

## Government Participation in Bad Debts Resolution; Case of Kosovo and Albania

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### Abstract

Banks need to make thorough analysis and take into consideration all the potential risks that arise related to their lending, preventing bad loans mostly during economic slowdown. The Non-Performing Loans (now on referred as NPL) in Kosovo continued falling from 8.7% as it was in 2013 to 8.3% in 2014. While in 2014 NPL level decreased, the provisioning for loans continued to increase from 110.5% to 114.4%. This is a positive toward any unexpected situation. Lost loans have continued to increase in moderated way for the last four years. Banking Sector in Albania since the last economic recession entered into third period of development which shows huge problems with high NPL ratio, credit shrink, lower banks' profitability and intensive attempts to introduce stabilizing mechanisms. NPL ratio was the highest in South East Europe Countries (now on referred as SEEC) region, number of outstanding loans tended to decrease such as profit in banking sectors. As a response to highest NPL ratio compared to world level, Kosovo authority has set only guidelines for restructuring and monitoring the process of regularity. This provides banks with a wide range of autonomy in the procedures of restructuring. Authority in Albania has been active in the process of normalizing the system. In 2013 has introduced the guideline on corporate loan restructuring. The guideline promotes 12 principles.

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**Key Words:** Banking sector in Kosovo and Albania; Non-Performing Loans; Corporate Debt Restructuring; Credit Quality; Good Loans versus Bad Loans; Government approach

## 1. Conceptual discussion

In order to support the growth and development of the economy, banks provide various products. Loans are main product of banks participating up to 70-80% of banks revenue and represent the main source of funding. Kosovo economy after war period, matches a smooth trend of growth, this trend of growth continued even during the crisis. Such growth is due to several factors as: private consumption, private and public investments where loans from banking sector have a critical role in their financing (Badivuku-Pantina and Borza, 2012).

While banks provide loans, they should be very responsible for their quality. The whole literature suggests that banks need to make deep analysis and take in consideration all the potential risks that arise related to their lending. This because any decision without detailed analysis covering all potential risks might lead to a wrong lending decision. As result of default to perform such requirements, the financial system faces problems. During this period, a coordination of risks is required. The best description of risk coordination is an attempt to coordinate possible costs and unproductive decision made as result of difficulties that the banks face due to the troubles of debtors (Brunner & Krahn, 2008). During the crisis are identified two reactions of banks in distress period, providing more fresh money and tightening the credit lines (Brunner and Krahn, 2001).

### 1.1 Good versus Bad loans

As we mentioned in the beginning, the high level of loans participation in financing the investments in private sector, the loans with troubles that have difficulties to be paid, are expected. Lawrence and Arshadi (1995) raised a very interesting discussion about what a "good" and "bad" loan means to a bank. Bad debt is a state of low return realization by particular company which disables the possibilities to meet its contractual repayment obligation (Brunner and Krahn, 2001). The necessity to distinguish bad debt from good debt is due to the fact that a notable number of loans are considered to be late in payments, but not so late to be considered as lost credits.

The life cycle of loans where we can identify four main phases: application, loan management, marketing to existing clients, channels management. The bad loans occur in channels management phase when loans start having delays. But, the question is if only this phase should be analyzed related to the quality of loans and potential delays. The phases of crediting are tightly connected. Any mistake in the process can cause problems for the bank to get the repayments.

### **1.2 Credit quality in economic recession**

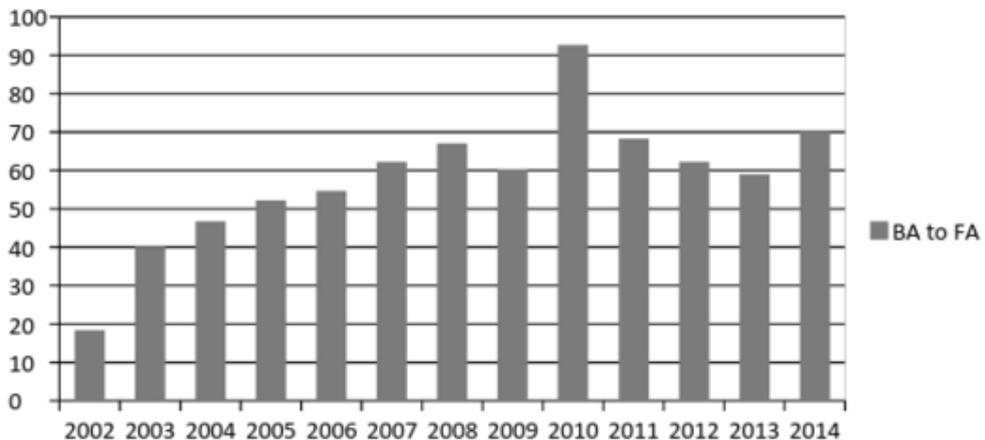
Generally, during economic slowdown, corporates experience numerous defaults and challenges to repay loans on time, so NPL ratio will increase significantly. Difficult time for corporate emerges as result of asset prices, equity and real estate prices deterioration, and sharp real interest rate increases (Claessens et al, 2001). The situation gets more complicated for transition countries which are less experienced (De Haas and Knobloch, 2010). According to (Grigorian and Raeli, 2013) the widely extended corporate debt problems produced negative effects in various dimensions. At first, working capital needs to secure production reduction. Second, less working capital lowers potentials to perform existing debt and exceptionally weakens the corporations 'assets. Third, the non-performing loans risk the decline in banking system capacity to provide loans.

Varesi (2014) analyzed the effects of crisis in banking sector of South East Europe Countries and evidenced that the demand for loans decreases due to economic situation as well as non-performing loans increases for the same reasons which contributed to the increase in the stress of banking sector. The worst situation is evident in Albania and Serbia where NPL ratio is doubled. Related to that, during the debt problems the stakeholders make various attempts to pass or at least to reduce the effect on the firm. According to Noe and Wang (2000) shareholders in order to acquire the confidence of creditors do not hesitate to put their personal assets or inject cash. As one of the most known cases is Jim Manzi, the former CEO of "Lotus". He gave over \$1 million to save his start-up project (Bogdan, 2011).

## 2. Overview of the banking sector in Kosovo

As reported from Central Bank of Kosovo in 2014 the number of licensed banks operating in Kosovo increased to 10 where a new bank entered the market. As presented to the Figure 1, banks hold the largest portion of assets in financial system (70.8%). We evidence that the proportion of banking assets in financial system assets can be separated in two main periods. The first period starts from 2002 to 2008 where we have a tendency of constant growth, while in the second part we have ups and downs in the level 60 % to 70%. The main products offered by banks are: loans, domestic and international payments, banking cards, banking guarantees, letter of credit, e-banking. These services are utilized through a developing system with 305 branches and sub branches, 493 ATM's, 9,039 POS and 113,171 e-banking accounts as reported by Kosovo Banking Association (now on referred as KBA).

**Figure 1:** Structure of assets of the financial system, shown in percentage



**Source:** Central Bank of Kosovo, Annual Report of the year 2014

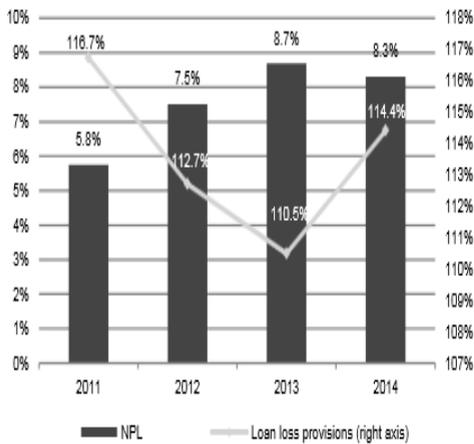
Loans are the main product participating with 70% in the assets of banks. These loans are distributed to enterprises and householders. Above 60% of these loans are provided to enterprises. Regarding the low development of hard industry and highly concentrated economy in trading, most of the enterprises' loans are oriented to trading industry as reported by Central Bank of Kosovo (now on referred as CBK).

The structure of banks' capital is dominated up to 92.8% by foreign owned banks. The foreign owned banks capital is diversified in origin. The structure of deposits contains mainly domestic deposits (79%) which guarantee independence from international financial movements. But as a serious problem appears the fact that majority of deposits are demand deposits reducing the possibility of investing for long term loans.

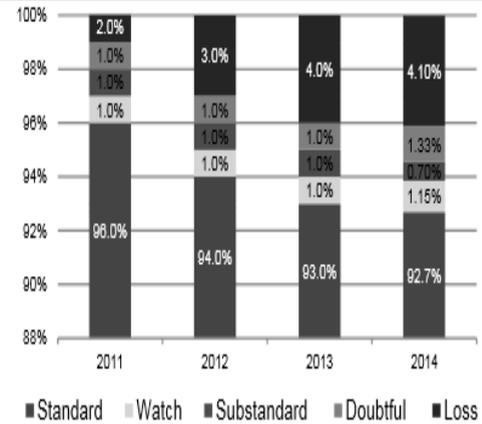
### **2.1 NPL in banks sector of Kosovo**

Even though for the first six months of the year 2014 banks have increased the support for the industry for 16.9% compared to previous year. Still, the numbers of companies that are out of financing scheme from loans is high, or face extremely unfavorable conditions of loans (Govori, 2013). The NPL in Kosovo continued falling from 8.7% as it was in 2013 to 8.3% from the year 2014.

In the quarterly report of Association for 2014, head of KBA argued that while the level of NPL of loans provided to corporates is higher than the level of NPL to loans provided to individuals 15.2%. Still banking sector would feel more secure toward crediting for businesses. While in 2014 NPL level decreased, the provisioning for loans continued to increase from 110.5% to 114.4% (Figure 2). This is considered as a positive measure from the CBK toward any unexpected situation when we could face an intensive increase in NPL level, also this is a solution for lost loans and loans with delays. The Figure (3) indicates clearly that the lost loans have continued to increase in moderated way for the last four year. Even though we have this risk that banking sector faces constantly, we can consider that the banks can extend the level of crediting toward private sector without high exposure to the risk and with focus on quality of loans.

**Figure 2:** Growth rate of total loans and NPL

Source: CBK (2015)

**Figure 3:** Structure of Loans by standard Class

Source: CBK (2015)

**Source:** Central Bank of Kosovo, Annual Report of the year 2015

### 3. Overview of the banking sector in Albania

As most of the countries in South East Europe Region, Banking System in Albania in the 90's entered into a circle of changes after the communist regime. As Kalluci (2012) deliberately elaborated, banking sector is characterized with two important periods: in the beginning of transition, operating banks concentrated their assets in short term investment, high security form of investment and cash. This form of doing business by banks weakened the chances to provide crediting products as result of vulnerabilities such as contract enforcement, lack of information, and difficult macroeconomic circumstances. The second period started in early 2000s. In this period, banking sector conditions show indices of improvement characterized by risk-averse attitude and massive lending. But, we want to complete the periods by adding the third period, which started after the economic distress when banking sector meets huge problems with high NPL ratio, credit shrink, lower banks' profitability and intensive attempts to introduce stabilizing mechanisms.

Since after the fall of regime, in the hierarchy of banking sector, Bank of Albania (now on referred as BoA) is highest bank authority enjoying attributes of central bank with full independence and, the structure of banking system consists of 16 banks (499 branches). Bank of Albania as an independent authority tries to accomplish its aims. As highest monetary and supervision authority BoA is responsible for drafting and implementing through its own mechanism the policies. Also, Bank of Albania is responsible for providing and canceling license for legal entities to perform the banking activities under its supervision. Bank of Albania carries out this authority which is in compliance with: Law "On the Bank of Albania" No. 8269 and, the Law "On banks in the Republic of Albania" No. 9662.

### **3.1 Non-performing loans as main vulnerability for the stability of banking system in Albania**

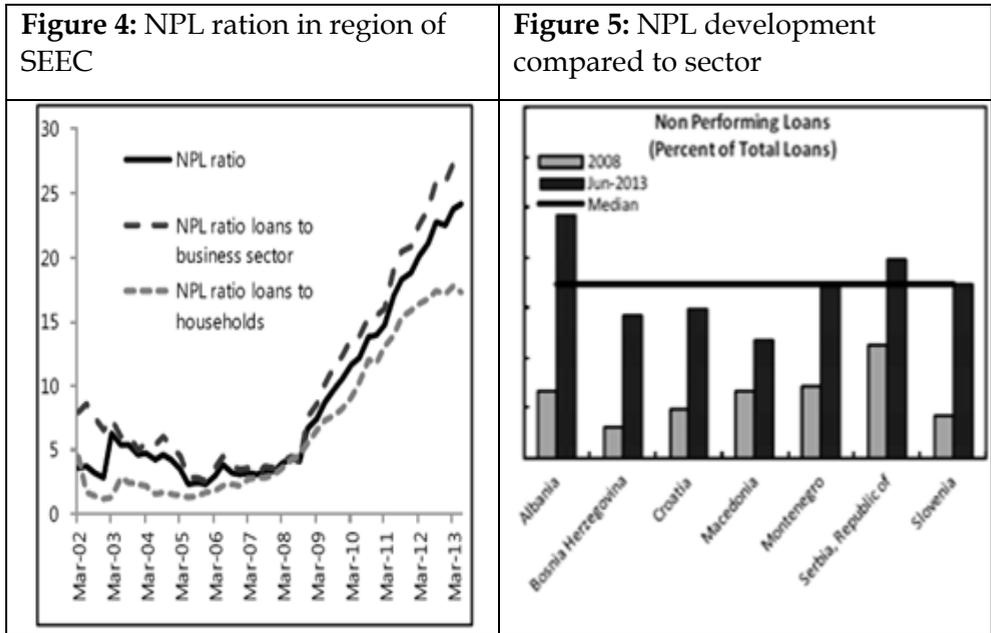
As presented in BoA Supervision Annual Report 2014 data shows these highlights in banking sector performance:

1. Outstanding level of credits increased by around 4.9%, against the fall by around 1.8% in the earlier year;
2. Gross non-performing loans fell by 0.7 rate point, remaining at 22.8% in December 2014, from 23.5% at the end of 2013;
3. Provisioning keeps on developing, at higher rates than the development in nonperforming loans. At end-2014, provisioning to non-performing loans proportion remained at 67.1%, from 65.2% in the prior year;
4. Banking sector increased its profit from 6.6 billion at end-2013 to 11.3 billion.

But, prior to this year, the banking was going through very uncommon circumstances with notable drawbacks in the process of keeping a stable financial system. As can be noted in the figure (4) NPL ratio was the highest in South East Europe Countries (now on referred as SEEC) region, number of outstanding loans tended to decrease such as profit in banking sectors. The NPL ratio tends to be the highest in loans provided to enterprises compared to householders (figure 5). NPL ratio tends to increase with years from 3.4% in 2007 to nearly 24% in 2013 reaching a very high level. This became a huge problem for banking sector in

Albania. According to IMF report NPLs rose due to the case of raise in interest rates and in the case of national currency depreciation.

Being aware of the risk that can come from this phenomenon, BoA and World Bank took certain steps to effect the huge problem for banking sector which became cancer for 50% of bank capital. As it was expected, BoA took a certain number of legal and regulatory measures with aim to reduce the NPL level and in contract to increase the crediting level.



**Source:** Albanian authorities and IMF staff calculations

**Source:** International Monetary Fund

#### 4. Government approach to restructuring of bank loans

After a broad discussion of potential losses that banking sector can meet as consequence of financial distress, we introduce the concept of debt restructuring. In this section we elaborate the fundamentals of Corporate Debt Restructuring (Now on referred as CDR) and the mechanisms applied in this process.

In the situation when banks meet problems with bad debt, they should be avoiding these behaviors of management in order to have an easier way for reviving bad loans:

- Being inactive
- Lack of willingness to undertake active measures with aim of loan recovery (restructuring).
- Attempt to window dress the problem.
- Quick profits with aim of compensating the losses coming from bad loans (Kawalec, 2002).

Strengthening the sustainability of banks' business models consists of higher capitalization, stable, local funding base of subsidiaries, Group recovery and resolution plans (Recuperation arrangements: Enabling firms to arrange how they would attempt to recoup from seriously unfavorable conditions. Resolution arrangement: Providing a guide to resolve distressed firms in a way that minimizes the effect on financial stability) representing restructuring (Reading and National Bank, 2012). Broadly described, the concept of debt restructuring could be as mutations in the development of credit processes for the ongoing loans granted from the bank. This process aims to examine the possible adjustments that could happen in the loan and related to the loan. In other terms, such changes might happen in both direction and may touch both the global dimensions of debt process or in some of features of the loan (Bogdan, 2011).

A firm that has difficulties to repay the debt that aims avoidance of default, meets two alternatives; bankruptcy or renegotiation of credit contract with creditor either privately or institutionally (Gilson et al, 1990). Corporates can run private debt restructuring applied mainly to revive medium corporates. In case the debt increases significantly, then it risks for a potential transfer of private debt to government balance sheets. In such circumstances involvement of state is necessary (Laryea, 2010), (Grigorian, 2013). During the history, US government has intervened with packages of support for companies in financial distress. Carter administration in December 1979 issued \$1.5 billion federal loan guarantee to prevent the failure of a large American manufacturer as Chrysler (Canis and Webel, 2013). Out of court, in other way, known as the London Approach involves debt restructuring process run out of court where are involved "creditor, debtor information sharing, a basic standstill, and a transparent negotiation of restructured debt terms based on a respect for contracts and a common perception of sustainable debt levels" (Insol international, 2013). London Approach requires a mediator which can be a private, public entity or government itself. The role of mediator will be in terms of arbitrating the

process and the state through co-financing (Dedu et al., 2009). Government also is responsible to set general framework or shape, useful for creditors in order to organize the process of restructuring De Haas and Knobloch (2010).

During the economic crisis, several times involvement of the governments to settle ongoing problematic loans, happens through restructuring process. The governments can have several approaches in this process and might influence with different mechanisms. De Haas and Knobloch (2010) identified three approaches: “decentralized, semi-centralized and centralized approaches”. A centralized approach is applied if the scale of the problematic loan might influence economic stability or if responsible institutions’ capacity is not enough to run this process. Semi-decentralized restructuring is where troubled assets of problematic banks are taken under semi-private or state asset management institution”. The most known case is Swedish approach of 1990s, where a state-owned asset management corporation took over 21% of the assets of problematic banks (Laeven and Laryea, 2009). As third approach is decentralized approach (case-by-case work-outs). This approach is applicable for majority of transitional countries involving Kosovo and Albania. But, due to the high complication it is in need to have active authority charged with the obligation to provide necessary legal and regulatory infrastructure. Following this logic, the Bank of Thailand established the Corporate Debt Restructuring Advisory Committee (CDRAC) and framework for corporate debt restructuring (Dasri, 2000). After this, we automatically face the question, is the state the only one that should take several measures and establish particular bodies? Kawalec (2002) argued that bank should separate Bad loan portfolio (BLP) and transferring it on the responsibility of a specialized body. This specialized body is work-out department which is separated from credit department.

#### **4.1 Central Bank of Kosovo approach toward bad debt restructuring**

Related to debt with troubles, three documents are involved for regulation in Kosovo: 1. Regulation of Banks’ Capital Adequacy, 2. Law for Banks, micro-financial institutions and non-bank financial institutions, 3. Regulation for credit risk management. In this part we will elaborate each aspect related to loans with delay, according to the above mentioned norms.

Several times, as we have elaborated in other parts of literature review, assets (loans) tend to default or risk to default. For this purpose, CBK has enforced regulation for credit risk management (2013) and the document for minimal standards of risk management (2006). The regulation for credit risk management (2013) requires from the banks to develop a system of credit risk management which will be harmonized with nature, volume and banks' activities and on yearly basis reviewed. Among the others the policy of risk management contains the debt restructuring guidelines. Regulation for credit risk management (2013) makes few distinctions for the loans with delays until lost loans, in such way as:

- Past due loans-watch, substandard, doubtful and loss;
- Classified loans-substandard, doubtful and loss;
- Non-performing loans: doubtful and loss;

Authority sets some requirements for restructuring, such as:

- Banks should not reschedule loans with aim to avoid lower classification and provisioning.
- Banks are not allowed to capitalize delinquent interest or refinance to pay the interest.
- Rescheduling should happen written with payment plan, including principal and interest.
- Loans can be rescheduled only if they are classified as substandard or worse and will continue to be classified the same until loan meets "sustainable performance" (four payments of installments and interest in time) (Article 8).
- Loans to a single borrower should be classified in the same category; problems with one loan often are indicative that problems may extend to the entire credit relationship.
- In circumstances when a single debtor, or a gathering of connected debtors, have loan exposures in different financial institutions, which are classified differently, should not be categorized better than one category from the worse categorization.

As can be noticed, authority only sets guidelines for restructuring and monitoring the process of regularity. This provides banks with a wide range of autonomy in the procedures of restructuring. Regarding the fragility of Kosovo's financial system, economic cycles and experiences

from neighboring countries, it can be concluded that authority could take responsibility for a deeper detailing of the aspect of restructuring.

#### **4.2 Central Bank of Albania approach toward bad debt restructuring**

Albanian banking system has been challenged mostly from defaults of large exposures to one client. It is challenging the situation where 35 corporates holds above 60% of bad loans and above 80% of 80 corporates as it presented by Central Bank of Albania annual report. CBA has been active in the process of normalizing the system. In 2013 has introduced the guideline on corporate loan restructuring. The guideline promotes 12 principles:

- Debt Restructuring is a concession, not a right.
- Good Faith - *The essence of negotiations should be fairness, transparency and performing of parties' rights. So, the success of negotiation is related to the level of cooperation between parties.*
- Coordinated Approach - *It is applicable when parts of restructuring are more than one creditor. Creditors can establish a coordinating committee.*
- Negotiation with the Borrower - *In case of group of creditors, a representative will be appointed to run the negotiation.*
- Moratorium Period - *A period of up to 6 month will be available for the parties to find a solution.*
- Finding New Resources - *Creditor can decide to provide additional finance to the borrower.*
- Actions during the Moratorium Period - *During the moratorium the creditor agrees not to take legal action in order to execute collateral.*
- Borrower's Pledge to the Creditors during the Moratorium Period - *Borrower agrees not to take any action that might violate the repayment.*
- Borrower's Complete Transparency during the Moratorium Period and New Contractual Relationships.
- Confidentiality of information - *Creditor is obligated to keep the confidentiality of information.*
- Designing the Loan Restructuring Plan - *The outcome of negotiations should be a plan for the repayment of the loan.*
- Settlement Proposals correspond to the Parties' Rights - *The rights of creditor and borrower.*

## 5. Conclusions

Kosovo's economy after the war period shows a smooth trend of growth; this trend of growth continued even during the crisis. Banks need to do thorough analysis and take into consideration all the potential risks that arise related to their lending preventing bad loans. Mostly, during economic slowdown corporates experience numerous defaults and challenges to repay loans on time. In Kosovo above 60% of loans are provided to enterprises. Regarding the low development of heavy industry and highly concentrated economy in trading, most of the enterprises' loans are oriented to trading industry as reported by Central Bank of Kosovo (now on referred as CBK). The NPL in Kosovo continued falling from 8.7% as it was in 2013 to 8.3% in the year 2014. While in 2014 NPL level decreased, the provisioning for loans continued to increase from 110.5% to 114.4%. This is a positive trend towards any unexpected situation when we could face an intensive increase in NPL level, also this is a solution for lost loans and loans with delays. Lost loans have continued to increase in moderation for the last four years.

Banking Sector in Albania since the last economic recession enter into third period of development which shows huge problems with high NPL ratio, credit shrink, lower banks' profitability and intensive attempts to introduce stabilizing mechanisms. NPL ratio was the highest in South East Europe Countries (now on referred as SEEC) region, number of outstanding loans tended to decrease such as profit in banking sectors. The NPL ratio tends to be the highest to loans provided to enterprises compared to householders. NPL ratio tends to increase with years from 3.4% in 2007 to nearly 24% in 2013, reaching a very high level. This became a huge problem for banking sector in Albania. According to IMF report, NPLs rose due to the case of raise in interest rates and in the case of national currency depreciation.

During the economic crisis, several times involvement of the governments to settle problematic loans occurs continuously through restructuring process. The governments can have several approaches in this process and might influence with different mechanisms in three approaches: "decentralized, semi-centralized and centralized approaches". A centralized approach is applied if the scale of the problematic loan might influence economic stability or responsible institutions' capacity is not enough to run this process. Semi-decentralized restructuring is where

troubled assets of problematic banks are taken under semi-private or state asset management institution". In Kosovo authority has set only guidelines for restructuring and monitoring the process of regularity. This provides banks with a wide range of autonomy in the procedures of restructuring. Regarding the fragility of Kosovo financial system, economic cycles and experiences from neighboring countries, it can be concluded that authority could take responsibility for a deeper detailing of the aspect of restructuring. Albanian banking system has been challenged mostly from defaults of large exposures to one client. It is challenging the situation where 35 corporates hold above 60% of bad loans and above 80% from 80 corporates. CBA has been active in the process of normalizing the system. In 2013 has introduced the guideline on corporate loan restructuring. The guideline promotes 12 principles.

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