

## **Ardian Fullani: Developments in the Albanian banking system**

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the Third Open Forum with the banking system in Albania, Tirana, 13 October 2009.

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Dear participants,

It's a special pleasure for me to open the proceedings of the 3rd forum of the Bank of Albania's dialogue with the banking system. Our communication with the market and its top administrators has now turned into a tradition, to share ideas and present attitudes related to developments affecting the banking and financial activity in general.

Such meetings are an important instrument that carry out an inter-institutional communication and simultaneously create a window of communication with the public at large. They serve for identifying issues posing a challenge to the overall financial market operation and are a precaution for finding solutions, aiming at coordinating the interests of parties operating in the financial market, with the financial stability strengthening as the final goal.

The 3rd forum we are holding today is the continuation forum. Allow me to remind you of the first forum, which, I would label, without any hesitation, as the forum that consolidated the financial stability foundations in Albania. Its conclusions highlighted many pre-emptive measures, which in the course of time, upon global crisis precipitation, resulted of an extremely immune importance.

The 2nd forum recorded another salient achievement, having the confirmation of scrupulous implementation by the banking system of all previous tasks and recommendations as the main motif. This forum, which was held on the eve of global turmoil outburst, indicated that the Albanian banking system had significantly increased its resilience.

It addressed important matters related to:

- Transparency and customer services,
- Risks related to foreign currency credit and consumer credit, as well as
- Interbank market functions and monetary policy transmission in the economy.

Today's forum takes place in an important moment of the banking and financial system. After a hard year, it seems that the situation is becoming eventually normal. Therefore, I am confident that, figuratively, the third forum will have the consolidation of public confidence in the Albanian banking system as the main motif. Achievements in this regard are not lacking. Statistics show that deposit level is approaching steadily to its prior-crisis level, while ALL credit livening-up is continuing.

Dear participants,

Today's meeting is held after some important financial and economic events dictated by the global crisis. Now that the situation has cleared up and has entered into an improvement stage, a thorough analysis is being made about its causes, about public authorities' reaction and about actions to be taken, in order to raise the global financial system's resilience.

Now, allow me to deal briefly with the main features of this unmatched crisis, and then continue with some arguments on the functioning of the Albanian financial system and some necessary regulations for its further perfection.

The crisis originated in the USA through the bursting of the housing bubble, bringing a number of existing problems to the fore. Now, it has become clear that global imbalances of currency flows, affected by irresistible behaviour of expenditures or savings between developed and developing ones, have led in the course of time to extremely easing monetary

policies in advanced economies, which have further deepened these imbalances, thus leading to rise in the financial activity risk, while searching for a higher return from investment.

Innovations in financial products reflected inside or outside financial institutions' balance sheets, found the necessary mechanism to conceal the real risk size in the extreme stratification.

Management structures' remuneration policies of financial institutions that were at the heart of the crisis supported the aggressiveness for short-term and unsteady profits on the back of the need for a better understanding of risk, intending a positive performance and long-term investments stability. Several market mechanisms resulted non-efficient to precede developments in some global-wide institutions. Pronounced weaknesses were reflected even in financial market regulatory authorities, who believed that difficulties would be sorted out by a market discipline mechanism or by a greater reliance on internal models of financial industry assessment. Also, it has become clear that the supervisory regulatory authorities have not paid due attention to developments that affect the overall financial system, focusing more on certain institutions' behaviour. From this viewpoint, it is deemed that actions to monitor the overall price performance of non-financial assets, the way of estimating them and recording them to bank balance sheets have been insufficient to pre-empt unjustified increases and to avert their procyclic moves.

All these elements are regarded as conclusions that go beyond certain jurisdictions and require a global response in the context of increased financial integration and ongoing economic globalization.

Emerging market economies are affected differently from this turmoil. The crisis shudder hit harder the countries with an economy damaged from macroeconomic and financial policies, with decreased competitiveness, reduced space for financial stimulation, with an unbalanced economic growth or an underlined dependence on foreign financing resources to stimulate an unrestrained economic and financial expansion.

In the face of an extremely difficult financial situation, spread swiftly on the entire real sector of the global economy, public authorities of advanced economies took extraordinary actions to ensure financial market functioning and attenuate the financial distress.

Through central bank actions, low-cost liquidity was injected into the markets, while governments took extraordinary actions to provide backup capital to financial institutions and to support domestic aggregate demand. Moreover, some emerging market economies, with robust economies and with an upward share to the global economy, have supported the domestic demand through their stimulating policies and have preserved their economic growth, playing an important role in mitigating the global crisis consequences. Along with extraordinary measures taken to withstand the crisis effects in the short run, authorities of advanced economies and international financial institutions have been strongly committed to change the way of global financial system functioning and its regulating superstructure. Many financial market regulation and supervision standards are expected to change, aiming at putting necessary boundaries to financial market dynamism and innovations, in order to ensure system's stability and its resilience to various risks.

In more details, the goals of these changes will be: strengthen the mechanisms that raise financial system stability; duly orient the stimuli that determine decision-making in the financial activity and decrease procyclicality in it. Changes to the regulatory and supervisory superstructure are aimed at strengthening the institutional mechanism, paying greater attention to systemic risks and global-wide financial institutions. Better conditions will be set for supervisory standards convergence and the cooperation among regulatory authorities operating in different jurisdictions will be strengthened. At the same time, the role of international financial institutions will be oriented towards financial crisis management and their resources will be adapted to this end.

For many reasons, which converge in ongoing processes of financial integration and economic globalization, no country can pretend to stand beyond these developments.

In such a case, what at the very beginning could be perceived as a more relaxing financial environment that would provide a competitive priority, would soon leave the place to recycling of problems that were at the root of this crisis, decreased investors' confidence and increased financial and social costs for recovery. Naturally, each country will adapt these standards to the degree of current financial system development, its composition and depth, as well as to its outlook. It is important to emphasise that these measures would be insufficient, if not accompanied by more general policies, aiming at diversifying sources that contribute to economic equilibrium growth, financing the economic agents, improving the legal framework of business development and following sound macroeconomic policies.

Allow me now to deal with the situation of our financial system and share with you some stances, which we have generally discussed even previously. The stagnant situation of the financial system during the last year was dictated by the banking system performance, because of its weight. The rest of the financial system, represented by insurance companies and other non-bank financial institutions, underwent a good growth. Regardless of this, their share to the financial system remains low.

The banking sector was faced with liquidity constraints in the last quarter of 2008 and in the first quarter of 2009. Deposit withdrawal from the banking system was withstood, thanks to liquid assets adequacy, capital availability and Bank of Albania's intervention to supply the market with liquidity, aiming at maintaining its stability and mitigating any expected contraction of the banking system's intermediary role. To this end, the Bank of Albania has supported the demand of the banking system for liquidity through open market operations. After cutting interest rate by 0.5 percentage point in January 2009 and mitigating inflationary pressures at home, the monetary policy paid special attention to financial stability, keeping base interest rate unchanged for the whole period. Thus, it was aimed to support the demand for financial assets denominated in the national currency in the short run. At the same time, the Bank of Albania carried out with a strong supervisory regime on banking sector developments.

Such a stance supported the efficient management of liquidity situation of the banking sector, oriented credit towards national currency and influenced the maintaining of financial stability parameters and capitalization of activity. The situation entered into a qualitative improvement stage, following the re-starting of the process of public deposit growth in the banking sector. This process, which took place gradually and steadily in the second quarter of 2009, continued at satisfactory paces. During this period, banks acted with due prudence and accountability.

Therefore, I would like to avail myself of the opportunity to thank you, the staff you manage, as well as the shareholders of your institutions, for their commitment and cooperation during this period.

However, the liquidity situation and the global crisis effects on the real sector of the economy have brought about underlined decline in lending paces and have reversely impacted the credit portfolio quality of the banking sector. Therefore, the financial result of the banking sector, though lower than that of 2008, continues to be positive.

It is clear to all of us that the banking sector would face a difficult business climate and needs to adapt in the mid-term. As a matter of fact, a complex interdependence between the economic growth and banks' financial soundness is noted. Decline of investments and partially of consumption in the economy has been reflected in decreased credit demand. On the other hand, increased premium risk has made banks more tightening in lending standards, showing greater attention to liquidity indicators. The Bank of Albania deems that we may enter into a vicious circle, where non-lending to the economy would result to a prolonged economic slowdown, due to damages in related interests of all stakeholders in the economy, including banks. We think that this situation requires countercyclic operations in a

general level. In practice, the banking sector should exercise its role in promoting the development of the economic activity, naturally showing proper prudence. This system is the generator and controller of market economy.

Provision of development impulses by acting jointly should be its primary task, while the positive synergies will bring mutual benefits to economic growth and financial stability.

The Bank of Albania deems that the banking industry should review the banking activity growth strategies, aiming at their better harmonization with the necessary human, financial and technological resources. Operational risk identification and management remain a priority. In practical terms, this process should aim at placing internal mechanisms to prevent creation of excesses in certain directions of the banking activity, aiming at a better diversification of investments and supporting steadier forms of financing resources. All these require strengthening of internal audit systems, stimulation of structures that assess and manage operational risks in general, bank staff expertise, and establishment of stable relations with depositors and other beneficiaries of banking services through transparency enhancement.

In this framework some issues that deserve special attention will be:

- a) Setting parameters that ensure a better equilibrium between performance of risky assets of the banking sector and financing resources, as concerns type of currency, maturity term, interest rate;
- b) Setting volumes and certain features of banks' operational assets that enable maintaining of satisfactory liquidity levels;
- c) Identifying certain mechanisms that will mitigate the cyclicalities in banking activity, particularly in the context of rapid growth of banking activity or in cases of its significant contraction;
- d) Strengthening requirements for managing extraordinary situations and business continuation;
- e) Improving structures of management, accountability and performance appraisal and increasing expenditure effectiveness for training, financial stimulation and human resources strengthening;
- f) Further strengthening of the requirements for transparency to clients, and the regulatory framework for customer protection from likely abusive practices in the financial system.

The Bank of Albania will be committed to this process, making use of all necessary human and financial resources, aiming at further improvement of legal, regulatory and operational procedures, so as to create steadier conditions for a balanced banking activity, which remains profitable and carries out the intermediation process in a competitive way over the long run. We are convinced that this reassessment process is necessary, not only to operate in the framework of convergence to international standards, which are changing, but also to act pre-emptively to financial and banking activity risks, which arise from its rapid development. In this process, we will make use of the experience gained during the last months and the directions in which the international standards are changing in this area. We are aware that this process requires constant communication with the banking industry. Also, the identified measures will be taken by allowing the proper time necessary for the banking industry to recover and prepare.

As a matter of fact, the Bank of Albania has initiated this negotiating process first of all within itself. Some regulatory acts of supervisory framework, which are being discussed lately, mentioning the draft-regulation "On liquidity risk management", are prepared by taking into account the above goals. Also, procedures for systemic risk identification and assessment, as well as response to them, are being completed.

In this framework and beyond it, the Bank of Albania believes that all the public authorities that play a role in financial market regulation, supervision and development, should be committed to a similar process, having the strengthening of the regulatory and operational framework as the final goal, in order to firm up the long-term financial system stability. To this end, we think that it is necessary to pursue such policies that enable re-establishment and maintenance of balances in fiscal, banking and monetary activity, supportive to a stable economic growth over the medium and long run. To provide a longer-term response to stable economic development, public authorities should speed up to design and implement stronger development policies, which in the medium run enable establishment of a better equilibrium in the contribution of various sectors to economic growth, which raise competitiveness of our economy and make it more formal. To find better development equilibriums even in the financial system, it would be necessary to draft policies that would promote a faster development of the non-bank financial sector and would support creation of capital and debt markets for private entities.

Accomplishment of these objectives would preliminarily require strengthening of financial reporting standards; completion, accuracy and improvement of law-enforcement in terms of business relations development; as well as a better protection of creditors' and consumers' rights of financial institutions and products. In practical terms, these measures would expand financing resources for economic development, thus relatively decreasing its dependence on the banking sector. Also, public authorities should, through a close cooperation among them, review and improve the framework of measures for efficiently withstanding the extraordinary financial situations, being ready to engage the necessary financial, human and technological resources and carry out necessary legal and regulatory changes.

Dear heads of the Albanian banking system,

The events we have experienced in these 12 months make us believe that prior-to-crisis economic and financial balances are likely to shift to a new equilibrium. I think that what I just said constitutes the essence of our contribution to the future: Let us do our best to make the economy move naturally towards a new equilibrium. All the institutions, policy-makers, administrators should be committed seriously to setting-up this new hotbed for our economy, so that as the years go by, it becomes attractive, competitive and profitable for every economic agent, either domestic or foreign.

Getting away from the pressure exercised by the crisis whirlpool requires much optimism, energy and financial resources. At national level, ensuring steady foreign currency inflows, particularly in the form of foreign direct investments, remains a major priority. I think that the banking system has a prior role to play in this regard. It should be active in identification, promotion and financial backup.

Thus the multiplier effect of foreign investments would gain a new dimension.

Bailing the country out of the crisis spillovers requires not only energies, but also joint efforts. The irreversible path towards a democratic system of market economy requires financial architecture perfection and the country's steady economic development in the long run. To this end, the drafting and implementation of wise development policies should be a constant, real and forward-looking priority, in full accordance with the European convergence framework. Only in this way we will harvest all comparative advantages that our country and the region and beyond provide to foreign investors.

Let me finally emphasise once more that a well-capitalised banking system is a long-awaited development. However, considering only the regulatory capital is insufficient, I think. What I really think poses an ongoing challenge is the capital of public trust. The latter one is not an output of regulations or banking supervisory practices. It is an output of all actors' sacrifices. Enhancement of public confidence would lead to more effective mobilization of all financial resources in the economy, addressing them according to free market principles to the benefit of individuals, businesses, decision-makers and banking industry itself. Ultimately, this would

be translated into the benefit of the country, giving an additional, real and tangible opportunity to the country's rapid convergence to the European Union.

Thanking you for your attention, I invite you to discuss on these issues.