CORPORATE GOVERNANCE IN BALKAN FINANCIAL INSTITUTION, CASE OF ALBANIA

Rezart Dibra*, Jetmir Bodini**

Abstract

Corporate governance has at its backbone a set of transparent relationships between an institution's management, its board, shareholders and other stakeholders. In this article, in the first part, the nature and purpose of corporate governance has been discussed with special emphasis on the problems of banks in the field of corporate governance.

Corporate governance involves regulatory and market mechanisms, and the roles and relationships between a company's management, its board, its shareholders and other stakeholders, and the goals for which the corporation is governed. Lately, corporate governance has been comprehensively defined as "a system of law and sound approaches by which corporations are directed and controlled focusing on the internal and external corporate structures with the intention of monitoring the actions of management and directors and thereby mitigating agency risks which may stem from the misdeeds of corporate officers.

The financial crisis exposed flaws throughout financial markets and prompted much investigation into the way banks work. The '2008 crisis in the financial industry, among other causes, brought to light the conflict of interest between achieving aggressive results by the executives in order to obtain bonuses and the long-term risk associated with the commercial company in its business.

This paper focuses on one line of investigation—the corporate governance of banks. It examines why governance of banks differs from governance of nonfinancial firms and where the governance of banks failed during the crisis; it also offers recommendations for improving the governance system. Bank governance has been the topic of much recent academic work and policy discussion (Senior Supervisors Group 2008, 2009; Walker Report 2009; Committee of European Banking Supervisors 2010). Because of their contemporaneous nature, there has been little connection between the academic approach and policy analysis. The purpose of this paper is to make such connections and ground the policy debate on scientific evidence.

The Corporate Governance in banks is one of the most important discussions overall the world, being reinforced especially after the crises period. It is related with the sensitive situation and the stage of developments of the local economy and moreover with the impact of the crises that is still ongoing. As an answer, during late 2008 and beginning 2009, it has been noticed a fast reaction and total focus from all banks on building (if missing) and improving their structures of Corporate Governance. The liquidity problems suddenly affecting the banking sector constrained Banks to enlarge their activities /operations and forced them in better evaluating their investments.

The importance of a strong financial sector in impacting the country's economy growth through both level of banking development and stock market liquidity (Levine and Sara Zervos 1996, 1998) is quite evident even in the developing countries. Moreover, Peter Rousseau and Watchel (2000) findings' confirm the positive impact of the stock market activity and the banking development. For this reason the governments in the developing countries are insisting in increasing credits of banks towards the private firms.

The banking system in Bulgaria, Romania, Serbia and Albania has certain similarities in terms of development stage, related with the economic growth rate as well.

The banking system there is operating for more than 100 years instead of 15-20 years of development in the remaining countries.

Keywords: Corporate Governance, Banking Sector, Board of Directors, the Principles, Best Practices

**European University of Tirana (UET)*
Email: rezartdibra@yahoo.com.
***University of Tirana, Economics Faculty*
Email: jetmir.bodini@yahoo.com

This paper was accepted to be presented at the conference in Paris (April 18-19, 2013).

1. Introduction

Corporate governance has at its backbone a set of transparent relationships between an institution's management, its board, shareholders and other stakeholders. It, therefore, needs to take into account a number of aspects such as, enhancement of shareholder value, protection of shareholder rights, composition and role of board of directors, integrity of accounting practices and disclosure norms and internal control system. In a service industry like banking, corporate governance relates to the manner in which the business and affairs of individual banks are directed and managed by their board of directors and senior management. It also provides the structure through which the objectives of the institutions are set, the strategy for attaining them is determined and the performance of the institution is monitored.

Virtually every major industrialized country as well as the Organization for Economic Co-operation and Development and the World Bank has made efforts in recent years to refine their views on how large industrial corporations should be organized and governed. Academics in both law and economics have also been intensely focused on corporate governance. Oddly enough, in spite the general focus on this topic, very little attention has been given to the corporate governance of banks.

Corporate Governance in banks in the Balkan countries is a new concept introduced gradually in the respective banking systems. It is part of the European integration process and imposed through the OEDC and Basel Committee principles. Aiming at enhancing the local economic growth and increasing the attractiveness of the Balkan countries for foreign investments, these institutions are monitoring and recommending the compliance of the local countries with the principles of Corporate Governance.

The fast expansion of the banking system mainly performed during the last 15 years, was not associated by a fast establishment of structures to support good corporate governance. Especially after "post-socialist" period, Balkan countries are experiencing different growth trajectories. However, the growth rate differs from one country to the other and is expected for these countries that the intensive market capitalization will lead to financial market volatility.

Balkan countries, after the financial crises in the region during the period 1996-1998and along with the initiation of the banking sector privatization, were the target of many international groups for expanding their network in the region. For the last 10 years, the strategy followed was focused in increasing market share through rapid expansion and sale of aggressive products with soft pricing policy, especially in lending activities, etc. Taking into account the necessity of the local economies for new fund injected in order to support the development and evaluating the important positioning of banks in their development prospects, the local governments become the major support for these fast expansion and growth of the banking system.

Under these circumstances, international institutions like EBRD, OEDC and Basel Committee were providing the local banking supervision and other regulatory authorities with assistance in promoting the adoption of the sound corporate governance practices in the region. Their frequent monitoring and assessment on the subject resulted that apart from the similarities of the banking systems throughout the Balkan countries there were different structural approaches to corporate governance from country to country. Therefore, their guidelines were given taking into account these differences and emphasizing the importance of the sound corporate governance in the quality of the banking supervision. (Enhancing Corporate Governance for Banking Organizations, Basel Committee, 1999).

As per the Basel Committee, the primary responsibility for good corporate governance remains with the board of directors and senior management of the banks. Since the local regulations on this subject differ from country to country, Basel Committee principles assists and guides the supervisory authorities in enhancing and standardizing the local corporate governance. They give a detailed guide on the respective responsibilities of the board of directors and management in terms of setting bank strategies for operations and defining clearly the accountability and responsibilities. Transparency of information regarding decisions and actions, current conditions or other disclosures given to the public is considered as other important issue for which board of directors and senior management should be responsible.

The above items complete the sound framework of the corporate governance structure contributing as well to the enhancement of the banking sector.

Therefore, especially after the crises started, early 2008, a stronger presence of central banks towards second tier banks in terms of increasing the internal control levels was evidenced. The advisory role of the central banks shifted immediately to the imposing one through new instruction and regulations especially on the following subjects:

– Segregation of duties and improvement of control levels

– Related parties with banks, including executives and administrators

– Detailed monitoring of liquidity position of banks and analyzing of funds movements from / to mother companies

– Definition of basic requirements for BOD and Audit Committees functioning

In addition, there was an enhancement in the frequency of reporting of banks towards the supervision and the items monitored were enlarged and detailed. The monitoring process requests as well for banks to provide the banking supervision with several stress tests for capital and liquidity position, provisioning policy and impairment funds, loans to deposits ratio, etc.

2. Albania. Corporate governance in the Albanian banks

Changes in the corporate governance components tune the Albanian banking system with the right and core requirement for a healthy system, that is, quality and responsible corporate governance. As OECD puts it : *"... that, corporate governance weaknesses in remuneration, risk management, board practices and the exercise of shareholder rights had played an important role in the development of the financial crisis and that such weaknesses extended to companies more generally*".

The first amendment in the framework of corporate governance of banks in one the mandate of members of Board of Directors (supervisory board), the decision making and the (supervisory board), the decision making and the supervisory organ of banks. It has become fix " for a period of 4 years" instead of "for a period not longer than 4 years" that was before. This amendment has an important consequence on increasing the responsibility of the members of the board of directors. The existing law would allow for a shorter mandate of the members. In this case, their decision making could be focused more on short-term consequences of the bank not taking much care for the long-run effects. Whereas, the four year fix mandate obliges them to take care of longer term consequences in the bank. Moreover, it increases the effectiveness of the board of directors that could be threatened with continuously changing members. The second amendment has to do with the composition of the board of directors that makes mandatory the majority of the members to be independent-not connected with interest to the bank, the shareholders or its executive directors. Increasing the number of independent members (from one third of the members that was before) contributes in getting objective and un-biased economic decisions that would protect the bank and its shareholders against possible conflict of interest. Of course, this creates ground of protecting more the interest of other stakeholders as well, like depositors.

The banking system in Albania is one of the newest in the area, starting with the privatization of one of the first state owned banks in 1994. Two years later, the two foreign banks, Piraeus Group and National bank of Greece entered in Albania by establishing the Tirana Bank and the National Bank of Greece, Albania Branch. It was followed by the opening of 8 other banks during the period 1998 - 2000. It was the start of the banking system for Albania that currently is composed by 16 Banks. The selected banks compose 92% of the banking system in terms of assets and are all owned by international groups (refer to the attachment no.1). As common characteristic of the selected banks, the Board of Directors is composed by the managers of the group (from different areas of the entity such as finance, treasury, products development and marketing, etc.) and only two or three members are executive directors of the subsidiary. The presence of the local management though is quite invisible since mainly the top management of subsidiaries of foreign groups is not local staff, but expatriates. In this framework, there are efforts from the central bank recommending in increasing the presence of the local staff in the Top Management level of banks, as well as in the Board of Directors composition. The target is to increase the efficiency of the decision making process by involving the local management, that is in charge of daily running the bank, and to have the proper expertise in evaluating the local market.

The interests of stakeholders as well (depositors for banks) are not protected through specific principles, but it is limited to a law for the deposits security which still is not complete and clear for the stakeholders and banks. Moreover the frequent reports of deposits insurance is not compulsory for all banks, it is requested in specific cases and mainly during the yearly inspection by the respective Agency for Deposits' Insurance.

It is recently noticed an active role of the Association of Banks in collaboration with the central bank by organizing common workshops with second tier banks with focus on corporate governance.

3.Improvement of corporate governance at Albanian banks

Effective practices of corporate governance are essential for achieving and maintaining public trust and confidence in the banking system, both very crucial for the proper functioning of the banking sector and economy as a whole. Poor corporate governance leads to bankruptcy of the bank, which may cause public costs and consequences considering the impact on the deposit system, and the consequences may spread on a wider macroeconomic scope, as may be the risk and impact to the payment systems. In addition, weak corporate governance can lead markets to lose confidence in the bank's ability to manage it's assets and liquidity, including deposits, which may in turn lead the bank toward a liquidity crisis. The recent changes to the law" On banks in the Republic of Albania" stipulate some of the principles of good corporate governance, one of them being the composition of the board of directors. Stipulating in the banking Law the principles of "loyalty" and the "conflict of interest", not only with regards to managers and directors but also to members of the management or directors board and shareholders, is the concrete expression of the principle of the reliability obligation of the above mentioned persons to perform their duties, set out in the law and the charter, trustworthily and in the best interests of the society as a whole. Board members must have the right qualification for their positions, a clear understanding of their role in the governance of the bank, and be able to provide a sound judgment about its matters, and this does not apply only to financial institutions. Shortcomings in the composition and authority given to Boards have been evident and widely disputed. The remuneration of board members and senior managers also remains a very controversial issues that emerged in the OECD report regarding the lessons learned from the 2008 financial crisis, where the banking sector was hit most. The crises in the financial institutions in 2008 have been described as the most serious financial crisis, since the Great Depression. By mid 2008 it was clear that the crisis in the USA along with the lack of liquidity had a major impact on financial institutions and banks in many countries.

4. Corporate governance and banks' performance

It is a fact that in the Balkan countries the Banks, especially the penetration of foreign groups was very aggressive during the last 10 years. The research shows at a great extend that along with the expansion in the local markets, banks were giving importance to the internal control policies as well and the establishment of corporate governance policies. The structures were accompanied by clear definition of tasks and responsibilities and moreover by a review of reporting lines and segregation of duties. The flow of operations is revised in order to be split between front line (business development) and back office by avoiding having the closed circle of operation within the same authority.

It was noticed that the expansion of the bigger banks, having well established structures and strong corporate governance was strongly related with the growth rate of this banks in the Balkan region. The existence of fixed organizational structures and clear definition of reporting lines and accountability provides for an improvement of the internal control, as well as a very efficient operational activity with clearly defined roles and responsibilities.

From the analysis performed in the annual reports of banks, banks having proper corporate governance structures were the better performing in the local market in terms of profitability as well. They used to have a gradual but controllable increase of profitability after the first years of establishment. Banks like Raiffeisen, Alpha Bank, and National Bank of Greece followed a fast expansion during the first years of their establishment tin the Balkan countries and gradually increased their respective market share. Currently, they have the majority of the respective markets in terms not only of assets but profitability and number of clientele. (reference is made to Annual Reports of the banks for the year 2008; no full data were available for year 2009).

The sound corporate governance policy supported the fast expansion and the increase of efficiency of these banks; in the respective markets they are market makers and very efficient in market innovations.

Assets held by banks and non-bank financial institutions (2005)

	Total assets (in Euro billion)	Share of total assets in GDP %	Share of bank assets in total assets %	Branches /000 000 inhabitants	ROA	ROE
Albania	4.2	62.3	78.6	3	1.3	21.1
Serbia	10.5	57.9	88.6	4	0.9	5.8
Bulgaria	19.6	91.3	85.8	9	2	21.6
Romania	42.1	53.2	84.1	14	1.7	12.9

Sources: ECB (for EU countries' banking sector data), EBRD, IMF and national sources.

From the data presented in the table, it is easily verified what we have stated during our analysis per country, that the majority of the country assets in all the Balkan countries is owned by the financial institution (banks and non-banks). For this reason of the high capitalization of the local markets, the financial crises had less impact in the region rather than in the rest of the world. (data taken from the ECB Monthly Bulleting 2006).

It is evident that even the expansion of the banks in the region has similarities; the concentration is more or less at the same levels except Romania. As pointed above the banking sector in Romania is the largest one compared to the remaining countries.

The average ROE for the 17 countries of the Central and Eastern Europe that were subject of study from the ECB report (2005) is 15.27%; meanwhile the ROE of the countries in Balkan areas is higher than the average (excluding Serbia), showing for a higher return of banks in these countries compared to the remaining ones. Until the year 2008 the profitability ratios continued to increase for the banking sector in Balkan and this can be demonstrated by the Financial Statements of each bank and increasing trend of the yearly profits.

Even the ROA indicator for these countries is better than the average one of the 17 countries which stands at the level 1.4%. Therefore the commercial performance of banks in the Balkan countries despite the short period of expansion is at very satisfactory levels.

In such way, it is supported the fact that a sound corporate governance structure is positively impacting the banking sector performance in the Balkan countries. A special case remains Albania that has no corporate governance structure and still the performance of the banking sector is one of the best in the region. One explanation may be the fact that 15 out of 16 banks in Albania belong to foreign banking groups and their corporate governance policy is propagated in the country's subsidiaries as well. Another explanation is that apart from the good performance of the banking system, the size of it compared to the other countries remains still as low level due to the current potential of the local market.

Moreover, if we analyze the statistics in the table below we can see that there are considerable differences in the level of credits in the private sector and no similarities regarding the interest rates for loans. The level of credits for private sector in Bulgaria is the highest one, approximately the sum of the three remaining countries (Albania, Serbia and Romania), by maintaining a very low balance of bad loans at the same time. From the other side, Albania by applying high rates for lending towards private sector has the lowest level of financing and with the highest bad loans balance.

Financing indicators for developing countries in 2007

COUNTRY	Private sector loans / GDP	Deposits Int. rates	Loans Int. Rates	Bad Loans
Albania	26.1	4	14.23	3.7
Serbia	47.5	4.1	11	na
Bulgaria	89.8	4.74	10.8	2.5
Romania	29.5	3	11	1.46
Greece	na	0.9	8	na

Source: EBRD Transition Report 2008

In Albania, Raiffeisen Bank is the leader of the market in all aspects, followed by Intesa San Paolo and Alpha Bank (in terms of assets and profitability). In Greece, National Bank of Greece, Eurobank and Alpha Bank are the market leaders in the same framework. In Bulgaria Unicredit and Raiffeisen are the leaders;

in Romania the market is headed by Societe Generale, Eurobank, Raiffeisen and Alpha Bank. Similar situation is happening in Serbia where the market is shared between Intesa San Paolo, Raiffeisen and Eurobank. By the end, in Albania the market is headed by Raiffeisen, Intesa and other banks with Greek interest. The steady structure of the above banks seems to be autocratic in most of the cases but it fully complies with the principles of the good corporate governance. (see organizational charts attached)

As mentioned above, the fact that these banks are European groups, it is compulsory for them to apply in their branches or subsidiaries the same principles of the corporate governance of the group. Therefore the policy and best practice has been propagated in the Balkan countries by improving even the overall banking system.

The application of such sound principles in the major banks is the most important factor for their good financial performance.

5. Corporate governance and supervisory authorities

It is a fact that banking supervision and the local government play an important role in building and maintaining a sound corporate governance structure. International institutions like EBRD, OEDC and IMF are frequently assisting the supervision in establishing and improving a proper regulatory framework for corporate governance.

Bulgaria and Romania, being part of the European Union are obliged to comply and as shown by the results of the research are countries with established regulations and laws, as well as with good practices in corporate governance, especially in the banking sector. Central Banks have been very active in introducing frequently regulations regarding portfolio risk management; capital markets and banking transparency; management principles of banks and branches of foreign banks and the criteria on the approval of their administrators, etc. (refer to attachment No.2)

The issuance of such regulations is imposing banks to comply and to enhance their internal control environment. The frequent inspections from central banks in order to control the correct application of such instructions verify the importance they re giving to the corporate governance principles.

6. Conclusions and Recommendations

There exist many studies that conclude that though not being a source, the corporate governance plays a key role in development of crisis. The ongoing problems in the European financial markets transfer their negative effects to Albania in different ways especially considering the fact that biggest share of the banks here is owned by European banks. Moreover, all the latest financial problems have contributed to negative reputation of banks and loss of trust by the public. Eventually, improving the corporate governance of the banks can be considered an important measure beside others. Improvement of corporate governance definitely will contribute to the creation of a better, stronger and more sustainable banking system in Albania. However, though the corporate governance principles guided by best practices are globally sound their application in markets like Albania poses considerable challenges.

From the analysis, it was seen that a strong corporate governance structure has a positive impact on the banking system performance (profitability ratios table); however, there were limitation on the analysis per bank.

In terms of recommendations, the most important one is addressed to the enhancement of the corporate governance principles in the Balkan countries complying fully with the OEDC and Basel Committee principles and instructions. In addition, frequent monitoring tools for controlling the application of such principles in the countries should be in place. The fact that these countries are developing countries and with a fast banking system growth for the last years make them more sensitive and difficult to be monitored.

Moreover, banks themselves must be more careful on certain issues like duality and internal control functions. A better definition of reporting and accountability is needed and as well the transparency is required.

The application of the corporate governance principles will ensure a better economical environment for companies and especially for banks. This is necessary taking into account the difficulties of the current situation in the country, where banks are reluctant in supporting the private companies with financings. If such situation will continue, the local economy will start to face serious problems and companies will suffer the lack of liquidity. One of the major reasons why banks reduced the lending activity is the loss of confidence in the local government to protect their contract rights and to speed up the execution process of properties for defaulted customers. In both directions the government is not proceeding by creating grounds to banks not to support the local economy. From the other side, taking into consideration that the lending activity is the most profitable activity of banks in the country, this issue is becoming more serious since banks will start to decrease their profit margins.

Another reason why banks are losing the confidence towards the government is the fact that even the public financings given recently to the government are experiencing difficulties in repayment due to the difficulties of the government.

Therefore, the enhancement of the local corporate governance framework will serve as a good support for banks and will reverse the current situation in favor of the economic market.

Thanks to the deposit insurance subsidy, shareholders in banks have created incentives for taking risks and maximizing leverage, at a substantial cost to other stakeholders. This effect has been amplified in recent years as banks have been able to push into newer, more complex activities and have thus broadened their scope. The nature of these businesses has made it difficult for regulators to keep pace with the changes and analyze the implications of the expansion.

References

1. Acharya, V. V., I. Gujral, and H.-S. Shin. Forthcoming. “Dividends and Bank Capital in the Financial Crisis of 2007–2009.” Journal of Applied Corporate Finance.
2. Acharya, V. V., P. Schnabl, and G. Suarez. 2010. “Securitization without Risk Transfer.” Working Paper 15730, National Bureau of Economic Research, Cambridge, MA.
3. OEDC Publication (2004) Corporate Governance – A survey of OEDC countries.
4. Clarke. T (2007) International Corporate Governance – A comparative approach.
5. Caprio, G. Jr., Levine, R., 2002. Corporate Governance of Banks: Concepts and International Observations, Financial Sector Governance: The Roles of the Public And Private Sectors, Washington DC: The Brookings Institution.
6. Levine, R., 2003. The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence, Discussion Paper No. 3, Global Corporate Governance Forum Catching up their Integration in the European Financial System, Fabienne Bonetto, Srdjan Redzepagic, Anna Tykhonenko, Panoeconomicus, 2009.
7. EBRD, Principles of Corporate Governance, Standard report Greece, October 2008.
8. Enhancing Corporate Governance for Banking Organizations, Basel Committee, 1999.
9. Corporate Governance of Banks in Developing Economies: Concepts and Issues, Arun & Turner.
10. Tonucci & Partners, Corporate Governance Legislation Assessment Project for Albania, 2007, www.ebrd.com.
11. Shleifer Andrei, Vishny W. Robert., “A Survey of Corporate Governance”, Journal of finance Vol. 52, pp. 737, 783, 1997.

Samples of organizational charts of the banks in the Balkan area

Figure 1. Organizational chart of National Bank of Greece, Greece

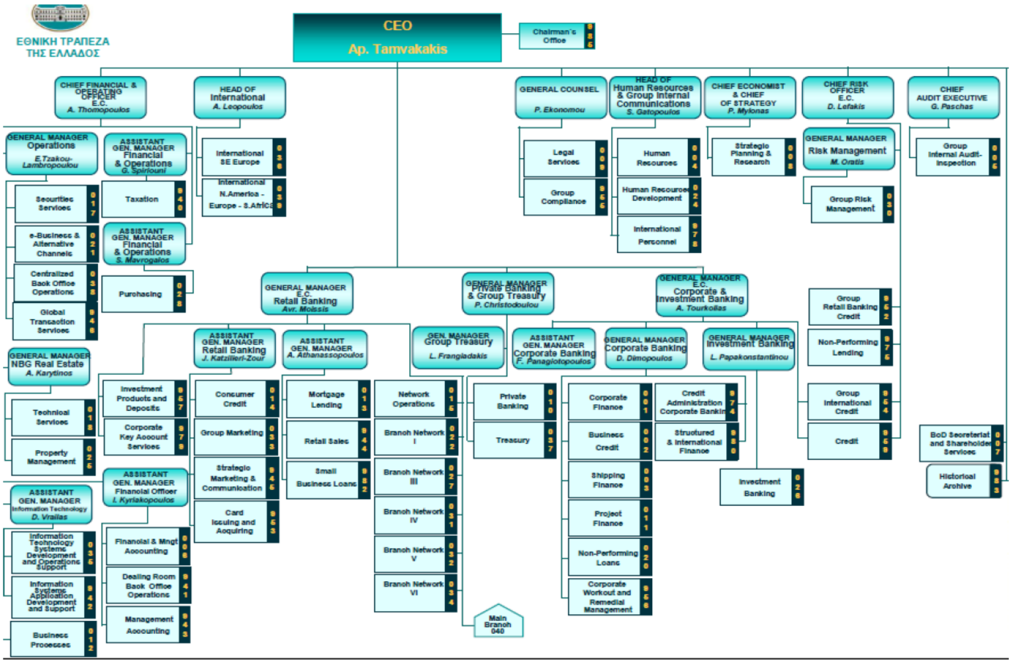


Figure 2. Organizational chart of Alpha Bank, Serbia

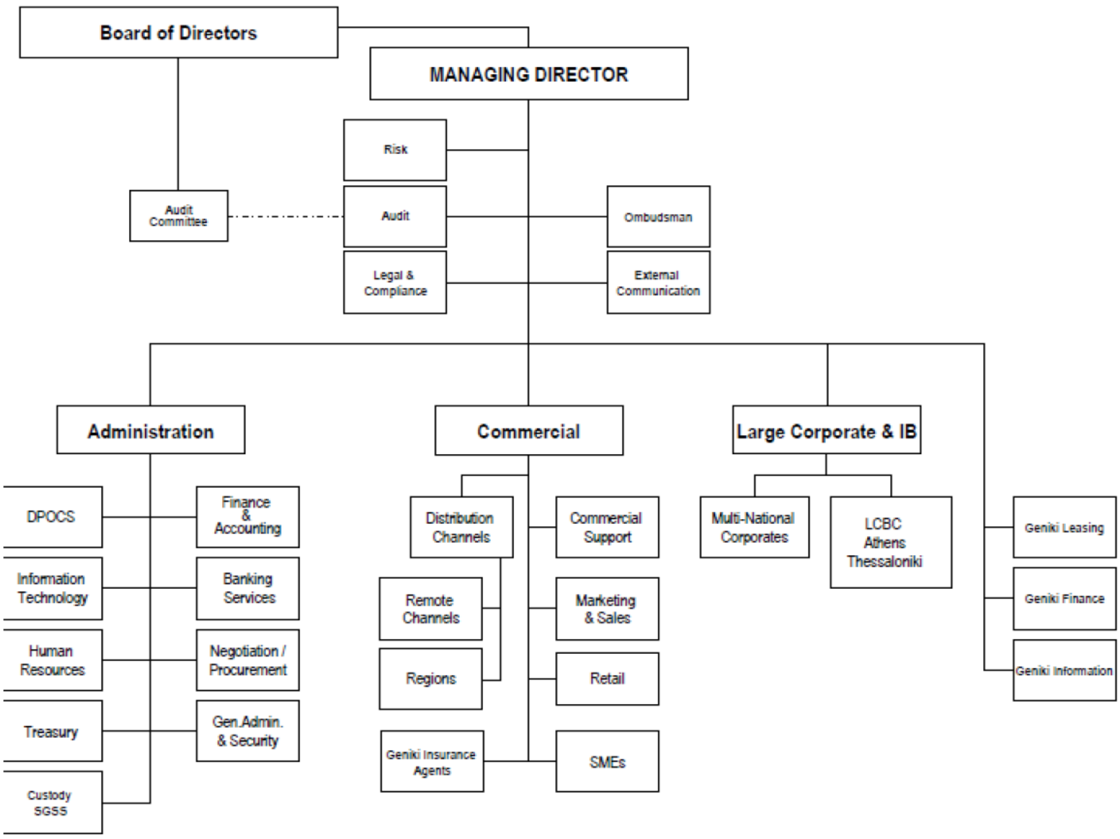
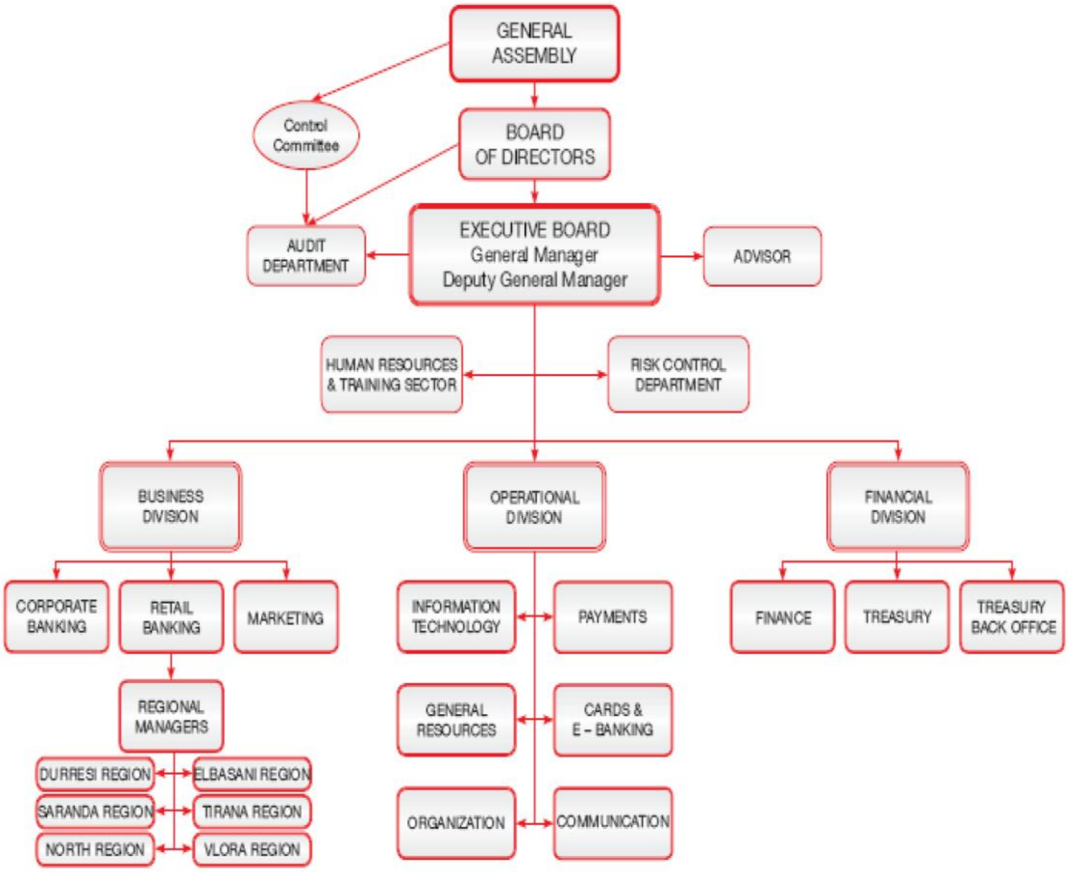


Figure 3. Organizational chart of Societe Generale, Albania



Attachment 1

Central Bank of Albania Regulations ruling Corporate Governance of the Banking System
Regulation no 71 "On liquidity risk management"
The purpose of this Regulation is to set out the minimum requirements and standards to effectively manage risk liquidity, by the subjects of this Regulation. This regulation shall apply on banks and branches of foreign banks exercising banking and financial activity in the Repu...
Aproved by Supervisory Council Entered into force 07.12.2009
Regulation on 38 "On the Operation of the Credit Registry in the Bank of Albania"
The purpose of this Regulation is to lay down the general rules on the organisation and operation of the Credit Registry at the Bank of Albania....
Aproved by Supervisory Council Entered into force 15.08.2009
Regulation no 44 "On prevention of money laundering and terrorist financing"
This Regulation lays down the procedures and documentation for the identification of customer, regulations for record-keeping, preservation of data and their reporting to the responsible authority from the subjects of this Regulation. Its purpose is the prevention of the use of t...
Aproved by Supervisory Council Entered into force 02.08.2009
Regulation no 52 "On credit risk management"
The purpose of this regulation is to provide guidance to credit risk management in order for the Bank to minimize possible losses from loans and other comparable assets, susceptible to interest rate fluctuations....
Aproved by Supervisory Council Entered into force 02.08.2009
Regulation no 31 "On risk management arising from the large exposures of Banks"
The purpose of this Regulation is to set out the rules and criteria on the calculation, supervision and reporting of the bank's large exposures against a counterparty or group of related counterparties, for the purpose to manage the risk arising from the concentrated exposu...

Aproved by Supervisory Council Entered into force 02.08.2009.
The Law no.10481, dated 17.11.2011 "On some changes and amendments to the Law "On Banks in the Republic of Albania". Article 8 of this law specifies certain changes to article 355 of the law on banks, tipically,at the point 2 the wording " at least one third" is replaced with "the majority". It refers to the number of the board members, with no conflict of interest, in a bank's Board of Directors. This amendments, is a novelty in the Albanian experience of corporate governance, marking a new advanced standard, in the field of management and administration of joint stock companies in the banking industry.