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Crisis management and the banking system in Montenegro

Abstract: General deregulations of financial markets and improper risk management have seriously shaken banking systems worldwide during the global financial crisis. The key challenge in the upcoming period is to find an optimum balance between necessary regulation and avoiding overregulation that could jeopardize competitiveness of the banking system. The emphasis should not confine to the capital adequacy ratio but it should also cover liquidity because problems with insufficient liquidity could bring a crisis even to a bank that otherwise meets the statutory solvency criteria.

The Montenegrin banking sector was no exception and it was severely hit by the crisis. This paper shows the movement of the banking system indicators through the following stages: preventive actions, strengthening of resilience, and crisis management. In addition, the paper shows the process of the banking system restructuring, followed by the conclusion that there can be no banking system restructuring without the restructuring of the real economy.

Key words: Montenegro, banking system, risk, crisis, solvency.

Jel code: E52 and G21

1. Introductory remarks

Crises have emerged in the past and they will reappear in the future. They were results of various factors but generally, as L. Santa (2007) notes, the basic underlying reasons for the crises appearance are the inefficient and imperfect functioning of financial markets and the asymmetrical information emerging in markets. Central banks cannot prevent all crises, but what they can and must do is mini-

mize their costs and act preventively. In the past, central banks mainly focused on price stability and, as indicated in the IMF (2004) policy paper “Central Banking Lessons from the Crisis”, they tended to focus less on financial system developments and built-up vulnerabilities. That is why one of the underlying culprits of the current crisis is improper risk management.

Even in normal times banks face numerous risks that only multiply in a crisis. As D. Ware (1996) indicates, the risks to which banks are exposed can be categorised as:

1. Credit risk – the risk that the bank’s counterparty might not pay on the due date;
2. Liquidity risk – the risk that the bank might itself fail to meet its obligations when they fall due;
3. Yield risk – the risk that the bank’s assets may generate less income than the expense generated by its liabilities;
4. Market risk – the risk of loss arising from assets (primarily bonds, foreign exchange, and the like) in which the bank has a position;
5. Operational risk – the risk of a failure in the bank’s procedures or controls;
6. Ownership/management risk – the risk that the owners/management might have goals that are contrary to sound banking operations.¹

All bank activities undeniably involve consideration of operational risk since profit, as the ultimate objective, can be generated only if certain risks are taken. However, risk taking requires proper risk treatment to prevent jeopardizing banking operations. That is why the general banking objectives should be risk taking as well as risk management, diminishing, and the finding of an optimum balance between risk and profit, that is, a proper rate of return on equity.

However, being sometimes motivated by short-term objectives, banks engage in excessive risk-taking. Inadequate implementation of risk management standards, coupled with the lack of proper regulation, directly generate capital decrease and increase liquidity risk in banking operations, which are the problems that consequently increase the risk of a crisis emergence.

Deregulation or insufficient regulation leads to growing risks which taking could bring higher profit. Therefore, higher profit may be the result of excessive taking and accumulation of risks. Consequently, this contributes to growing competi-

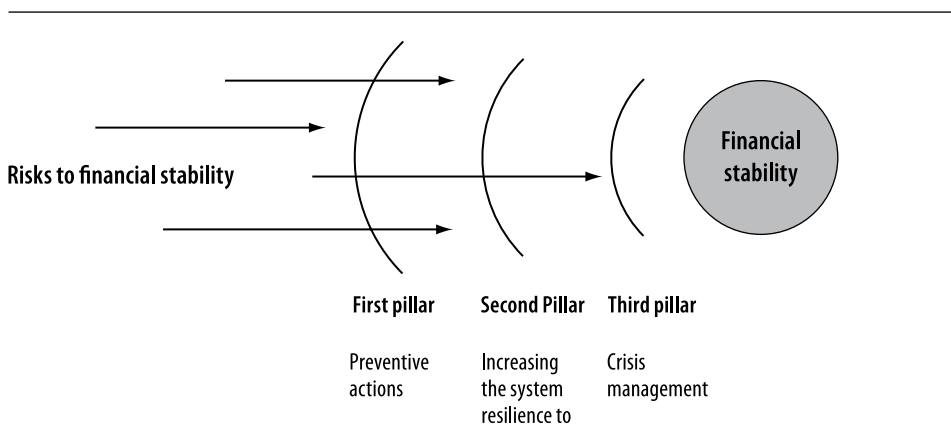
¹ As per recent classifications, this risk is classified under reputational risk.

tion, yet only in short term. In the long term, inadequate risk management and excessive risk taking may jeopardize not only competitiveness but operational stability of institutions as well.

Regulation and efficiency (competitiveness) are often conflicting objectives. On one hand, a rigid and voluminous regulatory framework may seem reliable yet restrictive to, *inter alia*, bank lending activity, and thus to contraction in the real economy. Another negative impact is the risk that banks would attempt to avoid such requirements while adjusting to new regulations. There are examples of a more rigid banking regulation that has led to unfair competition among banks and nonbanking institutions. The example of Japanese banks' operations in international market has confirmed this impact on their competitiveness. Due to the fact that the Japanese regulatory framework allowed lower capital requirements for banks and more flexibility with regard to risk-weighted assets, the Japanese banks strengthened their competitiveness through their subsidiaries in other markets in relation to similar institutions in those markets, thus pointing to the manner how a weaker regulation affects competition increase, that is, to the inconsistency of regulation and competition.

In such conditions, it is necessary for the regulator to take proper measures to prevent excessive risks. In this regard, the CBCG approach to maintaining financial stability can be described as a policy involving three lines of defence. The first line is prevention, the second one is increasing the system's resilience to shocks, and the third line is crisis management. All three dimensions are equally important though not having the same implications.

Figure 1: Three-dimensional approach to preserving financial stability



Source: Žugić, R. and Fabris, N. (2011), Financial stability as a central bank objective

When the level of non-performing loans (NPLs), that is, irregularly serviced loans, jeopardize the bank's capital due to direct losses, the spreading of information on these losses leads to the loss of market confidence in such a bank. Confidence represents the mainstay of the banking business and practice has shown that jeopardized confidence leads to bank run, that is, the spread of contagion that might have a negative impact on stability of both the bank in question and the system as a whole.

That is why the CBCG, in addition to regular monetary and prudential instruments, pays great attention to the channels of communication both with professional and general public and treats the public relations policy as an additional monetary instrument. Preventive acting on reducing uncertainty and asymmetry in information has a positive effect on the stability of the banking sector and the overall financial sector.

This paper is divided in two parts. The first part shows the evaluation of risk management standards whereas the second one portrays the development of Montenegro's banking system, the consequences of improper risk management and the forms of restructuring applied so far. The movement of all the aforesaid indicators is showed through the previously described three-dimensional approach to preserving financial stability.

2. Development of risk management standards

The evaluation and treatment of risks in the banking system on the international level have changed over time. In 1970s, financial systems were more rigidly regulated and had simpler products and trading instruments. A decade later, the banking industry underwent significant changes, with the emphasis on deregulation. On one hand, this deregulation meant the lack of new procedures and regulations necessary to accompany the market development and the emergence of new instruments, while on the other hand, it involved the guillotine of regulations necessary due to the outdated regulatory frameworks at the time.

Over time, due to these phenomena that could be viewed as anomalies occurring owing to deregulation, regulation rules have been developed and the process of deregulation has been replaced again by regulation based on generally accepted standards and practice.

For a monetary authority to respond to the requirements of taking a systemic financial risk, especially in bank-centric economic systems, the obligations of the regulator involve the following:

1. Building of a fair and open environment (the level playing field);
2. Implementation of standards and sound banking practices;
3. Fostering sound competition (without cartelisation of entities in the market).

These obligations are even more pronounced when we have a small and open market where interdependencies through relations, interactions and obligations of banks are so distinct that even a failure of the smallest bank could trigger the system erosion.

As a response to these challenges and with the intention of serving as the basis for banking regulation development, the Basel standards were created and improved. The Basel Committee on Banking Supervision passed the first capital accord (Barth, Caprio & Levine, 2006), known as Basel I, in 1998. Pursuant to this standard, banks were required to increase their capital to properly support their growing operations. Regardless of the breakthrough at the time, Basel I did not ensure a proper treatment of collateral, the guarantee for, and the prevention of, bank activities involving the migration of good assets from banks.

Eleven years later, a new capital accord was created, Basel II, as a response to the treatment and securitisation of risks, with the emphasis on several functions:

1. Internal controls and risk management;
2. Supervisory review process; and
3. Market discipline.

The Basel II philosophy is based on the knowledge of a greater bank exposure to various business risks (Fabris, 2006). It was based on more flexible and more sophisticated approaches to measuring credit and operational risks, which represented a new manner of and approach to banking supervision (Dages, 2004). Regardless of the standard's complexity, its application was supposed to contribute to the financial sector stability because capital requirements calculated according to these methods reflect more realistically the amount of risk exposure of every individual bank.

The biggest shortcoming of Basel II, its procyclicality, revealed with the outbreak of the global financial crisis and thus gave rise to the creation of Basel III.

Basel III further strengthens the regulatory framework with a view to improving both capital quantity and quality in order to discourage excessive borrowing and risk-taking in the financial sector. In addition to capital requirements, an integral part of this capital reform is also the introduction of a new minimum liquidity standard for internationally active banks. The new capital and liquidity rules should ensure that banks will be able to absorb future disturbances in the global financial market without any extraordinary support by government, as well as improve the risk management process. This provides fundamental contribution to long-term financial stability. The new Basel III requirements are presented in the following table.

Table 1: Basel III capital adequacy

	Common Equity*	Tier 1	Total capital
Minimum	4.5%	6%	8%
Capital buffer	2.5%		
Total capital	7%	8.5%	10.5%
Countercyclical capital buffer (optional)	Up to 2.5%		

* A new phrase "common equity", as the best quality capital, involves capital acquired through the sale of common shares and retained earnings; it is to increase from the present level of 2% to 4.5%.

Source: Kozarić, K., Fabris, N. (2012) *Monetarno-kreditna politika*, Štamparija Fojnica, Sarajevo.

Thus, excessive risk-taking, being one of the main culprits for the recent crisis, highlighted the need for more rigid regulation which in turn, as we have already said, can be costly. To wit, rigid regulation can reduce and slow down credit growth, but any longer period of slowdown can have more negative effects than any big financial crisis that appears in a relatively wide time span. It is obvious that a proper balance between the two is necessary in order to release potentials of an economy. However, as the IMF (2009) indicates in its policy paper, capital, provisioning, and liquidity norms should be more demanding in good times to build buffers that in bad times can help to offset procyclical pressures.

3. Development of the banking system in Montenegro

The banking system in Montenegro went through three different stages of development. The first stage covered the period until 2006 and it was a period of stable economic conditions and market expansion. The second stage covered the period from 2006 until the last quarter of 2008 - the period of credit boom. This stage

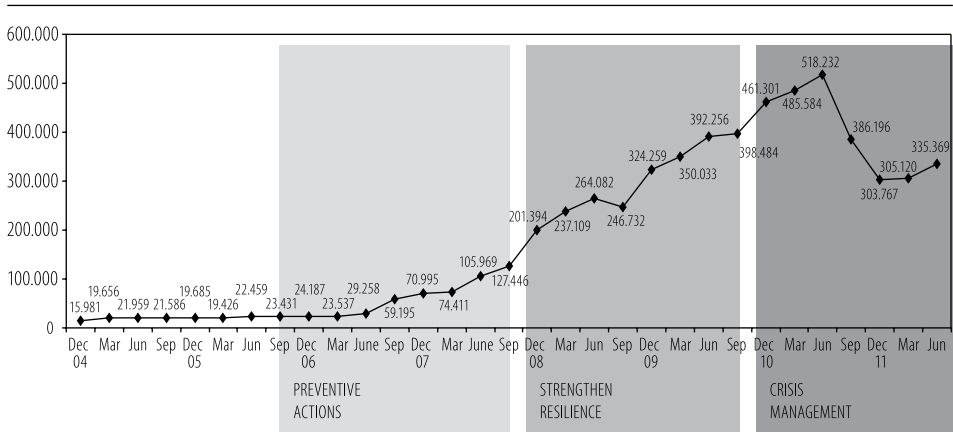
was characterised by extremely high lending activity, loose supervision with regard to risk-taking, intensified market competition, and a high inflow of international liquidity. The third stage covers the period of the global economic crisis emergence as of the last quarter of 2008 and present; in this period, the banking sector has been sharing the fate of the crisis adjustments and impact with the remainder national, but also a wider global, economy. This stage has been characterised by credit contraction, deterioration of asset quality, the loan portfolio in particular, and a lower risk appetite of banks.

The aforesaid development stages can be recognized in the movement of certain indicators in the banking system. The indicators of assets, loans, NPLs, solvency ratio, and interest rates depicted development trends over these three stages: a moderate growth at the initial development, followed by the entry into a strikingly exponential growth stage, and ending in the contraction of the banking sector under the crisis impact.

The expansion of the banking system, that is, banking assets, was based on a remarkably high credit growth in the pre-crisis period when total loans increased 8 times to plunge over 30% in the three-year period as of 2008. The negative impact of the global financial crisis has led to the contraction of lending activity in Montenegro and a strong deleveraging in the banking sector. Trends in lending activity indicate that the seed of all current problems that the banking sector faces directly can be recognized in the accelerated pace of lending in the past period, and the consequences of its spillover have been felt more widely. The interconnection of the real and banking sectors and the spillover of negative effects significantly slow down recovery of the real economy. Trending down in lending was accompanied by the growing problems in banking assets quality due to the weakening of economic activity and corporate income, which has led to a strong growth of NPLs.

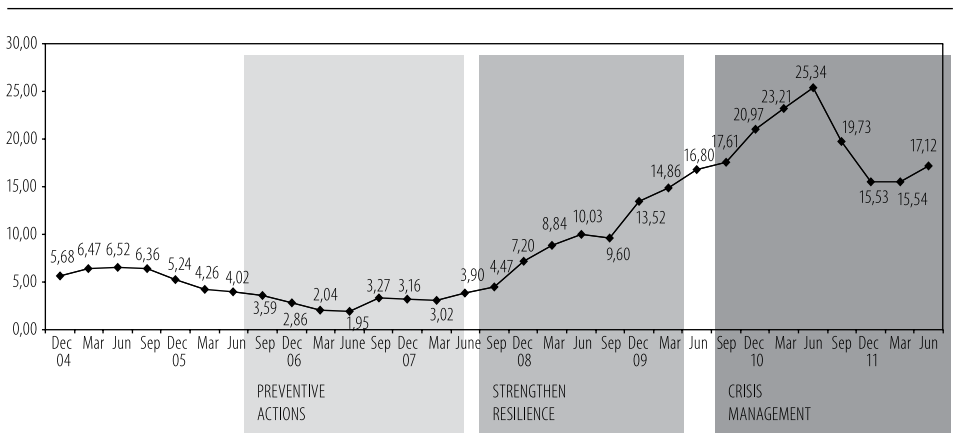
At end-2004, the share of NPLs in total loans amounted to a mere 5.68%. NPLs have recorded a rapid growth in the period as of Q3 2008, both in absolute and relative terms. Namely, the share of NPLs exceeded the level of 25% in mid-2008. In other words, in accordance with the applicable regulations, every fourth loan was treated as a non-performing one.

Figure 1: Movement of NPLs (EUR 000)



Source: CBCG

Figure 2: Share of NPLs in total loans



Source: CBCG

A high share of this portion of non-performing assets required a proper treatment so as to prevent additional contraction and jeopardizing of financial stability. Some of the banks accounting for the highest shares in the system found the solution in the sale of assets. This model is a relatively usual practice of revitalization of bank balances in countries with developed financial markets, yet it was a novelty for the Montenegrin system.

In concrete cases, the sale of assets involved the transfer of assets, usually bad debts, to parent banks and factoring companies, thus revitalizing banks' balances. These activities contributed to bank rehabilitations, while a positive impact was also made on the macro aspect, that is, the preservation of financial stability. Also, through dumping non-performing loans, net of discount part related to acquirer risk, banks came up with new liquidity. The following table provides an overview of these activities: relocated value, sales price, and discount in percentage.

Table 2: Relocation of assets from Montenegrin banks

Bank	Exposure	Sales price	Discount (%)
Bank 1	248,260	182,408	-26.53
Bank 2	157,528	145,435	-7.68
Bank 3	97,458	46,330	-52.46
Bank 4	18,272	13,643	-25.33
Bank 5	75,330	75,330	0.00
Total	596,848	463,146	-22.4

The share of non-performing categories of loans in tranches that followed was far more significant, which required higher discounts. The aggregate data of sold exposures and their comparison with the selling price show that the approximate value of the discount at the system level was 22.4% of the original value.

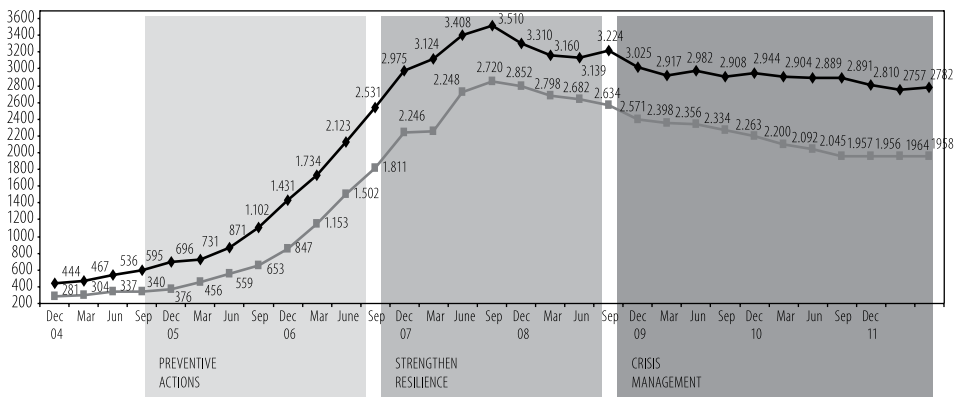
Sizable transfers of claims to parent banks, factoring companies and other investors started in late 2009. Although these amounts were high, the contribution to a downtrend of non-performing loans was not significant since the performing category of the portfolio had a significant share in the sold assets. The largest contribution to the descent in non-performing loans in total loans was recorded by asset displacement in the period end-2010 – end-2011, when a sizable decline of this share was recorded. The share declined from the maximum value of over 25% to below 15%.

The analysis of activities in assets displacement shows differences between the selling price and exposures. The discount mostly depended on the quality, i.e. the collection risk. Depending on the classification of credit claims, the allocated provisions were reversed, which also had effects on the selling discount. Performing loans (categories A and B) bore lower collection risk and the discounted value of these loan categories was lower compared to other categories.

Total effect of transfers at the system level reflected in a decline in the share of non-performing loans in total loans of almost 10 percentage points.

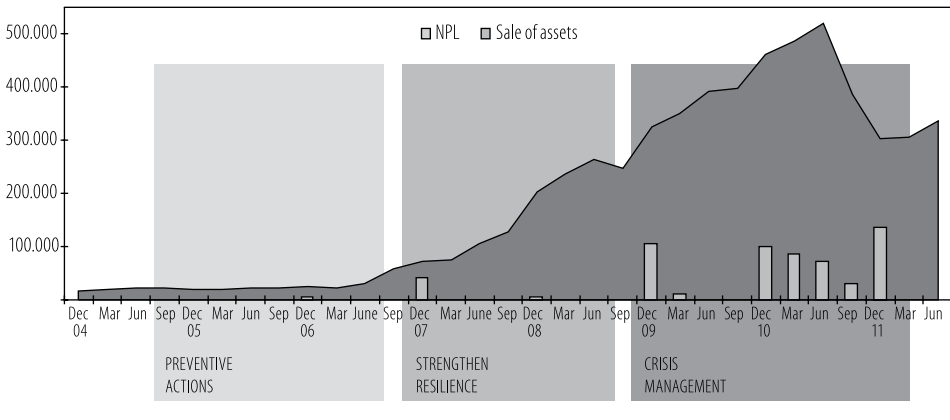
Activities on displacement of loans resulted in the aggregate decline in total bank assets. Assets indicators point to a decline in assets, but this decline was partially compensated by deposits increase, the claim collections, the amount of released provisions, bank recapitalisations, and foreign borrowings. Following the changes in these positions, assets had not declined proportionately to loans decline. The decline in assets consequently led to a decline in credit offer from the banking sector. The lending trends in the last 10 years ranged from a record boom and the annual growth of over 100% to prudence in the first phase of the crisis, all the way to the final lending “contraction” – condition that may be described as a state of (prevailing) bank passivity. Consequently, the lower offer accompanied by the risk premium growth, deteriorated financial condition of borrowers, the existing overindebtedness, the lack of viable projects and the like resulted in the adjustments of undertakings in the real economy. A growing uncertainty in the market resulted in a downtrend in implementation of (potential) development projects as well, thus clients themselves have been reducing their operations due to expensive working assets.

Figure 3: Assets and total loans (EUR million)



Source: CBCG

Although banks had other possibilities to influence non-performing assets at their disposal (such as the collection of claims or restructuring loans), its decline in the given period was largely the result of the aforesaid transfers. The latest available data, referring to Q2 2012 showed a continued uptrend in non-performing loans (17.12% of total loans) reflecting the continuation of the downgrading of loans granted during the boom period to worse categories.

Figure 4: Non-performing loans and sale of assets

Source: CBCG

It is worth noting that the existing regulatory solution means that the valuation of loans and other bank assets is performed by applying the criteria for assets classification and provisioning prescribed by the CBCG, and the allocated provisions directly affect the financial result of banks.

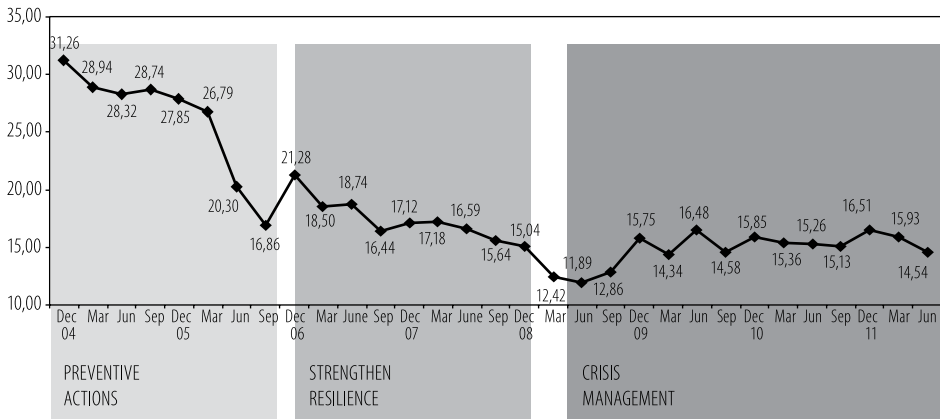
The new solution, to be applied from 1 January 2013, as well as many comparable solutions, is a combination of international accounting and prudential standards. Therefore, with a view to compiling and disclosing financial statements, banks will use the international accounting standards, and at the same time be obliged to value assets according to the criteria prescribed by the CBCG, which are typically more conservative. The difference between received amounts shall be a deductible item in calculating the regulatory capital.

This will preserve the principle of prudence, as a basis for prudential regulation and supervision of the financial market entities since the performance indicators, primarily capital adequacy as the main indicator of a bank's stability and its possibility to absorb possible operational losses, will still be based on more conservative, stricter rules, thus ensuring additional protection of depositors and other bank creditors.

The increased level of risks in the system reflected in an increase in the amount of weighted balance sheet assets and capital requirements for risks influencing a decrease in banks' solvency ratios. The solvency ratio reflected the performance of banks, their risk profiles determined by the level of risks taken over the three

development periods. The ratio fluctuated over these periods, depending on performance indicators, as well as on the applicable regulations which influenced its level and structure. It should be reminded that legislation dealing with capital requirements was strongly amended in early 2009 and that it is based on the Basel principles, i.e. risks, which had not been the case before. In the initial phase, the solvency ratio was even above 25%. It should be reminded that lending activity in that period was very low and that the level of risks was relatively low. It can be said that this indicator of the banking system serves as the reflection of situation in the overall macroeconomic environment. Thus, in the period of crisis intensification in this region, the solvency ratio declined from 15.64% in September 2008 to 11.89% in June 2009. By adopting temporary relaxation measures, the CBCG helped banks overcome short-term oscillations in their operations. The banking system maintained its stability throughout the entire crisis period also due to strong parent banks which supported their subsidiaries in Montenegro via recapitalisation and credit lines to ensure long term funding for their smooth operations. Over the past two years, the solvency ratio remained stable at around 15%, while the statutory requirement is 10%.

Figure 5: Solvency ratio (%)



Source: CBCG

Trends in these parameters were accompanied by changes in interest rates. The weighted average interest rates on loans extended over the three-year period have been on an ongoing increase. In 2010, these rates showed an uptrend, which temporarily stopped in Q3 2011, in order to peak at end-2011. During the first two

quarters of 2012, the weighted average lending interest rates showed downtrend and amounted to 9.54% as at 30 June 2012.

Stemming from these micro level inputs at the macroeconomic level, the logical result was: (1) a slow pace of recovery from the crisis, (2) adverse effects on new employment, (3) the giving up from, and a reduction of, investment projects and the contraction of working assets at company level, finally leading to the recession effects – a decline in GDP.

Today, negative economic trends and poor recovery of the corporate sector have a reciprocal effect on banks, whereby the repercussions are strongly exposed through a new growth in non-performing loans in the aggregate portfolio of banks. Moreover, the real economy trends consequently strongly affect the capitalisation and profitability of banks.

The banking sector's recovery (balance sheet cleaning, capital increase, more adequate risk management, greater dedication to clients and the like) does not imply improved balance sheets of companies. They reflect irrationalities that have been accumulated primarily during the period of investment boom and that may have adverse reciprocal effects on the banking system's soundness.

Concluding remarks

As Ugolini (2003) points out, it is clear that challenges to financial stability arise, and will continue to arise, whether central banks are ready for them or not. Central banks have to be ready and have to learn important lessons from previous lessons. As Paul Krugman pointed out, the lesson to be learned from the global financial crisis is that everything that needs to be saved in the period of crisis, because it is of crucial significance for financial mechanisms, should be regulated in the crisis free period for the purpose of prevention of excessive risk taking. It is obvious that excessive deregulation, in combination with inadequate risk management, was the seed for present problems. On the other hand, it would be dangerous to go to the other extreme, excessive regulation, because it aggravates competitiveness. The key challenge is to find a proper balance between regulation and preserving the banking sector's competitiveness.

Bank capital is the buffer for bank loss to be used to prevent bank failures. Sometimes, a high amount of capital is insufficient for a bank's stability if there is insufficient liquidity, which may become a direct trigger of problems and bank

failure. Thus, in addition to capital adequacy, each serious regulatory reform imposes the need for defining the minimum liquidity requirements.

The Montenegrin banking system has undergone a typical crisis cycle - a progressive growth, overheating of activity, and the post-crisis consolidation. Although the banking system recovered, it has not finished the post-crisis consolidation. The key issue in the post-crisis period is a clear identification of risks, the assessment of their level and management quality in order to prevent any underestimation or overestimation of their level and effects. However, the banking system of Montenegro will not be properly consolidated without the restructuring of the real economy.

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