



Bank of Albania

Bank of Albania

FINANCIAL STABILITY REPORT 2007

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C O N T E N T S

FOREWORD	7
1. SUMMARY	8
2. INTERNATIONAL DEVELOPMENTS DURING THE YEAR 2007	14
3. MACROECONOMIC SITUATION IN ALBANIA	30
4. ANALYSIS OF THE FINANCIAL SYSTEM'S SOUNDNESS INDICATORS	39
5. TECHNOLOGICAL INFRASTRUCTURE	54
6. STRESS-TEST ANALYSIS	59
7. NON-BANK FINANCIAL INSTITUTIONS AND INSURANCE COMPANIES	65
ANNEX 1	68
ENDNOTES	70

Chart 38	Distribution of credit by sectors	50
Chart 39	Liquid assets to total assets of the banking system	51
Chart 40	Liquid assets to total assets by banking groups	51
Chart 41	Liquid assets to short-term liabilities of the banking system	52
Chart 42	Return on assets for the banking system	52
Chart 43	Return on assets by banking groups	52
Chart 44	Gross non-performing loans to total loans of the banking system	52
Chart 45	Non-performing loans to total loans by banking groups	52
Chart 46	Distribution of loans by sectors of industry	52
Chart 47	Interest margin to gross income for the banking system in %	53
Chart 48	Interest margin to gross income by banking groups in %	53
Chart 49	Non-interest expenditure to gross income for the banking system in %	53
Chart 50	Interest expenditure to gross income by banking groups in %	54
6. Stress-test analysis		
Chart 51	Share of financial system's components to the GDP in % (2007)	65
Chart 52	Share of financial system's components in %	65
7. Non-bank financial institutions and insurance companies		
Chart 53	Change in assets of non-bank institutions in %	66
Chart 54	Ratio claims/premiums in the total insurance market	66

FOREWORD

This is the first issue of the Financial Stability Report, which will be published by the Bank of Albania on annual basis. The purpose of this report is to detect and assess the risks the financial system and its infrastructure are faced with, and in order to provide the public authorities with the possibility to identify the relevant measures for the necessary corrections. For the compilation of this report have been used data available at the Bank of Albania, and information has been exchanged with other authorities, which supervise the activity of the financial market. In order for this report to have a wide and diverse audience, the language used and the information presented in it is aimed to be as appropriate as possible. The improvement of the Financial Stability Report quality, in particular in terms of the data it contains, will be our objective in the future issues of this report.

The stability of the financial system is assessed based on the performance and risks derived from its interaction with the overall economic environment, both internal and external, and from its activity. In order to evaluate the risks arising from the interaction with the surrounding environment, the macroeconomic and markets' developments in Albania and in foreign partner countries have been analyzed. This report makes an assessment of the general developments and the expectations with regard to economic growth, trade balance, the overall price level, exchange rate and the fiscal indicators. It provides an analysis of the latest developments in the international financial markets and developed economies and makes an assessment of their impact on Albania's financial system and the banking sector.

In addition, through an analysis of employment, the following report provides an assessment of personal income and its effects on the banking sector's borrowers' creditworthiness. In order to assess the risks arising from the financial system activity, we have examined the performance of the main indicators of its financial soundness, namely capital, asset quality and financial performance. The extent of risks has been assessed through the stress-test analysis. The report also makes a brief assessment of the situation in the non-bank financial sector. The data and analysis mainly entail the developments occurred during 2007 and the first quarter of the year 2008. The expectations for future developments mainly cover the entire year 2008.

1. SUMMARY

The analysis of the characteristics of risks in the financial activity of Albania indicates an increased general level of risk. The risk spectrum has expanded during 2007 and the same tendency is expected to be maintained during the present year as well. This performance attributes to the further growth of investments of the financial system in assets with higher return (and risk), to the domestic developments in the economy, to its opening and to the gradual integration with the regional and global financial markets. Nonetheless, based on the analysis of the regulatory authorities, the financial system is presently protected from risks arising from internal developments and regional and global ones. In this context, no risks that may be materialized or which may harm abruptly and severely the activity of the financial system are identified. Although the risks level is manageable it is recommended to the regulatory authorities of the financial market, the financial institutions and to the public at large to enhance their supervisory prudence.

During the year 2007, macroeconomic indicators had a stable performance, similar to the trend of the past several years. Annual economic growth is expected to be close to 6%, as in the previous years, despite the trade deficit deepening. As of end 2007, the Albanian Government met the objectives related to the level of income and public expenditure, budget deficit, and to the extent of financing of a part of expenditure with financial market domestic sources. The expenditure carried out in particular in the last part of the year altered the features of the public finances which until then had shown a positive budget surplus. Monetary policy responded to the inflationary pressures which became more pronounced in the last quarter of 2007. In addition to the negative effects on producer cost and money supply arisen as a result of the dry weather in summer and autumn and of the deteriorated energy situation at home, there were other negative consequences arising from the difficult situation the global markets of raw materials, energy and foods were going through. The inadequate structure of domestic production and the dependence on import remain among the factors which damaged the protective mechanisms of the Albanian economic to the regional and global developments. Consequently, according to the INSTAT, in September and October of 2007 the annual increase of the consumer price index was 4.4% and 4.2% respectively, which is beyond the upper limit of 4% targeted by the Bank of Albania. In order to prevent the persisting inflationary pressures, the Bank of Albania raised the key interest rate on repurchase agreements twice to 6.25%. As of end 2008, the annual increase of the CPI reached to 3.1%, which is within the targeted band of the Bank of Albania and close to the 3% objective. During this period, the situation in the forex market presented as stable. The exchange rate of the lek to the foreign currencies fluctuated within the historical intervals for the period, reflecting at the same time the situation in the international financial markets.

The macroeconomic indicators for 2008 are expected to be within the objectives for a similar economic growth to the year 2007; however, there is greater vulnerability of the macroeconomic equilibrium to sectoral

performance, global economic growth and to the fiscal and monetary policy stance. Economic growth continues to benefit from the growth of banking credit and from the focus of government expenditure on investments which in turn improve the overall level of productivity. On the other side, the increased producer cost as a result of certain factors related to the raw materials prices and energy, the plausible trade deficit growth and the probable slowdown in the regional and European economic growth will have a negative effect on the Albanian economic growth. The year 2008 is characterized by the projection of a considerable government budget. At the same time, the need to finance several important investments will lead to an increased budget deficit. Expenditure and budget deficit increase will trigger inflationary pressures in economy, which are expected to be active throughout the year, also given the continued unfavourable situation in the global markets of energy and foods. In addition, the growth of public investments of the government will be followed by the increase of financing by the financial system and it may reduce the extent or worsen the financing terms for private entrepreneurships. Given the poorer performance of some sectors of the economy, construction for instance, this development may add to their difficulties. However, this effect may be managed if the government objectives for the orientation of a considerable part of expenditure on large infrastructure projects are achieved and if there is a better allocation in time of total income and expenditure. Through its monetary policy, the Bank of Albania will attentively attend the effect of various economic developments on the level of prices and will timely and duly act with the necessary instruments in order to prevent the constancy of plausible inflationary pressures.

The international financial markets were faced with a difficult liquidity situation in the short-term, in particular in the end of 2007, given the direct or indirect exposure of some important financial institutions to instruments that related to non-performing house loans in the USA. The considerable financial losses in some of the largest banks and financial institutions in the world, the credit crunch and the tightening of liquidity conditions in the interbank markets increased the chances for a negative impact on the real sector of the economy through the drop of household and business consumption and investments. It was for this reason that the US Federal Reserve, the ECB and some other central banks took several measures to facilitate the meeting of major global banks and other financial institutions' needs for short-term financing. At the same time, the US administration made public the plan for the approval of a fiscal package which would provide a financial stimulus of about 150 billion US dollars to preserve the demand of the real sector of the economy. In addition to the need for the alleviation of the crisis consequences, the stances of the main central banks to the performance of the key interest rates were also influenced by the changes in the monetary policy objectives and in the mode of their accomplishment. Hence, the Federal Reserve veered off the course of the key interest rate by cutting it three times in September to November to 4.25%. In addition, the Federal Reserve expressed its willingness to continue with other cuts in order to prevent the recession of the economy and the increase of unemployment. Meanwhile, the unfavourable inflationary developments in the euro area countries affected the stance of the ECB which

decided to keep the key interest rate of 4% unchanged until July 2008. The expectations for a more rapid slowdown in the US economic growth and for the further increase of interest rate differences between the US and the euro area led to the depreciation of the US dollar to other currencies, in particular to the euro and the British pound.

Crisis in the international financial markets has led to the reassessment of risk, evidenced by the review of decisions related to investments and by the repricing of certain instruments widely used before. The liquidity problems generated by the financial crisis led to the fall in the assets value for large financial groups and their losses were also extended in the first half of 2008. The general concern for the further influence on the global economic decline through the reduction of lending remains constant. The projections for the macroeconomic growth of the euro area during the year 2008 have dropped significantly, being assessed at around 2.1-2.3% in January 2008. Meanwhile, US economic growth has dropped to 0.5-1%. The central banks of the most industrialized world economies intervened in 2007, individually or in a harmonized way, to improve the liquidity situation in these markets through the cut of the key interest rates and the review of the regulatory framework on the open market operations. The US Federal Reserve lowered the key interest rate to 2.25%. However, these efforts are being hampered by the high inflationary pressures, in particular in the euro area where in May 2008 the annual inflation rate reached 3.7%. Although the slight drop in the differences between short-term interest rates and the key interest rates in the global interbank market may indicate that the most challenging situation of this crisis is over, the crisis effect on the balance sheets of the largest financial institutions and on its duration remains completely unknown.

The economic openness and the integration of the Albanian financial system into the regional and global markets increases the vulnerability of our financial system to the unfavourable developments in the economic region and in the foreign markets. Despite the financial integration, the investments of distinguished and large financial and banking groups of developed countries in the emerging markets still represent a small share to the total group value. This is especially true for the emerging markets in the Balkan Region. This and the absence of developed markets in emerging countries have curtailed the influence of the financial crisis on these countries, at least in the short-term. The recent figures for Albanian banks held by European banking groups do not reflect financial losses or issues originated from the financial crisis the developed markets are going through. The good liquidity situation of banks operating in Albania and the very limited use of group's financing are additional factors which do not allow the transfer of elements of this crisis to banks and other financial instruments in the country.

However, the transfer likelihood of the financial sector crisis to the real sector of our partner trading countries remains a potential risk for the Albanian banking sector. The channels through which this risk may be materialized are as follows:

- *The rapid change of the difference between the interest rate of the main currencies to the lek, favouring further lending in foreign currency and its financing through borrowing from the foreign markets (or the holding banking group).* These changes may further pronounce the factors supporting lending in foreign currency and in order to keep their market shares and to control the financing costs, the banking sector may choose to be financed by the foreign market in non-main currencies (different from the US dollar and the euro) with relatively lower interest rates. These shifts may lead to the deterioration of the characteristics of risks associated with the rapid lending and in particular foreign currency lending as a result of the financing in a currency over which the borrower does not have enough information or of the increase in the value of the credit instalment to be paid for credits having a changeable interest rate. The vulnerability of the foreign currency credit portfolio to a possible and unfavourable exchange rate change becomes even more pronounced. Banks and their borrowers should watch the dynamics of these factors' developments prudently and carry out the necessary operations in order to protect themselves from their unfavourable performance. Stress test analysis on the direct risk of the interest rate change and on the indirect risk of credit from the change of foreign interest rates for the main currencies indicates that the banking sector shows sufficient resistance to these risks. However, certain banks show relatively higher vulnerability to these risks.
- *Exchange rate changes.* In addition to the uncertainty related to the value of the main currencies (US dollar and the euro) in the international markets as a result of the financial crisis, the different direction of the key interest rates set by the central banks may lead to extreme shifts in the difference between them, as well as changes in their value in relation to the national currency. Nonetheless, banks' exposure to the exchange rate during the last quarter of 2007 has decreased and the stress test analysis shows that the banking system's capital would provide sufficient protection in case of a considerable depreciation/appreciation of the exchange rate both in the euro and in the US dollar. With respect to the indirect exchange rate risk or the risk foreign currency borrowers are faced with, it may be relatively high in certain segments of the banking sector.
- *Combination of difficulties in the international financial markets with the unfavourable dynamics of the prices of energy and food raw materials worldwide.* This unwanted combination limits the arsenal of central banks' instruments to fully meet the international financial markets' demand for liquidity. In addition, it increases the risk that it may have a negative influence on the global demand for consumption and investments and it may result in the slowdown of economic growth in the developed countries. This situation will lead to higher inflationary pressures in small economies, like the Albanian one, and to the tightening of domestic and external financing terms for different economic agents, including the governments. Additionally, it may result in the fall of income and employment in the countries most affected by the economic growth slowdown, drop in workers' remittances

and seasonal workers in emerging markets as is the Albanian one. In addition to the deterioration of the foreign currency borrowers' creditworthiness, new deposits denominated in foreign currency would fall and consequently, the generation of new sources in foreign currency would be made possible only through a high interest rate of deposits denominated in foreign currency or through borrowing from the foreign market. If on the other hand, the interest rate of credit denominated in foreign currency does not rise, the interest rate risk will increase.

- *Review of investment policies in view of reassessing the risk in general would lead to drop in foreign direct investments.* Risk reassessment in the financial and non-financial system in developed economies would decrease the interest of foreign investors in expanding their activity in emerging markets if a higher level of uncertainty is perceived with respect to these countries. In addition, lending policies of resident banks, which are controlled by non-resident financial institutions, may change reflecting more the new stance to the risk of banking groups rather than the internal conditions of the country they are operating in.
- *Financial system's exposure to the sectors of the economy that are negatively impacted by the possible decline of regional and global economy.* It is for this reason that the non-bank financial institutions and the banks should in line with the nature of their activity monitor the concentration of their products by sector of economy (taking into consideration the inter-sectoral influence as well), in order to provide a more balanced distribution of their activity and to prevent concentrations.

The financial system in Albania has by and large had a stable and balanced growth during the year 2007, being well supported by the existing infrastructure. The good financial outcome both in the banking and in the non-bank financial sector attributes to the better use of financial resources and to the relatively rapid and continued expansion of activities with high return on investment. The long-term tendency for the gradual decline of the capitalization indicator of the financial and in the particular the banking sector continued; however, the dropping rate slowed down. This performance owes to the behaviour of more active banks and financial institutions, whose business capitalization indicators are close to the minimum levels required by the legal and regulatory framework. The foreign capital continued to enter the financial institutions during this period and several institutional mergers took place, which further support the consolidation of the financial market.

The infrastructure of the banking sector, represented by the payment and settlement systems administered by the Bank of Albania, was a great support for the conduct of the banking sector business during the year 2007. As in the previous years, real time gross settlement system (AIPS) and the clearing system for small value payments (AECH) did not undergo any technical problems despite the increased number of transactions. In order to carry out the required transactions efficiently, banks made better use of the facilities

provided by the systems, such as the intra-day loan. During 2007, the use of payments' electronic instruments expanded further as a result of the increased use of cards, increased number of automated teller machines (ATM) and points of sale (POS). In addition, internet banking has found greater use during 2007 through the access of banking services via the internet. Given the primary role of the well-functioning of the payments system in the financial system stability, the Bank of Albania has prudently monitored the payment systems and has made several technological upgrading and has reviewed the regulatory framework in order to better meet the safety and efficiency demands established by the European standards.

The financial sector's assets have grown under stable rates; however, the share of the non-bank financial sector remains low, hence curtailing the contribution of this sector to the stable development of the entire financial system. Total assets of the financial system accounted for 78.5% of the GDP as of end 2007. The share of the banking sector in it accounts for 76% relative to 69.4% it accounted for the previous year. According to the Albanian Financial Supervisory Authority, until September 2007 total assets of insurance and re-insurance companies, which dominate in the non-bank financial sector, grew by 12% to 12.98 billion leks. It is estimated that total assets of insurance and reinsurance companies licensed in Albania account for about 1.3% of the GDP. The share of total assets of insurance and re-insurance companies to total assets of the banking sector was only 1.9 % in the same period, which is similar to the end-year 2006. According to the estimations of the Albanian Financial Supervisory Authority, the indicators of this important segment of the non-bank financial sector, including profitability, insurance capacity and capitalization, were positive at end 2007 and in line with the provisions of the regulatory framework. The penetration level of non-bank financial institutions' products into the Albanian market remains low. Consequently, the positive effect it provides as a mechanism that improves the risk characteristics of financial and banking products is limited. However, this market segment is assessed to have a lot of development potential in the future. The optimistic situation in the non-bank financial market is also evidenced by the enhanced interest of foreign institutional investors, in particular in this market segment represented by the insurance and re-insurance activity. During the past six months were finalized in the banking sector the merger procedures of two banks, providing evidence for the welcome consolidation process of the activity. In addition to the approval obtained from the supervisory and regulatory authorities of each sector, the changes in the structure of financial institutions' shareholders were also analyzed in terms of the effect they have on the market competition and have been approved by the Competition Authority.

The banking sector has further expanded the investments in loans and securities. It has maintained satisfactory level of return on investment although there has been a slight decrease in the capitalization and liquidity indicators. As of end 2007, the loan portfolio of the banking sector reached almost 40% of total assets in this sector, increasing by 4.4 percentage points relative to the end June. Investment securities accounted for 18% of total assets increasing by 1.6 percentage points relative to the same period the previous year. As