**Key Note Speech of the President of the Council of the Central Bank of Montenegro, Ljubiša Krgović, at the Conference of Banking Supervisors of Central and Eastern Europe (BSCEE)**

*Miločer, 10 April 2006*

***Ladies and gentlemen bank supervisors, dear guests,***

*I would like to greet you on behalf of the Central Bank of Montenegro, all the citizens of Montenegro and myself. It is a special honour to host this meeting in Montenegro in the year in which we will celebrate the centenary of the minting of the first Montenegrin coins, which marked the basis of the banking system of the then independent Montenegro, internationally recognized at the Berlin Congress. Moreover, it is always my special pleasure to speak about bank supervision. I think that bank supervision today, more than ever, relies on a scientific approach and simultaneously combines the elements of ones vision, intuition, experience and perhaps even art. The work of bank supervisors often remains invisible and, paradoxically, the less visible it is, the better it is, in most cases.*

*In this brief address, I would like to underline and share with you some experiences from the past and challenges awaiting us in the future, in the hope that I may initiate the discussion of some of these issues at this conference.*

## *The role of bank supervisors becomes increasingly challenging*

*In the last two decades, we have witnessed dramatic changes both in banking practice and in banking regulation and supervision. Could any of us foresee such changes in the second half of the eighties? Let me remind you of some particularly important changes: in global terms, the amount of credit per capita have increased several times faster than GDP per capita; banking products have multiplied and banking operations have become much more complex; combinations of banking, capital market operations and insurance under common ownership have become more and more frequent; new technologies have changed banking methods globally;*

*the global banking system is becoming more concentrated; there have been more banking crises in the last two decades than ever before and their consequences have been more far-reaching than ever before; banking has become the key generator of development but at the same time the key generator of crises; monetary policy has possibly lost its absolute supremacy in relation to bank supervision in the resolution of certain issues, and so on. The last two decades have shown the extent to which supervisors have been faced with an industry that works under stress. And that is exactly what prompted so many changes in the approach to bank supervision since Basel I and Core Principles of Efficient Bank Supervision, through their Annex treating market risk management, to Basel II, the latest CRD European Directive and the current revision of the core principles which are currently ongoing.*

*The role of bank supervision is becoming more challenging than ever before. The source and character of those challenges are multiple. I will mention only some of them that I consider the most important.*

*We need a banking system that will not only be safe but also innovative and able to respond to the requirements of clients and economic development. One of the biggest challenges for bank regulators and supervisors is therefore to find an optimum balance between financial stability, i.e. the safety and soundness of the banking industry, and economic development. Bank supervisors and regulators must promote the safety and soundness of the banking industry, allowing banks to expand, be innovative and competitive. You will agree that there are many inherent contradictions between these two goals. And, of course, the biggest problem is how to deal with the implementation of these goals on a daily basis. Can we always claim with certainty and support by facts what is, and to what extent, "unsafe and unsound" even when we have the knowledge to perceive such activity. Or, what is "efficient competition" in the conditions of ready access to subsidized sources of financing and safety nets. Or, to what extent and at which moment we, as supervisors and regulators, should interfere with management decisions with which we disagree?*

*We are all aware of the typical and predictable pattern of banks' procyclic behaviour. It comes down to the fact that crediting terms and conditions are relaxed in periods of a general expectation of positive economic cycles - and vice versa. The challenge faced by supervisors is how to alleviate this pattern of behaviour. But in practice it means conflict with general expectations and all who are interested in stimulating* *these positive expectations. Again, the role of supervisors in decreasing the procyclic behaviour of banks becomes more complicated when we add the fact that credit officers and bank management are motivated to strengthen credit expansion, market participation and nominal profit. Compounded by the dynamics of banking product expansion, which historically carries more risk in the phases of development and implementation than the banks are able to recognize and measure, the size of challenges faced by the supervisors increases in magnitude.*

*I am sure that you will agree that all of us, as supervisors and regulators, are more or less confronted with a challenge how to fit the numerous obligations related to concrete bank supervision tasks with an obligation to monitor changes in bank regulation and supervision standards, to participate in international bodies and develop mutual relationships. There is currently a great focus on the implementation of numerous standards by national authorities with the assistance of the international community. The Financial Stability Forum suggested, for the purpose of strengthening financial systems, that countries should give priority in the implementation of standards in twelve practical areas, and the IMF and the World Bank have developed tools for the evaluation of progress that countries achieve in the implementation of rules and standards. Standards of particular relevance to the development of a stable financial system are evaluated through FSAP (Financial Sector Assessment Programme). The Report on the Observance of Standards and Codes (ROSC) gives a summary evaluation of progress made in the implementation of standards in individual areas in the countries that have been evaluated through FSAP. At the same time, it helps creditors and investors to better evaluate the credit and investment risk of a country in comparison with others. Are our capabilities adjusted to these needs? Can we, as supervisors, adjust our organizational structures to these needs with sufficient frequency? What are the restrictions and possibilities of motivating our staff to constantly improve their skills and at the same time properly respond to their daily obligations? How well are we using our own resources and how do we plan our activities? These and many other questions are obligations to think about and act on both strategically and on a daily basis. These are the key reasons why an increasing number of countries consider the idea of consolidation of supervision in the overall financial system. I must say that such a need has not been sufficiently perceived in Montenegro so far, beyond the Central Bank.*

## *The concept of supervisors' response to challenges*

*What pattern of behaviour should be established in response to these huge challenges facing bank supervisors?*

*One of the approaches for bank regulators and supervisors is to be extremely liberal and allow full freedom of action to financial institutions. Of course, this approach is untenable in the long run, for at least two reasons. Firstly, the public interest in financial stability would be exposed to great risk and a global crisis of such a market, with unforeseeable consequences, would be unavoidable. Secondly, the advantages of the application of internationally accepted standards would thus be eliminated.*

*Another possible approach is over-regulation and supervision of banks without a particular attitude to any particularities. It is also untenable in the long run for many reasons, two of which I would point out. The first one is that it suppresses innovation and motivation in banks. Life is much more dynamic than rules. The second one is the inability of supervisors to maintain such an approach, which eventually leads to anarchy.*

*The third possibility is the one that all of us try to support. It is the approach of urging the industry to improve risk management, to solve its own problems, to develop strategies that will ensure more stability in the credit market and more competition and long-term return on investments. It is the approach that brings the categories of economic and regulatory capital closer. It must be based on the premise that "one suit cannot fit all". On their part, bank supervisors applying this approach must strengthen risk-based supervision, must devote more attention to emerging weaknesses and act very quickly towards eliminating them. While public policy requires us to limit the financial and social costs of bank failures, it must not be understood that a bank failure means a regulatory and supervisory failure. To do our job properly, we must understand that the economic purpose of banks is to undertake risks, and therefore, to count on mistakes. A perfectly safe bank would not be of much benefit either to the economy or to its shareholders. At the same time, our intervention is necessary in ensuring that a bank does not take risks that it is not prepared to manage. Such an approach demands that the community understands what is said in the Basel framework (paragraph 779): bank supervision is not an exact science and therefore discretionary elements are unavoidable in any supervisory approach.*

*Montenegrin experience*

*Following this pattern and modifying it after changes in the industry itself and changes in standards, we have managed, for a very short time, to stabilize the banking sector in Montenegro and to direct it to the path of accelerated development. It has become the key generator of economic changes in a positive direction. We have managed to provide a high degree of compliance with the Basel principles of efficient bank supervision and we intend to continue to anticipate changes in banking, modify our approach, as required, and adopt the principles of Basel II. The fact that we have been, so far, successful in changing the perception of the industry itself and also public opinion, we consider our great success. That has been achieved by our own efforts and resources, proving that potential is always the highest when devotion to your own problems is also high.*

*Supervision as the realm of national sovereignty*

*I think that there is no other area than the supervision of the financial system where the Westfalian system of absolute state sovereignty has been maintained so firmly. It is naturally so because the costs of a financial crisis are, eventually, paid by citizens of the country in which it has occurred. The established international standards are the result of the recognition of common interests and a form for preventing global crises. It is obvious that new market and political forces have changed European societies to a considerable degree in the last two decades, but sovereignty in the area of supervision of financial systems has mostly remained intact. Briefly said, although we work in a new global environment, I can still see the classic power of the state controlled in a new way that respects certain restrictions that have not existed before, but are equally necessary and desirable.*

*Conclusion*

*None of us have any illusions that bank supervision is not an extremely sensitive and complex area. There are no simple solutions, but I would like you to remained assured that, as this conference shows, any cooperation between supervisors and the resultant discussions do serve their purpose, regardless of the fact that they may not reach immediate results and conclusions.*

***I wish you a pleasant time in Montenegro and a successful conference!***