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TECHNICAL ASSISTANCE REPORT - INVESTMENT FUNDS AND INTERCONNECTEDNESS RISKS

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TECHNICAL ASSISTANCE REPORT

ALBANIA

Investment Funds and Interconnectedness Risks

November 2022

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GLOSSARY

AIF	Alternative Investment Fund
AFSA	Albanian Financial Services Authority
BoA	Bank of Albania
FSAG	Financial Stability Advisory Group
HQLA	High Quality Liquid Assets
LMT	Liquidity Management Tool
MCM	Monetary and Capital Markets Department
SFT	Securities Financing Transactions
UCITS	Undertakings for collective investment in transferable securities

Preface

At the request of the Albanian Financial Services Authority (AFSA), a Monetary and Capital Markets (MCM) Department remote mission assisted the AFSA from May 9 to June 16, 2022 to assist the authorities in assessing risks related to investment funds and their interconnectedness with the financial sector.

The mission met with senior officials and representatives of the AFSA and the Bank of Albania (BoA). The mission wishes to thank all the senior officials and representatives for their cooperation and productive discussions. The openness and engagement of all parties was very helpful in supporting the work.

EXECUTIVE SUMMARY

This report relies on the information submitted by the AFSA and discussions with AFSA and BoA. Detailed data on the fund sector had been shared by AFSA and discussions with Authorities covered issues around (i) data reporting, (ii) risk analysis, (iii) regulatory framework and (iv) interlinkages.

The fund sector has been expanding and remains highly concentrated. Since end-2019 the net asset value of Albanian funds has increased by 15 percent and accounts for around four percent of financial sector assets. The sector remains highly concentrated: (i) on the asset side, as domestic sovereign bonds account for most of exposures; and (ii) on the entity side, as the top fund represents 62 percent of the asset of the sector and the top 3 funds (all from the same manager) around 95 percent.

Interconnectedness between funds and the rest of the financial system is limited. On the liability side, fund shares are mainly held by retail investors, and institutional investors play a very minor role. On the asset side, funds do not have significant direct exposures to securities issued by financial entities. Fund bank deposits account for around 13 percent of fund assets, but represents a relatively minor funding source for banks. Counterparty exposures towards banks are also small, since funds barely use repo operations or derivatives.

Exposures to the sovereign market are the main risk transmission channel between funds and the rest of the financial system, given the lack of liquidity of domestic sovereign bonds. While funds hold only 5 percent of domestic public debt, there is a lack of activity on secondary markets. This implies that funds could face challenges in selling quickly sovereign assets to meet redemptions. The stress observed during the summer of 2022 shows how liquidity risks can materialize in the fund sector.

Funds perform liquidity transformation and are subject to liquidity requirements. Funds have an open-ended structure and offer daily redemptions with settlement done over a maximum of 7 days. Funds are typically subject to liquidity requirements (in the form of high-quality liquid assets, HQLA) equal to the maximum between (i) 10 percent of total net assets, or (ii) the cumulative gross outflows over the last three months. In addition, of the HQLA has to be in cash or assets maturing within 7 days.

The review recommends that AFSA should enhance its risk monitoring of the fund sector and its interlinkages with the rest of the financial system. Suggested enhancements include (i) more frequent data reporting on key items (flows, returns, asset composition); (ii) detailed analysis of funds portfolio (including calculation of duration and estimates of portfolio overlap); (iii) work on the drivers of (retail) investors flows (including an analysis of the flow/return relationship). AFSA should also consider scenario analysis and sectoral stress tests, with a focus on liquidity and market risk to analyze how stress could propagate in the fund sector. Joint work with the central bank on interlinkages could help identify the main links between financial institutions and markets and quantify them.

The review recommends that AFSA consider expanding the range of Liquidity Management Tools (LMTs) available to funds. The current regulatory framework only foresees suspension of redemptions, while other tools could be used to mitigate the risk of destabilizing redemptions. Price-based LMTs, such as redemption fees or anti-dilution levies, as well as quantity-based LMTs, such as side pockets or gates, could be made available to fund managers –after a cost-benefit analysis– to mitigate liquidity risk for funds. The use of repo operations, while already possible but not frequently used, could be also considered by fund managers to allay potential downward pressure on the sovereign bond market in case of stress.

Table 1. Key Recommendations

Recommendations and Authority Responsible for Implementation	Priority	Timeframe [1]
Recommendation 1: Data and portfolio analysis		
Increase the frequency of reporting of key data items such as flows and returns (AFSA) ¶20-23	1	Medium-term
Provide detailed analysis of funds' portfolio including risks related to interest rate (duration) and common exposures (portfolio overlap) at sectoral level (AFSA) ¶6-7; 19-22	1	Near-term
Recommendation 2: Investor behavior and stress tests		
Analyze the drivers of investors flows (AFSA) ¶11;21	2	Medium-term
Perform scenario analysis and stress tests (AFSA) ¶25-26	2	Medium-term
Recommendation 3: Liquidity Management Tools (LMTs)		
Conduct a cost-benefit analysis of price-based and quantity-based LMTs for Albanian funds (AFSA) ¶27-30	2	Medium-term
Expand the list of available LMTs, including through legislative change if necessary (AFSA, MoF) ¶27-30	3	Medium-term
Recommendation 4: Cross-sectoral linkages		
Conduct a joint work to (i) map the interlinkages between funds and financial institutions and (ii) quantity the identified interlinkages (AFSA, BoA) ¶13-14;27	3	Medium-term
Recommendation 5: Resources		
Increase the number of staff work on risk analysis in the fund sector to support (i) financial stability assessment and (ii) risk-based supervision (AFSA) ¶123-24	2	Medium-term

[1] Near term: < 12 months; Medium term: 12 to 24 months.

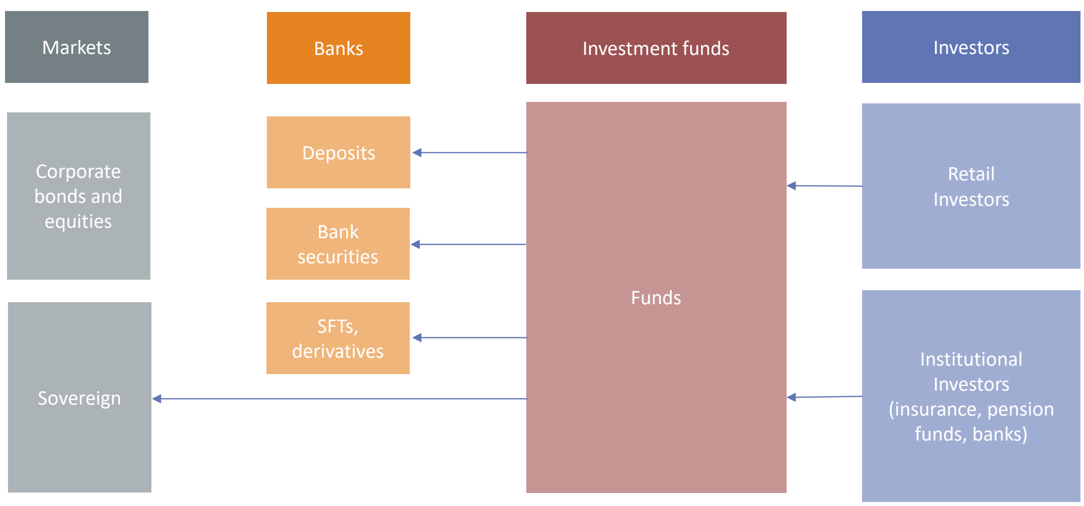
I. Introduction

A. Background

1. **In December 2021, AFSA requested TA from the IMF in respect of interconnectedness risks in the fund sector.** Discussions on the scope of the work took place between MCM and AFSA over the period December 2021–April 2022.

2. **The objective of the mission was to identify and measure risks related to interconnectedness in the fund sector.** Interlinkages can be related to direct exposures to entities within the financial sector through securities or activities, such as derivatives trading, or securities financing transactions (repo and securities lending). In addition, direct exposures to specific markets, such as the domestic sovereign bond market could also be significant. Finally, indirect exposures through common exposures of funds to the same issuer or asset could also increase interconnectedness (Figure 1).

Figure 1. Interlinkages within the fund sector



Source: International Monetary Fund Staff

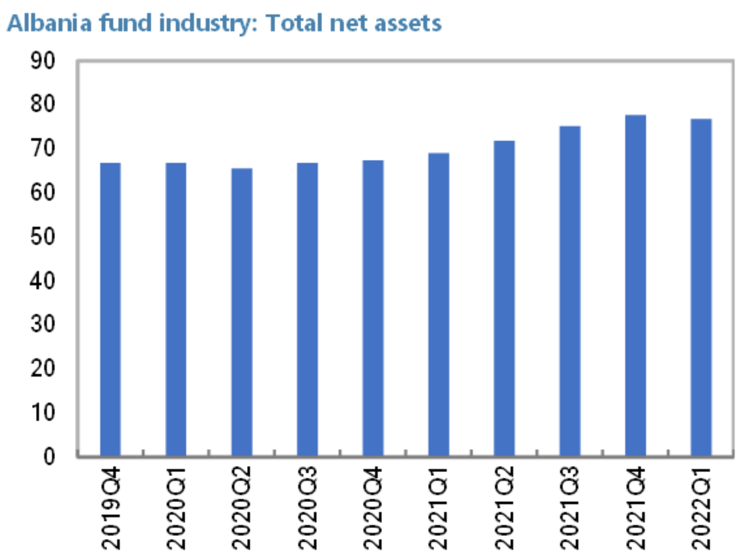
3. **The mission was conducted in several phases:**

- an initial questionnaire prepared by the mission and completed by the AFSA with additional supporting material provided in May 2022;
- a number of virtual meetings then took place between May and June 2022 with senior officials and representatives of the AFSA and BoA;
- an information assessment phase; and
- drafting of this report.

B. Albania's investment fund sector

4. The fund sector has expanded over recent years to reach Lek 77 billion in Q1:2022 (Figure 2), which equates to approximately 4 percent of GDP, and 4 percent of financial sector assets. The growth of the sector has been driven by inflows from investors (mainly retail), as well as positive returns on assets (mainly domestic sovereign bonds). Funds are held by around 41,000 investors, which are almost exclusively retail clients, as the share of institutional investors is less than 0.1 percent of total investors.

Figure 2. Total net assets of the fund sector



Sources: Albanian Financial Services Authority, International Monetary Fund Staff.
Note: Total net assets in Lek bn.

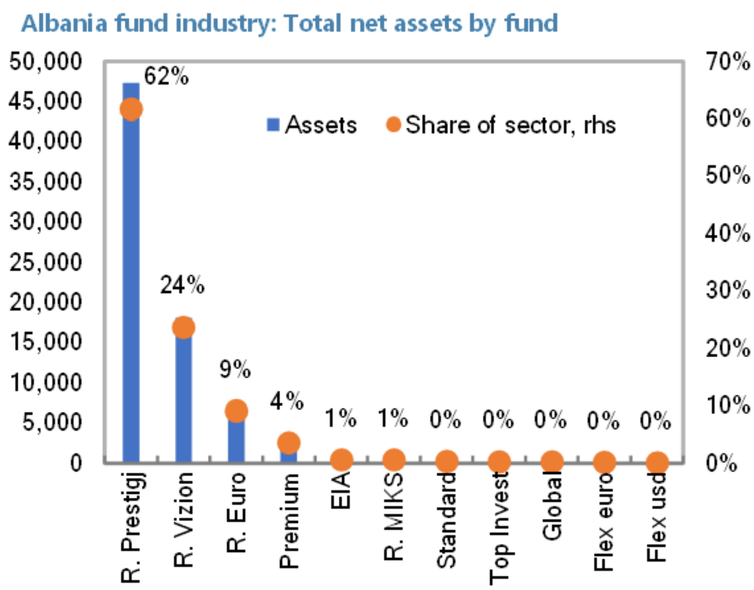
5. The fund sector is highly concentrated, with the largest fund accounting for 62 percent of total fund assets, and the three largest funds for 95 percent of the sector (Figure 3). As of Q1:2022, there were 14 funds in Albania[2]: 12 non-UCITS[3] funds, and 2

[2] The regulatory framework for open-ended funds in Albania distinguishes between (i) UCITS, (ii) non-UCITS and (iii) Alternative Investment Funds (see Law No.56/2020 on Collective Investment Undertakings).

[3] UCITS stands for Undertakings for Collective Investment in Transferable Securities. UCITS are subject to a specific European Union (EU) regulatory framework. For the purposes of this report, UCITS should be understood as investment fund structures that are subject to requirements broadly equivalent to those of the EU framework.

alternative investment funds (AIF)[4] recently launched[5]. This compares with six funds end-2019. The funds are related to five asset management companies, including one which accounts for 96 percent of the fund net assets.

Figure 3. Composition of the fund sector as of Q1:2022



Sources: Albanian Financial Services Authority, International Monetary Fund Staff.
Note: Total net assets in Lek bn as of Q1:2022.

6. **Funds are primarily exposed to the domestic sovereign bond market.** Some funds that have launched recently invest in foreign sovereign bonds and corporate bonds, as well as in foreign equities, but they remain small. Overall, around 65 percent of funds' assets are composed of domestic sovereign bonds (Figure 4). Most funds also have significant exposures to cash.

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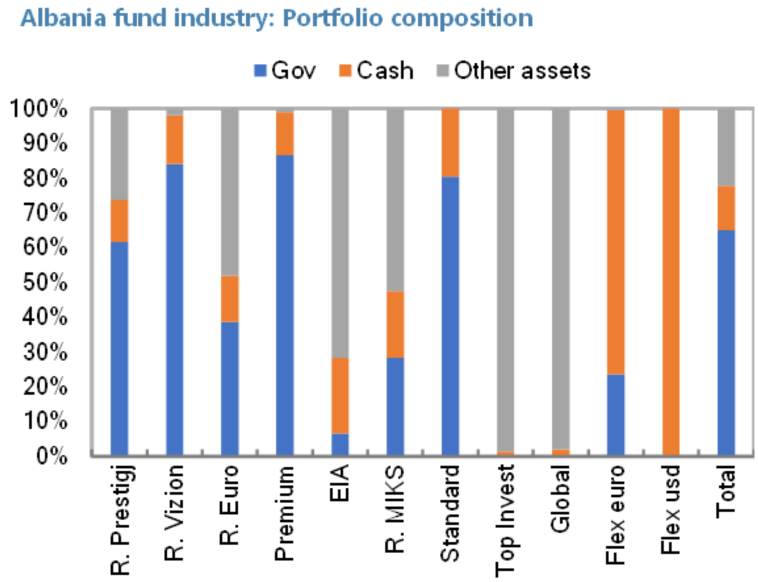
[4] In the EU, AIFs are all investment funds that are not UCITS, while in Albania AIFs are funds which are neither UCITS nor non-UCITS as defined in the Albanian legislation. AIFs are typically marketed to professional investors, unlike other types of funds which can be sold to retail investors.

[5] One non-UCITS fund was not operational as the time of the report and the two AIFs have to report end-year data once a year to AFSA. Therefore, the data used in this report do not include those three funds.

Figure 4. Asset composition as of Q1:2022



Sources: Albanian Financial Services Authority, International Monetary Fund Staff.
Note: Portfolio composition by asset type, in percentage a of Q1:2022.

7. **Funds' returns tend to be highly correlated, reflecting common exposures.** Using quarterly data on returns since 2017 for the three oldest funds (Prestigi, Vizion and Premium), a statistical analysis indicates that performance is highly similar with correlation coefficients across funds higher than 0.93. Similar results are obtained using a larger sample of funds (including Albsig standard and ABI EIA[6]), and data for 2022. The correlation of returns is driven by common exposures to the domestic sovereign bond market. This interconnectedness in returns implies that if domestic sovereign bond markets were to be impacted by a negative shock (increase in yields), funds' returns would be likely to deteriorate by a similar magnitude at the same time.

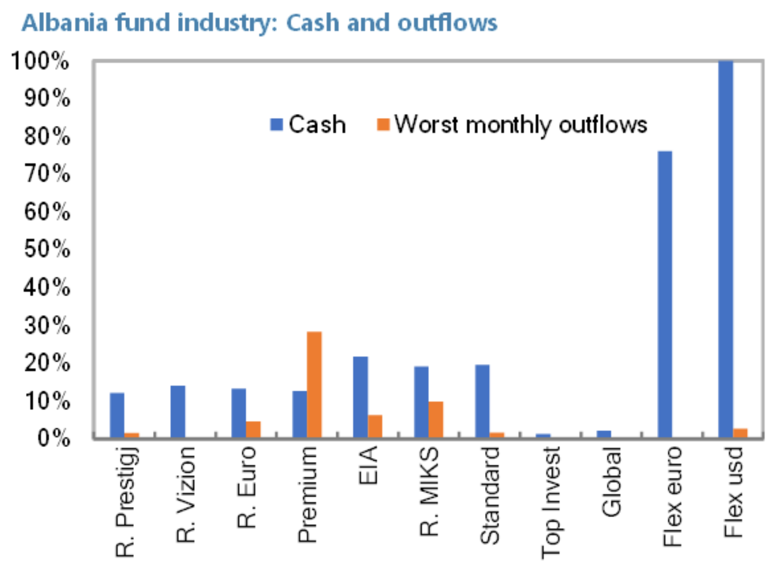
8. **Most funds are subject to a liquidity requirement.** Funds need to have high-quality liquid assets (HQLA) totaling the higher of 10 percent of total net assets or the cumulative 3-month gross outflows. At least 50 percent of the HQLA needs to be in cash or securities maturing within seven days. Funds that invest at least 50 percent in 'active markets' are not subject to the 50 percent requirement on cash and securities maturing within seven days.

9. **Most funds did not experience severe outflows in the first half of 2022.** While some funds have recorded outflows in 2022, redemptions have been relatively contained except

[6] Those two funds invest primarily in domestic sovereign bonds and were launched in 2020 and 2021.

for one fund which saw large redemptions related to outflows from an institutional investor (Figure 5).

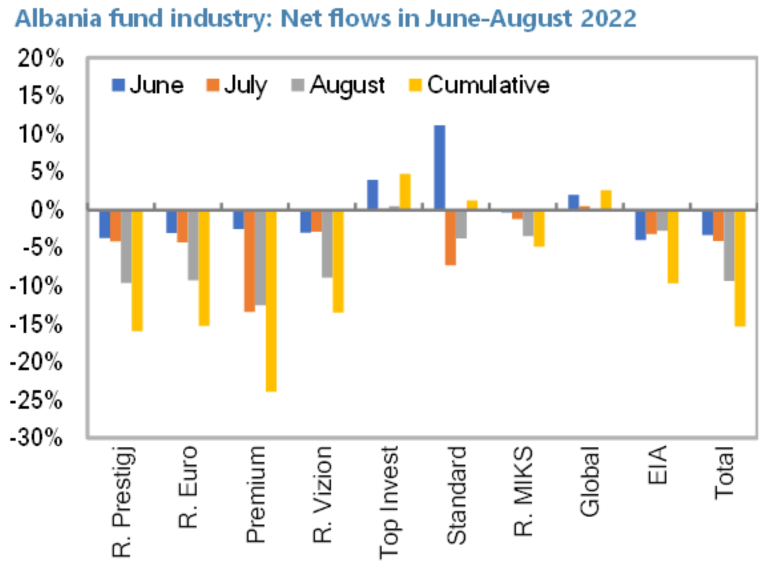
Figure 5. Liquid assets and outflows



Sources: Albanian Financial Services Authority, International Monetary Fund Staff.
Note: Cash holdings as of Q1:2022 and worst monthly outflows since December 2021, in percentage of total net assets.

10. **However, funds experienced stress in the summer of 2022 as financial conditions tightened.** In a context of inflationary pressure, the BoA increased interest rates by 25 basis points in July and 50 basis points in August. As a result, funds' returns declined, and investors redemptions increased. Between June and end-August, cumulative redemptions reached almost Lek 11 billion, 15 percent of total net assets of the sector (Figure 6). Outflows were concentrated in bond funds, due to their exposures to interest rate risk.

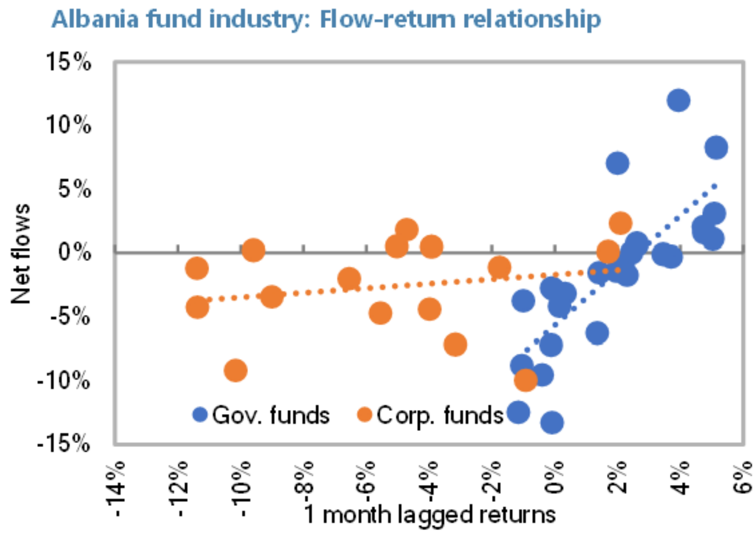
Figure 6. Net flows during the summer of 2022



Sources: Albanian Financial Services Authority, International Monetary Fund Staff.
Note: Net flows, in percentage of total net assets.

11. **Redemptions were very large compared to the decline in returns, indicating a potential high sensitivity of investors to performance.** Figure 7 shows that for government bond funds, negative returns are associated with very large outflows. Some of the funds experienced redemptions of 10 percent in August although returns declined by only 100 basis points over the same period. This indicates that investors might be prone to redeem when performance turns negative or when there are sizeable market shocks.

Figure 7. Net flows and performance



Sources: Albanian Financial Services Authority, International Monetary Fund Staff.
Note: Monthly net flows and lagged returns for sovereign and corporate bonds funds (January–August 2022).

12. **While funds managed to meet redemptions, this episode illustrates how liquidity risk can crystallize.** All funds were able to raise cash to pay redeeming investors through a combination of cash drawdown, sales of bonds and proceeds from the repayment of bonds maturing. However, if returns were to continue to fall sharply and outflows to increase, funds exposed to fixed income instruments could face heightened challenges related to liquidity risk.

13. **Counterparty risk is very limited as funds barely use derivatives or securities financing transactions (SFTs).** While funds can use derivatives for hedging, no funds had derivative exposure as of Q1:2022. Similarly, the use of SFTs was very limited with only one reverse repo transaction (where the fund lends cash against collateral) and one repo transaction (where the fund borrows cash by posting collateral). In both cases, Albanian sovereign bonds were used as collateral.

14. **Funds' interconnectedness within the financial sector rests mainly on banks.** On the asset side, funds hold around 13 percent of their asset in cash (Lek 9.9 billion), and funds' deposits only accounts for 2 percent of banks' total assets. Funds do not invest substantially in securities (debt or equities) issued by banks.

C. AFSA's approach to identify, monitor, and mitigate risks

15. **AFSA receives detailed information from funds on a regular basis.** On a quarterly basis, funds provide AFSA with full portfolio information as well as balance sheet data

and an income statement. AFSA publishes detailed information on its website every quarter through a statistical report.[7] More recently, AFSA has taken steps to increase the reporting frequency.[8] Funds have been providing data on returns on a monthly basis since early 2022 (against a quarterly frequency previously), net redemptions on a weekly basis (against monthly previously), and liquidity indicators (HQLAs and cash buffers) on a monthly basis (against quarterly reporting previously) since May 2022. Similarly, managers had to report to AFSA the stress test results for the end of March 2022. AFSA has the power to request additional information from fund managers.

16. **AFSA contributes to systemic risk discussions within the Financial Stability Advisory Group (FSAG).** The Executive General Director of AFSA is a member of FSAG, along with the Minister of Finance, the Chairman of the Financial Supervisory Authority Board, the Governor the BoA, and the General Director of the Albanian Deposit Insurance Agency. FSAG plays an advisory role in the design of policies, enhancement of inter-agency coordination and systemic risk monitoring.

17. **Risk monitoring tends to be done on an individual fund basis.** As part of its supervisory duties, AFSA monitors risk at fund-level but not necessarily at sector-wide level.

18. **The Supervisory department focusing on asset management has limited resources.** Overall, there are four staff at AFSA in charge of fund supervision in the private pension and investment funds market directorate. This compares to six staff in the securities market directorate, and four staff in the DLT-based financial market supervision directorate.

D. Summary of risk analysis

19. **The main risks in the fund sector related to liquidity transformation, potential outflows, and concentrated exposures to the domestic sovereign bond market.** While the investor base has been stable over time, in a context of tightening of financial conditions through rises in interest rates, Albanian bond funds could experience negative returns which could trigger outflows. Redemptions could in turn force asset managers to sell assets, including domestic sovereign bonds, and it is uncertain whether the market would have the ability to absorb those sales without price discounts.

[7] The statistical reports are available at https://amf.gov.al/statistika.asp?id=5&s=2.

[8] AFSA' Board decision No. 88 and No. 136 dated respectively 28 April 2022 and 29 July 2022.

II. MITIGATING RISKS IN THE FUND SECTOR

A. Data reporting and risk analysis

20. **It is key for AFSA to have access to timely data on key items to monitor the fund sector.** While AFSA already receives detailed information from funds, the frequency of reporting should be increased for some key items. Data on flows and returns should be reported a least on a weekly basis, in line with the redemption profile of the funds.

21. **Further analysis of the drivers of investor behavior is warranted.** While investors net flows have been contained so far, it is crucial to understand the main factors driving redemptions and subscriptions. Further insights on the distribution of fund products, including through bank networks, as well as the sensitivity of flows to past performance are key to assess potential risks of outflows looking forward.

22. **More granular monitoring of risks related to fund portfolios is also recommended.** With available data, AFSA can already use portfolio information to calculate risk metrics related to interest rate risk (duration), and credit risk (credit spread). In addition, given concentrated exposures to the domestic sovereign bond market, AFSA could perform an analysis of portfolio overlap at instrument-level across funds with sovereign exposures. Such analysis could be used to assess potential liquidation costs related to the sale of sovereign bonds during stress, and potential spillover to funds holding similar instruments. In addition, analyzing the correlation of funds' returns would also be useful in identifying market-based interconnectedness.

23. **Monitoring risks at sectoral level is key.** Since investment funds in Albania tend to have similar concentrated exposures to domestic sovereign instruments, risks should be analyzed at sectoral level, as well as individual fund level. The behavior of some funds can have a direct impact on other funds. For example, if a fund starts liquidating sovereign debt holdings, less liquidity will be available to other funds (given the limited absorption capacity of the market), and the sales are likely to put downward price pressure on similar bonds held by other funds.

24. **AFSA should have more resources to perform risks analysis.** Given the limited number of staff dedicated to the fund sector, there is a need to increase the resources of AFSA for the agency to perform more risk analysis. Analysts with a quantitative background would be best placed to carry out this work.

B. Stress testing and intersectoral linkages

25. **AFSA could use stress tests to assess risks in the fund sector.** Available data could already be used to perform stress test and scenario analysis (Box 1). Such an exercise could be used to identify vulnerable funds and potential vulnerabilities in the financial system.

26. AFSA, in coordination with BoA, could perform a joint analysis of intersectoral linkages within the financial system. Such analysis would seek to (i) map the interlinkages between financial institutions and markets, and (ii) quantify the materiality of those linkages. This work could then be used to assess the main risk transmission channels within the financial sector, and to perform scenario analysis.

Box 1. An illustrative stress test for Albanian funds

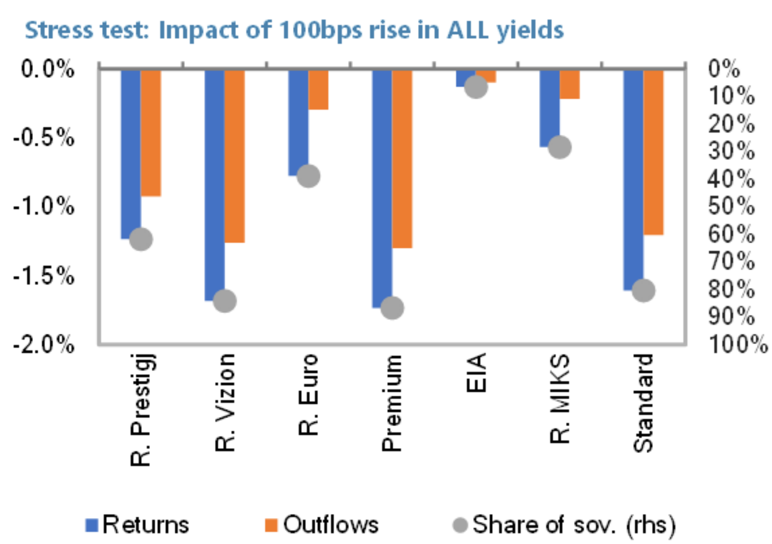
Scenario design

In this stress test, we assume that yields on Albanian bonds increase by 100 basis points (parallel shift of the yield curve). The rise in yield triggers mark-to-market losses on sovereign and corporate bonds held by funds, and we assume that the duration of sovereign bond holdings is 2, resulting in a loss of 2 percent.

Impact on returns and flows

Using data on fund portfolios, the impact on fund returns can be calculated. The mark-to-market losses would amount to Lek 1.1 billion. We then assume that negative performance would trigger investor outflows. The flow/return relationship is estimated to be around 0.75 for funds mainly exposed to sovereign bonds, and 0.38 for corporate bond funds, using monthly data on returns and flows over January–August 2022, which include the stress observed during the summer. Aggregate investor outflows would amount to around Lek 750 million (1.3 percent of funds' total net assets after the interest rate shock), with some variation across funds with outflows ranging from around 0.6 percent of assets up to 1.8 percent (Figure 8).

Figure 8. Impact of 100bps shock on funds returns and flows



Sources: Albanian Financial Services Authority, International Monetary Fund Staff.
Note: Impacts on returns assuming a duration of two. Outflows based on a flow/return relationship parameter of 0.75 for government bond funds and 0.38 for corporate bond funds (R. Euro and MIKS).

Asset sales

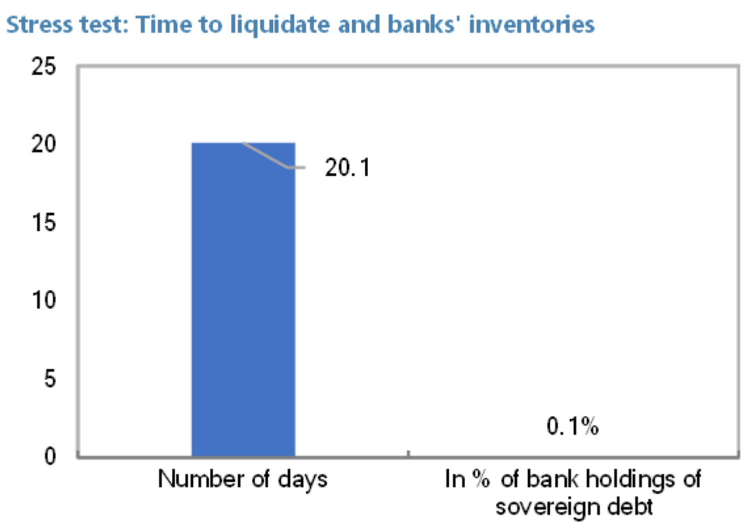
Given investors' redemptions, we assume that asset managers would follow a pro rata liquidation approach whereby they would sell assets in proportion of their share in the fund portfolio. This implies that funds mainly exposed to sovereign bonds would sell more sovereign bonds (in relative terms) than funds with a more diversified portfolio. Overall, funds would sell around Lek 753 million of assets, including Lek 502 million of sovereign bonds.

Absorption capacity of the market

The estimated volume of sales can be compared to liquidity measures in secondary markets. According to BoA, bond trading volumes amounted to Lek 3 billion in 2021h1, implying daily volumes of around Lek 25 million. Under average trading conditions it would therefore take a least 20 days for the Lek 502 million of sovereign bond to be sold, more than twice the settlement period for fund shares. An alternative measure is to compare the volumes of sales to banks' sovereign bond holdings (estimated at around Lek 450 billion). In that case, the additional purchase by banks of bonds sold by funds would only represent 0.1 percent of banks' bond holdings (Figure 9). Although such purchases would not represent a material increase in banks' holdings of sovereign debt, the mission team did not assess the feasibility of such purchases nor their compatibility with prudential requirements on assets held by banks. Based on discussions with the BoA, commercial banks might have limited appetite to increase their sovereign bond exposures.

The analysis shows that funds might face challenges in selling sovereign bonds quickly, unless banks were willing to increase their portfolio of domestic sovereign debt.

Figure 9. Ratio of sovereign bond sales to average daily trading volumes and banks' holdings of domestic sovereign debt



Sources: Albanian Financial Services Authority, Bank of Albania, International Monetary Fund Staff.
Note: Number of days needed to dispose of sovereign assets assuming daily volumes of Lek 25Mn, banks' holdings of ALL sovereign debt assumed to be around Lek 450bn.

C. Reducing liquidity risk in the fund sector

27. **AFSA should consider making additional liquidity management tools (LMTs) available to funds.** When funds face large redemptions from investors, they need to raise cash by using their available liquidity (bank deposits), and/or through the sale of securities. Given the lack of liquidity in sovereign bond markets, funds might face challenges in disposing of sovereign bonds quickly and at a low cost. LMTs can mitigate this risk by (i) reducing the likelihood of large redemptions from investors, and (ii) reducing the impact of such redemptions. AFSA should perform a cost-benefit analysis of those tools, in coordination with the industry. Operational issues related to the activation and use of these tools should also be considered.

28. **Price-based LMTs could mitigate the risk of large redemptions and reduce the impact of redemptions on remaining investors.** Price-based LMTs, such as redemption fees aim at passing some of the costs related to the disposal of assets to redeeming investors. In doing so, they reduce the incentives for investors to redeem (since they would have to pay a fee), and protect the remaining investors in case of outflows, since some of the costs are directly passed on to redeeming investors. For such LMTs to be effective, appropriate and prudent valuation policies are required, which could be challenging when markets are not liquid.

29. **Quantity-based LMTs can reduce the likelihood of large redemptions**. Such LMTs include mechanisms, such as side pockets –where illiquid assets are ring-fenced in a separate fund–, or gates –where the value of shares or units that can be redeemed in a single valuation/dealing day is limited. These could be useful tools for fund managers to mitigate liquidity risk and potential downward pressure on domestic sovereign markets.

30. **The use of repo operations by funds could also be studied.** In case of stress, funds might be able to obtain liquidity by pledging sovereign bonds, as collateral for repo transactions with banks. Such operations would enable funds to meet redemptions, without causing downward price pressure on the sovereign bond markets. AFSA could engage with the industry to discuss the set-up of repo operations, given their very limited use by funds so far.

III. CONCLUSION

31. **The growth of the fund sector in Albania can support the development of the economy, and the expansion of capital markets.** While the financial sector is primarily bank-based, funds offer diversification benefits for investors, and risk-sharing opportunities within the financial system.

32. **Financial stability issues in the fund sector are limited at the current juncture.** The relatively small size of the sector, its low degree of interconnectedness with the rest of the

financial sector, its stable investor base, and the existence of liquidity requirements, are important risk mitigants.

33. **The main risk is related to concentrated exposures to the domestic sovereign bond market.** The lack of substantial secondary market activity in the sovereign bond market, can make it challenging to sell large amounts of sovereign bonds. The stress observed during the summer of 2022, shows how liquidity risks can crystallize in the fund sector. Ongoing efforts on the establishment of Primary Dealers are welcome and should continue.

34. **The financial system is highly exposed to retail clients and investors, and maintaining confidence in the financial sector is crucial.** Most bank funding depends on deposits from retail clients, and retail investors are by far the main investors in funds. In addition, retail investors directly hold a sizeable share of domestic sovereign debt (higher than 10 percent of outstanding debt).