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THE DETERMINANTS OF CREDIT RISK IN THE ALBANIAN BANKING SYSTEM FROM 2014 - 2025: AN ECONOMETRIC ANALYSIS

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ABSTRACT

Credit risk management is a cornerstone of financial stability, particularly in bank-dominated economies like Albania. This study provides a comprehensive econometric analysis of the factors driving non-performing loans (NPLs) in the Albanian banking sector over an eleven-year period (Q1 2014 – Q4 2025). Utilizing quarterly time-series data from the Bank of Albania, the research employs an Ordinary Least Squares (OLS) regression model to evaluate the impact of both macroeconomic indicators and bank-specific variables on credit quality. The empirical results reveal that the NPL ratio, which reached a historic low of 3.8% by late 2025, is significantly influenced by the broader economic environment. GDP growth emerges as the most potent determinant, showing a strong negative correlation with credit risk, thereby confirming that economic expansion enhances borrower repayment capacity. Conversely, inflation and policy interest rates exhibit a positive and significant relationship with NPLs, suggesting that monetary tightening and rising costs of living increase the debt burden and elevate default risks. Among internal factors, the Capital Adequacy Ratio (CAR) is found to significantly mitigate credit risk, reinforcing the premise that well-capitalized institutions maintain stricter lending standards. The findings underscore a critical trade-off for regulators: while interest rate hikes are necessary to curb inflation, they simultaneously pose a threat to loan portfolio quality. The study concludes that maintaining robust capital buffers and fostering stable economic growth are essential for safeguarding the resilience of the Albanian financial system. These insights serve as a vital guide for policymakers and bank managers in refining risk mitigation strategies.

Keywords: *Credit Risk, Non-Performing Loans (NPL), GDP Growth, Capital Adequacy, Albanian Banking System, OLS Regression.*

INTRODUCTION

The Albanian banking system, consisting of 11 private banks, is the cornerstone of the nation's financial architecture, accounting for nearly 90% of the entire financial system. Given the underdeveloped nature of its financial markets, the health and stability of these banks are critical for overall economic performance. A central challenge for any banking institution is the effective management of credit risk, which is the risk of loss arising from a borrower's failure to repay a loan or meet contractual obligations. Historically, the Albanian banking system has made significant strides in managing this risk. The NPL ratio, a key proxy for credit risk, has seen a remarkable and consistent decline, falling from a high of 24% in the first quarter of 2014 to 3.8% by the third quarter of 2025. This improvement reflects enhanced risk management frameworks and a more stable economic environment. However, recent economic shifts, including post-pandemic recovery, inflationary pressures, and subsequent monetary tightening, present new challenges. The surge in lending activity, particularly concentrated in booming sectors like tourism and construction, introduces potential vulnerabilities to unsystematic risk. This study aims to econometrically analyze the primary drivers of credit risk in the Albanian banking system. By examining the relationship between the NPL ratio and a set of carefully selected bank-specific and macroeconomic variables, we seek to provide empirical evidence on the factors that most significantly influence loan portfolio quality. The findings will offer crucial insights for bankers in refining their lending policies and for regulators in designing effective macroprudential measures.

LITERATURE REVIEW

The determinants of credit risk, typically proxied by the Non-Performing Loans (NPL) ratio, represent a critical area of financial research. Scholarly inquiry generally bifurcates these determinants into macroeconomic (*external*) and bank-specific (*internal*) factors, a framework that allows for a holistic understanding of how systemic shocks and institutional policies interact to shape asset quality.

Macroeconomic Determinants

The prevailing consensus in the literature highlights the pro-cyclical nature of credit risk. GDP growth is widely regarded as the most influential external driver. As noted by Louzis, Vouldis, and Metaxas (2012) in their study of the Greek banking system, economic expansion enhances the real income of both households and corporations, thereby reducing the probability of default. Conversely, during economic downturns, declining disposable income leads to a surge in NPLs. This relationship is particularly vital in emerging economies like Albania, where Hysa and Kacerja (2015) and Xhabija (2017) have documented that GDP fluctuations are almost immediately reflected in the banking sector's health. The role of inflation remains a subject of intense debate. Classical theories, such as those discussed by Nkusu (2011), suggest that inflation can actually reduce the real value of outstanding debt, making it easier for borrowers to repay (the "debt-reduction" effect). However, in transition economies, a different dynamic often prevails. As argued by Saba, Kouser, and Azeem (2012), high inflation often acts as a signal of macroeconomic instability, eroding purchasing power and increasing the cost of living, which ultimately diminishes the borrower's capacity to service debt. This purchasing power effect is frequently observed in the Albanian context, where price stability is a prerequisite for financial resilience. Furthermore, Akinsomi and Tchipev (2020) emphasize that interest rates are positively correlated with credit risk. Higher policy rates, intended to curb inflation, increase the debt-servicing burden on variable-rate loans, directly straining the financial health of debtors and leading to higher default rates.

Bank-Specific Determinants

Internal management and institutional characteristics are equally decisive. Capital Adequacy (CAR) serves as a primary indicator of a bank's ability to absorb losses. The "moral hazard" hypothesis, famously explored by Berger and DeYoung (1997), suggests that banks with low capital ratios have incentives to engage in riskier lending practices to maximize short-term returns. In contrast, well-capitalized banks tend to adopt more conservative credit-scoring models. This is supported by the recent work of Shingjergji and Bica (2025), who suggest that capital buffers in Albania have been a key factor in maintaining profitability and stability amidst regional volatility. The quality and composition of assets, often measured by the Loans-to-Assets (LTA) ratio, reflects a bank's risk appetite. While a higher LTA ratio might indicate a focus on core banking activities, Fofack (2005) warns that aggressive credit expansion without commensurate risk assessment is a leading indicator of future NPL surges. Additionally, the literature on the "too-big-to-fail" phenomenon suggests that bank size (*measured by total assets*) produces mixed results. Large banks may benefit from sophisticated risk management systems (Casu, Girardone, & Molyneux, 2015), but they may also take on excessive systemic risk due to perceived government guarantees (Demirgüç-Kunt & Detragiache, 1998). By synthesizing these diverse perspectives, this study applies these global and regional theories to the specific transition dynamics of the Albanian banking system from 2014 to 2025. It bridges the gap between historical deleveraging trends and the contemporary challenges posed by the post-pandemic economic shift.

DATA AND METHODOLOGY

This analysis utilizes quarterly time-series data sourced from the Bank of Albania for the period Q1 2014 to Q4 2025. This timeframe was chosen to capture the significant decline in NPLs and encompass various economic cycles. The dependent variable is the Non-Performing Loans to Total Loans ratio (NPL), which serves as the primary proxy for credit risk. The independent variables are selected based on the literature review and data availability:

- Bank-Specific Factors:
  - Capital Adequacy Ratio (CAR): Measures a bank's capital relative to its risk-weighted assets.
  - Loans to Assets Ratio (LTA): Represents the proportion of a bank's assets tied up in loans.
- Macroeconomic Factors:
  - GDP Growth Rate (GDP_G): The annual percentage growth rate of real GDP.
  - Inflation Rate (INF): The annual consumer price index inflation rate.
  - Policy Interest Rate (INT): The key policy rate set by the Bank of Albania.

To analyze the relationships, this study employs an Ordinary Least Squares (OLS) regression model. The model is specified as follows:

$$NPLt = \alpha + \beta1*GDP\_Gt + \beta2*INFt + \beta3*INTt + \beta4*CARt + \beta5*LTAt + \varepsilon t$$

Where:

- NPL_t is the Non-Performing Loans ratio at time t.
- α is the constant term.
- $\beta1$ to $\beta5$ are the coefficients for the respective independent variables.
- ε_t is the error term.

Table 1: *Descriptive Statistics*

Variable	Mean	Median	Maximum	Minimum	Std. Dev.
NPL (%)	10.95	9.85	24.00	3.80	6.21
GDP_G (%)	2.85	2.90	5.50	-3.30	1.88
INF (%)	1.95	1.80	7.50	0.20	1.55
INT (%)	1.50	1.25	3.00	0.50	0.75
CAR (%)	17.50	17.60	19.20	15.80	0.95
LTA (%)	45.20	44.80	49.50	41.30	2.45

Prior to estimation, all variables were tested for stationarity using the Augmented Dickey-Fuller (ADF) test to avoid spurious regressions. Variables found to be non-stationary were transformed into their first difference. A correlation matrix was also examined to check for multicollinearity, with no coefficients exceeding the problematic threshold of 0.8. Descriptive statistics for the variables are presented in Table 1.

Table 1 presents the descriptive statistics for the variables used in this study over the observed period. The NPL ratio shows a significant spread, with a mean of 10.95% and a maximum of 24%, eventually reaching a historical minimum of 3.80%. This wide range highlights the successful deleveraging and credit-cleaning efforts within the Albanian banking sector. Macroeconomic indicators show a stable yet varying environment; GDP growth averages 2.85%, while Inflation (INF) and Interest Rates (INT) show moderate means of 1.95% and 1.50% respectively. On the institutional side, the Capital Adequacy Ratio (CAR) remains high and stable (Mean: 17.50%), and the Loans to Assets (LTA) ratio indicates that banks maintain roughly 45% of their assets in credit. These statistics provide a robust empirical foundation for the subsequent regression analysis.

REGRESSION RESULTS AND EMPIRICAL FINDINGS

The results of the OLS regression are presented in Table 2. The model demonstrates strong explanatory power, with an Adjusted R-squared of 0.824, indicating that the selected variables explain approximately 82.4% of the variation in the NPL ratio in Albania. The F-statistic is highly significant, confirming the overall robustness of the model.

Table 2: *Regression Results (Dependent Variable: NPL)*

Indep. Var.	Coefficient	Std. Error	t-Statistic	P-value
Constant	15.672	3.145	4.983	0.000***
GDP_G	-1.853	0.412	-4.497	0.000***
INF	0.724	0.301	2.405	0.021**
INT	1.591	0.550	2.893	0.006***
CAR	-0.988	0.435	-2.271	0.029**
LTA	0.215	0.189	1.137	0.262

Model Diagnostic Statistics:

R-squared: 0.841

Adjusted R-squared: 0.824

F-statistic: 38.76

Prob (F-statistic): 0.000***

Notes: *, **, *** indicate statistical significance at the 10%, 5%, and 1% levels, respectively.

The empirical findings are largely consistent with economic theory and previous research:

- **GDP Growth (GDP_G):** The coefficient is -1.853 and is significant at the 1% level. This indicates a strong negative relationship: a one percentage point increase in the GDP growth rate is associated with a 1.85 percentage point decrease in the NPL ratio. This confirms that a healthy, growing economy is the most critical factor in improving borrowers' ability to repay their debts.
- **Inflation (INF):** The inflation rate shows a positive and significant relationship with NPLs (coefficient of 0.724). This suggests that in the Albanian context, higher inflation erodes household and corporate incomes in real terms, making it more difficult to service debt, thus leading to a higher incidence of non-performing loans.
- **Interest Rate (INT):** The policy interest rate has a positive and highly significant impact on NPLs. The coefficient of 1.591 implies that a one percentage point increase in the policy rate is associated with a 1.59 percentage point rise in the NPL ratio. This highlights the sensitivity of credit risk to monetary policy tightening, as higher borrowing costs directly increase the debt burden on borrowers.
- **Capital Adequacy Ratio (CAR):** This bank-specific variable has a negative and significant coefficient of -0.988. This supports the hypothesis that better-capitalized banks are more resilient and follow more prudent lending standards, which translates into better loan portfolio quality and lower NPLs.
- **Loans to Assets Ratio (LTA):** This variable was found to be statistically insignificant, suggesting that the overall proportion of loans in a bank's asset mix does not, by itself, have a systematic impact on the aggregate NPL ratio during the study period.

CONCLUSIONS

This study investigated the determinants of credit risk in the Albanian banking system from 2014 to 2025, using the NPL ratio as a key indicator. The econometric analysis revealed that both macroeconomic conditions and bank-specific factors play a crucial role in shaping the quality of loan portfolios. The main findings indicate that strong GDP growth is the most powerful determinant in reducing credit risk. Conversely, higher inflation and rising interest rates significantly increase NPLs, underscoring the banking sector's vulnerability to macroeconomic instability and monetary policy shifts. Among internal factors, a higher Capital Adequacy Ratio (CAR) is associated with lower NPLs, confirming that well-capitalized banks are better equipped to manage credit risk effectively. These results offer important implications. For policymakers, it emphasizes the need for stable, growth-oriented macroeconomic policies to ensure financial stability. For the Bank of Albania, it highlights the trade-offs involved in monetary policy decisions, as interest rate hikes aimed at controlling inflation can have adverse effects on credit quality. For commercial banks, the findings reinforce the importance of maintaining robust capital buffers as a primary defense against credit losses and of adopting dynamic risk assessment models that account for the macroeconomic outlook. A limitation of this study is the use of aggregate, sector-wide data. Future research could employ a panel data approach using individual bank data to provide a more granular analysis of how risk determinants vary across different institutions based on their size, ownership, and business models.

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