Maja Kadievska-Vojnovik: Current trends and future of the financial system in the region

Address by Ms Maja Kadievska-Vojnovik, Vice-Governor of the National Bank of the Republic of Macedonia, at the regional summit of governors, bankers and businessmen "Financial systems in the region", Belgrade, 8 November 2013.

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Dear Mrs. Jorgovanka Tabakovic

Dear Governors

Dear guests,

First of all, I on behalf of the governor of the NBRM, Mr. Bogov, I would like to apologize for his non attendance today, on this very important event. He was unable to joint this event due to objective reasons, but, let me express my truthfully pleasure that I have opportunity to express my views and the views of the governor regarding to the latest development and future challenges for our country and our banking system.

After the double-dip recession, in the first half of 2013 SEE are on the way of recovery. The GDP growth in the RM in the first half of the year is 3.4% and is highly influenced by the positive contribution of reforms' agenda. The improved business environment (RM is at the list of 10 best reformers according to the Doing Business for 2013), the entrance of FDI's that have lead to export diversification alongside with the positive developments at the labor market, are key growth drivers. The increased public investments in the infrastructure, provided by still comfortable fiscal position (the budget deficit was on average 3% of GDP during the crisis and the government debt is at 34% of GDP, the forth lowest in the Europe) are additional factor for growth. However, although the negative spillover effects of the global and Euro zone crisis to the trade, remittances and FDI's could be diminished as Euro zone recover, still, the financial system of our SEE countries, that is broadly based on banks, is exposed to the risk of disruptive withdrawal of funds by European banks.

Thus, when we assess the crisis's impact on the financial system in our economies, we should distinguish the two phases. In the first phase of the global crisis, the negative spillover effects were pronounced on the local capital markets, with large portfolio withdrawals by institutional investors. On the other side, in that time, the Vienna Initiative has prevented a systemic banking crisis. However, with the new wave of the Eurozone crisis (extended at the end of 2011), there are many new challenges for SEE countries that should be rightly followed by Vienna Initiative 2.

Concerns with respect to ***Euro zone banks' deleveraging,*** due to new capital requirements by the EBA are materialized. The deleveraging by the Euro zone parent banks have affected the SEE credits' developments and now there is new concern regarding to the upcoming asset-quality review and stress test of the Euro zone banks that could lengthen this process even further.

In Macedonia, the relatively low share of external funding in total funding (10.8%; Q3 2013) shielded our banks from broader deleveraging trends among European banks. However, group strategies by foreign parents, which are asking strengthening the capital ratios at the consolidated level, impose limits for asset growth in the largest banks in the system. This largely has restricted the credits growth in our economy. The subsidiaries of European banks account for 56% of the banking system assets and are *systemically important* for Macedonia, but still account for a minor share of the overall group assets (parent banks are from Greece, Slovenia, Austria, and France). Local subsidiaries are well capitalized, liquid and have limited exposure to parents. Their funding structure is mostly based on local deposits. Thus, on system level, the funding liquidity risks remain low (loan-to-deposit ratio 0.89, high share of time deposits 67% in total deposits, liquid assets to total assets ratio 32% which is higher than the pre-crisis level). Since the start of the crisis, the balance sheets are expanding (total banks' liabilities as of Q3 2013/Q3 2008 raised by 43% and in Q3 2012/ Q3 2012 for 7%) and this trend has continued with the share of external funding remaining relatively stable. The capital adequacy ratio has climbed to 17.3 percent (with tier 1 capital at 14.7 percent). Non-performing loans rose moderately in the second quarter of this year (to 11.9% of total private sector credits), but the growth is continuously slowing, and they are fully covered by loan loss provisions (RM is within the group of countries with largest LL provision coverage ratio). Profitability is lower but positive, and profits are being used largely to strengthen capital buffers. The euroization of deposits continues to decrease gradually to below pre-crisis levels (44% of total deposit are FX deposits or with FX clause).

Even though the banking sector is in overall sound shape, the credits developments are not favorable and supportive to companies. The reasons for deceleration of the credits growth are on both sides, but mostly relay on supply side. Banks are likely to remain risk averse in an environment of low interest rate margin and the group strategies limit the credits' growth potential. Thus, although the banking system mainly relies on domestic sources of funding, the consolidation of the Euro zone banking system and the EC pressure on troubled European banks that have received international bailout to sell their subsidiaries in the region, are the potential source of risks. The slow realization of this process could cause confidence shocks in our economies, thus endangering financial stability. The latest ***Deleveraging and Credit Monitor*** well notes this process, it says -while past efforts were focused on raising capital on the market, future efforts are expected to emphasize the sales of assets and affiliates. In such an environment, our commitment could be to protect the domestic banking system, to foster banks' mergers and takeovers process with as much as possible, minor negative consequences.

Another challenge, is the introduction of the new Basel III regulatory framework, with more restrictive liquidity and capital requirements that may impact the cost and availability of financing for SEE. In case of Macedonia, the straightforward structure of banks' balance sheets as well as the presence of a high quality capital facilitates a relatively comfortable position for the NBRM and the Macedonian banks in their efforts to achieve the new Basel III capital requirements. The banks are of ***universal type*** with "simple" banking services without complex and structured financial instruments (credit risk is the dominant), ***well capitalized*** (capital ratios range from 9.1 per cent to 38.2 per cent, well-above the regulatory minimum of 8%) and our current regulatory framework limits the definition of equity and tier one capital only to ***high quality capital instruments.***

However, there are ***some challenges regarding to the implementation of the capital buffers***, especially the countercyclical capital buffer. In addition, ***capital market is still underdeveloped.*** In the past several years there are limited number of private bond issuances. As a result, banks have limited options to fund themselves through local bond markets. This feature could be considered as an advantage for the current quality of capital of the Macedonian banks, but it could present a considerable constraint in meeting the liquidity standards established by the Basel III package.

Implementation of Basel III for liquidity ratios by parent banks may have implications for domestic banks and monetary policy implementation in our countries. The liquid assets of our domestic banks are composed at large portion of domestic CB-bills and T-bills and accordingly, they are without investment rating (S&P BB with stable outlook; Fitch BB+ with sable outlook). This could cause serious disruption of design and effectiveness of monetary policy. Possibly, it could ask for transition from market based instruments to direct measures -such as reserve requirement.

Another challenge is to straighten the coordination with the home-host supervisory authorities. It is extremely important and central to the country's financial stability. NBRM is adequately included in the operation of some of the supervisory colleges, but not for all

Macedonian subsidiaries of foreign banks. As a result, NBRM is not always adequately informed, which could harm its ability to effectively determine the necessary capital level of these banks. In addition, there are still some unresolved gaps in regulatory coordination between home and host countries in the EU Single Supervision Mechanism.

And last but not least, the future challange will be impact of Single Resolution Mechanism for a European banking union to our banks and the prospective scaling-back of unconventional monetary policy that could affect the borrowing costs.

Summing up, the ongoing international regulatory reform, though primarily intended to promote financial stability, may also have some unintended adverse effects on emerging and developing economies, with SEE region not being an exemption. Given the similarity of the financial systems, the SEE region as a whole faces similar challenges also sharing the common concerns. This raises considerations for stronger regional cooperation as important tool to effectively address future challenges. The recent Bank of Albania's initiative for region's joint participation within Vienna Initiative 2.0, advocated by the Bank of Albania as Steering Committee member, can be considered as a huge step forward in building consistent cooperation framework. In it's very first joint initiative, the region focuses on home-host coordination including the confidentiality, cooperation and exchange of information between supervision authorities in the home and host countries, the need for EU banks to adequately adapt their strategies to local needs in host countries as well as some coordination issues among non EU host countries and ECB/SSM. The NBRM strongly welcomes this joint cooperation initiative hoping for it to highly contribute toward strengthening region's effectiveness in tackling various future problems that concern as all.