DE GRUYTER
OPEN

UDC: 336:338.124.4
DOI: 10.2478/jcbtp-2014-0002

Journal of Central Banking Theory and Practice, 2014, Vol.3 No.1, pp. 9-26
Received: 25 September 2013; accepted: 11 October 2013.

Milojica Dakić *

* *Central Bank of Montenegro*

E-mail:
milojica.dakic@cbcg.me

Global Financial Crisis – Policy Response

Abstract: Six years after the outbreak of the financial crisis that had shaken the global financial system, experts and analysts all over the world continue discussing the effectiveness, scope and adequacy of mechanisms and measures implemented in the meantime, as well as the adequacy of the underlying theoretical concept. A global consent has been reached on ensuring financial stability through the interaction of monetary, fiscal and prudential policy to ensure the necessary macroprudential dimension of regulatory and supervisory frameworks. The USA crisis spilled over to Europe. Strong support of governments to bail out banks quickly resulted in sovereign debt crises in some peripheral EU Member States. Fiscal insolvency of these countries strongly shook the EU and increased doubts in the monetary union survival. The European Union stood united to defend the euro and responded strongly with a new complex and comprehensive financial stability framework. This supranational framework is a counterpart to the global financial stability framework created by the G20 member countries. Starting from the specific features of the monetary policy whose capacities are determined by euroisation, available instruments and resources for preventive supervisory activities, as well as the role of the government in crisis management, Montenegro created a framework for maintaining financial stability and prescribed fostering and maintaining financial stability as the main objective of the Central Bank of Montenegro.

Key words: financial crisis, financial stability, banks.

Jel code: E58, G01, G21.

I Global Financial Crisis – Causes, Consequences

The 2007/8 global financial crisis has forever changed the relationship between macroeconomic and prudential policies. This statement abstracts the dynamic dimension of economic processes, cash flows and financial instruments by primarily focusing on mechanisms and institutional structures of the safety net, and its inherent framework of policies and decision makers which, being unfinished, unfortunately could not properly respond to the severity and complexity of challenges that the global market has faced so dramatically perhaps for the first time after the Great Depression. The crisis managed to unify different economic and financial groups, regions and countries from different continents, thus raising the level of global awareness on the necessity of establishing a new financial stability architecture in order to, as far as reasonably possible, cover the global network of financial flows and define universal standards of conduct for all participants tailored to their size and corresponding level of taken risk. This is why Basel III is particularly important here since it aims to convert this risk into additional required capital and liquid assets in order to achieve desirable levels from the supervisory point of view which is well reflected in the term "adequacy".

The crisis emerged in the financial system, the heart of economy, and spread to financial flows by undermining seemingly solid foundations of financial industry and the prevailing regulatory concept of risk-based supervision. Its consequences were devastating, measured in billions of U.S. Dollars and Euros in materialised losses, and the recovery of "patients" was long and uncertain. The causes for this condition were promptly diagnosed: the sophisticated, so-called subprime products were issued on the basis of bad mortgage loans in the USA, poor regulation and inefficient supervision of financial institutions, as well as credit rating agencies that were extremely biased and unrealistic in rating these quasi financial instruments. All that led to enormous increase in speculative activities and growing distrust in the U.S. financial market, which quickly spread to all countries whose banks had large balance sheet exposures to these products. Incomplete and procyclical regulations spurred the expansion of risks and the collapse of the financial system, which logically led to risk spreading via transmission channels to the real economy, leading ultimately to recession.

The key response to the crisis was strong support to the financial sector by countries and central banks. By the end of 2009, total global capital injections, both by the markets and governments, fully covered the total losses and writedowns of banks (Table 1).

Table 1: Bank losses, writedowns and capital injections

	Losses writedowns, $bn	Capital injections					
		From markets		Government		Total	
		In $bn	As a % of losses	In $bn	As a % of losses	In $bn	As a % of losses
Global	1226.8	744.6	60.7	484.4	39.5	1229.0	100.2
North America	665.5	301.4	45.3	211.3	31.8	512.7	77.0
Europe	520.1	318.9	61.3	272.1	52.3	591.0	113.6
Asia	41.2	125.3	304.1	0.0	0.0	125.3	304.1

Source: Hannoun, H., Towards a global financial stability framework, BIS,2010, p.10

The crisis raised numerous issues that needed to be addressed promptly. We single out the following: development of the financial stability framework at the global and national levels; redefining of the roles of the World Bank and the International Monetary Fund, upgrade of regulatory framework of capital adequacy and banks' liquidity in order to eliminate procyclicality under Basel II; redefining international accounting standards; stronger regulation of rating agencies and the like.

II European Union and Global Financial Crisis Consequences

The European Commission data show that the amount of aid granted by the EU Member States to stabilise the EU banking sector exceeded 1.6 trillion euros at the end of 2010, 13 percent more than the EU GDP (ECB, 2012, p.101). According to the revised data, in the period October 2008 – October 2011, the European Commission approved 4.5 trillion euros or 37 percent of the EU GDP of state aid to financial institutions and thus averted the collapse of the financial system (EC, 2012). The professional public shares an opinion that the EU would have responded to the global financial crisis much better if some of the Member States had not run unsustainable fiscal debts. The condition that had all characteristics of the financial crisis in the EU, induced by the crisis in the USA in H2 2007, translated into a classical debt crisis of the Euro area peripheral countries: Portugal, Italy, Ireland, Greece, and Spain, which in turn triggered doubts about the survival of the euro. The crisis revealed weak points of some of the Member States and pointed to unsustainable levels of sovereign debt that threatened to undermine the foundations of the European Monetary Union. Many experts identified irresponsible pursuit of fiscal policies and mismatch between economic policies as the main causes for the outbreak of fiscal crises. It became evident that the loose fiscal union represents the "Achilles heel" of the EU, which came as a consequence of independence of the Member States` national fiscal policies within the frames set out in the Stability and Growth Pact. A solid and united monetary union, with the strong ECB and a common monetary policy was not enough to prevent the growing fiscal uncertainties in the so-called PIIGS countries. What came after this was the economic crisis that manifested in negative economic growth rates and rising unemployment. The situation was made even more difficult by the fact that there was no European mechanism to banks whose large balance sheets exposures to fiscally irresponsible members of the monetary union. This prompted speculative activities in the financial market, which led to the risk premium increase, and hence the interest rates` (yields) increase on the government debt of these countries that reached extremely high levels. These countries were forced to implement rigorous austerity measures to send a signal to the financial markets that they had implemented sustainable policies aimed at budget balancing. The most dramatic situation was in Greece in 2011 and the solution was a combination of an aid package by the EU and the IMF and an agreement on private debt of over 50 percent. However, the problem became more complicated as the crisis spilled over to other Member States and deteriorated their position. However, unpopular austerity measures combined with a set of expansive measures of the ECB and necessary structural reforms yielded results, especially in Italy and Spain. Consequently, tensions in the financial markets reduced in 2012 as regards the Euro and public finance of the Euro area periphery, especially in H2 2012. Even though there are still problems in terms of encouraging the sluggish economic activities, what is positive is the fact that there is an ongoing process of strong fiscal adjustment and that there is a significant reduction of budget deficits. When it comes to developments in the Euro area, the situation in Cyprus confirmed that it is necessary to remain moderately optimistic and cautious. Cyprus is the fifth Euro area country which sought financial assistance from the European rescue funds (European Stability Mechanism). In order to receive the aid, the country was requested to accept the economic adjustment programme for overcoming the crisis prepared by the EU and IMF.

III Change of Macroeconomic Stability Concept

Safeguarding financial stability is now widely recognized as an important part of maintaining macroeconomic and monetary stability, and as important for achieving sustainable growth. (Schinasi, 2006, p.3) Hannoun pointed out to the necessity of abandoning the concept of financial stability before the crisis, which was based on avoiding recession, ensuring smooth business cycles free of volatility and inflation, relying on overoptimistic assumptions of potential output growth, and rejecting the need to act against the build-up of financial excesses (2010. p. 3-4). The author points out that the new concept of financial stability needs to reconcile autonomy of prudential, monetary and fiscal policy objectives. In this context, the implementation of microprudential objective of preventing the contagion of distress in individual financial institutions needs to respect the system component achieved through instruments such as providing additional capital and liquidity that act as systemic risk buffers. In addition, the contribution of monetary and fiscal policy to financial stability is reflected in countercyclicality of economic cycles. The foregoing shows that none of the mentioned policies can ensure macroeconomic stability because they do not include financial stability as an additional objective. This is confirmed by the years of controlled and moderate levels of inflation that preceded the crisis and yet failed to prevent it. "The attention of experts and professionals has caught the new integral concept of macroeconomic and prudential policies which shifted their focus from price stability, economic activities and idiosyncratic risk inherent to individual financial institutions to financial stability and systemic risk" (IMF, 2013). There is a new paradigm based on complementary monetary and macroprudential policy as the foundation of a new concept of the framework for preserving financial stability.

IV Global Financial Stability Framework

The transfer of financial risks via numerous transmission channels has threatened the global stability, pointing to the necessity of establishing an authority with a mission of preserving the global stability. The G20 played the key role in the process of global macroeconomic policy coordination and the establishment of the Financial Stability Board (FSB), the successor to the Financial Stability Forum (FSF). The FSB started its operations in April 2009 with a clearly defined mandate that includes: the assessment and identification of financial system vulnerabilities and oversight of actions needed to address them; promotion of coordination and information exchange among authorities responsible for financial stability; monitoring and advising on market developments and their implications for regulatory policy; advising on and monitoring the best practice in meeting regulatory standards; undertaking joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps; setting guidelines for, and supporting the establishment of, supervisory colleges; managing the contingency planning for cross-border crisis management, particularly with respect to systemically important institutions; and collaborating with the IMF to conduct Early Warning Exercises. In performing the above mentioned tasks, the

FSB closely cooperates with the Basel Committee, the Committee on the Global Financial System, the Committee on Payment and Settlement Systems, and the IMF. The implementation of the new financial stability concept required the redefinition of regulatory and supervisory frameworks. More severe regulatory rules were introduced and their implementation will significantly increase the financial institutions' expenses, especially of those too big to fail. Therefore, it was decided to implement it gradually, as it was done in the case of the Basel III capital requirements. The IMF underwent internal reforms of its management structure and voting rights distribution, while the new flexible precautionary arrangements were presented at the international level.

V European Financial Stability Architecture

As a very complex response to the consequences of the global financial crisis that later manifested as the sovereign debt crisis and the economic crisis, the EU created a new financial stability framework which rests on the European System of Financial Supervisors (ESFS), which includes the European Systemic Risk Board (ESRB), and three new European Supervisory Authorities (ESAs) at microprudential level, including: the European Banking Agency (EBA), European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pension Authority (EIOPA). The ESRB was assigned the central role in the macroprudential supervision, and its activities focus on the prevention and mitigation of systemic risks in order to ensure smooth functioning of the single market. In carrying out its duties, the ESRB closely cooperates not only with the ESAs but also with national supervisory authorities in the area of sharing information on all segments of the financial system, which contributes to the coherence of macroprudential and microprudential supervision. Since the ESRB does not have a status of a legal person, unlike the ESAs, its macroprudential supervisory function is based on collecting and analysing all data and information; identifying and prioritising risks; issuing and publishing warnings about significant systemic risks, issuing recommendations for remedial action; giving emergency warnings to the Council with an assessment of the situation, in order to enable the Council to assess the need to adopt a decision addressed to the ESAs determining the existence of an emergency situation, declaring the existence of a crisis, etc. It closely cooperates with international financial institutions and the Financial Stability Board (FSB).

The European Union has great expectations from the Banking Union, which should, in the medium-term, contribute to halting the financial market disintegration process and strengthening of consolidation, eliminating negative feedback loop between national governments and banking sector in many Euro area countries, and the like. The Banking Union rests on three pillars deriving from the Single Supervisory Rulebook, including: (i) the Single Supervisory Mechanism (SSM), (ii) the single deposit guarantee scheme, and (iii) the Single Resolution Mechanism. The ECB plays the key role in the SSM functioning, it supervises and is responsible for its functioning. In performing its new supervisory function, the ECB closely cooperates with the EBA and national supervisors. The harmonised single regulatory and supervisory framework divided the responsibilities of the ECB and the national supervisors, based on the bank size criteria. The ECB controls all banks with assets exceeding 30 billion euros or make up more than 20 percent of their home country's GDP (unless their assets are below 5 billion euros), or it ranks amongst the three most significant banks in the national markets; banks that requested financial assistance directly from the ESMA and complex banks involved in cross-border business operations. According to the ECB estimates as of November 2013, it is expected that the ECB will directly supervise around 130 credit institutions, representing 85 percent of total banking assets in the euro area (ECB, 2013, p.115). There is a possibility of involving non-euro area Member States in the SSM to ensure greater harmonisation of supervisory practices within the EU. The single bank resolution mechanism represents the very core of the Banking Union, but has long been the main stumbling block in the EU. Finally, at the beginning of December 2013, the representatives of 28 EU Member States reached an agreement on this issue and consented to the adoption of the relevant Directive, which will enter into force in 2016. The framework was divided into three areas that include: preventive measures (bank recovery and resolution plans), early intervention and resolution. Resolution instruments and authorisations include: the sale of all or part of the bank without the consent of the shareholders, the forming of a bridge bank, migration of bad assets, debt to equity swap, as well as the establishment of a common European fund. The single regulatory framework for deposit guarantee schemes, the third pillar of the European Union, rests on the stipulated amount of guaranteed deposits of 100,000 euros per depositor in a bank, and there is a proposal for shortening the payout period of guaranteed deposits from twenty to seven days.

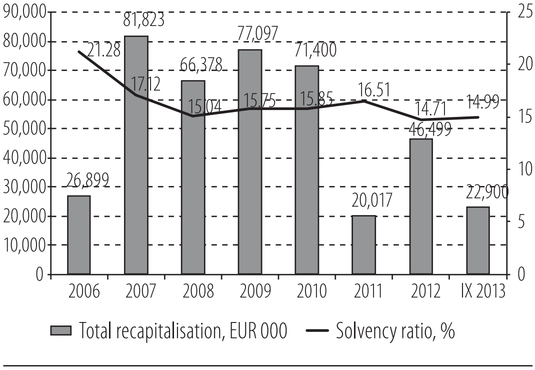
VI Montenegro – Long and Hard Recovery after the Crisis

Developments of the Montenegrin economy in the period 2006-2013 represent a classical reflection of influences of shifts between phases of ups and downs in business cycle, followed by corresponding ups and downs in the financial cycles and their counter effect on the business cycle again. Even though the consequences of the financial crisis had devastating global consequences, internal specifics of the national economy and the financial system determined the extent of consequences which we faced. Therefore, we should not be surprised by the fact that the recovery process that has started in 2009 is still ongoing.

The euroised Montenegrin economy attracted numerous foreign investors which vigorously fostered the development of the financial sector and the economy. This is best confirmed by the key macroeconomic indicators recorded at the end of 2008: the real GDP growth rate amounted to 6.9 percent, budgetary surplus amounted to 0.5 percent of GDP, the public debt was 29 percent of GDP, and net FDI amounted to 18.9 percent of GDP. The credit boom in 2006 and 2007, when credit growth rates were extremely high, resulted in a threefold increase in the total assets of banks at the end of 2008 in relation to 2006, reaching the amount of 99.1 percent of GDP.

The first impact of the global financial crisis affected the banking sector at the end of 2008 and the beginning of 2009 and it manifested as a 25 percent deposit outflow. Owing to countercyclical measures introduced by the CBCG and the Government of Montenegro, as well as the ad hoc adoption of the Law on Measures for the Banking System Protection which provided blank deposit guarantee and measures for the preservation of liquidity and solvency of banks founded and operating in Montenegro, the banking sector managed to avoid liquidity crisis which would have inevitably resulted in insolvency of banks. During this period, parent banks significantly contributed to maintaining the stability and liquidity of the banking sector by means of a stronger financial support to their subsidiaries in Montenegro. Since the crisis outbreak, foreign borrowings constantly increased and reached their maximum level of 930.6 million euros in May 2009. Also, this was followed by stricter supervisory inspections that focused on systemic banks and the macro stress testing of banks' capital adequacy was conducted for the first time.

Figure 1 – Bank recapitalisation in 000 euros (left-hand scale) and solvency ratio in % (right-hand scale)



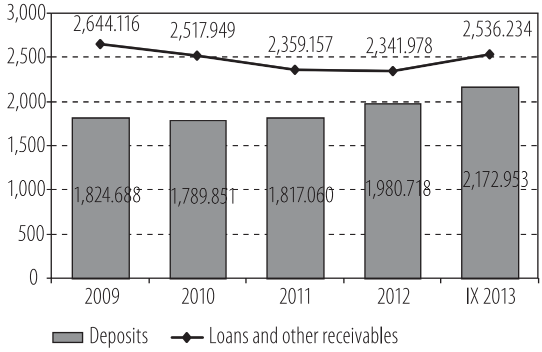
Source: CBCG

In the years following the crisis outbreak (2009 - September 2013), the banking system was recapitalised with 237.9 million euros, and the solvency ratio was above 14 percent over the entire period, which is way above the statutory minimum of 10 percent.

Since June 2009, funds deposited in banks, primarily by the household sector, have been recording a continuous growth which represents a reflection of trust in the banking system. At end-September 2013, bank deposits amounted to 2,172.9 million euros, and are approaching the level of deposited funds before the crisis (2,346.1 million euros).

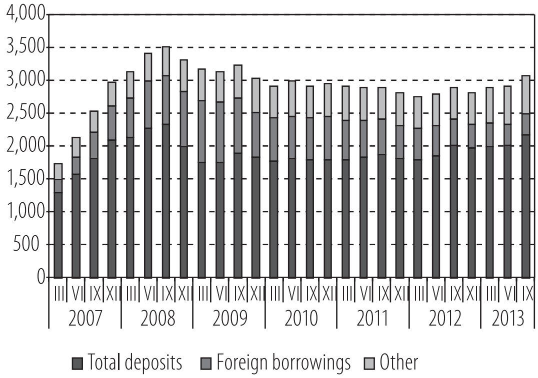
An increase in liquid assets both in Montenegro and abroad mostly resulted from systemic banks' rather prudential and conservative lending policy. The sovereign debt crisis that shook the EU home countries of parent banks having subsidiaries in Montenegro resulted in their firm position that subsidiaries should rely on their own powers and internal financing sources (domestic savings), which announced the deleveraging trend in the whole region. Banks' long-term restrictive lending policy with the lesson learned from the negative experience during the credit boom (2006-2007), which manifested through materialisation of losses and growth in non-performing loans as well as the obvious problem with the real sector's illiquidity, led to an increase in banks' liquid assets

Figure 2 – Total loans and other receivables and deposits, 000,000 euros



Source: CBCG

Figure 3– Total deposits, foreign borrowings (without subordinated debt and interest income) and other banks' liabilities, 2007 – 2013, 000,000 euros

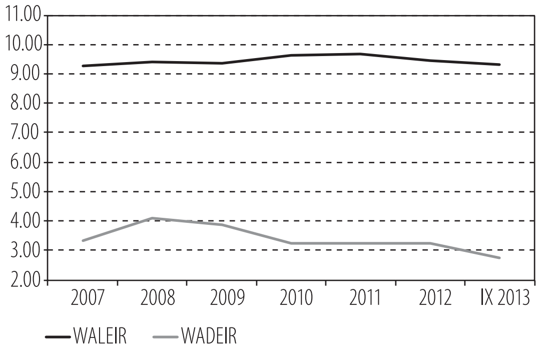


Source: CBCG

and incited the deleveraging trend. It should be taken into account that Montenegro, being a small and open euroised economy, is committed to ensuring unrestricted flows of cash and capital transactions.

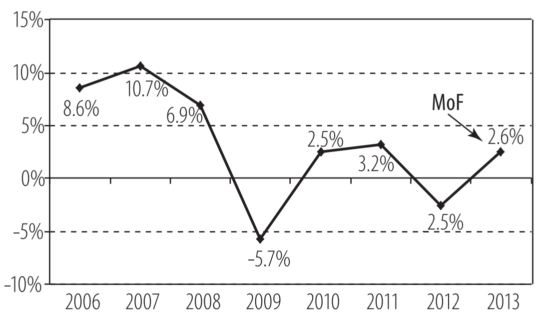
In the years following the crisis peak, lending interest rates recorded mostly a growing trend that primarily resulted in the high country risk premium, deterioration of the loan portfolio quality of domestic banks, operating expenditures, increase of client risk and illiquidity of the real sector, focusing on financing from the deposit potential. The growth of lending interest rates induced the growth of deposit interest rates. During the observed period, extremely high lending interest rates impeded loan repayments, leading to an increase in non-performing assets of the banking system and deepened the illiquidity of the real sector. Therefore, in November 2012, the Central Bank passed the Decision on Interim Measures for Limiting Bank Interest Rates which was in effect until May 2013. During this period, the weighted average lending and the corresponding deposit interest rates recorded slight downward trend, which continued even after the expiration of the Decision's validity.

Figure 4 – Weighted average effective lending (WALEIR) and weighted average deposit effective interest rates (WADEIR), in percent



Source: CBCG

Figure 5 – Real GDP growth



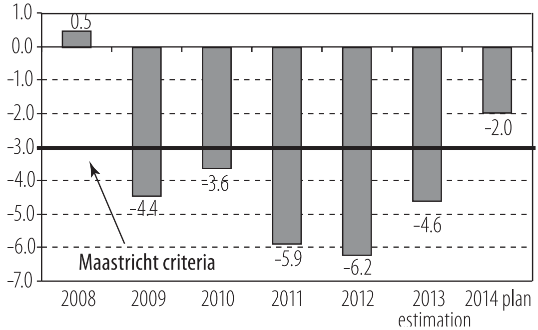
Source: Monstat

The crisis also deteriorated all key macroeconomic indicators. A significant drop in GDP of 5.7 percent in 2009 was followed by two years of slight recovery, but due to downward economic trends and bad weather conditions in Montenegro at the beginning of 2012, GDP recorded a 2.5 percent decline at the end of the year.

The analysis of the Montenegrin fiscal sector trends shows that Montenegro's recovery from the crisis from end-2008 to date has brought about fiscal adjustment that affected the emergence of fiscal deficit for five consecutive years. Comprehensive fiscal consolidation measures have been introduced and involve the expenditure reduction, expansion of the tax base and the introduction of new forms of taxation, a reduction of public sector salaries, the freezing of pensions, and the implementation of structural reforms. However, despite all efforts, the budget deficit rose from 5.9 percent in 2011 to 6.2 percent in 2012.

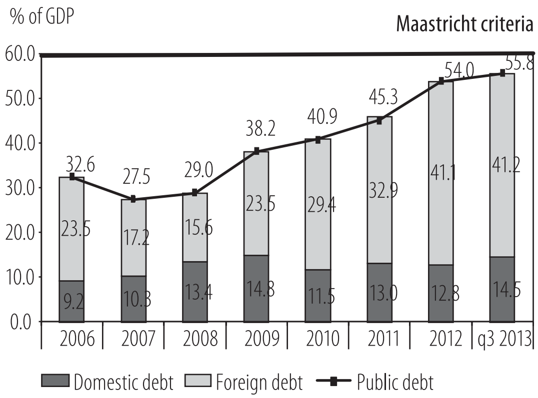
Due to the limited domestic funding sources, the deficit resulted in an increase in the government debt from 27.5 percent at end-2007 to 54 percent of GDP at end-2012. This represents the largest share of the government debt in GDP since 2003, when it amounted to 47.1 percent.

Figure 6 – Budget surplus/deficit, percentage of GDP



Source: Ministry of Finance

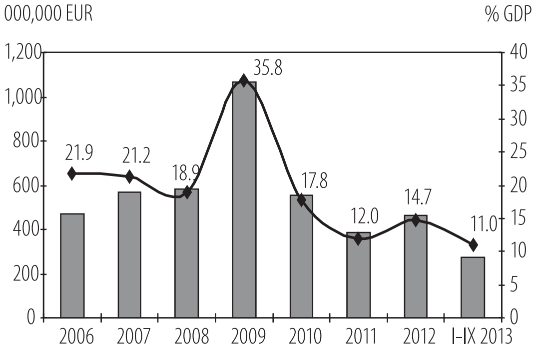
Figure 7 – Public debt of Montenegro, percent of GDP



Source: Ministry of Finance

This increase of debt came as a response to the crisis and countercyclical actions to avoid excessive reduction of public spending which would, in turn, further intensify the crisis effects. Only the level of net FDI almost doubled, amounting to 35.8 percent of GDP. The real economy was strongly hit by the crisis and it has not yet recovered; thus, it could not stimulate economic growth. Despite the adverse impact from the international financial markets, net FDI recorded a share of 11 percent of GDP at end-September 2013.

Figure 8 - Net foreign direct investment



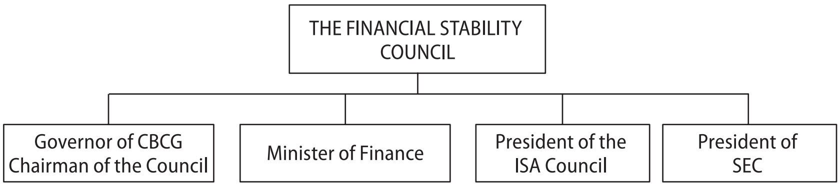
Source: CBCG

VII Montenegro's Framework for Preserving Financial Stability

As a result of an objective assessment of the situation and activities taken with a view to maintaining the financial sector's stability, as well as considering the current solutions and trends in this area devised by the international community, a set of financial laws was passed in July 2010 to provide the necessary regulatory and institutional framework for maintaining the financial system's stability. The enactment of the Financial Stability Council Law, the Central Bank of Montenegro Law, the Deposit Protection Law, the Law Amending the Banking Law, and the Law amending the Bank Bankruptcy and Liquidation Law provided the compliance of the regulatory framework with international standards and relevant EU legislation and directives in this area. The key innovations refer to the establishment of the Financial Stability Council, responsible for the monitoring of the financial system stability, whereas enhancing and preserving financial stability is stipulated as a responsibility of the Central Bank. Also, monetary policy instruments were extended to involve preventive actions, and the insured deposit coverage is set in the amount of 50,000 euros as of 1 January 2013.

The Financial Stability Council does not have the status of a legal entity, which means that it cannot pass regulations or prescribe measures, but only issue statements and warnings. The main tasks of the Council include monitoring, identification, prevention and mitigation of potential systemic risks within the financial system of Montenegro as a whole in order to ensure and maintain the financial system stability and avoid episodes that may lead to widespread financial distress. The Financial Stability Council is comprised of the Governor of the Central Bank, the Minister of Finance, the President of the Council of the Insurance Supervision Agency, and the President of the Securities and Exchange Commission. The Governor of the Central Bank chairs the Council as this stems from the Central Bank's constitutional responsibility for monetary and financial stability and banking system functioning. The Council passed the National Contingency Plan which enables efficient, effective, consistent and comprehensive functioning in the time of crisis.

Figure 9 - Structure of the Financial Stability Council



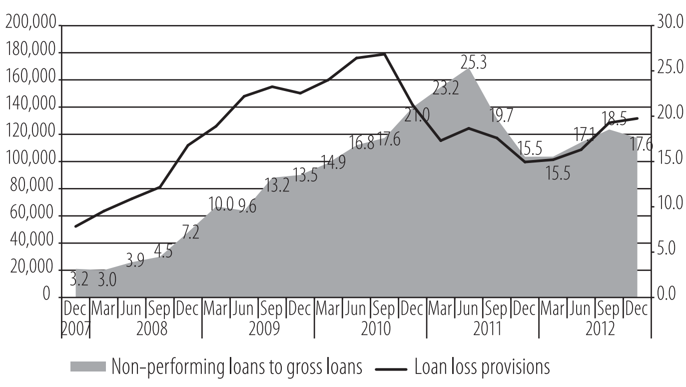
Source: CBCG

Unlike most central banks that accepted price stability as their main objective, the Central Bank of Montenegro opted for financial stability maintenance, including fostering and maintaining a sound banking system and a safe and efficient payment system, thus becoming one of the leaders when it comes to the implementation of modern monetary solutions. Such a solution was appropriate considering that the economy is euroised and has limited monetary policy instruments at its disposal due to the absence of the issuing function and the reference interest rate and the exchange rate. Therefore, the focus of achieving this goal inevitably shifted towards the fiscal policy instruments, in particular regarding the creation of fiscal buffers in times of stability which would serve as the key support to the financial sector in the time of crisis. This objective resulted in the Central bank's key function – to oversee the maintenance of the financial system stability as a whole and pass pertinent regulations and measures. The Central Bank became the lender of last resort and the Government can provide liquidity support to banks at the CBCG's proposal, so the framework for resolving problems in distressed banks has been improved. It also resulted in the expanded set of measures for corrective actions in banks that have not established adequate systems for risk management and which operations are not compliant with the law. The legislation specifies the trigger events for instituting interim administration and/or bankruptcy or liquidation proceedings against a bank and it also expands interim administrator's competencies. During and after the crisis, the Central Bank implemented countercyclical measures of monetary and prudential policy in order to prevent the escalation of risks generated in the system and their transformation into systemic risk. To this end, the CBCG has amended the reserve requirement policy several times, aiming first to encourage bank liquidity and then, after reaching this goal, to enable all banks to keep a part of their reserve requirements in Treasury bills. Strict prudential standards were relaxed in the part referring to the classification of assets and loan loss provisioning in order to mitigate the crisis effects. Also, IAS 39 and the so-called "prudential filters" have been implemented as of 2013. Banks are obliged to apply the internal methodologies for measuring the impairment of financial assets in line with IAS 39. The criteria and procedure for classifying assets and calculating loan loss provisions are stipulated for the purpose of reporting to the CBCG and examining capital adequacy and other indicators of banks' operations. This represents the "prudential filter" - a conservative approach to credit risk management, whose implementation means that the banks are obliged to allocate larger amounts of loan loss provisions in relation to those prescribed under the standards.

VIII "Podgorica Approach" - voluntary financial restructuring

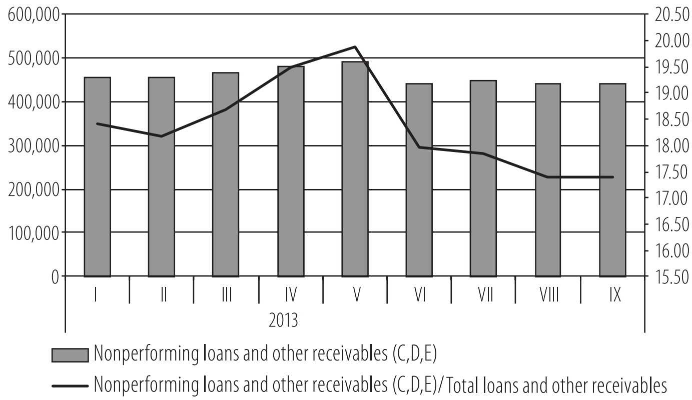
Credit risk has been assessed as a risk of potential systemic importance in the Montenegrin banking system. Since the beginning of the financial crisis, a deterioration trend in the quality of the loan portfolio i.e. increasing of non-performing loans in the Montenegrin banking system has been significant. In September 2008, non-performing loans accounted for only 4.46 percent in total loans, while they peaked to 25.75 percent in May 2011. By end-2011, the share of non-performing loans in total loans decreased to 15.5 percent due to the transfer of a portion

Figure 9: Non-performing loans to total loans ratio (in percent) and loan loss provisions (in 000 euros), 2007-2012



Source: CBCG

Figure 10 – Total non-performing loans and other receivables, 000 euros (left-hand scale), share of non-performing loans and other receivables in total loans and other receivables, in percent (right-hand scale)



Source: CBCG

of the loan portfolios to parent banks or factoring companies. However, despite the taken measures, non-performing loans continued trending up, reaching 17.6 percent of total loans at end-2012.

The upward trending of non-performing loans continued in 2013, but in June they started to decline due to the sale of assets in the amount of 65.5 million euros.

In the period 2006-2013, Montenegrin banks sold a total of 710.1 million euros worth assets to factoring companies and parent banks. Despite the significant results that banks have made in improving the quality of their loan portfolios, the vulnerability of the banking sector remains the key challenge in 2014. Namely, the situation is further complicated with a high degree of illiquidity in the real sector and its negative feedback loop in the banking sector through two channels: (i) irregular servicing of liabilities that affects the liquidity of the banking sector and encourages a growth in non-performing loans, and (ii) reduced room for credit investments and thus determined lending policies of banks. At end-November 2013, of 54,785 legal entities and entrepreneurs, some 12,761 or 23.3 percent were blocked and this was the month-on-month increase of 1.6 percent. Total debt against which the accounts were frozen amounted to 425.9 million euros or 1.6 percent less than at end-October. As at 30 November 2013, debt concentration was relatively high since the debt of ten largest borrowers (0.08 percent of total registered borrowers) still amounted to 22 percent of the total debt due to which the accounts were frozen. In addition, fifty largest borrowers (0.39 percent of total registered borrowers) accounted for 46.1 percent of the total debt.

Since individual approaches to debt restructuring that were primarily based on debt rescheduling yielded positive effects only in cases where a debtor faced temporary problems, it was assessed that the resolution of non-performing loans would require a systematic approach. During 2012 and 2013, activities were intensified to strengthen the regulatory and supervisory framework needed to solve not only problems of non-performing loans, but also of growing financial debt in general. In order to solve the problems of companies and entrepreneurs whose activity is economically viable but which are in default due to the lack of liquid assets, experts of the Central Bank, the World Bank and the Ministry of Finance prepared a draft Law on Voluntary Financial Restructuring as a part of the financial debt restructuring project ("Podgorica Approach"). The Law created an incentive regulatory framework for the support and encourages realistic restructuring of economically viable business entities in out-of-court proceedings, which will eliminate reasons for their bankruptcy that, as a rule, brings creditors and debtors in difficult position. The proposed Law is based on the concept of voluntary restructuring, with certain incentives for both creditors and debtors. Financial restructuring, within the meaning of this Law, implies the redefining of the debtor-creditor relationship between the debtors - a legal person (company or entrepreneur) and/or a natural person (mortgagor) eligible for financial restructuring and the creditors, with the exercise of certain rights to incentives. The Law regulates the conditions and manner of voluntary debt restructuring, i.e. loans classified in categories "B" and "C" by banks and MFIs licensed by the Central Bank, as well as the leasing companies with registered office in Montenegro. Financial restructuring can be implemented only if the debtor and at least one financial institution acting as the creditor consent to participate in this process. In addition to financial institutions, all other domestic and foreign creditors of the debtor, including foreign banks, may participate in financial restructuring. The implementation of the adopted solutions will contribute to attaining the following objectives: stimulating the recovery of the debtor i.e. users of housing loans experiencing financial problems, maintenance of the financial system stability, and provide access to new sources of financing to stimulate economic recovery and growth. The Law will become effective two years following the date of its entry into force. As a part of the same project, the Central Bank made amendments to the regulation at end-November 2013 to bind banks to develop a comprehensive strategy for dealing with non-performing loans for a period of three years, set annual operational targets for reducing the level of non-performing loans, and submit quarterly reports on the implementation of operational goals. The next phase of the project involves the development of new supervisory techniques and key performance indicators to be applied in off-site and on-site supervision and the monitoring of the process of voluntary financial restructuring of companies.

Conclusion

Financial stability is a public good, not only of national but of global importance as well. This perception has encouraged the international professional and financial public to examine all consequences of the global financial crisis and reaffirmed their position to act uniformly in creating a new institutional and regulatory framework for maintaining financial stability. Montenegro has followed the same path, thus showing its full commitment to the implementation of European and international standards in the area of macroprudential supervision and regulations. The establishment of the Financial Stability Council ensured a comprehensive approach in the assessment of the financial system risks. The same approach was implemented in solving the problem of non-performing loans and creation of the "Podgorica Approach", which implementation will start during this year. Since there is an ongoing threat of aggravating the accomplished level of financial stability against the backdrop of the global economic and financial flows globalisation, the time ahead will serve as a filter to assess the effectiveness of the current solutions and modalities in financial stability maintenance.

References:

1. Borio, C., 2003, Towards a macroprudential framework for financial supervision and regulation?, Bank for International Settlements.
2. European Central Bank, 2012, *Financial Stability Review*, December 2012.
3. European Central Bank, 2013, Preparatory work for banking supervision at the ECB, Financial Stability Review, November 2013, Frankfurt.
4. European Commission, 2012, New crisis management measures to avoid future bank bail-outs, Press release
5. Hannoun, H., 2010: Towards a global financial stability framework, Bank for International Settlements.
6. International Monetary Fund, 2013, The interaction of monetary and macroprudential policy, IMF.
7. Schinasi, G.J., 2006, Understanding Financial Stability: Towards a Practical Framework, Seminar on Current Developments in Monetary and Financial Law, Washington, D.C., October 23-27, 2006.