

Ardian Fullani: Achievements and challenges of the Albanian banking system

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the Open Forum with the Albanian banking system's players, Tirana, 29 September 2008.

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Dear heads of commercial banks operating in Albania,

Dear participants,

It has almost been 6 months since the first open forum was held, at the core of which were the achievements and challenges of the Albanian banking system.

Today's forum is a follow-up of the debate which commenced 6 months ago with the good will and goal to further bolster the banking system's stability in Albania. I consider the first forum a successful one, given that it generated a number of important decisions that have been made recently. In addition, I have the strong conviction that the discussions to be held this afternoon will be productive and will serve to the prudent examination of the banking system's activity, in particular in the context of the recent developments in the global financial markets.

To begin with, I would like to provide a general overview of the banking sector's financial situation and the extent of impact from the developments in the international financial markets. During the first half of 2008, the banking sector maintained its stable growth pace.

The Albanian banking system is lucrative, well-capitalized and liquid. The good financial result continues to be driven by the rapid growth of high return on investment activities. As of end June 2008, credit portfolio of the banking system accounted for nearly 43% of total assets, increasing by 3.6 percentage points relative to end-year 2007.

Consumer deposits remain the main funding source for the activity, accounting for 80% of total assets. Business funding through the credit lines from the parent banks increased to 9% of total assets in the first half of 2008.

As of end June 2008, return on average assets was estimated at 1.3% while return on average equity equalled to 16.6%. Capitalization indicator of the financial sector, and in particular of the banking one, increased slightly. Capital adequacy rate of the banking sector showed a slight increase to 17.3% as of end the first half of 2008.

Liquidity indicator continues to remain at higher levels compared to the other regional countries. Liquid assets of the banking sector share 47% of total assets, dropping by about 5.7 percentage points relative to end-year 2007.

The spread of the U.S. economy crisis to the international financial markets and the uncertainty for the nature of its effects, the institutions' map, the types of instruments and its extent, do theoretically increase the risk of its impact on the financial system at home. Basically, this crisis has not provided its impact on the banking activity in Albania.

The Albanian system's immunity to this crisis arises from certain factors, namely:

- The relatively low exposure of the Albanian financial system to international financial institutions;
- The low integration level in general; and
- The well-capitalized activity of European banking groups and their branches operating in Albania.

In general, we consider that no risks that may be materialized or which may harm abruptly and severely the activity of the financial system are identified. However, I would like to dwell on the risk analysis of the banking sector.

Scenario-based risk analyses confirm that the banking sector has the capacity to cope with the various risks that may arise as a result of the unwelcome shifts in the exchange rates and interest rates.

Prudent monitoring of assets' quality is required and time is ripe to pay greater attention to the performance of liquidity indicators. With respect to the latter, the following aspects are crucial to keep under consideration:

First, the absence of a developed money and securities trading market curtails the financial institutions' capacities to meet the unexpected liquidity needs through the sale of assets considered as "liquid". In addition, as a result of the financial crisis in the international markets, the trading of some securities, which were previously considered as favourite to the investors, has become challenging

Second, the differences in the size of the banking sector's institutions, the collateral's quantity and quality, and the restrictions for the direct exposure among institutions hamper the circulation of liquid funds in the interbank market in the duly time and extent.

Third, given the enhanced competition, there is a risk that significant disproportions arise between assets and liabilities in the balance sheet, with regard to type of currency and maturity term;

Fourth, some institutions have also turned to borrowing from parent banks in order to maintain the lending promptness and size;

Fifth, owing to objective factors that have conditioned the lack of efficiency, the banking sector at home has been characterized by very high liquidity levels. Given the enhanced competition and improved efficiency, it is objectively expected that liquidity indicators being to shift downward. These factors hamper the setting of the optimum liquidity level, in which the enhanced efficiency in fund use does not shackle the institution's capacity to cope with the business risks.

All these elements provide evidence for the need that the banks' governing structures follow practices that allow the institution itself to meet the expected liquidity needs independently, however, having options which improve their capacity to generate liquidity in urgent cases. You must re-evaluate the securities' portfolio quality, in particular that in foreign currency, in order to attain the optimum characteristics of safety and tradability. In addition, the portfolio of placements in foreign currency in the form of deposits or related products with international financial institutions should have as its main objective the safety of the investment and the adequacy of maturity term.

In a broader context, you should reassess the adequacy of certain indicators' level in terms of differences in maturity terms and the type of currency of assets and liabilities.

Assets' quality, which is mainly affected by the quality of loan portfolio, remains a constant risk to the banking business in general. The reduced quality of assets does not only impair the institution's income, but also harms its liquidity position. In the case of the Albanian banking sector, the loan portfolio quality has been decreasing, although at gradual rates, and the situation is presented as entirely manageable. The rapid growth of credit and the challenges certain sectors of the economy that have been lent significantly may be faced with, are factors that will continue to exert pressure on the loan quality in the near future. Hence, it is crucial for you to implement a policy of rapid detection of non-performing loans and promptly create reserve funds. It is for this reason that the Bank of Albania will increase the frequency of controls and the efficiency in monitoring and checking this process.

The Bank of Albania, through its Supervision Department, has prudently and constantly monitored the developments' dynamics in the banking sector, part of which are also the

recent developments related to interest rates on market products. We consider these interest rates as aggressive, providing their impact on the profit margin and representing a potential risk to the structure of balance sheet.

As you are aware, we have required from you information related to the strategy and procedures followed by your bank with respect to the application of these terms and interest rates, the purpose and grounding basis for the decision-making process and the structures involved.

It is essential for the Bank of Albania that any decision made is a product of deep and comprehensive analyses from the most junior expert to the decision-making structures, placing in addition special emphasis on the impact on the financial result. The entire process should be transparent, understandable and absorbing by the public at large. Otherwise, it will provide opposite effects.

This summer provided evidence for the fact that competition in terms of gaining market shares is a determinant element of the Albanian banking system's behaviour. It also holds true that we are dealing with one of the core principles in the functioning of free market economy: COMPETITION. However, given the fact that the other market principles, namely profit maximization, are not on the same wavelength, the balances between them may be distorted and consequently, different risk elements may be present. I repeat from the previous forum that it is necessary for you to consider the macroeconomic consequences of your behaviour at an industrial or institutional level, since they are important factors which ensure the long-term stability of your institutions and the system in general.

The difference between large and small-size banks, when public confidence in the system in general is in question, is relative. Each bank has its role and share in the system and the difference between the concept "a small bank" or "a large bank" in the context of systemic risks, is ever-increasingly reducing.

In addition, the U.S. financial crisis was caused by the imprudence of financial institutions to assess the stability of private debt and accurately weigh the effect of macroeconomic developments on the U.S. household budget. Its consequences remind us of the expression "there's no such thing as a free lunch".

With regard to the issues explored in the forum held in April, I would like to bring to your attention two other issues that I believe remain indisputable priorities for our work in the future.

As promised in the first forum, the Law "On repurchase agreements" has become effective upon its entry into force on August 19th 2008. Although this project was pre-announced by the Bank of Albania, according to the information made available by the operational staff of the central bank and the respective commercial banks, we notice that the entry into force of this law has found you unprepared. Hence, I require from you that the issue of binding contracts for the execution of repurchase agreements be placed at the top of your short-term agenda.

Your legal staff should equally assess both the retail and the Treasury Department products. Judicial and operational assistance will be provided by the Bank of Albania, but on the other side the Bank of Albania will not intervene in solving the liquidity needs in case these needs arise from the non-observance of the law on repurchase agreements.

I find it pleasing to confirm that after a general agreement on their usefulness, the package of regulations we brought to you in the first forum, has now become effective. The Bank of Albania is now expecting swift responses, in order to minimize their obligatory enforcement by us. The new regulations increase prudence in the elaboration and protection against foreign currency credit risk. I do not want to fail to disclose our stance that Albania needs a liquid and well-capitalized banking system given the situation we are going through. Regulations on transparency and obligation to disclose are another important part of the last package.

We have now taken steps to a more regulated market and other parties should follow the same steps as well. I refer here to banks' clients who at present have, can and should be acknowledged of all their rights in relation to the banks servicing them.

In every meeting with you, I will highlight the need of strengthening the control on the business of the institutions you are governing. In addition to the fact that only this way the personal philosophy of each of you with regard to the development of the institution will come true, this process is vital to the well-functioning and safety of its business, even more given its rapid growth. In this context, the control structures should act rightly and extend to all the bank's activities. Given the absence of a good collection, processing and reporting process of the business data, the control process on the institution's activity finds itself jeopardized.

The process of the banking sector's data collection and processing has improved over the recent years as a result of investments in modern technological systems. In many cases, however, it is observed that the adoption of these systems is made only partially and hastily. Their full potential is not used and the banks' personnel may not be fully familiar to their use; hence, weakening the necessary human control on these systems. Consequently, the control process on the institution's activity is segmented, and the process of data collection, processing and reporting at the required quality and time is hampered. As a result, you being heads of commercial banks and us the system's regulatory authority, risk to take decisions on data which are not fully accurate and furthermore are "old". Being present in different banks and in different levels, a final solution should be found to this issue. This situations needs to change and therefore, I require strong commitment from you and your shareholders.

In more concrete terms, I require each bank to promptly:

- a) Make a "cost/risk" analysis of all its activities and expand the information technology systems, at least in those areas of the activity where there is greater risk in terms of absence of accuracy in processes;
- b) Place all branches and its activity in a "net";
- c) Strengthen the human control structures in all the business processes, in particular in the treasury operations, deposits' collection, credit extension and execution of transfers and payments;
- d) Document and keep track of the entire process, evidencing clearly the responsible structures and people, and regulating the process of delegation of responsibilities.

Going back to the situation in the international financial markets, I would like to highlight that any negligence with regard to the serious assessment of the latest developments in these markets cannot be forgiven to any of us.

The monitoring and assessment of each event, news, action or response from the participants in the different markets should turn into every day routine in our work, in particular when energetic measures need to be taken in line with a given situation. In this context, the possible extension of credit lines from parent banks and the possible increased dependence of the banking sector on them represent an increased element of risk. You must avoid at any cost your dependence on these funds and pay careful attention to preventing the deepening of the spreads that may arise in the type of currency and maturity term. In the context of global economic developments, the uncertainty related to the future prospects in consumer prices and economic growth in the euro area EU countries and the USA, will affect the performance of interest rates in the money and credit markets and the exchange rate performance. These changes may affect the internal market through the exposure of the Albanian financial sector in assets and liabilities denominated in foreign currency. In addition, there is a risk that the challenges the economies of the EU countries and broader are going through be reflected in Albania through the fall in workers' remittances, deterioration of trade deficit and decrease of foreign direct investments.

Even though the materialization of these risks and their extent are not expected to be significant, you must assess the impact of these scenarios in your development objectives and take the necessary measures to be protected from them. In a broader context, in your relations with the parent banks, remember that you are leading banking institutions operating in Albania and that you are accountable to the Albanian authorities and the Albanian public for the well-functioning of your institution's business.

Increased vigilance is required from you in order to maintain low exposures in the international financial markets and ensure a well-capitalized and liquid business.

The Bank of Albania will constantly monitor and confirm that you are taking the necessary concrete measures to maintain and improve the capacity to constantly generate a positive financial result, by preserving the assets' quality and the liquidity indicators. If necessary, being the regulatory authority of the banking sector, the Bank of Albania will orient and support these measures through constant revision and creation of necessary regulatory stimuli.