where investment in loans has incrementally replaced investment in government securities. This transformation has been triggered by the increasing credit demand from the private sector in Albania and reduced interest rate margins that forced banks to enhance their credit activities. However, the level of investment on public debt at nearly 35% of total assets by end 2007 remains high compared with the regional average.

Deposits

Effective intermediation in the financial system involves collecting primary deposits from the households and lending to the private commercial sector to finance working capital and investment. The significant growth in deposits in Albania is a major sign that confidence in the banking sector has improved. Saving rate is relatively high; the annual growth rate of deposits has been at 18.2% on average for the 2004-2007 period resulting in a cumulative growth of nearly 95%. Deposits-to-GDP ratio increased from 48% in 2003 to 66% in 2007. Commercail banks in Albania collect a significantly higher percentage of GDP in bank deposits than their counterparts in Bulgaria and Romania; as shown in Table 16.

As to the deposit structure, foreign currency deposits make up 42.5% of total deposits, a relatively low level compared to the average of SEE region where currency and asset substitution is a widespread phenomenon and countries such as Croatia and Fyrom have the major part of their deposits denominated in foreign currency (Xhepa, 2002:14; IMF, 2005:6).

Figure 9: Banking System Deposits, 2002-2007 (Amounts in ALL)



Source: Calculation on data from BoA Supervision Reports

Nevertheless the ratio of foreign currency deposits to total deposits in Albania has entered an upward trend in the last years, evidence of the Euroization of the economy. So, foreign currency deposits increased from 30% of total deposits in 2003 to 42.5% in 2007. The structure of deposits according to maturity was: 72% of total deposits were time deposits and 28% demand deposits as of end 2007.

Table 16: Level of Financial Intermediation in Albania and Region Countries, 2006

	Assets/GDP	Loans/GDP	Deposits/GDP	Loans/Deposits
Albania 06	69.7%	22.0%	58.0%	37.8%
Albania 07	75.9%	29.6%	65.9%	44.9%
Fyrom	57.4%	29.6%	41.3%	71.7%
Romania	52.6%	30.1%	32.2%	93.6%
Bulgaria	88.9%	46.4%	49.5%	93.7%
Croatia	121.6%	71.5%	81.0%	88.3%
Avg CEE	102.2%	61.7%	56.1%	111.0%

Source: ECB Banking Structures Report, 2007; Central Banks of Countries

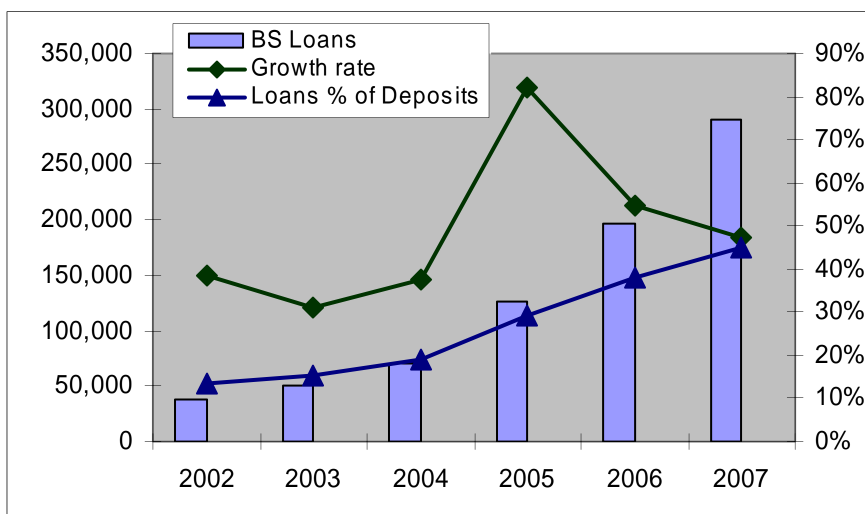
Loans

Lending is the main focus for the Albanian banking industry at present and in the last years the sector has experienced a credit boom. The growth rate of commercial loans to private sector and to households has been constantly exceeding the expansion rate of banking assets. Over the last 3 years, extended loans have increased considerably by an annual growth rate of 62% and a cumulative growth of 315%, which is the highest growth recorded in the region and the CEE countries (Ibrahimi, 2007:2). The loan-to-GDP ratio has grown to 29.6 %, yet a low level compared with the size of deposits and with other region countries as shown in Table 16. The ratio of total loans to deposits has tripled in the 2003-2007 period from 15% to nearly 45%, indicating for an improvement of financial intermediation performed by the banking system.

Despite the improvement of the overall loan related ratios, there are some structural problems in the loan portfolio of the banking system that represent potential risks and thus must be well managed by the authorities. For example credit in foreign currency accounted for 72% of total credit at end 2007. By extending loans in foreign currency commercial banks maintain relatively small open foreign currency positions. However, the low exchange rate risk borne by the banks is to

some extent replaced by a higher level of credit risk, as locals borrowing in foreign currency may not be hedged (IMF, 2005:14).

Figure 10: Loans Extended by the Banking Sector, 2002-2007 (Amounts in ALL)



Moreover intensifying competition among banks to protect their shares in the loan market could lead to riskier lending and an increase in nonperforming loans in the future. In the meantime the central bank has reacted to this by establishing new prudential measures in December 2006 requiring additional loan loss reserves to banks that exhibit annual growth of their loan portfolio higher than 30% and have a NPLs ratio above 7%.

The majority of bank loans, 98.6% in 2007, are extended to the private sector and the high growth rates of BCPS in the recent years (see Figure 11) might not be sustainable and pose risks to the financial system including:

Lack of viable financial information: Despite the establishment of a credit registry in early 2008, there is still limited information available on borrowers, which could hamper the sustainability of credit growth and could lead to increases in Non-Performing Loans.

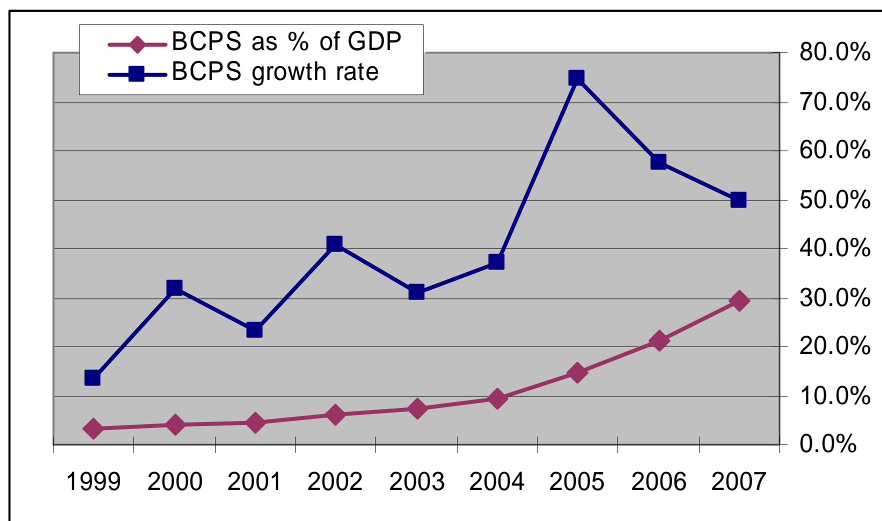
Capacity of banks to process loans: Banks are potentially unable to process loans in a timely manner, leading to misestimation of liquidity needs and errors in documentation and recording.

Excessive exposure to real estate: Since a large part of collateral and bank lending consists of real estate, large increases in property valuation could lead to

overextension of credit; which in turn increases the exposure of the banking system to possible real estate bubbles. In the first trimester of 2008 real estate loans made up 24% of the total loans of the banking system in Albania.

Collateral enforcement: Enforcement of collateral remains a major concern should banks seek to obtain the value of collateral in the event of nonperformance of a loan (WB, 2007: 35).

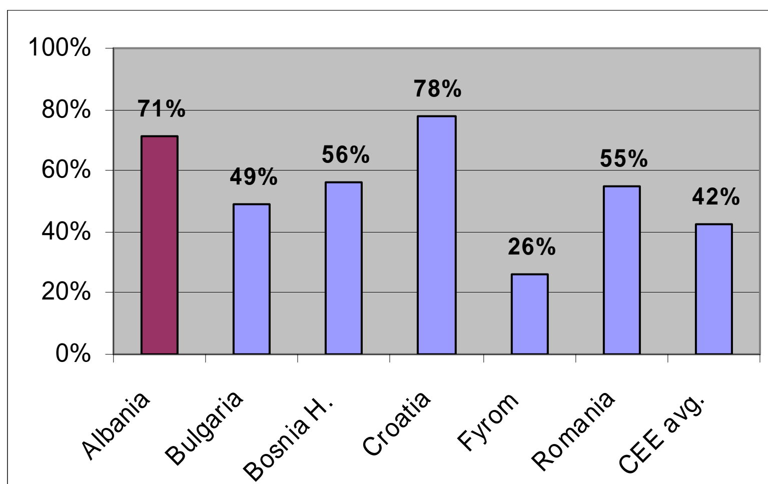
Figure 11: Bank Credit to Private Sector % of GDP in Albania, 1999-2007



Turning once more to the loan structure according to currencies, facts noticed in the past, such as the tendency of foreign banks to issue loans in foreign currency, are still current. This is mainly because of the greater demand for foreign currency loans by borrowers, and the possibility banks have to invest the local currency in Treasury Bills at high interest rates.

Foreign currency long-term loans accounted for more than 74% of total long-term loans by end 2007 in Albania. Credit in foreign currency exposes borrowers to exchange rate risk and can translate into a significant deterioration of banks' loan portfolio in an adverse economic scenario. Borrowers in Albania have been attracted by credit in foreign currency with lower interest rates, even though most of them only have income in Lek. Furthermore the gradual increase of long-term loans in the recent years transfers greater risks to the economy in the case of macroeconomic instability considering the high share of foreign currency loans.

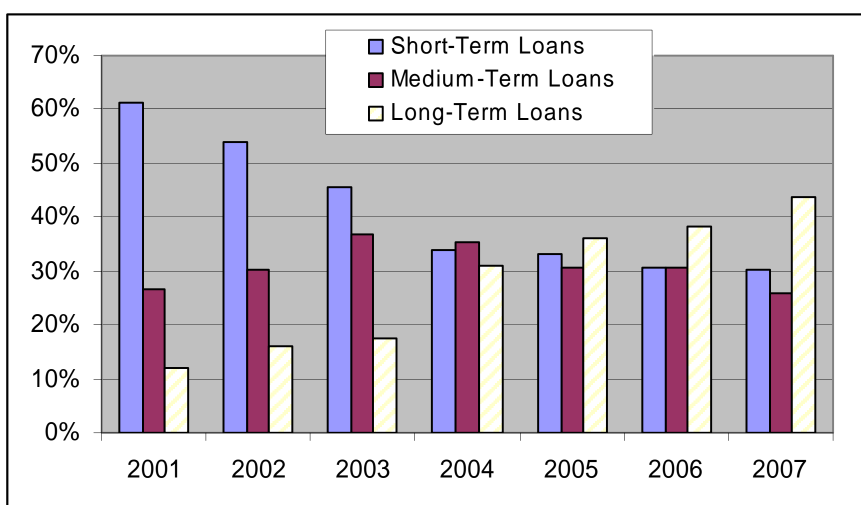
Figure 12: Foreign Currency Loans (% of total) in Albania and SEE Countries in 2006



Source: National Central Banks' Reports

As to the loan structure by maturity in the last years there has been a shift from short-term loans to long-term loans. The balance sheet of banks appears to signal potential for further expansion of long-term credit. By end-2007 the volume of long-term credit outstanding accounted for only 27% of the time deposits raised by banks.

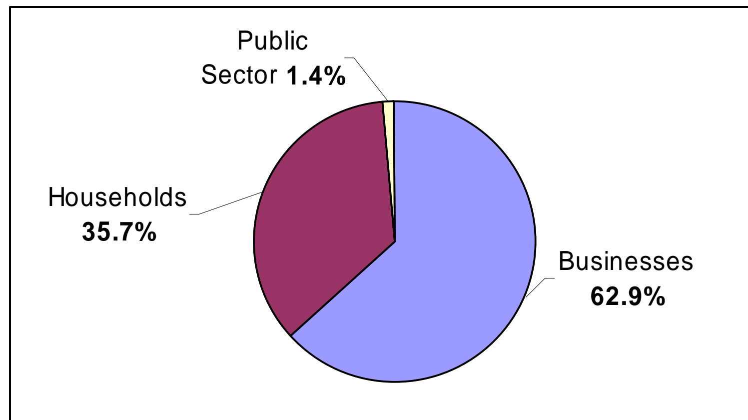
Figure 13: Loan Structure by Maturity in the Albanian Banking System



Banks have actively sought to expand operations beyond the segment of large firms to households and, to a lesser extent, to SME's. According to commercial

banks' expectations the segment of large enterprises appears to be close to saturation, with substantial access to bank loans and relatively small intermediation margins (WB,2007:16).

Figure 14: Loan Structure by Sector of Economy in 2007

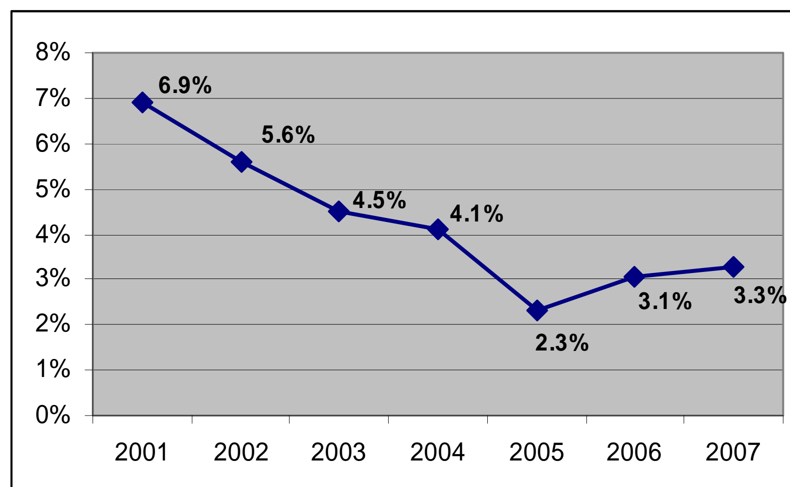


Source: BoA Supervision Reports, 2003-2007

Loan Quality

Thus far we may say that credit supply is in prudent levels, since non-performing loans' portfolio, though increased moderately to 3.3% of gross loans in 2007 from 2.3% in 2005, provides evidence for a limited exposure of the banking sector to non-settlement risk. However, the rapid credit growth might be hiding a potential deterioration in the quality of banks' loan portfolio because the increase in the share of new loans temporarily depresses reported NPL's.

Figure 15: Non-Performing Loans (% of Total) in the Banking System



As a matter of fact an upward trend in the NPL ratio can be observed in the last 3 years. Moreover experience in other countries in the region shows that the situation of the banking system can change drastically in a short period of time after a banking crisis and in most countries lending is strongly procyclical contracting quicker than output during economic recessions. A potential credit risk might also result from foreign currency lending to companies and individuals who are not hedged against fluctuations in the exchange rate (Craig, 2006:94).

The expansion of lending activity might be accompanied with the deterioration of the loan portfolio due to the following reasons:

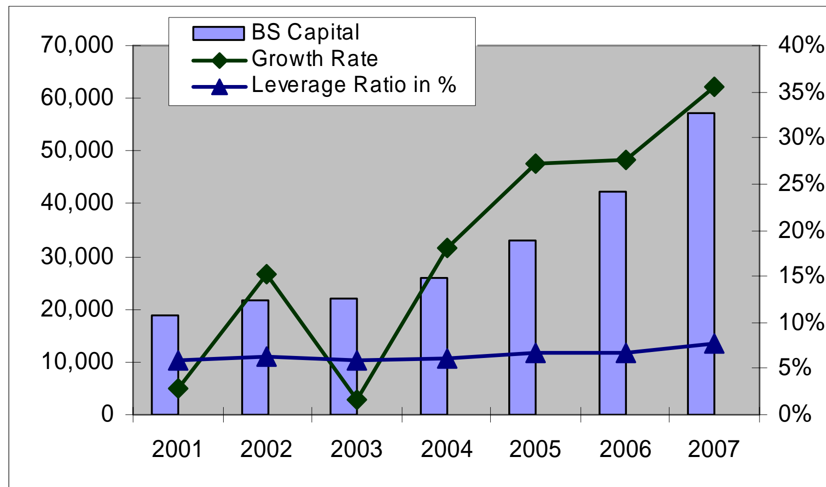
- The increase of lending activity without having adequate staff and the lack of experience to monitor the loans. Risk assessments may suffer due to the vast amount of new loans extended;
- The existence of an underdeveloped market which cannot comply with the obligations that derive from loan making or the principles of free market economy and non-diversification of loan portfolio;
- The unstable or weak situation in some sectors of crucial importance for the economy, such as energy, construction, agriculture etc.;
- The malfunction of certain legal aspects concerning lending process, such as property registration and enforcement of collateral.

Equity Capital and Capital Adequacy

The financial leverage that indicates the structure of funds of an institution is given as the ratio of shareholders' capital of the bank to the total assets. This indicator for the Albanian banking system was 6.8% in 2006 and 7.7 % at the end of 2007, while in the banking sector the interval of 5-9 % is considered as a standard level (BoA). The leverage ratio for the banking sector was 9.7% in Croatia and 9% for Romania (CNB, 2007:8).

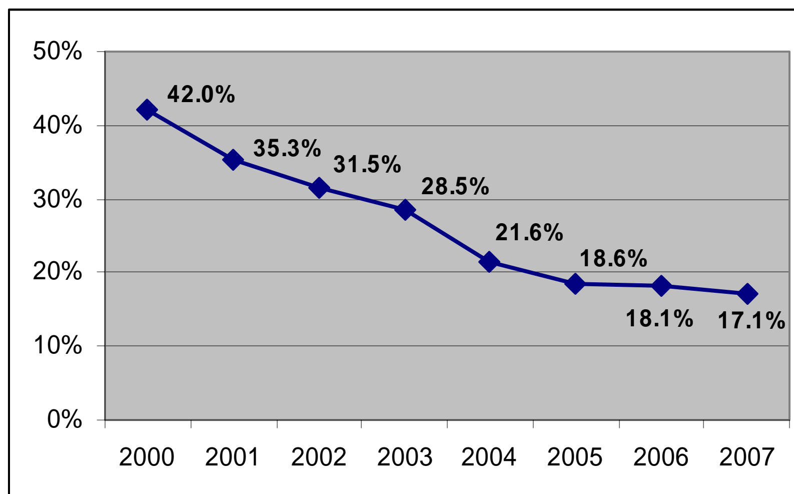
The ratio of capital adequacy determines the banks' ability to face possible losses. The calculation of this indicator is based on the methodology set forth pursuant to the Basle Committee Agreement on the Banking Supervision and is calculated as the ratio of regulatory capital to risk-weighted assets. In Albania, the minimum capital adequacy requirement is stipulated by the supervisory authority to be 12 %.

Figure 16: Equity Capital in the Banking System, 2001-2007



Source: BoA Supervision Reports, 2003-2007

Figure 17: Risk Based Capital Ratio in the Albanian Banking System



Source: BoA Supervision Reports, 2003-2007

After the privatization of the NCB and the recapitalization of SB in 2000 the capital adequacy of the system was a high 42%. With high capital adequacy ratios, banks managed to increase profitability in the following years by shifting the composition of their assets toward loans. After the increase in banking activity and investment in risky assets this ratio has been decreasing gradually to 17.1% in 2007. The capital adequacy ratio in Croatia was 13.2% in 2006.

Access to Banking Services

The significant growth in the number of employees, combined with the increased number of branches, reflects the expansion of the banking system network and the extension of the services offered. Overall, the increased number of banks, branches, agencies and the growing number of bank employees have significantly improved coverage of the population. Thus, the number of inhabitants per bank, banking unit, and bank employee has decreased considerably in the last years.

The ATM network experienced a significant growth during the past three years and most banks have established ATM's in the main cities. The number of ATM's increased from 222 at the end of 2004 to 433 by end-2007 and the number of debit and credit card holders increased drastically from 34 thousand in 2004 to more than 616 thousand in 2007. Two banks, ABA and BKT, have opened foreign branches in Greece and Kosovo. Even though at present the banking system network covers all region and towns the banks are still in the process of expansion to cover territory.

Table 17: Banking Sector Capacity and Coverage Indicators in Albania and Some SEE Countries in 2006

	Residents per Bank	Residents per ATM	Residents per Bank Employee	Residents per Bank Branch
Albania 07	186,329	7,315	608	8,081
Albania 06	185,365	9,103	752	10,718
Bulgaria	239,978	2,090	287	1,379
Romania	553,353	3,605	369	4,828
Macedonia	66.356	6.926	411	6,510
CEE avg.	101,113	2,713	258	4,426

Source: ECB, 2007:16; BoA, 2007:35

In order to make an accurate picture of the banking services performed, we compare the level of inhabitants per number of banks, bank branches, bank employees and ATM's in Albania with these indicators in some SEE and the average for CEE countries.

As we can see from Table 17 there is less banking services access for residents in Albania than region countries, suggesting that the system must undergo a further consolidation and network expansion in order to provide banking services to the population to a greater extent and in a more efficient way.

An important indicator of banking sector development in transition economies is the EBRD index of banking sector reform which assesses reforms in the supervisory and regulatory base, the ownership structure of banking system and liberalization of interest rates. For Albania this indicator at end 2007 was 2.7, fixed since 2004 when the SB was privatized.

Table 18: EBRD Index of Banking System Reform[2] in Albania and Some Transition Countries

	Albania	Fyrom	Bulgaria	Czech Rep.
1997	2	2.7	2.7	3
1998	2	2.7	2.7	3
1999	2	2.7	2.7	3.3
2000	2.3	2.7	3	3.3
2001	2.3	2.7	3	3.7
2002	2.3	2.7	3.3	3.7
2003	2.3	2.7	3.3	3.7
2004	2.7	2.7	3.7	3.7
2005	2.7	2.7	3.7	4
2006	2.7	2.7	3.7	4

Source: EBRD Transition Report, 2006

There remains potential for increasing credit to the private sector and allocation to underserved segments. Although the banking system has started to invest less in treasury bills and more in lending in pursuit of profitability, the system remains liquid. Therefore, the system has the capacity for further growth, provided the growth in credit is achieved in a sustainable manner (WB, 2007:5).

Any further expansion of credit to the private sector will have to be underpinned by strong regulatory environment, prudential oversight and improved governance. Issues in this area include continuing anti-money laundering efforts, improving the efficiency of the judicial system for enforcement of collateral, ensuring that regulatory capacity is sufficient to monitor credit growth and introduction of new

[2] This indicator provides a ranking of progress in liberalisation and institutional reform of the banking sector, on a scale of 1 to 4+. A score of 2 means that a country has established internal currency convertibility and has liberalised significantly both interest rates and credit allocation. A score of 3 means that a country has achieved substantial progress in developing the capacity for effective prudential regulation and supervision, including procedures for the resolution of bank insolvencies, and in establishing hardened budget constraints on banks by eliminating preferential access to concessionary refinancing from the central bank. A score of 4+ represents a level of reform that approximates the institutional standards and norms of an industrialised market economy, as represented, for example, by the Basle Committee's Core Principles on Effective Banking Supervision and Regulation.

financing instruments. Efforts in these areas will strengthen the competitiveness of both the real and financial sector, and improve the overall risk management.

Some other important features of the banking system such as concentration, profitability and risks will be considered in the next chapter. Since the banking system in Albania is dominated by foreign banks that account for more than 94% of the total assets, the above mentioned features will be analyzed in a more accurate and dynamic manner against the increase of the foreign bank presence in the banking system.

3.4. REGULATION AND SUPERVISION OF THE BANKING SYSTEM IN ALBANIA

The supervision of the second tier banks is a function of the Bank of Albania, as their only regulatory and licensing authority. The Bank of Albania operates as an independent legal entity accountable directly to the Albanian Parliament and its primary objective as stipulated by law is the maintenance of price stability (Cani and Haderi, 2002). Along with its main objective the BoA's mission of banking supervision is to maintain the liquidity, solvency and normal functioning of the banking system. The stated objectives of banking supervision are:

• To insure, through the licensing process, the entry in the banking market only for the qualified entities that meet the corresponding legal, professional and ethic requirements, have adequate capital for undertaking risks, as well as policies and procedures for managing them;

• To assure that banks are operating soundly in compliance with the laws and regulations, so that they can have the adequate capital, necessary liquidity, satisfactory assets quality, shareholders reserves to withstand the undertaken risks, managing them according to international standards of best practices, to insure the customers protection and evidence abusive practices;

• To assure problem banks are treated soon and effectively so that to protect depositors, making use of all the existing possibilities, minimizing government and households cost (BoA).

In 1992 the law "On Bank of Albania" provided for the first time the bases to establish an institution in compliance with Western standards and with a relatively high independence. A banking supervision department was established within the

central bank the same year. In 1993 and 1994 the first regulations on banking supervision were drafted and supervision norms were set for the state-owned banks.

Nevertheless during the fırst years of transition too little was done to establish solid financial institutions. The financial crisis of 1997 caused by the collapse of pyramid schemes revealed that banking legal framework was not complete and it was its deficiencies that allowed the rise of pyramid schemes (Ibrahimi and Salko, 2001:197). Immediate measures had to be taken for improvements in this sector and two new laws “On Bank of Albania” and “On Banks in the Republic of Albania” were approved in December 1997 and July 1998 respectively. The new laws’ aim was to ensure the real and formal institutional independence of the central bank in accord with its main objective, and to build a complete regulatory and supervisory system for banks. The framework was improved in accordance with international standards on loan classification, reserve funds, capital adequacy, liquidity and foreign exchange position.

During 1999 a measure was enforced by Bank of Albania to increase the minimum required capital for commercial banks to 500 million Lek from 350 million Lek previosly. By 2000 the minimum capital requirement was set at 700 million Lek or the equivalent of USD 5 million and more recently at 1,000 million Lek. An average period of 3 months is needed to review an application and grant a bank licence.

Since 1999 the Bank of Albania uses Camel, an evaluation system for second-tier banks which applies on the basis of relevant structures of human resources and legal basis. This increased the quality of examinations of the system and all the necessary indexes to perform banks’ rating. The second-tier banks submit to the BoA in a monthly basis reports that contain financial data required in separate regulations. Deposit insurance that offers protection to depositors in cases of bank bankruptcy was introduced in 2002 and all commercial banks in Albania are required by law to insure their deposits.

Many amendments to the law on the banking system have been made over the years. These amendments resulted from the need of adopting the European Community Directives concerning the financial institutions activity and the fulfillment of the obligations under the Stabilization and Association Agreement signed with the EU. This process was successfully finalized upon the approval of the new Law No. 9662 “On Banks in the Republic of Albania” in effect from June 2007. Compared with the previous law, the new law is more complete and more accurate. It has

integrated some new concepts which are in full compliance with the European Directives and it stipulates changes in the licensing of activities by level of capital, in consolidated supervision, transparency to customers, procedures on conservatorship and liquidation etc. In addition, “risk management”, which previously was provided for in specific regulations, has been now summarized in a specific chapter of the law and a section has been dedicated to the prevention of money laundering (BoA, 2007).

Over time, the expansion of financial activity will create yet further demand for more effective legal and regulatory frameworks. A particular challenge to the supervisory authority under the conditions of the recent lending boom and competitive environment will be the proper monitoring of the loan quality and the accuracy of NPL reporting from commercial banks.

There are very minor differences with regard to the procedures for granting a bank license among countries in the SEE region. These differences are insignificant and they do not give priority to any country in terms of attracting foreign capital or capital from a certain country (Baleta, 2001:11).

Private banks in Albania are required to meet the minimum capital requirement and be incorporated as joint stock companies. Subsidiaries and branches of foreign banks follow the same licensing procedure and rules for supervision as any bank and currently there is no distinction in the supervisory practices that are applied. Under the European Capital Adequacy Directive, the branches or representative offices of foreign banks are supervised by home country supervising authorities. In Albania, foreign banks are under the supervision of the Bank of Albania as the sole supervising authority. The ownership transfer of a significant share (10% or more) of bank’s capital to a third party after receiving the approval of the bank’s shareholders, requires the prior written approval of the BoA.

Apart from legal improvements, during the last years Bank of Albania has substantially enhanced the supervising and regulatory procedures for second-tier banks by issuing a number of by-laws and regulations in acordance with international standards related to many of banking activities and indicators. Such regulations cover the granting of licenses to banks and non-bank financial institutions; liquidity requirements; minimum capital requirements; loan classifications and provisions; open positions and foreign exchange activities; market risks and internal auditors. All regulations of BoA are in line with Basle Committee’s principles for an effective banking supervision.

Furthermore the Bank of Albania has signed Co-operative Banking Supervision agreements with supervisory authorities in Greece, Turkey, Italy and Austria in order to improve the supervising potential with respect to the foreign banks that operate in Albania. An important challenge remains the implementation of Basel II requirements while the adoption of International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) was officially done in January 2008.

3.5. NON BANK FINANCIAL INSTITUTIONS

As specified by various international standards, non-bank financial institutions are companies or institutions involved mainly with financial intermediation or with financial assisting activities closely related to financial intermediation, but that are not classified as accepting deposits. An exception to this make the Savings and Loan Associations that accept deposits from their members and are classified as other depository institutions. Except for the insurance companies and pension funds, all other nonbank financial institutions are licensed and supervised by the Bank of Albania (BoA, 2006:53). The Albanian Financial Supervisory Authority (AFSA) which was established in 2006 is responsible for the supervision of insurance companies, private pension funds and non-bank financial markets. AFSA replaced three entities: The Insurance Supervisory Authority, Albanian Securities Commission and the Inspectorate of Supplementary Private Pension Institutions (AMF, 2006:4-8).

Table 19: Assets of NBFI's and their weight in the financial system, 2005-2006

(ALL million)	**2005**	**weight**	**2006**	**weight**
Banking System Assets	496,561.5	95.2%	624,279.3	96.7%
Micro Finance Inst. Assets	10,829.9	2.1%	6,847.0	1.1%
Insurance Companies Assets	10,215.6	2.0%	11,409.5	1.8%
Savings and Loans Ass.	3,789.5	0.7%	2,734.0	0.4%
Financial System Assets	521,396.5	100.0%	645,269.7	100.0%

Source: BoA, 2006:38; AFSA: 2007

In the past few years, an ever-increasing number of NBFIs are performing activities in the financial market. Micro-credit financial institutions and Savings and Loan Associations are the more active in terms of crediting the economy, mainly

households and small businesses. The aggregate credit portfolio of these entities at the end of 2006 was around USD 95 million less than 5% of the loan portfolio of commercial banks and their assets are still a small minority in the overall financial system. However, with more than 30,000 active clients, MFI's and S&L Associatios service about 20 percent of the overall clientele of the financial system in Albania (World Bank, 2006:8).

Savings and Loan Associations, Micro-Credit Financial Institutions

A positive development noticed recently in Albania is the development of credit cooperatives that employ the savings of their members and extend credit to these members only. There were two unions of savings and loan associations with 125 members by end-2006 (BoA, 2006:72). The activity of these institutions is based on the law "On Institutions for Mutual Cooperation" and "On Savings-Credit Funds". The need to start the operation of micro-credit institutions arose from the banks' indifference to credit small business and farming activity. Various donators are playing an important role in supporting the establishment and consolidation of Saving-Credit Funds through some well-known projects. Micro-credit has proven an effective tool to reduce poverty and develop the small private sector. Repayment rates have been remarkably high over 95% because micro-credit relies on peer pressure and other non-traditional forms of collateral. These institutions cover those territories where banking system has not reached yet, increasing the number of actors in the market.

Today there is a growing number of Microcredit Financial Institutions in the country. The two largest are the Besa foundation, established in 1994, and Opportunity Albania established in 1998. These institutions target individuals and small businesses particularly the agricultural ones, not serviced by the commercial banks in urban and rural areas. The average loan size is between Euro 2,500-5,000 and interest rates can be as high as 28% annually. Presently both institutions have a branch network of 22 and 16 offices respectively. MFI's are restricted from accepting savings and deposits and they do not have the right to offer money transfer services.

Insurance Companies

The origin of the insurance industry in Albania dates back to 1996 when the state-owned Insurance Institute INSIG was founded. The activity of insurance

companies is based on the law “On insurance and re-insurance activity” issued in March 1996. The state insurance company, INSIG, kept its monopoly branches in 28 districts of Albania and in Kosovo for many years and the market was not developed until lately.

At present the insurance market is relatively more developed than other NBFIs and in the last years has attracted foreign interest including Uniqa Group of Austria, Vienna Insurance Group and Aspis Group. Nevertheless the sector continues to be dominated by domestic capital that represented more than 66% of total capital by end 2007. There are 10 insurance companies operating in Albania, the bulk of which are private institutions. When INSIG will be privatized, insurance market will be managed by private institutions only and state participation in the market will end. The main products offered by the insurance companies are: Life and non-life insurance; third party liabilities and guarantees. The insurance industry assets-to-GDP ratio equal to 1.4% in 2007 is very low compared to other region countries.

Pension Funds

Today there are 4 pension funds operating in Albania. The “Social Insurance Institute”, the state pension institution that deals with social insurance, was founded in 1993 based on the law “On social insurance in the Republic of Albania”. The activity of other private pension institutions was provided by law as early as 1995. Today there are 3 private pension schemes operating in Albania but the range of activity in this market is very limited. The American Private Pension Fund, that had a market share of 70% by end-2006, The Capital Private Pension Institute a private domestic company with a market share of 10% and Garantsig with a market share of 20%. All the funds offer products such as old age pension, defined retirement benefits and survival pension.

These private pension companies have emerged only lately and they still manage insignificant amounts of funds compared to countries in the region (ex. Pension Funds managed assets equal to 3.1% of GDP in Bulgaria in 2006 (ECB, 2007:64). Like investment funds, operation of pension funds depends on the investment in a diversified portfolio of tradable financial instruments. The absence of a functioning securities market in Albania has been the main reason for the underdevelopment of the private pension companies.

Stock Market:

After the law "On Securities" was approved, the Tirana Stock Exchange was formally established in 1996. Tirana stock exchange does not function as a stock market and the only securities to have been traded were the treasury bills until 1999. Afterwards no transaction occurred through this market. The failure of mass privatization is one of the reasons that stock market was not able to function properly. At present, there are no shares listed in the Stock Market practically making Albania the only country in Europe without a functional stock exchange. Even though a law on investment funds was approved in 1995 no such funds operate in Albania. The existing conditions, in which the economy of the country is facing the need for a fast and sustainable growth, require an increase of investments from the private and public sector. Thus the immediate start of the process for restructuring the stock market is crucial for the country's economic development.

Leasing Companies

Presently there are 4 leasing companies operating in Albania, three of them are subsidiaries of commercial banks and one is a joint-venture betwen a foreign finance group and domestic private capital. The leasing sector in Albania is estimated to have a size of Euro 30 million in financing by end 2007 and with potential to develop quickly. In the meantime, upon approval of the law "On Financial Leasing" in 2005, the Bank of Albania is no longer the licensing and regulatory authority of the companies that carry out only the financial leasing activity (BoA, 2006:52). This fact should be handled carefully by the authorities since lending activity carried out by these companies might represent risk in the system especially in the face of the recent credit boom in the banking sector. Examples of this can be found in the region countries: in Croatia commercial banks have started to use additional channels to extend loans through the leasing companies they own. This banking strategy helps development of other financial intermediaries, but it distorts the real picture of the lending dynamics (Sosic, 2003:3).

As we can see from the Table 20, NBFI's in Albania are less developed than those in other region countries. There are many reasons for the underdevelopment of NBFI's and financial markets. We know that the creation of stock markets depends on the presence of large, established enterprises with a reputation and tangible, readily-valued assets that turn to security markets for low cost financing

(EBRD, 1998:94). Since this kind of companies in the Albanian private sector emerged only lately, the government should have encouraged the listing of shares in the stock market for the SOE's that were privatized. Moreover the absence of disclosure, auditing and accounting requirements that support the information environment for financial transactions has blocked the development of this sector.

Table 20: EBRD Index of Reform in NBFI's in Albania and Some Transition Countries

	Albania	Fyrom	Bulgaria	Czech Rep.
1995	1	1	2	2.7
1997	1.7	1	2	2.7
1999	1.7	1.7	2	3
2001	1.7	1.7	2	3
2002	1.7	1.7	2.3	3
2003	1.7	1.7	2.3	3
2004	1.7	2	2.3	3.3
2005	1.7	2	2.3	3.7
2006	1.7	2.7	2.7	3.7

Source: EBRD Transition Report, 2006

The transition economies' weak legal infrastructure, which does not protect creditor rights in a timely, predictable and effective manner, impedes the development of financial markets and non-bank financial institutions. These also threaten to limit the growth of the banking industry and the quality of economic growth in general (Kraft, 2004:2).

CHAPTER 4

FOREING OWNERSHIP IN THE ALBANIAN BANKING SECTOR

There have been many developments in the ownership status of the banking sector in Albania, since the establishment of a two-tier system in 1992. The domination of state-owned banks has been decreasing and today, foreign-owned commercial bank assets account for more than 94% of the banking system total assets. During this time licensing requirements for establishing a bank in Albania have been similar for both domestic and foreign-owned banks. At present 14 of 16 banks operating in Albania are foreign-owned and some large international banking groups are present in the market.

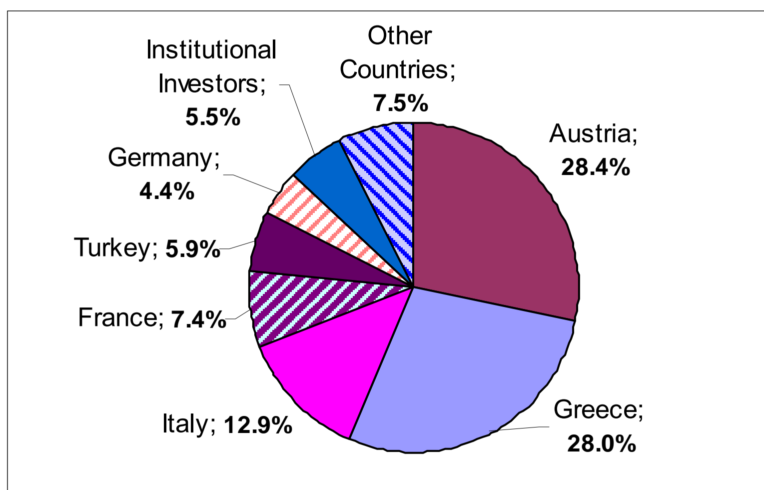
The current ownership is diverse; there are foreign investors from Austria, Italy, Greece, France, Turkey, Germany, Bulgaria, Malaysia and some Arab countries. Greek banks have been present in the market since 1996; the German and Italian investments have been present for quite a long time as well, while the latter has grown substantially and has become one of the market's key players. As of end 2007 foreign capital represents roughly 92% of the total capital of the Albanian banking system. As shown in Figure 19, Austrian investments may be considered as the most dominant ones with 28.4% of the foreign capital and 26.1% of the total capital of the banking system. Their ownership has resulted from the acquisition in 2004 of the Savings Bank the largest domestic state-owned bank. Greek banks' subsidiaries follow accounting for 28% of the foreign capital and 25.7% of total capital of the system. Italian capital represents 12.9% of the foreign capital and 11.8% of total capital of the system.

It is important to notice that capital from these three countries only accounts for nearly 69.2% of the foreign capital and almost 64% of the total capital of the banking system in Albania. This unfolds clearly the high degree of exposure of the banking system to adverse financial and macroeconomic developments in these home countries of the foreign banks. Foreign institutional investors such as EBRD, IFC etc., have invested also in the capital of banks in Albania representing 5.5% of the foreign capital in the banking system.

Obviously foreign capital diversification has certain advantages one of the most important being the aim to decrease the level of exposure of the host country

banking system to financial instability in the banks' home country economy (Baleta, 2001:5).

Figure 18: Foreign Capital in the Banking System by Country of Origin



Source: Calculations on data from BoA Supervision Report, 2007

Moreover the dominance of the SEE countries' banking systems by the same group of international banks is another issue that raises concerns in that it increases risks of contagion and financial instability through the region. Banking groups from different countries namely: Austria, Greece, Italy, France, Germany and Turkey have entered the SEE region as part of their expansion strategies in Eastern Europe.

Raiffeisen Zentralbank of Austria is a financial group well-known to the European Union and distinguished for important investments in the banking sector of Eastern European countries. Raiffeisen first entered SEE in 1994 with an acquisition in Croatia and followed with either acquisitions or greenfield investments in Bosnia in 2000, Serbia in 2001, Slovenia and Kosovo in 2002 and Albania in 2004. Raiffeisen Bank of Albania is the largest bank in the system with dominant market shares of 32%, 34% and 20.5% for assets, deposits and loans respectively. With 96 outlets and 1370 employees RBAL realized 42% of the banking systems' total profit in 2007.

The penetration of Greek banks in the SEE countries has been significant. In 2000, National Bank of Greece (NGB), the largest bank group in the country, purchased 90% of the United Bulgarian Bank, one of the largest commercial banks in Bulgaria, for an amount of 229 million Euro. NBG bought 65% of the shares of

Stopanska Banka, the biggest state-owned bank in Macedonia and Alpha Bank of Greece purchased 65% of Creditna Banka, for a price of 18.5 million US dollars. Alpha Bank has opened a subsidiary in Romania as well, while Piraeus Bank has purchased Pater Bank for 5.5 million US dollars (Baleta, 2001:19).

In Albania there are 4 Greek banks' subsidiaries namely Tirana Bank, Alpha Bank, Branch of NBG and Emporiki Bank although the last one became a subsidiary of the French group Credit Agricole in June 2006 after the transfer of 72% of the shares of its mother bank in Greece. Considered as a subgroup, due to similar characteristics such as: time and way of entry in the market, marketing approach and client target group, the Greek banks' subsidiaries in Albania have aggregate market shares of 23% in assets, 20% in deposits and 39% in loans as of end-2007. Having already established a sound loan business in the Albanian market these banks are characterized by high profitability and a very high loans/deposits ratio of 87% compared to the average ratio of the banking system at 45% in 2007.

French Group Societe General has made a series of acquisitions in the SEE countries as part of its European retail network growth strategy. In 1999 the group purchased 58% of the BRD, one of the largest banks in Romania and 98% of the Bulgarian Expressbank. In 2001 SGYB was established in Serbia. In 2005 Societe Generale took control of Podgoricka Banka in Montenegro by purchasing 87% of shares. In 2006 the group purchased Splitska Banka in Croatia and Ohridska Banka in Macedonia. Finally in 2007 Societe Generale took control of Banka Popullore in Albania by acquiring 75% of the shares. Banka Popullore has an extensive branch network of 40 outlets despite the modest market share of 5% in assets in 2007.

The leading italian banking group Intesa Sanpaolo also has a number of subsidiaries in the region. These include ISP bank in Romania that was established in 1996, Privredna Banka Zagreb in Croatia, Banca Intesa Beograg, the largest bank in Serbia, ISP bank in Bosnia and Herzegovina and the American Bank of Albania, that was purchased by the group in June 2007. After the merger with the Italian Albanian Bank in January 2008, ABA became the second largest bank in the system with 30 branches and market share of 14.3%.

4.1. FOREIGN BANKS IN ALBANIA AND THE IMPACT OF THEIR ENTRY

The first foreign bank, the Italian-Albanian Bank, was established in 1993 as a joint venture between the Ministry of Finance and Banca di Roma. This brought

the total number of banks in Albania to 4. Both the MoF and Banca di Roma (later Capitalia) held 40% stakes in the bank while the EBRD held a 20% share. In 1994 began its activity two other foreign banks, Dardania Bank, and the Arab-Albanian Islamic Bank, that was established also as a joint venture where the MoF held 40% of shares. In 1995, the three state-owned banks accounted for 95.6% of all banking assets while the three foreign banks held the remaining 4.4%.

In 1996, two other new private banks joined the banking system namely Tirana Bank, part of the Piraeus Bank in Greece, and the Tirana Branch of National Bank of Greece. In 1997 another private foreign bank, the International Commercial Bank, a subsidiary of the Malayan ICB group began its activity. In 1998 two other foreign banks entered the market, the branch of Alpha Credit Bank and the American Bank of Albania that was set up by the Albanian-American Enterprises Foundation. In the same year, the state-owned Rural Commercial Bank was liquidated thus leaving only two domestic banks in the system, the Savings Bank and NCB, both state-owned. Three new foreign banks entered the system in 1999, Fefad Bank (later Procredit Bank) with German capital specialized at lending to small and medium size enterprises, the Bulgarian First Investment Bank and the Greek Inter-Commercial Bank. Following this the number of subsidiaries and branches of foreign banks that performed banking activity in Albania was increased to 11. In 2002 the Credit Bank of Albania with Kuwaiti Capital received the license. Banka Popullore that had received its license in 2004 as a domestic capital bank became a subsidiary of the French Societe Generale Group in 2007 after the sale of 75% share of its capital.

During the last years foreign capital interest in investing in the Albanian banking system has increased. So, in June of 2005, 100 percent of the Dardania Bank's (currently, Italian Development Bank) stock capital was sold to Italian investors. In 2006 the government stake in the Italian Albanian Bank was transferred to the Italian group Sanpaolo IMI. The German Procredit Holding and Commerzbank gained control of all shares of Procredit Bank of Albania in 2007.

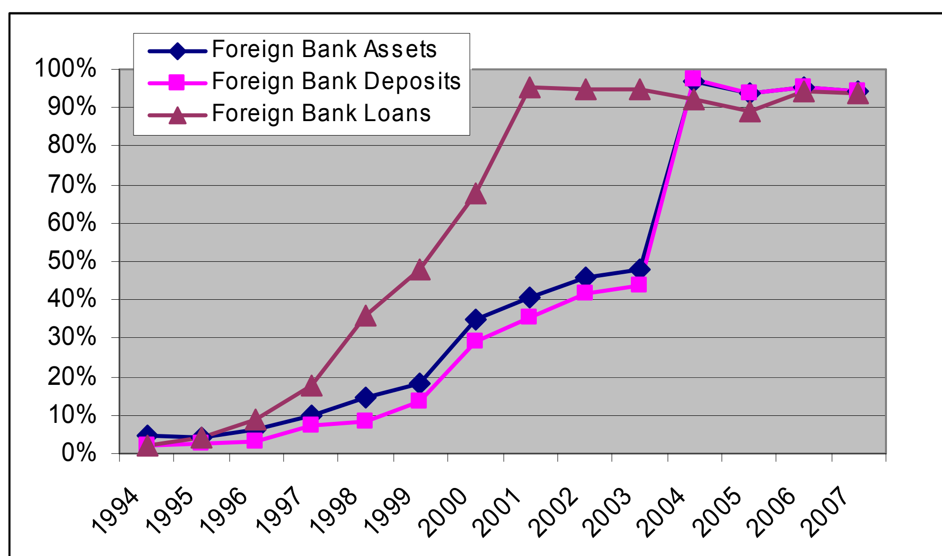
Recently Credins Bank, a totally domestic capital bank has transferred part of its shares to two different foreign financial institutions. The Balkan Financial Sector Equity Holding of Holland and The State Secretariat for Economic Affairs of Switzerland both acquired 25.3% of the stock capital of Credins Bank in January 2008 for an undisclosed price. This seems to have been a strategic partnership sale that will give the bank fresh resources to expand its activities.

The foreign bank entry process in the Albanian banking system can be at present considered completed 15 years after the first foreign bank started its activity. The effects of the foreign bank entry, the primary objective of this study, have been numerous and have transformed the banking system in Albania to a wide extent. Nevertheless due to the drastic changes in the ownership structure of the banking system, and the absence of a significant domestic banking industry, comparing foreign banks vis-a-vis domestic banks seems not to be possible in Albania.

For most of the 1990s domestic banks were represented by the large inefficient SOBs burdened by high amounts of non-performing loans and staff redundancy. Despite holding dominant shares in the banking system the SOBs were not operated as effective commercial banks in that the majority of their assets were invested in government debt securities and lending was managed strictly by the central bank. Furthermore the subsequent privatization of NCB and SB required a prior restructuring of the assets and liabilities of these banks, thus making balance sheet data not viable for comparative reasons. For example the NCB had no loans on its books in 2000 despite collecting 7.3% of individual deposits and SB's loan portfolio was downsized to negligible levels starting from 2001.

After the privatization of the SB in 2004 foreign bank-owned assets surged to 97% of total and the only two domestic banks Credins Bank and Banka Popullore were newly established, and were not suitable for fair comparison with the rest of the banks all of which were foreign-owned. The situation did not change in 2007, when even though a new domestic bank had begun to operate in the system, Banka Popullore that was established in 2004 by domestic capital was sold to the French Societe Generale Group. The domestic banks represented by Credins Bank, established in 2003, and Union Bank established in 2006 had an aggregate market share of 5.9% in assets, with the former holding a significant 4.8% of the market. Thus at present Credins Bank is the only domestic bank in the system that could be appropriate for comparative analyses given its established business patterns, and a significant market share. But in this case we could end up comparing the foreign bank industry to only one individual domestic bank, with the potential of misestimating the real effects of foreign bank entry on the domestic banking industry in general. Instead this study will focus on the impact of foreign bank entry on the banking system as a whole, in the structural change of assets, liabilities, regulatory measures and risks.

Figure 19: Foreign Bank Assets, Deposits and Loans as a % of Total, 1994-2007



Source: Calculations on Data from Bank of Albania Supervision Reports

The impact of foreign bank entry in the Albanian banking system was felt as soon as 1996 when foreign bank lending accounted for 8.7% of total bank loans, despite a low 3.3% in the deposit market. By 1998 the foreign banks' share in total lending had increased to 35.7% of total with a concentration of the loan portfolio on two foreign banks namely IAB and Tirana Bank that held the 25% of total loans of the system. The Albanian-Italian Bank (AIB) was about as active in bank lending as the SB the largest bank in the system. With only 5.4% of the banking assets and 3.4% of the total deposits in Albania, AIB made 31.5% of all bank loans in 2000. Other foreign banks that had entered the Albanian banking sector since 1995, including the microenterprise bank FEFAD with a 8.5% loan market share in 2000, played a significant role in bank lending as well (Bonin, 2001:43).

Notwithstanding, the level of financial intermediation in Albania was very low for most of the second half of the 1990s and early 2000s with bank credit to private sector (BCPS) below 8% of GDP. The commercial banks' activities remained restricted in lending, but even in introducing new banking products. The main cause of course was the disintermediation of the SOBs that kept most of their assets in government debt. On the other hand, even the foreign banks that had started to enter gradually in the banking market were focused for a long time on activities without risk. In this way they narrowed the profitable possibilities for the domestic

banks to a certain extent, while maintaining a good performance even during unstable periods, such as that of 1992-1997 (Cani and Haderi, 2002:7).

Other views are that during the second half of the 1990s many of the foreign banks in Albania were very strict and highly bureaucratic in their credit granting policies. Moreover there is evidence that Greek banks subsidiaries have rationed credit to Albanian economy during this period (Baleta, 2001:22).

Table 21: Indicators of Banking Sector Development in SEE Countries

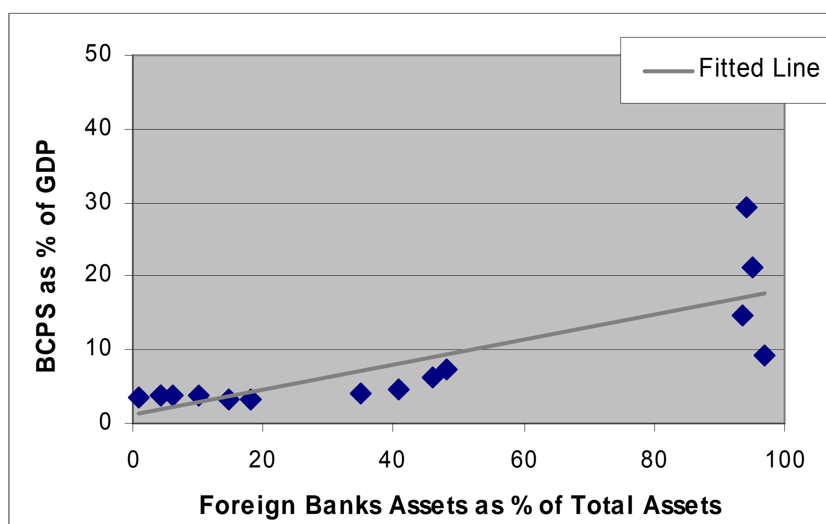
	Asset share SOB's		BCPS/GDP in %		Capital share of Foreign Banks
	1998	**2003**	**1998**	**2003**	**2002**
Albania	85.6	51.9	3.2	7.3	73.6
Bosnia & H.	75.9	5.2	8.9	14.6	66.8
Bulgaria	56.4	0.4	12.2	25.8	66.6
Croatia	37.5	3.4	26.6	48.5	78.3
Macedonia	1.4	1.8	17.7	14.9	44.6
Romania	75.3	40.6	11.6	9.5	64.9
Serbia & M.	90	34.1	11.2	5.6	--
SEE Average	**60.3**	**19.6**	**12.9**	**17.7**	**65.8**

Source: Kraft, 2004:7

Now let us analyze in detail the impact of foreign bank entry on the structure of the banking system assets and liabilities. As we can see from Figure 19 foreign banks have played an important role in the expansion of BCPS in Albania starting from 2000 when foreign bank lending accounted for nearly 70% of total loans. But the real growth in lending came in 2004 and 2005, just after the newly privatized SB (Raiffeisen Bank) started to operate, and BCPS as a share of GDP had scored 9.2% and 14.7% respectively. In the 2005-2007 period the BCPS-to-GDP ratio increased on average by nearly 7 percentage points annually and foreign bank lending represented more than 90% of total loans.

If we plot the BCPS-to-GDP ratio against the asset share of foreign banks in the system we can notice the positive trend between the two indicators. In fact foreign bank entry has been associated with increased lending in other SEE countries as well. In Bulgaria and Romania for example, a more aggressive lending strategy has been actively encouraged by the foreign banks' parent groups. Many of the foreign banks' owners are banking groups domiciled in less profitable mature markets, so they have encouraged their subsidiaries and branches to pursue aggressive loan portfolio expansion to gain market share and improve overall profitability (Duenwald, Gueorguiev, and Schaechter, 2005:13).

Figure 20: Bank Credit to Private Sector/GDP vs. Foreign Bank Assets, 1993-2007



Source: Calculations on data from BoA Supervision Reports

Despite the positive implications of the BCPS growth for the economy there are several potential macroeconomic risks that might arise due to the ongoing rapid increase of credit. These include:

- Over-stimulation of the aggregate demand that might negatively affect the inflation rate;
- Increased negative impact on the current account deficit by stimulating demand for foreign goods and services;
- The prices of non financial assets might evolve on a non sustainable pattern creating possible "boom and bust" cycles
- The effectiveness of the interest rate channel might decrease with the expansion of the non-governmental credit in foreign currencies.

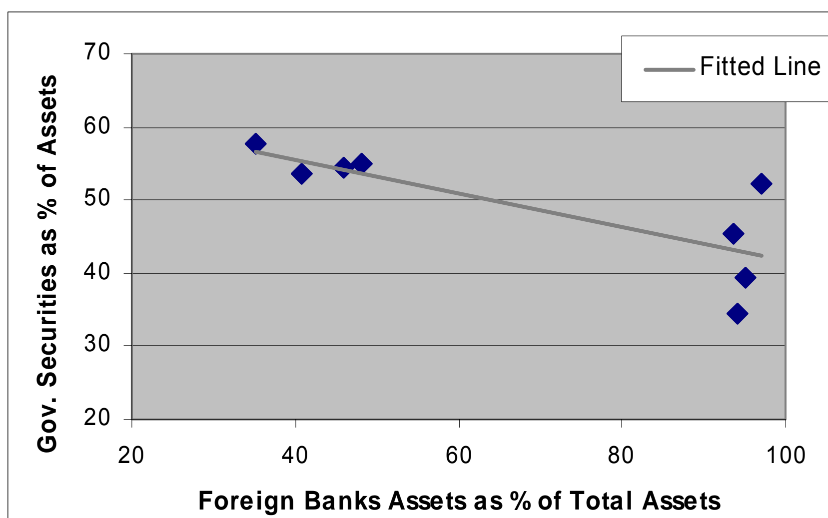
It seems that almost all of the above potential risks have materialized to some extent in Albania following the rapid increase of the BCPS in the last years. Inflationary pressures have become a burden for the central bank and the 12 month inflation got out of the targeted range with 4.6% and 4.4 %, in March and April 2008 respectively, despite several increases in the base interest rate during 2007; current account deficit increased by more than 60% relative to 2006 reaching record levels of 10.3% of GDP by end-2007 (trade deficit was more than 25% of GDP) and loans extended in foreign currency made up 72% of total. Moreover the recent credit

expansion has pushed up real estate prices building a potential risk, a bubble that could burst with grave consequences for the financial sector.

As a matter of fact the Central Bank of Albania has reacted to the rapid growth in lending by commercial banks by establishing new prudential measures in December 2006 requiring additional loan loss reserves to banks that exhibit annual growth of their loan portfolio higher than 30% and have a NPL ratio above 7%. Nevertheless, despite proving effective to some extent in slowing down the credit growth rate, these measures have been insufficient for mitigating the structural risks born by lending in foreign currency that are discussed below.

Examples of macroeconomic imbalances after periods of rapid credit growth in SEE region have been common. In 2002, BCPS in real terms rose by over 50 percent in Bosnia and Herzegovina and by 23 percent in Serbia and Montenegro. In the same year these two countries experienced sharp rises in their external current account deficits, which were attributed, at least in part, to the surge in bank credit (Cottarelli, Dell'Ariccia and Vladkova-Hollar, 2003:4).

Figure 21: Investment in Government Securities vs. Foreign Bank Assets in the Banking Sector, 2000-2007

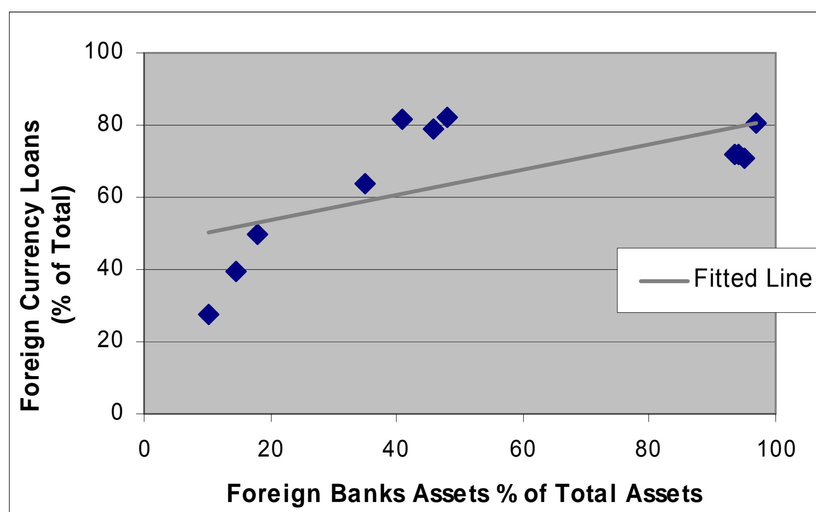


The increase in bank credit to the private sector in Albania has been partly supported by a shift of foreign banks' assets from debt securities to more profitable commercial loans. As we can see from Figure 21 the investment of banks in government securities has decreased with the increase in foreign bank-owned assets, suggesting for an increased efficiency of the banking sector in managing its

resources and a decrease of the crowding out effect of the private sector by the public sector.

Foreign banks in Albania have attracted basically customers that operate with foreign currency and this trend has been reinforced over the years. As a matter of fact in the recent years there has been a sharp increase in the structure of foreign currency loans for the overall system, compared to the domestic currency dominated deposits. As a representative of domestic banks Credins Bank had 49% of loans in domestic currency and only 51 % in foreign currency by end 2007 against the 28% domestic and 72% foreign currency loans of the system. In fact foreign banks might be more inclined to offer lower rates on foreign currency loans given their possibility to draw on their mother banks euro credit lines.

Figure 22: Foreign Currency Loans vs. Foreign Bank Assets in Albania, 1997-2007



Increase in the share of foreign currency loans to the economy is a serious issue to be considered. The share of foreign currency loans has substantially increased in the period 1997-2007 in line with the growth of foreign bank assets, creating potential risks for businesses and households in Albania that might not be hedged against exchange rate fluctuations. This has been a general trend in the CEE and SEE countries after the entry of foreign banks. Main reasons for the popularity of the foreign currency loans have been interest rate advantage, fixed or stable exchange rates, expectation to join euro area soon, lack of risk awareness,

appreciation trend of local currency, strong export orientation, scarcity of domestic financing, etc (NBRM, 2007:22).

In fact comparing the foreign currency loans to foreign currency deposits in Albania we can see that banks' foreign currency lending exceeds their foreign currency resources, if we consider reserve requirements and placements in foreign banks also. The foreign currency loans/deposits ratio is quite high at more than 75% in 2007 while for Lek this ratio is only 22%. By keeping long positions on foreign currency the banks are transferring the exchange rate risk to the private sector that nonetheless would create huge problems with NPL's in the case of macroeconomic instability or a sudden devaluation of the Lek.

The high level of foreign currency loans calls for regulative measures to be taken from the authorities such as: requiring commercial banks to increase provisions and additional reserves when a threshold is exceeded. Moreover tightening the monetary policy stance even further by increasing the rate of required reserves for foreign currency deposits can be considered. Furthermore, it is possible that a fiscal tightening could be necessary should the monetary measures prove ineffective in preventing a further widening of external imbalances.

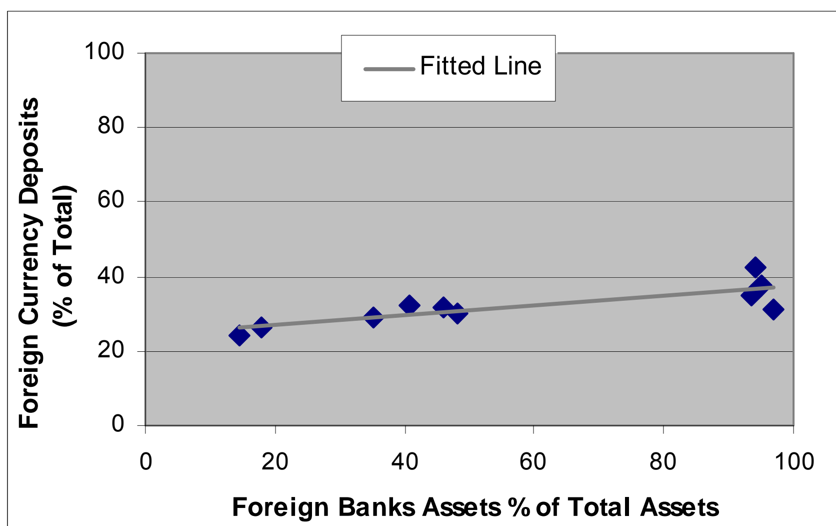
Central Bank of Romania succeeded in reversing the growth in foreign currency credit in 2006 by increasing minimum reserve requirements up to 40% for foreign currency higher than the 20% rate for domestic currency deposits (Lazea, 2006:110). Several measures to limit credit growth have been implemented in 2005 in Bulgaria also. These included monetary measures, notably moral suasion, a tightening of reserve requirements and prudential supervision, and quantitative restrictions on credit (marginal reserve requirements for banks exceeding the credit growth limits) (Duenwald, Gueorguiev and Schaechter, 2005:29).

But together with loans the share of foreign currency deposits has increased as well pointing to another disturbing fact, the general Euroization of the Albanian economy through currency and asset substitution. From only 24% of total deposits in 1998, foreign currency deposits accounted for nearly 43% of total in 2007.

Currency substitution occurs when foreign-currency-denominated assets are being used as a medium of exchange, whereas asset substitution occurs when foreign currency-denominated assets are used as a store of value. The indicator of the level of currency substitution is the ratio of foreign deposits to monetary aggregate M1. On the other hand, when measuring asset substitution we use the ratio of foreign deposits to monetary aggregate M2. For Albania the currency

substitution level was 53%, whereas asset substitution level was 24% at the end of 2000 (Xhepa, 2002:14). In 2007 currency substitution rate increased to 105% while asset substitution rate to 51%.

Figure 23: Foreign Currency Deposits vs. Foreign Bank Assets in Albania, 1998-2007



Foreign currency deposits have increased along with the foreign bank entry in the market. By offering high real return rates on foreign currency deposits as compared to Lek deposits, foreign banks create incentives for foreign currency deposits that have resulted in the artificial euroization of the economy. This in turn reduces the efficiency of monetary policy by making control of money supply and estimation of future inflation more difficult.

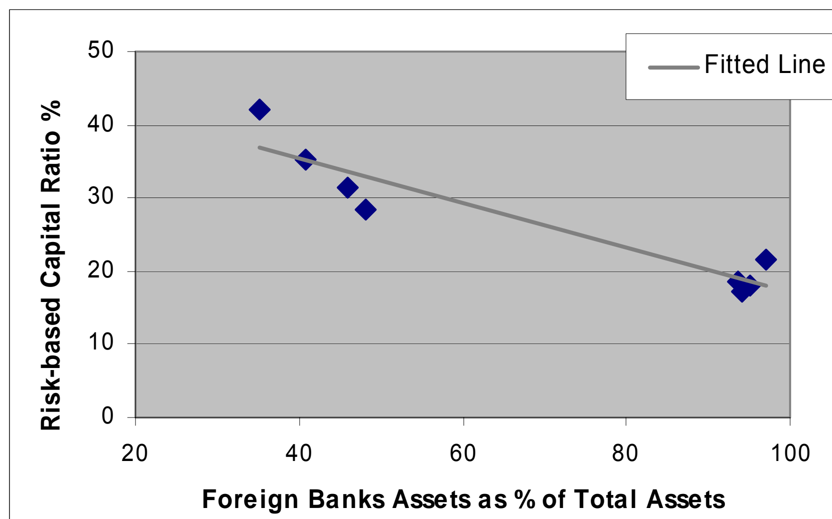
In fact average interest rate for all maturities on Lek deposits was 5.34% while average interest rate on Euro and USD deposits was 3.91% by end-2007. That makes interest rate differential between average rates of Lek and Euro/USD deposits for all maturities weighted by each banks market share only 1.43%, while the differential between interest rates on Lek and Euro/USD loans was 3.95%. Considering the relatively stable Lek/Euro-USD exchange rate and the high perceived inflation[1] in Albania it is understandable that foreign currency deposits are yielding higher returns in real terms. In this context there is evidence that foreign banks do not offer competitive interest rates on Lek deposits commensurate with the

[1] As (Cani and Shtylla, 2003:15) note statistical data published by the authorities in Albania are insufficient and erroneous. Anecdotal evidence suggests that annual inflation in Albania might be around 15%-20% much higher than the recently published 4.4% in April, 2008.

annual inflation rate, but they do charge higher interest rates on Lek loans. Average weighted interest rates on lek loans for all maturities by end-2007 were 12.85% while average interest on Euro/USD loans was only 8.9%

With the expansion of banking activity and the increase of risky assets such as business, mortgage and consumer loans, the risk-based capital ratio of the banking system has decreased substantially from 42% in 2000, when this value represented the highest historical value, after the recapitalization of SB and NCB together with the privatisation of the later, to 17.1 % in 2007. Even if this is evidence of a more efficient use of resources from banks it represents risks to the system as the ratio approaches the minimum required ratio of 12%. This fact might inflict moral hazard as banks managers might try to understate the level of NPL in order to have a capital adequacy higher than the limit. In this context the supervisory authority should monitor with attention the asset quality of the commercial banks.

Figure 24: Capital Adequacy vs. Foreign Bank Assets in Albania, 2000-2007



Foreign banks are often presented as well supported by their strong capitalized mother groups. However, even here one must be cautious. The case of Rijecka Banka, which experienced losses of 100 million Euros in foreign exchange trading due to a rogue trader in 2002, shows that foreign owners may not be willing to recapitalize their subsidiaries. In the Rijecka Banka case, the majority owner, Bayerische Landesbank, walked away from the bank, and returned ownership to the

Croatian government (Kraft, 2004:14). The government then succeeded in very quickly organizing a sale to Erste Bank, thus stabilizing the situation.

4.2. CONCENTRATION IN THE ALBANIAN BANKING SYSTEM

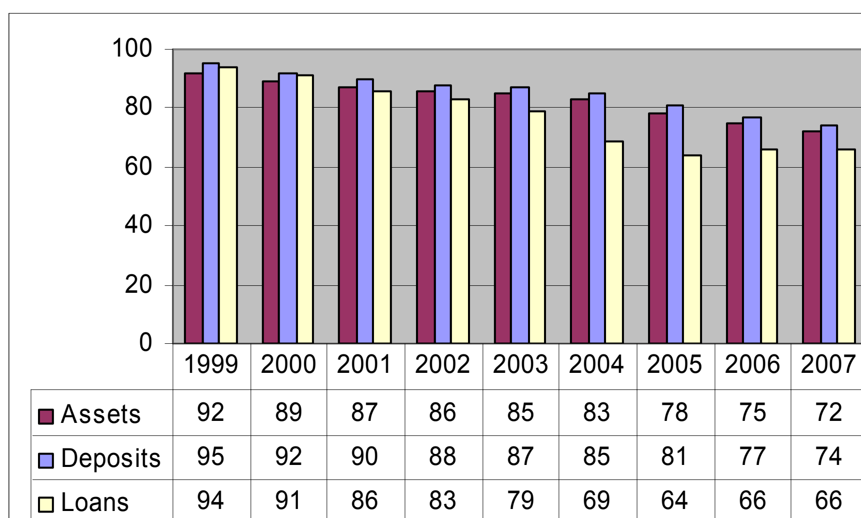
As the least developed of the former CPE's in the SEE region, Albania entered the 2000s with a highly segmented banking sector even though only one of the thirteen banks in the system was state-owned and the other twelve were all foreign-majority owned. The savings bank SB, dominated all aspects of banking with market shares as high as 60% in assets and 65% in the deposits market by end-2001. The dominance of SB in the loan market had been put to an end by the transfer of its loan portfolio to the BART in 2000 as a preparation for the privatisation of the bank. Despite being less segmented and equally shared between few foreign owned-banks the loan market in 2001 was highly concentrated with the first 5 banks holding a share of 86% of the total loans.

In the following years the concentration ratios for the Albanian banking system decreased steadily (Figure 25), with the deposits market continuing to be the most concentrated market. By end-2007 the first five banks held an aggregate market share of 72% of total deposits with Raiffeisen Bank only holding 34%. NCB followed with 14.5% of total deposits. After their privatisation, both banks continue to have the widest branch networks in the country with 96 and 38 branches respectively having an advantage in gathering the individual deposits.

Competition in the banking system has increased in the last years. Evidence to this has been the increase of the range of products provided by banks, their geographic expansion, and the boost of the lending activities. These developments have been associated by a steady decrease in the market concentration, which, however, remains the highest compared to other countries in the region (Note, 2006:7).

The concentration ratios for assets and loans remain high also. Given that deposits make up a large part of the resources for banks in Albania where the Deposits/Assets ratio for the banking system was higher then 85% for most of the 2000-2007 period it is understandable that the largest banks by assets are the banks who collect more deposits. The share of the 5 largest banks in assets was 75% in 2006 and 72% in 2007, one of the highest in the SEE region.

Figure 25: Market share of 5 Largest Banks for Assets, Deposits and Loans (in % of total)



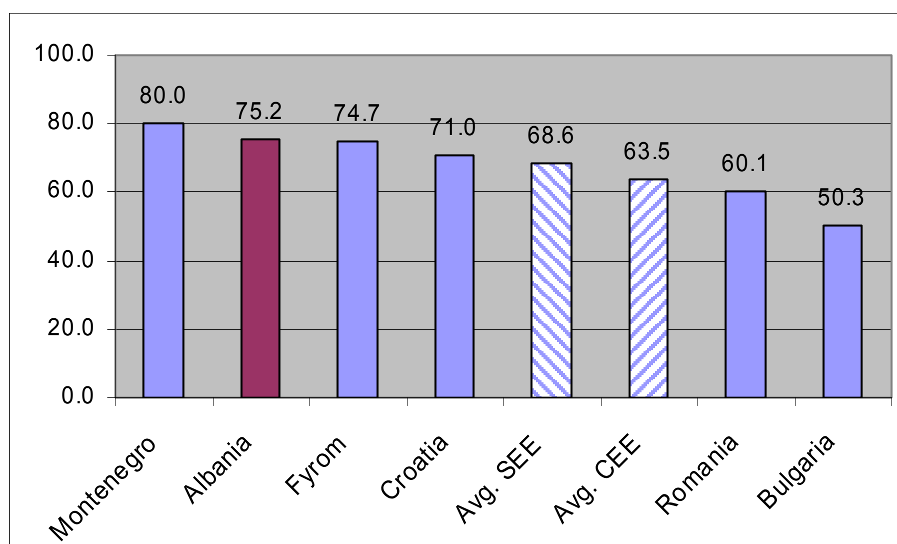
	1999	2000	2001	2002	2003	2004	2005	2006	2007
Assets	92	89	87	86	85	83	78	75	72
Deposits	95	92	90	88	87	85	81	77	74
Loans	94	91	86	83	79	69	64	66	66

Source: Calculations on data from BoA Supervision Reports

The loan market remains the least concentrated market in the banking system with the five largest banks holding 66% of total loans. After the privatization of SB in 2004 starting from a market share of only 1.4% Raiffeisen Bank catched up quickly and today leads this market with 20.4% of total loans in 2007. The concentration in the loan market, as seen in Figure 25, has slighly increased in the last 2 years. This is an indicator of the oligopolistic structure of the loan market with five or six banks holding market shares over 10% and the bulk of other banks that can not pass the threshold of 5%. This might lead to anti-competitive behaviour in the system since smaller banks can not compete with the largest banks that hold the major share of the market and this might result in overpriced loans and higher investment costs for the economy. As a matter of fact the five largest banks by assets that account for 72% of total assets and 66% of the total capital earned more than 85% of the banking system net profit in 2007.

According to Kraft (2004:12) foreign banks are becoming accustomed to high profits in SEE, and they may not be willing to undermine this with aggressive competition. This is particularly troubling if one believes that the development of the corporate business, which is closely related to medium-term growth prospects, requires greater risk-taking than the foreign banks have been willing to take so far.

Figure 26: Market Share of 5 Largest Banks in SEE countries in 2006 (in % of total assets)



Source: National Central Banks' Reports

Another measure for the concentration in the banking sector is the Herfindahl-Hirschman Index. HHI is the sum of squares of the individual banks' shares of market as a percentage of the total[2].

$$HHI = \sum_{i=1}^{n} MS_i^{\,2}$$

Where MS_i is the market share of bank i, and n is the total number of banks in the market

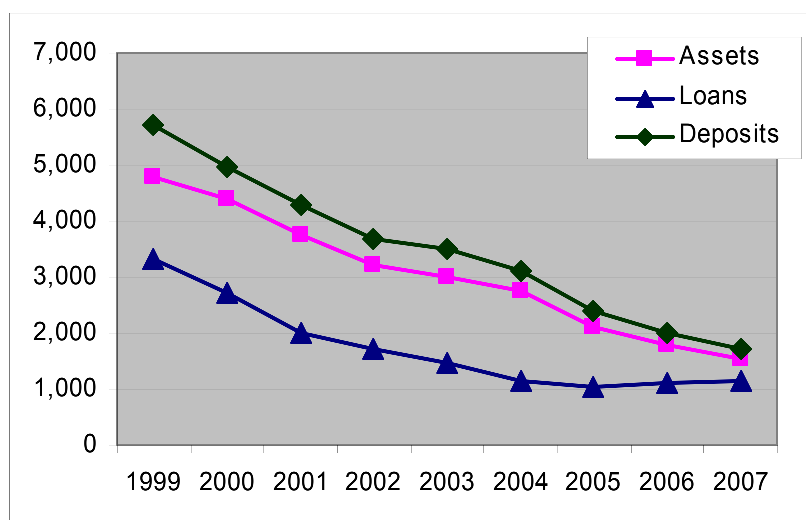
The index values for the asset, deposit, and loan markets in Albania by end-2007 were: 1,549; 1,697 and 1,126 respectively. As we can see from Figure 27, the concentration in all the markets has constantly decreased in the 1999-2007 period reflecting an improvement in competition in the banking system.

Obviously the deposits market is the most concentrated being near the threshold for a highly concentrated market as by definition of the HHI index. The high concentration of deposits might affect the concentration in the lending market because, accounting for nearly 87% of funds available to lend, deposits are one of the most important factors that determine the lending capacity of banks. This suggests that, without a further decrease in the concentration of deposits, it is less

[2] According to the value of the index the market can be defined: In perfect competition if the HHI is less than 1,000; In moderate level of concentration if the HHI is between 1,000 -1,800; Highly concentrated if the HHI is over 1,800 (Note, 2006:30).

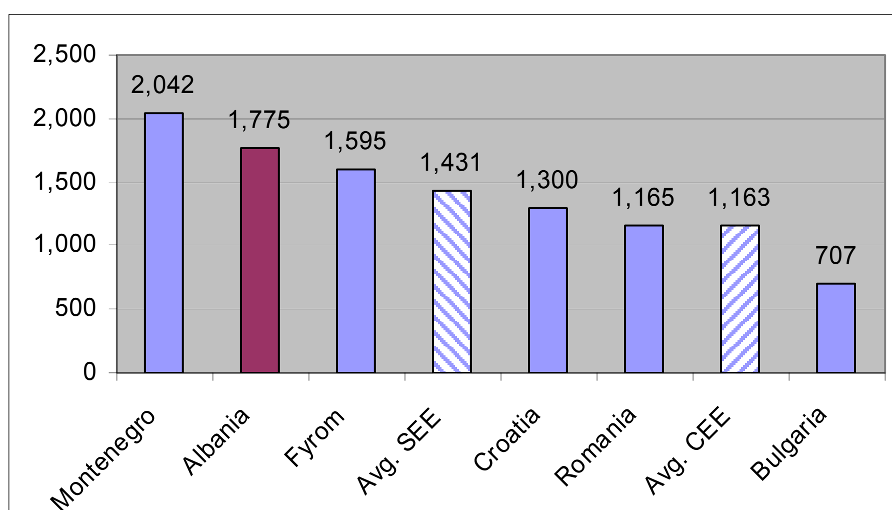
likely to observe a further decline in the concentration of the lending activity (Note, 2006:16). As a matter of fact despite being the least concentrated, the loan market shows a deteriorating trend in the recent years and remains in moderate levels of competition.

Figure 27: Herfindahl–Hirschman Index for the Albanian Banking System



Source: Calculations on data from BoA Supervision Reports

Figure 28: Herfindahl–Hirschman Index for Assets in SEE Countries, 2006

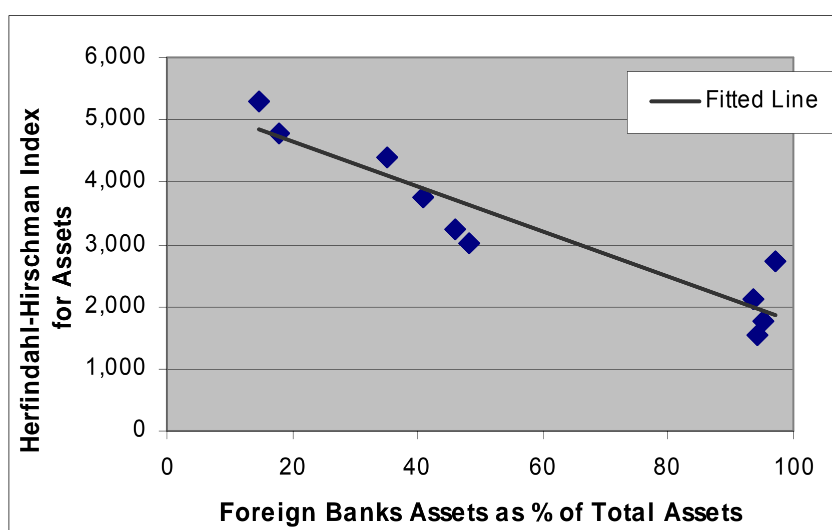


Source: Countries' Central Bank Reports; ECB, 2007

By comparing HHI values for bank assets in SEE countries (Figure 28) we can see that Albania has the most concentrated banking system in the region second only to Montenegro. The average index value for SEE countries was 1,431 in 2006 well below the index value for Albania. While CEE countries without Estonia had an average HHI value of 1,163 in 2006. We can say that by these standards Albania has a highly concentrated banking system, and with a value of 1,549 in 2007 competition in the Albanian banking system has to be furtherly improved.

If we plot the HHI value against the asset share of foreign banks in Albania for the period 1999-2007 we can see how the concentration of assets in the banking sector has gradually decreased with the increase in foreign bank assets in the system. Thus there is evidence that foreign bank entry has decreased concentration and thus has in some way increased competition in the banking system.

Figure 29: HHI for Assets vs. Asset Share of Foreign Banks in Albania, 1998-2007



Source: Calculations on data from BoA Supervision Reports

Even though thus far there have not been any cases of prices manipulation or banks exercising a dominant position in the market, the promotion of competitive mechanism of the market and the vitalization of other financial market segments in general is deemed as necessary push on the efficiency of the entire intermediation process (Ibrahimi 2007:3).

4.3. INSIGHT IN THE PROFITABILITY OF FOREIGN BANKS IN ALBANIA

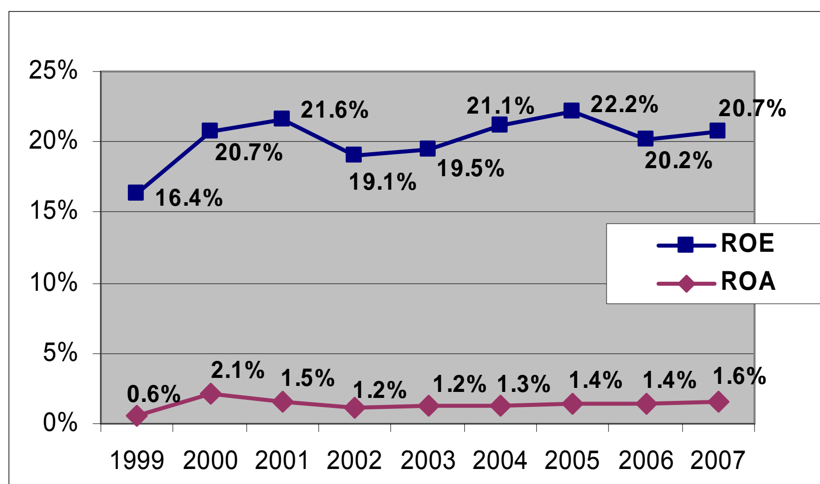
Banks are under great pressure to perform, meet the objectives of their stockholders, depositors, employees and borrowing customers, while somehow keeping government regulators satisfied that the bank's policies, loans and investments are sound. At the same time banks are in a continuous competition for loan and deposit customers (Rose, 1995:344). Let us take a detailed look at the most widely used indicators of bank performance, the most important performance dimensions being profitability and risk.

For most of the 1990s and early 2000s the Albanian banking system has been profitable and well capitalized, with the majority of assets invested either abroad or in treasury bills. Foreign banks during the 1990s period were particularly characterized by a high level of profitability.

Since 2002 the profitability of the commercial banks measured by ROA has been increasing, and the banking system closed the year 2007 with a profit of ALL 10,563 million roughly equal to Euro 86 million. Main profitability indicators ROA and ROE were at high levels of 1.6% and 20.7% respectively for 2007.

Both indicators remain above average compared to CEE countries, that had an average ROA of 1.2% and ROE of 20.2% referring to data for 2005. Region countries such as Bulgaria, Romania, Croatia, Fyrom and Montenegro in 2006 had average ROA of 1.6% and ROE 13.1% (NBRM, 2007:50).

Figure 30: Profitability Indicators in the Banking System, 1999-2007



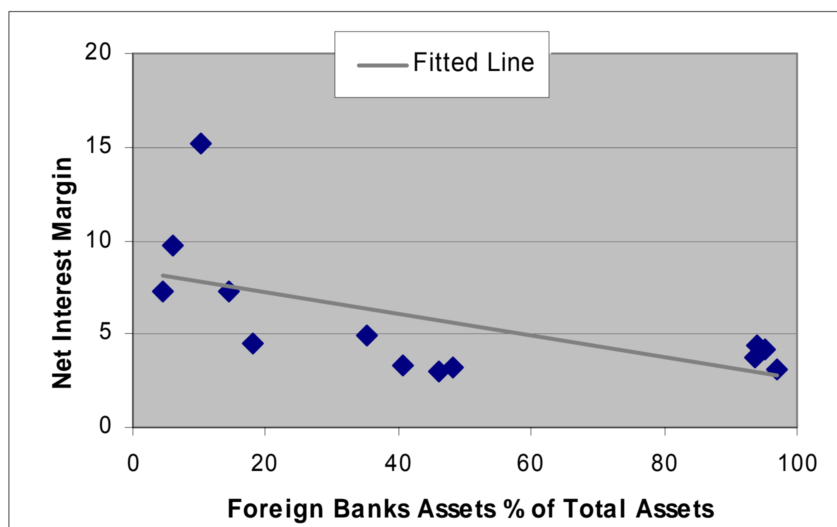
Source: Bank of Albania Supervision Reports

The high ROE in Albania is partly explained by market imperfections such as bank deposits that receive an interest well below that of treasury bills (Cottarelli, Dell'Ariccia and Vladkova-Hollar, 2003:25). Moreover the low leverage ratio of the Albanian banking sector at 6.8% in 2006 and 7.8% in 2007 compared to region countries does provide for a high ROE.

In general foreign owned banks in Eastern Europe tend to set high ROE targets of between 20 to 25 % before tax. In 2005 Austrian bank groups earned 43 percent of their profits in the CEE region although only 23 percent of their assets were invested there (Craig, 2006:95).

On of the most important indicators for commercial banks' assets and resources management is the Net Interest Margin which is the calculated as the ratio of (Interest Income – Interest Expenses) to Interest Bearing Assets (BoA, 2003:21). The NIM in Albania between 3% and 5% in the recent years is at the highest end of the spectrum when compared with those observed in other Eastern European countries. This shows that banks have successfully managed to match the increase in income generating assets with an increase in interest income, while at the same time controlling interest expenses.

Figure 31: Net Interest Margin vs. Asset Share of Foreign Banks, 1995-2007



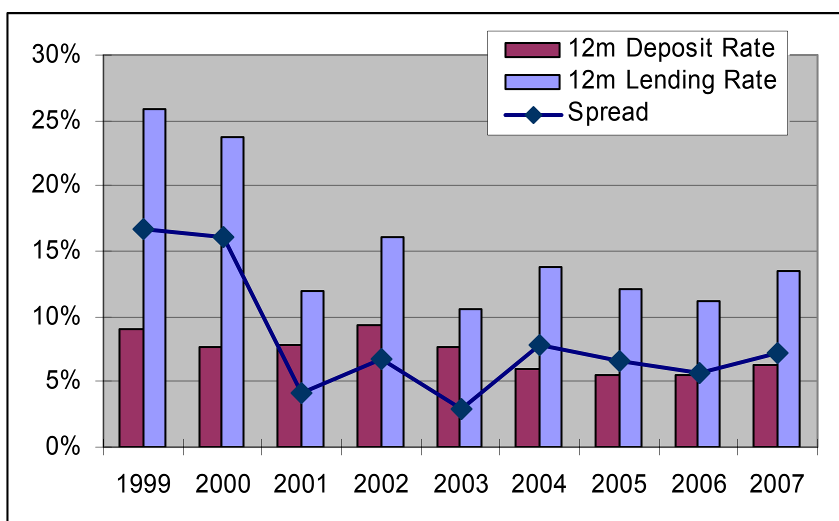
However, the banks in Albania generally have showed that the movements in the base rates of different currencies are reflected more at the liabilities side when the rates go down and at the assets side when the rates go up (BoA, 2005:26) This

might be the result of the structure dominated by long-term deposits and short-to-medium-term loans, because the banks can restate the credit terms but are not eager to decrease deposit interest rates at least immediately. High NIM's are not a positive indicator in the banking system since they tend to hinder the financial depth and thus economic development in the country.

By plotting the evolution of NIM's against the asset share of foreign banks in the banking system, we can notice a general reduction in the level of NIM's with the increase in the foreign banks' assets. However for a long time now, NIM's in the system have stuck to a high level thus reinforcing evidence for overpricing of loans to the private sector. The level of NIM for the banking sector in 2007 was at 4.35% higher than 4.22% in 2006.

Another factor that has resulted in commercial banks in Albania achieving high profitability figures are the large spreads between deposits and loans interest rates in the 5%-10% range. Specifically, there are some concerns that increasing interest rate spreads around 7.2% in 2007 may be reflecting not only increasing risks as banks move into new markets, but also higher concentration and perhaps lower competition in the banking sector (WB, 2007:10). Interest rate spreads between foreign currency deposits and loans were 4.6% in 2007.

Figure 32: Average ALL 12 Month Deposit and Loan Interest Rates in the Banking System, 1999-2007

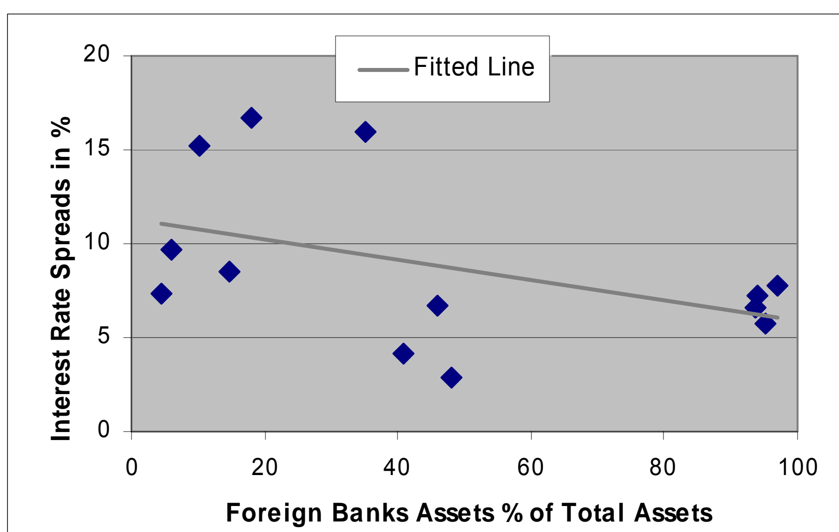


The lending-deposit interest rate spread measures the financial terms on which borrowers can access funds. Moreover, a reduction in banking spreads in

transition economies has proved to be significantly associated with productivity gains in the banking sector, an indication of overall development of the sector (Fries, 2005:11). The lower the spreads the more competitive is the banking sector and the legal protection of creditors, other things equal while high spreads reflect higher banking costs, greater monopoly power and greater lending risks (Berglof and Bolton, 2001:16).

As we can see from Figure 33 foreign bank entry in the Albanian banking sector has been associated with an overall decrease of interest rate spreads. However it can be clearly noticed that spreads between lending and deposit facilities have remained above 5% and in the recent years spreads have been as high as 7.7% in 2004 and 7.2% in 2007 above levels for region countries.

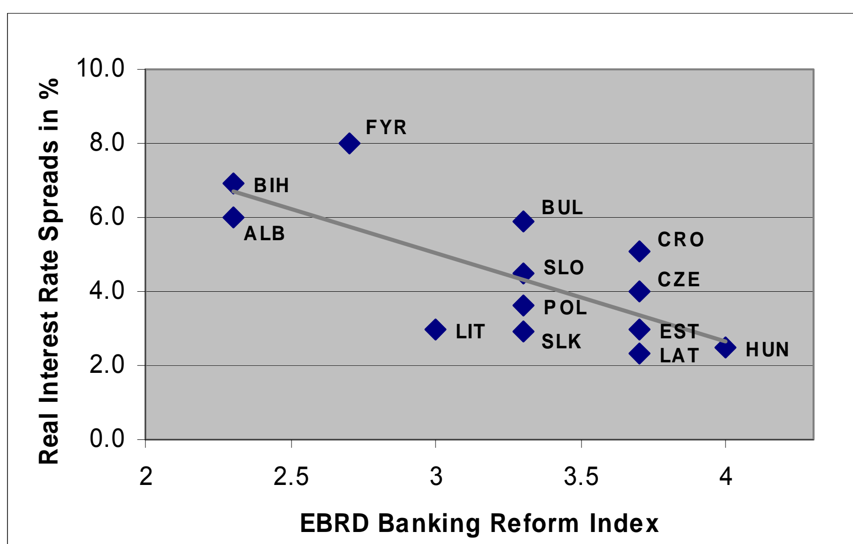
Figure 33: Interest Rate Spreads vs. Assets Share of Foreign Banks, 1995-2007



Source: Calculations on data from Bank of Albania Supervision Reports

Evidence from CEE and SEE countries show that interest rate spreads have decreased with upgrade in banking reform (Kraft, 2004:6), so for lending-deposit interest rate spreads in Albania to decrease further we must expect additional progress in banking reform; EBRD Banking Sector Development indicator for Albania in 2007 was 2.7.

Figure 34: Interest Rate Spreads vs. Banking Reform in CEE and SEE countries in 2002



Source: Kraft, 2004:6

Moreover there is much to be done on the subject of consumer protection and transparency. Regulation aimed at disclosure of the total annual cost of credit has been postponed. Although this regulation was issued in December 2006, the Bank of Albania has delayed its application because it believed that compliance would be too onerous for banks at this stage.

Finally let us have a look at the prudential indicators of the Albanian banking system that are at relatively satisfactory levels. Despite the ongoing credit boom, the banking system in Albania is well capitalized and liquid. Liquidity in the banking sector calculated as the ratio of short term assets/ short term liabilities was nearly 75% by end-2007. Healthy profitability and low nonperforming loan (NPL) ratios might pave the continuation of credit growth in the next years.

Table 22: Prudential Indicators of the Banking Sector, 2003-2007

	2003	2004	2005	2006	2007
Capital Adequacy Ratio	28.5	21.6	18.6	18.1	17.1
NPLs % of Total Loans	4.5	4.1	2.3	3.1	3.3
ROA	1.2	1.3	1.4	1.4	1.6
ROE	19.5	21.1	22.2	20.2	20.7
Liquid Assets/ Total Assets	40.5	36.3	33.5	31.9	n/a

Source: Calculation on data from BoA Supervision Reports 2003-2007

However the further growth of credit should be closely monitored by the authorities in order to minimize the negative effects on the macroeconomic indicators related to aggregate demand, inflation and current account deficit. Additional risks might be related to financial sector stability owing to deteriorating bank asset quality. The macroeconomic risks and financial sector risk are typically mutually reinforcing, that can create boom-bust cycles in credit and asset markets and large swings in macroeconomic fundamentals (Duenwald, Gueorguiev, and Schaechter, 2005:13).

As a conclusion the long presence of foreign banks in the Albanian banking system has influenced the establishment of a stable banking system and its stable growth. Previously, foreign banks were more conservative in terms of lending and 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 strategies to increase or maintain market shares (Ibrahimi 2007:3).

The system has benefited from foreign ownership through the transfer of technology, credit processes, risk management, and governance standards. Moreover, the fact that foreign owners are mostly financial groups based in countries with significant commercial links with Albania may facilitate financing of trade and export activities (WB, 2007:14).

The entry of reputable international banks and strengthening of the regulatory and supervisory frameworks of the central banks have restored the population's confidence in the banking sector, leading to a quick rise in deposits and pressure to find profitable investments.

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, financial reporting and supervision and capital adequacy standards.

The economic benefits deriving from the presence of foreign banks have not reached the proper levels yet. Issues that need improvement are the enhancement of the quality of information provided to the public at large and to the central bank, the lowering of the intermediation cost, and the further improvement of risk management (Ibrahimi 2007:3).

Some of the negative effects of the foreign bank entry that resulted from the analysis in this chapter are: the worrying macroeconomic implications that might be

caused by the rapid growth of credit; the structural risks represented by foreign currency domination of deposits and loans, the excessive profitability in the banking sector as shown by high ROE, NIM and interest rate spreads.

Despite an overall decrease in the concentration indicators associated with foreign bank entry, the banking system remains highly concentrated at present with the five largest banks having a market share of 72.1%, higher than any other region country except for Montenegro. There is an asymmetrical distribution of total assets between banks in the market. The deposits and loan markets are concentrated as well and this raises concerns for an oligopolistic environment in the banking system and risk of overpriced loans to the private sector.

Nevertheless empirical study on the question of optimal architecture of banking systems in transition countries suggest that banking sectors with few large, well capitalized banks are likely to generate better efficiency and higher rates of intermediation. These results owe to the positive effects of capitalization and market concentration combined together (Grigorian and Manole, 2002:23).

Finally considering the eventual repatriation of the banking system profit that accounts for more than 35% of inward FDI's we must point to the further deterioration of the current account deficit that represent one the most fragile parts of the Albanian economy. The almost totally foreign-owned banking sector profit for 2007 was nearly USD 125 million, while average FDI's for the 2003-2007 period were USD 345 million per year.

CHAPTER 5

EMPIRICAL ANALYSIS

Following our study of the Albanian banking sector and the impact of foreign bank entry in this chapter an empirical analysis of the degree of financial development will be presented. One important aggregate measure of financial and banking development in a country is the ratio of domestic bank credit to GDP (Fries and Taci, 2002:9; Levine, Loayza and Beck, 2000:8). The aim is to structure a model for estimating the level of BCPS as a percentage of GDP that is still low by any benchmark in Albania. The ratio of BCPS-to-GDP at 21.3% in 2006 and 29.2% in 2007 remains below almost all region countries and the SEE average of 48% in 2006. In the first part of the chapter the model specification together with the variables thought to be relevant to the level of BCPS in Albania will be presented followed by the results of the regression analysis. In the second part of the chapter the results of the empirical analysis together with conclusions and inferences from the fourth chapter will be used for proposing possible strategies for the future prospects of the Albanian banking sector.

5.1. REGRESSION ANALYSIS: BANK CREDIT TO PRIVATE SECTOR (BCPS) IN ALBANIA

Rapid private sector credit growth has been among the most notable economic phenomena across many transition economies particularly in the CEE and SEE countries over the past few years.

In Albania BCPS has increased from just 4.6% of GDP in 2001 to more than 29.2% of GDP in 2007. In the last four years BCPS-to-GDP ratio has increased on average by 5.5% percentage points annually. This lending boom presents both opportunities and challenges to economic policymakers. The surge in financial intermediation reflects a welcome catch-up from low levels, and financial deepening is generally expected to increase growth and efficiency.

Notwithstanding, rapid credit growth in transition and emerging countries has been associated with macroeconomic and financial crises, caused by macroeconomic

imbalances and increased risks in the banking sector. Policymakers therefore face the dilemma of how to minimize the risks of financial crisis while still allowing bank lending to contribute to higher growth and efficiency (Duenwald, Gueorguiev, and Schaechter, 2005:3).

The challenges and risks created by the credit boom in Albania have already been discussed in the previous chapters. Here we will try to determine the main factors that affect BCPS in Albania, and thus specify a model for estimating the level of BCPS-to-GDP ratio. Once we have tested the model than we can develop possible strategies for increasing the level of BCPS while minimizing risks for the economy in general and the financial sector in particular.

5.1.1. Model Specification

Our approach is based on the hypothesis test that BCPS in Albania can be explained by a set of macroeconomic variables and transition indicators. Bank credit to the private sector is in this case an indicator of the financial sector depth, keeping present that lending by banks is a measure of their main services provided to the real economy. So we try to specify and estimate a model of BCPS in Albania that has as explanatory variables together with the standard economic variables some variables describing the pace of reform and financial liberalization.

Similar models have been used previously in the literature. Cottarelli, Dell'Ariccia and Vladkova-Hollar, (2003) uses such an approach to estimate BCPS levels for several European transition countries. The authors try to assess by how much the BCPS ratio in these countries differs from its long-term equilibrium level. This is done by first estimating for a sample of non transition countries, the factors affecting the equilibrium level of the BCPS ratio, and by using this model to make projections for transition countries. For Albania an equilibrium BCPS-to-GDP level of 24.6% was predicted for 2002. In fact the real ratio was far below at 6.1% of GDP in 2002. In general higher equilibrium levels were predicted for all transition countries. This suggests that estimated coefficients for non-transition countries might have not been appropriate and do not lead to realistic projections for transition economies. Central planning under communist rule left a legacy that, even after more than a decade of

changes, distinguishes post-communist economies (in this case Albania) from other countries in the world with a comparable income per capita.

The specification of the equation to describe the level of BCPS as a percentage of GDP is drawn from the theory of finance and growth and, as variants of it have been used in several studies, no originality is claimed for the model employed in this work.

While we try to name the relevant factors that determine the level of BCPS in Albania we must keep in mind that for most of the last decade the level of credit to the economy was negligible, (never exceeding 5% of GDP until 2001). The banking system has been characterized by excess liquidity for many years and investment in government securities has constituted the major part of assets. Even if deposits inflow in the banking system in recent years has been a factor of credit growth in many region countries this is hardly the case for Albania.

The econometric model was specified in the form of the following equation, where BCPS/GDP is the dependent variable. Ordinary Least Squares (OLS) method was used to estimate regression results.

$$(BCPS/GDP)_i = a_0 + a_1 * ForeignBankAssets_i + a_2 * Log(GDP\ p.c.)_i + a_3 * IntRateSpread_i + a_4 * (FiscalDeficit/GDP)_i + a_5 * Inflation_i + a_6 * IndexBankReform_i + a_7 * (FxDeps/GDP)_i + a_8 * (FDI/GDP)_i + \varepsilon_i$$

5.1.2. Variables and Data Description

In selecting our set of explanatory variables we were guided by the general theory of financial development, as well as specific factors considered to be relevant to the Albanian financial system. Time series for the 1992-2007 period for each of the 9 variables were used for a total of 144 observations. Unfortunately the scarcity of available periodic data in Albania represented a restriction and only year-end data were employed. Data sources include IMF Statistical Appendices for Albania, Bank of Albania Annual Banking Supervision Reports, and EBRD Transition Reports. The explanatory variables that were considered as important in determining the level of BCPS and are included in the model are as follows.

Asset Share of Foreign Banks

Entry by foreign banks, together with the extent and maturity structure of foreign lending, provides an indicator of whether countries have succeeded in establishing safe, transparent, and enforceable rules and regulations for financial markets.

As already shown in the previous chapters, foreign bank entry has triggered the growth of credit to the private sector in Albania. Even if foreign banks have been for quite a long time in the market, until 2004 foreign-owned assets in the banking system were a minority. At present foreign bank lending represents nearly 94% of total loans of the banking sector. The asset share of foreign banks represents the ratio of foreign banks' assets to total assets of the banking system. The threshold of foreign ownership mostly used in the literature appears to be 50%. In our model the asset share of foreign banks will be used as a lagged variable, accounting for the time a foreign bank needs to be established and adapt to the market conditions and customer needs.

GDP per capita

The real demand for bank loans is assumed to be proportional to total capital stock of businesses and households, including housing and durable consumer goods. Therefore, the real demand for bank loans within a country can be expected to increase with the growth of output and to decrease with the level of interest rate or the competing demands for domestic savings by the government (Fries and Taci, 2002: 13).

GDP per capita income serves as a proxy for the level of development and for wages in a country, and thus reflects the purchasing power of individual consumers and their demands for bank credit. A number of empirical studies based on cross-country regressions have found that financial development at any given point in time, as measured by the ratio of bank lending to GDP, and/or the ratio of stock market turnover to GDP, is positively correlated with future per capita economic growth (Berglof and Bolton, 2001:21). The log of GDP per capita will be used in the model for specification reasons.

Interest Rate Spreads

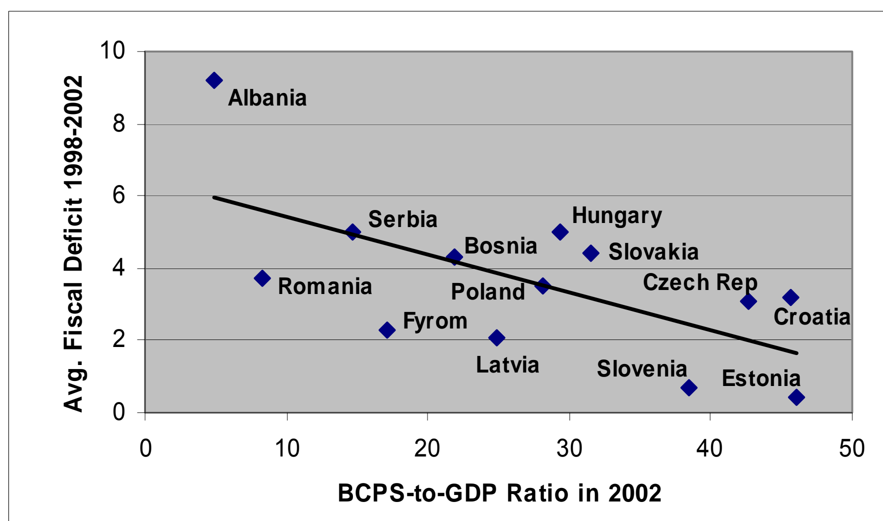
By using the lending-deposit interest rate spread as a variable we capture the performance of the banking system. If this spread is positive, then opportunities for effective financial intermediation exist and this should be seen as the mark of a

functioning banking system. On the other hand high interest spreads reflect the consequences of large government financing requirements crowding out private investment and thus BCPS. At the same time narrow interest rate spreads are often considered as an indicator of the progress made in banking reform (Kraft, 2004:7). In this context a negative relation between the level of BCPS and interest rate spreads is expected.

The Budget Deficit as a Proportion of GDP

This is also an important determinant of the level of bank credit to the private sector, as large government deficits make it more difficult for private companies to receive financing from banks. Moreover budget deficits are a likely sign of future tax increases or financial instability, conditions that impede private sector activities and thus borrowing from banks.

Figure 23: BCPS-to-GDP Ratio vs. Government Balance in Several Transition Economies



Source: EBRD Transition Reports, 1998-2004

The size of fiscal deficit should be an impediment to BCPS in Albania, where the government bills and bonds are held exclusively by banks in their investment portfolios thus being an alternative to credit extended to the economy. As of end-2007

government bonds constituted 35% of the assets of the banking system. As it can be seen from Figure 23, there is a negative relation between the level of fiscal deficit and BCPS-to-GDP ratio in many of the transition countries.

Inflation

Macroeconomic stabilization policies have a significant effect on the environment in which banks perform their deposit taking and lending operations. High inflation distorts the ability of both borrowers and lenders to perform the financial forecasting necessary to carry out long-term transactions. In particular, rapid inflation typically brings with it highly variable relative prices and increased uncertainty about the financial returns to economic activity (EBRD, 1998:99). For these reasons, an unstable macroeconomic environment is detrimental to the development of banking in general and the performance of bank lending to the economy in particular. The expected relation between the level of BCPS-to-GDP and inflation rate is negative.

Index of Banking Reform

The development of deeper financial systems depends significantly on the effectiveness of regulatory and institutional reform. Thus the growth of banking activity seems to depend crucially on the effectiveness of institution building and legal reform. EBRD's index of banking sector reform measures progress in liberalization, legal framework, and institutional reform of the banking sector, on a scale from 1 to 4.3. This indicator is an important variable as it captures central banks' policies on both interest rate ceilings and credit allocation to commercial banks, factors that affect directly the level of bank credit to the economy.

Foreign Currency Deposits / GDP

As already argued in the previous chapters the majority of bank lending in Albania is done in foreign currency. Foreign currency loans accounted for almost 72% of total bank lending in 2007. Obviously the primary source of lending in foreign currency has been foreign currency deposits, despite recent practices by foreign bank subsidiaries to draw on their mother banks credit lines. That is the reason to include the share of foreign currency deposits to GDP as a variable in the model.

Foreign Direct Investments / GDP

Strong FDI's, and related credit from parent companies, may be a substitute for bank credit growth. This may explain, at least in part, relatively slow bank credit growth in the Czech Republic in Slovakia, and in Hungary where intercompany loans exceeded 9% of GDP in 2002 (Cottarelli, Dell'Ariccia and Vladkova-Hollar, 2003:23). On the other hand the majority of foreign bank entry has happened through FDI's in the banking sector or acquisitions of existing domestic banks. If considered in this way financial sector FDI is expected to increase the rate of credit growth to the private sector. While we do not expect a certain direction of the relation between BCPS and FDI, it is obvious that FDI's can affect BCPS both positively and negatively.

Table 23: Correlation Matrix of the Variables Used in the Model

	BCPS / GDP	*Foreign Bank Assets*	*GDP p.c.*	*IntRate Spreads*	*FiscalDef. / GDP*	*Inflation*	*Index of BankRef.*	*FX Deps / GDP*
BCPS/GDP	1.000							
Foreign Bank Assets	0.949	1.000						
GDP p.c.	0.768	0.830	1.000					
IntRate Spreads	-0.241	-0.253	-0.129	1.000				
FiscalDeficit / GDP	-0.681	-0.755	-0.974	0.177	1.000			
Inflation	-0.257	-0.284	-0.670	-0.032	0.743	1.000		
Index of BankReform	0.659	0.715	0.970	-0.094	-0.951	-0.721	1.000	
FX Deps / GDP	0.933	0.937	0.763	-0.223	-0.662	-0.125	0.640	1.000
FDI/GDP	0.406	0.435	0.159	-0.479	-0.101	0.217	0.110	0.511

5.1.3. Results

The regression achieves a satisfactory fit, with an adjusted R-squared of 0.92 and most of the coefficients are statistically significant. As we can see from Table 24,

foreign bank assets and the level of foreign currency deposits to GDP both are positively related to the BCPS/GDP dependent variable as expected and are significant at the 95% significance levels. The index of banking reform also has a positive coefficient and is significant at the 95% significance level. The other variables: interest rate spreads, fiscal deficit/GDP, inflation, and FDI/GDP ratio all have negative coefficients as expected by theory with the former two being statistically significant. However the Log (GDP p.c.) variable has a negative coefficient that is not consistent with expectations. That is why an alternative regression is run using the first differences of the time series. In this second regression that has an R-squared of 0.73 all variables have coefficients consistent with theory. Nevertheless except for the FX/GDP and FDI/GDP variable the other variable's coefficients are not significant at conventional levels.

Table 24: Regression Analysis Results

1st Regression	*Coefficient*	*Standard Error*	*t-Statistic*
Intercept	110.682	64.550	1.715
Foreign Bank Assets	0.230	0.072	3.179
Log(GDP p.c.)	-50.299	25.381	-1.982
Int Rate Spreads	-0.138	0.162	-0.852
Fiscal Deficit/GDP	-0.192	0.769	-0.249
Inflation	-0.059	0.023	-2.635
Index of Banking Reform	15.945	8.098	1.969
FX Deps/GDP	1.581	0.476	3.324
FDI/GDP	-1.700	0.788	-2.158
Adjusted R-squared	0.927		
F-Statistic	24.677		

2nd Regression	*Coefficient*	*Standard Error*	*t-Statistic*
Intercept	-0.935	1.171	-0.798
ΔForeign Bank Assets	0.024	0.090	0.270
ΔGDP p.c.	0.006	0.006	0.995
ΔInt Rate Spreads	-0.027	0.120	-0.227
Δ(Fiscal Deficit/GDP)	-0.297	0.659	-0.450
Δinflation	-0.008	0.020	-0.394
ΔIndex of Banking Reform	0.167	3.974	0.042
Δ(FX Deps/GDP)	0.745	0.437	1.703
Δ(FDI/GDP)	-1.032	0.640	-1.611
Adjusted R-squared	0.734		
F-Statistic	2.066		

Scarcity of periodic data is of course a serious limitation to an accurate analysis of the level of BCPS in Albania. Even though all the transition time span data was included in the regression semi-annual or quarterly data points would yield more significant and reliable results. Further research remains to be done in the subject in order to determine the factors that affect the level of bank credit to the private sector given the importance of this as an indicator of financial depth.

The level of BCPS/GDP in Albania is expected to further increase in the next years and the resources for this will come from an increase in foreign currency deposits and borrowed foreign currency funds from foreign banks mother groups. These two factors that seem to determine the level of credit to private sector in Albania bear with them potential risks. Already discussed in the previous chapters these include currency risk, maturity mismatch, and sector risk related to possible asset-price bubbles. While the overall macroeconomic indicators should be kept inside reasonable levels a major challenge is related to external imbalances that might trigger a possible depreciation of the local currency and the materializing of the above-mentioned potential risks. Therefore authorities will have to stand ready to assess all implications of growing bank credit to the private sector, including those for financial stability.

5.2. OPPORTUNITIES, CHALLENGES AND POSSIBLE STRATEGIES FOR THE ALBANIAN BANKING SECTOR AND ECONOMY

The Albanian banking system, being the most dynamic part of the financial system, has made significant progress during the last years, and is undergoing a consolidation process. Together with these the Albanian economy in general and the banking sector in particular is facing many challenges. These include institutional, macroeconomic, and financial stability challenges.

5.2.1. Challenges for the Banking Sector in Albania

In the last three years the banking sector activity has significantly increased while the ratio of total assets-to-GDP has risen to 76%. The rapidly growing credit to the economy has provided new resources to private sector and households. Nevertheless,

some sectors of economy, such as agriculture, continue to be credited at low levels, less than 5% of total loans even if this sector accounted for 15% of the country's GDP in 2006. The contribution of banking loans to production investments is still low. Moreover the high share of loans for commercial purposes and consumers that are mainly used to finance imports is widening the current account to non sustainable levels. The level of public accessing the banking system is very low compared to other countries in the region.

Furthermore, bank credit appears to be concentrated on the largest corporate borrowers and some specific sectors of the economy, while credit to SME's and the rural agri-businesses remains limited. A small number of large businesses account for about 74 percent of the credit. SME's are the smallest category of clients for banks, both in terms of loan volumes and number of clients.

There is evidence that inadequate financing of small and medium enterprises is one of the main hindrances to private sector development in a situation when over 90 percent of the businesses in Albania are micro, small, and medium enterprises (WB,2007:7).

Non-bank financial institutions in Albania are less developed and manage insignificant assets compared to those in other region countries. NBFI's need to become more active by expanding their activity and by enhancing competition. This will provide a more symmetrical re-distribution of financial activity in the market.

Non-observed economy continues to be a burden for Albania, affecting negatively tax revenues, the circulation of money in the banking system and reducing the efficiency of monetary policy. Recent estimates about the share of informal sector are in the range from 50 to 60 percent of GDP (WB, 2007:9).

5.2.2. Instability and Potential Risks in the Financial Sector

Some similarities to pre-1997 Asian crisis conditions are apparent in emerging market economies today, including appreciation pressures, credit booms and increasing asset prices. The Asian crisis of 1997 was preceded by appreciation pressures associated with capital inflows and credit booms which led in turn to higher asset prices. "Sudden stops" or reversals in capital inflows were then linked with sharp currency depreciation, collapsing asset prices and severe downturns. Previous current account

deficits and losses associated with currency mismatches aggravated these problems, sometimes leading to banking crises (BIS, 2007:46).

In Albania rapid credit growth in the recent years has created an overextension in the private sector and has raised potential risks. Increased demand for consumption goods has created inflationary pressures in the economy. The government and the Bank of Albania have to get the public understanding and support to avoid any internally loss of confidence, after the creeping inflation left Albanians with reduced real incomes in 2007-2008. Inflationary pressures have become a burden for the central bank and the 12 month inflation got out of the targeted range with 4.6% and 4.4 %, in March and April 2008 respectively, despite several increases in the base interest rate during 2007.

Experience from other region countries has shown that traditional monetary policy tools such as changes in interest rates and open market operations are ineffective in containing credit growth. This is particularly true in countries with open capital accounts where increasing interest rates can result in a shift of credit in favor of foreign currency loans without reducing the overall credit growth (Duenwald, Gueorguiev and Schaechter, 2005:27).

In fact increasing the base interest rate might not have been the best policy for the BoA: while interest rates around the world remain depressed this might trigger more capital inflows thus more liquidity. Finally, raising the interest rates would increase the costs of servicing debt for the Ministry of Finance. Possible alternatives are explained below.

The currency substitution effect fueled by the increase in foreign currency loans weakens the efficiency of monetary policy and in a setting when Albania will adopt inflation targeting in 2009, this will be a major challenge for the central bank in forecasting inflation and in creating rational expectations among the economic agents.

The rapid credit growth might be hiding the true amount of non-performing loans which typically emerge with a delay, and authorities should be well prepared to handle such a potential risk. The price rise of real estates, which contributes to the increase of companies and individuals' wealth enhancing the opportunities for borrowing and the constant growth of credit demand might be artificial thus creating overpriced real estates and potential bubbles. More than 85% of real estate loans are extended in foreign currency.

All these risks must be evaluated properly and in a timely manner by the authorities. We should not forget that the collapse of the financial sector and economy in 1997 in Albania has been viewed merely as a result of Albanians' mistaken notion of capitalism and unawareness of risks.

The role of a strong domestic currency in encouraging the private sector's demand for foreign currency loans is beyond the scope of this work and has to be considered by further research.

Possible strategies for the central bank to control rapid credit growth and lending in foreign currency might be:

- To issue regulations that establish: lower monthly payment-to-net income ratios; lower loan-to-value ratio; higher down payments and guarantees for consumer and mortgage credit
- To increase the required reserve ratio on foreign currency-denominated liabilities
- To issue regulations that control credit institutions' exposure to currency risk when granting foreign currency-denominated loans to unhedged borrowers

Rapid credit growth can trigger banking sector distress through two channels: macroeconomic imbalances and deterioration of loan quality. If the rapid expansion of bank loans leads to large current account deficits and is accompanied by inflationary pressures, an economy might become increasingly vulnerable to macroeconomic shocks.

5.2.3. Challenges for the Albanian Economy

Poor physical infrastructure, including transportation, communication, power, and water shortages, has compounded underdeveloped financial infrastructure to create bottlenecks to business and economic development. Lack of rule of law and a reliable court system are deterrents to economic growth, as is corruption. Foreign investment levels have fluctuated in the past few years, but are generally low by

regional standards. Geographic concentration of exports is very high, with the top two trading partners (Italy and Greece) receiving more than 80 percent of all Albanian exports.

Albania’s overall infrastructure transition indicator by end-2007 was one of the lowest of all the region countries (EBRD, 2007:96). Albania has scored very poorly on the corruption perception indexes ranking constantly behind almost all other region countries and certainly fighting corruption remains one of its main challenges (IMF Statistical Appendix, 2003:29). Well-functioning financial institutions, in turn, increase the political support for anti-corruption measures (Boerner and Hainz, 2007:6).

Business environment in the country is worse than other countries in the region. The World Bank’s Doing Business indicators point out that Albania compares poorly against many of the other countries in the region, ranking Albania at 120 out of 175 countries (WB, 2007:9).

Table 25: Albania Macroeconomic Indicators, 2003-2007

	2003	2004	2005	2006	2007
Real GDP growth	6.0	6.0	5.5	5.0	6.0
Nominal GDP (USD mill)	5,600.0	7,452.0	8,382.0	9,137.0	11,809.4
GDP p.c. (USD)	1,740.0	2,328.0	2,619.0	2,855.0	3,690.4
Inflation (CPI % change)	3.3	2.2	2.0	2.5	3.1
Unemployment rate	15.0	14.6	14.2	13.8	n.a.
Fiscal Deficit % GDP	4.4	4.9	3.6	3.17	3.44
Current Acc. Deficit (Euro mill.)	331.0	287.8	493.2	534.7	878.1
Current Acc. Deficit % GDP	8.2	4.8	7.3	7.6	10.3
Exports (Euro mill.)	394.9	485.6	530.2	630.7	786.3
Imports (Euro mill.)	1,571.8	1,762.3	2,006.9	2,316.0	2,921.5
FDI (Euro mill.)	156.9	278.4	224.2	258.6	452.3
Emigrants' Remittances (Eur mll.)	710.7	822.1	894.2	935.1	947.0
Exchange Rate Lek/Euro	137.5	127.7	124.2	123.1	123.6

Source: BoA Annual Report, 2007

In a time when Albania is slowly moving towards a more integrated financial region, we stress the importance of preserving and improving current macroeconomic indicators such as GDP growth and inflation, the importance of the continuation of structural reforms and the immediate necessity to develop a foreign exchange-

generating strategy that will enable Albania to maintain a sound balance of payments position.

This is to be considered in the face of rapidly increasing imports equal to more than 30% of GDP for the period 2003-2007. Exports, FDI's and capital transfers to government and remittances all amount to only 25% of GDP or less during the period. In fact, Albania is well positioned many ways to attract foreign direct investment. Ports on the Mediterranean, a literate and educated workforce, competitive salaries, and natural resources all are attractive elements for investors.

While Albania is regarded as a country with low barriers to foreign capital and direct investment, inflows of capital in Albania are very modest. Albania seems to have been less of an attraction for foreign investors than other Southeastern European countries, even compared to the ones of similar size such as Macedonia or Croatia. The most important reasons why foreign investors are reluctant to invest in Albania seem to be: the presence of informal economy, unclear property rights and uneven application of laws and contracts (Cani and Shtylla, 2003:6).

The issue of current account deficit will be especially urgent next year as Albania has a commitment with the EU and the WTO to liberalize its capital account by end-2009. Practically this would permit free movement of capital, and many Albanians could easily transfer funds abroad, thus putting more pressure on the financial system to ensure and provide foreign exchange liquidity.

Promotion of tourism and agricultural production, developing export-oriented or import-substitution strategies can help reduce the current account deficit, while strategies designed to attract foreign direct investment can help increase financial inflows. Future growth will increasingly require higher investment levels underpinned with a robust financial sector that provides for effective and sustainable intermediation.

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.

CONCLUSION

The high share of foreign capital in banking sectors in Central and Eastern European and with a delay of some years Southeast European countries has become a key feature of financial development. At present foreign banks own more than 50 percent of banking assets in almost all of the CEE and SEE and in some countries the share of foreign-owned bank assets is as high as 80-90 percent, making these countries' banking systems among the most open in the world. The presence of foreign-owned banks in developing and transition economies increased dramatically during the 1990's, triggered mainly by the system change at the national level and the search by global institutions for profit opportunities in the emerging economies at the international level.

The dramatic increase in the presence of foreign banks, has deeply transformed the financial systems of the transition countries. There has been much research on the subject and the literature is mixed about the effects of foreign bank entry on banking sector in transition economies. Evidence shows that foreign bank leaded increase in financial intermediation and foreign capital flows have made a significant contribution to realizing the regions' growth potential, and these countries have benefited in terms of modernization of their financial systems, transfer of business practices and banking products.

Albania joined the group of transition countries in 1991 after the fall of the most totalitarian communist regime in Eastern Europe. At the beginning of transition the financial sector was underdeveloped due to the legacies of the old system during which the banking system was completely centralized and served strictly the central planning. During most of the 1990's the banking sector in Albania was dominated by large ineffective state-owned banks that collected the majority of household deposits and kept most of their assets in government debt securities. Bank credit to the private sector was at minimal levels of 3-5% and the banks followed a passive strategy in terms of developing new products and services. The 1997 pyramid schemes crisis and the 2002 bank run only accentuated the sluggishness of the banking sector and ruined public confidence in the financial system.

Nevertheless the privatization of the Savings Bank in 2004 and the subsequent entry in the market of international reputable banks started a

consolidation process in the banking sector. The increase in bank assets and individual deposits in the following years was a sign of restored public confidence. The share of state-owned banks has decreased gradually due to their privatization and the considerable increase in the number of new private and foreign banks from 6 operating in 1997 to 17 banks in 2007. During this time the foreign banks assets increased dramatically to account for more than 94% of the total system assets in 2007.

The Albanian banking sector has experienced a sizable growth during the 2004-2007 period with assets growing at an average rate of nearly 20% per year resulting in a cumulative growth of 98.8%. Supported by a rise in banking activity and products, lending to the private sector has increased with an average rate of 50% annually between 2003 and 2007 more than almost any other country in the region.

Extensive study has been done on the subject of finance, growth and the relation between the two. A growing body of empirical analyses demonstrates a strong positive link between the functioning of the financial system and long-run economic growth. The conclusion generally drawn from these studies is that well-functioning financial intermediaries and markets promote long-run economic growth and vice-versa. (Levine, Loayza and Beck, 2000:7). The functions of the financial system and financial intermediaries with positive implications for economic growth through enhanced financial intermediation between economic agents have been discussed in the first chapter. The transition of the Eastern European countries from a centrally planned to a market economy and the difficult challenge of building a sound financial system were presented in order to have a clear view of the chronological background of the country groups under study.

Toward the end of the 1990's most transition countries' financial sectors remained underdeveloped, burdened by the legacies of central planning and structural and macroeconomic problems early in the transition. Financial sectors were small and heavily bank-based. Banking systems were relatively underdeveloped in most countries, characterized by a lack of financial intermediation, continuing bad loan problems and weak central bank supervision. Lending to the private sector was very low by any standard (EBRD, 1998:93).

Despite considerable variation in the approaches to financial sector reform, the key driving forces across the transition region have been broad changes in the institutional environment, privatization and market entry by foreign banks.

Foreign bank entry in transition economies was considered in the second chapter together with all its advantages and disadvantages, opportunities and risks. As a conclusion, a growing role has been played by foreign banks in transition countries in Europe. In addition to stimulating competition more generally, foreign banks also play an active role in widening the access to banking services and introducing innovations into the markets. Foreign banks can also be a source of financial support to the banking system since they are less sensitive to host country-specific risk, and can also obtain foreign currency liquidity during episodes of financial stress.

Nevertheless foreign bank entry in transition economies raises some issues mainly related to the striking growth in bank credit, with rates sometimes as high as 81% per year (between 2000 and 2003 in Hungary) that might create risks which may not be well managed. Such risks include lending in foreign currency to unhedged sectors of the economy, rising asset prices that might result in housing market bubbles and deterioration of macroeconomic indicators. As a matter of fact rapid credit growth in transition countries has created widening macroeconomic imbalances and heightened current account deficits. Another important issue is that foreign bank entry in European transition countries has mainly originated from banking groups in their western more developed neighbors. Governments should be reluctant to have their domestic banking systems dominated by banks from a single country, in case these banks suddenly cut their activities when faced with problems at home. For this reason, the emerging economies may seek to diversify foreign owners.

The financial and banking sector in Albania were analyzed in the third chapter. After presenting the historical background of the financial system transformation in Albania and the difficulties in building a modern banking system, the present situation of the banking sector was discussed in detail.

At present the Albanian financial system offers a wide range of financial services and products to the private sector. The banking sector has grown to be one of the most important sectors of the Albanian economy. Total assets represented more than 75% of GDP and credit to private sector was 29% of GDP as of end-2007. The loan/assets ratio of the banking system was 39% at end 2007, rising from only 13.6 % at end 2003. An important development in the banking sector activity during this period has been a shift of assets from investment in government securities to investment in loans. However, the level of investment on public debt

securities at nearly 35% of total assets by end-2007 remains high compared with the regional average. The non-bank financial industry in Albania still remains underdeveloped and accounts for less than 5% of the financial sector assets. The stock exchange is non-functional and the securities market is wholly comprised of government bills and bonds with short and medium maturities. The industry still lacks mutual and investment funds, as well as investment banking services.

One of the main features of the banking sector in the last years has been the rapid growth of bank credit to the private sector of the economy. The main reasons for such a credit boom has been the increased competition and entrance by foreign banks in the market, the diversification of the range of banking products and services and the starting from a very low base of bank credit to private sector. For most of the last decade the level of credit to the economy was negligible, never exceeding 5% of GDP until 2001.

This lending boom presents both opportunities and challenges to the Albanian economy and financial sector. The surge in financial intermediation reflects a financial deepening that is expected to have positive implications for investment projects, growth and efficiency. On the other hand rapid credit growth in transition and emerging countries has been associated with macroeconomic and financial crises, caused by macroeconomic imbalances and increased risks in the banking sector. In Albania there are concerns related to: the lack of reliable information on borrowers despite the establishment of a credit registry in early 2008; the capacity of banks to process loans in the face of the ongoing rapid credit expansion; excessive exposure to real estate and difficulties in collateral enforcement that remains a major problem.

Despite an overall increase in the level of financial intermediation in Albania, indicators remain below almost all other region countries and access to banking services has to be improved. The EBRD index of banking sector reform for Albania in 2007 was 2.7, fixed since 2004 when the Savings Bank was privatized.

Foreign bank entry in the Albanian banking sector and its impacts were analyzed in the fourth chapter. At present with a foreign bank asset share of more than 94% in 2007, Albania has one of the most open banking systems in the world. The current ownership is diverse; there are foreign investors from Austria, Italy, Greece, France, Turkey, Germany, Bulgaria, Malaysia etc. Nevertheless capital from the first three countries only accounts for nearly 69.2% of the foreign capital and almost 64% of the total capital of the banking system in Albania. This unfolds

clearly the high degree of exposure of the banking system to adverse financial and macroeconomic developments in these home countries of the foreign banks.

The effects of the foreign bank entry, the main objective of this study, have been numerous and have transformed the banking system in Albania to a wide extent. Nevertheless due to the drastic changes in the ownership structure of the banking system, and the absence of a significant domestic banking industry, comparing foreign banks vis-a-vis domestic banks seems not to be possible in Albania. Instead this study focused on the impact of foreign bank entry on the banking system as a whole, in the structural change of assets, liabilities, regulatory measures and risks.

Growth of credit to the private sector seems to have been one of the major impacs of foreign bank entry in the Albanian banking sector. In the last three years BCPS has grown at an average annual rate of 60%, and more than 93% of bank lending has been extended by foreign banks. However despite the positive implications of the BCPS growth for the economy there are several potential macroeconomic risks that have materialized to some extent in Albania following the rapid increase of the BCPS in the last years. Inflationary pressures have become a burden for the central bank and the 12 month inflation got out of the targeted range with 4.6% and 4.4 %, in March and April 2008 respectively, despite several increases in the base interest rate during 2007; current account deficit increased by more than 60% relative to 2006 reaching record levels of 10.3% of GDP by end-2007 (trade deficit was more than 25% of GDP) and loans extended in foreign currency made up 72% of total. Moreover the recent credit expansion has pushed up real estate prices building a potential risk of an assets bubble that could burst with grave consequences for the financial sector.

Foreign banks have have preferred to grant loans denominated in foreign exchange and by doing so they have transferred exchange risk to the private sector. Having their revenues mainly in domestic currency the households remain unhedged against possible fluctuations in the exchange rate and in the case of a depreciation this would create huge problems with non-performing loans for the banking sector.

The high level of foreign currency loans calls for regulative measures to be taken from the authorities such as: requiring commercial banks to increase provisions and additional reserves when a threshold is exceeded.

Together with loans the share of foreign currency deposits has increased as well pointing to another disturbing fact, the general Euroization of the Albanian economy through currency and asset substitution. From only 24% of total deposits in 1998, foreign currency deposits accounted for nearly 43% of total in 2007. Foreign currency deposits have increased along with the foreign bank entry in the market. By offering high real return rates on foreign currency deposits as compared to Lek deposits, foreign banks create incentives for foreign currency deposits that in turn reduce the efficiency of monetary policy by making control of money supply and estimation of future inflation more difficult. In a setting when Albania will adopt inflation targeting in 2009, this will be a major challenge for the central bank in forecasting inflation and in creating rational expectations among the economic agents.

Even though foreign bank entry has triggered a downward trend in concentration in the banking sector concentration ratios for assets, deposits and loans remain high. The share of the 5 largest banks in assets was 75% in 2006 and 72% in 2007, one of the highest in the SEE region. Moreover concentration in the loan market has slighly increased in the last 2 years. This is an indicator of the oligopolistic structure of the loan market with five or six banks holding market shares over 10% and the bulk of other banks that can not pass the threshold of 5%. This might lead to anti-competitive behaviour in the system since smaller banks can not compete with the largest banks that hold the major share of the market and this might result in overpriced loans and higher investment costs for the economy. According to Kraft (2004:12) foreign banks are becoming accustomed to high profits in SEE countries, and may not be willing to undermine this with aggressive competition.

Since 2002 the profitability of the commercial banks in Albania has been increasing. Main profitability indicators ROA and ROE were at high levels of 1.6% and 20.7% respectively for 2007 above average compared to CEE countries. The high ROE in Albania is partly explained by market imperfections such as bank deposits that receive an interest well below that of treasury bills, high net interest margins between 3% and 5% in the recent years that remain at the highest end of the spectrum when compared to other Eastern European countries, and large spreads between deposits and loans interest rates in the 5%-10% range. There are some concerns that increasing interest rate spreads around 7.2% in 2007 may be reflecting higher concentration and perhaps lower competition in the banking sector

Even though foreign bank entry in the Albanian banking sector has been associated with an overall decrease of interest rate spreads it can be noticed that spreads between lending and deposit facilities have remained above 5% in the last years.

As a conclusion the long presence of foreign banks in the Albanian banking system has influenced the establishment of a more active banking system and its stable growth in terms of the variety of products, the growth of lending and the employment of strategies to increase or maintain market shares.

The system has benefited from foreign ownership through the transfer of technology, credit processes, risk management, and governance standards. The entry of reputable international banks and strengthening of the regulatory and supervisory frameworks of the central banks have restored the public's confidence in the banking sector, leading to a quick rise in deposits and pressure to find profitable investments. The investment of banks in government securities has decreased with the increase in foreign bank-owned assets, suggesting for an improved efficiency of the banking sector in managing its resources and a reduction of the crowding out effect by the public sector.

However the economic benefits deriving from the presence of foreign banks have not reached the proper levels yet. Issues that need improvement are the enhancement of the quality of information provided to the public, the lowering of the intermediation costs, and the further improvement of risk management. More research in the subject is needed to understand foreign bank behavior with respect to competition and possible tacit collusions between market leaders.

An empirical model for estimating the level of BCPS-to-GDP in Albania was presented in the last chapter of this study. The model includes a set of macroeconomic variables and transition indicators as explanatory variables, while the dependent variable BCPS-to-GDP is an indicator of the financial sector depth. Time series for the 1992-2007 period for each of the 9 variables were used for a total of 144 year-end observations.

The regression results point to the significance of two main variables in determining the level of BCPS in Albania. These are the share of foreign bank assets and the level of foreign currency deposits-to-GDP, both positively related to the BCPS/GDP dependent variable and significant at the 95% significance levels. The index of banking reform also has a positive coefficient and is significant at the

95% significance level. Other significant explanatory variables include inflation and FDI/GDP ratio that have negative coefficients as expected by theory.

Scarcity of periodic data is of course a serious limitation to a more accurate empirical analysis of the level of BCPS in Albania. Even though all the transition time span data was included in the regression semi-annual or quarterly data points would yield more significant and reliable results. Further research remains to be done in the subject given the importance of the bank credit to the private sector as an important indicator of financial development.

In the next years the growth of bank credit to the private sector is expected to continue in Albania. This will be the result of a steady borrowing demand from the emerging private sector in conditions of a stable economic growth. At the same time a more active and competitive banking sector together with a surge in bank deposits will support lending to economic agents.

Together with the significant progress made during the last years the Albanian economy in general and the banking sector in particular is facing many challenges. These include institutional, macroeconomic and financial stability challenges. Macroeconomic risks might be caused because credit growth stimulates consumption and thus creates inflationary pressures in the economy. Moreover increasing demand for goods can result in a further deterioration of the current account that Albania possibly could not afford. The current account deficit reached 10.3% of GDP in 2007 while trade balance deficit was at 24.9%.

Furthermore the rapid credit growth might be hiding the true amount of non-performing loans which typically emerge with a delay, and authorities should be well prepared to handle such a potential risk. Even if foreign banks are more efficient than domestic banks and their presence can accelerate financial sector development, this should not be a substitute for institutional reform and prudential supervision. Financial development is no guarantee against financial crises.

Finally we must once again stress the importance of preserving macroeconomic stability; current rates of GDP growth; inflation at low levels and, the importance of designing foreign exchange generating strategies.

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APPENDIX 1

FINANCIAL INSTITUTIONS IN ALBANIA

Table 1: List of Commercial Banks

No	BANK	URL
1	ALPHA BANK - ALBANIA (ALPHA BANK GROUP GREECE)	http://www.alpha.gr
2	AMERICAN BANK OF ALBANIA (INTESA SANPAOLO ITALY)	http://www.albambank.com
3	CREDINS BANK	http://www.bankacredins.com
4	CREDIT BANK OF ALBANIA	http://www.creditbankofalbania.com.al
5	EMPORIKI BANK - ALBANIA (CREDIT AGRICOLE FRANCE)	http://www.emporiki.gr
6	FIRST INVESTMENT BANK - ALBANIA (FIB BULGARIA)	http://www.fibank.com.al
7	INTERNATIONAL COMMERCIAL BANK (ICB MALAYSIA)	http://www.icbankinggroup.com
8	ITALIAN DEVELOPMENT BANK	http://www.bisbanca.com
9	NATIONAL BANK OF GREECE (NBG GROUP GREECE)	http://www.nbg.gr
10	NATIONAL COMMERCIAL BANK (CALIK GROUP TURKEY)	http://www.bkt.com.al
11	POPULAR BANK (SOCIETE GENERALE GROUP FRANCE)	http://www.bpopullore.com
12	PROCREDIT BANK (PROCREDIT BANK GERMANY)	http://www.procreditbank.com.al
13	RAIFFEISEN BANK (RAIFFEISEN INT. AUSTRIA	http://www.raiffeisen,al
14	TIRANA BANK (PIRAEUS GROUP GREECE)	http://www.tiranabank.al
15	UNION BANK	http://www.unionbank.com.al
16	UNITED BANK OF ALBANIA	-

Table 2: List of Insurance Companies

No	INSTITUTION	URL
1	ALBSIG	http://www.albsig.com.al
2	ATLANTIK	http://www.atlantik.com.al
3	EUROSIG	http://www.eurosig.al
4	INSIG (EBRD, IFC)	http://www.insig.com.al
5	INTERALBANIAN (ASPIS GROUP GREECE)	http://www.interalbanian.com
6	INTERSIG	http://www.albsig.com.al
7	SICRED	http://www.sicred.com.al
8	SIGAL (UNIQA GROUP AUSTRIA)	http://www.sigal.com.al
9	SIGAL LIFE (UNIQA GROUP AUSTRIA)	http://www.sigal.com.al
10	SIGMA (VIENNA INSURANCE GROUP AUSTRIA)	http://www.sigma-insurance.com

Table 3: List of Pension Funds

No	FUND	URL
1	APFA	http://www.apfa.com.al
2	CAPITAL	http://www.capital.com.al
3	GARANTSIG	http://www.garantsig-al.com

Table 4: List of Leasing Companies

No	INSTITUTION	URL
1	RAIFFEISEN LEASING (RAIFFEISEN BANK)	http://www.raiffeisen,al
2	TIRANALEASING (PIRAEUS GROUP GREECE)	http://www.tiranabank.al
3	LANDESLEASE	http://www.landeslease-al.com.
4	CREDINS LEASING (CREDINS BANK)	http://www.bankacredins.com