

Ardian Fullani: Overview of Albania's economy and banking sector

Speech by Mr Ardian Fullani, Governor of the Bank of Albania, at the 4th Bank of Albania Forum with the Albanian Banking System, Tirana, 14 April 2010.

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Dear commercial bank managing directors,
Dear guests,

I would like to welcome you to this periodic meeting, which aims at providing a platform for the exchange of ideas and presentation of viewpoints related to the developments affecting banking and financial activity in general, and which are focal to the financial system's stability.

Yesterday the Supervisory Council of the Bank of Albania approved the Financial Stability Report for the year 2009. This is the third issue of the Financial Stability Report and it is my pleasure to state today that now we do have a consolidated product, which aims at being in full compliance with the best standards. The conclusions derived from this report confirm that the Albanian banking system experienced an unusual liquidity situation in 2009 and has now entered a period of full recovery.

The satisfactory growth rate of deposits, in particular over the recent months, attests to the restoring of public confidence in the banking system. Moreover, the conclusions of this scientific research confirm that the Albanian banking system is sound and stable and provides full guarantee for the mobilization of the public savings and their channelling into boosting economic activity in home. I avail myself of this opportunity to invite all participants in this meeting, the decision-making and governmental authorities, the media and the public at large to address to this report. Only in this way you will better understand the current situation, the achievements made so far and the challenges to be faced in the future.

In what follows, I would like to provide an overview of the economic situation at home, and later dwell upon the banking sector's present situation and outlook for 2010. Credit quality and banks' transparency to their customers are two issues I particularly chose to focus on.

According to INSTAT's preliminary assessments, Albania posted a positive economic growth of 3.3 percent during 2009, despite the impact of the international financial and economic crisis. The financial system, dominated by the banking sector, was stable and the fiscal and monetary stimulus mitigated the difficulties of the real sector of the economy. This growth rate is very close to the early 2009 projections made public by the Bank of Albania.

Among the factors that boosted economic growth over the course of 2009 we can mention the public authorities' measures to rapidly restore public confidence in the financial system and the banking sector, and the monetary and fiscal stimulus provided through the cut of the key interest rate, the injection of liquidity and the increase of public expenditure.

Among the factors that led to lower economic growth rate we can mention:

- the trade balance deficit sustainability;
- harder times for the entrepreneurship due to lower foreign demand and contraction of banking sector lending; and
- lower dynamics in household consumption.

Banking sector's assets grew to ALL 886.3 billion, posting an annual growth of 6.3 percent relative to year-end 2008. The performance of the financial system's financial resources, revenue and capital was affected by the international financial crisis and its impact on Albania's real economy. As far as the banking sector is concerned, the decline of public

deposits terminated at the end of the first quarter, and their return to banks progressed at stable rates during the rest of 2009.

However, the changes in the liquidity situation, the exchange rate devaluation and the difficulties encountered by the real sector of the economy gave rise to slower lending and deteriorated loan quality. As at end 2009, lending, including the accrued interests, accounted for about 50.8 percent of total banking sector's assets or as much as 40 percent of GDP. In the meantime, the ratio of non-performing loans to total loan portfolio rose to 10.5 percent. The need to increase the reserve funds for coping with the credit risk from banks led to the decline of the banking sector's financial result, which however ended positive for about ALL 3.5 billion. Business capitalization was adequate during 2009, as a result of lower high-risk bank investments, injection of new capital by the shareholders and the preservation of a net positive result. As at end 2009, capital adequacy ratio was 16.2 percent.

The public authorities took several measures in 2009 to support the financial system and the banking sector in particular. Among these measures, I could mention the approval of the law which increased the insurance amount of public deposits, and the decisions of the Supervisory Council of the Bank of Albania to limit banks' exposure to foreign banking groups and to suspend the allocation of banks' profit in 2008 and 2009. Along with these decisions, during 2009 a number of other Bank of Albania decisions taken since the last quarter of 2008 continued to be implemented. These decisions related to the establishment of more facilitating conditions as far as the provision of liquidity in the interbank market is concerned. The Bank of Albania decisions in January and October, which cut the key interest rate by 1 percentage point to 5.25 percent, contributed further to increasing the banking sector's opportunities to provide liquidity at a lower cost.

Economic development at home during 2010 will be supported by a more favourable global economic situation, which will provide a better setting for foreign investments and will better boost the demand for the Albanian exports. In the domestic economy, the developments noted during 2009 as regards the increase of budget deficit and domestic debt, the lower banking sector lending, and a more rigid situation in production and consumption, need to be addressed through quick and decisive actions and in the course of an adequate time span.

It is therefore indispensable to keep the budget deficit for 2010 under check and at levels that guarantee the observance of the targets outlined in the Medium-term Macroeconomic Framework as regards budget deficit and public debt level. The consolidation of public finances, reflected through the restoring of budget deficit's downward trend is of great importance in terms of the decline of its financing cost.

It will also lead to improved liquidity situation in the financial market, releasing more financial resources into the system, the use of which will boost the private sector lending. The entrepreneurship and households need to assess the expected outlook of the Albanian economy for 2010 realistically. This period should be used by the entrepreneurship to control the costs and take the necessary measures for restructuring the activity in order to enhance the efficiency. In general, these actions of the fiscal authority and the private economic agents are in the short-term necessary to provide a more adequate environment that will enable the undertaking of other measures for increasing the contribution of production to economic growth and increasing the domestic savings in a longer-term.

During 2010, the banking sector will expand its activity at higher rates than in 2009, however less than the average long-term annual growth. The expansion of activity will likely be more rapid in the second half of the year. As regards the financial resources, the banking sector will benefit from the stable growth of public deposits. The growth of ALL deposits will continue to be supported by the more stable savers' flows, the positive real return and the expectation for greater exchange rate stability. The growth of foreign currency deposits will reflect the seasonal performance, hence being higher during summer.

The maturity structure of deposits is not expected to display any significant changes from the present situation; however the average maturity term of deposits is expected to be higher in

2010 relative to 2009. The extent of this change will be determined by the performance of depositors' income and the stimuli set by banks to orient the structure of savings.

The Bank of Albania will continue to provide the necessary liquidity to the interbank market. As far as the financing lines and shareholders' capital are concerned, the Bank of Albania will continue to require from banks that they maintain the necessary amounts not only in order to carry out a normal banking business and comply with the regulatory framework requirements, but also in order to support the recovery of banking business at well-controlled risks. With regard to bank investments, the Bank of Albania expects higher lending rates by the banking sector in 2010 relative to 2009, with the largest part of growth expected to take place in the second half of the year.

In terms of risk assessment, in the short-term, the banking sector's financial situation has benefited positively from the following developments:

- a) *Substantial improvement of liquidity situation against a background of public confidence recovery and stable deposit growth.* It is assessed that during 2009, the annual growth of public deposits was 7.6 percent, rising to ALL 694.3 billion. Presently speaking, the deposit level has exceeded that of end September 2008, prior to the beginning of the deposit withdrawal. The growth rate of public deposits would have been higher if the situation in the real sector of the economy had improved and the banking sector lending had recovered.
- b) *Lower growth rate of the banking sector's risk-weighted assets.* During 2009, the growth of the banking sector's risk-weighted assets reduced substantially, owing mainly to the much lower growth rate of lending and the lower expansion of banking business in general. In fact, during 2009 the banking sector increased lending by about 13.2 percent, compared to the growth by about 35.7 percent in 2008. It is assessed that ALL loans grew about 23 percent, while foreign currency loans grew about 9 percent. However, in real terms, the real growth of foreign currency lending was negative.
- c) *The devaluation of the national currency exchange rate during 2009 is assessed to have been at a reasonable rate and extent,* providing the banking sector and other economic agents with the necessary time to take adequate and protective measures. There are great expectations for a stable exchange rate during 2010. However, the movements in the exchange rate against a background of a flexible regime are normal and should be an expected phenomenon by the economic agents and which they should be prepared for.

In the medium term, the banking sector should cope with the impact that the loan quality performance has on its activity. Lending grew by about 13.2 percent in 2009. ALL lending provided the major contribution to the overall growth, supported by the gradual increase of public deposits and the injection of liquidity by the Bank of Albania.

Lending in foreign currency was stagnant, against a background of reduced availability of free foreign currency funds by banks and limited demand for loans as a result of the exchange rate devaluation. Another reason for the slowdown in lending owes to the more cautious lending policies adopted by banks against a background of higher credit risk resulting from the higher difficulties in the real sector of the economy. More specifically, the ratio of non-performing loans rose to 10.5 per cent at year-end. Its rise persisted in the early months of the present year though at a slower rate. As a result of the deteriorated loan quality, the entire banking sector has doubled the respective reserve funds, hence providing a negative contribution to the banking sector's financial result. The latter was in 2009 half as much as the value in 2008 and had a greater concentration.

The Bank of Albania has for long been vocal as regards the recovery of lending, which will not only boost the economy and customers, but also the banks themselves. The economic setting definitely remains challenging and the return to the 2008 lending growth rates is

unrealistic, indeed undesirable. But we do believe that there exist opportunities – particularly in terms of the deposit growth performance – that the growth of lending will be better in 2010 relative to the previous year. Based on the early months' survey carried out by the Bank of Albania for this purpose, the same expectation seems to be supported by you as well. However, though the recovery of lending is a desirable development, it should be carried out on the basis of a prudential analysis, monitoring carefully the loan quality performance. In more practical terms, it is necessary that banks fully reflect the size of non-performing loans for the existing loans and create appropriate reserves for covering the risk of loan losses.

As far as non-performing loans are concerned, banks must identify customers with temporary and surmountable problems, and should set up policies that provide support to these customers in exchange to additional elements that hedge the bank against such credit risk in the future. As regards the customers assessed as having low creditworthiness, banks should without hesitation follow the procedures for the execution of the collateral and other forms of collateral, in order to recover as large as possible amount of credit. The entire decision-making in this process should be clear and documented, and should be based on the analysis of specialized bank structures. Without carrying out this process first, the implementation of general regulatory measures for a temporary sorting out of this problem would result premature and indeed counterproductive.

With respect to new loans, taking into account the experience of banks faced with loan portfolio problems, there should be a better sectoral distribution and a more reasonable balance between public and private investment projects, between customers representing business or household undertaking, between the forms of lending in ALL or in foreign currency, etc., orienting lending in order to reduce the exposure to more problematic forms and the concentration of lending in general. Assessing first of all the borrowers' creditworthiness and lending safety, the Bank of Albania considers that there is sufficient room for commercial banks – depending on their size and opportunities – to support the SMEs with more lending and provide greater funding opportunities in ALL. In addition, the monitoring of the loan quality performance will necessarily require the prudential monitoring of the situation at individual banks, which may display a different performance from the average of the sector.

The performance of loan portfolio quality will continue to exert pressure on banks' financial result. In this context, the prudential monitoring of banking activity capitalization rates is of great importance, despite its current sufficient levels. I would like to note that this is another process that puts to test the capability of banks' managing structures in managing the situation carefully, with integrity and professionalism. Moreover, this process requires from banks' shareholders, who increased their investment and profit value during the credit "boom", to stand by banks in order to meet their eventual needs for capital or other forms of financing.

Allow me now to touch upon another issue, which I consider paramount and that relates to banks' *transparency to customers*. Despite the overall improvements in this regard I would like to focus on banking service-related issues.

The Bank of Albania has received frequent complaints from citizens, regular or casual users of banking services, in relation to the costs that banks apply for the services they provide. It comes out that in many cases citizens are left with no options as regards the obligations to the bank for the service provided to them, without first being notified of the reason and size of obligation. In other cases, the user of the service cannot find the necessary and convincing explanation from the bank about the "why" of the obligation and the way the latter is calculated. I cannot exclude here the cases when the problem stands in the limited financial understanding of the citizen himself; however it seems that the work of the banks' staff to ensure transparency to the customer is superficial and at times deficient. In a broader and technical concept, the method the costs are determined by banks for the services they provide remains unclear.

Based on a recent analysis made by the Bank of Albania on the level of various commissions applied by the banking sector, it results that the banks have not made any documented cost analysis for the services they provide to the customers and have not set up any methodology for setting the respective commissions/fees. Moreover, there are not any standards of the form, composition and designation of the commissions for similar services in different banks, hence making it difficult for the customers to make any interbank comparison and raising the confusion among the public. In addition, the transactions between customers of different banks are penalized by the relatively high commissions, hence burdening the making of payments through banks and providing undesirable consequences for the performance of cash in economy.

Regarding the way the commissions are set, banks are guided by the competitive institutions in the market and there does not seem to be any active and visionary banking services development policies, supportive to the increase of the number of users that may easily become potential bank customers. It is not accidental that the income from banking service commissions accounts for only 5.5 percent of their total income. According to us, it shows that banks are not active in using all their potential for raising their income through competitive policies in this area. I avail myself of the opportunity to require your utmost commitment to address this issue aiming at making a thorough improvement in this regard. The Bank of Albania will examine the possibility to require through the regulatory framework the setting up and implementation of documented methodologies for banking service commissions, as well as to encourage the establishment of a standard for the presentation/disclosure of commissions and the way they are monitored.

Dear commercial bank managing directors,

The Bank of Albania has constantly shown that it is a responsible and visionary institution. Withstanding the difficult situation was not merely casual. Our measures and actions of the last four years, pre- and post-crisis, were paramount. We are evaluating the measures and actions that will characterize the months to follow at the same level of responsibility. I refer, *inter alia*, to the so-called exit strategy, which refers to the gradual withdrawal of extraordinary political and regulatory measures established in order to withstand the effects of the crisis.

Noting that the liquidity situation in the banking system has improved and public confidence has restored, the Bank of Albania has started to implement the exit strategy.

More concretely, in the beginning of the present year, the Bank of Albania changed the form of its main refinancing instrument auction from fixed price to limited amount auction. It is with pleasure that I inform you that this change has been comprehended well by the market, given the stable interest rates in the interbank market. Similarly, the securities' market responded positively with the 12-month T-bill interest rates going down by about 1 percentage point in 2010.

As part of this strategy, the Bank of Albania has restored the relationships of bank investors with the profit on their investment in Albania to normal levels. Resetting the free movement of capital regime, besides being an obligation for Albania in the framework of the international conventions, provides a positive impact on Albania's perception as a reliable destination of investment and on pushing the entry of foreign direct investments into our financial system.

Moreover, along with the development of the banking system, the increase of the interbank market's role and the enhancement of our political and analytical institutional capacities, the Bank of Albania is planning to improve our system's refinancing operations. We are assessing the possibility of changing the operational objectives from quantitative to qualitative ones, expressed in the form of short-term interbank market interest rates.

In my speech I tried to touch upon the issues that the Bank of Albania considers that constitute our near and distant future objectives. However, I would like to highlight once again what I consider as constituting our major challenge for 2010. The economy needs to

be financed in order to ensure a stable development. Financial intermediation is the purpose of banking activity. To this purpose, I once more draw your attention to be more active in this regard. The return of deposits has now provided room for the recovery of lending to the economy.

The motto of the banking system for 2010 will be: every added deposit in ALL should be converted into a new ALL-denominated loan to the economy.

In conclusion, taking advantage of this forum with the banking system, I would like to address to the Albanian public at large as well.

The last crisis that hit the world economy highlighted an important element of the philosophy that characterizes the day-to-day life of every nation. Regardless of the similar recipes applied by individual nations, what is noticeable was the appeal on public's national awareness and the patriotic response of the latter. I avail myself of this opportunity to make this appeal to the Albanian public, which with the rational behaviour shown so far, has shown that it is prudent and responsible.

What I would appeal once again is simple. We should have:

- more confidence in our currency;
- more confidence in our banking system;
- more confidence in our analysis and conclusions;
- more deposits mean more loans;
- more loans mean more prosperity.

After all, this is the real convergence with the European Union.

In conclusion, I would like to note that the year 2009 was a relatively hard one for the banking sector. Although the year 2010 is expected to be a better one, some banking activity-related issues such as loan quality, its recovery, the shareholders' commitment to providing more support to the banking activity and the strengthening of risk management structures require your utmost attention.

The Bank of Albania remains committed to acting in full compliance with the legal and regulatory framework requirements that establish the norms for the conduct of banking activity. Therefore, your co-operation and professionalism are particularly important to this process.