## What is the problem under consideration?

For the third year in a row, the credit growth has been one of the main economic developments in the country's financial market. The growth trend, although in a decreasing tendency, has seized the attention of the domestic regulatory bodies as well as international monitoring institutions. Despite the decreasing trend of growth, in absolute terms credit to the economy have/has increased significantly. Such increase is warned with the increased portion over the markets assets as well as the as the same tendency over the country's GDP.

Table 1

| Ratio | 2005 | 2006 | 2007 |
|---|---|---|---|
| Credit / Assets | 25.73 | 31.71 | 39.37 |
| Foreign Currency Credit / Assets | 19.4 | 22.8 | 28.6 |
| Credit / GDP | 15.3 | 22.0 | |

The loan portfolio has showed different characteristics in terms of several features like maturity, economic sector, source of funding or the institution itself. Within this phenomenon, the feature that has raised concern for the regulatory body and the market participants is its portfolio structure according to the currency. As per the figures referring to December 2007, loan portfolio in foreign currency made of 72.5% of the entire portfolio. Since 2005, when credit expansion started showing up, the credit in domestic currency has increased its share in the total portfolio, but still the foreign currency loans has remained dominant*. The main foreign currencies used in the market are the Usd and the Euro.

It is necessary to elaborate the reasons behind such development, which can help in further analysis. The noticed trend is a result of market demand and supply. In our case it can not be noticed a clear indication for a firm one-side influence. Though, the results of such increase stand in the increase of both demand and supply.

On one hand, banks themselves have had enough deposits in foreign currencies or their capital is kept in foreign currencies, therefore the offered loans in foreign currencies are justified. There is still much activity based on foreign currency providing the necessary liquidity to support such trend.

One the other hand, the demand from the market has been quite high for some reasons:

- Interest rates for loans on foreign currencies have been lower; therefore lower installments had to be paid; while interest rates in ALL are higher in nominal terms it is charged a higher premium-spread;
- The high level of imports for business activities, since the domestic economy is heavily depended on imports, therefore the matching of currency in-flows and out-flows was needed;
- Some internal economic activities used to price their outputs in foreign currencies due to the stability of the foreign currencies.

Even within the foreign currencies loan portfolio, there has been a shift of demand and supply from Usd to Euro following the strong devaluation of the American currency and the increased business activities with the Euro zone countries.

Risks associated with the phenomenon of increased credits in foreign currency consist mainly of the counterparty failure. Banks balance sheets do not show any internal risks regarding liquidity or significant open position, since it is managed daily and there are regulatory requirements due for implementation.
Individuals might face the risks of growing interest rates or devaluation of domestic currency in case of ALL based incomes due to currency mismatch.

- The increase of reference index rates like EURIBOR or LIBOR, has raised the credit installments, thus reducing the repayment capacity of the borrowers.
- A possible depreciation of domestic currency, measured to credit currency, leads to a higher portion of income (domestic currency based) to be paid.
- The credit portfolio in the country is relatively young, though the installments paid during the first years, especially for long term lonas, consists mainly of interest, leaving the borrowers with a burden of principal for the years to come.

    - A complementary concern is unhedged positions of customers having fx-denominated income and borrowing in lek , although we have little quantitative evidence of this situation;

## Market Failure

The fostering of credit activity for three years now is mainly a result of growing competition. Although the non-performing loans ratio has been low, it is mostly a result of the higher increase of loans in absolute terms. Despite that, the tendency of this ratio is upward and raises concern. Banks have marketed strongly the crediting in foreign currency offering a diversity of products and raising continuously the maturity, especially for mortgages. Such behavior of the banks is justified for pure competitive reasons. There is a strong demand for loans and an appetite by banks to meet this demand.

For many years, banks have considered a secure investment the purchase of government treasury bills in domestic currency. Still today, there is low incentive from the market to lend in domestic currency. Also, the public, following the raise of base rate from Bank of Albania, has reduced the demand for loans in ALL.

Market themselves have failed to address their final products efficiently. The competition is growing and the banks still lack the capacities to design products features based on economic reasons or they behave passively in building the internal structures to properly monitor the process.

### Asymmetric Information

There is asymmetric information inside the institutions themselves and in the relation between the customers and the institutions.

- There has been low coordination between special units within the banks like the loan unit and the treasury one. Though, the products were designed to be attractive to the market, shading the future economic effects. Long-term predictions on exchange rates and interest rates have been ignored. There is not a special unit to analyze the macroeconomic developments. There are signs to reconsider the products design process, but not spread all over the market participants.
- Due to market concentration, products were initially offered with a high interest rates and interest margins; the analysis was performed based on the moment of application incomes. Now competition has almost equaled foreign-currency and lek spreads. Banks dn’t have the strong ncentives they used to have to lend in fx currency

- In many cases, the clients currencies in-flow and out-flow has not been matched, which, in some cases, was later introduced in repayment difficulties;
- The public has not been able to estimate the characteristics of the products; there choice was mainly based on the installments of the first year. The later developments have shown that many were surprised for the increased indebtedness due to changing interest rates and/or the long maturity.
- In many cases banks have shown low transparency, taking advantage of customer lack of knowledge.

## External Factors

- Positive external factors are considered the relatively high foreign currency remittances. On one side, it has been accounted for the domestic currency stability and on the other hand, it has provided liquidity to the borrowers for obligation repayments in that currency. Such issue has provided a strong support for economy by reducing the current account deficit.
- Most of the domestic property prices are denominated in foreign currency. Since most of the collateral requirements stand on fixed assets, a possible depreciation of domestic currency does not seem to affect the collateral value. At least, banks will have the proper coverage of the credit amount in case collateral execution.

- Negative external factors might be the adverse changes of interest rates or exchange rates. An adverse changes of interest rates is a supposed increase that might affect the portfolio entirely. As for the exchange rate, adversity is considered the depreciation of currency of borrower's income.
- Adverse changes of macroeconomic parameters such as increased inflation, unemployment growth or domestic currency instability might hazard the consumers purchasing power, translated in lower payment capacity.

Additionally, as second-round effects can be considered negative external factors referring to the property denominated prices.

- The residential construction activity has shown an upward trend, though the demand for apartments is expected to grow. Their currency of denomination prices, also increasing, will dictate a higher demand for loans on foreign currencies.

- Following this trend of residential construction activity, apartment prices could face a possible decrease in the midterm since the flats offer could exceed the demand. The government is currently introducing the application of VAT on apartment sales. It is expected to increase prices and reduce the demand.

Both the above mentioned negative externalities, evidence the risks of banks to recover the full loan amount in case of collateral execution or a reduction of inventiveness from the borrowers to repay their obligation whether the collateral value falls below the credit amount.

## Regulatory failure

In the past we had a regulatory failure given to a weakness of regulatory enforcement since banks have failed to comply with some regulative requirements.
It mainly refers to transparency issues such presenting the effects of products characteristics in short-term and long term. Recent changes on transparency requirements have started to be applied, but deficiencies in implementation are still present. Despite that, enforcement measures have already been taken through on-site examinations. It’s a process already started and ongoing.

At present there are not regulatory requirement to address detailed requirement regarding the creation of specific structures for product design and monitoring. Banks have been free to create their internal structures for developments according to their assessment. If deficiencies have been noticed, they have been revealed or addressed through recommendations during on-site examinations. To date there is no evidence that recommendations have been resisted by the banks but implementation is still in process..

# Why is regulatory intervention necessary?

**General goals**

1. Maintenance of a high quality portfolio by reducing risks of shocks from exchange rate changes. Negative developments from the internal and external markets need to be absorbed as softly as possible from the banks.
2. Conduction of fair business rules from all the market participants with reference to customer and public disclosures.
3. Increment of knowledge on financial services in general and products in special from businesses and individuals.

# "Do nothing" option

As for 1st goal, some of the banks already have identified the need to improve the quality of providing credits in foreign currency. The major banks, supported by their shareholder base such as large international groups will, or have already, built units of risk management. But the time required to secure its proper functioning and final results can extend beyond the necessity to mitigate the already evidenced risks.

With regard to the 2nd goal, the marke is left like it is and hence it is unlikely to enhance towards better standards

Other banks might assume a more simple behavior such as following the market developments and falling under the competitors' pressure. They will react passively, just designing product features based on markets not being able to create the internal necessary environment for smoothing the above mentioned effects.

With regard to 3rd goal, industry and banks themselves will find difficult to address this goal which can be regarded as "public good".

# Regulatory design of BoA objectives and principles

## Specific measures

Goal number 1 - Loan growth:

- Specification of strict standards during the customer selection in loan process phase with reference to their currency of inflows and type of collateral.
- As “unhedged customer” is meant ….
- receiving loans in fx currency and paying installments in lek
- A customer whose fx-currency revenues larger than annual debt service obligation

**What needs to be done (next steps)**:

- *BoA is going to receive, through questionnaire and on informal basis (email), the market practice experience in risk analysis and mitigation;*
- It might include requirements for setting a limit ratio “installment amount/income for the frequency of repayment” whether the borrowers income are based in a different currency from the loan currency. Otherwise, in case of such currency discrepancies, banks might require additional guarantees and/or set a limit ratio for loan amount to collateral value.

- definition of what “unhedged customer” means, focusing on the more riskier cluster which changes the risk position of the bank;
- definition of high risk means
- Identification of quantitative measures for applying restrictive measures to foreign currency loan increase. It is aimed to increase the provision rate by 5 % for the loans given to unhedged customers. In this cases there are two scenarios: first, application of his for the entire portfolio of unhedged customers and second, application of such rate granted after the changes approval. It is considered a ratio of 400% ***(please make it more explicit the rationale for 400%, how this % was identified and which intended purpose it is meant to address, making a comparison between basesline and scenario under the ratio-scenario. This in order to provide additional evidence. Given the resulting parameter, a policy might be designed accordingly)*** with between portfolio of unhedged customers and regulatory capital, and if ratio exceeds this limit, the

amount of such making the difference to be deducted from regulatory capital calculations.

**What needs to be done (next steps)**:

- *Financial institutions will provide evidence (written short note) of why the BoA preferred option (provision-rate tool) is likely not going to meet the intended effect as much as BoA would expect [IFRS-migrating banks will be less hit; such measure works with financial institutions applying Albanian accounting standards] BoA will reconsider the measures to implement according to the analyisis of the evidenced information by market participants.*

- Goal number 2 - Business conduct:
- Establishment of internal procedures for products design. The procedures need to include the criteria to assess ex-ante the effects of counterparty failure in case of adverse changes of foreign currency interest rates or exchange rates based on the characteristics of the products. It also aims at improving the internal communication by sharing information between units in the institution. Final products characteristics and applicability need to be assessed based on prior consideration of forecasted macroeconomic or microeconomic developments, in a short-term and long-term period.
- Financial institutions should be requested to make mandatory disclosure when promoting fx-denominated loans;
- Establishment of structures for controlling that proper implementation of approved procedures. In terms of internal control systems, it aims at adding personnel at two or three control levels to guarantee the correct implementation of the procedures as well as allow proper monitor or control in place. In terms of, internal audit department, additional and trained staff might be required to cover the adequacy of internal audits based on increased activity and product typology.

Goal number 3 - Consumer financial awareness:

There is not evidenced any regulatory failure that might interfere with the above mentioned goals. It is required that the present regulatory framework be completed with amendments as per the above goals.

## Operational Goals

Since improved requirements on transparency are already introduced, it is aimed to recommend enforced implementation on their implementation.

# Regulatory Change Options.

## Qualitative Options

- Assigning of regulatory restriction for the establishment of a special unit for risk management and economic analysis. The proposals will aim at introducing enforcing regulatory requirements to establish a unit for risk management and economic analysis. Some banks have identified the need and have already established it. The requirement will specify main working functions and relation to other units inside the banks. Working functions are meant to be analysis on micro and macro level. Size of unit should match the bank's size and type of activity.
- Imposing restricting rules for Board of Directors in order to secure an improved process of credit risk management and mitigation. This structure should decide the establishment of the above mentioned units. This decision should identify the size according to the needs and forecasted developments. It should identify its positioning in the bank structure, the structure reporting to and supporting units. The Board of Directors should supply the new units with the internal working regulations, work procedure and job descriptions.
- Defining of specific requirements for foreign currency loans such as ratio of installment on income or collateral value restrictions. This aims at involving Board of Directors in improving bank regulations fort the issue of setting conservatory requirements in case of unhedged customers. We have identified the above mentioned indexes that need to be addressed, beside any other feature that Board of Directors might deem valuable.
- Setting of transparency prerequisites for minimum information provided to the customers. There are already introduced

## Quantitative Options

Identification of quantitative constraints such as provision rate increase or exposure to bank's capital.

- Application of 5 % increase of provision rate for loans granted to unhedged customers. There are wo options: 1) application of the rate to entire portfolio of unhedged customers; 2) application of the rate to the newly disbursed loans, after the regulatory amendments.

- Defining a limit rate of 400% between the portfolio at risk of unhedged customers to the regulatory capital amount. The portfolio at risk sum beyond this rate should be considered as a deductive element in regulatory capital requirements.

The quantitative analysis of these two options will be presented in the CBA document.

The qualitative options are considered jointly as one option. The are also considered to have the priority in a regulatory change. The quantitative ones are additional. Whether the results will show net benefits, the quantitative options will be recommended to be applied together with the qualitative ones.