CENTRAL BANK OF MONTENEGRO

MACROPRUDENTIAL POLICY FRAMEWORK

June 2018

SUMMARY

The authority for safeguarding financial stability in Montenegro lies with the Central Bank of Montenegro. To that end and in accordance with best practices, the Central Bank has been entrusted with the pursuit of macroprudential policy.

This document defines the policy framework and its main and intermediate objectives, potential indicators, and instruments for the implementation of the set objectives. Through its pursuing and aligning with relevant international regulations, still taking into account the particularities of the national legislative framework, the created Framework provides an overview of policy actions and intermediate objectives and the ability to apply recognized instruments.

As a strategic course for the Central Bank's institutional and regulatory framework, the EU integration process steers the drafting of the national legislation under the competence of the Central Bank towards its full alignment with the EU acquis. In line with such long-term orientation, this framework has been created and it includes the Recommendations of the European Systemic Risk Board ESRB/2013/19 on intermediate objectives and instruments of macroprudential policy, and commends the EU Regulation 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

Montenegro's financial system is bank centric, with the banking sector accounting for over 90 percent of total assets of all financial market participants (money, capital and insurance markets). In this way, and in accordance with its supervisory and regulatory powers covering the operations of credit and other financial institutions (leasing, factoring, purchase of receivables, micro lending, and credit and guarantee operations), the Central Bank recognizes and controls the risks that may affect the financial market. Other segments of the market are subject to the authority of other regulators: the Capital Market Authority and the Insurance Supervision Agency with which the cooperation in risk identification and monitoring has been achieved through the work of the Financial Stability Council, which also includes the Ministry of Finance.

1. Mandate for implementing macroprudential policy in Montenegro

The macroprudential policy mandate is assigned to the Central Bank. Setting up a clear Framework with proposed potential instruments is the basis for a transparent and reliable policy pursuit. The importance of maintaining and safeguarding financial stability, as a non-quantitative objective, can be recognized in the benefits for the entire economy as viewed in smooth market functioning. This is the main reason why both theory and practice increasingly recognize this objective as a "public good".

This document details the macroprudential policy objectives and instruments implemented by the Central Bank of Montenegro.[1] Its objectives are:

a. setting the main policy objective, i.e. maintaining financial stability, and its connecting to indirect objectives and macroprudential instruments;
b. giving proposals for the use of recognized instruments in an efficient and effective manner.

2. Legal framework in Montenegro

The Central Bank's mandate for pursuing macroprudential policy stems from Article 143 paragraph 1 of the Constitution of Montenegro (OGM 01/07) that specifies that the Central Bank is an independent organization, responsible for monetary and financial stability and banking system operations.

The Central Bank's mandate for pursuing macroprudential policy is clearly regulated in the Central Bank of Montenegro Law (OGM 40/10, 46/10, 06/13, 70/17), which sets out that:

- the main objective of the Central Bank is to foster and maintain the financial system stability, including fostering and maintaining a sound banking system and safe and efficient payment systems (Article 4 paragraph 1);

[1] Macroprudential policy is subject to continuous development in order to ensure its compliance with applicable EU regulations.

- the Central Bank oversees the maintenance of stability of the financial system as a whole and pass pertinent regulations and measures (Article 14 paragraph 1);
- the Council of the Central Bank decides on the introduction of protective and other measures for the purpose of maintaining stability of the financial system as a whole (Article 44 paragraph 2 point 10).

With the aim of ensuring a comprehensive systematic approach to safeguarding the system's stability, the Central Bank also acts through the Financial Stability Council (FSC). In addition to the representatives of the Central Bank, the FSC comprises of representatives of the Ministry of Finance, the Capital Market Authority, and the Insurance Supervision Agency. The FSC was established in July 2010 under the Financial Stability Council Law (OGM 44/10) and it started operating in October 2010. This body represents an efficient manner to track and identify risks that could undermine financial stability. The Council's activities are aimed at preventing or mitigating potential risks in Montenegro's financial system.

3. Financial stability

Financial stability implies the stability of the constituent components of a country's financial system - financial institutions, financial market, and financial infrastructure. This concept entails the monitoring and control of systemic risk, as the risk of disturbance in providing necessary financial system products and services. Systemic risk management minimises the likelihood of these disorders in the financial system functioning as a whole, which could also reflect on the real economy and thus hamper the country's economic growth.

As indicated above, the Central Bank of Montenegro perceives financial stability as a condition where systemic risk build-up is prevented and safe and efficient market mediation is ensured.

4. Systemic risk in the financial market

Systemic risk represents the overall market risk and it reflects the situation regarding financial stability. It comprises of all relevant risks existing in the economy. If not adequately assessed and sufficiently controlled and/or covered by protective mechanisms, this risk could jeopardize financial stability. The policy's focus on financial stability requires continuous monitoring of all changes in economic factors and the creation of solutions that will foster a safe and sound financial sector and a competitive business environment that facilitates the economy's growth.

Systemic risk is the risk of major disruptions in providing financial services, which could have significant negative effects on the real economy and the financial system. Macroprudential instruments are measures aimed at diminishing or eliminating identified risk and they can be applied individually or as a group of multiple instruments. Moreover, measures can cover multiple categories or targeted exposure categories.

Timely identification of potential systemic risk is highly important. A detailed risk analysis needs to assess the instrument or a group of instruments to be applied, and/or those to be excluded to mitigate or eliminate risk. Therefore, preventive monitoring of all financial system elements is also an integral part of this framework.

Systemic risk analysis involves analysing two dimensions of impact: structural and cyclical. The first dimension depends on the interconnectedness of market actors, similar strategies of doing business and/or joint exposures to potential negative phenomena. When there is a bigger and stronger connection between the market entities, the spillover of negative impacts will be greater and stronger. In this sense, in small and open economies with strong intertwining of business and ownership of market entities, this effect can lead to a "domino" effect. This means that instability of one entity can jeopardize stability of other entities via a chain reaction. Another dimension, which can emphasize and deepen the impact of particular events in the market, is a cyclical component. If market actors behave cyclically in the market, this may reduce rationality and efficiency, i.e. lead to excessive risk taking during the expansion period, yet to a reduction or even a suspension of credit activity during contraction. Both phenomena create problems in the real economy. The monitoring and analysis of both influence channels, and the anomalies that may arise, serve as the basis for creating a framework for implementing a systemic risk policy. This policy has to prevent the accumulation of inefficiencies that could lead to market instability. Such framework actually becomes the policy action domain with a wider macro approach which shifts the focus from supervision and control of one participant or from one objective to the entire system. This policy is being used increasingly nowadays, and it is called macroprudential policy.

5. Macroprudential policy

Macroprudential policy is policy that limits systemic risk or systemic risk spread. In this way, it limits the frequency of disruptions in the provision of key financial services that may have serious impact on the real economy. Using this approach in defining the policy, the relevant authority’s activities are aimed at preventing the accumulation of financial imbalances and the building of defence mechanisms for rapid and stringent acting in preventing the development of recessive influence and effects on the real economy. Moreover, such policy orientation identifies and resolves joint exposure risks, risk concentration, and linkages and interdependence of certain events that can be a source of contagion and spillover. The emphasis is put on anything that could hamper the operation of the system as a whole.

6. Intermediate macroprudential policy objectives

The main objective of macroprudential policy is to safeguard the financial system stability. To ensure the achievement of the primary objective, intermediate macroprudential policy objectives have been defined. Intermediate objectives have been determined and defined based on recommendations of the European Systemic Risk Board (ESRB/2013/19) as of April 2013 on intermediate objectives and instruments of macroprudential policy. Transition goals include mitigating and preventing excessive credit growth and financial dependence (leverage), mitigating and preventing excessive maturity mismatch and market illiduidity, limiting direct and indirect concentration of financial institutions’ exposure to certain categories, limiting the systemic impact of inadequate incentives in order to reduce moral hazard, and strengthening the financial infrastructure resilience.

Intermediate objective 1: Excessive credit growth and leverage

Excessive credit growth has been identified as a key driver of financial crises, which is the reason for considering it the most significant intermediate objective. Risks are particularly accumulated in growth periods when due to the strong pressure from competition and the pursuit of profit financial institutions tend to underestimate risks when granting new loans. Large credit growth is accompanied by a credit bubble burst after which banks are not willing to extend loans to the real sector because of the risk of loss. Such period is characterized by decreased liquidity in the real economy resulting from the lack of available funds. Thus, adverse effects spread to other sectors in the system and affect economic growth.

Intermediate objective 2: Excessive maturity mismatches and market illiquidity

The maturity and market mismatch of assets and liabilities is a usual phenomenon in banks, but the aim is to minimize the risks that arise therefrom. Banks are obliged to have enough liquid assets they could use, if necessary. However, the financial structure has to include a significant share of stable funds from its clients, since overreliance on short-term funding can lead to an unexpected lack of liquid assets. The reason for illiquidity in the market could be a general fall in confidence or poor forecasts.

Intermediate objective 3: Limiting direct and indirect exposure concentrations of financial institutions to specific categories

A significant concentration of exposures to a particular sector or asset category can result in increased sensitivity of the financial system to that sector or category. This is the reason for introducing macroprudential policy instruments that would limit this type of risk.

Intermediate objective 4: Limiting systemic effect of inadequate incentives with a view to reducing moral hazard

The perception that certain financial institutions are too systemic (*Too-Big-To-Fail [TBTF]*) to allow their failure is a fertile ground for the occurrence of inadequate incentives as favouring some institutions and, on the other hand, often leads to excessive risk taking by these institutions. TBTF institutions are often burdened with additional capital requirements to ensure their resistance to shocks.

Intermediate objective 5: Strengthening the financial infrastructure resilience

Strengthening the resilience of financial infrastructure is provided by identifying and limiting the risks of a structural nature that may pose a threat to the financial infrastructure. Strong financial infrastructure supports smooth execution of transactions and functioning of payment systems.

7. Instruments of preventive actions and supervision of systemic risk in the Montenegrin financial market

The competence of the CBCG also includes structural and cyclical control and prevention of systemic risk accumulation. The set of instruments available to the CBCG should provide an efficient response to identified risks either by increasing the resilience of the financial system to negative shocks or by directly addressing the source of risk. In accordance with the ESRB framework and the CBCG powers, this creates the possibility of achieving medium-term intermediate objectives. The efficient use of this set of instruments defines a policy framework that influences systemic risk, and/or guidelines the activities of relevant authorities towards effective policy decisions.

Table 1 - Intermediate Objectives, Potential Macroprudential Indicators, and CBCG Policy Tools

Intermediate (middle term) objectives	Potential macroprudential indicators	Potential CBCG policy tools	
		Currently available – proposed by the Framework	*Available from CRR/CRD IV (Capital Requirements Regulation and Directive)*
Excessive credit growth and leverage			
Aggregate	– Credit to GDP gap – Credit growth – Growth in credit to GDP	– Capital requirements – (Sectoral) risk weights – (Sectoral) limits on credit growth – Limits on debt service-to-income (DSTI) and loan-to-value (LTV) ratios for new lending	– Countercyclical capital buffer – Leverage ratio
Households	– Growth in household credit (cash loans, housing loans) – Debt to income – Lending standards – Debt service to income (new lending) – Loan to value ratio (new housing loans)		
Nonfinancial corporates	– Growth in corporate credit (total and by industry) – Share of Foreign Exchange (FX) loans – Lending standards – Debt service ratio		

Financial sector	– Bank capital ratios – Bank leverage ratio		
Real estate	– Growth in real estate lending – House price growth – Price to income – Commercial property price growth		
Excessive maturity mismatch and market illiquidity	– Loan to deposit ratio – Share of non-deposit funding – Share of FX funding	– Minimum liquid assets ratio – Stable funding requirement – Reserve requirements – Constraints on FX funding	– Liquidity coverage ratio – Net stable funding ratio
Direct and indirect exposure concentration	– Exposures of banking sector to different sectors – Assets of G5 banks as percent of total banking sector assets	– Large exposure limits – (Sectoral) limits on credit growth	– Systemic risk buffer
Systemically important financial institutions	– Bank assets as percent of total banking sector assets – Bank assets as percent of GDP	– Intensified supervision – Limits on interbank exposures – Capital surcharges	– Other systemically important institution buffer – Systemic risk buffer

Note: The proposals listed in the table have been developed in cooperation with the IMF technical mission for defining the mandate and the Central Bank of Montenegro`s macroprudential policy framework.

CONCLUSION

The CBCG is in charge of implementing the macroprudential policy in Montenegro. The applicable legal framework provides the possibility of introducing a large number of instruments, i.e. it provides the CBCG, as the supervisor of the banking system and other financial institutions market, with the legal basis for introducing measures aimed at safeguarding financial stability. This framework additionally strengthens the scope of action and introduces the possibility of additional intervention by the CBCG in case of systemic risk.

Activities of the Financial Stability Council widen the scope of risk monitoring, identification, and control. This has created the possibility of an effective mechanism that may act beyond the CBCG's regulatory authority. According to the statutory powers of the Council members, the framework of action includes risk control in the capital and insurance markets.

Continuous alignment with the EU *acquis* introduces all elements of the European law into the Montenegrin market. This implies the implementation of the Directive 2013/36 EC on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, and Regulation 575/2013 on prudential requirements for credit institutions and investment firms in the coming period. These solutions have already provided a proposal for bank resolution, in accordance with the Directive 2014/59/EU on establishing a framework for the recovery and resolution of credit institutions and investment firms.

This framework provides with an overview of the currently created institutional and regulatory platform in Montenegro, which will continuously be aligned with the new EU requirements and specific features of the domestic market and amended as needed.