A Macroprudential Policy Framework for Albania

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Abstract

This paper discusses a framework for macroprudential policy in Albania, which is a foundation stone for ensuring financial stability role of a central bank. It focuses the way the macroprudential policy framework should be designed in a small and open economy like Albania. Based in the experience of the Albanian's financial system during the last two decades it provides the definition of macroprudential policy and its objectives. The paper argues that the establishment of the macroprudential framework in a bank-based economy with a relatively simple and small financial sector that is controlled by foreign banks, the phenomenon of procyclical behavior should be stand priority, but structural sources of systemic risks and associated instruments should be discussed as well. The paper suggests that strategic document of Macroprundence for Albania should be developed covering three main directions: i) development of new methodologies for measuring systemic risk and effective regulatory and supervisory framework; ii) improvements in internal organizations of Bank of Albania, as the macroprudential authority, and its cooperation tools with other authorities; iii) improvements in the macroeconomic policy and environment.

Keywords: *Financial stability, Macroprudential policy, Systemic risk, Procyclicality*

Introduction

Recent financial crisis has shown that previously defined and pursued economic policies do not suffice for maintaining financial stability. It proved necessary to formulate a new, macroprudential policy that would fill the gap. Macroprudential policy is a policy used to identify, monitor and assess systemic risks to financial stability with a view to protecting the stability of the financial system as a whole, which also includes enhancing the resilience of the financial system and preventing and reducing the accumulation of systemic risks to ensure that the financial sector makes a sustainable contribution to economic growth.

At international level, the Financial Stability Board (FSB) has been established to coordinate the work of national financial authorities and international standard-setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interests of financial stability. One of the most important tasks of the FSB is to advise on and coordinate the establishment of macroprudential policy framework. In the EU, the European Systemic Risk Board (ESRB) has been established as EU authority for macroprudential oversight. Many initiatives have also been set up to produce macroprudential regulations. Some of these have already been incorporated into the "Basel III" accord of the Basel Committee on Banking Supervision (BCBS) and into the EU proposal for its transposition, called the CRD IV package.

The paper aims to explain the definition of macroprudential policy and the framework for its conduct that should be developed in Albania as a small and open economy, with a financial system dominated by banks, without compromising monetary policy's main objective that is ensuring and maintaining price stability. The experience of Albanian financial system with regulating and supervising financial institutions over the preceding two decades will be very important source to develop the macroprudential policy of the country. The starting point for realizing the aim mentioned above is BoA's financial stability definition, the original macroprudential policy framework advocated by the Bank for International Settlements, as well as the information obtained from assessments of the latest global and euro-area financial crises.

The paper is structured as follows. Section 2 presents the structures of the Albanian financial sector and its historical developments deemed important for understanding the BoA's preferences and approaches. Section 3 examines the objective of financial stability and defines macroprudential policy and systemic risk. Section 4 highlights three policy directions that the framework of MPP in Albania should cover, while Sections 5 conclusions.

Albanian Financial System's profile and its historical development

Albanian Financial System's structures

The Albanian financial system similar to those in many other European countries is bank-based. It consists of banks, non-bank financial institutions, savings and loan associations, insurance companies, private supplementary pension funds and investment funds. As of the end 2015, the depth of financial intermediation ratio, measured by the total assets of the financial sector in percent of Albania's Gross Domestic Product (GDP)[1] was steadily increasing, reaching 101.3%. The banking sector made of 16 banks, dominates the financial system, its assets by 1,318 billion lek represent 90% of the financial system assets and 91.3% of country's GDP[2].

Hence, the identification and risks assessments that source from banking sector activity is very important in the context of financial stability. The relevance of the non-bank financial sector is very limited, thus its contribution to systemic risk is apparently minimal.

TABLE 1: Financial system segments as a percentage of GDP, in years

Licensing Supervisory Authority	Financial System	2010	2011	2012	2013	2014	2015
Bank of Albania	Banking sector	80.9	84.7	89.6	90.5	91.7	91.3
	Non-banking sector	2.7	2.5	2.7	2.5	2.7	2.7
	SIAs and their Unions	0.8	0.7	0.8	0.8	0.8	0.7
Albanian Financial Supervisory Authority	Insurance companies	1.4	1.5	1.6	1.6	1.7	1.9
	Pension funds	0.01	0.01	0.02	0.03	0.04	0.1
	Investment funds	-	-	1.21	3.7	4.5	4.7

Source: Bank of Albania, Albanian Financial Supervisory Authority

In December 2015, banking sector is exposed to other segments of financial system only 1.7% of the total banking assets. These low level of exposure to other non-bank financial segments, limit direct financial risk that might be transmitted through inter-sectorial relations. On the other hand, the exposure of non-bank financial segments to banking sector is in considerable level that means high sensitivity of them by the performance of banking sector. The banking activity continues to show high concentration. Out of all banks, the six biggest ones

1 GDP's value is evaluated about 1,443.7 billion lek as published from INSTAT and FMN.
2 As per Financial Stability Report of Bank of Albania H2/2016.

account for 75% of total banking sector assets. Foreign banks hold around 84.1% of total assets of the banking sector, currently all operating in “subsidiary” legal form. All banks participate in the interbank market.

Around 83 % of banks’ liabilities are composed of public deposits, and roughly 50% of their assets are represented by loans to businesses and households. In terms of currency composition, the ratio of loan to deposits, either in domestic currency or in foreign currency, is significantly lower than 1. Capital Adequacy Ratio for the banking sector is 15.72%, while regulatory requirements require banks to hold minimum level of 12 %. Minimum liquidity ratios in domestic currency and the two main foreign currencies, have maximum exposure levels to related parties in terms of regulatory capital. Governance principles require for any bank operating in Albania to have the Board of Directors, the Executive Managements, and various committees.

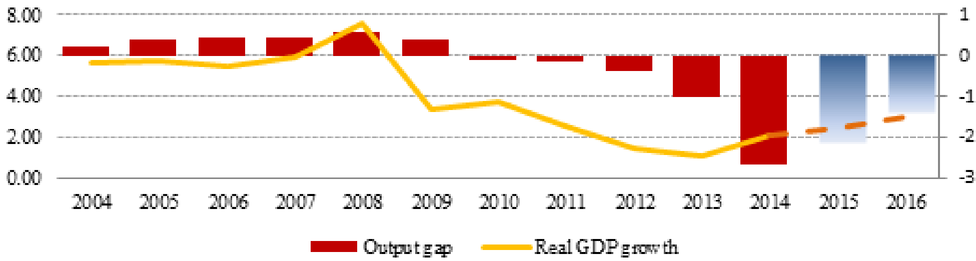
Bank of Albania is the central bank and plays the role of the regulator of the banking sector. From 2005, BoA manages the public infrastructure of the payment systems in the domestic currency. The central bank also provides clearing and settlement facilities for institutional transactions in the primary and secondary market of government debt securities. Hence, the functioning of the payment system is considered as with a very low risk. There are no securities of private debt traded in the capital market in Albania, and hence, the banking sector provides the main source of finance for the needs of real economy agents.

From this description, the banking sector, the payment system and the clearing and settlement for government debt securities, appear to be the most critical parts of the financial system in Albania. The focus should be on banks, which dominate the financial system and are part of foreign banking groups. Although the business model of banks is fairly traditional, based on deposits and loans, and their exposure to wholesale financing and sophisticated investments is quite limited, one has to consider other existing risk channels and possible risk built-up in the future. Hence there is a need to develop Macroprudential Policy responses and tools in a preemptive way.

Macrofinancial developments

During the period 2000-2008, Albanian economy has performed with a steady economic growth, average 6.1% and continues to perform well until in the wake of financial crisis in 2008 with 7.5% in real terms. The crisis impact was reflected in coming years, where the economy was raised by only 3.5% in 2009. Economic activity was slowed down in 2011 by 2.9 % in average, and in 2013 was grown with minimum historic level of 0.44%.

FIGURE 1: Performance of real GDP growth



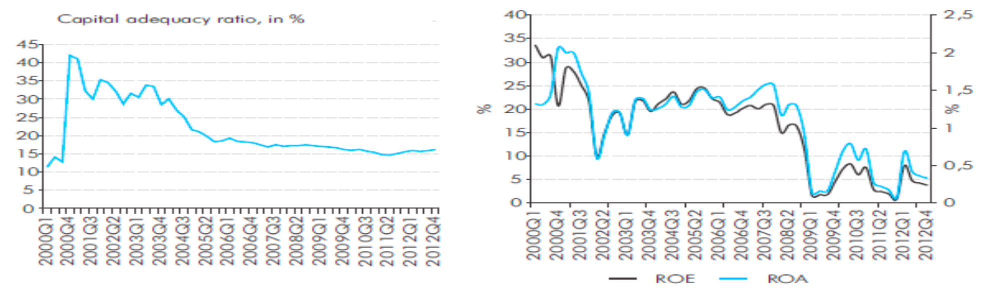
The structure of the economy has been changed following these economic developments. During 2000-2008 is evidence the flowering of construction sector, contributing by 13.8% in value added of 2008, while service sector contributed with 51.1% during period 2000-2008. Agriculture sector contribution is slow down in average 20.3%, meanwhile industrial sector continue to give a low contribute 8.1%. The starting of financial crisis has impacted negatively the construction sector, so its contribution into real economic growth is reduced considerably, while service sector is extended in sustainable way.

Inflation rate, since 2000 until 2013 is fluctuating in interval 2-4%, in the line of targeted band of 3% (+/- 1%) of the Bank of Albania. After financial crisis, the average rate of inflation rose to about 3.5% in 2010 and 2011, from 2.2% in 2009, mainly caused by high level price of import. The low economic growth during 2012 and 2015, mainly because of low level of consume and investments, reduces average inflation rate in 1, 7%.

Developments of exchange rate, discussed in terms of Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER), walked through the same line with macroeconomic developments during crisis period, as well as during normal times. Developments of exchange rate have been stabilized after 2001, when Albanian currency was gradually strengthened, until financial crisis was started. During 2009-2010, NEER and REER were depreciated, while the markets were stabilized, putting foreign exchange in a new equilibrium during development years.

Historically, the developments in financial sector reflect the main macroeconomic developments. Performance of financial system was stable; banking sector is good capitalized and has generated profits. Bank Capital indicator for the system during the period 2000-2008 have been average 24%, two times higher then minimum threshold regulator defined by the Bank of Albania 12%. After the global financial crisis, the Capital Adequacy Rate (CAR) has been reduced in 15% showing a good capitalization of banking sector. In terms of the profits, banking sector is characterized by positive profits during 2000-2015. It is evidenced the decline in profits from own assets, as well as from own funds mainly after last financial crisis.

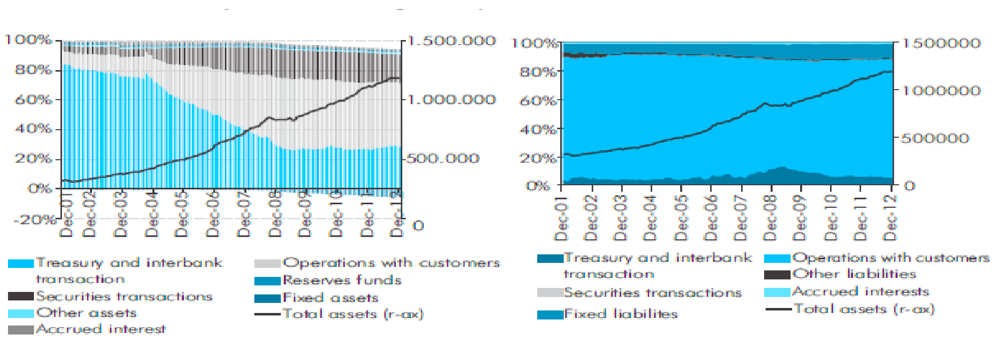
FIGURE 2: Capital Adequacy Rate and Profitability of banks



Source: Bank of Albania.

System Bank's assets and liabilities have been expanded during 2000-2015, but after 2008 until 2015 this expanded have been in slower terms.

FIGURE 3: Decomposition of total assets and liabilities of banking system

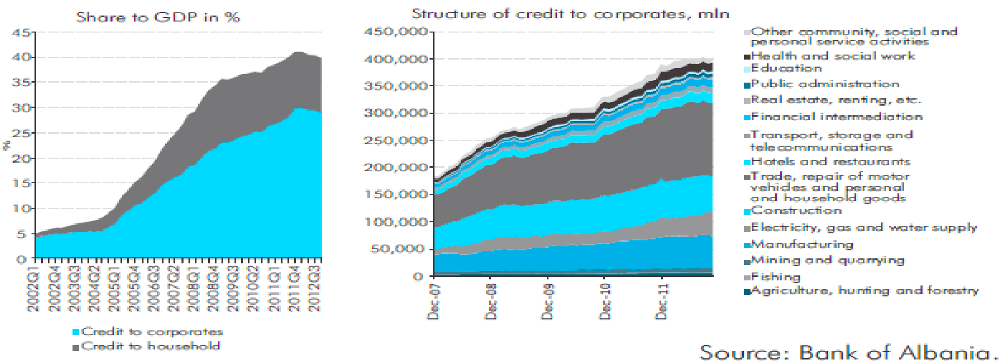


Source: Bank of Albania.

The item which has contributed in lower expansion pace of assets, is "transaction with clients", item that presents the lending of banking sectors to resident and non-resident subjects without including calculating interests. Deposits of the banking sector remain the main financial source of assets and made up about 83% of the total of liabilities. Regardless the financial crisis, deposits continue to contribute positively in the system.

The Lending activity in Albania started to be increased with quick pace after 2004. As of the end of 2015, total loan consisted in 40% of GDP. The beginning of financial crisis had a big impact on the growing of the credit. The annual rise rates suffered marked slowdown with 1.5% for the loan to business and with 0.43% for the loan to households, in the end of 2013.

FIGURE 4: Credit performance in Albania



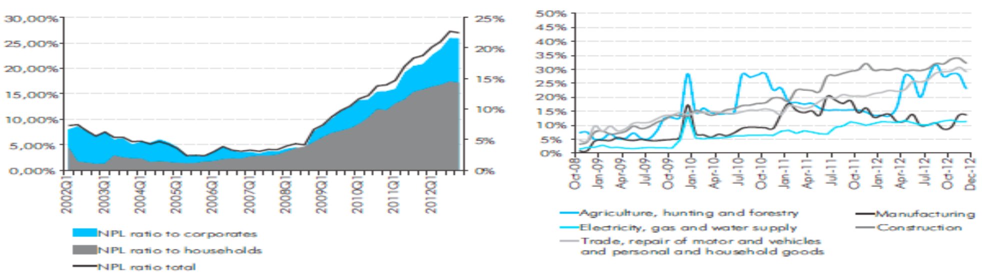
Source: Bank of Albania.

As regards the structure of loans to businesses, the sectors more financed from banking system have been trade, construction and elaborated industry / (manufacturing). After 2009, the lending to the construction sector was inherent slowdown with a grow rate of 6.3%, compering with 43.2% in 2008. The share of construction's loan to total one arrived at 14 % in the end of 2015, from 21% in the end of 2008. Trade and production sectors have been grown their weight to total business loan, while agricultural and electric energy have been more attractive for loans.

The financial crisis had a significant impact on non-performance loan indicator. The quality of the loan is worsted, from a low level of 6.6% in the end of 2008, in 22.8% in the end of 2014. Such a reality reflects the situation of the business non-performance loans stock, which was grown quickly. On the other hand, the quality of household loans was worsted too, albeit to a lower pace, accompanied with negative developments in their borrower activity.

Referring the main sectors of the economy, construction sector has marked higher pace of non-performance loan growth, arriving at 30% in 2013, from 7.6% in the end of 2008. Trading sector featured (appeared) high level of non-performance loans, while the sector of furniture with electric energy, gas and water, which has been financed in last years, is performing well.

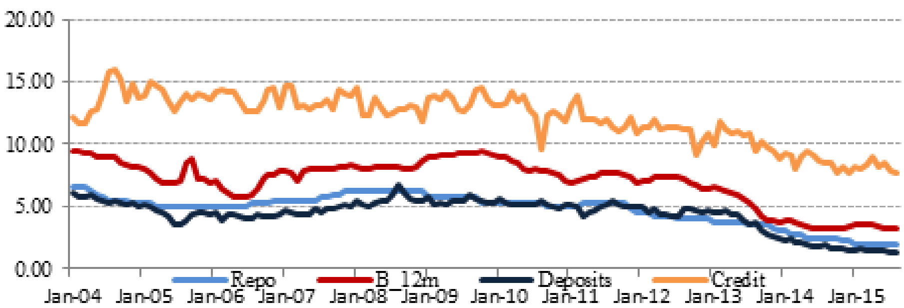
FIGURE 5: Non-performing loan ratio by different **AGENTS (LEFT)** and sectors (right) in the economy



Source: Bank of Albania.

The financial intermediation cost presents a very important element of financial development. Although it is difficult to evaluate these costs, the margins of banking interest rates have been used as a good indicator. Regardless the downward trends of interest rates for loans and deposits, their margins have not follow the same trend. As of the end of 2000, margins of interest rate arrived up to 5.94%, and then have been grown due to low level of deposit interest rate during 2004-2005 periods. After 2008, the margins of interest rates were extended due to higher cost of the loan, which was declined only during the first part of 2012. However, during that period, the margin of interest rate was about 5.1% until the end of 2012.

FIGURE 7: Interest rate performance in Albania



Thanks to above mentioned features of the Albanian banking sector, the consequences of the crisis in 2008-2009 were relatively contained, and banking sector was able to provide credit throughout without major disturbances. Prudent regulations and monetary conditions were the key ingredients of the macroprudential policy toolkit. At the same time, the fact that monetary policy and banking supervision have always been the responsibilities of the central bank proved to be rather important.

The BoA's Approach to Financial Stability and Macroprudential Policy

There is a broad consensus in central bank community that the objective of financial stability is to achieve continuously a level of stability in the provision of financial services (i.e. lending, payments' execution, insurance), which will support the economy in attaining maximum sustainable economic growth. The BoA defines financial stability as a situation where the financial system operates with no serious failures or undesirable impacts on the present and future developments of the economy as a whole, while showing a high degree of resilience to shocks. The core element of BoA financial stability framework is financial stability analysis, studying potential sources of systemic risk arising from the links between vulnerabilities in the financial system and potential shocks coming from various sector of the economy, financial markets and macroeconomic developments. An important element of financial stability policy is macroprudential orientation of BoA financial stability policies and the need to design macroprudential policy. The objective of a macroprudential policy approach in the BIS tradition is to limit systemic risk, i.e. the risk of episodes of financial distress with significant losses in terms of real output for the economy as a whole. This definition falls within the macroeconomic tradition and implicitly involves monetary and fiscal policies as drivers of the financial cycle. The spectrum of issues to be considering when determining macroprudential policies approach is vast, but there is a need to undertake this process in Albania in a sustained mode and establish the right framework and priorities.

The primary distinguishing feature of macroprudential policy is that unlike traditional microprudential regulation and supervision (focused on the resilience of individual financial institutions to mostly exogenous events) it focuses on the stability of the system as a whole. It primarily monitors endogenous processes in which financial institutions that may seem individually sound (or that may take individually sound actions) can get into a situation of systemic instability through common behavior and mutual interaction. Even if all banks are individually reasonably diversified, their balance sheets can be highly exposed to the same sources of risk, associated usually with macroeconomic developments. This calls for looking at the system from a systemic perspective, not from the perspective of its isolated parts. (Hanson et al. 2011) describe a microprudential approach as one which is partial-equilibrium in its conception, while a macroprudential approach is one in which general-equilibrium effects are recognized. Therefore, "true" macroprudential policy instruments are those, which are explicitly focused on the financial system as a whole and on the endogenous processes going on within it. Other measures that can be used to a certain extent to support financial stability and can also have macroprudential aspects include microprudential regulatory and supervisory instruments and monetary, fiscal and tax policy tools. The two perspectives are complementary.

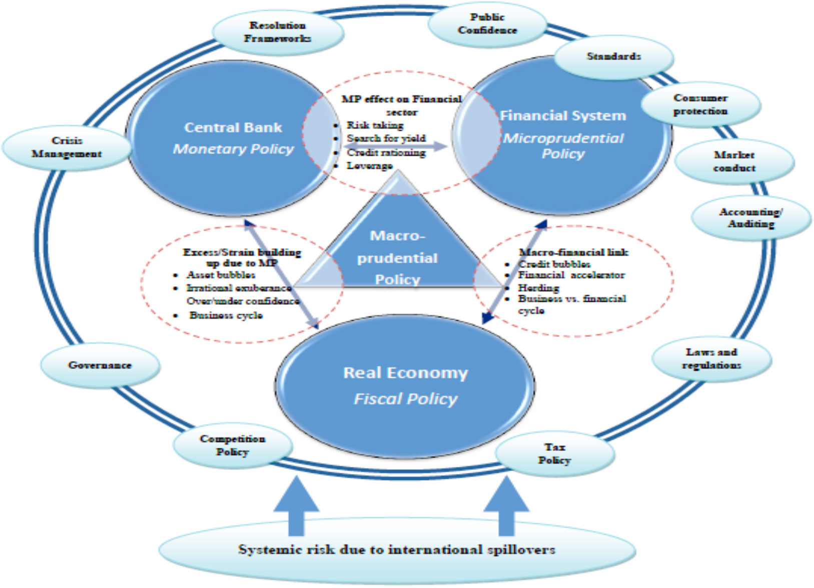
The macroprudential policy objective is to prevent systemic risk from forming and spreading in the financial system and thereby reduce the probability of occurrence of financial crises with large real output losses for the entire economy[3]. By suppressing channels of formation and spread of systemic risk, macroprudential policy should therefore act primarily preventively against signs of financial instability in the future and secondarily at least to mitigate their impacts if prevention does not succeed. The

[3] Reinhart and Rogoff (2009) document that systemic crises have a long-term negative impact on economic activity. In such crises, GDP contracts for a period of around two years on average and returns to its original trend only after four years.

object of macroprudential policy is systemic risk, which has two main dimensions. The time (cyclical, conjuncture, dynamic) dimension reflects the build-up and manifestation of systemic risk over time. The source of this dimension is procyclicality in the behavior of financial institutions contributing to the formation of unbalanced financial trends, which sometimes slip out of the control of institutions themselves or their regulators (see, for example, Brunnermeier et al., 2009 or Borio and Drehmann, 2009). Systemic risk of this type manifests itself primarily as correlated exposures to the same macroeconomic factors across financial institutions.

The second dimension of systemic risk is cross-sectional (structural) and reflects the existence and distribution of systemic risk at any given moment in time. The source of this dimension is mutual and chained exposures among financial institutions. Such institutions can underestimate the potential impact of their own activities on the risk of the financial network as a whole, thereby creating negative externalities for other parts of the system. The time and cross-sectional dimensions to a large extent evolve jointly and so cannot be strictly separated. Shin (2010) argues that increased systemic risk from interconnectedness of banks is a corollary of excessive asset growth and a macroprudential policy framework must therefore address excessive asset dynamics and fragility of bank liabilities. In a growth phase of the financial cycle, rapid credit growth is accompanied by a growing exposure of a large number of banks to the same sectors (usually the property market) and by increasing interconnectedness in meeting the growing need for balance sheet liquidity. Financial institutions become exposed to the same concentration risk on both the asset and liability side. This makes them vulnerable to the same types of shocks and makes the system as a whole fragile. When a shock comes, banks face problems with funding, their lending is tightened and all market participants try to sell their assets at the same time, which creates a downward spiral in both the financial and the real sectors. The time dimension shows up in the degree of solvency, while the cross-sectional dimension manifests itself in the quality of financial institutions' balance sheet liquidity. However, solvency and liquidity are also interconnected, as liquidity problems often transform quite quickly into insolvency. From the general perspective, and given the character of the Albanian economy and its financial system as mentioned above, the time dimension of systemic risk can be regarded as more important. Empirical analysis of the history of financial crises reveals that the credit cycle – whose primary features are changes in credit growth and in the level of debt of economic agents – usually lies at the heart of systemic financial crises with strong negative impacts on output. The 1997's crisis in the Albania, the 2007–2009 global crisis and the subsequent euro area crisis were all of this nature. However, the cross-sectional dimension and the role of sectors other than banks should not be underestimated either. Especially in a small open economy, connections between institutions in the domestic economy and their links with the international economy can both be sources of contagion. While acknowledging the greater importance of the time dimension, the approach to macroprudential policy must therefore cover both dimensions.

FIGURE 8: Framework for financial stability



The discussion and proposed changes to the international financial regulatory reforms is following with special attention from all countries, but the practical adoption of the proposed changes should be guided by the objective to achieve higher convergence with international standards, it should be determined by the characteristics of national or regional financial system and its developments objectives. Moreover, focusing only in achieving better regulation of the financial industry, without addressing at the same time other important and probably sustainable economic developments in the fiscal and monetary policies, represents an asymmetric approach that does not appropriately address financial stability risks.

Key aspects that need to focus the Macroprudential Policy Document

The first policy direction

Methodologies applied so far from the Bank of Albania, such as Financial Stability Map, Financial Stability Index, The methodology to identify systemically important financial institutions, Methodology to assess Financial Systemic risk, the Survey on Bank Perception on main systemic risks, which are focusing in identification and measurement of financial systemic risks, could serve as solid platform to develop future research for other methodologies that provide a more consolidated view on systemic risk and allow for building a risk universe in the financial system and possibly, economic environment. In the future, the efforts should be focus on developing models that analyze the overall relationship between the financial system and macroeconomic context. These models should investigate the impact of assumed changes in Gross Domestic Product, exchange rates, inflation, in banks quantity and quality of lending, capital, net interest income and vice-versa. Banking sector should become an important player in this process, engaging through the implementation of the bottom-up stress testing technique. This work could benefit from the existing financial macroeconomic model in the Bank of Albania.

Banking sector in Albania is sustainable, good capitalized, liquid and able to generate profits, even it is functioning in very fragile national and global context. This is because the banks in Albania have a traditional business model and a lack of excessive leverage. Regardless that, the legal and regulatory framework can be further improved from the macroprudential perspective, than means that legal and regulatory framework, as well as supervisory practices should be focused on the risk of banking activity and institutions, and have clear definitions and requirements that allow for some flexibility in decision making. In practice, in many cases this means that certain regulations may contain requirements that apply (or become void) automatically, avoiding the need for (possibly inconsistent) interpretations on a case-by-case basis from supervisors and the banking industry. The right of supervisors to judge and decide on particular issues, or that of the bank to express its position should be inviolable, but those must be supported by analysis and quantitative indicators, increasing transparency as well as the quality of discussion and decision making.

Macroprudential approach, differently from micro prudential one, where supervisory regulation are the same for all financial institutions, should undergo tighter regulation and supervision for systemically important financial institutions, proportionate to the impact they give in systemic risk or financial stability of a specific market segment or the country in general. Requirements for banks/ institutions with systemic importance may include quantitative indicators on issues such as the minimum level and the quality of the capital, the composition of liquid assets, minimum level of liquidity ratios, especially in foreign currency; limits on financial leverage; the size of borrowing from non-residents ; exposure concentration, etc. Also stronger qualitative requirements may be included in terms of the quality of management's structures (providing specific requirements related to professional knowledge and experience involvement in the activities of the Bank, Governing Council and the Executive Managements; various incentives for limiting the exposure of the institution to high-risk activities, etc.)

Strengthening of control systems and internal audit independence, adjust the scope of external audit to include risk assessments, limit exposure to certain activities, ensure the effective establishment and operation of the risk managements structures, ensure regular and comprehensive reports for market participants, requirements for the adoption of specific reports on crisis situation, instances of necessary restrictions on “outsourcing” etc. From the perspective of supervisory practice, systemic banks would require a specialized supervision process (methodology, technical infrastructure, people) and perhaps more frequent presence of supervisors. In general, such an approach is justified by the importance these banks have on the stability of the financial system and the economy, as well as may in fact represent a better used of limited supervisory resources and a concrete implementation of the concept of “risk-based” supervision. In additional effect, such an approach may prove useful from point of view of banking competition, with positive consequences for the costs of banking and financial services to the customer.

Furthermore, regulatory and supervisory perimeter should be extended to all institutions that provide financial services (horizontally), as well as to non-financial companies hat may influence or control systemically important financial institutions (vertically). Legal and regulatory framework should define clearly the authority responsible for the regulation and supervision in this case, as well as aim at a convergence of supervisory standards among authorities. Also, the supervisory framework in this case should identify and react to interactions that exist between banks and non-bank financial institutions, in order to control for specific risks in becoming systemic ones.

Such development would support the expansion of surveillance perimeter in the vertical direction, regarding the supervision of banks’ institutional shareholders. For the case of institutional financial shareholders, monitoring and supervision would be easer after implementing a similar framework should supervisory authorities be different. Regarding non-financial institutional shareholders, who own a significant participation in the capital of banks, supervisory framework should include stronger requirements on the management’s structure and their financial situation, not only during licensing process but also during the performance of shareholder of the bank.

These requests may start with the obligation to submit regularly audited financial reports at the supervisory authority of the bank, and can extend up with the obligation to undergo a specific supervision appropriated designed. Of course, such a thing would require legal support and sufficient capacity to act. An immediately and temporary solution could be for the bank supervisory authority to enter agreements of cooperation and exchange of information with authorities where these business are recorded, audited or report for tax purposes. These applications may be applied first to such shareholders who want to participate in systemically important banks. For non-bank financial institutional shareholders, it is also important to assess the suitability of the legal framework that defines their insolvency status and liquidation mode. Especially in cases when business companies have significant interests in banks, it is necessary to have similar and complementary liquidation procedures (to the extend possible). This would reduce conflicting legal requirements and possible delays in case of a "double" liquidation, of the bank and of the holding business entity.

The regulatory framework and supervisory practices should be directed to avoid excesses in banking activity, which are found in the case of pro-cyclical actions. For this purpose, the regulatory framework may contain requirements related to the increase in the bank reserves if the expansion of activity is going on with high rates (higher than a certain threshold). For that matter, the regulatory framework should be symmetrical, recognizing the right of the banking industry to use part of the reserves to fund activity in periods of financial crunch. Also, methods of risk assessment and the creation of appropriate reserves should require and include assessments of future developments.

For this purpose, especially for credit risk in banking activity, it is necessary that the current ways of assessing and establishing loan loss reserves (provisioning), be complemented with the methodology and regulatory requirements that enable the change of reserves on the basis of expected losses.

Legal framework and supervisory practices for the prevention and treatment of financial crisis could be improved if a comprehensive process to review the relevant legal definitions to improve the capacity and flexibility of the public authorities in dealing with these situations is undertaken. In general, it is acknowledged that a modern regime of financial crisis management should explicitly contain: the objectives of the regime; events that triggers it; the list of instruments that can be used in the process; the ability of the supervisor/ liquidator to transfer part or the entire property of the bank that is failing; protecting settings for creditors, counterparties or shareholders of the bank that is failing; specific procedures in case of dealing with banking groups; and specify the application of the regime for local banks that conduct international activities. In this context, the legal framework would have to be specified and improved terms of providing: (i) clearer and more definition of the role of the Bank of Albania in terms of financial stability; (ii) greater clarity regarding supervisory powers and procedures for resolving disputes with the supervisory authority of the home country, in the case when the branch or the parent bank is taken into conservatorship or receivership; (iii) clarity that the failing bank should not necessarily go through conservatorship process if conditions demand it to be taken straight into receivership.

The legal framework should determine complete and specific requirements for the protection of financial services' consumers. This element has to do with the way financial products are engineered and sold to them. Ensuring consistent monitoring of this process is important for consumer protection, for the integrity of the financial institution and well functioning of financial market. Often, these issues lead to disputes that have a significant value to the consumer, but do not (initially) have a material value for the financial institution. In other cases, the client's unresolved claim could end up in court and become subject of juridical decisions that do not appropriately consider the functioning of the financial institution, hence bringing adverse implications for its stability. Currently, at least for the banking sector, the Bank of Albania as the supervisory authority handles these issues. Not only in this case, but also in general, the position of the financial institution's supervisory authority to provide solutions to these disputes between the institution and the client is unsuitable. This is related with the primary focus of the supervisory authority, which is more concerned for the stability of the institution and of the market rather than the business conduct. Hence, in practice it results difficult to provide solutions that, while in favor of the consumer and fair, could cause material damage for the financial institution. Such hesitancy does not support the need for addressing the underlying problem and avoid similar cases in the future. Also it may actually push for the settlement of the disputes in courts, which could be costly for both the consumer and financial institution. Finally, these implications can bring damage to the credibility of the supervisory authority. Under these conditions, the optimal solution seems to be that of establishing an independent authority, which will follow the resolution of these disputes in a consistent manner, aiming at solving them in a fair, consensual and faster way. In Albania, such authority could be a new and independent institution or, should there be an unfavorable answer to the cost/benefit analysis, resolving disputes between consumers and financial institutions may be recognized as an added function to the existing authority of Ombudsman. The second solution may be more appropriate in circumstances where the number and values of these disputes is considered low and the financial cost of creating new authority may be considered disproportionately high.

The second policy direction

Regarding the second direction, the main challenge is to establish a practice that allows for better coordination between monetary policy and macroprudential one. Without compromising with the main objective of ensuring price stability, the Bank of Albania, through its existing committees on Monetary Policy and on Financial Stability, should discuss and formulate a position on whether the monetary policy can have a wider mandate and be used to " lean against the wind" and try to avoid extreme behaviors of financial institutions and markets. If so, than the tools that are necessary to capture the economic cycles and such extreme behaviors must be developed. For example, there is a need to develop a comprehensive methodology that captures developments in the non-financial asset prices, particularly of real estate, given the importance it has in banking sector-lending activity. In addition, such coordination should allow for the ability to define the most appropriate policy response, given predetermined economic situations. This is not an easy task but it is necessary to ensure transparency, accountability and credibility to the activity of the central bank.

International financial crisis and its impact in different countries, showed the necessity of a more effective cooperation between public authorities at national and international level, to identify risks, to manage them in real time according to the respective competences, as well as to limit the impact of financial sector problems in other segments of the economy. Moreover, this cooperation in national and international level continues to be indispensable in the design and preparation of financial system reform in different countries, especially in terms of the management of financial crisis situations. At a national level, the cooperation among public authorities should serve not only for the exchange of the information, but to identify the necessary legal or regulatory changes; technical capacities, human and financial resources; and operational or strategic actions which are necessary to address a problem that threatens the financial stability. This new level of cooperation should be formed on the basis of regular and frequent inter-institutional contact, which should be achieved through regular and formal meetings, both at the highest and at the technical level. Such meetings should be well organized and operate on the basis of some predetermined rules, defining the role and contribution of each participant in the meeting. Meeting should have a defined agenda, which enables the preliminary preparation of the participants as well as allows the track of various issues as they evolve over time. Finally these meetings should serve to identify solutions to specific problems, which at the largest extent possible, rely on market mechanism, provide a long term or final solution, are transparent to the public and avoid illusive expectations, have a low public cost. To identify and apply these solutions to specific circumstances, each authority must design in advance proper actions plans for addressing varying financial emergencies and must harmonize these plans with other authorities.

Cooperation between public authorities in the country and corresponding foreign authorities is an evitable necessary and a requirement dictated by the unstoppable process of economic, financial and political integration of the country in the financial markets and the European Union. One should remember the "impossible trinity" in the activity of supervisory authorities: it is impossible to simultaneously achieve an effective banking supervision and a similar process of crisis management, retain full sovereignty over supervision; and continue with the process of the integration into the financial markets and the European Union. Hence, the relevant legal framework in the country should support international cooperation on financial stability issues, of course taking into account the principles of confidentiality and reciprocity. Although the exchange of the information in the financial crisis between the authorities of different countries is necessary, it can simultaneously prove to be difficult at the required moment. Some of the problems that may arise relate to the uncertain legal support or conflicting legal definitions, lack of trust in each other, lack of the appropriate human capacities, etc. Some of these problems can be solved if the legal definitions are clear in terms of support for cooperation between the authorities in the country with international ones, in order to enable a sustainable and fair solution that preserves the financial stability of the country. For the banking sector, it may be necessary for Albania's legal framework to require the approval of cooperation agreements with foreign supervisory authorities at the time of bank licensing, particularly for systemically important financial institutions, implying that the authorities recognize each other's powers, especially for the supervision and liquidation of the financial institution and the way of operation of deposit insurance scheme. Cooperation should be easier and effective if there will be a convergence of methodologies and practices of regulation and supervision. For this reason, the law must require and the authorities of the country should ensure the broadest possible participation (especially in the form of membership) of their representatives in relevant organizations and forums, where standards for the operation, regulation and supervision financial industry are discussed. It is also necessary that part of the cooperation with international authorities becomes the regular participation in the supervision of common financial institutions (in the form of joint examinations, exchange of opinions on key risks, etc.) and procedures and operational testing for actions to be taken in case of a common financial institution facing significant financial difficulties or insolvency (and forthcoming liquidation). It is necessary that the law require consistency of decisions and actions in such instances.

The third policy direction

Regarding the third policy direction, a number of areas in the economic policy and management, can be addressed. In connection with development in the real sector of the economy, it is necessary to establish a better balance between the contribution of various sectors, particularly by increasing the contribution of agriculture, agro-food industry and tourism. These sectors that relate well to each other, have the potential to steadily improve employment, better the structure of domestic production and increase the export capacity of the country. Supportive government programs as well as other incentives that facilitate the funding of these projects are necessary to achieve the required improvements in the medium term.

In the fiscal area, it is necessary to establish a legal and transparent mechanism that enables effective control over public debt indicators, budget deficit, level of external debt and the financing sustainability of the public pension scheme. In addition for providing better conditions for improvements, this control is necessary to ensure foreign investors about the sustainability of the fiscal position of the country, to reduce the cost of public and private borrowing and to avoid the stress that debt service can bring in currency exchange rates. Through quantitative and qualitative constraints that are monitored in short to medium term, indicators can be placed in the connection between them and with other macroeconomic indicators such as revenue, expenditures, debt payments, exports, imports, official foreign exchange reserves etc., to achieve a framework of indicators that move in joint harmony and control each other.

From the perspective of risk management, concrete measures should be taken for the development of the financial market, especially of the capital market. In this way, businesses would benefit from direct access to financing in the form of issuing debt and new equity. This element would enable the development of a secondary market for trading such debt securities, would expand the funding base of businesses and would gradually reduce the weight of the banking sector in the Albanian financial system. To achieve this goal, it is necessary to improve the legal and regulatory framework and its applicability on financial reporting, handling of creditors' right, the establishment of specialized institutions for securities trading, etc.

The authorities have to identify a proper timeline for the implementation of macro-prudential framework (including policies and tools). Among other factors, such a timeline must consider the current position of the economy in the economic cycle and expectations or objectives of future economic and financial system developments.

Conclusions

The process of drafting and reviewing the regulatory and supervisory framework of the Bank of Albania during the course of last years is widely supported in the standard of the Basel Committee, European Directives and considers the best practices in the field of regulation and current developments in the Albanian banking system, banking supervision, by implementing Basel Committee principles for effective supervision.

This paper aimed to present Albanian macroprudential approach, as a key component of the financial stability policy toolkit. Besides the tools embodied in bank regulations, Bank of Albania should designed and conduct the document of Macroprudence in BoA, after experience accumulated from international and national in that matter. When conducting macroprudential policy it is also vital to respect the fact that systemic risk has two different dimensions. The time dimension is linked with procyclicality in the behavior of financial institutions and their clients, manifesting it as financial cycles. The cross-sectional dimension arises as a result of mutual exposures and network linkages between financial institutions. In an economy dominated by banking sector, with a relatively small and simple financial sector like the Albanian one, the time dimension of systemic risk is identified as being more important and the BoA is advised to prefer a relatively narrow macroprudential policy concept focused primarily on risks associated with financial cycle. Given that financial or informational contagion resulting from links between the economy and its institutions and the external environment can be a major source of systemic risk, the MPP framework must also include the cross-sectional dimension and external macroeconomic and financial developments.

When performing the two main tasks mentioned above, macroprudential authorities must focus their attention on forward-looking indicators and simultaneously take into account the potentially high degree of discontinuity in the evolution of systemic risk. To this end, they need to use specific sets of indicators and tools reflecting the different dimensions and phases of systemic risk.

When implementing such a policy, it will be vital to combine a rigorous analytical approach with a large dose of judgment. Although the priority should be to use rules and more or less automatically applied tools, it will be necessary to leave the macroprudential authority considerable room to exercise discretion. No macroprudential policy tool can work as a magic wand for "making sure it won't happen again". Factors mitigating procyclicality embodied in regulations will hopefully ensure accumulation of buffers, and better supervision may prevent bank managers from taking excessive risks. Monetary policymakers might need to step in directly using the interest-rate channel or indirectly using prudential tools to change its transmission.

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