8. MACRO-PRUDENTIAL POLICY

(97) In the Macro-prudential Policy Strategy[38], approved by the Supervisory Council of the Bank of Albania with the Decision No 38, dated 02.08.2017, as final objective is defined the prevention of systemic risks and the strengthening of the resilience of the financial system, in order to safeguard financial stability. The achievement of the final objective is carried out through the definition and realisation of several intermediate objectives, their relevant indicators and the instruments necessary to be operationalized to address specific risks. The entire process follows a well-defined cycle that includes the identification and assessment of the risk, selection and calibration of the instrument, the implementation of the policy and its communication, and the assessment of its impact. Having as primary role the implementation of the macro-prudential policy, the Bank of Albania has also defined in the document its structures that are directly engaged in the fulfilment of the macro-prudential policy cycle.

(98) Two important elements in the implementation of the macro-prudential policy are the:

a) definition and monitoring of the indicators that are needed to signal and activate macro-prudential instruments;
b) identification, calibration and operationalization of the most adequate macro-prudential instruments to address the systemic risk identified.

(99) With regard to these, the Bank of Albania, with the support and expertise of the International Monetary Fund, has worked towards the preparation of the relevant methodologies and the creation and structuring of the necessary database. Currently, the focus is on the creation of a set of indicators that signal systemic risk developments and the preparation of the necessary methodological and regulatory basis for the implementation of macro-prudential capital increase, in line with the Basel Committee recommendations, the requirements of the relevant European Directives, The European Systemic Risk Board, the technical standards issued by the European Banking Authority and the features of our financial system.

[38] *https://www.bankofalbania.org/Financial_Stability/Macro-prudential_policies/Macro-prudential_strategy/ /*

8.1 MACROPRUDENTIAL CAPITAL BUFFERS AND THEIR IMPLEMENTATION IN ALBANIA

(100) The global financial crisis of 2008 showed that its roots could also be found, among other things, in these developments:

a. the fast growth of lending by banks and other similar institutions;
b. the funding of this expansion through unstable financial sources and the inadequacy of capital levels and quality;
c. the presence of incentives to increase banks' size, increase their impact of systemic risk and the creation of institutions "too-big-to-fail".

(101) Immediately after the outbreak of the crisis, international financial institutions began to work on improving the regulatory supervision framework in order to prevent similar crises in the future and to best cope with them. Specifically, the Basel Committee on Banking Supervision published in 2010, what is now known as the Basel III standard. Among other things, this standard suggests the implementation of several capital buffers, which aim to:

a. improve the quality and quantity of capital, since these capital buffers are placed above the minimum capital under Pillar I and are composed by equity Tier 1 instruments;.
b. mitigate the volatility of the financial cycle and ensure a better stability, in the conditions where capital buffers will increase throughout the expansion of the financial cycle, and will decrease in case of need to absorb losses during the downturn phase of the financial cycle;
c. reflect the contribution to the systemic risk of the financial institutions with international and national systemic importance.

(102) The main objective remains the prevention of systemic risks and strengthening the resilience of financial sector against them. For this reason, these capital add-ons are considered as key instruments of macro-prudential policy, in fulfilment of its objective. Hence, the Bank of Albania, in the framework of its primary role for the implementation the macro-prudential policy, aims to apply these instruments to the Albanian banking sector, which consists in:

a. Capital Conservation Buffer (CCB), which is applied to all banks of a jurisdiction, and is 2.5% of risk-weighted exposures;
b. CounterCyclical Capital Buffer (CCyB), which varies from 0 to 2.5% of risk-weighted exposures, and is applied to all banks according to the composition of their exposures;
c. Systemic Risk Buffer (SRB), which is applied in the conditions of the presence of structural systemic risks, non-cyclical, and which varies from 1 to 3% of risk-weighted exposures;
d. Capital buffer from financial institutions with system importance (DSIB), which is applied towards banks with systemic importance, and is suggested to be 0-2% of risk-weighted exposures.

(103) The Bank of Albania aims to implement these instruments in the Albanian banking sector. For this purpose it has prepared the relevant methodologies and a special regulatory project, which currently are in consultation phase with the banking industry and other interested parties[39]. Similarly to the Directive 2013/36/EU and the relevant regulations of the European Union, the draft-regulation provides that macro-prudential capital add-ons in Albania are to be implemented in "phases", throughout 2020-2023.

(104) In the draft are defined the levels of the capital conservation buffer that banks have to meet in the targeted time period. These values are fixed, since the level of this macro-prudential add-on is also fixed (2.5%). Our preliminary analysis shows that, overall, banks will not have problems to meet this requirement, according to the levels predicted throughout the 4-year period.

(105) Countercyclical capital buffer is a new instrument in the implementation framework of the macro-prudential policy, whose value may change during the financial cycle. The countercyclical capital buffer has values from 0% to 2.5% of total exposures, but might be even higher in the cases where risks that are associated with excessive credit growth or other systemic risks are assessed as very high. During the accumulation period of systemic risk the Bank of Albania may apply the countercyclical capital buffer that may be used during the downturn phase of the financial cycle. Thus, during the rapid growth phase, banks need to create sufficient capital reserves that can be used during the downturn cycle to absorb possible losses on the balance sheet so that the credit supply in the economy is not reduced or discontinued.

(106) For this macro-prudential capital buffer, the project provides how the Bank of Albania will select the benchmarks, evaluate them and announce its rate for Albania, or accept/announce it for the foreign jurisdictions where the bank has credit exposures to the private sector. The project also envisages the development of a methodology by the Bank of Albania to detail the process, and the way the benchmarking analysis is linked to the add-on levels. Under the current conditions of the financial cycle, the benchmarks analysed by the Bank of Albania show the high likelihood that the level of this add-on will be zero or minimal over the medium-term. On the other hand, if there are unexpected developments suggesting acceleration of lending, the Bank of Albania may change the terms and the limits of the values of this macro-prudential add-on.

(107) Also, the Bank of Albania identifies "systemically important banks" and has some higher supervisory requirements towards them, mainly in the content of recovery plans. The draft-regulation presents for the first time the requirements for the corresponding capital increase for banks of systemic importance and it is proposed that this ranges from 0.5% to 2.5% throughout the target period. The identification of banks of systemic importance and the manner of determining the respective macro-prudential capital add-on are supported

[39] *https://www.bankofalbania.org/Stabiliteti_Financiar/Politika_makroprudenciale/Strategjia_makroprudenciale/Akte_ne_proces_konsultimi/*

by a revised methodology, with the latest technical standard of the European Banking Authority.

(108) The last of the macro-prudential capital add-ons, which is defined in the project, is that of **systemic risk buffer.** This is about structural, long-term and non-cyclical risks. The minimum and maximum levels of this macro-prudential capital add-on are the same as those contained in European directives (1%-3%) and its implementation will take place upon Bank of Albania's announcement. For this add-on, the project does not contain any implementation calendars. The definition of the values of the add-on will require a specific analysis which will be assessed below.

(109) The draft provides for the bank to have up to 12 months in case of an increase of their capital, while in case of its decrease, the implementation may be immediate if it was not defined otherwise. All macro-prudential capital add-ons must be fulfilled with equity Tier 1 instruments.

(110) The project envisages the possibility of non-compliance of macro-prudential capital add-ons, and in accordance with the Basel III standard, but also with the European legislation, the project stipulates that non-compliance is accompanied by restrictions on some payments that decrease the level of equity Tier 1 (the rates of these limits are set) and the bank may be required to present a plan of measures to strengthen the capital position in this case.

(111) The adoption of this regulatory project for the implementation of macro-prudential capital add-ons is appropriate when:

- the quantity and quality of banks' capital, as well as the timely implementation of requirements, are adequate to enable them to be satisfied by banks without significant cost;
- it represents an important step towards:
  - implementing a macro-prudential policy;
  - complying with the European legal/regulatory framework in the financial field; and,
  - maintaining positive assessments for the competitiveness and stability of the banking sector in the country, compared to that of our region and beyond.

9.2 BENCHMARK PACKAGE

(112) The Macro-prudential Policy Strategy Document contains the intermediate objectives of this policy which are to: i) mitigate and prevent excessive credit growth and leverage; ii) mitigate and prevent excessive maturity mismatch and market illiquidity; iii) limit direct and indirect exposure concentration; iv) limit excessive risk-taking by systemically important financial institutions . The first two objectives address cyclical risks, while the others two structural risks.

(113) The nature of systemic risks is dynamic and needs a broad monitoring of the system to prevent potential risks, despite the fact that, in a particular period they may not be significant. Due to the difficulty of identifying the main risks in a timely manner, a broad selection of indicators organized according to the macro-prudential intermediate objectives has been established to identify imbalances or accumulation of risks at the right time. Although part of the indicators may not be at a critical level, they will be monitored continuously for any changes they may have in the future. Each indicator is assessed based on thresholds, which will also serve to indicate the risk level. The results will be presented for a point in time, as well as quarterly time series over the past years, thus facilitating the monitoring and the decision-making process for macro-prudential policies.

(114) Currently, this package contains several indicators, not all with the same importance, grouped according to the four macro-prudential intermediate objectives. The indicators of each intermediate objective are grouped under sub-categories to facilitate their monitoring and analysis. More specifically, some of the indicators that will be monitored and analysed as part of the Package, are the following:

Objective 1: Mitigate and prevent excessive credit growth and leverage.

- Credit to GDP gap and leverage indicators - monitor the size of the credit portfolio compared with the GDP, the growth pace and the funding sources of capital or liabilities.
- According to industry and currency - identifies rapid growth in a particular industry or currency;
- Indices - are used to assess the supply and demand for lending according to households and enterprises, the performance of house prices, rent and the relative cost of housing.

Objective 2: Mitigate and prevent excessive maturity mismatch and market illiquidity.

- Liquidity indicators - include the key indicators for measuring the overall liquidity level of the financial system.
- Maturity gap indicators - addresses the gap between assets and liabilities by maturity as well as the imbalances on banks' balance sheets.
- Foreign exchange market indicators - are very important for monitoring the volume and prices to identify risk accumulations in the system.
- Money market and secondary market – provides important information on the performance and the liquidity cost in the interbank and money markets.

Objective 3: Limit direct and indirect exposure concentrations.

- Large exposures, exposures to the real economy and to parent bank - these indicators measure the concentration of the exposure to large borrowers, the share of credit to GDP and the exposure of the banking system to the owning groups.
- Concentration by industry and geography - helps to identify the exposure of the banking system to a certain country or economic sector.
- Financial system interconnectedness - measures the exposure of the financial system among the stakeholders of the banking and non-banking systems.
- Foreign currency concentration - the exchange rate risk is one of the most significant risks due to the level of use in the economic activity and the financial system.

Objective 4: Limit excessive risk-taking by systemically important financial institutions.

- Sizes - defines the extent of the banking activity against GDP, the share of banks with systemic importance against GDP.
- Interconnectedness - measures the exposure of banks against the interbank and sovereign markets.
- Substitutability - monitors the share of systemically important banks as a share of the total banking system to indicate the level of concentration.
- Complexity - is assessed through non-resident assets and liabilities, non-interest income and marketable portfolio as a percentage of total assets.

(115) The potential risks to be monitored every quarter will be assessed based on the objectives and the indicators' sub-groups. Although the intermediate objectives are unchangeable, the indicators themselves are dynamic and will be reviewed/enriched periodically. Also, the thresholds for each indicator will be reassessed at least once a year, considering the regulatory framework, the historical performance, foreign expertise, as well as the level of the indicators in countries with an economy and financial system similar to Albania.