1. OVERVIEW OF THE MAIN RISKS TO FINANCIAL STABILITY

1.1. FINANCIAL STABILITY MAP

(1) At the end of 2018, the Financial Stability Map shows risks in the external economic environment increased slightly, whereas risks in the domestic environment related to banking activity and real sector developments decreased, compared to results as at the end of 2017. The value of indicators suggest that the risk related to developments in the “domestic economy”, the “government” and “households” trended overall down, compared to the end of the previous year, whilst risk from “enterprises” trended upward. On the contrary, the indicators of banking activity related to “capitalization and profitability” and the “structure of the banking sector” did not show significant changes at the aggregate level of risk, whilst risk related to “liquidity and financing” was overall downward.

In more concrete terms, at the end of 2018, in:

a. Overall economic environment:

I. Aggregated risk from the “domestic economy” is rated as “moderate” and downward, compared to the previous year, mainly as a result of stable GDP growth, and decline in the size of the external debt stock.

II. Risk from the “external environment” continues to be classified as “moderate” but slightly upward compared to the end of 2017, driven by the slowdown of the economic growth rate in our trading partners. This slowdown may drive to a decline in the future demand for exports, while a potential increase in short-term interest rates in money markets may increase external financing costs.

b. Real economy agents:

I. Risk from “enterprises” is assessed as “moderate” and upward during the period, in view of the deterioration of short-term expectations by enterprises and of the index of their financial situation.10

9 The Financial Stability Map shows the allocation of risk among factors that determine the stability of the financial system, which include the surrounding external and internal economic environment, the banking sector, and the real economy agents: government, enterprises and households. The closer to the “centre” of the map, the lower the risk.

10 The financial situation of enterprises is one of the sub-indices calculated by the Business Confidence Survey conducted by the Bank of Albania quarterly. In this methodology, this index substitutes the index of output volume, published by INSTAT.
II. Risk from “households” is assessed as “moderate” and remained almost unchanged during 2018.

III. Risk from the developments in the “government” sector, is assessed as “low” and slightly downward during the period, as a result of the decline in the size of government debt to GDP. The risk from other sub-indices in this category either remained unchanged or declined.

c. The banking sector activity:

I. Risk from “capitalisation and profitability”, is assessed as “average” and remained unchanged compared with the end of the previous year. The increase of the sector’s capitalization level and the improvement of credit quality, mitigated the risk from the decrease in the sector’s revenues, keeping the aggregate risk level from this category unchanged.

II. Risk from “liquidity and financing” is assessed as “moderate” and trending slightly downward, compared to the previous year, reflecting the narrowing of the banks’ assets and liabilities gap, of up to three months maturity, and a slight decrease in financing from non-residents.

III. Risk associated with the “banking sector structure” is assessed as “average” but trending slightly upward from a year earlier, as a result of the increase of concentration in bank credit to enterprises.

Box 1.1 shows the Financial Stability Map components over 2018 H2, the score for each risk level and comparison with the scores in the previous year.
Risk from “domestic economy” is assessed as “average” but downward compared to the previous year, due to the persistent growth of GDP against its long-term expectation, and decline of external debt. On the other hand, increase of the need for external financing at the end of the year, contributed to the increased risk from this category.

Risk related “households” is assessed as “moderate” with a slightly downward trend compared to the end of the previous year. The decrease of the registered unemployment rate and improvement of households’ portfolio quality decreased the risk from this indicator, whilst the deterioration of their expectations contributed to risk increase.

Risk from “capitalisation and profitability” is assessed as “average” and unchanged during the period. Increase of capitalisation of the banking sector and improvement of the loan quality, due to the constant growth of GDP against its long-term expectation, and slowdown of economic growth in our main trading partners (mainly Italy and Greece), the deteriorating of expectations and of financial situation in this sector (the financial markets and signals for the decrease of the global business cycle according the CLI). The deterioration of expectations contributed to the increased risk from this category.

*The financial situation index (Composite Leading Indicator - CLI) is one of the main indicators that signals the turning points in the business cycle or the fluctuations of the economic activity around its long-term potential level and it is evaluated by OECD.

Source: Financial Stability Department, Bank of Albania.
1.2. SYSTEMIC RISK

To assess the banking sector’s exposure to systemic risk, we analyse the performance of indicators related to: a) the materialization and accumulation of systemic risk; b) the stress level in the financial system; and c) the perception of the banking industry regarding the exposure to systemic risk. The materialisation of the systemic risk assesses the actual level of the risk, whilst indices of risk accumulation, financial stress, and banking industry perception on it are mainly forward looking.

(2) Materialisation of systemic risk was downward over the period, compared to the previous year, whilst the indices of risk accumulation decreased in annual terms. The improved quality of credit to households, the decline in the unemployment rate at home, and the diminishing exchange rate volatility contributed to the performance of this index. Decrease of outstanding loans unhedged against the exchange rate and decrease of external and public debt contributed to the decrease of the systemic risk index.

(3) The financial stress index resulted as downward, mainly due to the improvement in the performance of certain banking sector indicators (such as deposits and net interest margins) compared to their historical trend, whilst the indicators of the money market and exchange rate did not cause significant changes in this index.

(4) The perception of the banking industry on systemic risk was overall downward during the period; the risk of the “deterioration of the domestic economy” remains the main systemic risk in the country, but the perception on its importance is assessed as “average” and downward. The steady growth of the country’s economy over the recent years, has contributed to the reduction of the perception of the banking industry regarding this risk. The perception of risk associated with “collateral execution” was downward during the last two surveys. Although the process of collateral execution continues to be considered as difficult and costly for banks, the various legal, regulatory and administrative measures taken over the recent years within the framework of

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11 Systemic risk is defined as “the possibility for the materialization of shocks that impair the functioning of a financial system to the point where economic growth and welfare suffer materially.”
the strategy for the treatment of non-performing loans may have contributed to facilitating this process.

(5) During the period, banks’ concern on “domestic political risk” and “exchange rate risk” has increased. Political developments at the end of 2018, which led to a cabinet reshuffle, and pressures for the appreciation of the Albanian lek against the euro seem to have been reflected in heightened attention by banks to these risks, which they have identified as systemic risks.

**Box 1.2: Macro-Prudential Policy**

The macro-prudential policy focuses on the prevention of systemic risk and the strengthening of the financial system resilience against it. Systemic risk develops in two dimensions: cyclical and structural ones.

The cyclical dimension of the systemic risk is related to the tendency of financial institutions to increase their risk appetite in times of economic boom, and to show more reluctance in times of economic downturn. None of these behaviours are desirable; so, through its instruments, the macro-prudential policy aims to mitigate this pro-cyclical behaviour of the financial system. The Bank of Albania has worked to assess the procyclicality of the financial cycle with economic growth (GDP performance).

Thus, an index of the financial cycle was initially built, which, based on the relevant literature and the structure of the financial market in the country, correlates credit indicators with asset prices. The latter are considered as equally important variables of the financial cycle, though literature always considers them correlated with credit variables. More specifically, the financial cycle index for Albania includes:
- ratio of credit to GDP, as an important variable of macro-prudential analysis;
- annual credit growth, as a variable that assesses the rate of credit expansion acceleration, adjusted for inflation.
- house price index, as a variable that captures price developments of non-financial assets, adjusted for inflation.

A rapidly developing financial cycle tends to improve financial indicators of financial institutions, and is accompanied by increased risk and, further on, its materialization. To estimate this link for Albania, the ratio of non-performing loans is considered as an indicator of the risk materialization. The chart clearly shows that the growth in the financial cycle (index increase) during the period 2000-2007 was accompanied by a decrease in the ratio of non-performing loans, whereas its decline, in this case driven by the outbreak of the global financial crisis in 2008, was associated with the rise of non-performing loans in the period 2008-2013.

In order to better capture the financial cycle in view of the country’s economic development stage, using another indicator, the Credit to GDP gap, is suggested. This indicator identifies the gap between the current value of “Credit/GDP” with its long-term trend. When this gap is significant, it is evaluated whether the credit growth/contraction is or is not excessive. In Albania, “credit to the economy” is taken as a credit indicator, which includes the loan to private non-financial resident entities by banks and non-bank financial institutions.

The “Credit to GDP” gap is an important indicator for the macro-prudential policy. It serves as a primary indicator for implementing countercyclical capital buffers. The latter, trending upward for banks during the upturn of the cycle and permitted to decrease during its downturn, acts as a mechanism that lowers the procyclicality in banking activity, and mitigates major fluctuations in financial intermediation. The standards of the European Systemic Risk Board suggest that the above indicator should be supplemented/supported with other indicators that may signal unwanted developments more quickly. The Bank of Albania has defined and calculated these indicators for Albania. In addition to the Credit-to-GDP gap, the “Supplementary Early Warning Indicator” was used, which also includes some sub-indicators of credit intensity and non-financial asset prices.

From the performance of these indicators, it can be concluded that:

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12 For credit, data relate to bank credit to the private non-financial sector;
they capture adequately the current phase of the financial cycle, which is downward. However, the Credit-to-GDP gap and SEWIs indicators appear to suggest the downward trend stopped;

- in the context of the possible implementation of countercyclical capital buffers, the performance of the Credit-to-GDP gap (deeply in negative territory) does not suggest the need for implementing this instrument in the foreseeable future.

In addition to the cyclical dimension, the Bank of Albania has also worked towards assessing the structural dimension of systemic risk. This dimension stems from the expansion of risk to parts of the financial system. It occurs when financial institutions are so large or are so interconnected that when they are affected by an unfavourable economic or financial development, local or cross-border, the consequences may jeopardise the stability of the entire financial system. In this regard, the focus of Bank of Albania’s efforts was to review the methodology for determining systemically important banks, and to determine how the respective capital buffer could be applied for the systemic importance as an instrument of the macro-prudential policy.

Thus, in 2018, the scoring methodology for the assessment of systematic importance is reviewed, based on the methodological framework of the European Banking Authority and the Basel Committee on Banking Supervision; the minimum threshold for the designating of systemically important banks to reflect structural changes in the domestic banking sector is reviewed also, as well as the calculation of the requirement for capital buffer for each basket / interval of the systemic importance score is reviewed.

In order for the methodology to better reflect the features of the domestic banking sector and the relationships of this sector with other segments of the financial system, some of the categories of systemic importance scores, such as “size”, “substitutability” and “complexity” have undergone changes of sub-indicators and relevant weights. Thus, “Substitutability” includes indicators related to the investment of banks in the stock exchange, assets under custody, and assets of investment and pension funds in which banks may be participating. The “Complexity” category includes the indicators of over-the-counter derivatives (OTCs) and illiquid investments. Despite the fact that the application of the revised methodology has not led to radical changes in the relevant scores and in the ranking of banks according to their importance, the Bank of Albania estimates that this methodology, which combines the best international practices with the experience and empirical results of the analysis of the Bank of Albania, represent an important instrument for assessing, monitoring and preventing structural risk increase in all its critical dimensions.

As part of the framework for macro-prudential capital buffers, the above-stated methodologies are published at Bank of Albania’s website, for consultation by the banking industry and the public.

In the framework of implementing the macro-prudential policy in order to mitigate systemic risk in its structural dimension, the Bank of Albania has taken some measures to strengthen the use of lek in the banking activity. These measures entered into full force during the period (July 2018). In line with the commitments made in the respective inter-institutional memorandum, the Bank of Albania has identified some indicators to assess the impact of the measures and the need for their revision/enrichment. Based on the performance of these indicators during 2018 H2, it is noted that movements in most cases are insignificant,
and in general, the indicators’ values remain largely deviant from the average values of the indicators for countries with similar economy to Albania. Against this backdrop, it is too soon to provide an assessment of the impact of these measures and a continued monitoring of the relevant indicators is needed.