

Relationship Lending Within Banking and Non-Banking Institutions

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Article DOI: 10.48028/ijprds/ijasepsm.v13.i1.02

Abstract

The purpose of this paper is to analyze the development of the financial system in Albania, how banks and non-banks financial institutions are developed. Albanian financial system is considered bank-based system considering its high concentration of banking shares to the total market. Considering this, financial institutions are the most trustworthy sector where Albanian borrowers use to borrow between banks and non-banks financial institutions. Important sectors as hotels, trade, followed by industries and building sector choose banks for their financing. Since markets are not well developed in Albania, this allows banks to have the highest part of the market share. Since our financial system lacks in information for investors and borrowers, we can say that there is a high chance of the presence of asymmetric information, meaning that banks are preferable than markets due to the close relationship established with the customer and the constant monitoring they do at firms. Smaller sectors considered as informal sectors of economy as agriculture, fishing, forest, or other wholesale trading in general are used to nonbanking financial institutions for borrowing.

Keywords: *Financial System, Banking Financial Institutions, Non-Bank Financial Institutions, Lending process, Informal Sector*

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First Published: <https://ijecm.co.uk/wp-content/uploads/2022/03/10316.pdf>

Background to the Study

The financial systems in the world today have developed by leaps and bounds, making their management extremely difficult, but also profitable at the same time. The stability of the national financial system is an integral part of the stability of the global financial system, regardless of the stage of development and depth of any financial system in the world. Such a reality makes financial stability increasingly important and necessary. The purpose of this paper is to analyze the development of the financial system in Albania, financial institutions, banks, and non-banks, and how is developed the market share of Banks over Nonbanks Financial Institutions. For this paper I have identified objectives such as analyzing the current situation of the financial system in Albania, identifying in which category of financing are more concentrated citizens, in banking or non-bank institutions and conducting a general overview of the Albanian financial development.

Theoretical studies have argued that the production of information about the bank's potential customers is provided through bank loan officers. In this sense, the bank-borrower relationship in lending to small and medium-sized enterprises can best be described as the loan officer's relationship with entrepreneurs (Berger and Udell 2002). The theory shows that the production of information is generated by the loan officer, who has the most direct and frequent contact with the borrower (Berger and Udell 2006). The literature emphasizes the fact that the transmission of information within the organization spreads and is transmitted further within the organization, namely in the most hierarchical layers of the organization (Becker and Murphy 1992, Radner 1993, Bolton and Dewatripont 1994, Garicano 2000). However, it can be quite difficult for the loan officer to communicate this information to others in the banking organization without significantly mitigating its contents (Stein 2002, Liberty and Mian 2006, and Allessandrini). This means that the relationship with the bank's lending clients when lending to small and medium-sized enterprises can be equivalently described as the lending officer's relationship with the business (Berger and Udell 2002). The structure of the paper will be as follows: Section 2 is the literature review which contains general definitions and the evolution of the term Financial Institutions Bank and Non-Bank, different definitions of this concept and its elements. Section 3 is the development of financial system in Albania. Section 4 is the conclusions, which explains the confirmation of the hypothesis or the rejection of it.

Literature Review

Banking relationships include two types of relationships: deposit relationships and credit relationships. This research focuses on credit relations. Banking relationships are expressed through the number of banking relationships, their duration, the amount of credit (Peltoniemi, 2004), interest (Bolton and Freixas, 2000) and banking services (Degryse and Cayseele, 2000). From the perspective of businesses, establishing good relationships with banks will help these businesses to increase their reputation in the market, to reduce the flow of information to competitors (Campbell, 1979), to reduce the negative impact of asymmetric information (Diamond, 1984 and 1991; Fama 1985; Holmstrom and Tirole, 1997; and Bolton and Freixas, 1996; Rajan Deloof and Verm_oesen, 2010), to increase access to credit and reduce interest costs (Houston and James, 1992), (Pertersen and Rajan, 1995). This leads to less dependence of firms on liquidity and cash flow.

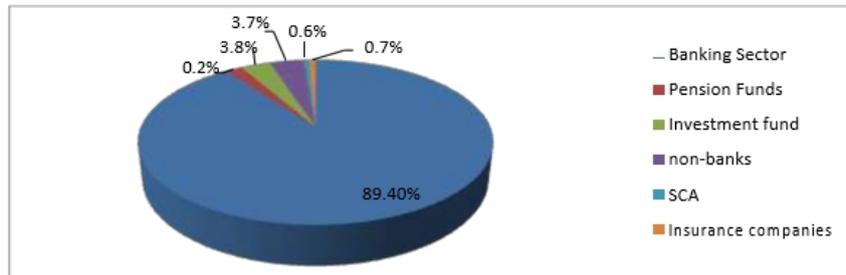
Diamond (1984) finds that a close relationship allows the bank to undertake an active monitoring role that can alleviate problems related to information asymmetry¹. In addition, when firms establish close banking relationships through repetitive lending by a bank, they will increase their prestige in the various financing channels. Diamond (1991) also shows that firms choose bank funds² to create sufficient credibility and then have access to capital markets.³ In the process of building stable relationships, banks have a lot of information (especially sensitive and important information) related to the performance of firms, banks will disclose information to competitors intentionally. The longer the relationship with the firms, the more monopolian information the bank gains. This means that firms cannot provide information to other financial institutions to establish credit relations with them, because they must deal with the problem of overload. Therefore, the main benefit of bank financing in relation to other sources of finance is that banks help overcome asymmetric information problems by producing and analyzing information and drafting credit agreements that improve borrowers' expectations.

Banking and Non-Banking System in Albania

Prior to 1990, the banking sector as well as the country's economy itself was fully centralized. The banking system was composed of one level, thus composed of the State Bank - the monetary and lending authority of the economy. The year 1992 brought a significant change in the banking system, as part of the financial system through the adoption of the laws "On the Bank of Albania" and "On the banking system in the Republic of Albania". This change made possible the transition to a two-tier system of financial structure and laid the institutional and legal foundations for a banking system based on free initiative and market structure. The two-tier structure meant the creation of the Central Bank as the first level (where the Bank of Albania was legitimized as the responsible authority), and the creation of commercial banks as the second level, which at the time of its creation was composed of three banks: Bank e Savings Bank, National Commercial Bank and Agrarian Commercial Bank. Currently, our financial system consists of 12 commercial banks of foreign and domestic capital origin, 32 non-bank financial institutions and 10 insurance companies⁴. In addition to the increased number of banks, the banking system has been accompanied by the privatization of the National Commercial Bank, the Savings Bank, as well as other restructurings.

The financial system in Albania is dominated by the banking system. The figure below shows the weight of the financial system segments to the system assets for the period December 2020. The banking system occupies 89.4% and is followed by a much smaller % than other non-banking institutions without affecting the competition with banks at all. Microfinance institutions occupy 3.7%, investment funds 3.8%, and are followed by a very small% of insurance companies 2.2%, pension funds 0.2%, SCA 0.5%.

Figure 1: Weight of financial system segments to total system 2020 assets



Source: Bank of Albania and the Financial Supervision Authority 2020

During the period 2019-2020, the assets of the banking sector expanded by about 4%, while compared to a year ago the growth of assets is about 1.5%. The reported value of assets increased by ALL 52 billion during the period, reaching about ALL 1.476 billion. The main contribution to the growth of assets was given by the expansion of investments in securities by about ALL 38 billion and the reduction of reserve funds by about ALL 10 billion. The banking system is quite liquid, with liquid assets at 89.4% of total assets, mainly due to lack of borrowing opportunities and relatively high and safe returns on government securities.

Table 1: Weight of financial system segments to GDP in years (in%)

Financial system	Bank of Albania			Financial Supervision Authority			Financial Intermediation
	Banking Sector	Non-Banking Sector	SCA and Union	Insurance company	Pension funds	Investment Funds	
2014	97.6	3.0	0.8	1.9	0	4.8	108.2
2015	97.3	2.9	0.8	2.1	0.1	5.0	108.0
2016	100.5	3.0	0.6	2.1	0.1	4.7	111.0
2017	99.4	3.1	0.6	2.1	0.1	5.0	110.3
2018	96	3.5	0.6	2.1	0.2	4.5	106.9
2019	95.5	4.2	0.7	2.2	0.2	4.3	107.2
2020	106.8	4.4	0.8	2.6	0.2	4.6	119.4

Source: Bank of Albania and the Financial Supervision Authority 2020

Credit in the Banking Sector and the Non-Banking Sector

New loans granted during the period amounted to about ALL 130 billion⁵, increasing by almost 12% compared to the previous six months, but being about 3% lower than in the same

period a year earlier. The expansion in the inflow of new credit during the period came mainly from the growth of credit to the business sector (about 14%), within which the main impact was given by the growth of long-term credit. For the household sector, new credit expanded by 7% compared to the previous six months. Its lower growth rate compared to business loans and the low share of total loans, made its contribution to the performance of new loans low. The new loan for individuals went mainly for the purchase of housing. In annual comparison, credit increased by 2.5% compared to 2018. The expansion in the flow of new credit during 2019 is also led by the credit of the business sector which occupies 63%. For the sector of individuals, the credit expanded by 10.2% compared to 2018 and went mainly for the purchase of housing.

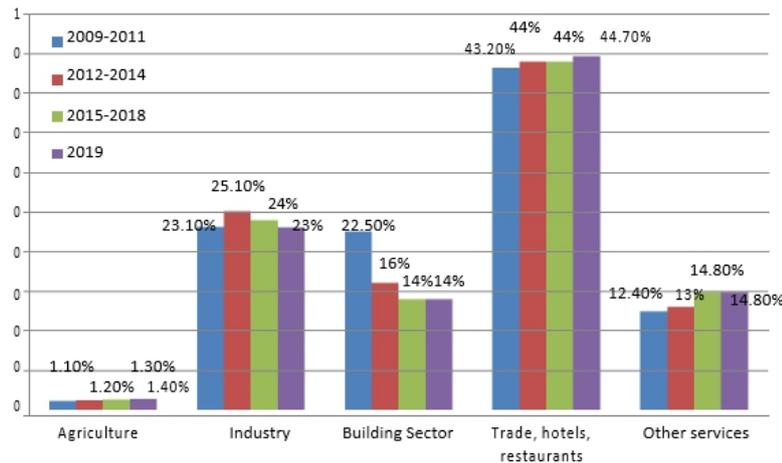
Table 2: Credit, by sector and purpose of use (value in billion ALL and weight of each item to total credit) in the banking sector

Description	December 2018	Weight %	Difference December 2017- December 2018	December 2019	Weight %	Difference % December 2018- December 2019
Total Loan	533.5	100.0	-0.1	546.6	102.5	2.5
Loan for business	364.3	68.3	0.6	335.9	63.0	-7.8
Overdraft	123.7	23.2	0.1	84.8	15.9	-31.4
Working Capital	52.0	9.7	0.7	62.4	11.7	20.1
Purchase of equipment	97.9	18.4	1.313.2	88.3	16.6	-9.8
Immovable equipment	84.2	15.8	-13.9	89.9	16.8	6.7
Other loans						
Loan for individuals	169.2	31.7	-1.4	186.5	35.0	10.2
Overdraft	7.4	1.4	-11.4	7.5	1.4	1.9
Non-durable goods	24.9	4.7	0.7	31.2	5.8	25.3
Durable goods	19.0	3.6	0.8	18.8	3.5	-1.1
Loan for house purchase	108.0	20.2	1.4	116.8	21.9	8.1
Loans for other purposes	10.0	1.9	-23.5	10.0	1.9	

Source: Bank of Albania 2019

The distribution of the loan portfolio by sectors of the economy shows that the short-term growth of business loans was mainly supported by the increase in business financing in the trade sector. This development is since the trade sector was among the few sectors that were allowed to operate under the measures taken for the Covid-19 pandemic.

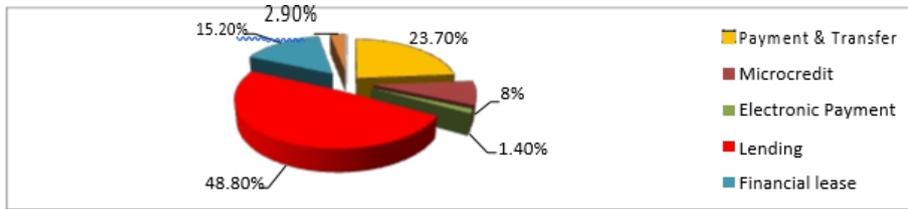
Figure 2: Credit structure by sectors of the economy in the banking sector



Source: Bank of Albania 2019

Meanwhile, credit to the construction, industry and agriculture sectors showed moderate growth⁶. The services sector was the only sector to decline. In the period of one year, it is noticed that trade credit has given a stable contribution of about 3.4% to the growth of the business loan portfolio, followed by the industry sector with a contribution of 1.7% and the services sector with 1%. The contribution of the industry sector to the expansion of credit has been in constant contraction throughout the year, closely influenced by the financing needs of the energy sector. The loan portfolio for agriculture and the construction sector have hardly contributed to the annual growth of loans to businesses. In the non-banking sector, credit accounts for the largest share with 48.8%, followed by payments and transfers with 23.7%, financial lease with 15.2%. Meanwhile, the smallest share is occupied by advisory services with 0.1%. Family businesses have more need to cooperate with non-bank financial institutions, as they encounter difficulties in meeting the requirements related to collateral or detailed financial documentation, conditions that are required by banks. While through microcredit institutions can get loans only with ID card.

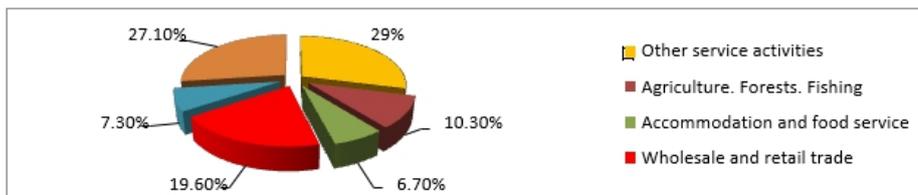
Figure 3: Loans, by sector and purpose of use in the non-banking sector



Source: Bank of Albania and the Financial Supervision Authority 2021

Most of the segment of the non-banking financial system that performs lending activities, consists of NBFIs followed by those that make payments and transfers. About 70% of the share capital of these entities is domestic capital. NBFIs are most active in lending to service activities (about 29%) and wholesale and retail trade (20%).

Figure 4: Loan portfolio structure by sectors of the economy in the non-banking sector



Source: Bank of Albania 2021

Impact of High Concentration on Banking Institutions

Albania has a financial system developed asymmetrically with the developed pillar of the banking sector, and a non-banking sector modestly developed. Despite the positive developments in the Albanian economy, the financial system remains dominated by the banking system and its developments. According to the financial stability financial reports presented in the above treatment, it is quoted that banks represent 89.4% of the total assets of the financial system. In this study through my research, I have managed to identify some reasons why people choose the banking market and what impact gives the high concentration of the financial system in banks compared to other non-banking institutions.

The dominance of the banking segment has naturally led to a high degree of concentration of financial products and services in its favor. Over 80% of residents' investments in the financial system are in the form of deposits and current accounts. Just over 12% are in the form of government securities while the rest, about 6.5% are invested in investment funds and those of private pensions. The latter constitutes only 0.1% of the total assets of the financial system. Statistics show that the number of companies operating in other segments of the financial sector remains low, while their activity in terms of Domestic Production or financial market remains negligible.⁷

Microfinance entities face insufficient financial resources and limited access to credit. Specifically, more than 1/3 of the interviewed enterprises assess the low access to finance and the cost that accompanies it as the main reason for not expanding the activity. Long-term financial instruments are rare, while short-term ones outside the banking system are apathetic and fragmented, both in products and markets. Bank-based systems have several advantages over market-based ones. Bank monitoring solves some of the agency's problems and enables firms to borrow more.⁸ Market finance does not play such a role and results in a lower amount of external finance available to all firms. Second, bank-based systems allow greater participation in productive activities, providing external financing for a larger number of entrepreneurs. Policy reforms in a bank-based system increase the growth rate and reduce the size of the traditional sector; in a market-based system they improve growth but leave the traditional sector intact unless such policies also reduce intermediate finance costs.⁹ An interim redistribution policy, under both financial regimes, has permanent effects on the growth, distribution, and relative size of the traditional sector.

Problems of the Non-Banking Financial System

1. The non-banking sector remains relatively small and is not currently a source of systemic vulnerability. The small size of non-bank financial institutions is a consequence of its early stage of development, the lack of understanding of financial products and services by potential users and the still rudimentary level of basic financial infrastructure. The enterprise sector consists mainly of small firms (91% of enterprises have 1-4 employees) that make extensive use of domestic funds and have little direct access to foreign currency lending from abroad.
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4. Lack of sufficient or reliable financial data, and virtually no official financial reporting means that the development of non-bank financial entities will take time.¹⁰
5. In the market there is a lack of competition of non-banking systems against banks. The main challenges are also related to the conduct of monetary policy, which includes the possible pressure caused on the interest rate, the reduction of the effectiveness of credit control and the reduced credibility of monetary aggregates as intermediate policy objectives¹¹. Of particular importance is the in-depth reform of

- the Financial Supervisory Authority, to enable more secure oversight of non-bank financial institutions.
6. The Bank of Albania has suspended some of the institutions that are robbing citizens through extremely high interest loans. From the frequent scandals that have been published with non-bank institutions in 2020, the BoA has been set in motion and has launched in-depth investigations against these institutions. In the annual report submitted to the Assembly, the BoA shows that from the conducted investigations, numerous violations, and lack of transparency towards clients have been noticed, which have brought great value damage to the citizens.
 7. An important part of the examinations and a very tangible issue in the case of non-bank entities is the assessment of the level of transparency with clients.

Conclusion

This paper discussed the importance of financial institutions banks and non-banks in the financial system in our country. The good functioning of the banking system is an important factor for channeling funds in the economy efficiently and for increasing banking intermediation. The dominance of the banking segment has naturally led to a high degree of concentration of financial products and services in its favor. Over 80% of residents' investments in the financial system are in the form of deposits and current accounts. Promoting competition in the banking system is another factor that affects the provision of better services to customers, that ensures the use of new banking technology, introduction of new products and services, reducing the cost of banking, etc. This serves to bring customers closer to the banks where important sector as hotels, trade, followed by industries and building sector choose banks for their financing. Since markets are not well developed in Albania, this allows banks to have the highest part of the markets share. Since our financial system lacks in information for investors and borrowers, we can say that are a high chance of the presence of asymmetric information, meaning that banks are preferable than markets due to the close relationship established with the customer and the constant monitoring they do at firms. Smaller sector considered as informal sector of economy as agriculture, fishing, forest, or other wholesale trading in general are used to nonbanking financial institution for borrowing. Considering the fact, that taking a loan to NBFIs does not require many documents, this sector is preferred by firms who lack in reporting their financial statements.

When a firm has a strong banking relationship, the firm's investment is less sensitive to cash flow. In addition, when firms establish close banking relationships through recurring lending by a bank, they will increase their prestige in the various financing channels. The small size of non-bank financial institutions is a consequence of its early stage of development, lack of understanding of financial products, high interest applied for the loans make difficult for the NBFIs to developed. Lack of sufficient or reliable financial data, and virtually no official financial reporting means that the development of non-bank financial entities will take time. The main challenges are also related to the conduct of monetary policy, which includes the possible pressure caused on the interest rate, the reduction of the effectiveness of credit control and the reduced credibility of monetary aggregates as intermediate policy objectives. Scope for further studies is to find out the perception of the borrower about the borrowing process in banks versus nonbank institutions, which service is more satisfactory for the client.

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