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CORPORATE GOVERNANCE FRAMEWORK AND PRACTICE IN ALBANIAN BANKING SECTOR

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ABSTRACT

In this paper, we thoroughly analyse the corporate governance practices and its legal framework in the Albanian banking sector. Issues of "gaps" between banking regulation and corporate governance have recently remerged, once the global financial crisis exposed the flaws of past decade's deregulation process in developed countries. In transition economies, these gaps are outcomes of transition challenges mostly related to the rule of law consolidation, ownership structure and professional and institutional capacities.

Our analysis shows that the applied model of corporate governance in the Albanian banking system resembles an insider model of corporate governance , which contrasts with the legal and regulatory framework in place. We believe that this divergence is a direct outcome of ineffective law enforcement and the lack of market-based control instruments and incentives.

The highly concentrated ownership structure of Albanian banks ultimately exacerbates agency problems, thus strongly affecting the pivotal role of the Board of Directors and agency relationships, at the cost of other stakeholders' interests, like depositors and the regulatory agency that acts as an agent of public interest.

The Albanian banking supervisory authority perceives sound governance of banks as an endogenous source for financial stability, public trust and consumer protection. Its commitment is continuously validated by a wide range of banking regulatory activities during and after the global financial crisis.

Our analysis on the independence of the banks' Board of Directors shows that, despite high standard legal requirements, there is room for a more active role of the Albanian banking regulatory authority in terms of enforcement of these requirements, following the guidelines of the Basel Committee and the European Union.

1. INTRODUCTION

Corporate governance issues have gradually become important in Albania during the last decade. Such development is in line with the country's efforts to create a sound business climate, attract new investments and develop capital markets.

The transformation of Albania's economy from an isolated and centralized economy to a market-based and open one called for the design and implementation of a new legal framework. The process could only be successful if due importance were paid to building institutional and human capacities. While many goals have been achieved, the road has been bumpy and major improvements are still needed. All these developments directly impact corporate governance practices, determining to a great extend its model and quality.

We focus on banks' governance issues in terms of their balance sheet structure, regulatory requirements, and other issues, mainly because of their crucial role in efficiently allocating capital in an economy, and their paramount importance in Albania's financial stability and economic growth prospects. Our analysis starts with a description of the relationship between corporate governance and banking regulation from a financial stability viewpoint. We show that banking regulations and the actions and inactions of the regulatory authority –as an agent of public interest– greatly affect agency problems in banks. Furthermore, given the lack of a functioning stock market in Albania, we believe that sound bank governance practices could serve as an external force on other companies' governance practices.

The aim is at providing policy recommendations, after providing a clear understanding of the corporate governance model in Albania. We also identify factors that hinder and discourage sound corporate governance. The paper's main theoretical approach is based on OECD principles, Basel recommendations, reports of international institutions, such as EBRD, the World Bank and IFC, as well as a number of research papers and academic textbooks. Although we do not explicitly conduct empirical applications of the theoretical models, we do use data from Bank of Albania surveys, banks' annual reports, INSTAT[1] and the European Commission's Progress Report on Albania to illustrate and support our arguments.

In chapter 2, we provide a short overview of Albania's overall development since the beginning of transition, concentrating on the financial system development. We describe how the privatization of banks, the establishment and collapse of pyramid schemes, the role of a capital market (or the lack thereof) and the consolidation of the banking system in the past decade, have significant impact on corporate governance practices in Albania.

In the second part of chapter 2, we provide the theoretical foundation of our corporate governance analysis, focusing on two key theories: the Agency Theory and the Stakeholder Theory. These theories have given rise to two of the most representative models of corporate governance, the *insider* and *outsider* models, which we then refer to when assessing the Albanian banking sector.

The third part presents the theoretical literature on corporate governance in banks, focusing on theories developed after the financial crisis of 2007-2009. The chapter continues with detailed arguments on the differences between banks and firms in general, such as their capital structure, bank runs, the opaqueness of balance sheets, risk profiles and interrelation between banks. Furthermore, we depict specific agency problems in banks and how such problems influence the role of the regulatory authority. The complementary relationship between the corporate governance and regulation is treated in the fourth part of the chapter.

The last two parts of chapter 2 cover the latest developments on corporate governance after the crisis, which are mainly due to the Basel Committee for Banking Supervision principles and EU's response to the financial turmoil. The chapter concludes with references to transition economies, emphasizing common characteristics, like underdeveloped financial markets, inadequate legal protection for investors and minority shareholders, lack of transparency and lack of qualified managers.

[1] Albanian Institute of Statistics

In chapter 3, we present a detailed account of our analysis in identifying a corporate governance model for Albania, focusing on the legal framework of corporate governance and its implementation. Our main focus in this chapter is to present corporate governance facts and results in Albania, while emphasizing critical areas like financial disclosure, ownership structure and law effectiveness.

The first three chapters serve as a solid background to the comprehensive treatment of bank governance provided in chapter 4. The first part of this chapter aims at providing a better understanding of the banking sector in Albania, how the crisis affected it, competition in the sector, ownership structure and the sector's performance in general.

In the second part of Chapter 4 we thoroughly analyse the legal and regulatory framework that determine corporate governance aspects like the qualification of the Board of Directors, independence of the board, strategic objectives and corporate values, transparency, and control systems.

Chapter 4 concludes with the interpretation of survey results on Albanian banks governance and other data available on the topic, including materials published by banks. Throughout our analysis we focus on areas like the factors that impact boards' quality, e.g. independence, qualifications, strategic thinking and decision making, as well as the level of disclosure and transparency on corporate governance practices.

Chapter 5 concludes and provides policy recommendations and possible avenues of corporate governance improvements.

2. COUNTRY OVERVIEW AND THEORETICAL REVIEW

2.1 COUNTRY OVERVIEW

In the past two decades, the Albanian state and its society have witnessed a relatively long transition period from 50 years of a communist totalitarianism towards a democratic free market economic regime. Among other things, the transition period featured major changes of the country's geopolitical diplomatic relationships with the rest of the world, where European Union (EU) integration goals replaced isolation and xenophobic policy. Following this new agenda, Albania became a member of the World Trade Organisation (WTO) on 8 September 2000, and signed the Stabilization and Association Agreement (SAA) with the EU in 2005. The SAA serves as a transitory instrument (10 years period) designed to raise Albanian standards and values, bringing the country closer to the EU. Albania joined NATO on 1 April 2009, and the government is currently working towards fulfilling EU preconditions for candidate member status.

In addition to positive developments, the Albanian transition has been also associated with negative phenomena like high and persistent unemployment, corruption, weak domestic institutions and partially free markets. Albeit common in transition experiences, such problems seem to still be a leitmotif of the country's political and social life. Despite the country's progress in many areas, progression towards EU integration goals is very slow. The highly polarised political environment very often deflects from the country's main objectives, resulting in political deadlock that constantly postpones the EU candidate member status for Albania (EC 2011).

2.1.1 ECONOMIC DEVELOPMENTS

Changing from central planning to free-market economy in the early nineties brought about radical structural transformations in Albania, including new macroeconomic policies and structural reforms, such as price and trade liberalization, large scale privatization, fiscal reforms, and opening of the country to foreign capital. The GDP has stably grown with an average of 6% per year up to the 2008 world financial and economic crises. It has also remained positive since 2008, albeit reduced to 3% (Bank of Albania, 2011). Bank of Albania data reveal that inflation is kept within the monetary authority's target band of 3±1%, while the ALL exchange rate vis-à-vis the EUR and USD has mainly been stable. Furthermore, during 2009 and 2010 the trade and current account deficit have considerably shrunk, mainly due to Albanian exports' good performance. Public debt mounts to 58.44% of GDP, of which 25.15% being external debt and 33.29% domestic. Although higher than other regional emerging economies (IMF, 2011), public debt is within limits of the Maastricht Treaty economic criteria.

All the above mentioned characteristics of the Albanian economy, coupled with a low level of international financial integration with the rest of the world, seem to have contributed to the moderate impact of the world financial and economic crises in the country's overall economic health. The EU Commission, IMF and Bank of Albania confirm on their reports that, although fragile, macroeconomic stability is still in place. However, unemployment, the trade account deficit and the level of debt are the key areas that need immediate addressing.

2.1.2 THE FINANCIAL SECTOR

The financial market in Albania is dominated by banks, comprising nearly 95% of the sector. Other financial institutions include insurance companies, non-bank financial institutions, saving and loan associations and private supplementary pension funds.

The financial sector has undergone slow and limited reforms. At the beginning of 1990s, the three state-owned banks (Savings Bank, National Commercial Bank, and Rural Bank) had nearly 90% of the deposits, whereas the number of private banks was limited and most were established in the second half of that decade.

During the early nineties, the financial system witnessed two important developments: lack of an equities market and increased savings. The latter were mainly a result of high inflows of remittances. Such an environment favoured the emergence of an informal financial market, where companies mainly borrowed from each-other or individuals, usually at higher interest rates than the formal ones. One of the most seriously damaging results of such informality was the emergence of Ponzi schemes, which spread quickly and at a large scale during 1994–96. Favoured by the fact of a largely cash-based economy in Albania, and the lax financial supervision, shady financial companies started taking cash deposits from households, promising them returns of up to 50% per annum.

Fullani (2009) argues that
"*due to large capital accumulation, these schemes induced consumption beyond equilibrium levels, distorting the savings-investment ratio and impairing the channelling of capital into real investments*." (p. 229)

The flourishing of such schemes confirmed the necessity to strengthen supervisory institutions and free market structures in the country. Based on the severe outcomes of such schemes on the Albanian economy, it is important to thoroughly analyse the reasons behind their establishment. What convinced 2/3 of the Albanian population to trust these shady companies with their money, amounting to nearly half the yearly GDP of 1996 (Jarvis, 1999)?

In an analysis of the phenomenon, Jarvis (1999) concludes that the level of poverty and unfamiliarity with the free market economy, the inefficient financial system, and governance issues were the main reasons for the rise and collapse of the pyramids schemes in Albania. He also stresses establishing a well-functioning formal financial system, setting up a regulatory framework that covers informal as well as formal markets and has clear lines of responsibility for supervision and action, and tackling general governance problems. Although preventing Ponzi schemes should not be the primary aim of good governance, "the Albanian experience is a powerful reminder of the social costs of unchecked criminality" (Jarvis, 1999, p. 6).

Under the viewpoint of corporate governance principles, we could argue that the lack of good governance, coupled with a cash-based economy, were the impetus for the rise of pyramid schemes, since these companies were not obliged to publicly disclose financial statements while presenting fraudulent statements to the authorities. Hence, we believe that complying with corporate governance principles is a key measure for preventing such events.

2.1.3 OVERVIEW OF BANKING SECTOR IN ALBANIA

The Albanian banking sector is composed of 16 banks. The presence of the foreign capital is dominant in all banks (Bank of Albania, 2011, p. 77) (subsidiaries of larger groups and branches of foreign banks), such as in Intesa San-Paolo Bank, Raiffeisen Zentrale Bank, Societe Generale, and Credit Agricole. The high degree of foreign ownership has brought the best experiences and banking practices in the financial system, along with modernisation and innovation through high-tech products. More importantly, they have contributed to developing high-standard organizational and corporate governance practices.

The Albanian banks' origin of capital includes countries like Austria, Italy, Greece, and France. According to the Bank of Albania (2011, p. 77), the total assets of the banking sector mount to EUR 7 billion, representing nearly 80% of the GDP in 2010. Sixty four per cent of the total bank assets belong to the largest four banks.

The total outstanding loan portfolio was nearly EUR 3.5 billion, representing 40 % of the GDP in 2010, with the majority of loans denominated in foreign currency (nearly 70%).

Remaining a concern for the banking sector, non-performing loans (NPL) in the second quarter of 2011 reached 16.6% versus 13.6% at the end of 2010. Such a high level of NPL could be "partly explained by institutional and judicial weaknesses that have hampered collateral execution" (IMF, 2011, p. 26).

Total banking system deposits continue to have an upward trend growing by 18% since 2010. Domestic currency deposits are slightly higher than foreign-currency denominated ones (51.2 % vs. 48.8%), while the majority of total deposits is concentrated in a few large banks. Shareholders' equity has increased by 9% in 2010 (Bank of Albania, 2011, p. 77). The banking sector remains well capitalized (EC, 2011, p.26), with a capital adequacy ratio of 15%.

As the Bank of Albania reports,

"The country's financial system and banking sector are regarded stable. The banking sector's activity has expanded further and its share to the Albanian economy has increased. Profit indicators have improved relative to the previous period. Capitalization and operating liquidity position is good. The need to improve the loan quality remains the main challenge facing the banking sector. Stress-test exercises show that banks are resilient to assumed adverse economic and financial shocks." (Bank of Albania, 2011, p. 77)

2.1.4 CAPITAL MARKETS

Capital markets are a relatively new experience for Albania. The Tirana Stock Exchange (TSE) was initially created under the Bank of Albania on May 1996 and ran until February 2002 (TSE, 2002), when it was transformed into a joint-stock company (JSC). Its core activity was trading government T-Bills on the primary (until 1998) and secondary market. The main actors of the securities' market are the Government, who is supplying public debt securities, and financial institutions who create the demand for securities. Having only this type of activity, there is not actual securities' trading on the market and there are no listed companies.

The most widely perceived reasons for the non-functioning of the TSE are the lack of transparency and distorted financial statements for tax avoidance purpose. Therefore, firms' financial needs are mostly met by the banking system and an informal credit market. In contrast with equity financing requirements, banks very often accept to evaluate companies on the basis of unofficial financial statements (the so called "real statements"). As a result, equity financing is not an attractive form of financing for companies in Albania, so long as banks accept unofficial financial data.

2.2 THEORETICAL APPROACHES AND LITERATURE REVIEW

The issue of corporate governance has become increasingly important in the last couple of decades. Many financial crises during this period have identified poor corporate governance as one of the leading causes. The subject covers different disciplines including finance, accounting, law and jurisprudence, management, business ethics and policy making. Each crisis event has raised concerns on particular governance features. However, they establish a system of correlated and dependant principles (Kirkpatrick 2009 and Wearing 2005)

There are different theoretical approaches to explain corporate governance, which use various terminology and techniques rooted in specific economic, social, legal systems and historical backgrounds. The main theories–also the most debated ones - are Agency Theory and Stakeholder Theory (Smerdon, 2010). To analyse and identify the specific features that distinguish banks from other types of corporations, we briefly describe these two theories and the models of corporate governance.

2.2.1 AGENCY THEORY

The agency theory was developed in parallel with the invention and development of the stock market as a new source of financing for companies. Prior to the existence of stock markets companies financed their business activity through individuals with family relationships that acted both as owners and runners of the company. Due to growing needs for activity expansion, it became necessary to generate financing from other sources. This led to the development of stock market as a means to raise capital by selling shares to investors who become shareholders. The stock market offered an opportunity not only to buy shares but also to trade them, causing, therefore, fluctuations in the ownership structure of the company. These developments originated in the UK and the USA (Solomon, 2010).

The foundations of the Agency Theory, also referred to in the literature as "Principal-Agent Theory" or "Shareholder Value", rely on the separation of ownership and control, where the shareholder - the principal- delegates the management of the company to the managers -agents. The later have a fiduciary responsibility to the principals, acknowledging the primacy to shareholders' interest, which is maximization of the shares value (Solomon 2010, Wearing 2005 Minzt 2004, Smerdon 2010, and Stephen and Backhaus 2003). Agents entrusted with the day-to-day management of the business have actual control over the company, creating an information asymmetry between them and the principals. This asymmetry serves as an impetus to possible principal–agent conflicts of interest. The main causes for such a problem rests on the fact that greater knowledge might induce managers to place their own interests, such as higher bonuses, above shareholders' interests -known in the literature as "the agency problem". To prevent these problems, oftentimes, businesses incur agency costs, including monitoring costs that burden the principal, bonding costs that burden the agent, and a possible reduction of shares' value due to decisions taken by agents contrary to principals' interests.

According to Minzt (2004, p. 4), even though there is a variety of solutions, "*the agency problem can never be perfectly solved*". Illustrations of this statement can be found in the numerous and recurrent financial scandals worldwide and the recent global financial crisis of 2007-2009.

The main findings of the literature in terms of possible solutions to the problem can be grouped as follows:

- Shareholders should monitor agents' behaviour via the establishment of a professional board, where knowledgeable and capable directors are charged with oversight responsibility and can hire and fire managers;
- Well-enforced contracts that define the rights and responsibilities of both the principal and the agents, geared towards shaping the behaviour of agents in the shareholders' best interest;

- The market mechanism for corporate control will eventually "force" managers to act in principals' best interest by maintaining high share value to avoid hostile takeovers and thus loss of their jobs. A possible negative consequence of this rationale is focusing on short-term objectives, rather than trying to achieve long-term value;
- Aligning agents' and principals' interests by linking the compensation of managers to the long-term performance of the company and its valuation and/or by issuing stock options;
- Controlling the reliability of the managers' financial reports by internal auditors and external certified accountants;
- Designing and putting in place an effective internal control system, which consists of policies, procedures and technology to assure the reliability of financial reports, compliance with law and regulations and effectiveness and efficiency of operations.

2.2.2. STAKEHOLDER THEORY

As discussed so far, the agency theory is rooted in the legal and moral entitlement of shareholders to supervise the company they have claims upon in terms of residual flows and property rights. Taking it to another level, the stakeholder theory requires managers to be accountable to stakeholders as well, rather than just to shareholders. Such a rationale is based on the argument other than shareholders; affiliated constituents that are affected by the company's activity have a 'stake' in the company. This includes employees, the community, creditors and clients. Solomon (2010) points out that in some extreme approaches of this theory, the group of stakeholders may include environment, animal species and future generations as well. However, the prevailing criterion for the classification of stakeholders is the legitimate stake of these subjects in the company. This theory gains more support in the case of large companies, which have considerable impact on not only a sole group of society, i.e. its shareholders, but also on a broader society group, as well.

The stakeholder theory finds its application in continental Western European countries, more traditionally in France and Germany, where employees have an important say in the management of the company. In these countries, employee representatives either sit on Boards or hold company shares. Consequently, they affect policies, strategies and the day-to-day management of the company by exercising their voting rights.

In these lines, corporate social responsibility - closely linked to stakeholder theory - is becoming a crucial element in establishing and maintaining market confidence in companies. While self-consciousness and social awareness are key elements in motivating companies to engage in corporate social responsibility, the social and political environment are also pushing businesses to be more responsible to communities and related stakeholders.

The stakeholder theory seems to be conflicting with the foundations of the agency theory. The main issue remains whether it is possible for companies to satisfy shareholders' interests, while serving the needs of other stakeholders at the same time. According to the agency theory, managers may be accountable to a wide range of stakeholders, but their primary responsibility is to satisfy the interests of the shareholders (Goodpaster, 1991). Smerdon (2010) argues that even in the countries where the stakeholder theory is a prominent dimension of doing business, there have been financial scandals caused by failures similar to those happening in the UK or the USA – countries where the agency theory is embraced.

Despite the seemingly diametric differences, the fundamental distinctions between these two theories are becoming vague in practical terms. Even in countries like the UK and the USA, companies are increasingly paying more attention to social responsibility as a promoter of long-term sustainability. This approach named "enlightened shareholder value" is also being included in legal acts governing companies (Smerdon2010, pp. 23-24).

2.2.3 OUTSIDER AND INSIDER MODELS OF CORPORATE GOVERNANCE

While theories of corporate governance focus on the fiduciary duties of managers towards shareholders (Agency theory) or to a broader group of stakeholders (Stakeholder theory), studies on corporate governance systems in the world provide more comprehensive insight on this topic by analysing culture, financial and legal systems, and historical background.

The most widely used models of corporate governance are “outsider” and “insider” models, with the UK and USA being the biggest study subjects, along with countries with similar financial and legal systems (outsider), and Germany and Japan (insider). The current literature covers different, and yet interlinked, criteria for categorizing these systems.

In one of the most comprehensive studies of corporate governance, Shleifer and Vishny (1997) put more stress on the concentration of companies’ ownership and the influence of legal systems, referring mostly to the legal protection of investors’ property rights. Solomon (2010) finds as more important ownership concentration and companies’ sources of finance. Stephen and Backhouse (2003, p.393) see these two models as “institutional arrangements through which managerial behaviour is controlled”.

Outsider system of Corporate Governance

The outsider system, also known in the literature as the market–based system, is shaped around highly developed stock markets, which provide a primary financial source, typically in the UK and the USA where banks are generally restricted from stock ownership. Generally, it is referred to as the Anglo-American or Anglo-Saxon model, built on the foundations of separation of ownership and company control. As previously explained, the agency theory and solutions to problems related to the separation of ownership originate in this system of corporate governance. Developed stock markets in these countries serve as a means for institutional investors to generate revenues by trading shares. The two main outcomes of such a system are: limiting ownership concentration, and providing an incentive-based disciplinary framework for managers. While being relatively positive, the first outcome of the system might actually discourage better corporate governance, since in case of disagreement with the management, investors might prefer to sell their share rather than incur additional costs by promoting better governance. This is typically common in small individual investors characterized by free-riding behaviour. The second outcome of the system is based on phenomena that are typical for stock markets, such as hostile takeovers. A low performance of managers affects the market share value, encouraging large investors to hostilely take over with the intention of generating benefits from higher share value in the future through better management (Stephen and Backhaus, 2003). The hostile takeover, however, may also have adverse effects. For example, when trying to avoid takeovers, managers might engage in short-term strategies to ensure high returns on capital, affecting the long-term financial performance of the company.

Another feature of this model is the high level of transparency in the stock market sanctioned by strong rules protecting investors' interests from abusive behaviour of managers (Cioffi, 2003). Shleifer and Vishny (1997) argue that the higher level of investors' legal protection, as compared to that of creditors, is an essential feature of the outsider model. In insider system countries, debt issued by banks is the most important source of financing for companies because valuation is easier through tangible collateral, and breaches of contracts are easier to prove in case of lawsuits. It also provides a more secure way of investment through collateral execution in countries where the execution of collateral is timely and legally effective (Shleifler and Vishny 1997).

Insider system of Corporate Governance

The insider system of corporate governance is characterized by concentrated ownership and control by a small number of major shareholders. In such systems, companies are owned by founding families or other small groups of shareholders like governments, small companies interrelated with each-other through cross-shareholding and pyramid-type ownership structures (Solomon, 2010). Due to the lack of developed stock markets, there is no market for corporate control through hostile takeovers in insider systems (Stephen and Backhouse 2003). Furthermore, takeovers in general are almost impossible to occur, due to the highly concentrated ownership structure (Cioffi, 2003). Companies are internally financed by members of the cross- shareholding structures or by bank debt instead of equity.

Cioffi (2003) defines the German financial system as
"*[…] bank-centred stipulated by law and regulation, which design the companies as a largely self – regulating entity situated within a consensus-based social market economy with its neo-corporatist interest representation, centralized wage bargaining and network of relational finance and corporate ownership*"(p. 7),
which has led to the stakeholder model. According to Miawa and Ramseyer (2000, p. 403), the insider system in Japan is shaped according to Japanese cultural foundations in the form of corporate groups (keiretsu) with the "*main bank*" in the centre of the group. As in the case of Germany, in the Japanese system information sharing occurs through the keiretsu, cross- shareholdings, where managers do not have to deal with the pressure of the stock market, but are instead accountable to the "*main bank*". The latter exercises monitoring powers on client firms (members of the group), and control on the non-performing members, often through bailouts (Stephen and Backhaus2003, p. 394).

Banks hold significant amount of shares in their business depositors and exercise high supervisory power through insider information, avoiding in this way the agency problem of information asymmetry. In addition, by supervising management as insiders, the alignment of managers and shareholders seems like a much simpler task, narrowing the distance between ownership and control. The diminishing separation between ownership and control may be disadvantageous for minority shareholders, who are not able to obtain information about company's operations. This has been observed in East Asian countries, whose corporate governance systems are closer to the insider model. The system is characterized by weak minority shareholders' legal protection- a factor that was identified as one of the causes of the Asian financial crisis of 1997 (Classens and Fan 2002, Solomon 2010).

The insider system –referred to as the two-tier model of the Board- in Germany is considered as one of the main contributors to the country's high economic performance in Germany after WW2. It has even been suggested that this model is more effective and efficient than the outsider system, in terms of eliminating agency problems and promoting long-term sustainability. Figure 2.1 provides a summarized overview of insider and outsider systems of corporate governance features.

Figure 2.1 Comparative table of insider and outsider systems

Outsider system of corporate governance	Insider system of corporate governance
Dispersed ownership by outside shareholders	Concentrated ownership of insider shareholders (usually founding family members, governments and companies through cross – shareholdings and pyramidal ownership structures
Separated ownership from control exercised directly by managers generating agency problems	Loose separation of ownership and control with rare agency problems
Managerial behaviour disciplined by hostile takeover	Managerial behaviour monitored and controlled by insider shareholders and rare hostile takeovers
Shareholders prefer more "exit" than "voice"	Majority shareholders tend to have more "voice" in the management of their investee companies
Shareholders more short-term oriented	Majority shareholders as insiders ensure long – term strategies and sustainability
Developed and sophisticated financial markets.	Low level of sophistication and diversification of financial market.
Equity the main source of financing expressed in low debt/equity ratio and low ratio of bank credits to total liabilities	Inside the group/family financing and bank loans expressed in high debt/equity ratio and high ratio of bank credits to total liabilities
Strong legal protection of investors interests (transparency and property rights enforcement)	Weak legal protection of investors' interest
Potential for shareholder democracy	Potential for expropriation of minority shareholders
No transfer of wealth from minority shareholders to majority shareholders	Wealth transfer form minority shareholders to majority shareholders

Source: Solomon (2010, p. 196) and Stephen and Backhouse (2003, p. 394).

2.2.4 CONVERGENCE OF SYSTEMS

The development of the global financial market is associated with the tendency towards the convergence of corporate governance systems of different countries.

In the UK and the USA, large financial institutions are becoming larger and larger shareholders, changing companies' dispersed capital structure. This is associated with increased monitoring of managerial behaviour -a distinct feature of the insider system (Solomon, J. 2010).

On the other hand, for German companies, the patterns of the insider model seem to have turned into barriers for financing in international financial markets. As Solomon notices (2010), the reforms carried out during the last decades, involving improving transparency and adopting widely accepted international standards of corporate governance, have led toward the relaxation of the insider system in Germany, pushing convergence with the outsider system.

2.3. CORPORATE GOVERNANCE IN BANKS

Unlike the relatively rich literature on corporate governance in general, corporate governance in banks has received little attention by academics until the recent financial crisis of 2007-2009. The crisis, among other things, identified bad corporate governance as one of the causes of failure. Kirkpatrick (2009) – commissioned by the OECD, one of the most influential international organizations focused on corporate governance developments– identifies insufficient regulatory and accounting standard requirements; poor risk management; and misalignment of remuneration policies with the strategy, risk appetite and long term interests of the firm. Other authors stress upon other features of corporate governance, like ethical behaviour and opportunistic conduct or misconduct of the Board of Directors and Senior Management of financial institutions (Solomon 2010, Clarke and Klettner 2010). However, Műlbert (2009) and Kirkpatrick (2009) argue that there is no strong evidence of a pure one way causality between governance failures and the crisis. Műlbert (2009) argues that even numerous anecdotal evidences cannot serve as a strong proof that governance failures were the most important cause of the crisis. Nevertheless, the inability to show causality with significant confidence does not undermine the effect of governance failures on exacerbating the crisis, and the need for reforms to improve corporate governance in banks in some specific areas. That being said, it is widely accepted that governance failures and deficiencies of the regulatory system, if not facilitated have not prevented practices causing the financial turmoil in the banking sector (Kirkpatrick 2009, Műlbert 2009, Walker 2009).

In order to build the theoretical background of our analysis of governance in the Albanian banking system we first look at the specifics of a bank, banking regulation, the role of regulators/ supervisors and how they affect banks' governance.

2.3.1 HOW DO BANKS DIFFER FROM GENERAL FIRMS?

Unlike normal firms, banks have a specific role in society. They are trusted with safeguarding savings and, particularly in economies with underdeveloped capital markets, reallocating financial resources into productive investment projects. Furthermore, their capital structure is reported in a particular way; banks and their business partnerships have systemic importance; and they are regulated very differently from the rest of for-profit companies. Banking regulation, as Cinancianelli and Gonzales (2000, p.6) put it,

"is an intriguing element, for the existence of regulation can be considered as either an outcome of the distinct nature of banks or as and endogenous feature distinguishing banks from other public listed companies."

In our opinion, both views deserve some discussion.

2.3.2 IMPORTANT ASPECTS OF BANKS' CAPITAL STRUCTURE

(i) *Capital structure*. A specific feature of banks, rooted in both the liabilities and assets' sides of the balance sheets, is the mismatch between their maturities (Műlbert 2003, Macey and O'Hara 2003). Unlike general firms, which finance their activity with more equity than debt, banks' debt-to-equity ratio is uniquely adverse. Bank owners provide only around 10% of financing. The rest of funding is generated mainly from debt, usually in forms of demand deposits. On the other hand, assets are typically loans with longer maturity than that of deposits. Hence, banks' core activity is based on this term mismatch, allowing them to generate profits in the form of premiums from loans (with higher interest rates than deposits' ones). From this perspective, banks have a liquidity-providing function, which highly depends on a continuous stream of liquidity from deposits and, loans in the interbank market, funding from highly secured financial markets, and, in case of distress, from central banks through the lender of last resort instrument (Műlbert 2003).

(ii) *Bank runs* –a phenomenon closely related to the maturity mismatch and the liquidity providing function of banks. Banks extend loans from funds generated by its creditors (depositors/borrowers), keeping only a limited amount of funds as reserves. In case of a bank run, these reserves get quickly exhausted from massive deposit withdrawals, leaving banks unable to satisfy all creditors at once. Bank runs are considered as the classic prisoner's dilemma of creditors, who cannot rationally coordinate their actions to refrain from withdrawal of their funds simultaneously, thus causing even a solvent bank to fail (Műlbert 2003, Macey and O'Hara 2003).

(iii) *Opaqueness of banks' balance sheets*. Generally speaking, it is more difficult to assess the riskiness of intangible assets, like bank loans, than tangible ones like inventory, plants, machinery. According to Műlbert (2003), measuring the quality of banks' assets is intricate even for other banks, as illustrated by the events following the collapse of Lehman Brothers.

(iv) As pointed out by Műlbert (2003), another specific feature of banks is the changing risk profile even in face of non-changing investment positions. This happens when banks hold substantial portfolios of derivatives that are very sensitive instruments to external market conditions.

(v) In developed banking systems the interbank, foreign exchange and OTC derivatives markets are important sources of financing, along with taking deposits from the public. Banks trade among each other acting as both competitors and counterparties; hence they are exposed to each-other's risks. This interrelationship between banks provides a perfect mechanism for the fast transmission of the financial problems of one bank onto the whole system, and, consequently, onto the entire economy. The systemic importance of banks for an economy's financial stability makes them subject to regulation and supervision by state agents representing public interest (Ciancianelli and Gonzales, 2000).

2.3.3 AGENCY PROBLEMS SPECIFIC TO BANKS

The specific characteristics of banks, as described above, lead us to expect agency problems of a different nature in these types of firms. The existence of a regulator and bank regulation affects agency relationships since there is a third party –the regulator- that serves the public interest. Ciancianelli and Gonzales (2000) argue that, due to regulation, the agency problem in banks is more complex. The authors identify (2000, p.6) "three other additional information asymmetries in banks: (i) between the depositors, the bank and the regulator; (ii) between the owner, managers and the regulator; (iii) between borrowers, managers and the regulator". This implies that bank governance is substantially different from general corporate governance.

The role of the regulator can be explained as an additional external force, affecting bank governance. This means that banks serve not only to the private interest of the shareholders, but also to the interest of the regulator, who acts as an agent for other stakeholders, i.e. the public. Consequently, we can infer that banks best fit the stakeholder model of corporate governance.

In addition, while subject to control by the regulator, agents in a bank (managers) are pressured to ensure compliance with one set of interests (principals) without compromising the other set of interests (the regulator's). This, in turn, imposes a different managerial behaviour as compared to other firms (Ciancianelli and Gonzales, 2000).

Other important determinants of corporate governance in banks include the policy instruments used by regulators to prevent systemic risk, such as 'lender of last resort', deposit insurance and competition policies (Ciancianelli and Gonzales, 2000).

The existence of a '*lender of last resort*' implies that bank owners, contrary to owners of general firms, share their risk with the regulator. The bailing out in case of bankruptcy might create incentives to take greater risk than a firm that does not have that option. Ciancianelli and Gonzales (2000) argue that because managers are monitored by both the Board and external supervisors, a 'lender of last resort' option actually incentivises shareholders to take higher risks, not managers. Although this rationale may not be directly applied to the recent crisis and the major bailouts of western financial institutions, the concern the authors raise is important in the case of transition economies like Albania, where big western parent banks have the majority of ownership in banks operating in the country.

With respect to 'deposit insurance', it has already been proven to be an effective instrument of preventing bank runs. Nonetheless, because of being a sort of unconditional insurance for banks, it might have adverse effects on good bank governance. Similar to the 'lender of last resort', 'deposit insurance' increases the principals' and agents' incentives to take additional risk (Macey and O'Hara 2003). In addition, deposit insurance might create disincentives for depositors to monitor the use of their funds by banks. On the other hand, Mű lbert (2009) argues that this reasoning practically applies to big depositors with expert knowledge on banking risks, rather than to small depositors.

Because of the specifics of the bank as a financial entity, unlimited competition within the sector may have adverse effects to the soundness of the banking system. Aggressive competition in this case might lead to increased risk appetite of both owners and managers, beyond the prudential expectations of regulators/ supervisors. As Ciancianelli and Gonzales (2000, pp. 13, 21) put it "*[...] regulation, aiming at correcting market failures and managing of systemic risk, affect the structure and features of competition within the banking sector*". Restrictions related to market entry, capital requirements, "fit and proper" control of employment of managers and supervision activity, if effective, create barriers to competition, which consequently affects governance (Shull et al, 2007, Ciancianelli and Gonzales 2000). This, however, does not imply that competition is inexistent in the banking sector. With the pre-crisis financial deregulation in action, banks did provide banking services at market clearing prices, but, because of regulatory restrictions on competitiveness, they did not face the pressure of competition as general companies do. This creates an essential "governance gap" that was overlooked during the deregulation process (Ciancianelli and Gonzales 2000, p. 19).

2.4. THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND REGULATION

Both corporate governance and banking regulation can be viewed as outcomes of the agency problems related to the separation of ownership and management. In this light, as in the case of corporate governance, banking regulations' object is to prevent self-serving and abusive behaviour of managers rooted in their conflict of interest. Trying to tackle problems of the same nature, and using similar means to achieve it may cause an overlap between corporate governance and bank regulation (Shull et al, 2007). Műlbert (2009) argues that this functional relationship should be seen as substitutive or as complementary rather than overlapping in a strict sense. Caruana (2005, p. 2), General Manager of Bank for International Settlements, used this argument when stating that "*good corporate governance and supervisory actions complement each other*". He adds that "*bank regulation and supervision would not be effective in conditions of poor corporate governance*". Sound governance in the case of banks plays a wider role than in general firms, because it does not solely serve to the interests of the corporate; it also serves to the interests of supervisors by providing the proper environment for sound and prudent management (Banca d' Italia, 2007).

The approach of complementariness of corporate governance and bank regulation seems to have gained more attention in the process of deregulating the financial services. As Shull et al (2007, p.4) put it, the regulators during the process of deregulation were expected to withdraw from hard rules, leaving the field to the corporate governance to advance by external self-correcting market forces. Ciancianelli and Gonzales (2000) argue that both regulation and corporate governance should be considered as external forces that affect a banks' owner and the manager in different ways. They go even further by arguing that "regulations and regulators themselves have not paid due attention to corporate governance as an endogenous source of systemic risk" (Ciancianelli and Gonzales, 2000 p. 11).

2.5. THE INTERNATIONAL RESPONSE TO THE FINANCIAL CRISIS FOR ENHANCING CORPORATE GOVERNANCE IN BANKS

The global financial crisis of 2007-2009 called for immediate reaction with regard to enhancement of corporate governance in the banking sector. The main idea of these actions is that supervisors should use corporate governance from a financial stability perspective. As explained above, corporate governance is considered as a complementary tool to bank regulation that contributes to maintaining public trust and confidence in the banking system, both being essential to financial stability and the whole economy (Basel, 2010; EU Green Paper 2010).

2.5.1 THE BASEL COMMITTEE ON BANKING SUPERVISION

On 16 March 2010, the Basel Committee on Banking Supervision issued a revised draft of corporate governance principles in banking organizations (originally drafted in 2006) as a response to corporate governance failures observed during the latest crisis. The final draft of new principles, issued in October 2010, aims at addressing problems like insufficient board oversight of senior management, inadequate risk management and unduly complex or opaque bank structures and activities.

The Basel Committee approach relies on the financial stability perspective, stressing bank governance in internal processes, such as, in particular, effective risk management, control and compliance, and audit functions. In this respect, external governance imposed by market forces and the role of banks' shareholders are out of the scope of the new principles. Indeed, from the supervisors' viewpoint, sound corporate governance in banks, like sound business management practices, are preconditions for a cost-efficient supervisory system and permit the supervisor to place more confidence on the bank's internal processes. Another distinct feature of the Basel Committee approach, which derives from the supervisors' perspective as a stakeholder concerned with financial stability, is the orientation of the bank governance toward the stakeholder model. According to the principles (Principle 1, p. 23), when discharging its responsibilities, the board should take into account not only the interests of shareholders but also the interest of depositors and other stakeholders.

2.5.2 CORPORATE GOVERNANCE IN THE EU

Corporate Governance has been identified by the European Commission as an important tool to generate the proper conditions for an efficient EU internal financial market (EC, Financial Services 1999). The main conclusion derived from different initiatives taken in this respect is that a harmonised EU code of corporate governance would not be effective given the differences in legal and financial systems of Member States. Instead, an increasing trend towards convergence of national codes should be encouraged.

As a response to the global financial crisis, the European Commission on 3 June 2010, issued the "Green Paper on Corporate Governance in financial institutions and remuneration policies", which provides a programme for examining corporate governance within financial institutions. The general context of the EU approach to corporate governance in financial institutions is similar to that of the Basel Committee. First, it focuses on the limited definition of corporate governance covering only internal processes of bank's business management without dealing with other important aspects, such as clear separation of responsibilities and functions. Second, the paper reinforces the supervisors' perspective on corporate governance emphasising the importance of sound corporate governance in financial institutions because of the need to protect creditors' interests along with those of shareholders.

In this light, the European Banking Authority (EBA) –successor of Committee of European Banking Supervisors (CEBS)– issued on 11 September 2011 "EBA Guidelines on Internal Governance" (GL 44). These guidelines, based on the supervisors' perspective, go even further: they define a new, narrower framework of corporate governance –"the internal governance" of financial institutions. They state (EBA, 2011) that:

"*[...] Corporate Governance is a broad concept that can be described as the set of relationships between an institution, its management, its shareholders and other stakeholders. Internal governance is a limited but crucial component of corporate governance, focusing on the internal structure and organization of an institution*". (p. 9)

In other words, the roles of external auditors, shareholders or other external stakeholders are not subject to these guidelines.

The guidelines suggest a "three-line-defence" model for financial institutions to apply. This model includes Risk Management processes; Internal Control framework; and Control Functions like risk control, compliance and internal audit.

The subject of these guidelines as stated in Title I, is the harmonisation of supervisory expectations and the improvement of the sound implementation of internal governance arrangements in line with Article 22 and Annex V of Directive 2006/48/EC and national company laws. The guidelines could be applied to single institutions and parent undertakings and subsidiaries on a consolidated or sub-consolidated basis. Another feature related to their scope is the *Proportionality principle*, which at a first glance looks similar to the "comply" or "explain" approach of codes of good corporate governance. In fact, this principle, stipulated in Directives 2006/48/EC and 2006/49/EC, does not provide an "explain" option. Rather, institutions should explain how "*[...] its approach, reflecting the nature, scale and complexity of its activities, meets the outcome required by guidelines*" (EBA 2011, p.16). To our understanding, this principle leaves no room for non-implementation under the "explain" approach. It only provides institutions with discretion in choosing the manner, instruments, and tools according to their size, activity and complexity, when meeting guidelines' requirements.

2.6 CORPORATE GOVERNANCE IN TRANSITION ECONOMIES

Corporate governance problems are existent in all countries regardless of their system or their stage of development. However, in countries in transition from a centralized economic system to the market economy, corporate governance issues become particularly important. The centralization of the economy and of social life in post-communist countries seems to be serious hurdles for solid corporate governance.

One of the main common characteristics of these countries is underdeveloped financial markets, which makes banks the main source of financing and gives them a dominant role for economic growth (Arun and Turner, 2004). One might argue that banks might have gained this role due to countries choosing to embrace the insider model of corporate governance when designing their new legal and economic systems during the transition period. Although the insider model argument is possibly true in particular cases, we argue that the stage of development of the capital markets and the special role banks have in such countries is highly influenced by the challenges faced during the transition period.

Because of the lack of private ownership and the perfectly 'monopolistic' state during communist times, these countries have very low levels of investor legal protection, particularly of minority shareholders, which, according to Shleifer and Vishny (1997), is prerequisite for effective functioning of capital markets as an external force to sound corporate governance.

Generally speaking, common law countries like the UK and the USA offer strong legal protection to investors and have well-developed financial markets as a consequence (Shleifler and Vishny, 1997).

Regardless of the legal system, however, effective law implementation seems to be the biggest common challenge of transition countries. In its White paper on Corporate Governance in South East Europe (SEE), the OECD identifies the weak capacities of SEE judicial systems as one of the major hurdles of effective corporate governance (OECD, 2003). Although legal reforms have brought about high standard legal acts, the judiciary systems seem to be unprepared due to lack of experience, lack of continuous training and insufficient resources. Indeed, insufficient specialized know-how, professionalism and resources, combined with a high level of corruption and lack of independence of judiciary systems, exacerbate the negative outcomes of the 'Rule of Law' absence (Barth, Caprio and Levine, 2002).

In addition to poor investor protection, especially of minority shareholders, the weak reliable financial information and disclosure requirements constitute an additional barrier to equity financing (Arun and Turner, 2004). To Shleifer and Vishny (1997), in transition countries bank debt is a more secure means of financing as compared to equity, since debt is backed by collateral that is easier to valuate.

Furthermore, Arun and Turner (2004) argue that the list of potential problems in transition countries is augmented with concentrated ownership. Coupled with the vague separation of ownership and control, this causes additional agency problems at the expense of minority shareholders. The concentration of ownership is a direct result of either family-based structures, or a slow privatization process in transition economies.

Among the most important direct outcomes of the lack of financial markets are: low level of skilled managers in the labour market, inexperienced board members, and political influence in the governance process of companies where the state is a majority shareholder and has dominant control over the company (Mc. Gee and Preobragenskaya, 2004).

All the above-mentioned features of transition economies push for an insider model of corporate governance, regardless of the system designed in the letter of laws (Shleifler and Vishny, 1997). As a result, banks have to cope with a whole new range of agency problems, specific to transition economies, which stem from relationship between corporate governance and banking regulation. This calls for a stronger role of regulatory and supervisory agencies. The latter, acting as agents of public interest in an environment with lack of private external monitoring and market control, have more incentives than judges in enforcing laws and regulations (OECD, 2003).

Based on this theoretical ground, we intend to explore the institutional and legal environment of corporate governance of banks operating in Albania with the main focus on the role of the Board of Directors. For this reason, we analyse the legal arrangements and their enforcement defining the model of corporate governance of companies and, in particular, of banks.

3. CORPORATE GOVERNANCE IN ALBANIA

3.1 A CORPORATE GOVERNANCE MODEL FOR ALBANIA

In this section, we will try to identify the corporate governance model applied in Albania by analysing the legal framework and several problems Albania is facing, as a transition country.

3.1.1 REFORMS IN THE LEGAL FRAMEWORK OF CORPORATE GOVERNANCE

Albania is a developing country[2] that is still undertaking structural, economic, social and legal reforms –most in light of the country's EU integration process. However, despite accomplishments to date, the country is still stuck in the long–lasting transition that started in year 1992.

In 2003, Albania started the negotiation process for a Stabilization Association Agreement (SAA)[3] with the European Union, which was eventually signed in 2005, and entered into force in 2006. The SAA serves as a transitory instrument (10 year period) aiming to bring Albania closer to the standards and values of the EU and to prepare the country for accession.

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[2] According to countries classification methodology used by the World Bank, see http://data.worldbank.org/country/albania

[3] SAA is a contractual instrument used for achieving the objectives of the Stabilization Association Process. See OJ L 107, 28.04.2009. According to the Glossary of the European Commission: "The Stabilisation and Association Process (SAP) is the European Union's policy towards the Western Balkans, established with the aim of European integration. Western Balkan countries are involved in a progressive partnership with a view to stabilising the region and the eventual establishment of a free-trade area. The SAP sets out common political and economic goals although progress evaluation is based on countries' own merits. Contractual (Stabilisation and association agreements*), economic (exceptional trade measures*) and financial (CARDS*) instruments support its realisation by strengthening reforms and the transition process. Regional co-operation* constitutes a fundamental part of the procedure". See http://ec.europa.eu/enlargement/glossary/terms/sap_en.htm

The entire agreement is based on the three pillars of the EU[4], focusing mainly on the first pillar especially on EU internal market principles and standards.

With regard to the corporate governance legal framework, the main legislation includes:

- Company Law[5]
- Public takeover law[6]
- Securities Law[7]
- Registration and Disclosures Law[8]
- Banking Law[9]
- Accounting and Financial Statements Law[10]
- Certified Accountants Law[11]

According to Article 70(3) of the SAA, these newly designed legal acts where part of the legal reform toward the approximation of

[4] Pillars of the European Union: The Treaty of Maastricht (1992) introduced a new institutional structure which remained until the entry into force of the Treaty of Lisbon. This institutional structure was composed of three "pillars":
the Community pillar, which corresponded to the three Communities: the European Community, the European Atomic Energy Community (Euratom) and the former European Coal and Steel Community (ECSC) (first pillar);
the pillar devoted to the common foreign and security policy, which came under Title V of the Treaty on European Union (second pillar);
the pillar devoted to police and judicial cooperation in criminal matters, which came under Title VI of the Treaty on European Union (third pillar);
http://europa.eu/legislation_summaries/glossary/eu_pillars_en.htm

[5] Law No. 9901 dated 14.04. 2008 'On Entrepreneurs and Companies" as amended.

[6] Law No. 10236, dated 18.02.2010 "On takeover of companies with public offer"

[7] Law No. 9879 dated 21.02.2008 "On Securities"

[8] Law No. 9723 dated 03.05.2007"On the National Registration Centre"

[9] Law No.9662 dated 18.12.2006 "On banks in the Republic of Albania" as amended in December 2011

[10] Law No. 9228, dated 29.4.2004 "On Accounting and financial Statements" as amended

[11] Law No. 10091, dated 05.03.2009 "On legal audit and the organization of certified financial accountants profession" as amended.

legislation with the *Acquis Communautaire* in the first stage[12] of the SAA in the areas of company law and financial services.

Referring to the annual Progress Reports (EC 2007-2011) issued by the European Commission, the above-mentioned legal reform should bring Albania closer to EU standards in terms of the functioning of market economy and to the European Single Market standards, providing solid foundations for further improvement.

In this regard, this newly designed legal framework mirrors the recent developments in the EU Company Law. From the 1960s to the 1990s, EU legislation and jurisprudence was focused on providing a common field of play for European companies, stressing the importance of the Right of Establishment and Free Movement of Capital.[13] The establishment of supranational companies with fragmented financial markets and the need for funding from international investors pushed the EU towards equity markets and corporate governance development.[14] Theoretically speaking, this meant a shift from the insider model of governance towards a hybrid model –a combination of the insider and outsider models, where the latter relies on capital markets and corporate governance.

As a result, the Albanian corporate governance legal framework is also a combined insider-outsider model, providing the legal infrastructure for a functioning equity market.

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[12] Article 6 stipulates that "The Association shall be implemented progressively and shall be fully realised over a transitional period of a maximum of 10 years, divided into two successive stages." while Article 70(3) stipulates that the approximation in the first stage shall focus on fundamental elements of the internal market Acquis, which are: "competition, intellectual, industrial and commercial property rights, public procurement, standards and certification, financial services, land and maritime transport — with special emphasis on safety and environmental standards as well as social aspects — company law, accounting, consumer protection, data protection, health and safety at work and equal opportunities". The remaining parts of the Acquis are subject to approximation in the second stage.

[13] Harmonization of company and accounting laws through Member States: First Council Directive 68/151/EEC; Second Council Directive 77/91/EEC; Fourth Council Directive 78/660/EEC; Seventh Council Directive 83/349/EEC; Free Movement of Capital Directive 88/361/EEC.

[14] A stepping stone for these reforms was the Action Plan for Modernization of Company Law and Improvement of Corporate Governance in the EU" 21 May 2003 {COM(2003) 284}.

As stipulated in Article 1 of the Securities Law,

"*...regulates the manner of and conditions for issuance, trading and registration, identification and performance of transactions in securities and persons and individuals authorized to perform transactions with securities, the conditions for the organization of the public trading of securities, the protection of investors and the securities-right holders, and the conditions for dematerialized securities, the organization and functioning of securities registries, exchanging and regulation of the securities market*".

In addition, the TSE was established in 1996 and licensed recently by the Albanian Financial Supervisory Authority, according to the requirements of the Securities Law.

Furthermore, legal requirements for financial information disclosure and transparency have been considerably improved. Articles 28 and 29 of the Securities Law stipulate the obligation of issuing companies to prepare and publish their prospectuses according to the principles, procedures and legal requirements on both the object and the content of prospectuses. The Accounting and Financial Statements Law obliges banks and other relatively big companies (i.e. with revenue over €10 million over the last two years and with 100 or more employees) to adopt International Accounting Standards for their financial statements (Art. 4). In addition to online business registration facilities, the Registration and Disclosures Law, provides for compulsory disclosure of annual accounting documents and other data in the National Registration Centre, which are made electronically available to the public. Moreover, the recently adopted Certified Accountants Law provides additional requirements on reporting quality. It "... aims to improve and strengthen the public supervision of registered and authorised accountant's profession" (Art.1/1). This law also regulates individual and consolidated annual financial statements, as well as the organization and functioning of audit companies and professional accounting organizations.

One of the most important developments in the legal area was the adoption of the new Company Law, which aims to provide a simple, clear and up-to-date system. It adopts EU standards on company law, corporate governance and social responsibility. With regard to companies ‘organisational framework under the new law, the joint-stock companies are free to choose between the one and two-tier system governance model, resembling the Italian company law. Under the two-tier system, the company is governed by the Supervisory Board appointed by the General Shareholders meeting, and the Managing Board, appointed by either the General Shareholders Meeting or the Supervisory Board. The optional design of the governing bodies is meant to facilitate business operations. This option offers a combination of two different systems of corporate governance. As mentioned in Chapter 2, the one-tier system is found in common law countries (outsider model), while the two-tier system is a distinguishing pattern of the German company law (insider model). In our opinion, the application of this option deserves careful attention in the future as it may result ambiguous, rather than supportive for attracting equity investors, at the cost of equity market development. Information asymmetries, probity of financial statements and different practices of corporate governance deriving from these options, combined with lack of knowledge and experience on corporate governance, might have a counter effect on equity market development.

Another novelty provided by this law is the abolition of the compulsory employee representation in the board. According to the old law, one third of the Supervisory Board had to be appointed by employees. However, there has been no evidence of the application of this provision in the past. The new Company Law stipulates the optional membership of employee representatives upon agreement between employees and the company management (Art. 21). Nevertheless, in concert with European standards, it foresees a legal obligation for company representatives to inform the Employee Council, and the right of the latter to be informed directly on activities, decisions, policies and strategies that affect employee interests, as well as to issue opinions and recommendations and to get feedback on their addressing (Art. 20).

Another important development is the initiative by the Ministry of Economy, Trade and Energy on encouraging Corporate Social

Responsibility (CSR) of economic actors, regulators and decision-making bodies. The project so far is being elaborated by an inter-institutional working group, business actors and other stakeholders. It aims at producing a policy document on further reforms in this field to catch up with EU standards. In the first draft of this document, the Albanian Government stresses its commitment on encouraging CSR as a key element for sustainable competition in the Albanian economy. The draft also contains a preliminary Action Plan resulting from a SWOT analysis of the current state of CSR in Albania.

Another important aspect in our analysis is the legal and structural position that banks hold in the Albanian corporate governance model. To Claessens (2004), banks and equity markets have complementary functions as sources of financing. According to his observations, in countries where a well-developed banking sector is in place, economic growth per capita is higher, regardless of the level of equity market's liquidity and sophistication.

However, as mentioned in Chapter 2, banks have a pivotal role in the case of the insider model, where market financing is not well developed. Unlike those in Germany and Japan, banks operating in Albania face legal restrictions on capital investments in any other non-financial commercial company. With Article 70 falling under Chapter V – *Risk Management* of the Banking Law, one can assume that these restrictions exist for prudential reasons. Indeed, Albanian banks may buy up to 10% of the capital of any commercial company. However, such an investment should not exceed at any time 15% of the bank's regulatory capital requirement. In companies with dispersed ownership, the 10% limit would probably grant banks, if not the majority of shares and voting rights, at least a controlling position similar to that of the "main bank" in Germany and "*keiretsu*" in Japan. Nevertheless, section 5 of Article 70 stipulates some exceptions. Namely these limits shall not apply when:

a) such shares or other ownership rights over them are taken in exchange for the loans granted. In such a case, the bank or the branch of a foreign bank shall hold all the shares or ownership rights over them for one year, unless the Bank of Albania decides to extend this period;

b) the bank or the branch of a foreign bank has gained such shares or other ownership rights over them in its status as agent;
c) such shares or other ownership rights are purchased with the view of selling them to third parties."

We believe that banks' investments above the 10% and 15% limits seem to be conditional. Reading between the lines of these provisions, one could identify two types of additional conditions: (i) short–term holding of shares by a bank, and (ii) the purpose and reason for obtaining such number of shares of a commercial company.

(i) While in case "a" above the time constraint is clearly defined, in case "b" the time is assumed to derive from the terms of the agency contract. In case "c" the situation seems somehow unclear. We have not found any evidence of the materialisation of this provision in banking practice to date. However, following the spirit and logic of the entire Article 70, holding of the purchased shares should be temporary and the bank ought to inform the supervisory authority about the time that the bank foresees to sell them.

(ii) In all three cases, exceeding the limits is allowed based on reasons closely related to the banking business. In case "a" the exception provides a restitution facility of loaned funds in case of clients' default. Case "b" and "c" may be considered as transactions subject to conventional intermediation and consulting services banks may provide to their clients.

Based on the analysis above, banks could affect corporate governance of commercial companies if the 10% amount of shares allows them a controlling position over the company's management. On the other hand, Albanian banks may perform the role of a "main bank" in the insider model in exceptional cases, as described above, especially in case "a". However, given the "temporary" nature of these exemptions, adverse negative effects on the company may not be excluded.

For all these reasons, we are able to conclude that the letter of law establishes a combined insider-outsider model of corporate governance in Albania, focusing on a proper legal infrastructure for a functioning external financial market (equity market). However, to fully determine a model for Albania, we would need to look at factors beyond the letter of the law, drawing on practical considerations with regard to law enforcement.

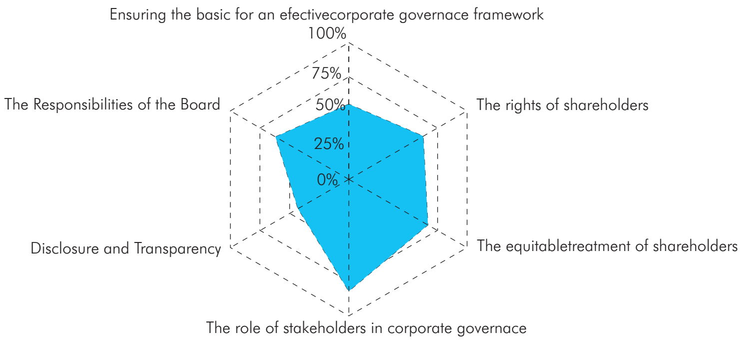
3.2 STATE OF PLAY

As mentioned in the previous sections, a well-functioning financial market contributing to economic growth needs to have sound legal foundations and an effective Rule of Law (Claessens 2003, Shleifler and Vishny 1997). Thus, building a modern legal infrastructure should be parallel to building institutional capacity for effective implementation and an effective judiciary system. Article 70 of the SAA implies that an effective approximation of legislation does not only mean to incorporate the *Acquis* in the national legislation, but also to ensure its effective implementation and enforcement. This obligation is reinforced in Article 78, which focuses on the importance of the consolidation of the Rule of Law, the judiciary system and other enforcement administrative institutions.

With law enforcement practices in mind, our analysis of the corporate governance model in Albania will focus on three equally important determinants: the quality of legal foundations from an effectiveness point of view, the quality of enforcement bodies, and Albanian companies' ownership structure.

The European Bank for Reconstruction and Development (EBRD) has conducted an assessment of corporate governance in Albania once the new Company Law entered into force. The assessment highlights improvements, but the law still needs to be harmonised with the EU legal framework, and the capacity of implementing institutions should be improved. Figure 3.1 shows that, despite the legal reforms under way, financial disclosure and transparency, as well as the right of shareholders and treatment of minority shareholders still remain poor. Indeed, these findings are confirmed by the screening process of the European Commission (EC, 2010 and 2011).

Figure 3.1 Quality of corporate governance and legislation in Albania



Source: EBRD, 2010.

The quality of financial disclosure, structure of ownership, as well as sound legal environment has a cumulative impact on the functioning of the equity market. Although established since 1996, there is not a single joint stock company out of 725, listed in the TSE (EC, 2011, TSE 2002-2010).

3.2.1 FINANCIAL DISCLOSURE

Despite legal reforms on accounting and financial reporting, the perception on reliability of financial information provided by enterprises, especially SMEs, in Albania remains low. In addition, although the annual disclosure of accounting information in the electronic register of the NCR is mandatory, the low compliance with this requirement points out the enforcement inability of the NCR (EC, 2010 and 2011).

The Accounting and Financial Statements Law stipulates that companies' legal representatives are responsible for the reliability of financial statements, but there are no sanctions foreseen for Supervisory Boards. The National Accounting Council–the supervisory authority responsible for the implementation of accounting standards– "lacks sufficient monitoring capacity for their enforcement" (EC, 2011 p.33).

In addition, financial statements are more tax oriented than investor oriented. The non-functioning TSE significantly reduces the demand for qualitative financial reports. The latter, as mentioned above, are an important tool to attract external financing.

3.2.2 OWNERSHIP STRUCTURE

SMEs represent almost 100% of enterprises in the Albanian economy according to the EU definition of SMEs[15] (Figure 3.2). They are considered as the main driver of economic growth. However, as shown in Figure 3.3 and Figure 3.4, 78.5% of SMEs are single person micro enterprises (physical persons), 17.1% are Limited Liability Companies (LLC), and 0.7% Joint Stock Companies (JSC). Albanian enterprises are mostly family based with a highly concentrated ownership structure and very small size in terms of number of employees and business expansion rate. In the absence of a functional equity market, SMEs finance their activity mostly through internal (informal) sources and bank loans. These factors do not provide enough incentives for owners to produce qualitative financial reports, while keeping away external investors due to very high costs of investments. In most of the cases, banks do not rely on official financial statements when making loan decisions, but they base their judgment on the evaluation of collateral, business plans and information gained through site visits.

Considering such a structure, in December 2011, the Ministry of Economy Trade and Energy introduced The Internal Corporate Governance Code for non-listed companies. The code encompasses the best international practices and is considered as a guideline for effective governance of non-listed companies, through determining the roles and responsibilities, as well as a clear

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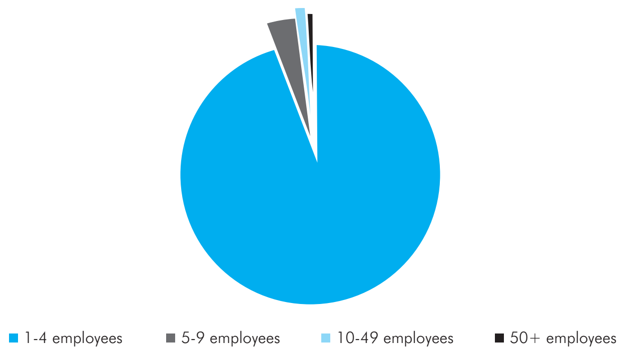
[15] Commission Recommendation (2003/361/EC) concerning the definition of micro, small and medium-sized enterprises, 6 May 2003. According to the definition, medium-sized enterprises employ fewer than 250 persons.

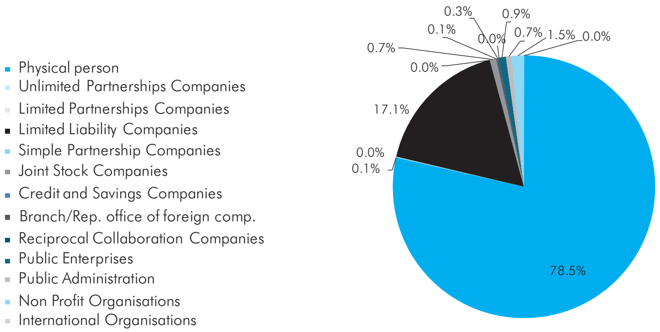
distinction of competences of shareholders, board of directors, management and other stakeholders. The code is a necessity for reaching EU standards and reforming corporate governance, while building up the trust of foreign investors towards Albanian companies (Bozdo, 2011).

Figure 3.2 Active enterprises by number of employees (Share of SMEs)



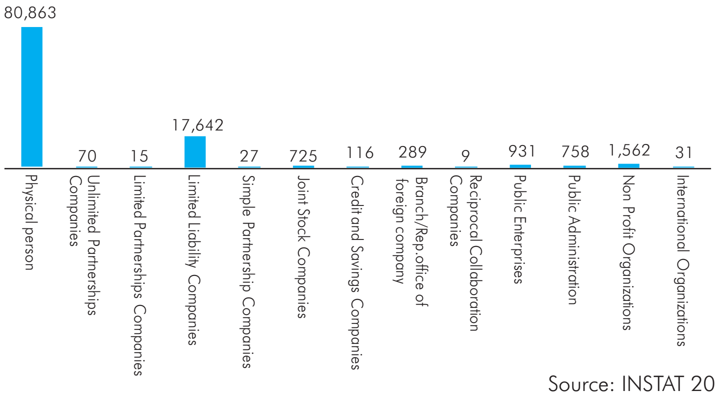
Source: INSTAT 2010.

Figure 3.3 Active enterprises by legal form



Source: INSTAT 2010.

Figure 3.4 Active enterprises by legal form



Source: INSTAT 2010.

3.2.3 LEGAL ENVIRONMENT – RULE OF LAW

Efficient law implementation and an efficient judiciary system remain obstacles for financial market development and investment quality improvements. More generally, the judiciary system still hinders Albania's progress across all the areas. Its independence, transparency and efficiency suffer shortfalls. In most cases, court rulings are neither fully transparent, nor fully enforced, and the proceedings are delayed. The European Commission points the judiciary system as one of the areas where corruption in Albania is prevalent and the public trust very low (EC, 2007-2011). Among the causes of such problems are insufficient training, suboptimal professional capacities and an inefficient performance appraisal system. Oftentimes, the nomination of judges is subject to political dispute, thus limiting the independence of the system. The enforcement of contracts and legal certainty are yet other problems that often lead to informal methods of contract enforcement.

The NRC does not have sufficient power to enforce compliance with the new Company Law. Most of the companies have not updated the by-laws, forcing the NRC to postpone the deadline. This delay has led the parliamentary commission to refuse amendment proposals for the company law, e.g. increase of the required paid up capital for joint stock companies (Shekulli, 2011).

In conclusion, we show that Albania faces the same problems as all transition countries do, summarized in section 3.1 of this chapter. Despite the letter of the law on the model of corporate governance, equity markets are absent in Albania. This absence results in reduced financial sources for expansion and lack of market monitoring with regard to companies management. Bank credit remains the most important formal source of financing, representing 95% of financial sector assets. Consequently, in face of lack of a strong Rule of Law and lack of reliable financial information, the pivotal role of banks in the Albanian economy and highly concentrated ownership indicate an insider corporate governance model in Albania. As a result, sound bank governance and the role of the supervisory authority as the agents of depositors and creditors, ought to be paid more attention.

4. GOVERNANCE IN ALBANIAN BANKS

4.1 OVERVIEW

4.1.1 THE FINANCIAL CRISIS AND ALBANIAN BANKING SECTOR

The recent global financial crisis did not severely affect Albanian banks mainly due to their stage of development, low integration with global financial markets and prudential regulation and supervision by the Bank of Albania (IMF, 2011). However, the banking system witnessed a sharp decline in deposits, mostly owing to the public's perception and memory of the pyramid schemes' collapse in 1997. The deposit portfolio recovered quickly as a result of prudential measures undertaken by the supervisory authority. A post-crisis concern emerged with regard to increasing nonperforming loans (NPLs), from 3% pre-crisis to 16.6% in the second quarter of 2011 (EC 2011, IMF 2011). According to the IMF (2011), such an elevated level of NPLs is partly caused by institutional and judiciary weaknesses that have hampered collateral execution and partly by the slowdown in economic activity. However, we believe that high NPLs can be grounded on other factors, including shortfalls in bank governance.

During 2008-2010, as a response to the potential indirect effects of the global financial crisis on the Albanian banking sector, the supervisory authority introduced stricter regulation in cooperation with banks. Corporate governance issues were also part of these new legal measures. In early 2009, the Deposit Insurance Law[16] was amended to increase the amount of deposits insured, resulting effective in restoring public confidence in the banking system. However, the counter-effects it may have induced on banks' risk-taking behaviour have not yet been assessed. Other legal measures include: risk management policies and procedures defining the responsibilities of Board of Directors and executive management;

[16] Law No.10106, dated 30.3.2009 "On some amendments to the Law No. 8873, dated 29.3.2002 "On deposits insurance".

financial disclosure and transparency on products and services; and internal and external audit systems.[17]

The most important legal novelties with regard to corporate governance were the adoption of a new regulation in 2009, which sets the core principles and rules for a responsible and efficient management of banks and branches of foreign banks and fit-and-proper criteria for bank administrators.[18] These measures also led to the amendment of the Banking Law in November 2011, increasing the minimum number of independent members of the Board from one third to the majority of the Board.

Bank of Albania's heightened focus on banks' corporate governance was introduced in the Medium-Term Development Strategy of Banking Supervision 2009-2014 (Bank of Albania, 2009). One of the challenges of banking supervision is "Capacity improvement of Albanian banks with regard to independent risk management and implementation of the best standards of corporate governance" (Bank of Albania, 2009, p. 11). In the same document, the Bank of Albania commits to improve its supervision processes by focusing on direct inspection and assessment of corporate governance of banks, responsibilities of the Board of Directors and other management bodies for risk management and sound business processes.

Furthermore, in 2010 the Mission of Banking Supervision reinforced this approach, in line with that of Basel Committee and the EU stating that

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[17] Risk Management: Regulation No. 31 "On risk management arising from the large exposures of Banks" (2009); Regulation No 71 "On liquidity risk management" (2009); Regulation No. 48 "On open foreign exchange positions risk management" (2010); Regulation no 62 "On credit risk management" (2011); Regulation No. 03 "On the operational risk management" (2011); Financial disclosure and transparency: Regulation no 59 "On the transparency for banking and financial products and services" (2008); Regulation no 60 "On the minimum requirements of disclosing information from banks and foreign bank branches"(2008); Regulation No. 45, "On the reports at the Bank of Albania accordingly to the Unified Reporting System" (2009); Internal and external audit systems: Regulation no 24 "On the Internal Audit System of banks and foreign banks' branches" (2008); Regulation No. 06 "On the authorized chartered auditors of banks" (2011) amended.

[18] Ibid, supra et 23

"In fulfilling its legal responsibilities, the Bank of Albania will aim to safeguard the banking system's stability through [...] recommendation of necessary measures, so that the supervised entities adjust to these developments and be governed according to best practices" (Bank of Albania, 2010 p. 1).

Such legal reforms provide a solid basis for banks' governance, which implies the Bank of Albania perceives sound governance as an endogenous source of financial stability. To reinforce this approach, in early 2010, an internal working group was established within the institution[19] to assess the implementation of the legal framework and design a corporate governance rating index of banks.

4.1.2 COMPETITION AND OWNERSHIP STRUCTURE IN ALBANIAN BANKS

There are sixteen privately-owned banks operating in Albania, representing individual shareholders and large European banking groups (see Chapter 2). The ownership structure is highly concentrated, with the exception of one bank that represents the highest number of shareholders and the most dispersed structure (Figure 4.1). Eight banks are fully owned by a single shareholder, mainly a parent European bank, while four banks are controlled by a single shareholder with more than 50% of shares.

[19] The working group comprised representatives from Supervision, Research and Human Resources departments of the Bank of Albania

Figure 4.1 Ownership structure and average number of shareholders in Albanian banks

Participation in ownership (%) Highest stake by a single shareholder	Number of Banks(out of 16)	Highest stake In these class of banks	Lowest stake in this class of banks	Average number of shareholders in this class of banks	Comments
Fully owned 100%	10	100%	96.70%	1.3	Here are included two banks, which the highest % of shares held by a single shareholder are respectively 96.70% and 99.61% thus 8 banks are fully owned by a single shareholder mainly financial institutions.
80% - 90%	3	87.47%	83.13%	5	Lowest number of shareholders 2; highest number of shareholders 9
50% - 80%	1	55%	0.5%	12	Only one bank recorded with highest percentage of shares by a single shareholder 55%
30% - 50%	1	33.35%	33.30%	3	Almost equal blocks of shares
≤30%	1	24.89%	0.29%	15	The only bank with highly dispersed ownership structure

Source: Bank of Albania, November 2011, own calculations.

As we can observe, the ownership structure of banks mirrors that of other companies in Albania. This implies an insider model of corporate governance within the banking sector and a strong internal force for banks' management monitoring and control by shareholders.

In chapter 2, we concluded that competition in the banking sector would be an external force for good corporate governance. Unlike general firms, unrestricted competition in the case of banks may have counter-effects on the financial performance of a single bank, and/or the financial stability of the entire system (Note, 2006, p. 6). Hence, banking regulation such as entry capital requirements, regulatory capital, capital adequacy and fit-and-proper requirements restrict competition according to the financial stability expectations of the regulatory authority.

Note (2006) has measured the level of competition in the Albanian banking sector using the Panzar-Rosse (PR) methodology.[20] She finds that banks are moderately competing, which is satisfactory given Albania's development stage. Calculations of the Herfindahl Hirschman Index (HHI) during the first half of 2011 (FSR, Bank of Albania, 2011, p. 63),[21] show that the level of competition has remained moderate since 2007, including assets, loans and deposits (Figure 4.2).

Based on these results, we believe that moderate competition,[22] along with prudential banking regulation, serves as an external force to improve banks' governance.

Figure 4.2 Herfindahl Hirschman Index (HHI)

HHI	Assets	Loans	Deposits
1999	4,795	3,316	5,719
2000	4,382	2,727	4,966
2001	3,757	2,011	4,282
2002	3,226	1,729	3,676
2003	3,016	1,459	3,487
2004	2,736	1,150	3,107
2005	2,110	1,035	2,391
2006	1,775	1,095	2,003
2007	1,550	1,121	1,743
2008	1,506	1,188	1,732
2009	1,433	1,115	1,555
2010	1,421	1,126	1,503
2011 (June)	1,449	1,119	1,525

Source: Bank of Albania, 2011.

[20] Note (2006, p. 10) explains that according to the PR methodology "depending on the competition level of the market, banks exhibit different pricing behavior in response to changes in their costs. It examines the relationship between the revenues earned by banks and the costs used to generate these revenues in order to infer the competition that these banks face"

[21] Bank of Albania, "Financial Stability Report 2011 H1" (2011) also available online at http://www.bankofalbania.org/web/Financial_Stability_Report_2011_H1_6305_2.php.
A HHI index is interpreted as follows: 0.01 (or 100) = highly competitive environment; 0.1 – 0.18 (or 1,000 to 1,800) = moderate concentration; above 0.18 (or 1,800) = high concentration.

[22] Monopolistic competition occurs when there are many firms in the market, but each of them focuses in specific geographical segments or provides products with different characteristics. Therefore, it is possible for firms to exercise market power to some extent and to earn higher-than normal profits.

In a nutshell, the highly concentrated ownership might have some impact on the role of shareholders, Board of Directors, as well as on the specific relationships among stakeholders (shareholders-management-depositors/creditors-regulatory agency). On the other hand, moderate competition can be considered an external market force in the banking sector.

In the following section we provide a detailed analysis of corporate governance legal framework and its effectiveness, with a focus on the Board of Directors, based on the impact of Basel Principles on corporate governance of financial institutions, as described in Chapter 2.

4.2 THE LEGAL FRAMEWORK FOR BANK GOVERNANCE IN ALBANIA

The legal framework for bank governance in Albania consists of Banking Law, Company Law, the regulation on core management principles of banks and branches of foreign banks[23] and a set of other banking regulations endorsed by the Bank of Albania in implementing the Banking Law. Banks in Albania are established as Joint Stock companies (JSC).[24] Hence, they are subject to most of Company Law provisions on corporate governance, even though their organisation and governance are specifically dealt with in Chapter III of the Banking Law.

These pieces of legislation usually complement each other, even though in some cases they overlap. While corporate governance provisions in the Banking Law are motivated by financial stability

[23] Regulation approved by the Supervisory Council of the Bank of Albania No. 40, dated 27.05.2009, "On core management principles of banks and branches of foreign banks and the criteria for the approval of their administrators". This regulation abrogates the Regulation "On the administrators of banks and branches of foreign banks" approved by the Supervisory Council No. 120, dated 30.12.2003, amended. The new regulation widens its scope by defining the principles of banks management and the responsibilities of the governing bodies with regard to the implementation of these principles according to Basel Principles for enhancement of corporate governance in financial institutions

[24] Article 10(1) of the Banking Law

concerns and systemic importance of the banks for the financial stability, Company Law provisions apply to banks as JSC. Therefore, Company Law provisions should apply to banks on issues that Banking Law and regulations are silent or ambiguous. However, the Banking Law should prevail in case of legal conflict for two main reasons: First, the Banking Law regulates a specific type of JSC, unlike the Company Law, thus the postulate *lex specialis derogat legi generali* should apply. Second, based on the systemic importance of banks, the Banking Law should prevail, based on the arguments of financial stability concerns and public interest. However, whenever Banking Law provisions are vague or ambiguous, we believe that the supervisory authority should apply Company Law requirements.

The following sections provide an overview of the legal framework according to the Basel Principles on the corporate governance of financial institutions.

4.2.1 QUALIFICATIONS AND UNDERSTANDING OF THE ROLE OF BOARD MEMBERS

Under Article 134 of the Company law, a Joint Stock Company established in Albania needs to have: a General Meeting of Shareholders and either a Supervisory Board, a Management Board (two-tier system), or an Administrative Board (one-tier system), depending on their company statutes.

Unlike general JSCs, banks are directed by a board of Directors and a directorate (senior management).[25] They have no Supervisory Board.[26] In contrast with the old Company Law, Article 35(1) of the Banking Law only provides for a one-tier structure for banks. Accordingly, the Board of Directors is both the decision-making (direction and management) and the supervisory (control) body. It delegates day-to-day management to one or more executive directors.

[25] Ibid., Article 32.

[26] Ibid., Article 30(1).

Under Article 35(2) of the Banking Law, the Board of Directors should be composed of an odd number of individuals, between 5 and 9 members.

The Banking Law significantly emphasizes the need for a board that is sufficiently separated from management in order to exercise objective decision-making, to ensure accountability of and provide strategic guidance to the management. Before the most recent amendment, Article 35(4) required at least one third of board members to be outsiders (independent), i.e. persons not related through private interests to the bank itself, its shareholders or its executive directors. The amendment of November 2011 requires that the majority of Board members be independent. This is also consistent with Article 155(1) of the Company Law, which requires the majority of the board in JSCs to be independent and non-executive directors.

Furthermore, the supervisory and managerial bodies are not entirely separated in terms of composition, given that executive directors may sit in the board, provided they do not make up the majority.[27] Strikingly, under Article 167(3) of the Company Law, the Board of Directors is barred from including company executives or executives from other companies, as well as persons related to them. Arguably, this provision considers these kinds of relationships likely to hinder objectivity.

At this point, we deem necessary to focus on the concepts of "nonexecutive" and "independent" directors in a context of highly concentrated ownership, especially when a bank is fully controlled by a parent bank. The new amendments to the Banking Law are not yet implemented. Under the abrogated legal requirements, the board should have had at least one third of independent members, with executive directors not accounting for the majority. The potential number of board members is 5, 7 and 9. A simple mathematical exercise shows that a board needs to have at least 2, or 3 independent directors, depending on the total number of members. Given that executive directors cannot exceed the majority of members, the remaining part is 1 or 2 nonexecutive directors,

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[27] See Article 35(7) of the Banking Law.

although not necessarily independent. To conclude, we believe that this legal setting implies that a nonexecutive director might not necessarily be an independent one. Such a rationale might have served as a foundation for the recent amendments. Indeed, in the Medium-Term Development Strategy of Banking Supervision 2009-2014, the Bank of Albania stresses the importance of independence of the Board of Directors of Albanian affiliates from their parent banks in fulfilling their responsibilities (Bank of Albania 2009). It argues that independent administration of risks, which foreign banks incorporated in Albania may encounter as result of their business activity in the Albanian market, shall ensure the prevention of incorrect risk assessment and share value maximisation in the long run (Bank of Albania 2009, p. 11). Anecdotic evidence extracted from unofficial interviews with Bank of Albania officials reveals another reason. Their main concern seem to have been some of shareholders sitting in boards, either personally or by their legal representatives, having adverse implications in the case of banks.

As per the role of the chair of the board, under Article 35(2) of the Banking Law, he/she has to lead and organise work. The chair and the deputy, elected among board members, should be non-executive directors.[28] Such a separation between leadership roles aims at increasing the distinction between the supervisory and the managerial functions of the board, as well as at strengthening its independence, and eliminating potential sources of conflicts.

Under Article 37(ç) of the Banking Law, many supervisory functions may be delegated to special board committees. These bodies help organise the work of the board, particularly where the interests of the bank and the interest of its senior management may come into conflict, notably in areas of audit, remuneration and performance. Even though the law is silent, it is widely accepted that independent directors should have the majority in committees, due to their special role in banks' supervision.[29] Indeed, properly composed

[28] Ibid., Article 35(8).

[29] This is expressly recognised in Article 161(4) of the Company Law, as well as in Article 44(5) of the Banking Law, whereby the board may establish ad hoc committees composed of non-executive directors for handling cases of conflicts of interest.

committees constitute an effective means of providing objective judgement on key issues in which senior management may have a personal interest. Such an arrangement is in line with the OECD principles of corporate governance.[30]

Article 37(2, e) of the Banking Law empowers the board with oversight of the audit function, which is key to shareholder and depositor confidence and the integrity of markets.

Under Article 42, board members –as well as senior management, and the director of the audit unit[31]– shall be a priori approved by the Bank of Albania. The requirements on the approval, revocation, dismissal and removal of management are set forth under Regulation "On the core management principles of banks and branches of foreign banks and the criteria on the approval of their administrators".

The quality, experience, and independence of the board's membership affect its ability to perform its duties. Therefore, board members should possess the necessary qualifications, reputation and expertise to enable effective governance and oversight. The qualifying criteria include a university or post-graduate degree –as a general rule– in law or economics, or, if not, at least five years of experience in the banking sector, good reputation, and at least three years of experience in the financial sector, risk management in the financial markets, financial management, banking/financial supervision, business, auditing, legal or academic experience related to financial market economics or jurisprudence.[32]

4.2.2 STRATEGIC OBJECTIVES AND CORPORATE VALUES

Under Article 37(1) of the Banking Law, the members of the Board of Directors
"while discharging their duties should comply with the highest ethical standards and act upon sufficient and adequate information,

30 See OECD 2004

31 See Article 4(19) of banking law.

32 Ibid Article 13 and Article 2 of the Banking Law

in good faith, with the due care and responsibility, fully committed to their responsibilities, in the best interest of the safety and sustainability of the banking and financial activity, of the clients and their shareholders".

In addition, the Board is charged with responsibility to set long-term objectives of the bank, monitor their achievement and approve and control the implementation of bank policies and strategies with regard to its business plan, risk management and annual budget.[33]

4.2.3 CLEAR LINES OF RESPONSIBILITY AND ACCOUNTABILITY

Accountability of the supervisory and managerial bodies on the company's activities is a central theme in corporate governance. Because this issue is not dealt with in the Banking Law, the Bank of Albania issued the Regulation "On the core management principles of banks and branches of foreign banks", which defines the roles of the Board and the Directorate in terms of corporate governance principles. In addition, the relevant provisions of the Company Law apply to banks' bodies, as well. Under Article 163(2) of the Company Law, managers and Board members should be held accountable to the company for every act or omission committed in bad faith.

Senior management consists of one or more executive directors –including the general director, deputy director and department chairs– who are responsible for overseeing the day-to-day management of the bank.[34] These individuals should fulfil the same qualification, reputation, and experience requirements as the Board members, and their nomination is also subject to prior approval by the Bank of Albania.

Senior managers oversee department chairs in specific business areas and activities consistent with policies and procedures set by the bank's Board of directors.

[33] Ibid, Article 37 (2, a, b)

[34] See Article 39 of the Banking Law

4.2.4 APPROPRIATE OVERSIGHT BY SENIOR MANAGEMENT

One of the key roles of senior management is the establishment, under the guidance of the board of directors, of an effective system of internal control[35]. The main objectives of the internal control system include[36]:

- assessing the efficiency of the bank in carrying out its activities and using its assets;
- ensuring the reliability, adequateness and accuracy of the financial and management information;
- ensuring compliance of the bank with applicable laws and regulations, as well as with organisation's policies and internal procedures approved by the board and senior management.

Under Article 37(2) of the Banking Law, the Board of Directors has the ultimate responsibility of ensuring that an adequate and effective system of internal control is established and maintained. As noted above, the Banking Law provides for the establishment of an audit committee to assist the Board in carrying out its responsibilities in this area. The audit committee is responsible for overseeing the implementation of internal accounting procedures and the internal control system[37]. Accordingly, the internal audit unit reports to the audit committee on the results and findings of its activities.[38]

Senior management is responsible for carrying out the implementation of the board's policies and procedures, including risk identification, assessment, overseeing and control.[39] In this respect, the CEO coordinates work with department chairs to carry out any corrective measures adopted by senior management when implementing the findings and recommendations of the internal control unit.

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[35] See Article 45 of Banking Law.

[36] See Article 4(2) of Regulation on the internal control system of banks and branches of foreign banks, approved by the Supervisory Council of the Bank of Albania, Decision no. 24, dated 26.3.2008.

[37] See Article 38(3, a) of Banking Law.

[38] See Articles 10, 18, and 22 of Regulation on internal control systems of banks and branches of foreign banks, supra 38.

[39] Ibid., Article 9

4.2.5 EFFECTIVE INTERNAL AND EXTERNAL CONTROL

The Banking Law also provides for the establishment of an audit committee as an advisory unit to the board.[40] Under Article 38(3), the audit committee is responsible for overseeing the bank's accounting procedures and internal control; proposing the appointment of the external auditor; evaluating audit reports; and ensuring bank's compliance with laws and regulations.

In contrast with the old Banking Law, the above-mentioned stipulations in the new Banking Law state that the members of audit committees should not be employees or executive directors of the bank. They may, however, be members of the Board of Directors. Such arrangements aim to achieve sufficient objectivity and independence in the performance of their duties. Moreover, the members should have, at least, three years of experience in accounting or auditing.

Under Article 38(1, c) of the Banking Law, the Board of directors may establish other specialised committees to perform advisory functions.

4.2.6 COMPENSATION POLICIES

Determining the compensation of executives is a key supervisory body function. Such a function is regulated by Article 37(2, d) of the Banking Law.[41] In addition, Bank of Albania's regulation on core management principles[42] assigns the board the responsibility to adopt remuneration policies and rules that are in line with the strategies, the long-term objectives of the bank, and its performance and development. The regulation provides for the establishment of remuneration committees upon the Board's judgement. The Board or the committee are responsible for supervising the implementation of these policies in compliance with the principles mentioned above.

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[40] See Article 38(7).

[41] Compare to Article 154(1, f) of the Company Law, which provides for detailed rules for the remuneration of the governing bodies of joint stock companies.

[42] Article 10 supra et 23.

The Banking Law and regulation are silent with regard to the remuneration schemes of Board members who are executive directors at the same time, and the publication of such schemes. However, Article 160 of the Company Law may be applicable in these cases. It stipulates that Board members may be granted other incentives, apart from remuneration, including parts of the company profit or share options for their work, while the salary of Managing Directors may be supplemented by incentives.[43] These schemes and their application should be made available to shareholders and other stakeholders, as well as published in the annual report.[44]

4.2.7 TRANSPARENCY

Under Article 53 of the Banking Law, a bank is required to disclose the financial performance and the risk position in its annual and periodic reports. Public disclosure may occur in banks' websites, in their reports, in their reports to the Bank of Albania, or by any other appropriate means of publication.[45] The information to be disclosed by the banks includes:

- the main business, as well as bank's organisation, management, direction and control[46]
- its financial situation and progress[47]
- accounting policies used when preparing financial statements.[48]

With regard to the publication of corporate governance practices, Article 134(2) of the Company Law stipulates more detailed requirements that apply to both banks and JSCs. Under these provisions, the annual report should contain a coherent and descriptive statement on key elements of corporate governance

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43 Article 160(1) of the Company Law

44 Ibid. Article 160(4)

45 See Regulation of the Supervisory Board of the Bank of Albania, no. 60, dated 29.08.2008, on the minimum requirements for publishing information from the banks and the branches of foreign banks, Article 7; Official Bulletin of the Bank of Albania, volume 10, no. 7, August 2008, p. 28.

46 Ibid., Article 9.

47 Ibid., Article 11.

48 Ibid., Article 12.

rules and practices followed. With regard to management, this statement should include the profiles of executive directors and Board members, explaining in detail why individual directors or supervisors are qualified to serve based on their profiles. The law assigns them responsibility on the probity of this statement.[49]

The above information serves to provide depositors and other customers with a clear and comprehensive picture of the financial and management performance of the bank as a means for market discipline and public trust building.

4.3 APPLIED CORPORATE GOVERNANCE IN THE BANKING SECTOR

Our analysis so far shows that corporate governance in Albania encompasses the insider model of governance. As we have already established, this model typically features concentrated ownership, and higher participation of shareholders in the company' management, more monitoring and controlling over management, very few cases of agency problems, and generally encourages long-term strategies and sustainability. On the other hand, such a model might induce conflicting interests between major shareholders and minority shareholders, such as potential expropriation of minority shareholders. Furthermore, conflicting interests might arise between stockholders and other stakeholders.

The role of the board on preserving/ensuring balance among stockholders, stakeholders and management is crucial for good corporate governance. This role becomes particularly important in the case of banks, as previously argued. According to the Basel principles "Indeed, in addition to their responsibilities to shareholders, banks also have a responsibility to their depositors and to other recognised stakeholders" (Basel 2010, p. 5). The importance of the board is rooted in its responsibility to ensure public confidence in the banking system. Poor corporate governance can lead to bank failure, a shock that might be propagated into the entire financial system due to high public sensitivity.

[49] Article 164 of the Company Law

In the following section, we will focus on the application of two aspects of corporate governance: the board and transparency.

4.3.1 BOARD INDEPENDENCE IN ALBANIAN BANKS

Board independence is measured directly via the number of independent board members. Board independence is necessary in that it should ensure objective judgement and accountability of the board when monitoring management, setting strategic objectives, and preventing conflicts of interest. In addition, independent board members significantly contribute to the decision-making process, especially in areas where the interests of management, the company and its shareholders may diverge, such as executive remuneration and succession planning (OECD, 2004).

The Basel Committee on Banking Supervision reinforces this principle by stating that:
"*Banks should have an adequate number and appropriate composition of directors who are capable of exercising judgment independent of the views of management, political interests or inappropriate outside interests* (Basel, 2010, p. 11).

Apart from the direct measure, i.e. the number of independent directors, Board independence depends largely on the personal integrity and business ethics of Board members.

Referring to the Banking Law and its description of legal requirements of Board composition, we analyse the implementation of these requirements in Albanian banks. Surveys conducted by Bank of Albania in 2010 and 2011(Bank of Albania 2010 and 2011) with regard to Board composition and practices show that the level of independent directors in banks Boards is very low. According to the 2010 survey, nearly half of the banks have less than one third of independent directors, i.e. they do not meet the minimum legal requirement. Believing that responses might not have been accurate due to possible confusion about the definition of 'independence', the survey was altered in 2011, providing a clear definition of independence. Unfortunately, not only did the second survey reinforce previous results, but it also revealed that many banks do not even have one independent member sitting in their Boards. Figure 4.3 illustrates the results of both surveys.

Figure 4.3 Number of independent directors in Boards of Albanian Banks

Banks	Number of independent directors compared to the total number of Board members (in %) 2010 SURVEY	Number of independent directors compared to the total number of Board members (in %) 2011 SURVEY
B1	1 out of 6 (16.7%)	1 out of 5 (20%)
B2	1 out of 7 (14.3%)	2 out of 7 (29%)
B4	1 out of 5 (20%)	0 out of 5 (0%)
B5	3 out of 5 (60%)	0 out of 4 (0%)
B7	4 out of 4 (100%)	2 out of 4 (50%)
B9	3 out of 7 (42.9%)	2 out of 7 (29%)
B10	1 out of 5 (20%)	2 out of 5 (40%)
B11	0 out of 6 (0%)	0 out of 6 (0%)
B12	0 out of 5 (0%)	0 out of 5 (0%)
B13	4 out of 5 (80%)	1 out of 5 (20%)
B14	2 out of 7 (28.6%)	2 out of 7 (29%)
B15	N/A*	0 out of 5 (0%)
B8	N/A*	0 out of 9 (0%)
B16	2 out of 5 (40%)	3 out of 5 (60%)

Source: Bank of Albania 2010, 2011.

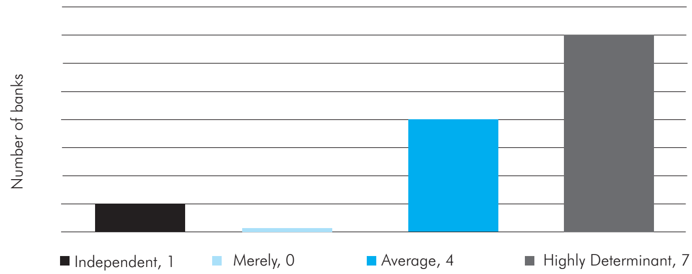
We would argue that a possible explanation for these results is that bank shareholders do not pose strict requirements about independent Boards, which seems likely when Albanian banks are owned 100% by parent banks. These results provide robust evidence regarding Bank of Albania's concerns, raised in its Banking Supervision Development Strategy (Bank of Albania 2009 p. 21). They validate the new regulation on Board members' independence, giving the regulatory authority greater scope as an agent of public interest. Nevertheless, adopting laws, regulations and codes is not sufficient for guaranteeing good corporate governance, best illustrated in Figure 4.3. Our analyses in sections 3.1) and 3.2.2) reveal that Board composition in Albania does not differ from other SEE countries, reflecting a concentrated ownership structure.

4.3.1.1 ARE BOARDS APPROVING AND OVERSEEING STRATEGIC OBJECTIVES?

Under Basel principles,
"The Board has overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, risk strategy, corporate governance and corporate values. The Board is also responsible for providing oversight of senior management" (Basel, 2010, Principle 1).

Practically speaking, we could agree that parent banks or large shareholders do impose company policies and strategic objectives. According to Bank of Albania's 2011 survey, the majority of the banks that are branches of affiliates of foreign banks confirmed that strategic objectives are closely linked with and determined by the policies and strategies of the foreign shareholder/parent bank (Bank of Albania 2010, 2011). Figure 4.4 illustrates the level of influence from the main shareholder on strategic decisions.

Figure 4.4 Role of the shareholders on strategic decisions
What is the role of shareholders/foreign bank (when your bank is an affiliate) or the parent banks (when your bank is a branch of the parent banks) in determining strategic objectives of your bank?



Source: Bank of Albania, 2011.

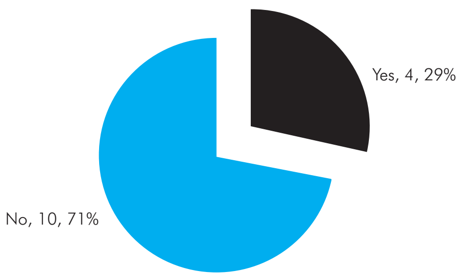
While we could agree that it is reasonable for major foreign bank branches to tie their strategic objectives to their parent bank, we believe that this phenomenon is problematic in the case of independent entities –banks incorporated in Albania. We believe that this would exert considerable pressure on the Board and the company's management to meet their imposed upon strategic objectives, up to the point of potentially undertaking greater risk.

4.3.2 WHAT DO BANKS THINK ABOUT BOARD MEMBERS' QUALIFICATIONS?

Generally speaking, to clearly understand business principles and take strategic decisions, Board members need to be well qualified. The decision-making process needs to be backed by qualifications in accounting, strategic planning, risk management, financial reporting, etc. The Basel principles on bank governance encourage banks to have on-going training and education for Board members, or take other steps to ensure they are knowledgeable enough for fulfilling their responsibilities (Basel, 2010 Principle 2).

We motivate the focus on this aspect of corporate governance on the Bank of Albania survey results of 2011. Ten banks gave negative answers on: *Are the banks developing training/ education programmes for the Board members on corporate governance?"* Figure 4.5 shows a distribution of answers.

Figure 4.5 Board qualifications
Does the bank and the board bank ensure that board members have access to initial and ongoing trainings on relevant issues, dedicating sufficient time, budget and other resources for this purpose?



Source: Bank of Albania, 2011.

4.3.3 DO BANKS FULFIL LEGAL REQUIREMENTS ON DISCLOSURE AND TRANSPARENCY?

As previously mentioned, studies of the EBRD (2010), the OECD (2003), show that transparency and disclosure remain the weakest points of corporate governance in Albania and the SEE in general. The model of corporate governance, low demand on qualitative and reliable financial statements, coupled with a non-functioning stock market in Albania, are among the key factors that impede transparency and disclosure. The Basel's principle 14 states that:

"*Although transparency may be less detailed for non-listed banks, especially those that are wholly owned, these institutions can nevertheless pose the same types of risk to the financial system as publicly traded banks through various activities, including their participation in payments systems and acceptance of retail deposits.*" (Basel 2010, paragraph 124)

Annual reports published by Albanian banks tend to cover only information related to financial statements. Some information about their governance can be found on their web sites. However, the information is limited to organisational structures and Board members, clearly violating the standards of good governance and Company Law requirements.[50] The same conclusion is found by the Bank of Albania based on their surveys. Banks' answers on whether they disclose information about remuneration policies, director and executive compensation, bonuses and stock options show that only half them include such information in their reports. The other half considers such information as confidential.

4.3.4 ANALYSIS RESULTS

The banking sector in Albania is well organized from a regulatory and institutional viewpoint, disposing regulations, internal procedures and practices, elements of good governance. Banks have clear lines of reporting for auditors' findings (internal and external), where, oftentimes, recommendations may be dealt

[50] Article 134(2)

with by the Board. Albeit being among the only JSCs that have good and measurable corporate governance practices, they need improvements on Board quality and transparency. Given that external forces for sound corporate governance are weak in Albania, the supervisory authority could be more aggressive in enhancing bank governance. This role does not imply higher legal and regulatory activity, but additional pressure on banks for better governance.

It is also important for the shareholders to increase the attention toward good corporate governance, and understand its weight on the performance of the company. It is true that this is not necessarily a given precondition, as other factors that impact the performance make this correlation insignificant. However, we argue that for banks operating in Albania, this correlation exists, and is positive. On a paper studying the relation between the CG index and performance, Kodra and Kalluci (2011, p. 17) have concluded that: "Banks with a higher governance index (which means they are more regulated and organized in their governance framework) proved to generate more net income relative to their capital and assets."

5. CONCLUSIONS AND RECOMMENDATIONS

In this paper we analyse the corporate governance framework of the Albanian banking system. Since there is no comprehensive academic research on this topic in Albania, we first provide a substantial theoretical review of the distinguishing features of prevailing corporate governance models, particularly the ones developed after the global financial crises of 2007-2009.

Our analyses show that sound corporate governance and a strong role of the financial regulator are of paramount importance, regardless of the development stage of an economy. While the financial crisis revealed that deregulation in developed countries was not accompanied by proper self-regulating corporate governance practices to be encouraged by external market forces, transition countries like Albania also face such "gaps", albeit of a different nature and from different reasons. As we show, regardless of the high standards of the legal framework in Albania, a weak Rule of Law, with special concerns on property rights, legal protection of investors, poor enforcement, as well as corruption, call for a more aggressive role for bank regulators. The latter are expected to have more incentives than judges, since they act and are directly responsible for safeguarding public interest and the financial stability of the country.

An analysis of the Albanian legal framework reveals that the corporate governance model designed in the letter of the law is a combination of the insider and outsider models, following the European Union approach. However, the lack of a functioning equity market and other external market forces push for an insider model, with banks providing the main source of financing. In this environment, Albanian banks gain a crucial role in consolidating good corporate governance practices in the market. In addition, given the social and systemic importance of banks in the Albanian economy, the above-mentioned shortfalls (i.e. lack of external forces) call for additional due attention on banks governance.

Albanian banks are governed in an insider model fashion, like other general firms in Albania. However, the model consists of different patterns due to banking regulation and highly concentrated ownership.

Albanian banks are established as JSCs based on the Company Law and on specific requirements of the Banking Law. This mere fact serves as evidence of the complementarities that exists in the relationship between corporate governance practices and banking regulations. While the Banking Law designs internal governance of banks as internal business processes stemming from financial stability concerns, the Company Law stipulates corporate governance principles and requirements from a broader viewpoint, treating banks just as JSCs. We believe that these legal acts, coupled with Bank of Albania regulations, provide a solid basis for enhancing good bank governance.

However, given the highly concentrated ownership structure of banks, we conclude that Boards of Directors lack sufficient independence from parent banks, not even fulfilling legal requirements of the Banking Law. Given this level of independence (or the lack thereof), the lender-of-last-resort and deposit insurance instruments might potentially incentivise shareholders to indulge in high risk-taking. We find that parent banks have beyond reasonable influence in setting long-term performance objectives of their affiliated banks in Albania. This raises questions on whether strategic objectives are based on Albanian market conditions and whether they take into account the public interest. Therefore, we argue that, apart from economic slowdown and shortfalls in collateral execution, the current high and increasing level of NPLs in Albanian banking might partially be a result of low independence of Boards and quality of Board membership in general.

In addition to independence, a crucial determinant of good Board performance is their collective knowledge and education, which depends on the harmonization of their qualifications, skills and professional experience. Our analysis reveals that this issue has not been paid the necessary attention and that it lacks enforcement.

We find evidence that the Bank of Albania is increasingly paying more attention to bank governance practices, perceiving the latter as endogenous sources of financial stability, following Basel and EU guidelines. Such commitment is set forth in the Medium-Term Development Strategy of Banking Supervision 2009-2014 and materialized in numerous regulating interventions during and after the financial crisis. The main focus has been the role and independence of banks' Boards of Directors. However, we find that there is more room for corrective measures, in that the Bank of Albania could be more aggressive in its actions and reforms with regard to implementation of recently introduced legal requirements on Board of Directors' independence. Furthermore, we believe that these actions would provide the necessary conditions for cost-effective banking supervision.

As revealed by the recent global financial crisis, good corporate governance does not rely only on proper legal and regulatory frameworks and on "box checking" implementation assessments. The Bank of Albania should consider other factors that influence the quality of corporate governance, such as human behaviour, implementation practices, and bank-specific patterns. For this purpose, we recommend the development of effective tools and methodologies to thoroughly analyse and correctly measure corporate governance practices. The OECD and IFC provide methodologies that could serve as foundations for designing country -adapted methodologies, more adequate to the Albanian banking sector, and the country's institutional and legal environments.

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