5. MACRO-PRUDENTIAL POLICY AND RISK ASSESSMENT

5.1 RISK ASSESSMENT AND MACRO-PRUDENTIAL MEASURES IN THE EU COUNTRIES AND REGION

The following analysis presents the main risks identified in the financial stability reports and the macro-prudential policy instruments implemented in the European Union (EU) and the Region. To this end, several risk assessment reports were analysed, prepared by the European Central Bank (ECB), the European Systemic Risk System (ESRB), the European Insurance and Occupational Pensions Authority (EIOPA), and the International Organization of Securities Commissions (IOSCO), etc. The reviewed reports date from 2018 until 2019 H1. Their experience serves to enrich and implement the relevant policies and instruments in the Bank of Albania.

5.1.1 RISKS ASSESSMENT AND MACRO-PRUDENTIAL MEASURES IN THE EUROPEAN UNION

During the period the main risks do not show substantial changes compared to the previous year. However, the risk arising from the activity of the non-bank financial sector (shadow banking) is upward, and therefore the European Central Bank (ECB) has recommended the undertaking of special measures for the monitoring of this risk. The identified risks are interconnected and if one of them escalates in size it would affect the other risks, thus creating a chain-reaction.

From this perspective, the main risks identified by the EU countries are the following:

I. sudden and non-homogeneous increase of the risk premium, influenced by the reaction of markets to policy uncertainties in EU countries;
II. concern about the sustainability of the debt level, driven by the expansion of economic activity in EU countries;
III. reduction of the intermediate capacities of the banking sector, as a result of the low levels of profitability from the activity, which poses an increased risk for the financial stability of the Euro area;
IV. increase of risk-taking by the non-bank financial sector, accompanied by a risk-increase in terms of liquidity and credit in their investment portfolio.

For the purposes of this analysis, Italy and Greece are also included in the countries of the Region, in the framework of the exposures of the Albanian banking sector to them.
In terms of macro-prudential measures taken by EU member countries, there is a significant increase in their total number during the one-year period. Most of the measures taken are tightening and mainly address cyclical risks. The most commonly used macro-prudential instruments are mainly capital-based instruments, in compliance with the regulatory requirements of the European Capital Requirements Directive (2013/36 / EU - CRD IV). The other most applied measure concerns the setting of threshold levels for the “debt service-to-income” ratio (DSTI), with the aim of mainly limiting borrowing from households. A summary of these measures is shown below.

The list of most active countries in the implementation of macro-prudential instruments is leaded by the Nordic countries and the countries of Central and Eastern Europe such as: Czech Republic, Hungary, Denmark, Slovakia, Finland and Sweden.
5.1.2 RISK ASSESSMENT AND MACRO-PRUDENTIAL MEASURES IN THE REGION

The risks identified by countries of the Region did not change over the one-year time frame. It is worth noting that the risks are very similar to those identified by the Bank of Albania, due to the similarity of economic characteristics between countries. Some of the main risks are:

I. foreign exchange risk;
II. Low profit in the financial system accompanied by relatively high level of non-performing loans;
III. High public debt, albeit slightly down recently;
IV. High concentration of exposures in some sectors of the economy, thus impacting the current level of non-performing loans.

Among the non-EU countries in the region, Serbia and North Macedonia are more active regarding the activation of the demand for additional capital for macro-prudential purposes. The most used instruments in these countries are related to the management of structural systemic risks.

5.2 RISK ASSESSMENT AND MACRO-PRUDENTIAL MEASURES IN ALBANIA

5.2.1 RISK ASSESSMENT IN ALBANIA

The Bank of Albania, in cooperation with other authorities, contributes to safeguarding of financial stability in Albania. As part of this contribution, the Bank of Albania drafts and implements the macro-prudential policy, which
analyses and assesses the systemic risk and implements measures to prevent and mitigate it, in two aspects:

1. preventing the accumulation of risks in the financial system, and
2. strengthening the resilience of the financial system.

Regarding the prevention of risk accumulation, the Bank of Albania drafts analyses aimed at identifying financial imbalances based on close monitoring of the performance of indicators that reflect the accumulation of risks, with the main focus on the banking sector. The Bank of Albania has identified a full set of macro-prudential indicators in full compliance with the recommendations of the European Systemic Risk Board (ESRB), which are grouped into four objectives, as shown in Table 12.

Table 12 Intermediate objectives and some of the main indicators

<table>
<thead>
<tr>
<th>Intermediate objective</th>
<th>Explanatory</th>
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<tbody>
<tr>
<td><strong>Mitigation and prevention of fast expansion of lending and borrowing</strong></td>
<td>• Annual increase of credit volume; • Private sector debt load levels; • “Credit to Gross Domestic Product (GDP)” ratio and gap; • Developments in the real estate market; • LTV and DTI indicator (LTV: Loan to value, DTI: Debt income), debt financing of banks.</td>
</tr>
<tr>
<td><strong>Mitigation and prevention of excessive duration gaps and liquidity shortfall in the market.</strong></td>
<td>• “Loan to deposit” ratio; • Liabilities structure and maturities distribution; • Support on market funding and on the central bank; • Liquid assets structure and share to total assets; • Liquidity hedging ratio; • Sustainable net financial ratio; • Stress test on liquidity risk;</td>
</tr>
<tr>
<td><strong>Limitation of direct and indirect exposure concentrations</strong></td>
<td>• Exposure concentrations by sectors, entities, countries, currencies and maturities</td>
</tr>
<tr>
<td><strong>Limitation of excessive carried on risk by financial institutions with systemic importance</strong></td>
<td>• Assets to GDP ratio of banks; • Volume of deposits and assets; • Claims and Liabilities toward other financial institutions; • Other indicators that show the size, interconnection, substitutability, complexity and cross-border activity of the banks;</td>
</tr>
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The analysis of the above indicators shows that at end of 2019 H2, the banking sector continued to maintain good levels of capitalization and liquidity, sufficient to meet the short-term needs. The promotion of lending to businesses, the widening of the negative gap between assets and liabilities by residual

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54 Indicators that best signal the systemic risk, for which the objective is built, are selected for each objective. The monitoring of these risk signals is done by comparing the current value and the timely performance of the indicator to a critical value, exceeding of which may signal the accumulation of risk.

55 For more information, please see “Macro-prudential Policy Strategy”, approved by the Decision No.37, dated 02.08.2017, of the Supervisory Council of the Bank of Albania: https://www.bankofalbania.org/Financial_Stability/Macro-prudential_policies/Macro-prudential_strategy/
maturity, as well as the reduction of the use of foreign currency in the domestic economy continues to be among some of the issues that require special attention. Below you may find a more detailed analysis of each objective:

**Objective I.** The narrowing of the negative gap of credit to economy to gross domestic product (GDP) signals an improvement in domestic credit, largely influenced by the business loan portfolio. Also, the financial leverage ratio improved over the year, which confirms the maintenance of a good level of capitalization in the banking sector.

**Objective II.** Liquid assets continued to be at high levels, upward at 36% of total assets or 1 pp more than at the end of the last six months. On the other hand, the negative gap between assets and liabilities for short-term maturities continued to widen. Also, the spread of the exchange rate for the euro in the interbank market continued the upward trend during these six months.

**Objective III.** Bank’s exposures by sectors of the economy declined this half-year, whilst real estate loans increased. Unhedged foreign loans expose the banking sector to exchange rate fluctuations, particularly to the Euro. The analysis by economic activity highlights the concentration of credit mainly in the trade sector, construction and manufacturing industry exposing the sector to possible shocks in these sectors. The use of foreign currency remains high accompanied by negative effects on the transmission channels of the monetary policy and on the management of foreign currency liquidity. For this reason, the Bank of Albania undertook a package of measures to stimulate the use of the domestic currency, in the framework of the Memorandum of Cooperation with the Ministry of Finance and Economy and the Financial Supervisory Authority, signed on 18 April 2017.

**Objective IV.** The total assets of the banking sector in terms of GDP reached about 96%. Referred to the Herfindal index for the level of concentration of systemic importance, at the end of December 2019, concentration declined. At the same time, non-resident liabilities decreased significantly compared to the previous six months and the previous year, mainly influenced by the break effect in the statistical data, following the structural changes in the banking sector during 2019.

### 5.2.2 MACRO-PRUDENTIAL MEASURES IN ALBANIA

In view of strengthening the banking sector’s resilience, the Bank of Albania drafted the relevant regulatory framework and is calibrating the necessary macro-prudential instruments for this purpose.

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56 The Herfindahl index method was used to monitor the concentration of exposures at the system level.
Adoption of the regulation “On macro-prudential capital buffers”\textsuperscript{57}, enabled the operation and implementation of capital buffers as instruments of the macro-prudential policy. Their implementation aims to strengthen banking sector resilience in Albania against systemic risks of cyclical and structural nature. In accordance with the provisions of this regulation, the Bank of Albania, starting from 2019 Q2, has published quarterly, some decisions of the Governor\textsuperscript{58}, which announce the requirement for capital conservation buffer, countercyclical capital buffer, as well as the list of systemic banks, and required capital buffers for each of them. For the first time, banks will report the fulfilment of the above requirements starting from 2020 Q1, but the level of fulfilment is expected to be complete under the conditions of good capitalization level of banks activity. In the framework of the pandemics’ impact, the possibility of using these countercyclical measures will be assessed. The establishment of macro-prudential capital buffers represents an important achievement in terms of approximation with the relevant European Union standard set out in the European Parliament and Council of Europe legislation, and to the relevant technical standards, published by the European Banking Authority and the European Systemic Risk Board.

In parallel, more attention has been paid to the analysis of the conception of instruments that prevent excessive credit and debt growth, mainly by households. Important in this regard is the development analysis of real estate and consumption credit. A more detailed analysis is given below regarding the latter.

\textbf{I. DEVELOPMENTS IN CONSUMER CREDIT AND FINANCIAL STABILITY RISKS}

Over the past years, consumer credit has grown at a rapid pace in the Eastern and Central European countries, marking similar levels of growth with the period prior to the financial crisis of 2008\textsuperscript{59}. Some countries have addressed the risk of excessive credit growth in this segment by adopting macroprudential measures.

These measures mainly intend to limit the share of the loan service relative to the borrowers’ income, for example, by setting a cap to loan-to-income ratio, or in the debt service-to-income ratio, but may also include other restrictions such as: maturity limits for the loan contract, amortization requirements etc. This aims to strengthen the borrower’s resilience (by reducing the probability of failure) and banks resilience (by reducing the size of loss in case of failure) through limiting the credit service burden and unsustainable levels of credit growth.


\textsuperscript{58} Can be found in the following link: https://www.bankofalbania.org/Financial_Stability/Macroprudential_policies/Instruments_of_Macroprudential_Policy/Instruments_and_Decisions/

\textsuperscript{59} For more information, see the Economic Bulletin of the European Central Bank, No. 7/2017 “Recent trends in consumer credit in the euro area.”
Consumer credit in Albania experienced a rapid growth during 2005-2009, which is related to the increase in the level of financial intermediation in Albania, which started from a relatively low base. Immediately after the materialization of risks, which coincides with the financial crisis, consumer credit shrank, following the general trend of credit contraction in Albania. Consumer credit growth gained momentum at the end of 2014 and lasted up to the first half of 2018, being the most significant contributor to overall household loan growth. However, the growth rate of consumer credit slowed down during 2019.

Exposure of banking sector to this segment is low compared to the total loans given to the private sector: consumer loans account for 11.5% of loans granted to private non-financial sector and constitute only 4.2% of the banking system’s balance sheet assets. Also, the share of consumer loans to total loans to households has not experienced significant changes, ranging between 23%-37%. This share has been decreasing over the last year, reaching 34% at the end of December 2019.

The non-bank financial institutions contributed positively to the performance of consumer credit. The growth of consumer credit increased at double-digit rates, however the outstanding amount of consumer credit provided by this part of the financial system, accounts for just 10% of consumer credit granted by the banking sector.

Consumer loans are typically procyclical, as they support consumption. This procyclicality is obvious in Albania’s data, if we look at the performance of the new consumer credit ratio to the consumption of households. In an environment of positive economic growth, new consumer loans increased more than the final consumption of the population, a phenomenon mostly pronounced during 2014 - 2017. During this period, the indicator increased by approximately 1 percentage point.

Referring to the Bank Lending Survey, the increased demand for consumer loans was an important factor to the growth of credit (yellow dashed line in Chart 118). On the other hand, banks have also eased the lending standards for this segment, as shown by the positive values of lending standard index for consumer credit.

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60\[ The annual growth rate of this loan reached 6.9% at the end of December 2019.\]
61\[ a) Indicator of the flow of consumer credit to consumption (left axis); Consumer Credit Demand Index and Consumer Credit lending Standards (right axis); b) On the right axis of the chart, the negative value indicates that banks have tightened the lending standards and vice versa. Also, the positive value shows increase of credit demand, while the negative balance shows decrease of credit demand.\]
62\[ For more information, see “Bank lending Survey” at: https://www.bankofalbania.org/Monetary_Policy/Surveys_11282/Bank_Lending_Survey/.\]
The main component that contributed to the cyclical fluctuations in consumer credit is credit for the consumption of durable goods, a phenomenon widely encountered in other countries as well. In the case of Albania, this contribution is evident in both the contraction of 2009, as well as in the intensification of consumer credit growth during 2014-2017.

In terms of cost, in recent years, banks have operated in an environment with historically low interest rates. But interest rates of consumer credit have averaged 1.4 pp higher over the past year. The structure of the initial period of interest rate fixation for new on consumer loans is shown in Chart 120, and it is notable that the dominant part of new consumer loan contracts (about 80%) foresees an unchanged interest rate.

By composition, loans for the consumption of non-durable goods represent the largest share in consumer credit, by 54% at the end of 2019, and this share has been increasing over the past years. On the other hand, “overdraft” loans account for the lowest share in the consumer credit stock at 13% in the end of 2019, and this share has been shrinking. As consumer loans are characterized by a smaller principal and shorter maturities compared to housing loans, the composition of their outstanding stock in the banks’ balance sheet may change more rapidly.

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63 For example: cars, household appliances, electronic devices, etc.
64 Goods that are consumed completely within a year assuming a normal usage, such as food products, office appliances, clothing textiles, most services including vacations, etc.
By currency, consumer loans in ALL dominate in the portfolio of banking sector. At the end of 2019, consumer credit in foreign currency accounted for 13.7% of consumer credit. More than half of consumer loans in foreign currency (about 58%) is classified as unhedged against exchange rate risk, however the latter account for only 8% of consumer loan stock. From the borrower’s solvency point of view, the risk that comes as a result of unfavourable exchange rate fluctuations remains limited. In terms of credit quality, consumer credit has historically had lower levels of non-performing loans, despite its higher-risk nature. The ratio of non-performing consumer loan has followed a downward trend since 2013 H2, marking its lowest value at the end of 2019. Also, consumer loans contribution to the growth of total non-performing loans stock has been minimal.

Similar to the other countries mentioned at the beginning of this analysis, Albania has experienced an increasing trend of consumer lending from various sectors of the financial system, where the banking sector continues to play a dominant role. Credit demand, especially for the consumption of non-durable goods, played an important role to the expansion of consumer credit. Consumer loans are procyclical in nature, with shorter maturities and higher interest rates. As such, under eventual worsening conditions in the labour market or the economic cycle in general, systemic risks arising from this segment might materialize. However, in Albania, the risks arising from the expansion of consumer credit are mitigated by its low weight. Although the current level of risk remains low and controlled, macroprudential policy actions should be forward-looking, aiming to prevent and mitigate the accumulation of risks that could lead to elevated levels of stress in the financial system.