

Ardian Fullani: Building a sound and efficient Albanian banking system

Opening address by Mr Ardian Fullani, Governor of the Bank of Albania, at the workshop on “A sound and efficient Albanian banking system; activities and results achieved under the EU-funded Twinning Project”, Tirana, 04 June 2012.

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Dear participants,

The development strategy of the Bank of Albania provides, inter alia, for the swift approximation of the institutional, legal and operational framework with the best standards of European Union (EU) central banks, in view of the country’s major priority, i.e. accession into the EU.

The Bank of Albania has been engaged in an EU-funded Twinning Project for strengthening the institutional capacities, particularly in the areas of banking supervision, statistics, payment systems and the implementation of monetary policy, capitalising on the extensive experience and outstanding professionalism of Bank of Italy and Bank of France experts.

This project had set challenging objectives, which had to be achieved within a relatively short time. Its success depended on the commitment and professionalism of participating institutions, and on their capability to implement a true cooperation.

Today, I have the pleasure to address this important event, which marks the successful completion of the twinning project after about 18 months of intensive joint work. I would like to thank all the experts that have been working for this project at the Bank of Italy and Bank of France, for their commitment and professionalism. I would like to also thank the representatives of the EU Delegation to Albania for their support as they monitored the project.

The twinning project was implemented in 6 modules as follows:

- Coordination of European integration process
- Financial literacy
- Supervision and financial stability
- Payment systems
- Statistics
- Inter-bank market

Coordination of the European integration process was implemented with the Bank of France and consisted in developing and mastering the required instruments for coordinating the European integration process with a view to preparing meetings at European level and coordinating Albania’s accession process in the EU. The Bank of France provided its experience in organising meetings at European level and administering the process of approximating the banking legislation with the *acquis communautaire*.

Financial literacy was implemented with the Bank of Italy and consisted in drafting a financial education strategy for the public. Under this module, our research drew on the European experience and was adapted to Albania’s needs. In addition, we established a standard for conducting surveys and questionnaires to assess the public’s awareness and knowledge on financial literacy and the effectiveness of educational activities.

Thanks to this project, we have a modern infrastructure for compiling macroeconomic statistics at the Bank of Albania, in particular regarding the balance of payments.

The payment systems regulatory framework was reviewed with a view to amend and fully align it with the relevant EU directives and practices.

Further development of the inter-bank market was another important component of the project, given its significance in enhancing the monetary policy transmission mechanism to the economy.

The supervision philosophy started to change in January 2010 with the establishment of a new dynamic structure oriented towards risk identification and management. Therefore, in addition to human resources capacity building for its eventual application, best European standards had to be identified and acquired in detail. The precious experience of the Bank of Italy, one of the most prestigious institutions in Europe, helped the Albanian supervision process conform to the best European models.

I would like now to highlight several key developments:

First, we have migrated from the actual CAMELS evaluation system towards another evaluation model based on a wider spectrum of individual risks, as envisaged in Basel II and Basel III standards. That was the most intensive process of this project, which required maximum engagement of Bank of Albania's experts throughout these 18 months. Eventually, we produced a new supervision manual with European principles and methodology, broken down by risks and individual evaluation systems. Bank evaluation improved as qualitative criteria were taken into account in addition to quantitative data.

Second, the Regulation "On capital adequacy ratio" has been revised in accordance with the BASEL II and Capital Adequacy Directive. The revision is followed by introduction of the standard method for credit and market risks and the simple and standard method for operational risk. Given its significance, the draft-text of the Regulation is being consulted with the banking industry.

Third, to increase our prudence towards the financial system stability, we adopted new techniques for a more comprehensive systemic risk assessment, enriched stress test exercises with the "bottom up" approach and improved models for the indirect credit risk assessment.

The twinning project concentrated most of its resources on supervision and financial stability. In addition to constant motivation for improving the regulatory framework, supervision activities and risk administration, this priority becomes even more necessary given added challenges related to specific developments over the past years.

The Bank of Albania has undertaken a number of actions to face and overcome these challenges.

For the fourth consecutive year, the Albanian economy has been under the influence of the global economic and financial crisis. Its latest stage, the sovereign debt crisis and its interrelation with the balance sheets of the financial system have placed us on the frontline. Our two main trading and financial partner countries, Greece and Italy, have been severely hit by the crisis. Against this unfavourable landscape, the Albanian economy has grown and has maintained its financial soundness.

Private agents have an overall sound financial position, relatively low debt levels and positive savings rates. In contrast to other countries in the region, the Albanian financial system has continued to lend to the economy, although at slower pace and somewhat tighter terms.

Building on an appropriate and flexible regulatory framework, this response has been determinant to encourage the restructuring of the economy and guide it towards profitable sectors. Looking ahead, according to the Bank of Albania, the main risks to economic stability pertain to economic growth.

A number of signals from the real and financial sectors show that the contraction of consumers' balance sheets and slowdown of investments, used so far by economic agents

as buffers to the crisis, may imperil the mid-term prospect of economic growth. The propensity to save and defer investments may affect the competitive advantages and growth potential of our economy. Deleveraging, mostly driven by regulatory requirements that are not related to the performance of the economy, may undermine the existing financing channels, which have been so far an important component for growth.

According to the Bank of Albania, the current situation requires higher attention and courage by all economic agents to make the right decisions for development and in response to the challenges arising from the external environment.

In a more general setting, the Bank of Albania believes that implementation of right macroeconomic policies by harmonising the monetary and fiscal policies, is a prerequisite for the country's sustainable and long-term development. They should have two main components: support growth and sustainable development for the country's economy and boost long-term development through encouraging structural reforms.

In Bank of Albania's view, our economy is flexible and the infrastructure of core services, financial services and regulatory framework is constantly improving. The labour force is competitive, in terms of cost, and increasingly qualified. Nonetheless, competitiveness indicators for the Albanian economy reveal that there is a lot more to be done in this regard, to face competition both in the region and globally.

The Bank of Albania is committed to maintaining monetary and financial stability through:

a) A prudent monetary policy. We have ensured price stability, complied with the inflation target and anchored long-term expectations of the economy.

This move has increased the space for harmonising better the short-term stimulation with the long-term stability of the economy. In response to shocks, we have progressively eased the monetary policy since 2009. This approach has brought the key interest rates to their record low to boost consumption and investments. The depreciation of the nominal and real exchange rate has provided another incentive for the Albanian economy, encouraging exports and discouraging imports.

We have continuously adjusted our monetary operations to guarantee an increasing supply of liquidity against an expanded collateral base with longer maturity terms. Given the current situation of the Albanian economy, we believe that macroeconomic policies should continue to be stimulating even in the future. The need for stimulating economic policies is conditioned first by the fact that the Albanian economy is operating below its potential, as the demand may not guarantee a complete utilisation of capacities. Second, it is enabled by short and medium-term controlled risks to economic stability.

In the context of harmonisation of fiscal and monetary policies, the Bank of Albania has supported the increasing orientation of the fiscal policy towards debt consolidation. We remain ready to respond within a short time to any consolidating initiative of the public sector. Our easing measures will remain within the legal framework of Bank of Albania's instruments and in line with the consolidated philosophy of central banks action.

The monetary policy may prove successful only if its transmission mechanism is functional. In this context, the banking system plays a key role, as the first actor of the transmission mechanism.

b) A prudent supervisory and regulatory policy. This policy maintains sound balance sheets of the financial system and the private sector. Thanks to the timely measures to manage credit, capital and liquidity risks, the Albanian economy has successfully withstood the shock from global financial markets and has now a consolidated financial stability and a banking system that is able to credit and support the Albanian economy.

Maintaining banking sector stability is one of the two main priorities of the Bank of Albania. I take this opportunity to draw the attention of the banking industry executives, to engage

maximally to act in full compliance with the legal and regulatory framework and respect the standards for sound management of banking activities.

Our objective remains unchanged; maintaining and strengthening public confidence in the banking sector. To this end, the banking system should:

- Verify constantly the compliance and strengthen the internal audit systems.
- Empower capacities for risk assessment and management.
- Maintain adequate capital and liquidity levels. Thus, the system should monitor daily the performance of liabilities of a bank, in order to create and maintain the required liquid assets for these liabilities.
- Factor expected developments in capital requirements. Injection of additional capital by shareholders should consider the establishment of a security “zone” in the capital value, against unexpected developments. Therefore, the banks should cautiously interpret the requests to distribute dividends.

Credit quality remains the main concern of the banking sector. The increase in non-performing loans intensifies the banking stress and reduces the contribution to financial intermediation and economic growth. The Bank of Albania has monitored this situation closely, focusing on:

- Accurate identification of the problem, through inspection and verification of procedures for assessing the credit quality and category;
- Relevant contingency funds provided at the required amount and time;
- Encouragement to banks to address the issue by taking strict initiatives for collateral execution.

In our view, this is the only way to identify and tackle the problem on time, prevent its spillover and reduce uncertainties for the future.

The banking industry has intensified its requests for the revision of the supervisory regulatory framework, so as to soften it in relation to the handling of non-performing loans. The Bank of Albania is open to consider valid and realistic proposals by the banking industry, as long as they do not weaken the capacity of the banking sector in a situation with unclear developments.

Focusing more concretely on some recent opinions, we see the request for lower provisioning values as inappropriate, since we are dealing with an unrealistic improvement of the position of capitalising the operations.

I take the opportunity to clarify the public opinion that in this regard, the rates we have applied are in accordance with the experiences of other countries; in some cases, they are lower.

The Bank of Albania holds that the current regulatory framework creates the necessary space for the banking system to assist good clients, who may be facing temporary difficulties in the current situation. This assistance may come in various forms, including appropriate restructuring for parties. The Bank of Albania will consider the possibilities and forms so that this process becomes more stimulating for the bank as well.

As regards the collateral value for reducing the risk-bearing asset value, the Bank of Albania upholds that concentration of collateral as immovable property and difficulties in executing collateral and recovering the value for the loss loan void this initiative from the beginning.

Improvements to the legal and regulatory framework, as identified by the joint working groups with the banking industry, need to be implemented correctly, so that collateral earns its optimum value.

In the end, the banking industry should prove that it is active in tackling non-performing loans and releasing resources into the balance sheet to further support the activity. This is the best form to test the real possibilities, which may later be supported by amendments to prudential regulatory framework. Our common goal is to stop progression of the value of non-performing loans and improve the situation gradually. Some banks, thanks to their prudent and steady efforts over the past three years in relations with their clients, have managed to significantly reduce the non-performing loans share. They have continued lending to the economy at good levels. Organisation and management of their work is an example for other banks.

The current legal and regulatory framework is comprehensive and in line with the best international standards, although it may require ongoing improvement. Our consolidated opinion, however, is that all the stakeholders need to exhaust all the available tools and gradually make further steps in the legal and institutional framework. More specifically, the banking industry and the business community need to work more closely. I believe there is more space for better understanding and more fruitful cooperation. The business community and the banking system should leave their trenches and cooperate in concrete terms to face future challenges.

The banking system is ready to increase its support to the economy with loans. This was confirmed to me in a meeting I had with the management of the largest five banks. Personally, I urged the banking system for a more active approach to lending.

This is a real challenge and many institutions and groups of interest are involved in it. Therefore, I would like to invite all other stakeholders to be open-minded and very cooperative to boost lending to the economy.

First, I would suggest to the business community to be more creative, transparent and formal in its operation. It should comply with all obligations arising from the contractual relations with the banking system. This should be broadly understood and accepted. A correction is necessary in the economy, first of all implying a rebalancing of prices. There may be no reduction in non-performing loans, increase in lending to the economy, improvement in business and bank balance sheets, unless collaterals are executed and, subsequently, fix asset prices are corrected. This process would release huge financial resources that would be a vital serum of fresh money injected back into the economy. With this fresh money we must encourage the creation of new and effective initiatives that yield swift return on investment.

One of the lessons learned from the crisis is that any new healthy money should go to a healthy business initiative. We need to encourage highly productive sectors of the economy. This is the only way to ensure revitalisation of the economy and make it a dignified European partner.

Second, I would like to encourage the banking system to be more dynamic, by looking continuously for worth-funding opportunities. Offer reliable funding packages by assigning priority to economic health of the country, which would, in turn, guarantee the long-term success of your business. Do the utmost to increase the lobbying authority and capacity with the Albanian executive, parliament and judiciary. Intensify your contacts with business associations and analyse every claim or request, case by case, even if it comes from a single business. Take a public stance in any case so that speculations and abuse are reduced to maximum. Engage all your financial, human and media arsenal for a more solid anchoring of your expectations with the public. Turn the public into your most powerful anchor.

Third, I would like to call for the Albanian executive to increase the confidence in and support to the banking system, especially as regards finalising legal amendments on collateral execution.

Cooperation between public institutions and the banking system may be fruitful also in terms of introducing specific development programmes and providing financial and concession support to sectors, branches, important operators, including foreign investors.

Fourth, I would consider as vital a broad-based consensus of the entire political spectrum for supporting the Bank of Albania's efforts and moves to maintain the country's macro-financial stability. We remain open to explain continuously, transparently and responsibly our past, present and future decision-making. We remain firm in our position that a central bank is successful and enjoys the trust of the public when it makes independent, far-sighted and fully transparent decisions. In these moments, the unquestionable guarantee that the Bank of Albania gives to the public for the country's macro-financial stability is paramount.

Fifth, I would like to encourage the Albanian and international media to uphold the good tradition of accurate and real-time transmission of economic and financial developments in Albania, including the activity of the Bank of Albania and the financial sector, which occupy a significant place.

Last but not least, I would like the Albanian public to continue to be discreet and have full confidence in the financial architecture we have built. We commend its added prudence, which is reflected in its propensity to increase savings. Therefore, household balance sheets remain positive, an indicator that sends positive signals for a potentially growing consumption in the near and distant future. I take this opportunity to reiterate that optimism shapes our present and our future.

The time has come for the consumers' sentiment to start its take off. This would create the desired chain reaction for accelerating money velocity and circulation of goods in the economy, making the economy recover to its pre-crisis parameters.

On my behalf and on behalf of the Bank of Albania, I would like to thank the Bank of Italy and the Bank of France for the assistance and partnership during the twinning project. At the completion of this project, the Bank of Albania has upgraded the organisational and operational framework of its main departments and has approached to its European counterparties.