

Ardian Fullani: Lending to the economy and the long-term stability of the banking system

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at a forum on “Lending to the economy and the long-term stability of the banking system”, Tirana, 4 March 2013.

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Dear Guests,

Welcoming you to this forum, allow me to say a few words about its importance. The Bank of Albania considers that an open and ongoing communication with the banking industry and business community is a pre-condition to ensuring greater macroeconomic and financial stability of the country. These meetings serve as platforms to present incentives and strategic decisions, with direct impact on the economic and financial activity of both sectors represented in this meeting. Therefore, this is an open forum where the Bank of Albania’s analysis, conclusions and decision making will be confronted by the analyses and conclusions drawn by both other groups.

I believe this meeting will lead us to a good understanding and assignment of responsibilities to provide Albania’s economic activity with a new stimulus by reviving lending to economy. Hence, allow me to share with you the main topic of today’s forum: lending to the economy and the banking system’s long-term stability. Besides professional discussions on the topic, this meeting is also aimed at launching the Bank of Albania’s new initiative, which I would call the Bank of Albania’s package to revive lending.

Let me elaborate this topic further, dividing my speech into three main sections:

1. Highlights on the recent economic and financial developments in Albania;
2. A retrospective view of the confrontation of our economy with the global crisis;
3. A package of measures we propose to revive lending to economy.

Albanian economy during 2012

Year 2012 was a challenging one for Albania’s economic development. The Albanian economy recorded positive growth and its economic and financial balances were stable. Economic growth, however, has pursued a clear slowing path over the past four years and the concerns accounting for this performance remain present.

As we have continuously stated, Albania’s economic activity suffers from lack of final demand for goods and services. Consumers and businesses, in particular, appear reluctant to consume and invest due to higher uncertainty and tighter lending standards. The lack of this demand is reflected in partial utilisation of productive capacities, yielding, in turn, low economic growth, a sluggish labour market, business financial constraints, and deteriorating loan quality.

Although as at end-2012, non-performing loans rose to 22.5% as a percentage of total loans, the banking sector appears stable. Capitalisation and liquidity figures stand at good levels. Profit was distinctly better than in 2011.

Loans and deposits grew higher than in 2011 but at a lower growth rate. The decelerating lending was particularly significant, growing by merely 2.1% in the past year. Only lending in Albanian lek provided a positive contribution, while lending in foreign currency shrank on a year earlier. Banks increased their prudence in lending, leading to a relatively tightening credit supply. A significant impact was made by tightening of regulatory and prudential regulations at European level, which were passed on to a refrained lending activity throughout the countries that have European banks in place. This phenomenon, which is

technically recognised as deleveraging or reduced “risk appetite”, has brought about a phenomenon which according to McKinsey is known as “balkanization” of the European financial system.

This phenomenon, either open or hidden, is rather damaging from the viewpoint of development perspectives of the countries in the region and for the European integration process. From our viewpoint, the banking system should be avant-garde in this process, by exposing the country’s competitive advantage at parent banking groups and attracting foreign investors.

In its analyses, the Bank of Albania has identified the weakening demand as the main concern facing the Albanian economy. Mandated by law to maintain price stability, we assess that the low economic growth may be an obstacle to achieving our mandate in the medium run. We have, therefore, emphasised that Albania’s economic policies should be stimulating.

We also deem that the fiscal policy faces lack of room for fiscal stimulus and that it should increase its orientation toward consolidating the long-term stability of public finances. Under these circumstances, we have fully steered our policies and instruments toward boosting consumption and investments in Albania. Bank of Albania’s monetary policy has been more and more stimulating. It has lowered the key interest rate for six consecutive times to record low of 3.75%. We have also continued to supply the banking system with the required liquidity to support the public and private sectors’ activity. In parallel, our communication with the public has aimed at guaranteeing the economic agents and financial markets on maintaining of an easing monetary policy in the future.

Overall, our monetary policy has been successful in preserving macroeconomic balances; however, its effect on stimulating the economy has been more limited. The financial market and the banking system have not fully reflected the key interest rate cuts in their main products – loans, deposits and Government securities – while the Albanian consumers and businesses have slightly responded to monetary stimulus and lower interest rates. To our opinion, this performance reflects two core problems that our economy and macroeconomic policies are facing: These two problems are: the first is the structural vulnerability of the Albanian economy, and the second is the restriction of conventional instruments of economic control, monetary and fiscal policy, in boosting the aggregate demand and economic growth.

Addressing them in a differentiated way requires the formulation and implementation of necessary structural reforms that support entrepreneurship, enhance productivity, improve competition and support economic growth. In addition, it points out that need to take unconventional measures to boost lending and support the economy.

Let me now briefly dwell on structural concerns/vulnerabilities/problems and focus on the Bank of Albania’s initiative to address the second challenge.

Albanian economy in the face of the global crisis

Like all developing and emerging economies, the Albanian economy has undergone a rapid economic growth on its path to catching up EU economies. This growth has been mostly supported by rapidly increased consumption in economy and has been financed by using previous savings or foreign financing sources. The main beneficiaries of this demand are construction and services, i.e., the sectors that use labour force intensively and ensure increase in wages and employment but which are slightly export-oriented. On the other hand, industry and agriculture slowed down, suffering from lack of attention by the banking system, a higher degree of investments and expertise, and longer time needed for return on investments. This tendency has left Albania with a small base of export-oriented industries or of those competing with import products.

The global crisis served as an important testing for this growth model. It highlighted its limits to face external shocks and its restrictions in an ever challenging global environment. In

simpler words, the global crisis revealed the importance of maintaining sound balances in both public and private sectors. It also depicted that more competitive economies that have successfully competed in global markets are those economies that have higher and more sustainable growth rates. It is my pleasure to state that this lesson has been learned by the Albanian economy at both consumer and producer level. More specifically, Albanian households have been more reluctant to spend and more inclined to save.

In a longer-term horizon, this is undoubtedly positive. First, it guarantees the health of individual household balances, and second, it creates a sufficient fund of financial savings to boost credit and investments in the country.

In a shorter-term horizon, it induces lack of demand and makes economic growth difficult. On the other hand, the Albanian business learned that the domestic market has limited abilities to generate a sustainable economic growth. As a consequence, it is showing a rising interest to industry and agriculture, as sectors that have a better development perspective and a larger market.

The above-mentioned situation has important implications for the country's development pace and macroeconomic policies. First, it implies that the country's economic growth potential is lower in the medium term. In other words, the transfer of financial and human resources across sectors, acquisition of technologies and modern business practices, as well as exploration of foreign market penetration, need time and determine the economic growth rate. Moreover, this development is faced with an unfavourable external environment, relatively high cost of funds and lack of domestic demand. Recovery of previous development paces takes time. Second, the higher propensity to save and increased risk premia restrict the ability of monetary policy to generate additional demand in the economy by lowering the key interest rate.

Global economic developments are optimistic. The euro area and the European currency appear more consolidated due to the ECB's contribution and nation-wide efforts for fiscal consolidation. However, the optimism is fragile. Central banks of advanced economies have stated clearly that they will continue to apply the quantitative easing, as long as inflation remains below the target and unemployment remains high.

Actually, the so-far solutions have been in forms never experienced before. In fact, they pose new challenges with regard to implementation and potential risk spillover effects projected in the long run.

Under these circumstances, the Bank of Albania, considering the situation as rather complicated and after an intensive work, has succeeded in designing a full package of measures. They aim to boost credit and improve micro and macroeconomic balances of financing the economy, about which I will inform you in the following.

Package of credit recovery

The idea about the package that we are introducing today occurred last year, where we discussed, jointly with you and representatives of the Ministry of Justice, about legal amendments needed to promote collateral execution. Since that meeting, our experts have worked intensively for enriching it and bringing it to today's form.

The package consists in three pillars: legal pillar; monetary policy pillar and prudential pillar. I will dwell on them in the following:

1 – Legal pillar

The rapidly increased non-performing loans in the recent years, reflects, inter alia, a number of known and unknown problems of collateral execution. Therefore, together with the banking industry, we have identified and made relevant proposals for a higher efficiency of the collateral execution process. In consultation with other important stakeholders in this

process, legal amendments to the Civil Procedures Code and to the Civil Code have been drafted.

These amendments aim to accelerate the obligatory collateral execution, avoiding procedural delays caused by bank debtors.

More specifically, the proposed amendments address the following:

- Courts do not take measures to secure charges/sues, when the bailiff actions are rejected;
- Courts do not take measures to secure charges and do not suspend the execution of collateral, when the debtor requests the invalidity of the executive title, arising from a bank credit;
- Reduction by 50% of the initial price of the immovable property, placing an acceptable average for the debtor and the bank, and making clearer the value (price) of the item with which the second auction begins.

We are informed by the Ministry of Justice that these amendments are in process of finalisation and this legal package will be sent for approval to the Council of Ministers and then to the Parliament of Albania. I take this opportunity to iterate the need for these legal proposals to be approved by the Assembly of Albania at an earlier time possible. Improvements in the legal framework and collateral execution practice would provide public authorities with new spaces to boost lending in Albania.

2 – Monetary policy pillar

I mentioned earlier that Bank of Albania's monetary policy has been easing recently, undertaking 6 consecutive key interest rate cuts.

The one-week repurchase agreement rate, following the last cut in January 2013, reached the lowest historical level, to 3, 75%. It is a record low, not only historically but also if we compare it with all other economies in the region, including most new EU member states as well. The Bank of Albania deems that the monetary conditions are appropriate to ensure the meeting of inflation target in the medium run, providing at the same time the necessary monetary stimulus to support domestic demand. However, from the viewpoint of this meeting, the future of monetary policy is what really counts.

As stated in the last Statement by the Bank of Albania's Supervisory Council, the Bank of Albania will continue to pursue a stimulating monetary policy, as long as inflationary pressures remain weak. Furthermore, I would like to ensure the banking system that the operational framework we provide will maintain the same stimulating nature. It aims at preventing banks from any tensions, even sporadic ones, with regard to market liquidity adequacy (its quantity, price and maturity).

3 – Prudential pillar

While both first pillars impact indirectly and over an extended period of time, the prudential pillar impacts directly and swiftly on credit recovery. It includes a number of measures that will release financial resources to banks and will encourage them to channel those resources toward lending. Regulatory changes are at the core of these measures:

- Reduced requirements for liquid assets by banks;
- Changed risk coefficients in the investment structure to boost lending.

The reduction of the requirements for liquid assets by banks may be carried out without infringing the stability of the system, since their level is generally higher than that of international standards and of banks in the region. Moreover, given that banks operating in the country have their origin mainly in Europe, this reduction may take place under the conditions of declining risk premia in European financial markets. However, it will be

monitored and implemented according to each bank's risk profile. This means that though the reduction may be general, the level of liquid assets requested by currency and in total may be different in different banks.

Change in the risk coefficients of the investment structure will take place, so that banks' capital better supports the shifting of their resources toward lending. More specifically, we propose significant increase in risk coefficients that are used for calculating the banks' capital, for new flows of bank investments with non-residents.

This increase in risk coefficients may take place also for part of bank investment stock with non-residents, taking into consideration:

- Regulatory requirements for liquid assets;
- Adequate coverage of bank liabilities to non-residents; and
- The time needed so that this shift does not cause any operational overburden to banks.

On the other hand, risk coefficients may decrease in banks for the amount of new credit added to the existing stock, for a certain period of time. In this way, the intended shifting of funds toward lending in the country may be conducted even by those banks that have a lower capital adequacy ratio.

These measures are not administrative. The decision to conduct funds shifting to private sector credit in the country will be decided by the bank itself. As in any other case, the bank should balance all the factors affecting risk, costs and benefits from such a shift.

The implementation of the above measures requires amending the existing regulatory framework, which will be temporarily applicable (ad hoc). After that, banks should gradually return to complying with the existing regulatory framework, as regards the methodology for calculating capital requirement. In this way, we preserve, at any time, the necessary stimulus in banks to lend prudentially.

Focusing on the need to address non-performing loans, we deem that it represents a concern both for the banking industry and the Bank of Albania, not so much for the stability of the system, as for the costs that this phenomenon brings to banking activity, consumers and related services.

Also, public authorities may take measures in this regard. I take this opportunity to iterate the need for settlement of public sector's liabilities to private entities. This would positively contribute to settling a part of liabilities that these companies, or connected ones, have to the banking sector, hence mitigating the level of non-performing loans.

In parallel, this process should be treated at its roots, to establish a transparent and stable mechanism that addresses factors, which contribute to the increase of public sector liabilities toward private companies, and avoids their increase in the future.

Furthermore, the Bank of Albania will amend the regulatory framework to urge banks to support borrowers' request for credit restructuring, from the moment the credit is considered as good. If the banks realise this in an effective manner, they will have a lower cost as regards requirements for credit risk provisioning.

This element would enable banks to address more prudently and proactively their best clients, who may be showing their first signs of credit repayment problems due to factors that are beyond their control.

As an element to keep this action in check, the regulatory framework will envisage that this loan stay temporarily under this category (or in the substandard category), and will immediately fall in a lower category, if the loan quality deteriorates after restructuring.

After broad consultations with the banks, the Bank of Albania has drafted the relevant instructions that will guide them in the debt restructuring process.

Similarly, the Bank of Albania finds that a part of the non-performing loans, mainly the loss loans, remain in the balance sheets of the banks owing to different interpretation by the banking industry and the tax authorities about the commencement and completion of the legal proceedings against a debtor. Eliminating these loans from the banks' balance sheets, in the absence of a coordinated interpretation, leads to consequences on the banks' tax burden and prevents writing off loss loans from balance sheets; subsequently, the level of non-performing loans swells and banks allocate their capacities inefficiently.

I take the opportunity to underline that the banking industry and fiscal authorities need to identify the factors that lead to different interpretation of the same problem, and to formulate the necessary legal and sublegal amendments to provide a definite solution. The Bank of Albania is willing and stands ready to provide comprehensive assistance on this matter.

Role of business

The business-banks relationship is fundamental to economic activity success. This relationship is always conditioned by developments in the surrounding environment. The effects of the economy's slowdown have not been uniform across the sectors of the economy, and businesses do not face the same problems.

Nevertheless, overall, businesses face lower volume and income of economic activity. Some businesses need to restructure their activity, not only by decreasing costs and improving efficiency, but also by entering new markets and introducing new products.

To achieve this target, the owners' instinct and willingness do not suffice; it takes professional expertise, well-studied projects and additional financing or restructuring of the existing loan. I think that the business-bank partnership is indispensable in this process. Banks are increasingly developing their financial advisory capacities and are also developing banking products in order to be closer to the needs of the business. Also, they are increasingly active in the restructuring the credit to businesses.

Nevertheless, both sides have complaints related to each other. The businesses complain that banks are tight fisted, and often banks' lending does not correspond with the businesses activity cycle.

On the other hand, banks claim that businesses submit unreliable projects for crediting, and deficient financial information for decision making.

The Bank of Albania is confident that the relationship between business and banks will develop to the benefit of both parties, if they:

- Enhance their understanding of the activity profile, market conditions and regulatory requirements, which determine the activity of each of them;
- Enter into cooperation agreements, based on transparent, comprehensive and professional information;
- Act proactively to detect situations in which this agreement should be reviewed, to improve the possibilities to settle liabilities against each-other.

The measures that Bank of Albania proposes today support the need for a closer relationship between banks and business, in the current economic situation in Albania. They expand the banks' room for a greater flexibility in the process of credit restructuring. However, banks would not finance unsuccessful businesses; neither would they lend to businesses that do not supply transparent and complete information. A closer relationship also implies that, in their analysis, banks need to utilise more effectively the available information about existing and new borrowers, which may be generated by such sources as the Credit Registry.

Banks should establish sustainable long-term relationship with the businesses to enhance consultancy and lending, especially with regard to the small and medium-sized enterprises.

Conclusions

In conclusion, I would like to highlight that the current economic and financial situation in Albania requires maintaining the financial intermediation rates and addressing non-performing loans with priority. Collaboration with other public authorities has been successful; also, concrete action is expected to be taken on settling outstanding payments to private companies, and approving the proposed legal amendments on collateral execution. Today, the Bank of Albania proposed some additional measures aimed at inducing banks to lend more. These measures, which will be soon reflected in the regulatory framework, have a countercyclical nature and are in general temporary.

This element, and the needed control mechanisms that accompany such measures, will encourage banks to respect the obligation to credit prudentially and soundly. Given that, at present, crediting has additional risks, the banks management and shareholders should ensure that these short and medium-term risks are covered by adequate capital. The outcome of these measures would improve if businesses understood and used them properly. To this end, the relationship between businesses and banks should be based only on transparent and professional collaboration. ***This should be better reflected in the media and transferred to the public.***

The Bank of Albania will assess the impact of these measures and monitor their implementation on regular basis. In the view of this process, we stand ready to adapt them to the economic and financial developments, or support them with other measures. The stability of the financial system shall be at the foundation of each action of the Bank of Albania in this regard.

Finally, I would like to remind all the representatives of the private sector, whether in production or financial industry, that under the effects and impact of the crisis, the public authorities, lawmakers, fiscal and monetary authorities, have made important changes in terms of philosophy, objectives and decision making, far from traditional considerations. These temporary changes aim at mitigating the crisis effects, stabilising the economy, consumption and private investment.

The package I introduced today is a good example to illustrate this change. It is necessary, therefore, for the private sector to adopt such a temporary adjustment.

Ms. Lagarde, Managing Director of the International Monetary Fund, appealed that in the current situation, the goal of the private sector cannot be only profit; it must also be to add value, create jobs, develop the new ideas that drive an economy forward and provide stability. Boosted employment and higher income from employment means more consumption and investments, higher consumer demand for goods, services and lending instruments. The private and financial sector should be accountable to the real economy: a private sector that supports employees and consumers, and a financial sector that adds values instead of destroying them.

Concluding, I would like to share with you an important message: the crisis came in as a global crisis and its solution should come as such. However, each country should do its homework and undertake the necessary structure reforms to overcome it.

People only accept change in necessity and see necessity only in crisis – said Jean Monnet, regarded by many as chief architect of the European unity.

Thank you and success in your work!