Policy Brief

FINANCIAL COOPERATION

BETWEEN ALBANIA AND SERBIA

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Background

The economic dimension of regional cooperation is a key pillar for achieving an interconnected and developed Western Balkan region. With this regard, strategic policy documents of Western Balkan countries, compiled in collaboration with EU Institutions, underline the objective of establishing a unified regional market in the Balkans. The South East Europe Strategy (SEE 2020), the central platform of economic cooperation in the Western Balkans, focuses on several shared projects in the areas of trade, tourism, transport and energy in order to foster the formation of the regional market.

Most of these projects are expected to be co-financed by the IPA II funds (approximately EUR 1 billion available for the 'Connectivity Agenda' related investments over the 2015-2020 period)[1] and by the respective countries involved in the projects. Due to the co-financing scheme, Western Balkan countries have recognized the importance of having an efficient financial cooperation with the concerned lead International

[1] Viena Summit 2015. http://ec.europa.eu/enlargement/pdf/policy-highlights/regional-cooperation/20150828_chairmans_conclusions_western_balkans_summit.pdf

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Financial Institution. Under the technical support of the European Commission, the six Western Balkan countries (WB6) have agreed to prepare yearly credible National Economic Reform Programs (NERPs). In January 2015, the WB6 countries submitted to the European Commission the first NERPs, which included macroeconomic and fiscal programs, structural reforms, and competitiveness programs, all of these along with clear timelines and detailed budgetary implications. However, despite the cooperation with International Financial Institutions, the role ofregional financial cooperationin facilitating the creation of the regional market has been less pronounced in the policy documents[2]. A regional network of financial institutions, by providing liquidity and development financing, macroeconomic surveillance and consultation, and peer review of prudential regulation, would in fact act as a function of economic development and integration in the region.

The financial sectors both in Albania and in Serbia are not well-developed, compared with the EU financial markets. More than 90% of these financial sectors is composed by banking sector. The current 'unsophisticated' financial sectors in Albania and in Serbia are a consequence of the difficulties that have been imposed by the previous socialist banking systems. The services of previous socialist banks were of little use in today's market economy, since these institutions were primarily bookkeepers for the planned allocation of resources and credits were allocated only to enterprises on the basis of planned investment priorities.

During the socialist period, Albania and the Socialist Federal Republic of Yugoslavia (SFRY) implemented different banking models[3]. Albania represented a special case within the European socialist bloc, with its constant loyalty to the classical socialist system and its isolation, while SFRY's banking sector developed parallel with the general economic reform waves and incorporated various market economic elements over time. The fundamental difference is the establishmentof a two-tier banking system in SFRY since the 1960s – thus, local banks were established and it was prohibited for the central bank to channel credits directly. However, despite this difference, throughout the socialist years, the banking system in both countries

[2] Various research (Odedokun, 1996; Rousseau and Wachtel, 1998; Rousseau and Sylla, 2005; Burhop, 2006) has shown that the development of a regional financial system improves regional economic growth.

[3] Shkelqim Cani & Sulo Haderi. Albanian Financial System in transition progress or fragility? Bank of Albania. 2002.

had limited or no experience as financial intermediary, as credit evaluators and risk managers. For this reasons, Albania and Serbia (the main successor state of SFRY) had to tackle the same challenges during the afterwards transition period towards a market economy.

The stabilization and the establishment of a market-oriented banking system in Albania and in Serbia has been part of a general stability and reform programs. Albania implemented the two-tier banking system in 1992, followed by the adoption of the central bank and commercial banking laws. On the remains of the former mono-bank, a central bank and three commercial banks were created - the Agriculture and Development Bank, the Savings Bank and the Import-Export Commercial Bank. One of them was liquidated in 1998 and another was privatized in 2000, while the largest of the three with the broader national coverage was privatized to a foreign investor only in 2003. However, the favorable development in Albania, which started after the stabilization of the economy, was abruptly shattered by the collapse of several large pyramid schemes, which held a large part of the population's savings. Due to the fact that the people have lost their savings, the consumption fell sharply, the real GDP contracted by 11 percent, while inflation exceeded 33 percent.[4]

Among the countries of the region, the largest lag in the banking sector's development could be observed within the group of Federal Republic of Yugoslavia (FRY). During the 1990s, no major banking sector restructuring took place, only certain legal documents were passed. That is why this period was considered'the lost decade'. In addition, during this period, there was an issue of frozen foreign currency deposits. The fundamental reforms in Serbia started only in the 2000s after the fall of the Milošević regime. The government eventually repaid the deposits frozen in 1991 in their currency of denominationion starting from 2002. Foreign currency deposits were repaid in full while local currency deposits had lost their value during the period of hyperinflation[5].

During transition period, banks in both countries were characterized by a very high ratio of non-performing loans (NPL), high lending rates, and lack of competition, which was coupled with an environment of transitional

[4] Elez Biberaj. Albania in Transition- Hard road to democracy 1990-2010, publishing AIIS - Tirana Times, 2001 p. 10–20

[5] Jelena Fabris. InflationTaregting in Serbia. Journal of Central Banking Theory and Practice, 2015, 2, pp. 59-74

recession and high inflation. In addition, the confidence regarding the banking system became very low, due to the painful experience of frozen foreign currency deposits and the various pyramid scheme scandals of the 1990s.

Beside these challenges, both countries benefited from several foreign banks penetrating their markets. The lack of experience regarding modern capitalist banking techniques and environment, was compensated by the parent bank-subsidiary channel. Generally, the foreign banks in transition economies were able to enhance the transfer of various benefits and resources, including, know-how, international accounting and auditing standards, managerial skills, IT technology, risk management techniques, loan monitoring methods, business network, relevant market information, product innovation[6]. Thus, foreign banks have played a major role to the region's economic transition from a socialist model to a market economy. These has also enabled the banking sector is Albania and Serbia to be reach an index of 3, based on EBRD index of banking sector. [7]

Despite these common characteristics, there is no record of financial cooperation between Albania and Serbia neither during socialist nor transition period. At a time when the formation of Balkan regional market is a priority and monetary payments are needed for these markets not to function at high costs, the question is to what extend the financial cooperation between Albania and Serbia can facilitate the formation of the regional market[8].

This policy brief aims to present the current state of financial markets in Albania and Serbia. In addition, the research reckons the common projects and challenges faced by the two financial markets and assesses the future potential cooperation. Lastly, the policy brief provides some recommendations to increase the financial cooperation between Albania and Serbia, aiming for both markets to be integratedin the larger EU financial market.

[6] Eszter Kazinczy. The transition time of the banking system in the South-East Europe. Koz-Gazdasa G. 2013/2 http://unipub.lib.uni-corvinus.hu/1242/1/kg_2013n2p151.pdf

[7] The scores are available from 1 to 4+, whereby 1 refers to minor progress beyond the establishment of the two-tier banking system, while 4+ means the adaption of the advanced industrial economies' norms

[8] Steven Fries and Anita Taci. Banking Reform and Development in transition economies. EBRD 2002 http://www.ebrd.com/downloads/research/economics/workingpapers/wp0071.pdf

State of play: Albania

The current financial system in Albania includes the banking system (banks and central bank) and other financial institutions, such as non-banks financial institutions, savings and loan associations and their unions, investment funds, insurance companies, and pension funds. Nonetheless, the banking sector has always been and still remains the dominant segment of financial intermediation sector in Albania. The banking sector is composed of 16 banks, out of the which only 2 are with Albanian capital. As at end-2015 H1, the banking sector assets averaged 90.2% of total financial system's assets, accounting for 92.7% of the GDP[9]. Two important indicators show improvements - gross non-performing loans fell by 4.58 percentage points, standing at 18.22% in December 2015, from 22.8% at the end of 2014 and capital adequacy ratio remains at 16.04%, above the regulatory minimum threshold of 12%. Banking system's profit was satisfactory at the end of 2015, about ALL 15.70 billion. In addition, the Albanian Association of Banks has declared that the Albanian banking system has continued to perform positively, marking an increase by 2.4% in the third quarter of 2016, which was mainly driven by a surplus of liquidity that banks have not found a way to invest in more profitable instruments[10]. According to unaudited data from the Albanian Association of Banks, 12 out of total 16 banks ended the third quarter with positive earnings.

The non-bank financial sector is represented by 29 non-bank financial institutions (NFBIs) and13 savings and loan associations(SLAs), which are licensed and supervised by the Bank of Albania (BoA), and insurance companies, private supplementary pension funds and investment funds licensed and supervised by the Financial Supervisory Authority of Albania(AFSA). Despite the recentyears expansion of the activity of NFBIs with new micro credit and electronic money institutions, at end-2015 H1 they accounted for2.7% of GDP, while SLAs accounted for much less, only 0.8% of GDP.

[9] Bank of Albania. Financial System 2015 H1.https://www.bankofalbania.org/web/pub/financial_system_7859_1.pdf

[10] Albanian Association of Banks. 2016. https://www.ata.gov.al/en/aab-albanias-banking-system-expanded-by-2-4-in-q3-2016/

The insurance market in Albania, as of end 2015, consisted of 10 insurance companies. In the market structure, 7 insurance companies operate their activities in the Non-Life insurance, 2 in the Life insurance and 1 composite company in the Life and Non-Life insurance[11]. One of the Non-Life insurance companies operates in the reinsurance market as well. In May 2016, market composition had an important change – 100% of the shares of INSIG sh.a, the only public insurance company, were bought by one of the other private insurance companies. The insurance market's total assets have fluctuated in the range of 1.3% - 1.7% of GDP for the period 2005-2014 and in 2015 they accounted for 1.92% of GDP.

The structure of the voluntary private pension market consists of three Management Companies, one of which manages a voluntary pension fund and also two investment funds. The other two companies manage a voluntary pension fund. The pension market appears to be negligible, accounting for only for 0.05% of GDP in end 2015. However, it is showing a higher dynamics of growth, in particularly in relation to the number of members. This has been supported by the inclusion of appropriate fiscal incentives in the fiscal package of the year 2015, which recognized as non-taxable income the employer and employee contributions to pension funds schemes, up to the limits set by law and reflected in payroll. On the other part, the investment fund market in Albania, which started operations in 2012, has increased considerably compared to the other countries in the region, being listed as the second largest market after the banking market, with assets accounting for 4.8 % of GDP.

During the post-transition years, the financial sector in Albaniahas demonstrated a dynamic growth in various aspects which were associated with the expanding range of financial products and services and their horizontally stretchingacross the territory of the Republic of Albania.The World Bank Report 2014 states that: *'The financial sector continues to face important risks, especially external ones, but it has remained stable and recently has shown improving trends'.*

Nevertheless, the Albanian financial system is relatively new and small compared to European developed economies or other emerging markets. These means that the Albanian financial system is still in the growing stage, characterized by simple procedures and transactions and the lack of sophisticated

[11] Albanian Financial Supervisory Authority. Supervision Report 2015. http://www.amf.gov.al/pdf/publikime2/mbikeqyrje/sigurime/10471_Raporti%20i%20Mbikeqyrjes%20 2015.pdf

financial products that are normally used from European financial institutions. The lack of an active stock exchange or securities market in Albania, in which banks or other financial institutions would have invested in more complex securities such as mortgage backed securities, plays also a role. Brokers operating in Albania are still in their infancy and are dependent on the public because they are unable to create additional capital through investment in the most favorable and profitable case. Most importantly, the financial sector, supervised by of BoA and AFSA, should be constantly prudential toward external risks, particularly those imposed by the European markets.

State of play: Serbia

The financial marker in Serbia is composed of 30 banks, 24 insurance undertakings, 16 lessors and 7 voluntary pension funds, all monitored by the Financial Institutions Supervisory Authority, a specialized regulatory unit within the National Bank of Serbia. The supervision of other participants in Serbian financial and capital markets, such as broker-dealers, investment funds, stock exchanges and securities clearing house are under the remit of the Securities Exchange Commission.

Banking sector has a dominant role in the financial system of Serbia, accounting for 91.6% of the total financial sector balance sheet. As of October 2016, there are 30 licensed commercial banks in Serbia, 21 of the which are in majority foreign ownership. From these foreign banks, 6 of them operate also in Alania: Alpha Bank, Intesa San Paolo, Procredit Bank, Raiffaisen Bank, Societe General Bank, Piraeus Bank/Tirana Bank.

The banking sector appears to be adequately capitalized, with increasing profitability levels, and widespread foreign ownership is bolstering the sector’s shock resistance. The results of the Serbian banking sector at end-Q4 2015 indicate improvements in banks’ profitability - the banking sector’s pre-tax net result was RSD9.7 bln (serbian dinar currency), up by 6.2 bln compared to the same period last year[12].

The insurance sector is composed by twenty undertakings that are

[12] National Bank of Serbia. Bank Supervision Department. 2015.https://www.nbs.rs/internet/english/55/55_4/index.html

exclusive insurers and four that are exclusive reinsurers. Among the undertakings engaged in insurance activities, five are engaged only in life insurance, nine only in non-life insurance and six undertakings in both life and non-life insurance. The breakdown by ownership shows that 18 insurance undertakings were in majority foreign ownership. The 2015 premium to GDP ratio in the insurance sector is 2.0%, relative low compared to the ratio of 7.6% to GDP pf EU countries However, when compared with the 1.9% average for countries in Central and Eastern Europe, it may be concluded that Serbia holds a satisfactory position.

At end-2015, the market of voluntary pension funds (VPFs) comprised four companies managing seven VPFs, one custody bank and four agent banks. Government debt securities accounted for the major portion of VPF assets – 82.8%. Despite the Serbian volunteer pension fund assets have been growing, their investment comprise only 0.6% of GDP.[13]

Investment funds in Serbia represent a new type of participants on the financial market, whose establishment was enabled by the Law adopted in December 2006. In the financial sector of Serbia, today there are 8 management companies governing 15 investment funds actively involved in the financial markets, out of the which 7 are property growth funds, 3 are balanced funds (50% investment in shares and 50% in bonds, banks deposits, bank notes)and 5 are funds to preserve the value of property. Despite this sector is more developed than the Albanian one, especially when considering that the long-term securities market in Serbia has been functioning under the Belgrade Stock Exchange since 1992, still it has much more to grow since out of 6 million people the number of investors don't exceed 20.000.

The above data show that following the "lost decade" of the 1990s, Serbian authorities have carried out successful financial restructuring measures to stabilize the sector. The financial sector in Serbia is trying to be comparable to financial sectors in advanced transition countries with respect to the size and the activity. However, structural imbalance in the development of banks, non-bank financial institutions and capital market in Serbia remain pronounced. In addition, in spite of its significant results, the Belgrade Stock Exchange is still insufficiently developed. As in the case of Albania, the exposure to external financial shocks, mainly European ones, remain high – thus, prudential measures from supervision authorities is constantly needed.

[13] OECD. Pension Funds in figures. 2015 https://www.oecd.org/finance/Pension-funds-pre-data-2015.pdf

Financial cooperation and common projects

The financial cooperation between Albania and Serbia have historically been low, especially when compared to the financial cooperation these countries have with other countries. As an example, in October 2016, the Serbian Securities Commission signed the extension of the Declaration on Cooperation among the securities regulators in the Balkan region from Macedonia, Serbia, Croatia, Montenegro, RepublikaSrpska, Federation of Bosnia and Herzegovina and Brcko District, but not including Albania. Apart from the lack of central institutions cooperation, neither private institutions have a clear cooperation strategy – ex. commercial foreign banks that are present in both countries do not a pre-defined collaboration strategy, except of recently occasional staff exchange or common conferences.

In addition, the financial cooperation is not explicitly stated neither in the current bilateral Albania-Serbia projects, which are part of the 'Berlin Process'. However, both countries share the same goal of being integrated in the EU financial market and therefore, they have been part of several same/ common integration projects. As part of these projects, both countries have to fulfill certain criteria which pose them common challenges.

Article 89 of the Albanian Association and Stabilization Agreement and Article 91 of the Serbian Association and Stabilization Agreement, state: *'Cooperation between Albania/ Serbia and the Community shall focus on priority areas related to the Community acquis in the fields of banking, insurance and financial services. The Parties shall cooperate with the aim of establishing and developing a suitable framework for the encouragement of the banking, insurance and financial services sectors in Albania/Serbia based on fair competition practices and ensuring the necessary level playing field'[14].*

Despite the acquis on financial services includes rules for the authorization, operation and supervision of financial institutions in the areas of banking, insurance, supplementary pensions, investment services and securities markets as well as with regard to financial market infrastructure, the current common Albania-Serbia project are mostly related to the banking sector. An important achievement in 2015, has been the memorandum of understanding signed between the European Banking Authority (EBA), the Bank of Albania and the National Bank of Serbia, as well as other WB6 central banks[15]. The consideration these non-EU national supervisory authorities to be equivalent to the one prescribed in the EU is an important condition for non-EU authorities to take part, to get and to share experience in the work of EU colleges of supervisors.

[14] Stabilization and Association Agreement. http://ec.europa.eu/enlargement/pdf/serbia/key_document/saa_en.pdf

[15] European Banking Authority. Memorandum of understanding. 2015. https://www.eba.europa.eu/documents/10180/1244268/Memorandum+of+Cooperation.pdf/950f264e-8b3b-48b1-b6c6-e01634188bcb

In the field of banks and financial conglomerates, the acquis sets out also requirements concerning the calculation of capital of credit institutions and investment firms. The Capital Requirements Directive and Regulation ("CRD IV") translating the Basel III international standards into EU law entered into force in 2014. Aiming to align the supervisory standards with international best practices, both Albania and Serbiaconsolidated within 2015 the implementation of the requirements of the regulations: "On capital adequacy ratio" and "On rregulatory capital of the bank",according to the criteria of Pillar I, Basel II and partly Basel III.Within 2016, central banks aim to finalize a standardized guideline in order to orient commercial banks to implement the Internal Capital Adequacy Assessment Process (ICAAP) which is based on the components of Pillar II of Basel II. This way, banks will understand and comply with the assessment of the adequacy of their capacities to face risks to which they are exposed.

European Central Bank has offered several assistance programs for both Albania and Serbia. During 2010-2012 both countries where part of a program designed to strengthen macro and micro-prudential supervision in the Western Balkans In addition, both countries' central banks have been part of ECB programs aiming to identify areas in which the two central banks will need to make progress in order to reach a level compatible with that of the European System of Central Banks.

Moreover, Albania and Serbia are both part of SPI Adriatic[16], a Convergence Program to promote financial sector modernization in the Adriatic countries through micro-regulatory reforms designed in partnership with authorities and market participants, and with the assistance of World Bank and Italy. Some of the project in 2009 include: Enhancing banks' liquidity risk management; Debt Procurement; Unique and rationalized reporting systemRevising regulatory act on Execution of Procedures on Bank accounts; and Revising Foreign Currency Open Position. However, these project are last reported in 2009 and since then there is no update of projects in the Convergence Program.

Some more recent forms of financial cooperation include the creation of Network of Parliamentary Committees for Economy and Finance of the Western Balkan countries (NPC) in 2009, primarily including the committees on economy and finance. Following several years of regional parliamentary cooperation, in 2013, NPC decided to set up a clear governance and organizational structure with MPs participants from all WB6 countries. Other form of financial cooperation has been central banks conferences, such as the "European Economic Governance and EU membership process: The role of central banks," hosted by National Bank of Serbia in Belgrade in May 2015.The general agreement among WB6 central bank governors was that central banks in the region need to cooperate and share expertise on economic modelling, analysis and financial projection. Meanwhile the regional networks

[16] SPI Adriatic Program. http://spi-albania.eu/en/2009-program/unique-and-rationalized-reporting-system/

would help with coordination of these issues and process enhancement in the framework of European economic governance and EU membership process.

Despite financial cooperation is one of the aims of Stabilization and Association Process, efforts towards cooperation should not be observed as a fulfilment of the EU membership requirements only, but also as a factor contributing to reforms on the way to sound regional market. Some similarities among these countries related to mutual aims towards European integration, harmonization of legislation as well as common heritage related to market and regulations make the cooperation easier. Based on European, Asian and Latin America Experience, there are two crucial forms of financial cooperation:

(1) Development financing, the area where there is more extensive experience, including novel ideas, such as initiatives to strengthen regional bond markets. This might be too ambitious given the experience of Albania-Serbia financial markets and their final aim which is not to create a regional financial market, but to be integrated in the EU one. However, there might be scope for a regional development bank or other mechanisms (commercial banks of the other countries) to support investments in regional infrastructure and other "regional public goods".

(2) Mechanisms for macroeconomic and related financial cooperation (liquidity financing during balance-of-payments crises), which include mechanisms of policy dialogue and peer review; more elaborate systems of macroeconomic surveillance and policy consultation/coordination; and reserve funds and swap arrangements among central banks. This type of cooperation is feasible and should be adapted by Albania and Serbia. Several research have shown that the exchange of information and periodic technical meetings involved in integration processes help to build knowledge and mutual trust, to preserve the regional financial stability from external shocks and to foster regional trade by discouraging competitive devaluations[17].

As the Regional Economic Issue of IMF[18] states: *'Without bridging the gap of financial development, WB6 countries would find it challenging to ensure economic convergence with the rest of Europe'*. Despite the improvements in the banking sector, domestic savings and deposits alone are unlikely to be sufficient to finance credit, investment and GDP growth that will be needed to enable the WB6 countries to converge to EU income level. Thus, there is scope for an increased share of regional funding in WB6 countries and for the development and application of common macro prudential policy framework, still at a nascent state in Western Balkan. In the longer term, the extension of euro payment area in the Western Balkan countries would be another building block for fostering regional financial cooperation and for developing of a truly regional market

[17] José Luis Machinea and Guillermo Rozenwurcel. Regional Integration and Public Policy: Evaluation of the European Union case. United Nation Publication 2005.

[18] IMF. Regional Economic Issues: Central, Eastren and Southeastern Europe – Effective government for stronger growth. https://www.imf.org/external/pubs/ft/reo/2016/eur/eng/pdf/rei1116.pdf

Recommendations

A set of policy recommendations emerges out of the experience of other regional financial cooperation (ex. EU, Asia, Latin America) combined with the expertise provided by the financial experts:

- Fostering the cooperation in the context of improving the regulatory and legal systems in financial area (ex. Regional Network of Central Banks, Regional Network of Parliamentary Committees for Economy and Finance of the Western Balkan countries). One of the main prerequisite of the financial development is the efficiency of the legal system[19]. Cooperation between Albania and Serbia can contribute to the improvements in the legal system to be harmonized with EU directives. In addition, a Regional Network of Central Banks can also help sharing signals of external shocks and coordinating common prudential measures.

- Signing a memorandum of understanding to foster cooperation among regulators of financial sectors and agencies for law enforcements on fight against frauds in financial system and money laundering. The money laundering often takes form of cross-border transactions, implying the importance of collaboration among the countries in order to prevent or detect it

- Forming cooperation linkages between stock exchanges[20] – harmonization of listing rules, connectivity between trading platforms (in order to achieve scale economics), cross-border listing and product development

- Sharing knowledge and experience in the field of finance through educational/training programs, conferences and forums, and staff exchanges particularly among Central Banks' staff and staff of common banks in both countries

- Organizing a Regional Association of Financial Experts, including experts from financial institutions, representatives from universities and other study institutes. Sharing experience would be beneficial for all the parties in managing IPA II funds, in developing new financial products and services and in developing study programs closer to the financial institutions' needs

[19] Rafael La Porta et al. Legal determinants of External Finances. The Journal of Finance. 1996. Volume 52. Issue 3. pp.1131-1150. http://socsci2.ucsd.edu/~aronatas/project/academic/la%20Porta%20et%20al%20on%20law%20and%20finance.pdf

[20] With thisregard Tirana Stok Exchange, whichispracticallyinexistitence, needsfurtherdevelopment to atleastreach the level of Belgrade Stock Exchange