

Gent Sejko: Albania's economic and financial developments in 2016

Introductory statement by Mr Gent Sejko, Governor of the Bank of Albania, presenting the Annual Report 2016 to the Parliamentary Committee on Economy and Finance, Tirana, 2 May 2017.

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Honourable Chair,

Honourable Members of the Committee,

I have the pleasure of presenting today the Annual Report of the Bank of Albania 2016. This report is a synthesis of the activity of the Bank in accordance with our legal objectives, obligations that arise from relevant by-laws, and commitments with our international partners.

Overall, I reckon the Bank of Albania has worked with dedication, seriousness and efficiency, in all such aspects. The policies, measures and legal and regulatory amendments we have initiated, and have provided a substantial contribution to addressing macroeconomic imbalances, bolstering economic activity, enhancing financial stability, and promoting Albania's European integration process.

In parallel to complying with our legal obligation, the presentation of the Annual Report is an important pillar of accountability and transparency for the Bank of Albania. These two commitments accompany and balance our institutional independence.

In this context, I believe the Annual Report addresses many of the recommendations the Committee left for us in the Resolution "On the assessment of the activity of the Bank of Albania for 2015".

In line with the above-stated overview, the presentation will address the following: (i) activity of the Supervisory Council and strengthening corporate governance; (ii) monetary policy decisions, achieved results and future challenges; (iii) measures taken to enhance financial stability and promote lending; (iv) steps taken to foster internal control and monitoring systems and procedures; and, (v) work carried out to strengthen independence, accountability and transparency.

I would like to start with the activity of the Supervisory Council of the Bank of Albania and our work toward good governance.

1. Activity of the Supervisory Council and strengthening institutional governance

The Supervisory Council has performed its activity in line with the competences set out in the Law "On the Bank of Albania" and the procedures established in the regulation on its organisation and functioning.

During 2016, the Council met 15 times and approved 136 decisions, of which 82 were acts approved for the first time, and 54 were amendments to existing acts. Eight meetings were dedicated to monetary policy decisions, four meetings focused on issues related to supervision and financial stability, and three other meetings were dedicated to control and oversight of the activity of the institution. The decisions have been thoroughly communicated to the public through press conferences, publication of relevant reports and public explanation, on a case by case basis, of various issues.

Beyond formulating policies and monitoring their implementation, the vision of the Supervisory Council is to raise the public trust in the Bank of Albania by enhancing the governance of this institution. In this regard, the Council has paid particular attention to this process, building on the

structures and processes that had been established in 2015.

I would like to update you briefly on their progress insofar and introduce you to new developments for 2016.

- ♦ Established in 2015, the Audit Committee conducted its activity independently in 2016. During the period, the Committee met seven times, exercising its functions as the supervisor and coordinator of internal and external audit functions, with a view to enhancing their efficiency.
- ♦ In accordance with the Internal Audit Policy, the Council adopted for the first time the annual plan of activities of the Inspector General and of the Internal Audit Department. The Audit Committee, and in turn, the Supervisory Council have been informed regularly on audit findings and recommendations by the Internal Audit Department, which provide additional guarantee on the effectiveness and quality of the internal audit systems.
- ♦ In July, the Supervisory Council adopted for the first time the Operational Risk Management Policy at the Bank of Albania. The document sets out the objectives, resources and key risk assessment principles, reporting lines and responsibilities of the relevant units. On these grounds, in August, rules were adopted on the organisation and functioning of the Operational Risk Management Unit, which is now operational.
- ♦ Also, in July, the Council approved the new budget regulation, which disciplines budget drafting, and planning and control of capital expenditure. In December, the Supervisory Council adopted the annual budget for 2017. For the first time, based on the alignment of the regulatory budgeting framework with the best national and international practices, the budget included projections for the medium-term horizon (2017 – 2019).

After the overview on the activity of the Council, I would like to focus a little longer on its monetary policy decisions, in view of conformity with the main mandate of the Bank of Albania. I would like to start with a short description of the underlying macroeconomic backdrop for monetary policy decisions.

2. Albanian Economy and Monetary Policy

In 2016, economic developments were positive and some of the main macroeconomic balances improved. According to INSTAT data, the Albanian economy grew at 3.5% in 2016, accelerating against the 2.6% growth rate in 2015. Economic growth was driven mainly by domestic demand, private investments and consumption, and was reflected, to a larger extent, in the expansion of the activity in services and construction sectors. In parallel, the unemployment rate fell to 14.2%, driven by the constant increase in employment, and the economic agents' confidence hit the record high of the last five years. Likewise, public debt took a downward turn, for the first time after six years. Lastly, inflation has been upward, after the low rates recorded in the first months of the year. It settled at 2.2% in December and IINSTAT publications for the first months of 2017 point to further rise in inflation rates.

For 2017, we expect these trends to consolidate. The return of the economy to potential is accompanied with the strengthening of inflationary pressures and the return of inflation to target within 2018.

Notwithstanding positive trends, the economic and financial environment has been a challenging one for the monetary policy. At the year start, we faced a rapid and sharp decline in inflation, as a result of acute disinflationary shocks from the external environment. Downside risks intensified. Also, extraordinary events such as Brexit or geo-political tensions in the external environment led to heightened uncertainty.

Against this backdrop, the Bank of Albania reacted with determination. The policy rate was lowered in two stages, in April and in May, down to 1.25%. The corridor of interbank rates – the floor is the rate on the overnight deposit and the ceiling is the rate on overnight loan – narrowed to two percentage points. In addition, the Bank of Albania continued to use the forward guidance to inform the public on its the monetary policy stance in the future. The use of this instrument was strengthened over the year, and was enriched with time frames. These actions signalled the willingness and capability of the Bank of Albania to fulfill its objective of price stability.

The operational framework of the monetary policy did not undergo significant changes and the banking system was supplied with liquidity through traditional monetary policy instruments.

The latter were adopted to better satisfy the needs of the banking system for liquidity.

In our assessment, the accommodative monetary policy has contributed to strengthening economic growth and creating the necessary conditions for maintaining price stability, through a number of channels.

- ♦ *First*, the accommodative monetary policy has contributed to lowering the interest rates in all the products in the financial market. The monetary stimulus is assessed to have been transmitted completely. The average interest rates on credit, deposits and 12-month T-bills in ALL were respectively 0.8, 0.5, and 1.5 percentage points lower than in the previous year.
- ♦ *Second*, the reduction of financing costs contributed to the expansion of credit. Credit portfolio in ALL to private sector grew by 10.2%, over 2016, while total credit grew by 3.2%. The growth of credit in the Albanian lek is a welcomed development, as it expands the monetary policy scope and serves to fostering financial stability, by reducing the economic agents' exposure to the exchange rate risk.

Despite this positive development, credit recovery remains sluggish, due to the limited qualitative demand and the banks' conservative credit policies. For 2017, we expect a better performance of lending to the economy.

The expansion of private demand is expected to absorb enterprises' excess liquidity, thus increasing the incentives for boosting credit demand. Similarly, the credit supply is expected to rise, in line with the lowering of uncertainties and reflecting the implementation of the action plan of measures for reducing non-performing loans and measures for Sound Credit Growth.

- ♦ *Third*, the low interest rates helped to reduce the service costs of the existing loans and to lower their re-financing costs. This has facilitated the activity of borrowing enterprises and households.
- ♦ *Fourth*, the low interest rates supported the increase of private consumption and investments in the economy, through encouraging a behaviour oriented more towards consumption and less towards savings.

According to our economic models, in the absence of monetary policy effects, economic growth and inflation for 2016 would have scored respectively 0.5 and 0.4 percentage point lower than their actual values.

Honourable committee members,

The Bank of Albania is independent in formulating and implementing its monetary policy. It is, however, aware of the mutual impact between the monetary policy and the fiscal policy in achieving the respective objectives. Therefore, for a right combination of macroeconomic policies, we are constantly mindful to coordinate the monetary policy stance with the fiscal policy stance; similarly, the latter is detailed in the budget per calendar year, and in medium-term draft

budgets. As I have said previously, the inclusion in 2016 of specific provisions for guaranteeing fiscal stability in the Organic Budget Law, established more solid basis for a better coordination of the two macroeconomic policies, as it contributes to increasing the discipline and foreseeability of the fiscal policy.

About the latter, the Bank of Albania finds that the fiscal policy has been on a consolidation path during in 2016, reflected in the reduction of the public deficit and public debt. Although it has injected a weak stimulus to the economy, the consolidating fiscal policy has facilitated the accommodative monetary policy pass through, by reducing the risk premia in the economy, favouring the reduction of financing costs, and increasing the space for lending to the private sector. According to reports from the Ministry of Finance, for the first time after six years, the public debt was reduced from 72.7% of the GDP in 2015, to 71% in 2016.

The Bank of Albania has been and is certain in the position that efforts for reducing public debt should continue.

The functioning of the monetary policy pass through mechanism, and factors contributing to or preventing it, are an integral part of the work of the Bank of Albania. Research efforts in 2016 aimed to assess the ability of the tools used for generating economic projections at the Bank, as well as the understanding of the functioning of monetary transmission vis-a-vis the current challenges in the financial system. In this context, I would like to point out that the Bank of Albania has identified two main obstacles in the monetary policy pass through mechanism, whose solution requires broader-scale cooperation.

- ♦ The first obstacle relates to the high level of non-performing loans. To reduce this risk, a national action plan for reducing non-performing loans has been drafted, and is currently underway.
- ♦ The second obstacle relates to the high level of euroisation in the economy, which creates potential risks in the financial system and renders the monetary policy pass through more difficult. Preparing a plan for reducing euroisation in our economy is a joint commitment by a number of authorities and the Bank of Albania is in the process of identifying measures that may be taken in this regard.

Amid a complex and challenging economic and financial environment, the coordination of the monetary, micro and macro-prudential policies assumes primary importance in promoting monetary and financial stability. In 2016, the Bank of Albania has worked with the same intensity in all three aspects, aiming at an optimum calibration for them. Following, is an overview of our work for maintaining and promoting financial stability.

3. Promoting financial stability and sound lending

In accordance with its mandate and institutional responsibilities, the Bank of Albania is jointly responsible for safeguarding financial stability in Albania. It communicates its assessment on the financial stability regularly, and coordinates its policies with other institutions, through the Financial Stability Advisory Group (FSAG). With regard to financial stability, during 2016, we continued to work for drafting a comprehensive framework of the macro-prudential policy and constructing macro-prudential instruments. This framework is based on recommendations of the European Systemic Risk Board and standards of the Financial Stability Board.

Moreover, in accordance with its institutional mandate and responsibilities, the Bank of Albania is tasked with safeguarding the stability of the banking system and addressing potential risks that may jeopardise it.

The main financial indicators of banking sector soundness – capitalization, liquidity and profitability – show it has full capacity to withstand operational risks under normal conditions, as

well as good resilience against shocks.

The share of banking sector assets in the Gross Domestic Product was 95.8% at the end of 2016, up by around 4.5 percentage points from a year earlier. Credit and deposits rose by 2.5% and 5.2%, respectively. In terms of capitalisation, the capital adequacy ratio stands significantly above the regulatory requirement. It stood at 15.7% for 2016, against the 12% regulatory requirement. Good capitalisation remains a characteristic feature of our banking system; it was maintained due to continued positive values in the net financial result. However, the financial result of the system fell slightly during 2016, mainly reflecting the increase in provisioning for the credit risk. The increase was a result of the conservative approach adopted by the Bank of Albania requesting banks to reclassify under non-performing loans those of certain large borrowers facing financial difficulties or a bankruptcy situation. The Return on Assets (ROA) of the system fell to 0.7% from 1.2% a year earlier, whereas the Return on Equity (RoE) fell to 7.2% from 13.2%.

In terms of risks, the Bank of Albania deems that the banking system's exposure to liquidity risk and market volatility is within acceptable parameters, but the management of such risk requires on-going attention by the banking industry. In the meantime, credit risk is the main risk to which the banking sector remains exposed. This risk becomes even more present as a result of its persistence and continuous problems that banks face in the process of collateral enforcement. Following the rise in non-performing loans in the first half of the year and their fall in the second half, the ratio of non-performing loans to total loans fell to 18.2% at the end of 2016, at the same level as in the previous year.

Therefore, the reduction of non-performing loans and creation of stimuli to boost sound lending has been and remains a priority issue for us.

The Bank of Albania has worked in several aspects to address this problem. *First*, the assessment of the credit risk and the recoverability of non-performing loans have been subject to intensive monitoring during our on-site examinations. In parallel, we have maintained a prudent approach in assessing lending policies and practices applied by banks. *Second*, the Bank of Albania has fulfilled its engagements under the National Plan for the Reduction of Non-performing loans.

In this regard, the Bank of Albania has made regulatory amendments to clarify the concept of non-performing loans write off and the administration of properties taken into ownership as a result of collateral enforcement. Moreover, the Bank of Albania has cooperated with the IMF to review the regulatory framework about the licencing of companies that purchase bad debt. *Third*, we have strengthened the regulatory and reporting requirements for banks as regards the due management of credit risk, in accordance with European practices. *Fourth*, we have intensified the communication with the banks to address the credit portfolio quality, concerning both the treatment of non-performing loan borrowers and loss loan write off. *Fifth*, the coordinative role of the Bank of Albania has produced results in terms of restructuring borrowers exposed to more than one bank and will continue in this year to prepare an interbank cooperation platform for a solution to common borrowers; the Bank of Albania is drafting it in cooperation with World Bank's FinSAC project.

In our judgement, the steps taken insofar for resolving non-performing loans will contribute to a fruitful environment to boost sustainable and sound lending. This is a major priority, which requires a multidimensional action matrix and a broad cooperation between state authorities and the banking system.

In this aspect, the Bank of Albania drafted and promoted the signing of a joint Memorandum of Understanding for the Sound Growth of Credit in Albania¹.

In the supervisory process, the Bank of Albania has supported the pursuit of pro-active policies

against potential risks, with regard to both the quality of the risk analysis performed by banks, and the creation of adequate provisions.

This new approach, introduced a year ago, has required amending the regulatory framework, as well as internal practices and capacities. The regulatory framework and respective methodologies are drafted pursuant to the requirements of Basel II, and in accordance with European Union directives. About regulatory amendments, I would like to highlight two of the most important ones, which have now taken the form of a law: The Law on the Functioning of Savings and Loan Associations and their Unions and the Law on Recovery and Resolution in Banks. The first provided for a comprehensive revision of the regulatory framework for the supervision of savings and loan associations, which consists in respective regulations on licencing and risk management in these institutions, as well as the reporting system about their financial activity.

The second provides the Bank of Albania with the attributes of the Resolution Authority, through a set of legal instruments. This law is an important qualitative step towards guarantees for safeguarding financial stability in Albania.

Moreover, in response to the negative events in the previous year, when the security related to transportation and keeping monetary values was affected, the Bank of Albania has urged the cooperation between banks and law enforcement authorities to take measures for eliminating the deficiencies; it has added on-site inspections to examine the probability of occurrence of a risk; and, has strengthened the regulatory framework for establishing criteria on the minimum physical security.

Lastly, a good functioning of the financial system in general and the banking sector in particular has been endorsed by efficient payment systems. The national payment systems operated by the Bank of Albania have operated uninterruptedly and correctly. During 2016, we intensified our work to enhance the effectiveness of electronic payment instruments, and reduce the use of cash in the economy. For that purpose, in accordance with EU directives, the regulatory framework on electronic payment instruments was revised.

Moreover, to fulfil the recommendations of the National Payments System Committee, a project was finalised on the standardisation of the payment-order; meanwhile, the implementation of the Interbank Direct Debit project is underway. It is aimed at increasing the use of this instrument by the clients of all banks, contributing thus the reduction of *cash* in the economy.

In our judgement, the coordination of the monetary policy with the micro and macro-prudential measures by the Bank of Albania has contributed to promoting monetary and financial stability.

4. Fostering internal control and monitoring systems and procedures

The last two years have seen important changes in terms of fostering internal control systems, in order to bolster risk prevention. The internal audit at the Bank of Albania is an independent activity from the management, ensured through the Inspector General, appointed by the Parliament. It also contributes to a smooth operation and accountability at the Bank of Albania, assessing both the control over processes and the efficiency in the use of resources.

The practices in control systems are approximated with international audit standards, and are adopted to address recommendations by international institutions.

One of the recurring recommendations from these institutions pertains to the implementation of the operational risk management at bank level. Started in the previous year, the realisation of this project was finalised in 2016. Now, the Bank of Albania has an Operational Risk Management Policy, which sets out the core principles for the identification, assessment, control, management and follow-up of the operational risk as an integrated process at bank level. We

have also established a dedicated unit for evaluating and making recommendations for addressing vulnerabilities.

The internal audit function acts also as a consultant service for the Supervisory Council. The audit engagements focused on: (i) issuing opinions on the sufficiency of internal audits established by the Management for audited functions/processes, including supportive applications for the activities; (ii) issuing opinions on the accuracy and completeness of financial data in periodic reports; and (iii) other audit and non-audit engagements, ad hoc, upon special request by the Administrators or other institutions outside the Bank.

With added prudence on designing work processes by Bank units, at the beginning of 2017, a project started on the implementation of the Programme on the Business Continuity Management at the Bank of Albania. The realisation of this project ranks the Bank of Albania among the banks applying best practices on institutional good governance.

5. Medium-term strategy and strengthening of independence, accountability and transparency

The medium-term development strategy of the Bank of Albania for 2016–18 was launched in 2016 to activate the entire potential of the Bank of Albania. This document sets out the institutional objectives throughout a three-year period, 2016–2018, and identifies the measures and sources needed to accomplish these objectives. The fulfilment of these objectives depends, first of all, on how understandable we are to the public, how responsible we are in our policies and actions, and how trustworthy we are to the public. Hence, enhancing the Bank of Albania's independence is always considered related to the strengthening of transparency and accountability.

In terms of accountability, the Bank of Albania has regularly fulfilled the accountability obligations to the Parliament, the financial system and the public. Also, information on the activity and results of the Internal Audit Department is attached to the Annual Report 2016. Also, the financial statements and the opinion of the external independent auditor were an integral part of the Annual Report, in compliance with the International Audit Standards. The approval of the financial statements in compliance with the International Financial Reporting Standards (IFRS Standards) was among the most important priorities of the Bank of Albania for 2015. The implementation of this priority over 2016 met the legal requirements and observed the internal and external recommendations.

Transparent communication is an important pillar in Bank of Albania's activity for both fulfilling the responsibility for maximum transparency about decision-making and its effects, and raising public confidence in the central bank. Following are some statistics:

- ♦ Our official website is a place where the public may find complete and updated information on the Bank of Albania, as well as on the economy and finances in Albania. During 2016, the website had about 720 000 visitors, who viewed our page around 2.100.000 times and browsed in total about 4.310.000 items.
- ♦ Also, the Museum of the Bank of Albania was visited by 1900 visitors; while 1180 textbooks "Personal finance in your hands", were distributed in eight high schools.

Since the beginning of 2016, in compliance with Article 7 of the Law No. 119/2014 "On the right of access to information", the Bank of Albania has compiled and published the Transparency Program on its website. In this regard, we have assigned a coordinator and answered 65 official requests and 120 requests delivered via electronic mail.

For nearly a decade now, the Bank of Albania has been committed to expanding and deepening financial literacy of the public, focusing on the younger generation.

Although, the financial education of the public is not a legal obligation of the Bank of Albania, we are confident on the positive return of this investment. Two are the main goals of the programmes, activities and special educational publications prepared by the Bank of Albania: introducing the central bank, its functions and role to the public; and cultivating and strengthening the financial literacy in society. In our view, financial literacy has become a necessity, taking into consideration not only the level of economic, banking and technological development, but also the importance and significance of information in today's global setting.

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Honourable Chair,

Honourable Members of the Committee,

In conclusion, I would like to highlight that, over 2016, the Bank of Albania has showed initiative and devotion in addressing the challenges we have faced. The positive results of our work show that we are on the right direction.

Nevertheless, I think that for successful institutions there is always something more to do. They are guided by the medium and long-term objectives; they invest to enhance the professional standards and increase their capacities through the preparation, strengthening of independence, accountability, transparency and good governance. This credo of ours will be a guide for our action plans in the future.

Thank you for your attention!

¹ This Memorandum was signed by the Bank of Albania, Ministry of Finance, Ministry of Economic Development, Tourism, Trade and Entrepreneurship and the Albanian Association of Banks.