

Corporate Bonds - The New Frontier for Corporates in Albania

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Abstract

Despite the fact that the Albanian economy and its business & banking system weathered an indirect shock, in the course and in the aftermath of the global financial and economic crisis of 2008, it revealed the characteristic phenomenon of cartel-like financing, of the economy and Albanian companies, by the banking system. This source of financing, as derived from an oversized and wholly bank-based economy, conveys all the issues and risks, accompanying the banking system activity, towards companies as borrowers, especially in times of economic contraction, in the form of tightened lending terms & conditions and lacking cost-effective and competitive financing terms. This paper addresses the importance of corporate bonds as a long-term source of finance and proposes their issuance, as a still-absent, but efficient & competitive alternative source of financing, for medium and large-sized enterprises in Albania, given the first signs of an emerging interest for bonds' public issuance. Also, theoretical and practical advantages, regarding corporate bonds' issuance, are mentioned in the paper, which could be easily energized and implemented by Albanian companies, in the frame of the existing legal environment in Albania.

Keywords: Corporate bonds, bond financing, bad loans, collateral enforcement.

1. Introduction

Foreclosure, or the collateral enforcement is described as an extreme act of a bank, in the course of its practical inability to collect its problem loans, by its clients who have stopped paying and honoring their respective contractual obligations.

This kind of phenomenon was not frequent, just a couple of years ago in Albania, but it has become a real issue, the Albanian business has to live up with and shall be faced with, now and on. This thorny issue, when combined with effects and aftershocks of global financial crisis and tightening credit conditions by the whole banking system, has already placed corporates in Albania in a position, where it must confront a real challenge, in the course of obtaining sustainable mid and long-term funding sources.

2. Lending to businesses during 2009-2012: A total dependence from the banking system

The year 2009 was the first year the Albanian economy, its banking system and businesses were faced with the shockwaves effects of global and financial crisis. It is a well-known fact that, although being indirectly hit from the global economic and financial crisis, and notwithstanding the dynamic intervention by Bank of Albania in preserving the financial health of the Albanian banking system, the business, could not avoid "a conservative stance of banks in lending and by the economic activity slowdown" (Bank of Albania, 2009).

"In the first months, banks significantly tightened the lending terms, first in response to a difficult and uncertain liquidity position induced by deposit withdrawal and panic in international financial markets at the end of 2008. The ever more conservative stance of banks reflected the concern about ongoing decline in the loan portfolio quality. Lending terms remained tightened in the following months, though at lower rates. In the second half of the year, the tightened lending standards and the economic activity slowdown triggered the decline in credit demand" (Bank of Albania, 2009).

The institutional stance expressed by Bank of Albania unfurls two key effects, the global financial crisis produced

and marked on the Albanian economy and business: (1) an increasing portfolio of problem loans, and (2) an en bloc tightening of credit conditions, by the banking system. Logically, both effects are interchangeably positioned as each other's cause-and-effect, respectively.

1. Although "the increase of problem loans during 2009 and on was inevitable, following the explosive growth of bank lending during 2003-2008" (Meka & Filipi, 2010), it was not the only contributor in producing such a surge in this figure. Additionally, the sharp contraction of new loan applications, especially by businesses, caused the denominator's growth to lag behind the respective growth in problem loans, themselves. This intensified the bad rate further, thus pushing banks toward more tightened loan terms and conditions.

By being indirectly integrated with global financial market and economy through the real economy and international trade network, was easily understandable that, initially Corporate Albania met with the economic shocks of global financial crisis quite tangentially. But as the first shockwaves of 2008 left Albanian economy quite intact, the aftershocks would be inevitable. These global crisis shockwaves, would be materialized in the form of falling domestic consumption, either for durable or non-durable goods, dwindling liquidity, steady decline of remittances, as well as a slowing pace of investments in machines & equipment (see Exhibit 1 and Chart 1, in Annex 1), which normally are intended to support an overall growing of business activity (mainly manufacturing and service sector).

All these (macroeconomic) factors, substantially impacted by the global financial and economic crisis, have inevitably deteriorated Albanian borrowers' repayment ability, therefore increasing problem loans (See Exhibit 2 in Annex 1).

2. The above mentioned increase in problem loans witnessed an aggravated business solvency, thus increasing the credit risk within the banking system and in the same time, triggered a simultaneous and automatic "protection" mechanism of the entire banking system, in the form of immediate tightening of lending terms and conditions by commercial banks, thus acting as a simultaneous "cause and effect" mechanism (problem loans & tightened lending terms & conditions).

In the frame of the outbreak of global economic and financial crisis, this banking system's behavior was more than justified, but bringing this behavior in front of ongoing funding needs by Albanian economy and businesses, it ended up being a typical cartel-like financing behavior, since business financing is a quasi-exclusive domain of commercial banks, given the model under which, the Albanian financial system is developed and structured. Practically, the banking system is almost the sole provider for business (external) financing, as the share of banking intermediation and banking assets, within financial system, goes beyond 94% (see Chart 2, in Annex 1). Thus, in the absence of alternative competing funding channels, other than bank (loan) financing, Albanian businesses were faced with "mandatory" acceptance of tightened conditions, offered in a concerted way by all banks, as well as the limited bank loan offer, throughout the period of 2009-2012. Therefore, businesses had no way out to raise capital and liquidity from sources, different in type and origin, with bank loans, which could have relaxed the impact of bank loans' tightened conditions and global financial crisis shockwaves on financial system and real economy, too.

As per above, a mutually negative impact was evident among bank-business relationship; businesses continued to carry additional financial and non-financial costs, related to its mid and long-term financing, and banks, on the other side, are (and will be) obliged to absorb and weather, for some full years, the cost of still-increasing bad loans.

3. Risks accompanying the absent corporate bond market in Albania

Common sense and past evidence suggest that a sound credit and debt market strengthen the resilience of economies in the face of a crisis. On the contrary, erratic and haphazard borrowing by public and private institutions (especially in foreign currency and at short maturities) is often associated with financial fragility and ultimately costly financial crises... (Saidi, et.al, 2009). Too much reliance on bank loans or direct bond finance, however, exposes a firm to excessive risk of bankruptcy in the event of default (Goodfriend, 2005).

On the other hand, the existence of several large financial institutions, within financial system is fairly counterproductive and leads to a non-competitive financial system.; "...in the case of Albanian financial system, which is almost entirely modeled around banks, has already concentrated all possible risks within banking system, thus contributing to establish a permanent systemic risk within it, with no way of possible diversifications on individual or market basis (Meka and Filipi, 2009)".

Also, the economy is at risk of crisis due to excessive reliance on bank lending. Because banks are highly leveraged institutions, the economy is much more vulnerable to a financial crisis than if more corporate borrowing had taken place in the bond market and the claims were held in well-diversified portfolios (Herring, Chatusripitak, 2000). Certainly, in the event that a banking crisis occurs, the damage to the real economy will be much greater than if investors had access to a well-functioning bond market and the financial restructuring process will be more difficult (Herring, Chatusripitak, 2000). Additionally, a heavy reliance on banks means a correspondingly heavy exposure to banking crises. And the consequence can be catastrophic for the real economy (Herring, Chatusripitak, 2000).

It is more than clear that the systemic risk is the paramount of all risks, the Albanian banking system (and the whole financial system) has to address right now, following characterized the oversized bank intermediation and quasi-inexistent private securities market (both equity and bond securities) in Albania. The prominence of this type of risk is always evident in periods of crisis in countries with significant bank-based systems. "The Asian crisis essentially demonstrated the systemic risk of an unbalanced financial structure, particularly with regard to an overreliance on bank credit and a lack of deep and liquid bond markets to supplement the banking system" (Eichengreen and Luengnaruemitchai, 2004).

Thus, the absence of the corporate bonds market makes the systemic risk within banking system quite an endemic phenomenon. Therefore, it is an imperative for the business (Corporate Albania) identifying and finding new fundraising ways and opportunities, to finance its long-term investment needs. One of them could be the issuance of corporate bonds, as a practical and efficient funding alternative, not only for companies, but also for banks, themselves.

4. Financing through corporate bonds – a new frontier in the financing alternatives for companies

Corporate bond issuance and its respective use and trading is widely known as one of three forms of external financing of economic activity of a company, along with bank lending and stock issuance. If the last two alternatives are already well-known and used by Albanian businesses (although the first public stock offering is still waiting to make its maiden flight, joint stock companies do exist), what remains totally untapped within Corporate Albania's reality, is the alternative of issuing corporate bonds.

So far, the absence of using this instrument as an alternative and competitive product to bank loan could be justified by the stage of economic development and the necessary time, to consolidate the bank loan instrument, within the mechanism of a functioning market economy in Albania. Notwithstanding this important element, some other essential elements have been instrumental in supporting such an absence, as follows:

1. The current stage of Albanian mid and large sized companies' institutional and organizational status. Specifically, large-sized businesses in Albania are at the first stage of their development, in the context of Albanian economy, as a new capitalist economy. In this frame, they could be typically classified as growth companies, "which are also likely to choose private over public sources of debt because renegotiating a troubled loan with a banker (or a handful of private lenders) will generally be much easier than getting hundreds of widely dispersed bondholders to restructure the terms of a public bond issue (Barclay, Smith, and Watts 1999; Barclay and Smith 1999)";
2. The 'crowding out' (effect) by FDI-supply (Iakova & Wagner, 2001), as the bulk of substantial foreign investments in Albania are originated and provided by companies, which are actually listed in their own country's stock exchanges abroad, or with easy access into international capital markets (bond or stock markets). Almost all large companies (corporates) in Albania are product of the privatization process and the implementation of economic reform, which saw European companies privatizing these large ex-state-run companies. Logically, all the required investments were provided by parent companies.
3. Lack of possible ratings for these instruments by credit rating agencies and the respective costs accompanying the issuance process, as well as continuous obligations for financial disclosure. Albania still lacks an established capital market and several important market players and institutions, serving as catalysts in the process of providing Albanian corporates with necessary infrastructure and pipelines to ensure bond financing. Also, the lack of any practical example in bond issuance by a corporation in Albania makes bond's cost information process complex and its respective issuance quite hesitant.
4. Absent role of non-bank financial institutions. These institutions are relatively new in the Albanian financial landscape and their role in the financial system is in the level of quasi non-existence (see Chart 2 in Annex 1). Their balance sheets are focused predominantly on short-term assets, thus reflecting the absence of long-term financial instruments, as well as the underdeveloped stage of securities market in Albania.

Apart from these factors, it should be noted that, the actual situation is quite suitable for Albanian companies to consider any bond issuance, given many positive and favorable considerations such a move could produce to them, in a theoretical, practical and legal viewpoints.

5. Theoretical and practical advantages & considerations

Diversification of financing sources of companies is a key rule of thumb. When it comes to use of debt, "the best alternative is to have a debt structure less sensitive to crises" (Fernandez, et.al, 2007). Additionally, as source of financing, bonds compensate the fluctuations in the overall supply of external funds. Even though bond financing is dependent on the economic cycle, it shows less pronounced cyclical patterns than bank loans (Davis, 2001)

Also, the existence and usage of corporate bonds constitutes a more gradual build up of loan repayment inability for companies (companies' bad loans increase and accelerate bank's provision fund significantly, as compared to individual's bad loans), as they will, during periods of liquidity crunch, be primarily limited to coupon repayments, rather than adding up principal rollover, too (as in the case of loan repayment installment) (Meka & Filipi, 2010)".

6. Legal considerations and the emergence of private offerings for bonds

Albania has already enacted the fundamental legal framework for corporate bonds (Law no. 10158, dated 15.10.2009 "On Corporate and Municipal Bonds"), which establishes the mainframe, allowing and entitling Albanian companies to issue various types of bonds. Surely, the legal framework may need any necessary add-ons, but it is deemed as a significant pillar in the road of issuing corporate bonds in Albania.

In this framework, Credins Bank is the first corporate in Albania to issue corporate bonds in late 2011 (Santo, 2012). This title is offered in the Albanian market through private placement. In terms of bond characteristics, its has a 6-year maturity, with fixed semi-annual coupon, but whereas the principal payment is made at the end of the maturity period, in the form of "bullet payment". Recently, the bank has expressed the interest to issue bonds through a public offering, but the current legislation does not prescribe clear and exhaustive clauses about public offerings of securities by non-public companies (Credins Bank is a private company). This could hamper the Albanian private corporations to tap capital markets, especially the bond markets, as the most imminent segment of the capital market with potential positive developments in Albania.

7. The impact and importance of developing corporate bonds market

Bond issuance by Albanian companies would logically promote and bring about the commencement of a formal secondary market on these titles, thus reinforcing and adding up positive effects and bringing further advantages for the financial system, other markets, groups of interest and economic development in general. The advantages and positive aspects, the existence of this market could produce are numerous, but the most significant could be listed, as follows:

1. Reducing the relative size and specific weight of the banking sector within financial system, thus reducing some negative effects, caused by quasi-absolute dominance of this sector, such as:
 - concentration of decision-making on crediting remains in a few hands and financial power centers. Developing the bond market decentralizes this decision-making power, by transferring it in the hands of market forces, thus bringing more transparency and information,
 - creation of "crony capitalism", since bad loans can often be kept from being written down for long periods with the government's tacit or express approval - in contrast to the situation for corporate bond investors, who generally must face the music from the start (Hakansson, 1999),
 - lack of all-time efficient administration of funds collected through deposits. Banks in possession of bulging deposits need outlets for their funds. When demand is insufficient, the tendency is to "force" them on perhaps unwilling borrowers by easing the usual terms or by other means. ..This in turn tends to relax the borrower's investment criteria, resulting in a low return on capital investments and on equity. Thus, excessive borrowing leads to excess capacity, which in turn converts many of the loans to bad ones (Hakansson, 1999),
 - systemic risk (as previously mentioned), since banks are institutions with extensive use of financial leverage. A functioning corporate bond market tends to balance this with the banking market, thus

reducing this risk, in a more natural way.

2. From a macroeconomic perspective, the cash flow provided by bond securities correlate well with obligations of many institutional investors (banks, pension funds, and insurance companies, etc.) and helps such investors better match the maturity of their assets and liabilities and manage risks (Huang & Zhu, 2007),
3. Providing more investing options and alternatives for general public. Bonds are viewed as an opportunity for the investing public to diversify its savings on a wider range of investment alternatives, not only in the risk management perspective, but also in terms of channeling its savings into more productive investments, thus increasing social welfare.
4. Providing investment alternatives for pension funds and insurance companies, by enabling them to design and offer long-term saving and investment schemes & products;
5. Bond markets can constitute a transmission channel of monetary policy and perform an information function. The interest rate structures which emerge are determined by the development of bond markets, and are in turn a prerequisite for the development of bond markets (Fink et al., 2005),
6. The presence of the bond market provides the economy with a market-determined term structure of interest rates that accurately reflects the opportunity cost of funds at each maturity (Herring & Chatusripitak, 2000),
7. Banks could use corporate bonds as a new investment alternative and a bit different one from bank loan, as well as a good opportunity to yield some fees or offering value-added services for their clients in the securities market;
8. A market for direct debt also improves the incentive for banks to remain efficient and to innovate. By encouraging innovation, competition among banks and non-bank financial markets helps to improve the distribution of financial risk in the economy and lower the cost of external finance (Goodfriend, 2005),
9. Developing the bond market as a key component of the capital market, would establish a special funding alternative for important infrastructure projects, thus preventing and discouraging the export of capital abroad in the form of investment.

8. Conclusions

Companies in Albania are obliged to use the banking channel as the only funding source to finance their long term projects and activity. In this regard, they will, unavoidably, be faced with a cartel-like behavior by banks, without exploiting the opportunity of accessing cheaper funds, as compared to bank finance.

In the absence of bond markets, as part of capital markets, companies have to bear a big part of consequences deriving from the adjustment process, which usually follows any bank crisis situation, or complex situations within banking system, which heightens the systemic risk.

Actually, Albanian companies must consider corporate bond issuance as an important lever to ensure a sustainable and efficient financing for their own (long-term) activity. This could be a mutually profitable undertaking (business – banks), from the economic and financial standpoint, but in a broader picture, it could yield additional benefits, in the frame of developing the financial market and the overall economy in Albania. Finally, it could be of great help for them to increase their own negotiating power with banks, when it comes to long-term funding.

The Financial Supervision Authority (AMF) must consider taking legal and regulatory interventions to address the ambiguity which covers the issuance of corporate bond by private companies, thus enabling them to utilize the capital market for fresh funds.

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Annex 1.

Exhibit 1: Credit to business in Albania, Q4 2008-Q3 2011 (ALL million)

Period	Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2012	Q2 2012	Q3 2012	Q4 2012
Business (total)	254.01	268.99	270.12	279.45	291.21	299.32	308.34	310.04	330.39	340.11	351.76	369.09	389.43	396.71	400.06	403.26	401.70
Overdraft	75.67	86.87	90.70	92.45	96.77	99.86	101.38	100.65	108.31	107.72	111.58	120.91	123.60	123.52	120.24	118.62	119.89
Working Capital	48.75	49.59	45.48	46.65	49.60	50.48	53.15	51.55	55.03	57.76	61.27	63.07	70.98	73.05	75.96	76.82	78.54
Equipments	68.35	71.70	64.86	72.30	77.06	78.24	79.50	81.53	87.99	86.08	88.20	93.07	99.18	102.37	106.19	109.65	88.85
Real estate	61.24	60.83	69.09	68.06	67.79	70.75	74.31	76.31	79.06	88.56	90.71	92.04	95.66	97.762	97.673	98.17	114.42

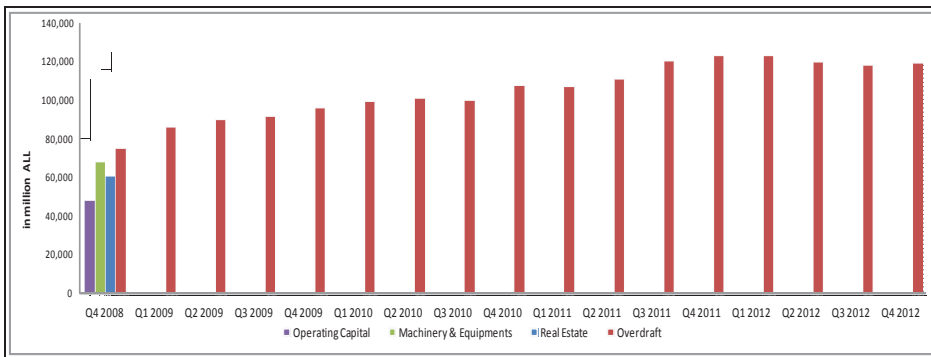
Source: Bank of Albania

Exhibit.2: Problem loans in Albania, Q4 2008 – Q4 2012 (in %)

Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2012	Q2 2012	Q3 2012	Q4 2012
6.6	7.6	8.7	9.7	10.5	11.7	12.2	13.8	13.8	14.7	17.0	18.3	18.8	20.1	21.1	22.7	22.5

Source: Albanian Association of Banks (AAB) - (as per NAS - National Accounting Standards.)

Chart 1: Credit to Business Q4 2008 - Q3 2011



Source: Bank of Albania

Chart 2

