Gent Sejko: Supervisory policies after the start of the Banking Union – initial experiences and outlook for CESEE economies

Intervention by Mr Gent Sejko, Governor of the Bank of Albania, in 6th ECB Conference on CESEE: “CESEE, old and new policy challenges”, session’s topic “Supervisory policies after the start of the Banking Union – initial experiences and outlook for CESEE economies”, Frankfurt am Main, 10 June 2015.

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Dear participants:

I am honored and pleased to be in this important conference among distinguished professionals of banking and financial industry! I want to start by thanking the organizers for the invitation to be here, but also to congratulate the ECB on its new building: I wish it is as functional, as it is beautiful!

Coming from the banking industry, I have been feeling the impact on the banking activity arising from the changing economic and financial environment due to recent global financial crisis. Since my appointment as the new Governor of the Bank of Albania at the beginning of this year, I have been seriously estimating the challenges we face in order to maintain the stability of our banking sector and ensure that it is fit to play its role in support of Albania’s economic growth.

In my intervention today, I would like to share with you how we see the impact of changes in the financial landscape, including those in supervision superstructure, on the financial system of CESEE countries and more specifically on Albania’s one.

With that being said, please let me start with supervision superstructure and the relevant changes in the post-crisis financial landscape, on the first place.

Since the beginning of the global financial crisis, there have been significant changes in the financial landscape. These changes have been driven by a combination of:

1) pre-crisis excesses;

2) restructuring measures;

3) international financial regulatory reforms;

Pre-crisis excesses were due to:

- increasing financial integration and innovation;
- misalignments between incentives for risk-taking and risk-provision;
- weaknesses in monitoring and supervision (especially lack of monitoring and assessment of systemic risk development, as well as cross-border interaction issues);

Such pre-crisis excesses led to risks coming from:

- higher (and often, hidden) concentration of exposures and interconnection, especially on a cross-border level;
- over-indebtedness (both in private and public sectors);
- unrealistic increase in both, financial and real asset prices;

Hence, *restructuring measures* were necessary to address inherent risks in the financial institutions, which were coming from:

- high leverage;
- falling asset quality;
- funding constraints;
- insufficient capitalization;
- fragmentation and conflicts of interest in supervision;

Such measures were associated with public intervention in the financial system (mostly banks), increasing further the linkage between "banks and sovereigns" and creating more "moral hazard". At this point, a financial regulatory reform was necessary at international level, to address such risks.

Under the guidance of the G20, broader and more comprehensive regulatory reforms were designed, with a special contribution by Basel Committee, the Financial Stability Board, IMF/WB group and many other. Such reforms were aiming to:

- strengthen the resilience of the financial system;
- avoid future similar crisis;

In more details, such reforms included:

- Improving the surveillance superstructure of the financial system, through:

– establishing institutions with macro-prudential powers to monitor, assess and address systemic risk (in ***EU*** – ESRB, ECB; in ***US*** – FSOC; in ***UK*** – FPC; etc.);

– reducing fragmentation and possible conflicts of interest in supervision, and achieve supervision consistency: notably in ***EU*** through the "Banking Union/Single Supervisory Mechanism": ECB – EBA – ESRB; in ***UK*** – BoE – PRA – FPC;

– new directives to ensure timing and effective restructuring of banking business (BRRD);

– better design and use of tools to assess resilience of financial institutions to risks, like stress-testing (in EU – EBA/ECB);

- Improving the financial system infrastructure, through:

– better protecting the "core" banking activity from other activities like "proprietary investment" through new rules and proposals (in US – the "Volcker" rule; in UK – proposals of the "Vickers" Commission; in EU – proposals in "Liikanen" report);

– improving clearing and settlement of securities transactions and streamlining financial reporting;

– improving deposit guarantee schemes

- Improving in banks under "Basel III":

– the quantity and quality of the capital;

– the funding structure

– their risk management requirements and capabilities;

To summarize, the legacy of previous financial excesses and the following crisis, is a changing financial landscape ultimately determined by international financial regulatory reform, local financial market characteristics and the crisis impact itself.

Following, in the second part of my speech I would like to briefly share some thoughts about possible implications for emerging markets and economies, including those in CESEE region. Such implications are determined by:

(1) local financial system features and inherent risks;

(2) political and macroeconomic developments;

(3) approach to reforms' implementation;

In terms of financial system features, compared to advance economies, in CESEE the financial system is generally characterized by:

– more reliance in retail (longer-term) funding and more "buy to hold" business model

– wider use of foreign currency in retail transactions;

– less complex financial system, good level of capitalization and simpler approach to risk management;

– serving as "host" to foreign financial institutions (usually from EU advanced economies)

– higher reliance in banking to finance the public and private needs;

– evolving regulatory framework of the financial system;

In terms of political and macroeconomic developments, CESEEs are generally characterized by:

– efforts to develop the financial system and integrate more the local economy in the regional and world one (in Europe, the process is driven by the process of European Integration);

– stronger macroeconomic developments, which have seen improvement in the inflation due to more effective monetary policy, better use of economic resources and better fiscal management;

However, in terms of approach to international financial regulatory reforms implementation, given their features, CESEE will have to consider that:

– staying "out" is not an option;

– less financial integration is not an option

and, given the complexity of reforms, preparations should progress quickly, although the pace of change should be carefully weighted and prioritized with local market features.

In this regard, to my opinion, CESEE may feel some stress impact during the process of reforms implementation which will come most likely from:

– deleveraging, in terms of lower "parent" support for liquidity and lending to local economy;

– cross-jurisdictions similarity in economic and financial cyclicality;

– cross-border cooperation in supervision;

– possible capital movements and impact on exchange rate;

– political process as, in SEE, the EU integration process is determinant;

Nevertheless, there is no option on "holding back" from the reforms for a long time, given the unstoppable process of financial integration and globalization. Hence, an early start of a pacing approach to financial regulatory reform is appropriate.

In the last part of my speech I would like to stop by on the impact on Albania's financial sector and economy and possible ways to avoid/mitigate negative externalities.

The features of our financial system are similar to those of other CESEEs. In fact:

– in Albania, the banking sector dominates the financial system;

– banking activity is concentrated and controlled by foreign banks (87% of the assets);

– in total there are 16 banks and the 4 biggest ones possess 68% of total assets.

– home countries are: Austria (1 bank), Greece (3), France (2), Italy (2), Turkey (1), Bulgaria (1).

– banks play the main role in meeting the private and public financing needs, and they rely heavily in local deposits to finance their activity;

Changes in the regulatory superstructure, and enforcement of the regulatory requirements, have had *important impact on Albania's financial sector and economy*. More concretely:

In the financial sector, we have experienced:

– deleveraging in local financial assets investments, particularly seen at subsidiaries of European banking groups, as they try to meet requirements coming after EBA and ECB stress tests;

– increasing preference by financial institutions to place local funds in foreign investments (abroad);

In the economy, such behavior by some of the banks has materialized in:

– lower financial intermediation to both private and public sector;

– negative impact on economic growth;

However, the stability of both, financial system and macroeconomic framework, have been saved and at this point I would like to state that *we believe that there can be found ways to further avoid or mitigate any negative externalities.*

On deleveraging, Bank of Albania has raised the concern on such phenomena directly with the EU counterparts, but also through its role in Vienna II initiative. In this regard, we have highlighted the need to establish effective mechanisms to restore healthy lending to economies of non-EU countries where subsidiaries of EU banking groups operate.

Furthermore, we consider important to ensure that macro-prudential policies undertaken in the Euro-area, and banking group solutions originating from the EU, should take into account the relevant impact on non-EU host countries financial stability where systemically important EU bank subsidiaries operate. This could be bridged also by an effective exchange of information in the supervisory colleges, in accordance with the new EU directive for the recovery and resolution of banks, and particularly by working to remove barriers for non-EU host countries to come closer to the European forums and be able to participate and exchange their views.

Despite some negative externalities that could be temporary, in the Bank of Albania we do believe that the Banking Union/Single Supervisory Mechanism and the new role provided to ECB, will also serve to improve the supervision of the banking sector in our country. This will come not only by much more consistent approach in supervision practices, but also through improving the coordination framework between home and host supervisors. In this regard, in the Bank of Albania, we are willing and hopeful that we can establish a much stronger working relationship with the ECB.

Thank you very much for your attention!

Glossary

CESEE – Countries of Eastern and South-East Europe;

SSM – Single Supervisory Mechanism (EU)

ESRB – European Systemic Risk Board (EU)

FSOC – Financial Supervision Oversight Council (USA)

ECB – European Central Bank

EBA – European Banking Authority

FSB – Financial Stability Board

PRA – Prudential Regulatory Authority (UK)

FPC – Financial Policy Committee;

BRRD – Banking Recovery and Resolution Directive (EU)