

## Ardian Fullani: Stress-testing workshop

Opening remarks by Mr Ardian Fullani, Governor of the Bank of Albania, at the "Stress-Testing" workshop, Tirana, 5 April 2005.

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Dear participants and guests,

I accepted with pleasure the invitation to open this workshop "On Stress-Testing", having also in mind that the topic you are going to discuss in these three days, is an important issue in enriching the tools of the supervisory institution on identifying in advance areas or developments of potential fragility, and acting in accordance to prevent adverse situations for the licensed institutions.

Life has shown us that risk is everywhere. Certain things are not sure of happening at all, some others that will happen for sure are not known when or where. The activity of individual people, of entire families, of businesses, of the government, are affected considerably by what is really going to happen in a moment, tomorrow, the day after tomorrow and so on. Is there any way of completely avoiding any risk, in our life, in our activity, etc.? The answer to this question is one of the few risk-free statements: no, there isn't any. It is then unavoidable to live with risk, to understand and to accept it, to manage it.

Banking is a business activity, where risk is Inherent. This is obvious when you think of a normal bank balance sheet composition, or when you try certain ratios when assessing their liquidity position. Banks intermediate among entities that avail their liquidities for a certain period of time and others that need liquidity to continue to perform their life, services and activities. These groups have different risk attitude, that is formed as part of their previous experience. They express their risk attitude by choosing a certain bank, a certain product, a certain maturity structure, a certain currency, or by keeping out of the banks at all. It is rather a consequence of a limited choice, and in many cases, of limited knowledge. As such, it means less risk awareness capabilities by clients, and as a consequence, less stimulus for banks themselves to carefully monitor their risks.

Hence, it is important that banks (and other financial institutions), set up their systems to identify, measure, monitor and manage risks. Systems here, first of all mean people and procedures that are an indication of how well the bank management, including its board of directors, understand the risks associated with its business nature and size. Certainly, this work becomes more efficient if supported by information technology, at the scale that is sufficient for the size and the complexity of the bank business. From a practical point of view, in those financial systems where the size of certain financial institutions is of a systemic importance, the development of a risk management program is paramount. Besides the bank management, whose responsibility, I repeat, is of primary nature, the supervisory authority has a clear interest and responsibility in making sure that individual banks (and other financial institutions) understand what they are doing. This interest stems not only from their legal obligation, but also is an instrument in ensuring the public that the financial institutions are managed in a sound and safe manner. In the end, all this gives a remarkable contribution toward the goal of reaching and maintaining financial stability.

History and practice have shown that having a good supervision function is very important, but not enough. It is the market that could very well and in a timely way, discover behaviours that indicate imprudent risk taking by financial institutions. In a market that functions under normal conditions, competitive factors force its players to look at each other to identify what can be done better. This is much stronger if complemented by greater transparency and accountability. Under a deep and developed market, the work of the supervisors, from the viewpoint of identifying in time imprudent risks that financial institutions are taking, becomes easier. On the other hand, open and developed markets, usually mean more complex products with more complex risk features that require more complex systems to support and monitor them. This requires greater and more skilful supervision.

While the market well-functioning and transparency, are elements that help supervision, these elements do not substitute it. Firstly, while developed markets mean more capacities to analyse past and future events, the risk is that they still may miss the global picture, as individual institutions do not have the data and most of the times, the need, to analyse the financial stability of the system as a whole. Secondly, what individual financial institutions analyse and expect from the future developments, is frequently what they want. One should also remember that financial institutions of a certain important size that expect similar events, have the power to move the market in one direction.

Based on specific elements of any national or regional market, this does not necessarily show a reduction in the level of risk. Moreover, the systemic risk in this case, is still very high.

It is then important to provide the supervisor with the necessary analytic tools, to use the global data of their supervised financial institutions, for setting up models that will provide for a global analysis. By what we do and who we are, we are more concerned with what will happen if something extreme occurs. What if the exchange rate moves adversely? How is that affecting the credit portfolio of X bank, that is lending mostly in foreign currency? How big is this issue for the banking system as a whole? What are the developments in the interest rate that could negatively impact the balance sheet of one financial institution and of the entire system? What about the combination between the interest rate risk and the concentration risk, and its impact in one institution that holds most of the treasury bills in circulation?

All these questions are important in the case of Albania. The financial market is developing, but there is a long way to go. Banking sector is the most important part, with its assets counting for around 90 percent of the financial system. Looking at the size of the banks, the system continues to be asymmetric. However, when you look at products and services that banks offer to the public, the picture is more balanced. Lending is still low compared to other countries in the region, but is increasing quickly. Around 80 percent of the lending portfolio is in foreign currency. Investments of liquidity in securities is increasing. As of the end of 2004, return on equity stood at 21.1 percent, while return on assets was 1.28 percent. Capital adequacy ratio stood at 21.6 percent. As of the beginning of 2004, state is no longer controlling any bank capital. Even though the Albanian economy is a small one, the potentials for expansion are real as the economy is very much opened and the region is more and more integrating into the European Union economic area. As such we expect more positive developments in the financial sector and the banking sector in particular. While the situation for the system as a whole is satisfactory, there are certain challenges out there, that need greater awareness among the industry and a careful monitoring from the Bank of Albania.

Hence, due to the structure of the banking system and the expected tightening competition environment, individual small banks are expected to experience difficult times ahead. We expect to see a lowering of their profit margins, which may hamper their attempts to position themselves better in the marketplace. On the other side, they will be forced to find new ways of increasing their financing and their incomes. From its side, Bank of Albania will pay particular attention to these banks, as in such difficult times, the procedures and the controls in the high earning bank activities (like lending) tend to relax. At the same time, as a central bank we believe that there are possibilities for consolidation taking place in the banking system. We believe that through this process, higher profile international banks could enter the growing Albanian market or existing small and middle sized banks could position themselves better in the marketplace.

Bank of Albania wants to see a higher intermediation level of the banking system and a greater impact in the economic development of the country. We will encourage the banking system to lend more to sound businesses and to those areas of the economy that appeal to them with solid and continuous progress. However, in every instance, we shall insist that banks maintain strong loan underwriting and administration processes, in order to ensure a balanced and solid growth of the activity. Due to the currency composition of the loan portfolio, it is important that banks pay particular attention to the cash-flow of their borrowers, as this may not be denominated in the same currency of the loan. Any unexpected adverse change in the exchange rate could mean problems, if not prepared in advance to cope with that. On the other side, Bank of Albania wants to see higher levels of lending in domestic currency. This, along with other information, will improve its ability to forecast better the developments in the transmission mechanism and in performing its monetary policy. Looking at a broader macrofinancial picture, Bank of Albania has contributed to that goal by reducing its Repo rate to historic low levels and closing the lending interest rate differential between domestic and foreign currency.

New developments of the banking and financial system, pose new challenges. It is important that these challenges are well identified, well understood and well acted upon. We want to do this in cooperation with the banking system. Opening communication lines and transparent and fruitful discussion of the new developments will help each side to understand the problems better and to act quickly to amend the situation, within the regulatory framework. We will continue to improve our supervisory processes, with the aim of making the supervision completely risk-oriented and proactive. We will invest considerable time and money in upgrading the quality of our staff. We intend to make our regulatory framework compliant with the best international standards as much as possible under our specific local conditions.

Dear participants,

I believe that this workshop is going to help us in expanding our knowledge about risk in the financial and the banking sector, and in promoting stress-testing as one of the techniques. Stress-testing, used separately and together with other techniques, is a valuable tool in verifying the endurance of our financial institutions and financial system. In the Bank of Albania, we have a lot of interest in knowing your experiences. Hence I would encourage you to provide this workshop with your real examples. I believe you will also enjoy Tirana, a city that is changing quickly, even for those who live here. You will understand a little more about this country and its people, and this could prove as interesting as to make you wish to come back again. Last but not least, I would like to thank the International Monetary Fund, Mr Driessen and his colleagues, for supporting and developing this joint workshop in Tirana and for providing their valuable theoretical and practical expertise.

Thank you and enjoy.