

Ardian Fullani: The development of the financial market and money market in Albania

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the General Assembly of the Dealers Association, Tirana, 25 October 2007.

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Mr. Chairman
Distinguished Guests,

It is a great pleasure to be here amongst old and new friends and colleagues. I have dearly welcomed the reorganization and reactivation of the Albanian Association of Dealers, and the attempts made by its new board to affiliate ACI-Financial Market Association. I am confident that this reactivation will promote, above all, the market development, education and professional training of new members.

I deem that the meetings of the Dealers Association is a good opportunity to share with you some thoughts and concerns regarding the development of the Albanian financial market in general and the money market in particular.

I would like to emphasize that the interbank money market is the starting point to the transmission mechanism, driven by base interest rate change. Currently it is the most important channel of transmitting monetary policy decisions to the economy. I have to remind you that where you realize the profit, the Bank of Albania implements the monetary policy, whose efficiency depends directly on your capability to maximize profit in this market. This policy is based on the assumption that market participants are rational and their primary purpose is profit maximization under the conditions of a competitive environment. The current development of the interbank market in Albania does not fulfil these assumptions yet and therefore, it makes the work of the Bank of Albania difficult in carrying out this essential function.

Year 2002 recorded the start of the interbank market, the same year when the indirect instruments were introduced by the Bank of Albania to conduct its monetary operations. The Bank of Albania has attended the developments of the interbank money market in the last five years. During this period the trading volume has been fifteen folded, climbing from a daily average of 130 million lek in 2002 to a daily average of around 2 billion lek in 2007. Also there has been an increase in the maturity of the traded funds, from only trading overnight back in 2002 to trading up to three months in 2007.

Also there has been an increase in the maturity of traded funds, from only trading overnight back in 2002 to trading up to three months in 2007. From the beginning of this year, we have been able to publish the fixed interest rate indexes, TRIBOR and TRIBID, which is hoped to promote the development of the interbank money market.

However, we have to admit that this development has been a very slow one. During the last five years, the lek liabilities of the banking system have increased by 135 billion lek, which makes the increase in the trading volume of interbank market by a daily average of 1.9 billion lek, only a peanut in a big cake. On the other hand, besides an increase in the volume of one-week maturity transactions, longer term transactions are very sporadic. In addition, this low development of the interbank money market is also reflected to the wide spreads of the quotations for trading, published by commercial banks.

Nevertheless, the development of the interbank money market is made difficult also because of other reasons, some of which are of objective nature.

It can not be developed as an isolated market. Its progress is highly correlated to the economic development in general and the development of other financial markets in

particular. The financial market is still characterized by the domination of the banking system, while its other segments continue to be in a minor state of their development. There are interesting developments in the insurance companies market, while the segment of pension funds is still underdeveloped. Furthermore, other specialized intermediaries are completely missing, including here even the capital market. All the above and other reasons such as the high degree of informality in the economy, credit demand dominated in foreign currency, are factors which directly or indirectly impede the enhancement of money market efficiency.

However, rightly comprehending that many of the reasons are of objective nature, we believe that within the limitations imposed by the abovementioned factors, still there are gaps, about which I encourage you, to jointly fill as soon as possible.

In the latest survey conducted by the Bank of Albania on "Money Market Issues", 7 out of 14 respondents (commercial banks), (which possess 59 per cent of the market share), outlined "the excess structural liquidity" as the main barrier to the development of the interbank money market, while 4 out of 14 banks (which have a market share of 30 per cent) highlighted "the credit risk" as the second most important barrier. The tendency to keep excess structural liquidity as a bank policy was pinpointed by 13 out of the 14 interviewed banks, otherwise meaning that banks that share 92 per cent of the market do have a tendency to keep excess structural liquidity.

We notice that the reasons and obstacles brought up by banks are mostly subjective, and their prevention depends more or less depend on their policies and behavior. Banks keep excess liquidity because there is no a developed money market where they could invest this liquidity at all times at a fair market price.

This market can not be developed on its own!

It is banks' active liquidity management as opposed to a passive one that creates incentives for developing the markets. In this context, I would highly recommend you to implement stricter internal control policies and procedures, so that they can identify opportunity cost and missed profit opportunities. Such a thing will lead to improved efficiency and competitive positions of the bank on the one hand and market development on the other. The Bank of Albania requires that you design management policies that are oriented toward profit maximization. The limitation to simple financial intermediation, such as collecting public savings and keeping them in the form of excess reserves waiting to be invested in low risk government papers, is not a characteristic of contemporary financial markets. All I mentioned above implies the indispensability for a more effective management under the conditions of enhancing the transparency.

As to the structural excess liquidity, the Bank of Albania is currently targeting to keep it under appropriate levels, in order to increase the degree of the banking system reaction to Bank of Albania's operational decisions. **At the same time, we are carefully evaluating necessary refinements to monetary policy instruments, to further promote the trading in the interbank money market.**

Beyond the structural liquidity position, another important issue is the existence of limits that certain banks apply in lending relations with one-another. From a pure academic viewpoint, it is quite easy to label these limits as an effort to ensure an oligopolistic structure in the market. I do not like to prejudice the prudent stance and measures reflected in these limits. However, I should state that in your business with non-bank clients, there may be identified elements, to which you take a higher degree of risk than the one materialized in interbank money transactions.

Considering the need for market development and the identification of the role of the Bank of Albania in these markets as the Lender of Last Resort as indispensable, we have prepared and will soon enough implement a complete package of regulations, whose purpose is to establish incentives and minimize risks in the Albanian financial market. Concretely, these changes consist in:

The law on repurchase agreements. There is compiled the draft-law, which enables the risk-free conduct of repurchase agreements among commercial banks. It will guarantee the prevention of credit risk, which is cited by commercial banks as one of the primary causes for the existence of limits in the lending relations among banks. This law will also prevent the legal risk the banks are faced with when using repurchase contracts.

Drafting of the regulatory framework and putting into application the custodian principle of delivery versus payment. In order to minimize the payment settlement risk and facilitate the intermediation in all types of transactions involving securities, such as collateralized loans, repurchase agreements, and outright purchase and sale of government papers, it is being worked on to put into practice the principle of delivery versus payment.

Reducing the frequency of government treasury bill auctions. In collaboration with the Ministry of Finance, we have agreed on less frequent and increased size auction schedule of the government treasury bills. This less frequent auction schedule will limit the opportunity of banks to "be liquid" based on distributing their treasury bill investment in such a way that liquidity is generated by maturing these government papers.

Increasing the investment base of investors. In cooperation with the Ministry of Finance and the Financial Supervisory Authority, it is agreed upon increasing the investors' base, eligible to directly invest in the auctions of government papers. The new agreement signed between the Bank of Albania and the Ministry of Finance provides the necessary regulative framework for giving an end to the monopoly that the banking system has had in investment in the primary market of government papers, leaving space to natural and legal persons, foreign and domestic individuals.

I do not feel well to assert that this step became indispensable, under the conditions of high commissions applied by commercial banks in providing this service, making the clients reluctant to this kind of investment.

Earnestly believing in the efficiency and development driven by competition, I am convinced that increasing the number of operators licensed to trade government papers has also become a necessity.

Primary rate for favorable clients. Being convinced that the monetary policy efficiency is enhanced through transparency, the Bank of Albania aims at including even this rate to the entirety of orientation rates used by commercial banks.

This package is designed to increase incentives for you to find new profit opportunities and secure the necessary liquidity at a fair price in the secondary security markets. These measures are oriented toward promoting the activity, so that you will not wait for the client to ask for the government papers but search and find this client yourself. And the very first step you should make in this direction is: abandon the traditional pension fund security portfolio classification as "hold to maturity". **In other words, this implies the necessity for more flexibility, more diversification and for the existence of efficient risk management structures.**

A constant concern, which I want to pay particular attention and get your highest interest on it, is the professional development of human skills. I am not making any prejudice about the human resources that are currently working at the banking system, but I would like to point out that the mobilization of capable human resources, devoted to and shaped professionally is vital for the accomplishment of success. To be more competitive and bring new developments, we have to constantly upgrade the skills of each employee at all levels. It is true that the majority of the banks of our banking system represent international well experienced banking groups. However, I would like to emphasize that there is still room for more expertise and qualified human resources, so that the best practices of the international markets are infiltrated in our banking system.

In addition, within the framework of this association, I would advocate that the Dealers Association must very soon come up with a *Code of Conduct*, agreed by all its members.

While this code is a non-statutory body, with no executive powers, it complements the self-regulation of the market by bringing together the best minds of the market participants and professionals to create a reliable trading practice.

Concluding, I would say that developing the interbank money and security markets is among the top priorities of the Bank of Albania. As such, we will make all our efforts to create the necessary conditions to minimize the trading risks, as well as create and support initiatives to active trading in the these markets. I hope these efforts will receive your understanding and more important your cooperation. It will be very satisfactory indeed, that in my next appearance in this platform I will be able to bring concrete results of our common efforts to develop interbank money market and secondary market.

Concluding my speech, I would like to emphasize once more that no long-term and stable development may exist, without having effective financial markets. The financial market with all its segments, should precede the signals and novelties brought about by rapid dynamics of development of the private sector and the economy in general.

Thank you all for your attention!