THE ROLE OF COLLATERAL IN BANK LENDING: ALBANIAN CASE

Juliana IMERAJ
Lecturer at “Aleksander Moisiu” University, Durres, Albania.
E-mail: jimeraj@yahoo.com

Abstract
Lending is the main activity of second level banks. Banks in Albania were very aggressive during 2003 – 2008. But as the world financial crisis hit, even the Albanian banks were negatively affected. Problem loans increased and as today (September 2014) the official NPL ratio is 25%. It is important for banks to be prudent in lending. One way they manage credit risk is by requesting collaterals from the borrower. The collaterals can be of different types, forms but they must fulfill certain conditions. Although banks try to be selective in accepting collaterals, the test of their validity will only be realistic in times of crisis. In this paper we will provide some theoretical approach on objects that can be accepted as collaterals and then we will concentrate on immovable properties, as they play a very important role. Then we will derive some numerical data regarding the problem loans for which the banks have sequestrated the collaterals and have put them on sale. What type of collateral is mostly accepted by banks, which are more problematic for sale, what is their proportion in respect to problematic loans? Have banks been able to recuperate the outstanding loan amounts and what kind of problems do banks face when they try to sell the collaterals? These are the questions we aim to answer in the paper.

Keywords: collaterals, immovable properties, bad loans, banks

Introduction
The widespread use of collateral has taken a lot of theoretical considerations. The contractual relationship between borrowers and lenders is subject to asymmetric information, adverse selection and moral hazard which usually lead to credit rationing. Therefore, one way banks manage credit risk is by requesting collaterals from the borrower. Collateral may serve as a signaling device for borrower quality (e.g. Chan and Kanatas, 1985; Bester, 1985; Besanko and Thakor, 1987a, 1987b; Boot et al., 1991), may lower the agency costs of debt by preventing the problem of asset substitution (Jensen and Meckling, 1976) and mitigate Myers’ (1977) underinvestment problem (Stulz and Johnson, 1985). In general, when moral hazard risk shows up in the lending relationship, collateral may play a disciplinary role in the behaviour of the borrower. Consequently, stronger creditor protection from collateral would lead to better credit terms or even the approval of credit that otherwise would not be granted.

The collaterals can be of different types, forms but they must fulfill certain conditions. Although banks try to be selective in accepting collaterals, the test of their validity will only be realistic in times of crisis. In this paper we will provide some theoretical approach on objects that can be accepted as collaterals and then we will concentrate on immovable properties, as they play a very important role. Then we will derive some numerical data regarding the problem loans for which the banks have sequestrated the collaterals and have put them on sale, the type of collateral mostly accepted by banks, the more problematic collaterals for sale, their proportion in respect to problematic loans.

Types of collateral
The collaterals can be of different types, forms but they must fulfill certain conditions. Although banks try to be selective in accepting collaterals, the test of their validity will only be realistic in times of crisis. The main types of acceptable collaterals are as follows:

(a) Mortgages: The most common collateral for
commercial lending is a mortgage on real estate. A mortgage is the most obvious form of security for a loan to purchase real property or develop real estate. However, the collateralized property may end up being an unmarketable property or sales of real estate may be held up for a certain period of time by legal proceedings. In practice, the collateral is often worth considerably less than its book value, especially in the case of real estate because of costs of collection, price volatility, and burdensome legal procedures.

(b) Pledged deposits and securities: These instruments are also permitted as collateral.

(c) Guarantees: Guarantees by the government or banks also play an important role as security. Such guarantees are usually irrevocable, unconditional, and should be signed by the appropriate authorities.

(d) Lien on machinery and other equipment: This type of collateral is not very practical in that it is usually designed for a specific purpose, making it more difficult to sell. The valuation of specialized machinery by the borrower may be substantially different from the lending bank because of limited marketability.

(e) Pledge or lien on inventory: A pledge on claims can be necessary when the bank has accepted inventory as security for the finance of the inventory. The value of inventory may be at risk because the inventory is perishable, obsolete, and difficult to sell quickly and often damaged. So, inventory taken as collateral, for a borrower who may be in liquidation, is often required to be sold at a heavy discount, as a part of the liquidation process.

(f) Letter of comfort: It can be used by parent companies instead of formal guarantees with respect to their subsidiary borrowings. The bank accepting the letter of comfort only has the benefit of the moral and commercial stigma that would be attached to a parent that did not support its subsidiary.

Risks associated with collateral

Despite the importance of collateral the excessive reliance on collateral poses risk for a bank such as:

a) Collateral is often illiquid and costly to realize through foreclosure or other legal means,

b) Collateral is even more critical when a loan is impaired and other sources of repayment become inadequate.

c) Collateral in residential mortgages is usually considered of relatively low risky, as recognized in Basel risk weightings, but it can present considerable hazard to the bank, depending on real estate market developments and the effectiveness of the legal and judicial system.

Risks associated with mortgage collateral

In general, the collateral cannot be used as a substitute for the comprehensive assessment of the borrower. The collateral is usually considered as secondary means of repayment in case the borrower defaults. Although a mortgage is one of the most used form of collateral for a loan to purchase real property or develop real estate, practices of countries on foreclosure or liquidation of collateralized real estate may differ.

- Banks may incur costs in terms of time and money to Foreclose on real estate.
- Real estate involves costs to maintain the property and market it for sale.
- Realizing pledged assets through the courts is an extremely lengthy process (due to deficiencies in legal systems or inefficient bankruptcy procedures).

These difficulties make an enormous difference in the practical value of mortgaged collateral.

Characteristics of mortgage collateral of banks in Albania

Banks in Albania followed a liberal credit policy up to year 2008 (Annual reports of Bank of Albania) when the financial crisis emerged worldwide. Soon banks started experiencing bad loans, this was reflected in increasing share of Nonperforming loans (NPL) to total loans which in the first half of 2004 reached 24.1% (figure 1).

During this period it has continued the gradual migration of non-performing loans towards the category “lost loans”. At the end of June 2014 the “lost” loans represent 51% of NPL’s. Loans were usually guaranteed by real estate collateral, cash collateral or other. The Loan to value ratio (LTV) applied was approximately 70% or stated in the other way the value of collateral was 140% of the loan amount granted. According to Financial Stability Report of June 2014 of BOA, the coverage with collateral was 78.6%, of which 55.8% is covered by real estate collateral (figure 2). One important issue is the execution of collateral. This process was very lengthy and problematic; however the amendments of the Civil Procedure Law, which entered into force in September 2013, have eased the legal and execution procedures.
After the execution of collateral, the banks (in total) have recovered about 52.1% fixed assets, 38.7% cash and 9.3% a combination of cash/fixed assets (Financial Stability Report 2014 H1). However, the transfer of real estate management to banks after the execution of collateral, calls for an evaluation of their management capacities for this increasing portfolio.

Regarding the amount of repossessed assets by banks, in the figure below are shown the 5 largest banks in Albania.

Source: Banks’ reports and calculations of the Supervision Department.
The role of collateral in ....

It is obvious that BKT and Credins Bank have been faster in repossessing collaterals. However, banks are not interested in keeping these collaterals, therefore a very important step is the auctioning of these collaterals. According to data published on the website of Albanian Association of Banks, the Portal of Auctions, the properties for sale by banks are presented in the following graphs.

Source: Albanian Association of Banks (calculations by the author)
The collaterals for sale represent even the focus of lending of each bank. Almost 64% of Procredit Bank’s collateral is Land. Meanwhile the other banks have a more even distribution of real estate collaterals. In figure 6 are shown the number of properties auctioned by banks. It points out that procredit bank has the largest number of collaterals for sale, which consist mainly of agricultural land. This is mainly the most problematic type of collateral to be sold.

Figure 6. Number of properties auctioned by banks

![Properties on auction by banks](image)

Source: Albanian Association of Banks (calculations by the author)

Regarding the distribution of collaterals for sale according to districts it is clear that Tirana district has the largest number, followed by Durres and then Kruje and Lushnje.

Figure 7. Properties according to districts

![Properties according to districts](image)

Source: Albanian Association of Banks (calculations by the author)
Conclusions
Although a secondary source of loan repayment, collateral plays an important role in lending. It can be used to solve multiple economic problems, but it provides little benefit to banks even in good times, because of the difficulty in valuing and realizing collateral.

According to Financial Stability Report of June 2014 of BOA, the coverage with collateral was 78.6%, of which 55.8% is covered by real estate collateral. One important issue is the execution of collateral. This process was very lengthy and problematic; however the amendments of the Civil Procedure Law, which entered into force in September 2013, have eased the legal and execution procedures. Even collateral in the form of residential mortgages can also pose considerable risks, depending on real estate market developments and the effectiveness of the legal and judicial system.

Bibliography