Ardian Fullani: Financial supervision and measures to strengthen financial stability

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the International Conference for the 10th Anniversary of the Central Bank of the Republic of Kosovo, Prishtina, 30 October 2009.

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Dear Governor Rexhepi,

Distinguished ladies and gentlemen,

It is a pleasure for me to participate in this Conference which is perfectly organized by the Central Bank of the Republic of Kosovo, and to witness the amazing progress this institution has achieved in such a short but intense period of time. The energy and desire of the local staff to contribute to the history of this institution, has been rightly channeled by the vision and experience of several managing professionals that have given a valuable contribution in chairing this institution in the last years. I am sure this story will continue to be a successful one, based on the commitment of the management of the Central Bank of Kosovo to achieve and comply with the best work organizational and efficiency standards, by pursuing a clear long-term policy of investing in the quality of its personnel, and by supporting actions that contribute to maintaining fruitful inter-institutional cooperation.

In addition, I want to thank the organizers for giving me the honor to speak in front of you today, regarding a topic that has become so relevant in the last year, following this unprecedented international financial crisis. Given the fact that the causes and consequences of this crisis have been broadly identified and discussed, in the first part of my speech I will focus more on the main findings of the professional discussion that is taking place nowadays to identify a new financial supervision approach. I am sure you will elaborate on these issues further during this Conference. In the second part of my speech, I will try to give you more detailed information on how we at the Bank of Albania are thinking about the future approach of the public authorities and of the financial industry, in relation to necessary measures to strengthen financial stability.

Very shortly I want to reiterate what has now become clear to many: the recent crisis was a consequence of wrong incentives which supported unbalanced financial activity development and misconception of risk assessment, pricing and management. Such wrong incentives were present not only to the financial industry and markets, but also to the balance sheet of households, businesses and entire countries. Given the nature, the size and the impact of this crisis, not only to the financial industry and markets but also to the real economy, public authorities in many countries were forced to adopt swift, coordinated and extraordinary measures, both in the area of monetary and fiscal policies. Central banks abandoned almost any restriction and even adopted unconventional measures in providing ample and low-cost liquidity to the financial markets. Governments showed a strong commitment to reduce systemic risk by saving important financial institutions, by providing guarantees for inter-bank lending, by raising the level of deposit guarantees for the public etc. Such measures, most of the times designed as temporary, appear to have been successful in restoring the market confidence and steering the world economy back in the gradual recovery path.

Focusing on the financial markets and institutions in the aftermath of the crisis, a number of issues, previously known but many times neglected, have re-appeared forcefully to request a serious and thorough response by the authorities. Many of these issues relate to the financial activity itself, others are connected more with the surrounding economic environment.

It can be said now that the supervisory authorities of the financial markets and institutions are partly responsible for what happened. Despite the rhetoric, they failed to properly and timely identify and control the risk in the financial industry. Here one can mention the soft-hand on bank wholesale borrowing that financed the foreign currency credit in a certain jurisdiction, the neglect for the special purpose entities that were created to by-pass balance sheet prudential requirements etc. There are many reasons for this weakness and a number of them, in my opinion, go beyond the legal and resource capabilities of the supervisory authorities to act. On their own, the supervisory authorities were wrong in basing their work on the misconception that strong individual financial institutions are sufficient for the entire financial system stability. By doing so, they missed the negative effects and excesses that arise from the herd behavior of the financial institutions, many times a consequence of the pro-cyclicality that is inherent in the financial activity and the regulatory framework itself. The attention of the supervision was focused on the banking sector, but insufficient attention was given to its interaction with the non-banking financial sector, that by being much less regulated, in the meantime was increasing in size and importance. Also, as part of their general and commending goal to focus their supervisory approach on the most important risk sources of the financial industry, but also as a sign of their objective difficulty to keep the pace with the financial markets developments and innovations, the supervisory authorities relied more and more on the market discipline and on the sophisticated and unclear risk models of the financial industry, that also proved to be deficient. Some times, the structure of the supervisory authorities has proven to be fragmented or too complicated, giving rise to regulatory arbitrage by the market players. Other times, the resources needed to effectively perform the supervisory role have been limited, negatively affecting the supervisor's performance.

But this crisis showed that risk came also from other sources, out of the direct control of the supervisory authorities in a given jurisdiction. For example, the increasing asset prices were fueled by ample liquidity and credit conditions, which were often affected by international developments and financial flows. The borrowing in the international markets by the financial institutions was also affected by increasing fiscal and current accounts deficits, arising due to wrong policies that created imbalances in the saving-consumption behavior of most important economic players in the economy, including the households. It is now a question, whether some of these issues could be addressed by a more powerful role of the monetary policy. Financial integration, among other things, has also contributed in the rapid expansion of the financial activity, and many financial institutions have become too big for a single country. This has occurred at a time when, for the same reason, the "de facto" power of regulation has shifted away from the local supervisors toward their host counterparties. Hence, despite a steady trend of convergence between financial legislation in many countries, there are still marked differences that, particularly at a crisis situation, create strong tensions between public authorities in different countries.

A very strong effort by the public authorities in the world to address the abovementioned issues in order to improve the supervisory standards and superstructure is now underway. Both in the United States of America and in the European Union, the creation of special institutions is being envisaged, whose role will be to identify and control systemic risk through a different supervisory approach for financial institutions with systemic importance. At the same time, such financial institutions are expected to become subject of a more stringent regulatory framework in terms of capital and liquidity requirements, balance sheet composition and expansion, and governance relationships. Revising the liquidation procedures for similar financial institutions with cross-border presence is another area that will confront the public authorities in the world with a stronger challenge.

The main purpose of the reform of the financial regulatory framework will be to accommodate new incentives that will create a stronger environment for risk management in the financial industry. The main principle here is "prevention is the better cure". In this regard, the perimeter of the supervision regulatory framework will be extended to include other important non-bank financial institutions and probably the bank holding companies. At the same time, the approach in the regulatory framework is expected to feature more automatic requirements (and less discretionary ones), as it tries to move toward more simplicity and clarity. The move toward simplicity and clarity, will certainly reduce manipulability and enhance transparency and credibility of the banking and financial activity. These changes will be complemented by similar ones in the area of customer protection and market transparency. The regulatory framework of the financial industry is also expected to be less pro-cyclical, as new interesting proposals are being identified to adopt a countercyclical approach for capital requirements, provisioning and accounting. Ensuring responsible governance for the banking and financial institutions is going to be another area of developments. New regulatory requirements and instruments to seek more involvement and higher responsibility of boards of directors for risk management and discourage uncontrolled risk undertaking are being identified. On the other hand, the supervisory authorities will need to strengthen their macro-prudential risk assessment capacities, by focusing more on systemic behaviors of the financial institutions. The central bank is expected to take a larger responsibility in this area, particularly in those countries where it did not use to have a strong supervisory role. Whatever the approach in this direction, the supervisors will need stronger legal powers which will ensure their ability to act in a timely and flexible way. As mentioned also above, procedures for managing distressed financial institutions and for crisis management will need to be revised to ensure stronger and more effective inter-institutional and cross-border cooperation, and in general to better address the potential conflict between ex-ante supervision and ex-post intervention.

This important process of financial regulatory reform is not without risks. I believe that the public authorities will pay particular attention to control the tendency for over-regulation, and to avoid a "blind" adoption of the regulatory changes as well as asymmetric/unilateral approach. Regulating more should mean regulating better. Undertaking risks is a natural thing for the financial industry in their valuable role of financial intermediation. Such undertaking of risk, when well identified and properly managed, is useful for increasing efficiency and returns of the activity, two important elements for a viable and solid on-going financial performance. Every country should certainly follow with particular attention the discussion and the changes that are being proposed for the financial regulatory reform, as this process will affect them for sure. In this regard, it is important for the public authorities to start a process that would analyze and assess the impact in their financial industry of the expected and well identified proposed changes. Clearly, the practical adoption of the proposed changes should be driven by the goal for achieving a higher convergence with international standards, but it should be determined by the characteristics of the national or regional financial system, and their development goals. In addition, focusing only at better regulating the financial industry, without addressing other important and probably unsustainable economic developments, is an asymmetric approach that will not deal properly with the risks to financial stability. In this regard, governments, businesses and households, should identify measures and adopt actions to reduce imbalances in their own balance sheets, as this will, on the other side, improve the quality of the financial industry and reduce risk.

Dear participants,

Let me now focus more on how the Albanian economy and our financial system was challenged by the international crisis, and what are some of the future measures the Bank of Albania believes are important to strengthen the stability of the financial system and of our economy.

The recent international crisis showed that at the time of continuing financial integration and economic globalization, small economies like Albania's or other countries' in the region, should not count only on some natural protection coming from less developed financial markets and a much lower level of indebtedness from the households and businesses, to compensate over time for potential risks coming from less diversified economic growth, overreliance in remittances, insufficient culture of risk management in financial institutions and other economic agents – in particular for the exchange rate and liquidity risk, and very limited space from the public authorities to introduce anti-crisis financial measures similar to those in the developed countries. Hence, policy measures should address these and other deficiencies to find a proper solution in the medium-term. Such measures should reflect the preference for preventive approaches.

In fact, over the last 4 to 5 years the Bank of Albania was vigilant over time to point out areas of the banking activity that required attention from the industry. We have expressed our concern regarding the rapid increase in lending, as we believed that this could negatively affect the credit quality. The composition of the loan portfolio, which is dominated by the euro-denominated loans, has also been identified as a point of concern. Despite the fact that this position is supported by a strong presence of foreign currency denominated liabilities in banks balance sheets and very close economic links to Euro-area countries like Italy and Greece, Bank of Albania has been consistent in its approach to introduce gradually regulatory measures that would discourage rapid increase in lending, encourage banks to lend more in domestic currency and increase transparency toward clients on banks products and services. On the other side, the monetary policy has successfully anchored expectations of very moderate growth in the price level and has supported demand for local currency financial assets by offering sufficient positive real return.

As the crisis hit, the first impact in our economy was shown on the balance of payments, reflecting the relationships of our economy with the world. The increase of unemployment and the tightening of financing conditions in the neighboring countries of European Union were followed by the decline of Albanian emigrants' remittances that live and work in those countries. While the gap between the domestic and external demand was widened, this was accompanied with an increase of current account deficit and the mounting pressure on the exchange rate. At the same time, the banking sector, which heavily dominates the financial system in Albania, reduced its funding contribution to the domestic economy as a response to the increasing demand for liquidity, following the deposit withdrawal from the public and an increasing borrowing demand from the Government. The combined effect of these developments affected negatively the real sector of the economy, mainly the business sector. In the first quarter of this year, business confidence index fell under its historic average, reflecting a more difficult financial situation. The latter was also shown by the lower-than-planned realization of fiscal revenues as well as by the decline of loan portfolio quality that banking sector has encountered throughout the period.

In the short-term, the public authorities took measures to lessen the impact of the global financial crisis in the economy. Through the significant increase of the fiscal expenditures share designated for investments, mainly in infrastructure, the government supplied an important impetus for the support of the real sector of economy to cope with the global crisis effects. The Bank of Albania has also been active to provide liquidity in the interbank market, with the aim to preserve the stability of the banking sector and to lessen the expected decrease of its intermediation role. We removed quantitative limits in the size of the liquidity injections through our week-long reverse repurchase agreements, and extended the maturity of our injection operations up to three months. Following a cut of the policy rate by 0.5 percentage points in January and the subdued inflationary pressures at home, the monetary policy paid an important attention to the financial stability, by keeping the policy interest rate unchanged throughout the period.[1] Through this policy, we intended to maintain strong incentives that would support the public demand for financial assets denominated in the national currency, in the short term. At the same time, along with the Ministry of Finance, the Bank of Albania initiated legislative changes to increase the deposit insurance level, as a necessary measure to restore the public confidence for the safety of their banking deposits. From the supervision point of view, the Bank of Albania established a stronger day-to-day

[1] Two days ago, the Supervisory Council of the Bank of Albania, adopted a decision to reduce the policy rate by another 0.5 percentage points, to the new level of 5.25 percent.

monitoring of the banking sector developments, focusing particularly in the liquidity situation. This was part of a broader approach that included also changes in the regulatory framework, better analysis through improving stress-test methodologies, stronger communication with the banking sector, increasing number of publications and more presence in the media. We believe that such policies were important for the effective management of the banking sector liquidity needs, provided an orientation of lending in national currency and maintained strong capitalization parameters for our banks. The situation entered into a qualitative improvement phase after the return of public deposits growth in the banking sector. This process, which was developed gradually and in a stable way in the second quarter of 2009, continues with a steady pace.

We believe that, after coping with the short-term effects of the international financial crisis and following the improvement of the international economic situation, it is the time for the public authorities at home to initiate a process of assessment for the legal and financial operations framework, with the goal to re-establish appropriate balances in the fiscal, monetary and banking activity, to further sustain a stable economic growth and maintain financial stability. In this regard we consider important for the fiscal policy to take respective correcting measures in order to keep the confidence of the resident and non-resident market agents and investors. At the same time, the monetary policy should assess the possible effects on inflation of the financial incentives it provided to the banking sector and to the economy, and later analyze the possibilities to support the financial intermediation of the banking sector in the economy at a lower cost. To provide a longer-term response to the stable economic growth, public authorities should insist on the compilation and implementation of the strategies for future economic development, which in a medium term shall provide for:

a) the establishment of a better balance on the contribution that different sectors give for the economic growth. In this regard, it is important to increase the support for economic sectors with strong growth potential, like agriculture and tourism;

b) the increase of our economy's competitiveness and its further formalization. In this regard, the debate should focus on finding the incentives to increase the domestic production and support domestic savings. Over the time these would improve our current account balance, and improve the availability of our foreign currency assets;

c) the expansion of the economic agents' funding sources. In this regard the authorities should implement policies that support the development of the non-banking financial sector and that sustain the establishment of capital and debt market for private entities. The accomplishment of these targets shall firstly require the strengthening of the financial reporting standards; the completion and improvement of the legal framework for the developments of business relationships and the improvements in the protection of creditors and consumer rights, regarding the financial institutions and products. In more practical terms, these measures are expected to improve the availability of the funding sources for the economic growth, and gradually decrease its dependence from the banking sector;

d) the improvement and the completion of the legal and operational framework to strengthen the crisis management capacities of the public authorities. In this regard, the authorities should identify the necessary measures for the prevention, the treatment and the elimination of financial crisis consequences. Bank of Albania believes it is important that each public authority carry out an assessment of its legal, financial, human and technological capabilities, to perform its role in the crisis-prone situations. Needless to say, throughout this process, the coordination among the public authorities should be at the highest level.

The banking industry itself is required to carry out a process of re-assessment of its development objectives and models for the future, so as to ensure consistent and stable profits. In this regard, the managing structures of the banks are expected to undertake a process with the purpose of: a) re-assessing the development priorities; b) establishing a better balance regarding income sources and focus on cost control; c) enabling a higher specialization of their business and identify competitive priorities; d) achieving a better balance regarding the composition of their assets and liabilities according to the currency, maturity structure, etc.; e) implementing more active policies to approach and maintain the public (customers) close to the institution; f) strengthening the internal audit structure and risks management and research capacities.

Bank of Albania is now working with the goal that, within the needed time frame and after properly consulting with the financial industry, to support this process through the introduction of changes in the regulatory and supervisory framework. With this in mind, we shall aim at strengthening the internal mechanisms of the banking activity that incentivize its more controlled and balanced expansion, with adequate characteristics of liquidity and capitalization. At the same time, Bank of Albania shall assess the need for a new supervisory approach for the banks with systematic importance. The transparency of banking activity in its relationships with customers and public in general, shall remain at the centre of our supervisory activity. In general, in this process the Bank of Albania, shall consider the alternations that shall occur in the European standards, by supporting the strong collaboration with other central banks and supervisory authorities.

In conclusion, let me point out that the ultimate goal of the new financial regulatory changes that is being identified in the international level is to provide the right incentives, which over time will ensure a more balanced, risk-averse and stable financial markets and institutions activity in the future. On a global and national level, such changes should be complemented by other more general economic measures that should enable an adjustment process to ensure a better alignment of asset and liabilities in the balance sheets of the various economic agents. All this should be achieved, as we still want the social benefits of economic and financial integration. This means the path ahead will witness a continuous and challenging effort to find and strike a new and more appropriate balance between risk appetite and more stable returns by the economic agents, and between short-term national concerns and long-term regional economic and political integration objectives.

Once again, I wish to the Central Bank of the Republic of Kosovo, to its management and staff, a successful future!

Thank you for your attention!