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### **Indicators for determining the Countercyclical Capital Buffer (Alb. 'KUNC')**

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The countercyclical capital buffer (hereinafter, CCyB) is an important macroprudential instrument, which alone or combined with other macroprudential instruments, helps maintain the stability of the banking sector and mitigates volatility in the financial cycle by addressing the cyclical nature of risk systemic related to excessive lending.

The application of CCyB for local banks is based on regulation no. 41, dated 05.06.2019 "On macroprudential capital additions", and on the methodology "On countercyclical capital additions in Albania" (November 2021). The first decision of the Governor on the level of the KUNC supplement is that of no. 3368, dated 28.06.2019, where the value of KUNC was set at the level of 0%. The value of KUNC has remained unchanged at the level of 0% in all subsequent quarterly decisions.

The decision-making on the level of the countercyclical addition is mainly based on the performance of the values of the indicator of the gap of credit to economy to GDP ratio, otherwise considered as the primary indicator. Although "the gap of credit to economy to GDP ratio" is the main indicator for the activation of CCyB, the practice of its implementation in other countries and in Albania has evidenced the slowness of the reaction of this indicator in general, and its insufficiency to capture and evidence rapid developments in certain loan segments. Therefore, the regulatory and methodological framework of the Bank of Albania foresees that the decision-making for the definition of CCyB is also supported by the Complimentary Early Warning Indicator (CEWI), where, in addition to the primary indicator, other indicators that monitor the intensity of lending as a whole and in certain segments of it are included.

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### **Justification for setting the CCyB rate**

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The values of the primary indicator have continued to be negative until Q1-2024<sup>i</sup>, but the size of the negative value has decreased. Although the primary indicator is at a level that still does not suggest, as a rule, the adoption of macro-prudential measures, the performance of CEWI suggests that this attitude needs to be reviewed under circumstances where credit growth has been steady and even accelerated in certain segments of it. These developments signal the transition to a situation with a pronounced acceleration of lending, which may be accompanied by the accumulation of risks for credit quality in the future. In this case, the need to react counter-cyclically in order to control risks, directly reflects the concept and purpose of CCyB.

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<sup>i</sup> INSTAT has announced in its official website the postponement of the deadline for the publication of the value of the Gross Domestic Product for Q1-2024, from 26.06.2024, to 08.07.2024. Under these circumstances, the calculation of the value of the primary indicator is based on the estimated value of the GDP by the Bank of Albania. The analysis can be updated after the publication of the official GDP value by INSTAT, in case of significant changes.

Performance indicators

**At the end of the first quarter of 2024, the primary indicator records a narrowing of the negative gap (improvement in its values) for the third consecutive quarter.** The value of the indicator has narrowed both versus same period a year ago and the previous quarter<sup>i</sup>.

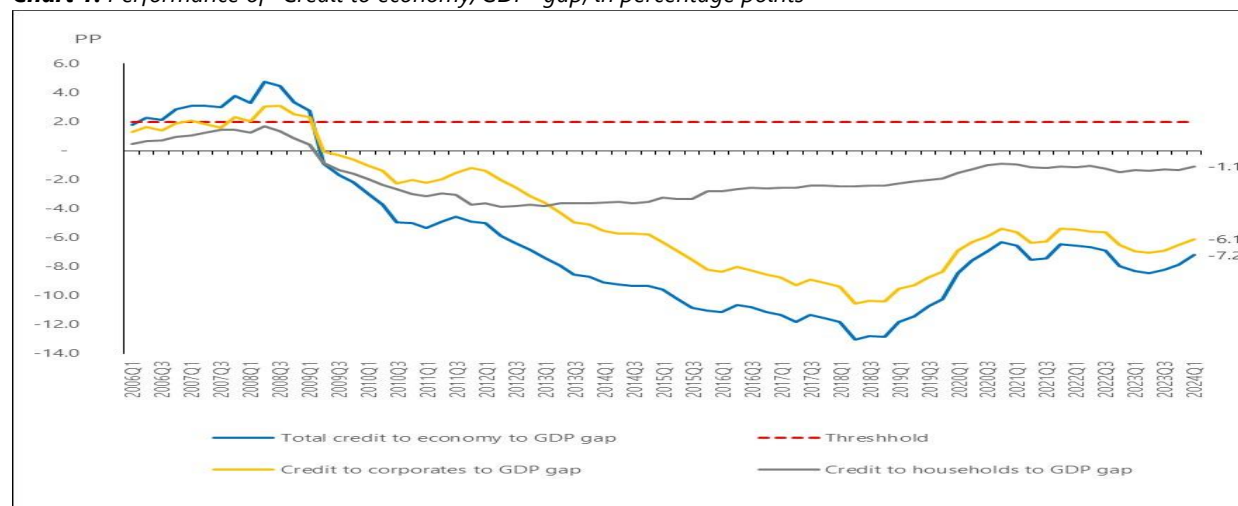
**Table 1.** The primary indicator

Indicator <sup>ii</sup>	Historical average		2024 Q1
	2003 Q4 : 2008 Q4	2009 Q1 : 2023 Q4	
"Credit to economy / GDP" <sup>iii</sup> gap	2.1 pp	-7.93 pp	-7.2 pp <sup>iv</sup>

Source: Bank of Albania (BoA) and Institute of Statistics (INSTAT).

The above performance reflects the higher annual growth rate of credit to the economy in Q1-2024 (6.8%), compared to the growth of gross domestic product for the same period. The primary indicator recorded a narrowing of the values of the negative gap both for the "individual" and "business" segments. The latter continues to make the main contribution to the performance of the value of the primary indicator.

**Chart 1.** Performance of "Credit to economy/GDP" gap, in percentage points



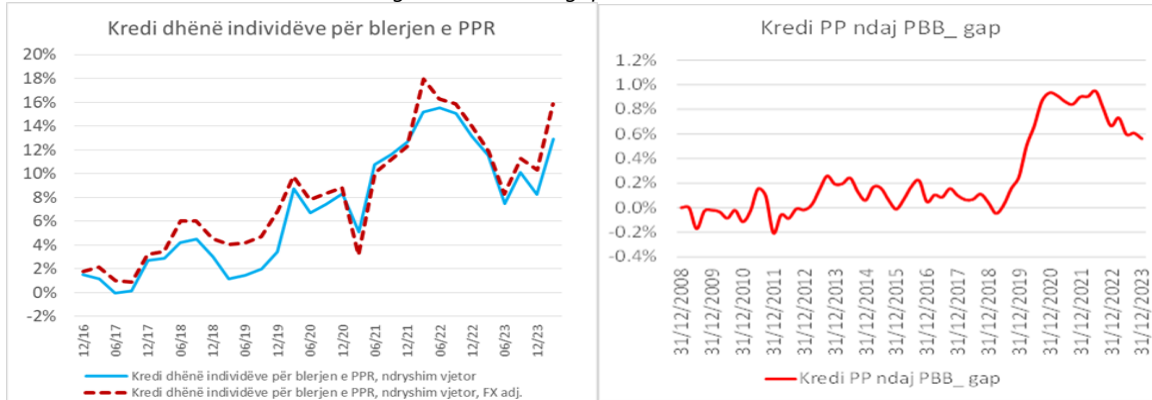
Source: Bank of Albania calculations.

As can be seen from the graph above, after Q2-2008, where the highest positive value was recorded (4.7 pp), the values of the primary indicator have mainly followed a downward trend. Both for businesses and individuals, a period of continuous decline (widening of the negative gap) was observed, mainly in the periods 2008-2012 (for individuals) and 2012-2018 (for businesses). Afterwards, their values have shown an upward trend, so the negative gap has narrowed. This trend has been more stable over time for individuals.

**In general, the development of the nominal value of loans to individuals (as reported by banks) is determined by the development of loans for the purchase of real estate (residential real estate).** The growth of this credit has been faster than the growth rate of the overall credit balance, faster than the nominal growth of GDP, and as a result its weight in relation to GDP has increased since 2019.

The growth of credit as a whole, and that of credit for the purchase of residential real estate, is even stronger when corrected for the diminishing effect of (appreciation) the exchange rate. As can be seen from Chart 2 (left), at the end of March 2024 annual credit growth, when corrected for the effect of the exchange rate, was 10% (compared to the reported 7%). The same indicator for the mortgage loans was 16% (compared to the reported 12.5%).

**Chart 2.** Household real estate loans granted and the gap to the ratio to GDP



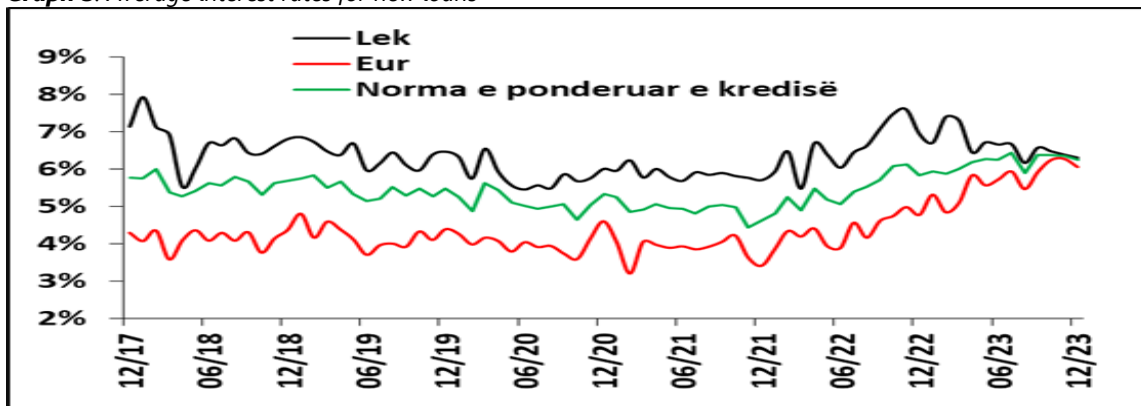
Source: Bank of Albania calculations.

If the gap of this loan type to GDP is calculated, in a similar way as for the primary indicator, it can be observed (Chart 2, right) that this gap records steady positive values, starting from 2019.

If we analyze the performance of loans granted to businesses, for development and investments in real estate (residential and commercial), when corrected for the exchange rate effect, the annual growth rates until March 2024 were over 30% in each case. Further, when aggregating the loans granted to households and businesses for real estate (residential and commercial), the annual growth rate of this portfolio is 25% (from 21% according to reporting in nominal value). This growth rate is significantly higher than the annual growth rate for the entire loan portfolio of 10%, evidencing the acceleration of lending for this segment.

Credit growth in the last 2-3 years has continued to be strong, despite the increases in interest rates for the Albanian Lek and for foreign currencies. This increase in interest rates has been particularly significant during 2022.

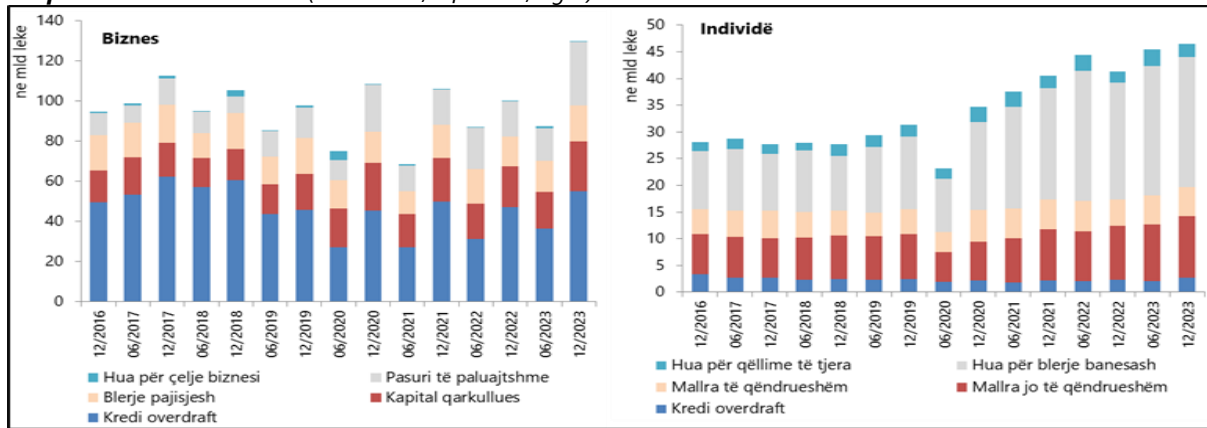
**Graph 3.** Average interest rates for new loans



Source: Bank of Albania calculations.

Despite expectations, the increase in interest rates has not had a significant restraining effect on loan volumes. On contrary, it is observed that the volumes of new loans, according to sectors, have generally been stable or have increased (Graph 4).

**Graph 4.** New loan volumes (businesses, left – HH, right)



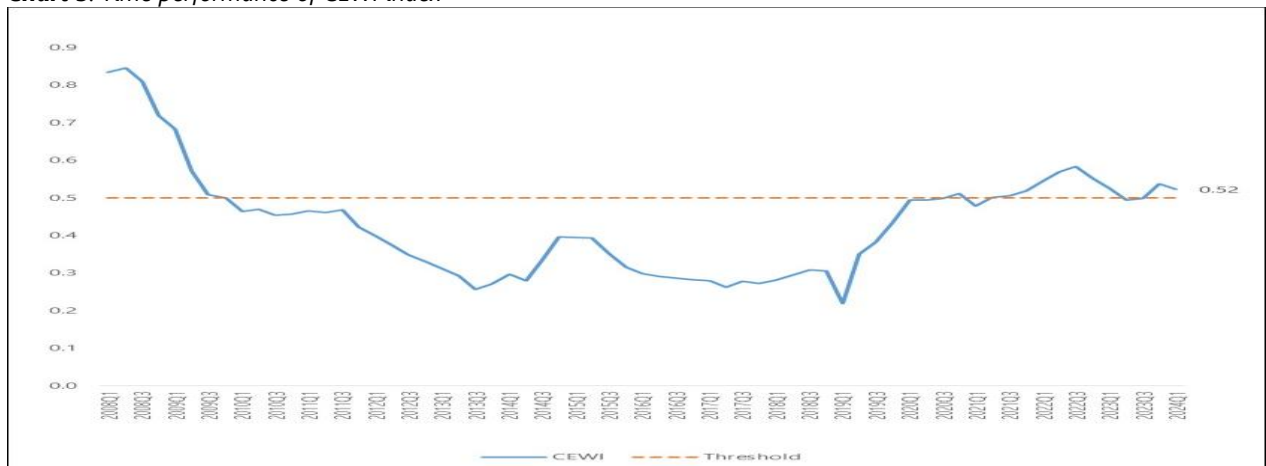
Source: Bank of Albania calculations.

If interest rates will stop at these levels or change direction, then the possibility of accelerating credit growth would be strengthened.

**The accelerated credit growth over the last few years has not been sufficiently reflected in the values of the primary indicator.** The index values, although narrowed, remain clearly in negative territory. This phenomenon has also been observed in other countries, and is mainly attributed to low rates of lending for a long period of time in the past (mainly after the global financial crisis of 2007-2009).

**But the complementary early warning indicator (CEWI) has been signaling this rapid credit growth for several quarters.** The values of the index (actually 0.52) are above the maximum threshold defined in the Methodology "For determining the countercyclical capital buffer" (0.5), a territory where this methodology foresees the application of a positive value of CCyB (of 0.5%).

**Chart 5.** Time performance of CEWI index



Source: Bank of Albania.

**In general, the positive developments in the financial cycle are also reflected in the performance indicators of the banking sector.** Throughout 2023, the sector continued to expand its activity, ensured a good quality of assets as the ratio of non-performing loans fell to historically low levels (4.7%), achieved a very good financial result and maintained good levels of the capital adequacy ratio (19.4%). This trend has generally continued in the first months of this year, especially in terms of profit realization. However, the ratio of non-performing loans showed a slight increase (4.8% in May 2024), while the capital adequacy ratio decreased by 0.3 percentage points, to the level of 19.1% (March 2024).

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*Conclusion and proposal for the CCyB rate*

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From several quarters, the Albanian economy is experiencing a positive financial cycle based on the accelerated growth of bank credit. Such periods are associated with good levels of financial performance for agents of the real economy and for the financial system. However, these periods are also associated with the beginning of certain risks, which may be related to a decrease in credit standards, the increase in the levels of its concentration in certain sectors or markets, the increase in debt levels for agents of the real economy beyond the healthy levels etc.. These situations, if allowed to further develop, can make the economy and the financial system more sensitive to various shocks, thus undermining financial stability. For these reasons, in these cases it is suggested to use macroprudential instruments that soften the course of the financial cycle (act in a counter-cyclical way) and prevent the uncontrolled development of these risks. Among these instruments, CCyB holds an important place.

In our case, positive developments in the financial cycle are better reflected by the performance of the values of the Complementary Early Warning Indicator (CEWI). Based on the values of this index over several quarters, the use of CCyB is suggested by the methodology "For determining the countercyclical capital buffer".

In conclusion to the analysis of these developments, we propose:

**- The increase of the CCyB rate for Albania from 0% currently, to 0.25%. Banks will have to meet this level of the buffer for the first time in June 2025.**

If lending growth rates will remain high, further increases in the KUNC rate can be expected in the coming periods.

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**NOTES**

<sup>i</sup> The value of the primary indicator was: [-8.28] pp in Q1-2023, [-8.45] pp in Q2-2023, [-8.20] pp in Q3-2023 and [-7.84] pp in Q4-2023.

<sup>ii</sup> In analyzing the values in the table, it should be considered that the calculated values of the primary indicator and its historical average differ due to two factors: a) developments in the values of credit to economy and GDP; and b) possible revisions of GDP value performed regularly by the Institute of Statistics (INSTAT). These two sets of factors can influence the value of the primary indicator, in the same or opposite directions.

<sup>iii</sup> GDP is estimated as the sum of the values for the last four quarters. The actual GDP growth rate for the referring period might be subject to revision in the short-term by INSTAT.

<sup>iv</sup> The value of primary indicator in Q1-2024, records a narrowing (a lower negative value) of the credit gap compared to the value of Q1-2023 [-8.28].