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Futuristic View of Banks in Albania

Speech at the Albanian Association of Banks New Year Dinner

Tirana, 19 December 2012

Honourable Governor Fullani,

Chairman of the Albanian Association of Banks, Mr. Pencabligil,

Ladies and gentlemen,

Dear friends,

It is a great privilege and a special honour to have an opportunity to address this gathering tonight. The AAB New Year Dinner is a special occasion in itself, but, as you know, this year is not just any year, but a year in which Albania is celebrating the 100th anniversary of its independence. So, happy Independence Day, Albania.

Please accept my apologies as tonight I am not only emotional because I am back to Tirana, where, as some of you know, I lived for some time, which I visited very regularly in the last few years and where I am privileged to have friends. For me addressing the AAB is special as I remember very well my conversations in the spring of 2001 with the then newly elected Chairman of Albania's Bankers Club. We spoke about the role of bankers associations and their relations with central banks. I am sure you know the name of that person. How then not to be thankful for this opportunity to be with you tonight?

Banks in Albania, as I have recently learned, have a long history. The AAB, as you know, has just published a wonderful book entitled Historical View of Banks in Albania. Banking activity has been documented since 1839, and a central bank formed in 1863. But no more history, I am personally very much interested in the future as I intend to spend the rest of my life there. And the title I gave to this speech: The Futuristic View of Banks in Albania is a direct reference to the book I have mentioned. I am quite nervous about this speech because I am not sure if I will deliver the topic I have chosen tonight.

Before I give you the opportunity to judge, let me ask you a question. How much can we really know about the future? If you promise to keep it for yourselves and not to tell it to my boss or our new heads at the parent bank in Milan, I will share with you a very telling story. The story goes like this. A then young psychologist by the name of Phillip E. Tetlock did not believe much in expert forecasts. So in 1984 he started an experiment. What he did is ask about 300 experts in many fields, including government officials, professors, journalists, etc., to make more than 27,000 predictions about the future. He asked quantifiable, verifiable questions. In 2005 he published the results in the book entitled Expert Political Judgment. His findings? Experts' forecasts were only slightly more accurate than chance. Let me repeat this once again: slightly more accurate than chance. Interestingly, they were worse than basic computer algorithms (which extrapolated trends).

In other words, experts' judgments about the future are not very useful. We tend to believe them, we make them all the time, I earn my living by making forecasts, and yet, as Tetlock demonstrated, they are not very accurate. I think we all lost a lot of faith in forecasting when a black swan appeared in the form of the crisis that we are still in today. The point is: we all need to be much more humble about our ability to predict complex and dynamic systems that our economies are. Long time ago, the world was simpler, easier to predict. So, let me share with you one of my favourite sayings: the future is not what it used to be. Sounds ironic, but it is true.

So, although I may seem to contradict what I have just said, let me start presenting my futuristic view of banks in Albania by saying that it might be shaped by two sets of forces:

- macroeconomic forces, both domestic and international, and
- micro trends in banking.

I. First, the macroeconomic trends that will influence the banks in Albania. Here I have chosen three issues, out of many:

II. a) a new growth model;

b) the financial crisis and new banking regulation; and

c) the banking union in the eurozone, EU, and its consequences for our countries.

a) As regards the new growth model, I would like briefly to point out the following. Most of the countries in the region experienced high growth rates before the crisis and so did Albania, with a rate of 6% from 2000 to 2008 or more than 7% before that period. For 2013, the IMF predicts about 1.3%, but a bigger issue is that one can expect the growth rates of the Albanian economy in the next 5-10 years to be roughly half of those achieved before 2009. This will have consequences for banks. The loan growth will not reach the high double digit figures that we observed in early this century; ROE will not return to 20%+, the NPL ratio will continue to be an issue in the medium term. Bottom line, we live in a different world, and need to understand the new normal. This is not a cyclical crisis and soon we will be back to, say, the world in 2002. And even this much lower growth is not guaranteed. The eurozone crisis will be with us for some time. The euro will not disappear (yes, this is a bold statement), but bankers have to realize that growth rates of the economy and of banking aggregates will simply be much slower, not only in 2013 but in the medium term too. So, please do keep this in mind. Yes, I know I should send this message to your home banks next time you discuss budgets for the next year and settle for KPIs.

b) New banking regulation. I have to mention it for the big picture, no doubt, but I will not spend much time on it. In spite of the fact that Basel III, neither its capital requirements nor liquidity requirements like the NSFR or LCR will be automatically applied to our countries, no doubt they will affect us, if not via domestic regulation than via parent banks. Let me mention just one consequence. When they were developing the new capital adequacy rules (CAR), the regulators seemed to have forgotten that the CAR is a ratio. One can increase it either via an increase in capital or a decrease in assets. So one should not be too much surprised to see deleveraging taking place in our countries. I know that the LDR is not binding for Albanian banks on average, but this is a relevant issue and it will affect inflows in the future. Less capital which will flow to the countries with a higher EVA. In short, the trend is clear, let us be vigilant and see what happens. The changes in the regulation happening now are the biggest changes in decades, on the international level, of course.

c) The banking union. Much has been said in Europe about the vicious circle between sovereigns and banks in the eurozone. One of the ways to try to destroy this loop is setting up a banking union. And after a lot of haggling, political negotiations, speculations, poker bluffing, Europe at last agreed along the following lines. The banking union should have three pillars: the SSM or Single Supervisory Mechanism, the Single Resolution Mechanism and joint deposit insurance. So far, only the SSM has been agreed upon, under the auspices of the ECB for banks with assets more than EUR 30 billion or systemically relevant in a country. And only for eurozone countries. The SSM should became operational in March 2014 (i.e. the ECB should take it over then). It may not sound as much, but this is relevant. For example, if foreign banks “enjoy“ even indirect supervision by the ECB, will small domestic banks look riskier to depositors? We, in this region should not neglect these developments. The EBRD Transition Report 2012 (I had the honour to participate in its launch in London) speaks about possible negative consequences of this union for our countries. A lot of questions remain. Will we be left out? Even if we one day we opt in (which is not certain) will the ECB as supervisor pay enough attention to us? Or, what will it mean if they shut down a bank (God forbid a parent bank or our subsidiaries) and our countries are left with the bill? Neither the Governor nor Indrit need to worry about this today, but they absolutely must follow this very closely. Banks and their supervision, resolution etc., are a much more dangerous field than monetary policy. I have the experience of managing a full-blown banking crisis in my country in the 1998-1999 period. I was left with the blood of 20 banks I had to close down on my hands. Not only did I lose my job as the governor because of that, but, much worse, I also lost my hair (as you can clearly see today). Losing the job proved to be for the better, as I ended up working in Tirana, a big benefit. But hair? Of course, there is always the Berlusconi solution, but can you imagine me with black hair and a lot of it? Banking supervision and resolution are not academic or intellectual exercises. For example, the latest fashion in central banking is that countries should not only target inflation, but either announce that interest rates will be low until unemployment exceeds 6.5% (the FED with a different mandate) or toy with targeting nominal GDP rates, not inflation (the new BoE governor Carney). I am not saying those are intellectual exercises only. But, banking and financial crises, as this country knows all too well, are messy, costly, and lengthy, they may be bloody and aggressive, there is nothing nice and decent about them. So, the developments regarding the banking union in the EU should not be taken lightly neither by domestic regulators nor by banks. Any bank's main asset is its credibility, and we should do all in our power to preserve it.

II. Micro trends in banking.

I have tried hard to identify the main trends we are going to face in the near and not so near future. I have googled "trends in banking 2013", talked to clever people, thought about it a little bit myself, etc., and I found out many issues to be discussed. Finally, I decided to settle on two topics, both of them in the retail segment. One is mobile banking and the other concerns the changing of bank branches.

- Mobile banking. This is a serious change. Yes, Internet banking has been around for a while. Basic mobile banking as well, via SMS, etc. All of this was before smartphones and tablets became so dominant. Internet/mobile banking via smartphones/tablets has changed the way we do banking in a very substantial way. According to data by the Intuit company, published December 17 this year, we can see the following trends. First, mobile customers are in much more frequent contact with the bank than before. From the desktop internet they would log in on average 10 times a month. From mobile/tablets 31 times a month. The higher engagement results in financial outcomes for a bank, so mobile and online users are 61% more profitable than offline customers. I will repeat, 61%. This is nothing new to us, but I was still surprised by these figures, i.e. by the difference. Investing in digital channels is obviously a good thing to do. With smart phones we can pay bills from anywhere and obviously customers like this. Mobile phones are changing and they will change the way we do payments even more. The NFC (near field communication), Google Wallet, etc. are just some of the innovations that will make us change not only the way we use cash, but also the way we use plastic. I do not believe that cash or plastic will disappear, but the way we do payments will change in the future.

- We also have to point out the changing role of bank branches, to some extent a consequence of the above mentioned trends. Traditionally, the more branches the bank had, the bigger it was, as customers valued the national network of branches. Truth to be told, when Internet banking was developed some predicted the death of brick and mortar banks. As we can see, they are alive and kicking. So brick and mortar branches will not disappear, but their nature has changed and it will change even more in the future. McKinsey has been collecting data on visits to bank branches in the US for the last 13 years. Last year, for the first time, the number of visitors fell by 5%. In the Netherlands only half of all bank customers entered a branch last year and 80% use Internet banking.

  Bank branches are expensive, so there is a need to find more profitable opportunities for customers to use them. Simple transactions will be pushed even more to ATMs, mobiles, the Internet, i.e. to automated channels. Branches should be viewed in such a way that every conversation with a customer is a potential advice and sales opportunity. Banks should reinvent branches, think about value added for customers. It is very expensive to come to a branch just to pay a bill. This will probably result in fewer branches, which will be significantly modernised, resembling coffee shops; bank officers will need to be better educated, become better salespersons, walking around with iPads, and branches will be run much more efficiently. More value added in personal contact with customers is the key. Think of it next time you are opening a traditional branch, it may be the last one you open in this way.

III. Finally some good news, I am near the end of my speech. But before I finish, let me humbly suggest what you bankers might consider doing. Two issues: the first is innovation and the second one is data mining and finding your own trends

What does innovation in banking mean? Some banks are creating innovation divisions, the same as big IT companies Apple or Google. They hire top talent to work there. And here I am not talking about IT divisions in banks, I am talking about banking divisions. There is a need for increased profitability in banking. I have mentioned the falling ROE, the pressure to "deliver" measured by EVA, the increased competition among banks. In a slow growing market, with lower volumes of growth than before, what we need are new products. And profitability for a successful new product is there for those who hit the market first. Well, you may say, but we are all subsidiaries, why invest in innovation when our parent banks are telling us what to do? Of course I am confident that a lot of products can be successfully sold across countries, but not all. Some are very specific to a country, depending on its culture, habits, local regulation currently in effect, etc. So, not all products that are maybe attractive within our banking group in another country might be as successful in ours. The Czechs do not like debit and credit cards. We in Croatia love them. Some countries have never experienced depreciations and hyper inflations and trust their own currency, in former Yugoslavia we did not (at least not much). Monetary regimes are different and so are banking products. Even if we take a product from our group we have to adjust it to a specific market. So, the key word here is "fast". As the competition increases time to market will decrease. Others observe carefully and they will catch up. Once a product is mainstream its profitability will decline. So think of having a CIO –a chief innovation officer – within your bank. Innovation is not only for Google or Facebook, you should engage in it too, even if on a smaller scale. It could turn out to be a smart decision at the end of the day.

The second thing I propose to you is more data mining. What do I mean by this? Banks have a fantastic amount of information (about their customers) but this information is not used to its full potential. We live in the era of analytics. Previously, the available information was too large to manage. Today we have huge and expensive IT systems, which we feel sometimes run our banks (with risk managers). A digression. If an observer from outer space watched our credit committee meetings I am sure he would conclude that the CRO is far superior to anyone in the bank, including the CEO, President, whoever. So, for example, we can now focus much better on the profitability of a single retail customer. This was not possible before. By profitability I mean the profitability of a typical bank customer who has a time deposit, current and gyro accounts, mortgage and cash loans, 2 debit and 3 credit cards, uses Internet banking, m-banking, who has maybe bought some insurance with the bank and invested in the bank's fund and, of course, makes his payments either over the teller or via the Internet. Can you tell today what the profitability of such a client is? Can we cross-sell something according to his needs? Maybe this guy, or his wife, has a company or is an artisan? Let me say this. Until now banks have been selling products to their customers. We invent a product, like a new hamburger or a soft drink, and then market it, sell it to customers. What we should do in the future is try to find financial solutions for our customers. This is a different approach.

I know that you are probably puzzled now and think that I am trying to convert banks into universities, think tanks or incubators, while we still have to fulfil those KPIs given by our headquarters. But my point is that we live in an uncertain, dynamic and rapidly changing world. Only those that adapt will survive. Think of dinosaurs. They had been running the world for millions of years, yet as they did not adapt to climate change, they perished. So did big corporate giants that did not adapt. Remember Kodak? Did not adapt to digital technology and disappeared? Remember Pan Am? They underestimated the deregulation impact and are no more? Even Nokia, Finland's pride, was late with smartphones and is now barely surviving. Finally, think of Lehman Brothers, Bear Sterns, or some of 100 plus banks that have failed in the US every year since 2009. We may not know the future, but in our region we have the privilege to observe the trends and follow them sooner rather than later.

When I started making forecasts, someone told me that it was very difficult to make any kind of forecast, especially the ones about the future. So, will my speech prove me right or not? I am afraid there is only one way to find out. You should invite me again in the future to analyze whether your time was completely wasted tonight or maybe there was at least one hint that you found useful. Thank you and hope to see you soon to discuss this answer.