

## OVERVIEW OF CREDIT ACTIVITY IN ALBANIA

Klejda GABESHI

University of Craiova, [klea.gabeshi@gmail.com](mailto:klea.gabeshi@gmail.com)

**Abstract:** *The dominant component of the Albanian financial system is the banking sector, whose activity is transparent and leads to an efficient market economy. The mission of a performing banking system is to allocate the capital exclusively in profitable projects, to facilitate the best functioning of the lending activity, helping to improve the rational distribution of resources between different entities. The purpose of this paper is to provide a comprehensive statement of the most recent credit developments in Albania, in order to determine if banks, with their role as financial intermediaries, can help stimulate economic growth. Loans compose the majority of the Albanian banking system assets. In the last years, loan portfolio quality has been significantly deteriorated, which can be easily understood from the increase in non-performing loans. The methodology used in this article is a quantitative and qualitative analysis of credit data provided by the Albanian banking system, the identification of factors that can boost credit growth in conditions of its significant slowdown and the study on lending performance and progress, in comparison with different countries in the region.*

**Keywords:** Banking system; Credit activity; Lending performance.

**JEL Classification Codes:** C10, G21.

### 1. INTRODUCTION

Being the principle pillar of the national financial system and in terms of the functions it performs, the banking sector has a particular importance in the economy. Namely, the way in which it operates becomes an essential condition for maintaining the financial stability and ensuring sustainable economic development.

The banking system plays an important role in the modern world economy, providing financial assistance to the government and the private sector. The main function of a bank is to facilitate the lending activity, helping to improve the efficiency and the rational distribution of resources between different entities. Extending credits will allow consumers to borrow and spend more, and businesses to borrow and invest more. Increasing consumption and investment will create new jobs and will expand revenues and profits. In financial terms, an efficient, profitable and reliable banking system means profitability and stability of economic activities. It is also particularly important for a sustainable economic growth.

The main objective of this paper is to provide a comprehensive statement of the most recent credit developments in Albania, in order to determine if banks, with their role as financial intermediaries, can help stimulate economic growth.

In the Albanian banking system, exposure to credit risk is the main risk from which the system is exposed to. Loans compose the majority of the banking system assets. Furthermore, in the last years, loan portfolio quality has been significantly deteriorated, which can be easily understood by the increase of the so-called bad loans. The increase of non-performing loans has



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sparked the interest of many bank institutions and researchers to find the key factors that have brought this progressive and disturbing augmentation. Developments in the global economy and particularly the global economic crisis are exerting a negative impact on the Albanian market and are causing the contraction of the credit market.

## 2. LITERATURE REVIEW

Analyzing the previous studies conducted on loans and factors influencing their level in the Albanian banking system, it's observed that the majority of researchers distinguish two categories of factors: external factors and internal factors. The external factors are generally associated with the country's macroeconomic indicators, such as the GDP, unemployment rate, inflation rate, etc. whereas the internal factors are related to bank specific factors, such as credit growth, loan interest rate, loans to assets ratio, the quality of credit monitoring service, etc.

Shijaku and Ceca (2011) have studied the credit risk in the Albanian banking system, identifying it with the level of non-performing loans. According to this study, the stress test methodology for credit risk is based on directly testing the increase of non-performing loans of the banking system and measures the effect on capital adequacy. According to the statistical analysis, the dependent variable was the rate of non-performing loans while the independent variables included: the level of economic growth, changes in foreign currency interest rates (Euribor and Libor), national interest rate, ALL / EUR and ALL / USD and finally the level of inflation. The regression coefficients had the expected values and GDP growth though small was significant. Other statistically significant variables were the Libor interest rate and the ALL / USD exchange rate, the Euribor interest rate and the ALL / EUR exchange rate.

In their study, Kalluci and Kodra (2010) have analyzed the determinants of non-performing loans in the Albanian banking system by dividing them into two sub-categories: loans to businesses and loans to households. The study was based on quarterly data from the second quarter of 2002 to the fourth quarter of 2009 and used the OLS (ordinary least squares) regression technique where the dependent variable is the credit risk measured by the ratio of non-performing loans to total credit. As independent variables were used: interest rate, inflation rate, unemployment rate, Euro / Lek exchange rate, export growth rate, M1 and M3 monetary aggregates, real effective exchange rate, remittances and GDP. According to the results, non-performing loans to businesses are influenced by treasury bill interest rate, real effective exchange rate, M3 monetary aggregate, export growth rate and GDP growth. Albanian business has a greater sensitivity to interest rate changes than to exchange rate changes. Individual loans are affected by the treasury bill interest rate, the Euro / Lek exchange rate and the rental and home price index. Again the impact of interest rate changes (treasury bills) is much stronger than the impact of other variables on their solvency.

Mancka (2012) estimated that exchange rate Euro/All and Euro/\$, as well as a variable that measures the global financial crisis are factors that affect the severity of non-performing loans. The analysis was based on data from 2002 to 2010.

In another study, Shingjergji (2013) analysed the impact of the macroeconomic variables on the non-performing loans level in the Albanian banking system, using quarterly data from 2005 to 2012. From the regression analysis is noticed a positive correlation between NPLs ratio and GDP growth, interest rate of four quarters lag and foreign exchange rate Euro/All. In the same year, the author (2013) wrote a paper in which he analysed the relationship between the NPLs ratio and several bank specific variables in order to understand at what extent the banking variables will be able to explain the NPLs ratio.

By testing the model resulted a positive correlation of the loan's level and net interest margin with NPLs ratio and a negative one between NPLs ratio and the loan to asset ratio, ROE and capital adequacy ratio (CAR). In a more recent study, Kurti (2016) studied the determinants of non-performing loans in Albania during 2000-2013, with the purpose to give recommendations of what actions should be taken to reduce the level on these problematic loans. The results were in the same line with those of Shingjergji.

In one of my previous articles (2017) I analyzed the impact of macroeconomic and bank specific factors on Albanian non-performing loans, by employing data approaches to this country over the period 2005-2014. The results of the econometric model showed an indirect, statistically significant link between the level of non-performing loans and factors such as ROE. The data from the Albanian Banking System show that profitability measured by ROE, has suffered a major decline especially after 2008 global financial crisis. This result is in line with the studies conducted in this area, as an increase of the non-performing loans would lead banks to a reduction in the level of ROE.

Gjini and Koprencka (2018) analyzed the links between non-performing loans and some economic factors for the Albanian banking system, for the period 2003-2016, through the Stata 14 statistical program, using the simple and multi-linear regression method. The dependent variable was the non-performing loans ratio, and as independent variables were identified some economic indicators such as: GDP growth rate, unemployment, inflation and interest rate. At the end of the analysis, the results clearly showed that there are strong links between the economic indicators and the rate of NPLs in Albania, identifying a positive relation between unemployment and NPLs ratio and a negative impact of the GDP growth rate, interest rate and inflation to the NPLs ratio.

### **3. CREDIT ACTIVITY IN ALBANIA**

The methodology used in this article is a quantitative and qualitative analysis of credit data provided by the Albanian banking system, the identification of factors that can boost credit growth in conditions of its significant slowdown and the study on lending performance and progress, in comparison with different countries in the region.

Like all countries transitioning from totalitarian regimes to a market economy, Albania in the first years after economic and political changes, was faced with a very low level of lending to GDP. After 2004, when bank lending began to grow at a rapid pace, its ratio to GDP also increased significantly. The economic recession, after the global crises, has affected the reduction of trade exchanges and the entry of foreign currency into the country. Less credits to the economy in general and to individuals in particular is translated into less rewards for employees, meaning less disposable income expected to bring less household disposable income for consumption and savings.

The effects of the global crisis in Albania were felt in many areas such as the gradual rise in prices especially associated with consumer goods, the increasing and decreasing inflationary fluctuations and gradual depreciation of the local currency in the foreign exchange market, the decline of taxes and customs revenues, the decline of remittances, the drastic decline in real estate sales to 50%, etc. Moreover, the developments in the global economy and particularly the global economic crisis are exerting a negative impact on the Albanian market and are causing the contraction of the credit market, tightening the conditions of bank lending. However, the situation in Albania regarding the crisis appears to be relatively less influential compared to other European and Balkan countries.

One key reason is because we do not have the same form of assets as the American banks had and mainly our bank clients are business clients. Another reason relates to the balance sheet structure of banks in Albania, which are characterized by a high liquidity.

There are several reasons that forced commercial banks to constrain credit standards in the last years, especially in the sector of small and medium enterprises, but also in the large enterprises sector. These reasons are also related with the increase in non-performing loans in the Albanian banking system. Firstly, this trend is related to the financial difficulties of the construction sector, processing industry and trade, repair of motor vehicles and household appliances. These sectors represent the largest share of the distribution of credit by economic sector and inevitably had a negative impact on the increase of non-performing loans. In the meantime, the decrease of remittances has contributed, directly or indirectly, in the reduction of the solvency of the Albanian customers, without neglecting the large decline of the pace of economic growth in Albania, which has brought the weakening dynamism of the economy and economic operators. Finally, another reason is the outstanding liabilities of the government to private businesses for the public affairs committed.

At the end of 2018, non-performing loans reached ALL 64.36 billion, down by ALL 15.14 billion or 19% from a year earlier. Non-performing loans decreased by 2.15 pp, reaching 11.08% at the end of 2018. However, non-performing loans provisioning is high and net non-performing loans to total net loan portfolio ratio stands at 3.81%, up slightly by 0.07 pp compared to December 2017. In the portfolio of qualitative loans, the growth of "standard" loans increased by 1.66 percentage points, and the share of loans "in pursuit" decreased by 4.16 percentage points. In the non-performing loans portfolio, meanwhile, there is a decrease in the "substandard" and "lost" classes, by 0.07 pp and 2.38 pp respectively. While the class of "suspicious" loans is increased by 0.31 p.p.

**Table 1. Composition of loan portfolio over the years 2017 and 2018 Source: Banf of Albania**

Distribution	Composition of loan portfolio, Quarterly data (%)							
	2017(1)	2017(2)	2017(3)	2017(4)	2018(1)	2018(2)	2011	2012
<b>Standard</b>	77.6	74.3	77.0	78.1	72.7	74.2	77.9	79,7
<b>In pursuit</b>	5.0	10.2	8.2	8.7	9.0	7.8	4.8	4.5
<b>Substandard</b>	4.6	4.0	3.4	3.3	3.6	3.7	3.5	3.2
<b>Suspicious</b>	2.3	2.2	2.5	2.2	2.6	3.0	3.3	2.6
<b>Lost</b>	10.6	9.3	8.8	7.7	7.2	6.6	6.1	5.3

As seen in Figure 1, the gross non-performing loan (NPL) ratio of Albanian commercial banks rose slightly in monthly terms in January, defying the long-term downward trend with a 0.22 of a percentage point increase.

The central bank intends to cut the bad loans ratio further via its plan to fight against the informal economy. The national plan for the reduction of NPLs envisages the establishment of regulatory criterion according to which lending will depend on tax declarations starting from 2018.

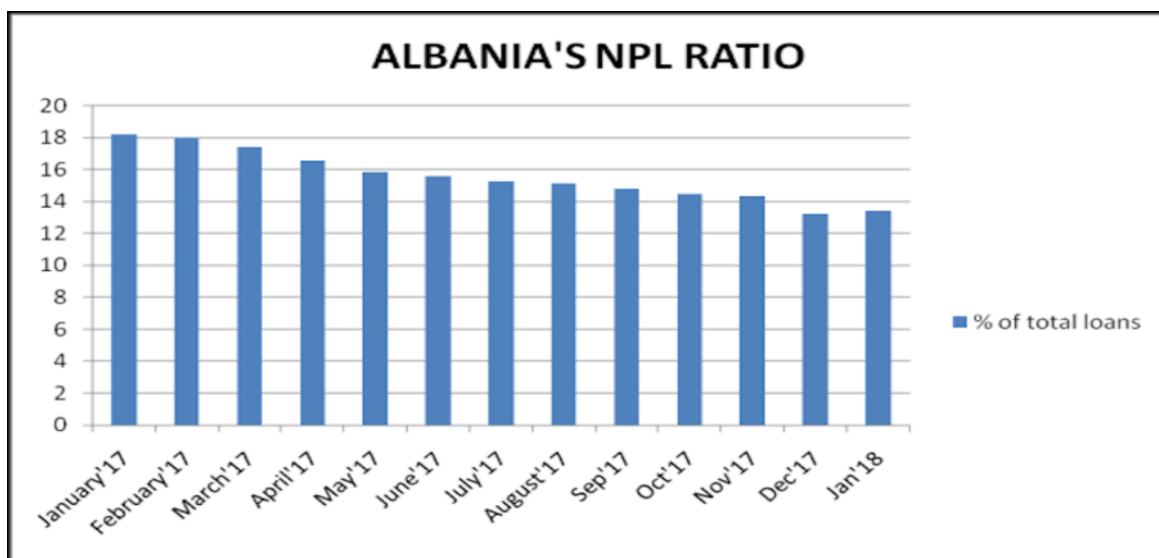


Figure 1. Albania’s NPL Ratio for the year 2017

Source: bne intelliNews

Kosovo has the lowest NPLs in the region. Although NPLs are heading down in other countries, they are still high (Figure 2). FYR Macedonia and Kosovo had less exposure to international markets before the crisis and thus less need for reforms, likely a reason their NPLs are below pre-crisis levels. Albania, Montenegro, and Serbia continue to write off and sell old NPLs, and have reduced NPLs considerably since 2017, especially Serbia. New insolvency laws are in place in Albania and the Bosnia and Herzegovina entity Republika Srpska.

Albania is preparing to introduce a system for voluntary out-of-court restructuring. Montenegro has expanded coverage of the credit registry to enhance the capacity of lenders to assess credit risk.

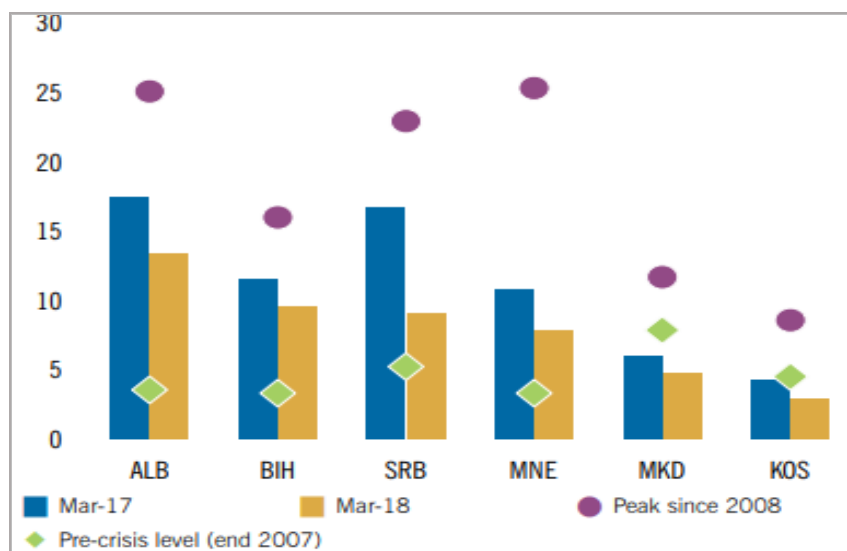


Figure 2. NPLs as Percent of Total Loans, Source: World Bank

#### 4. CONCLUSIONS

Although NPLs are still high in most countries, improving asset quality is helping drive credit growth. While NPLs in Albania have steadily declined from over 20 percent at peak to 13.3 percent as of June, that is still the highest in the region; at 2.8 percent, Kosovo has the lowest NPLs. Banks in the Western Balkans remain well-capitalized, though further bank consolidation is still expected.

The increase of non-performing loans in the Albanian banking system has made many banking field researchers try to find the key factors that have brought this progressive and disturbing augmentation. Buying financial products with high risk, strengthening banking supervision and screening of banks, taking decision based on a strong analysis of the cost-benefit, etc. are the suggestions provided by some economic experts in order to decrease the level of non-performing loans in the Albanian banking system, which remains among the highest in the region, at about 19%.

Banks should fully reflect the size of non-performing loans and create adequate reserves for credit risk losses. In the portfolio of non-performing loans, banks should identify clients with temporary and transient problems, and develop policies for them that provide support in exchange for adding elements that protect the bank from the risk of such loans in the future. For clients who value a low credit repayment option, banks must firmly follow legal procedures for executing guarantees and other forms of collateral to recover as much credit as possible.

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