

- The increase of inflationary pressures which are prompted by the dominance of the following factors: a) the increase of business cost due to the price rise of energy, formalization of the economy and the enhanced collection of taxes, b) the difficult financing conditions of business needs as a result of the concentration of government expenditure (in terms of time and sectors), c) financial stimulus in domestic demand which results from the rise of wages in the public sector and of pensions which was higher than the expected economic growth and than the inflation increase. This element of risk would relax if the lek exchange rate will appreciate gradually as a result of the increased interest of foreign investors in Albania;
- The increase of the T-bills issued amount and the decrease of frequency of T-bills auctions which would theoretically increase the liquidity of these instruments. In addition, the measures taken to extend the maturity term of debt instruments for the banking system will lead to the deepening of the domestic money market and the T-bill market. These measures will in particular deepen the instruments' market with maturity term of longer than one year. In order to make these instruments more attractive to banks, they should be used as collateral at the Bank of Albania, in case of liquidity shocks and increase of these instruments' tradability in the secondary market. With regard to the issue of Government's debt instruments in foreign currency, the creation of this new instrument has the advantage of increasing the lenders' base and improving the cost of debt in the short-term. However, considering the vague situation in the international markets and the constant risk repricing, no conclusions could be drawn on the benefits of the cost of debt in the medium-term. Given that the amount of government debt in foreign currency has a very small share in government's borrowing, the exchange rate risk for this instrument is inconsiderable.

4. ANALYSIS OF THE FINANCIAL SYSTEM'S SOUNDNESS INDICATORS

4.1 GENERAL DEVELOPMENTS

Banking sector's assets and the positive financial outcome continued to expand during the year 2007 and the first quarter of 2008. Among the assets' elements, credit continues to grow more rapidly than the other elements. As of end March 2008, the share of credit to total assets grew by 10% relative to the end-year 2006. Credit denominated in foreign currency continued to have the main share to total credit and grow at rapid rates; however, the sector's ability to collect deposits denominated in foreign currency has grown at slower rates. If the same tendency is maintained in the future, the high demand for foreign currency sources may lead to: 1) growth of borrowing from foreign banking groups, reduction in interests' margins for foreign currency from banks and increasing preference to collect foreign currency with low interest rate, or 2) deterioration in terms of maturity

concordance between assets and liabilities in foreign currency. In both cases, the liquidity risk and the interest rate risk increases for the banking system. The banking sector has extended loans to the most productive sector of the economy. Non-performing loans are still at low levels; however, this ratio may deteriorate later given that credit has grown very rapidly in the last years and the large use of credit may imply its enhanced restructuring. As a result of the credit growth, liquidity indicators have decreased, being expressed in the form of the share of liquid assets to total assets. Nevertheless, this ratio still remains at satisfactory levels. The banking sector's financial leverage has decreased and the borrowing cost remains relatively low for the banking sector. The financial outcome is presented positive and it represents a stable source for the increase of the capital and the expansion of the activity. The banking sector shows pronounced dependence on interest income due to the concentration of the banking sector's investments in securities and credit and to the insufficient competition. This dependence is expected to be present in the foreseeable future as well. The reliance on interest income makes the banking sector vulnerable to factors that may prompt a slowdown in the growth of credit or collection of deposits. Therefore, this situation requires the expansion of sources which generate income. Return on assets and return on equity are at stable levels. Capital adequacy resulted sufficient to cover the risks stemming from the activity exercising. However, there is a downward tendency in capital adequacy ratio as a result of the shift in the assets' portfolio to high-risk investments and the deterioration of the credit portfolio. The risk analysis indicates that the level of risk has generally increased for the banking sector, although it still remains in acceptable levels. Despite the increased exposure to credit and exchange rate risk, the downward tendency of the liquidity indicator and the use of foreign currency financing by foreign banking groups increase the vulnerability to risks that affect the foreign financial markets.

Total assets of the banking sector grew by 23% during the year 2007 and the first quarter of the year 2008. Risk-weighted assets resumed their upward tendency after a drop in the last quarter of the year 2007. As of end March 2008 they accounted for 37.2% of total assets relative to 34.6% as of end-year 2006. Among the risk-weighted assets, credit recorded the main growth by 58%. Credit denominated in foreign currency grew by 61%, accounting as of end March 2008 for 73.1% of total credit portfolio. The second half of the year saw the main contribution to the increase of the system's activity in total, while the developments in the credit portfolio have been more uniform during the entire period.

Credit activity was financed by domestic sources of the banking sector, where deposits have the main share. It is for this reason that the downward tendency of the deposits' ratio to loans has deepened to 202% as of end March 2008 (chart 14). The drop in this ratio shows that the system's ability to extend loans has been greater than its ability to collect deposits. Acknowledging the fact that sources, that is deposits denominated in foreign currency, are relatively more curtailed than sources in lek, the monitoring of the growth of deposits in foreign currency and its comparison with the

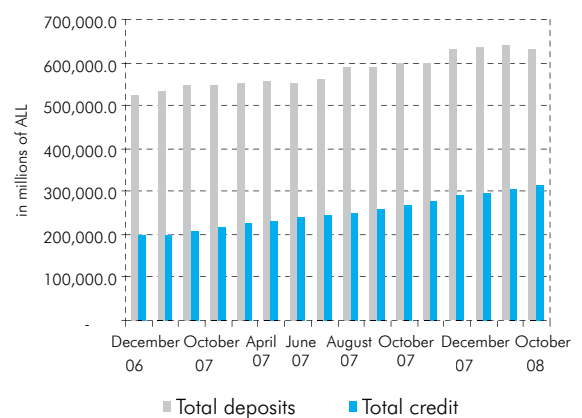
existing and expected tendency of credit growth in foreign currency is of great interest. As shown in charts 15 and 16, almost throughout the year 2007 credit denominated in foreign currency has grown more rapidly than deposits denominated in foreign currency. *This fact signals that the limited sources in foreign currency may lead to the increase of financing from the foreign banking group, the reduction in the margin of interests for foreign currency activity and the increased preference to collect foreign currency with low interest rate or the deterioration in the maturity concordance between assets and liabilities denominated in foreign currency. In all cases, the liquidity risk and the interest rate risk have their implications on the banking sector.* The banking system's exposure to these risks will be more elaboratively explored in part 5 of the present report which deals with the stress-test analysis.

Banking groups⁷ show different characteristics. For G1 and G2 banking groups, the share of credit to total activity was higher during the first half of the year and the first quarter of 2008. While for G3 banking group, the growth has almost been linear throughout the year 2007 and fell in the first quarter of 2008. The drop in the share of credit for the first two groups responded to the seasonal effects and the shocks of the real economy that occurred during the second half of 2007.

The same tendency is shown with the drop in the ratio of deposits to credit during the entire period which maintained the same performance as credit (charts 13 and 17). This ratio fell considerably in the first quarter of 2008, in particular for G2, providing evidence for the increasing lending rate by this banking group. With regard to G3 banking group, the ratio of deposits to credit has dropped constantly during the entire year 2007. However, this ratio increased in the first quarter of 2008 as a result of the lowered lending rate. The growth of credit during the first half of 2007 was higher than the increase of capital of G2 and G3 banking groups. In particular for the G2 banking group, this ratio marked its peak of the last three years.

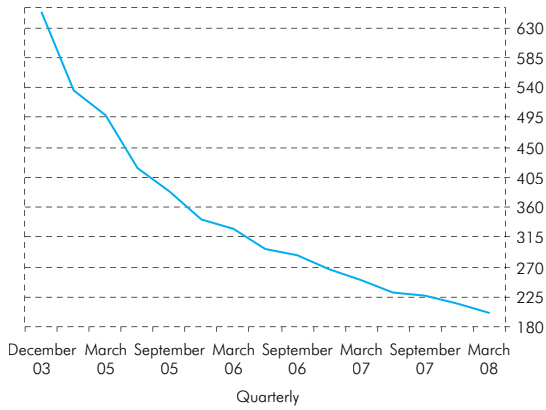
As a share to total credit, credit denominated in foreign currency grew more for G1 and G2 banking groups. Meanwhile for G3 banking group this ratio reflects the change of the exchange rate during the second quarter (chart 18). On the other hand, the ratio of foreign currency-denominated liabilities to total liabilities has been dropping for G1 banking group. For the other two groups, this ratio has increased during the entire period indicating that the banking system's ability to collect deposits denominated in foreign currency and finance lending in foreign currency provides adequate protection from the direct exchange rate risk (chart 19).

Chart 13 Performance of deposits and credit in the banking system



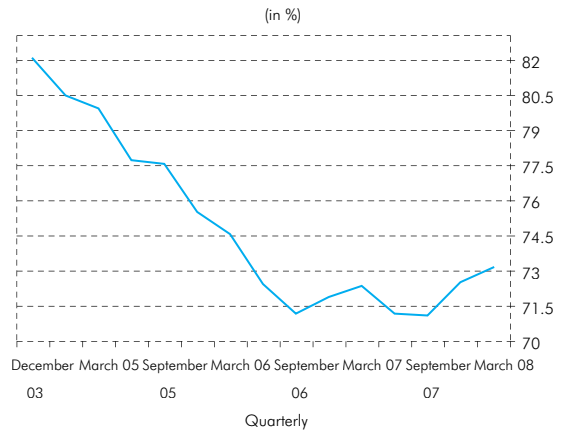
Source: Bank of Albania

Chart 14 Clients' deposits to total credit of the banking system



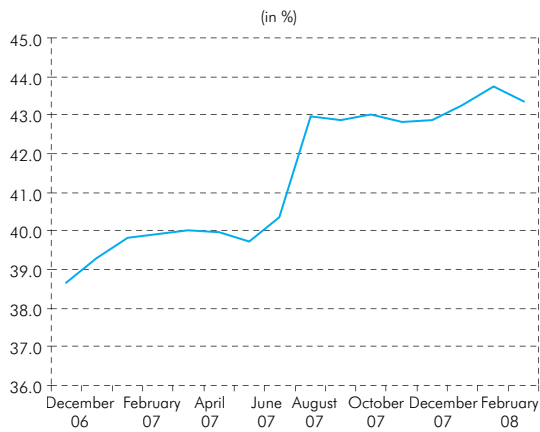
Source: Bank of Albania

Chart 15 Foreign-currency denominated credit to total credit of the banking system



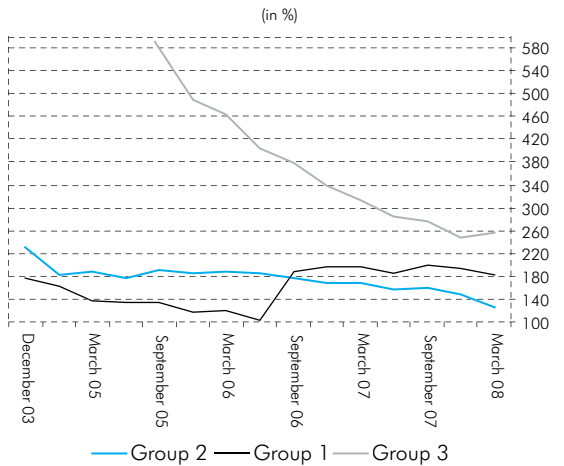
Source: Bank of Albania

Chart 16 Foreign-currency denominated deposits to total deposits of the banking system



Source: Bank of Albania

Chart 17 Total deposits to total credit by banking groups



Source: Bank of Albania

Chart 18 Foreign currency-denominated credit to total credit by banking groups

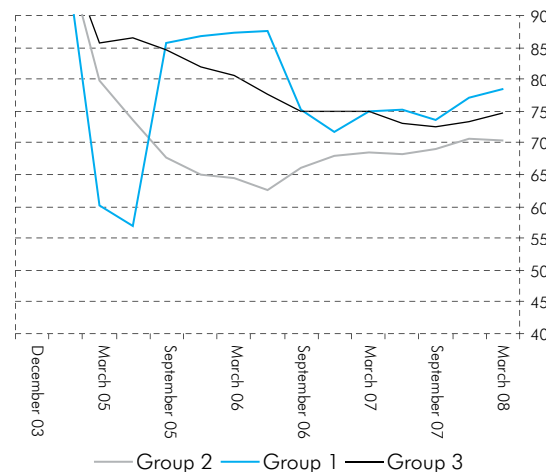
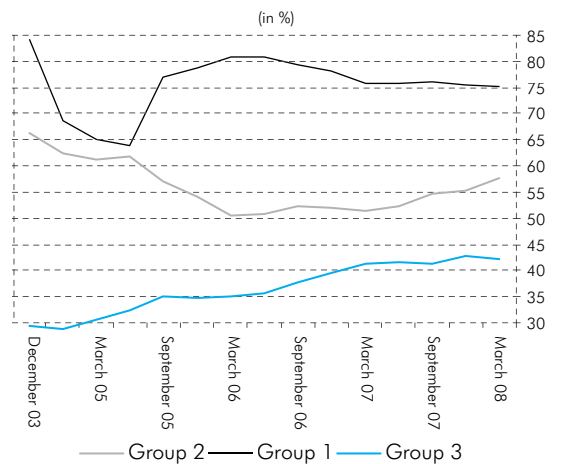


Chart 19 Foreign currency-denominated liabilities to total liabilities by banking groups



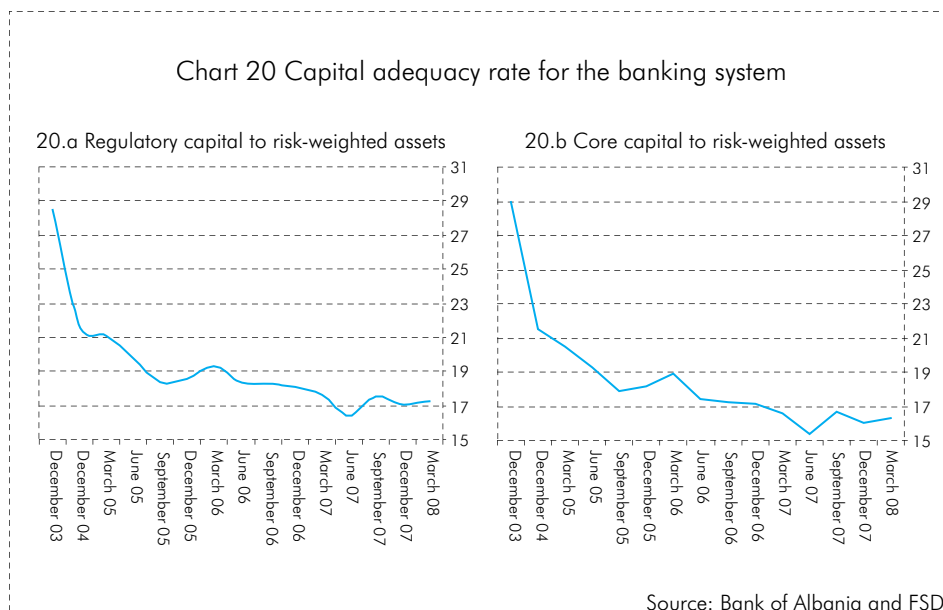
Source: Bank of Albania

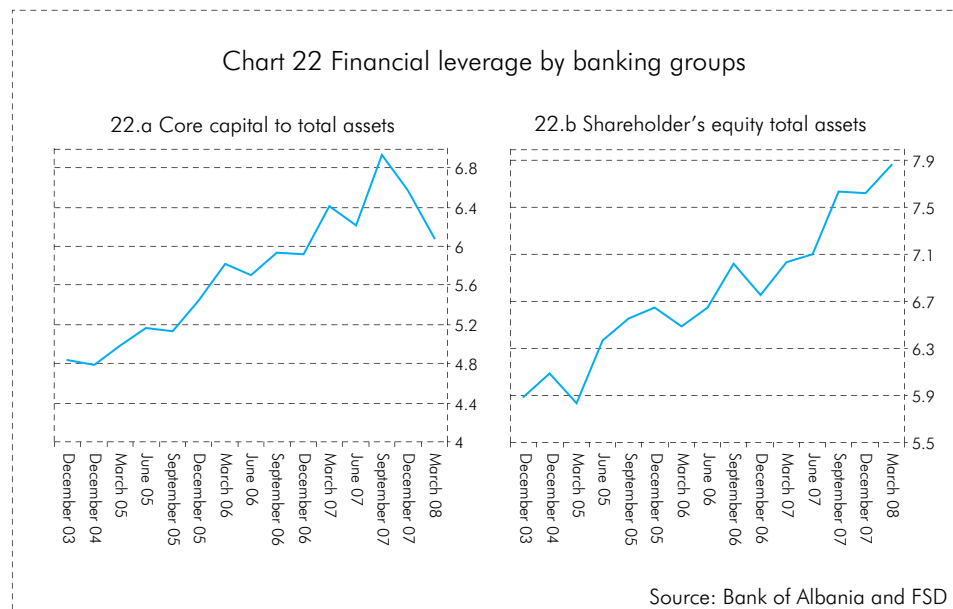
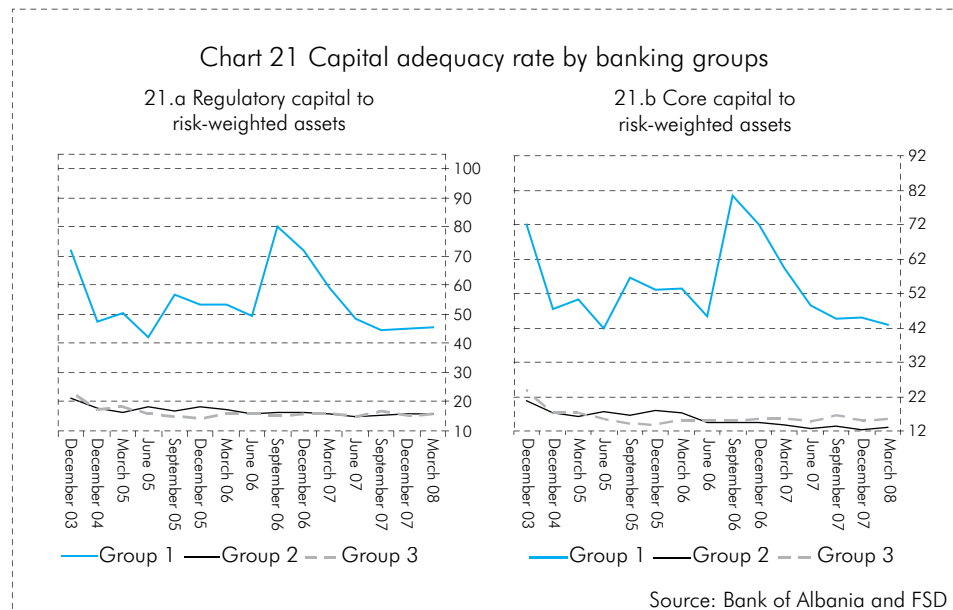
4.2 CAPITAL INDICATORS

Capital adequacy indicator, expressed as a ratio of regulatory capital to risk weighted assets ratio for the banking system (chart 20.a and 20.b) have had a downward tendency during the entire year and in particular in the first half of the year, although the financial leverage expressed as a percentage of shareholder’s equity to total assets has remained around the same levels. This performance is explained by the more rapid growth of risk-weighted assets than the increase of the regulatory capital and by the increase of provisions due to the deterioration of credit portfolio. The ratio improved in the third quarter of 2007, reflecting the augmentation of regulatory capital although its performance did not respond later to the upward tendency of non-performing loans in banks’ portfolio. However, as of end 2007, capital adequacy indicator reached 17.1%, remaining above the minimum required level of this indicator of 12%.

In terms of banking groups, the drop of this indicator during 2007 was more pronounced in G1 banking group (chart 21.a and 21.b) by about 27 percentage points to 45.1%. The drop of this indicator in this group owes to the increasing share of risk-weighted assets and it indicates these banks’ efforts to improve their business efficiency. With respect to G2 and G3 banking groups, the drop of capital adequacy indicator during 2007 was low by respectively 0.3 percentage points and 0.5 percentage points to 15.8% and 15.5%.

During the year 2007 and the first quarter of 2008 there was a gradual drop in the use of the financial leverage, in particular in the second half of the year as shown in chart 22.a. The drop in the financial leverage while the capital adequacy ratios have generally had a downward tendency suggests that the banking sector’s assets have grown less than the shareholder’s equity and at the same time they have shifted to riskier-weighted assets. The ratio of shareholder’s capital to total assets as shown in chart 22.b for the banking system has also grown during the entire period.





The banking sector's capacity to cover with capital the possible losses from non-performing loans, expressed as a percentage of net non-performing loans to capital indicators (see table 6 below), continued with its downward tendency (charts 23.a and 23.b). The growth rate of this ratio accelerated in the last quarter of 2007 and in the first quarter of 2008.

Table 6 Ratio of net non-performing loans to capital indicators

Indicators (in %)	2008				2007		2006
	March	December	September	June	March	December	
Net non-performing loans/core capital	13.7	12.0	9.0	8.5	7.8	7.2	
Net non-performing loans/regulatory capital	13.0	11.2	8.5	7.9	7.4	6.8	
Net non-performing loans/shareholder's equity	10.6	9.1	8.2	7.4	7.1	6.3	

Source: Bank of Albania

It is observed that the deterioration tendency of credit portfolio in relation to capital indicators is more pronounced for G2 and G3 banking groups (charts 24.a and 24.b). Meanwhile, for G1 group, the capacity of the capital to cover the losses from net-performing loans is presented relatively higher and more stable.

The banking system's efficiency in using the capital has remained at almost the same levels throughout the entire year 2007 (chart 25). This indicator is higher for Albania than the European average. The increase of non-performing loans and the respective provisions may have affected the drop in profit per unit of capital. The rise of the key interest rate by the Bank of Albania and foreign central banks has provided its impact on the spread between the interest rates paid on liabilities and earned on assets by the banking system (charts 26, 27 and 28). In terms of banking groups, there is a downward tendency shown in G3 banking group, which started in the early 2007 while this ratio appears more unstable for G2 group (chart 29). In addition, this indicator has recorded high drop for G2 group in the first quarter of 2008 while the financial leverage has increased during the same period. On the other side, the decline in return on equity (ROE) indicator may also reflect the increase of provisions by this banking group having into consideration the deterioration in the credit portfolio quality.

The banking system's exposure to the exchange rate risk as shown by the percentage of the open foreign currency position to the core and shareholder's equity (chart 30) has increased in the first quarter of 2008 relative to the historical values of the last 4 years. In terms of extent per banking group, it is noticed that despite the extensive oscillations during the period the percentage of net open position to the capital remains within the accepted levels for all groups (charts 31.a and 31.b). The instantaneous decline in open positions in December, despite the high values during the quarter, may reflect the seasonal behaviour of the exchange rate and the respective positioning of banks.

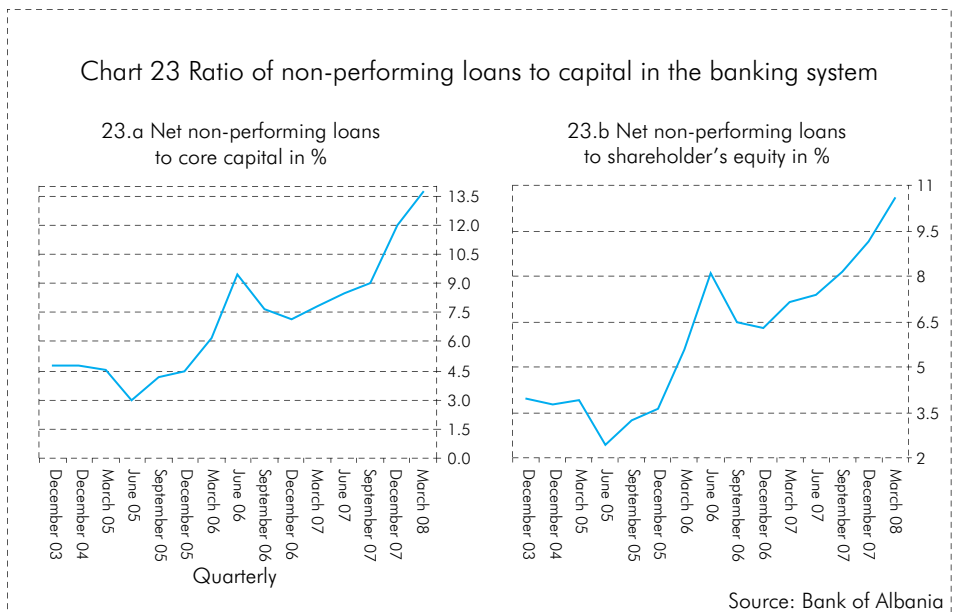
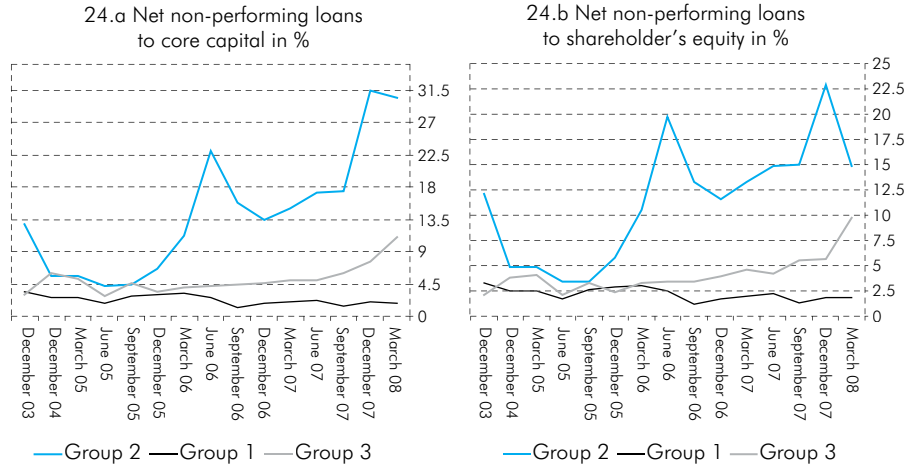
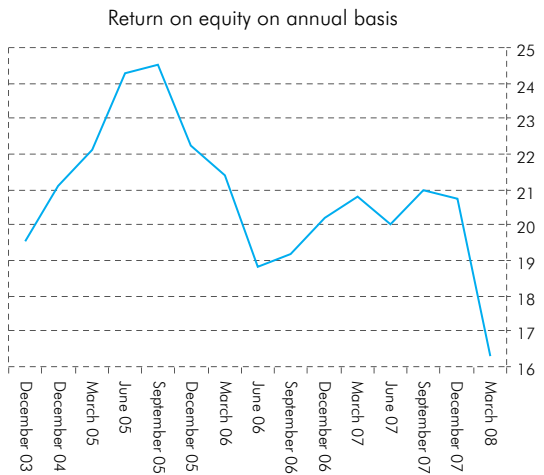


Chart 24 Net non-performing loans to capital by banking groups



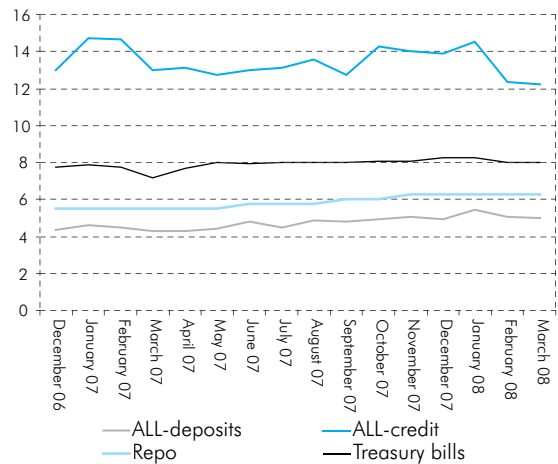
Source: Bank of Albania

Chart 25 Return on equity for the banking system



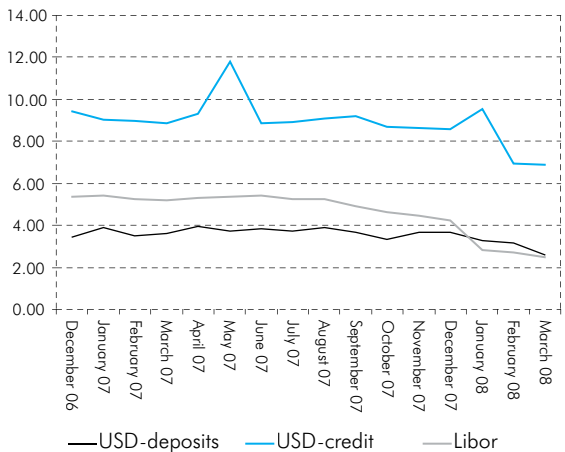
Source: Bank of Albania

Chart 26 Interest rates for ALL-denominated instruments



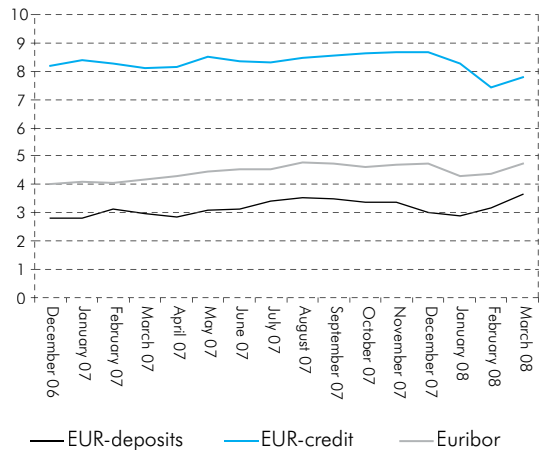
Source: Bank of Albania

Chart 27 Interest rates for USD-denominated instruments



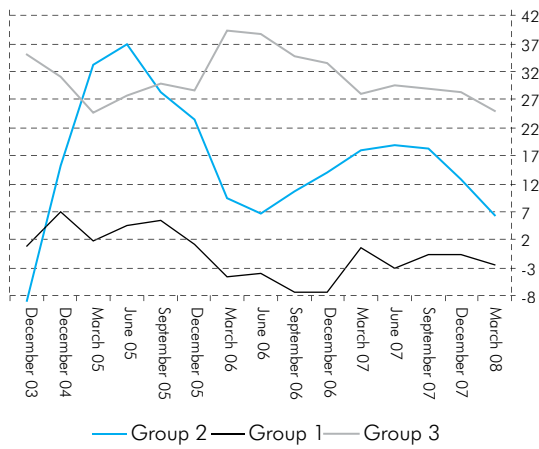
Source: Bank of Albania

Chart 28 Interest rates for EUR-denominated instruments



Source: Bank of Albania

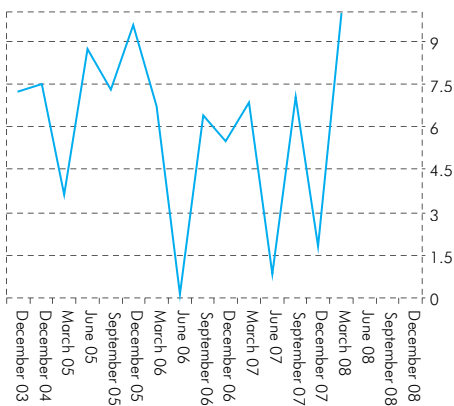
Chart 29 Return of equity by banking groups in %



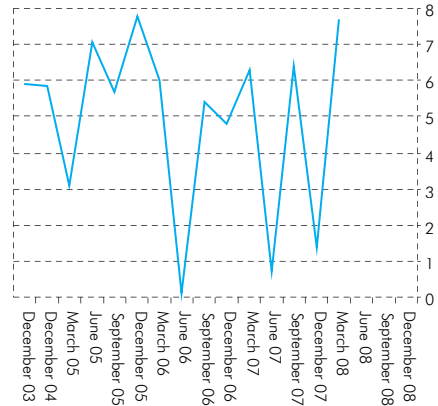
Source: Bank of Albania

Chart 30 Exposure to exchange rate risk for the banking system

30.a Net open foreign currency position to core capital in %



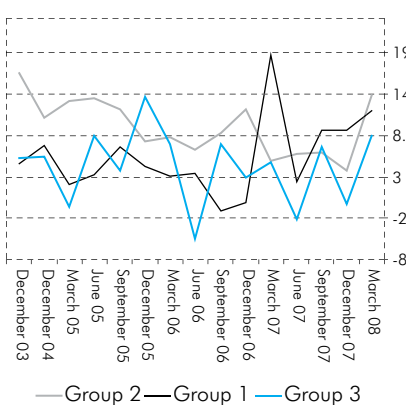
30.b Net open foreign currency position to shareholder's equity in %



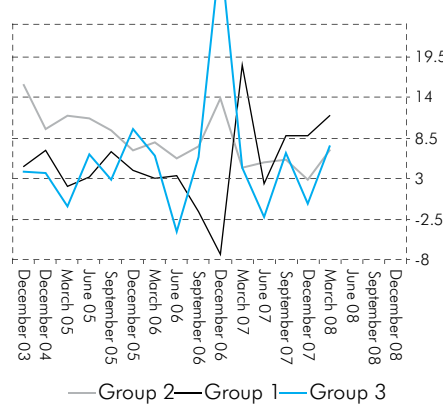
Source: Bank of Albania

Chart 31 Exposure to exchange rate risk by banking groups

31.a Net open foreign currency position to core capital in %



31.b Net open foreign currency position to shareholder's equity in %



Source: Bank of Albania

4.3 ASSETS' QUALITY

Banks' balance sheets provide evidence for the rapid growth of risk-weighted assets. Credit portfolio has grown owing to the steady decline of banking sector's investments in government securities and deposits held with the Bank of Albania. As of end-year 2007, credit portfolio shared 39.1% of banking assets relative to 31.5% as of end 2006. For the same period, low-risk (or risk-free) assets (investments) dropped by 11.1 percentage points to 39.5%. As of end March 2008, the share of credit portfolio to total assets of the banking sector increased to 40.4%, while the value of low-risk assets dropped further to 38.2%.

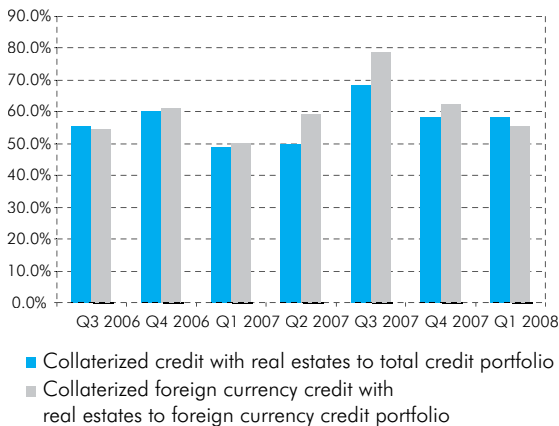
The ratio of non-performing loans to total credit portfolio has increased during the entire period, providing evidence for the deteriorated quality of the banking sector's credit portfolio and for the increased exposure to credit risk. Given the rapid growth of credit, the share of non-performing loans may deteriorate further as a result of the latter effects on extended loans (charts 37 and 38).

Considering the analysis provided in part three of the present report, the banking sector's capacity to be protected by credit risk in the lending process is of great interest. The existence of sufficient collateral provides the full or partial recovery of the loan in the extreme case of the borrower's full incapacity to pay the remaining part of the loan. According to preliminary and approximate data, as of end March 2008, about 58% of total credit portfolio are credits provided with collateral. This figure is considerable, taking into consideration that real estates are the only type of the collateral used. Real estates are banks' favourite form of collateral used for house loans to households or for investment/development loans to businesses. If this ratio included other forms of collaterals used and their value, then the ratio value would result higher. For the rest of the credit portfolio in foreign currency, this ratio for the same period was 56%.

In addition, from the examination of credit coverage with collateral for the main currencies (chart 33) it results that this indicator has recorded considerable decline for the US dollar in the last quarters. This performance shows a lower risk perception from the banking sector for credit in this currency, since the expected US dollar depreciation would strengthen the borrowers' positions. However, this indicator indicates an increase for credit denominated in

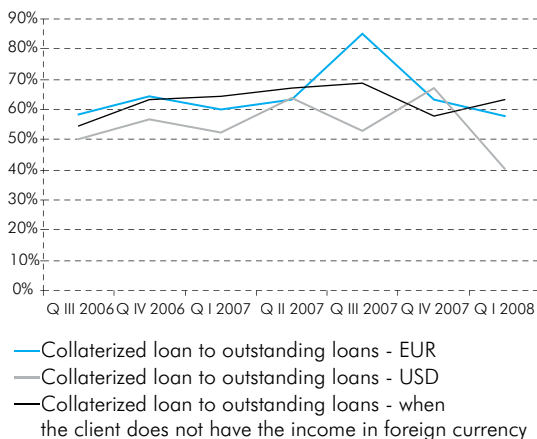
Chart 32 Credit coverage with collateral

Collateralized credit with real estates to credit portfolio (in total and in foreign currency)



Source: Bank of Albania

Chart 33 Collateralized loan to loan portfolio in main currencies in %



Source: Bank of Albania

foreign currency, where the borrower does not have his/her income in the same currency. This may imply an increased attention of the banking system for the indirect exchange rate risk.

In more concrete terms, chart 34 shows an increase in the last quarter in the coverage of this type of credit with collateral, both in total and for non-performing loans.

During the year 2007, credit portfolio (stock) grew by 93.7 billion leks or by 34.2% relative to the year 2006. New credit extended during the year 2007 was 246.2 billion leks or 56.8% higher than in 2006. Use of credit (paid credit) was 152.5 billion leks in 2007 or about 75% higher than in 2006. The ratio between credit use (paid credit) and new credit has been increasing, standing at 69.3% as of end March 2008.

The increase of this ratio may imply the enhanced efficiency in the lending process and at the same time the increase of interest income for the banking sector. The analysis of credit portfolio distribution and of the performance of its average duration⁸ would be required to support this conclusion. In case the banking sector has increased the use of credit when its composition by maturity terms has changed and the average duration has increased, it is more likely that the high use of credit implies an increase in the restructuring process of credit (a new loan has been received in order to pay the existing loan).

Chart 36 presents the distribution of credit portfolio by maturity term. As the chart shows, there have not been significant changes in the distribution of credit portfolio by maturity term in the last three years. During the entire period, the share of portfolio with maturity term of up to 1 year has grown gradually and has fluctuated around 41.5-43.5%. However, there is insufficient data to calculate the average maturity term for each segment.

Average duration of credit portfolio is the most important indicator. Its measurement indicates the average maturity term within each segment of credit portfolio. The following chart shows that the average duration of credit portfolio has increased,

Chart 34 Collateralized loan to loan portfolio in foreign currency when the borrower does not have his/her income in foreign currency in %

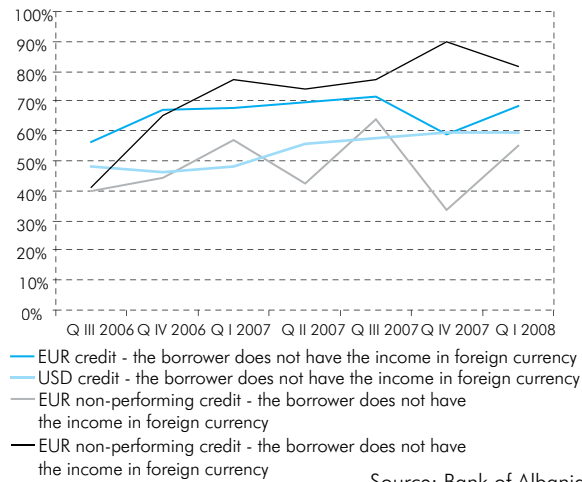


Chart 35 Use of credit to new credit

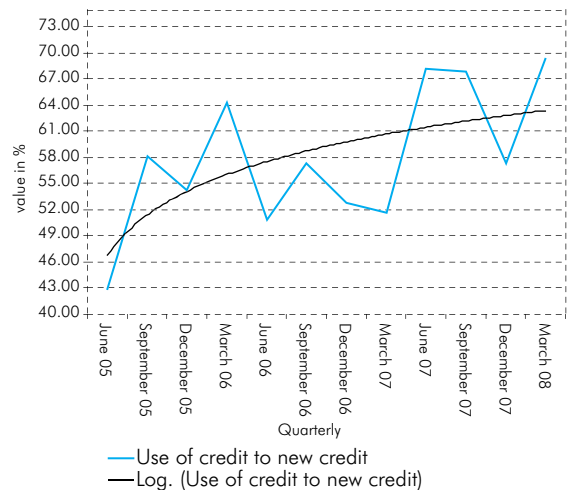


Chart 36 Composition of credit portfolio by maturity term

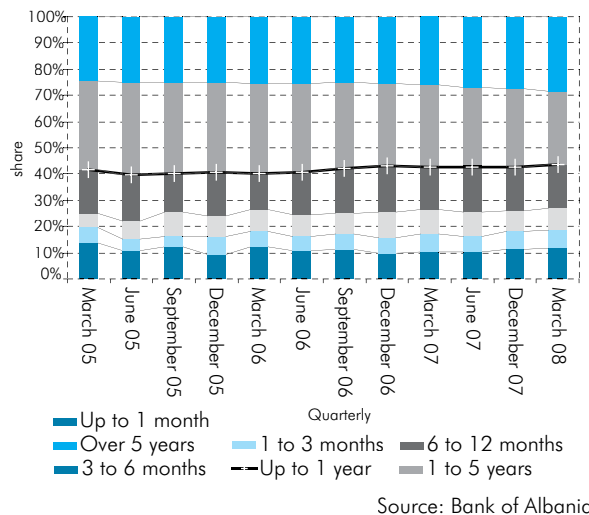
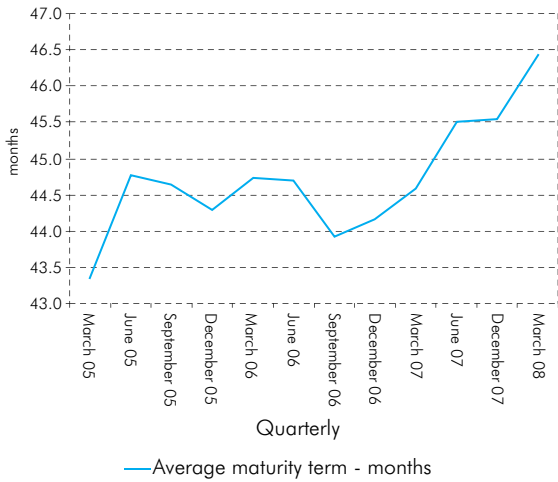


Chart 37 Average duration of credit

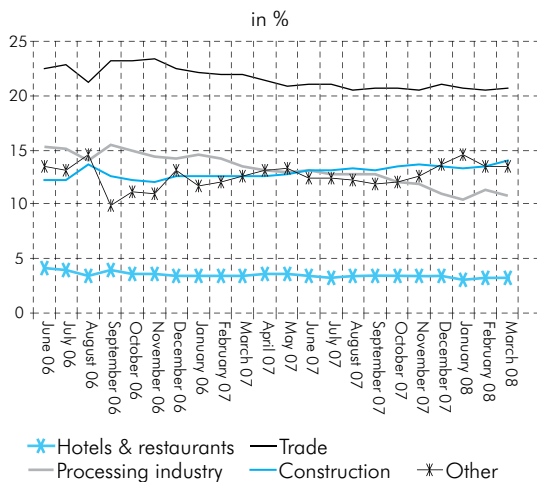


Source: Bank of Albania

in particular during the year 2007. This indicator has increased more rapidly starting from June 2007 and it has recorded the highest figures for the entire period.

The analysis does not allow reaching final conclusions (due to the absence of longer timely data); however, the tendency for the increase of the average duration has been quite evident, in particular in the second half of the year. Hence, there is the probability that the increase in the use of credit in particular during the last year, will at the same time reflect the increase of credit restructuring cases (in the form of granting a new loan to pay the existing loan). If this is the case, it may be attributed to the incapacity of the borrowers to pay the credit and it precedes the further deterioration of credit portfolio quality.

Chart 38 Distribution of credit by sectors



Source: Bank of Albania

Credit to households (charts 38 and 46) has the main share of nearly 21.4% in the last quarter of the year 2007. There has been a downward tendency in the shares of processing industry and trade sector during the same year although credit to these sectors has the main share in total banking sector lending. Ndërkohë që ajo perfaqëson përqendrimin më të madh të kredisë së sektorit bankar. The share of construction sector of 14% to total extended credit has remained almost unchanged during the year 2007. Credit to processing industry shows a decline which may attribute to the increased costs of industry-related activities.

The further diversification of credit portfolio by the banking sector would decrease the activity risk and enhance its contribution to the country's economic development. The sector of agriculture remains an almost complete unexploited direction in this context. In order to enhance the contribution of the banking sector to the development of agriculture (by improving at the same time the risk characteristics of the banking business) reforms are required to accelerate in terms of solving the issues related to ownership, the creation of facilities to enlarge the agricultural areas, the introduction of innovative technology and the upgrading of infrastructure in trading agricultural and animal products. These elements, which reduce the vulnerability of the agricultural sector to different shocks, should stand at the core of the initiatives undertaken to enhance the contribution of the banking sector to the development of agriculture at home, maintaining at the same time parameters of the business risk under check.

The share of liquid assets to total assets of the banking system has remained high despite the downward tendency in the last years. As of end the first quarter of the year 2008 it accounted for 48.9% (chart 39). The same performance is confirmed by the three banking groups (chart 40). However, it is evident that the maturity compliance between assets and liabilities has been maintained at the same levels⁹ for the entire system (chart 41). The maintenance of this indicator at high levels is particularly important from the banking sector's stability viewpoint, when the international financial conditions are still experiencing the consequences of liquidity crisis and the financing of liquidity needs from the parent banks is absent or it has become more expensive. In addition, until December 2007 the international financial crisis has not transmitted any liquidity issues to the Albanian banking sector. The coverage ratio of short-term liabilities with liquid assets also remains at satisfactory levels.

Return on assets (chart 42) recorded high levels for the banking system throughout the year 2007. Despite the portfolio deterioration and the growth of the banking sector's assets it has shown an upward tendency during the same year. In the first quarter of 2008 there has been considerable decline of this indicator to 1.28%, which owes to the fall in profits and the stable growth of total assets. In terms of banking groups by business size, the ratio has increased steadily for the G3 banking group. Banks falling under G2 showed a downward tendency in this ratio starting from the third quarter of the year 2007 (chart 43) due to the same reasons as described above.

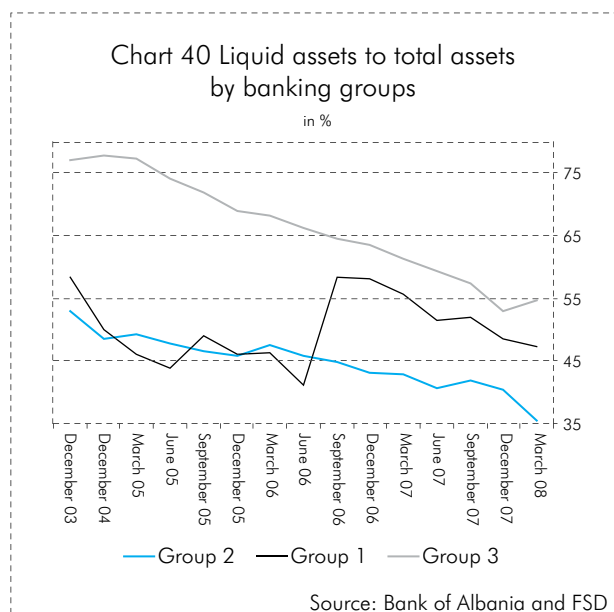
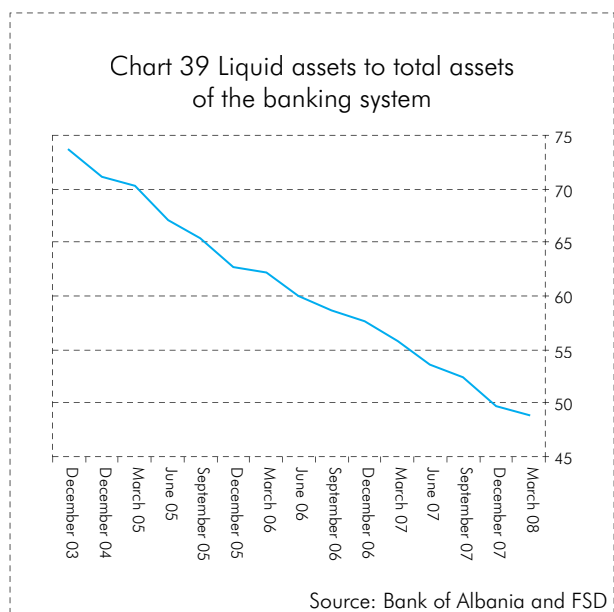
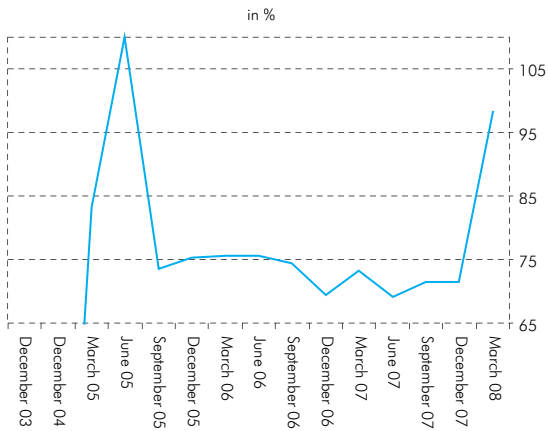


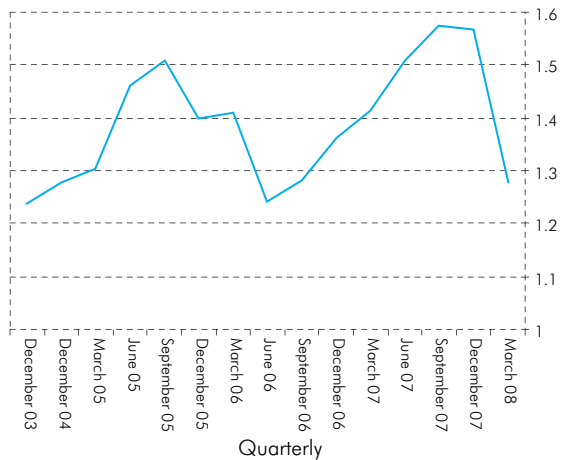
Chart 41 Liquid assets to short-term liabilities of the banking system



Source: Bank of Albania and FSD

Chart 42 Return on assets for the banking system

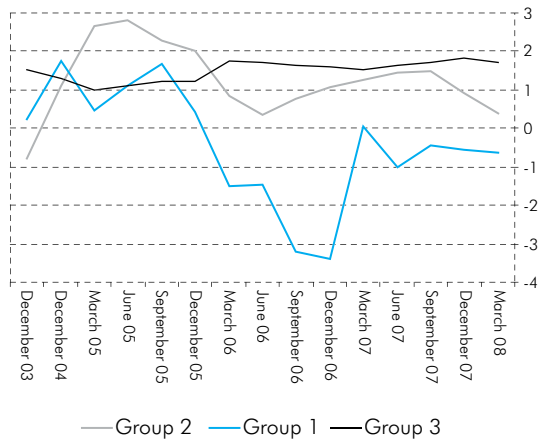
Return on Assets (RoA) - Net income to total average assets, annual basis



Source: Bank of Albania and FSD

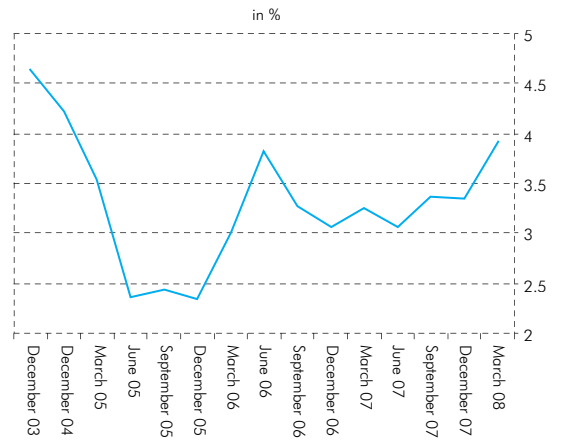
Chart 43 Return on assets by banking groups

Return on assets on annual basis (RoA)



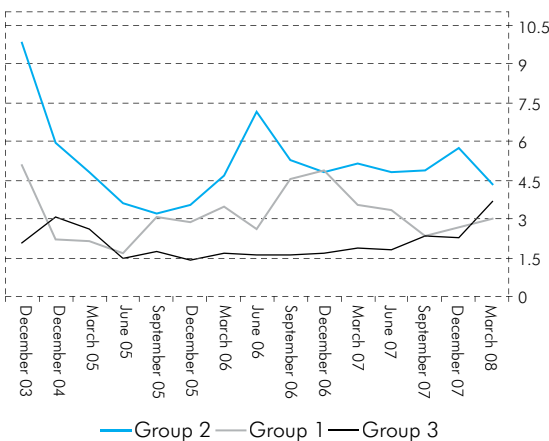
Source: Bank of Albania and FSD

Chart 44 Gross non-performing loans to total loans of the banking system



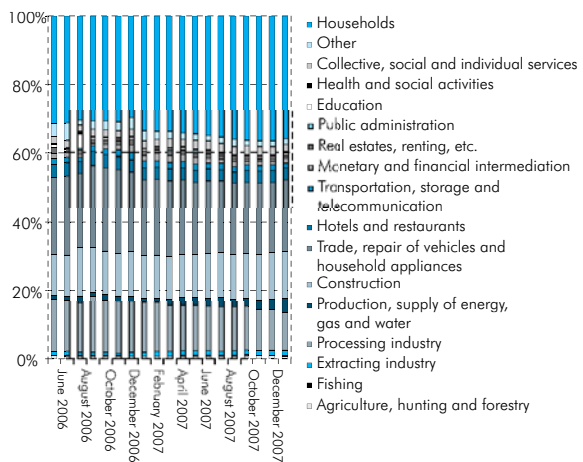
Source: Bank of Albania and FSD

Chart 45 Non-performing loans to total loans by banking groups



Source: Bank of Albania and FSD

Chart 46 Distribution of loans by sectors of industry



Source: Bank of Albania and FSD

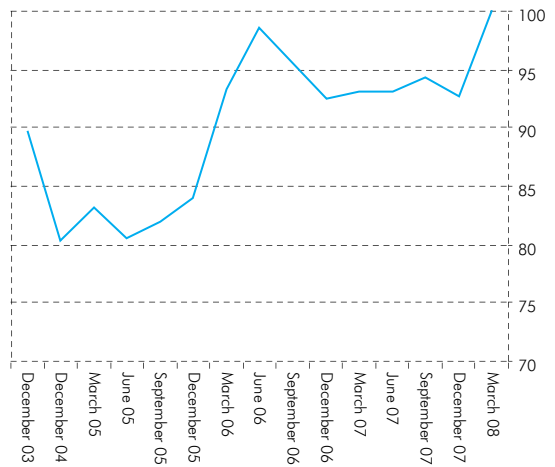
4.4 INDICATORS OF INCOME AND EXPENDITURE

Borrowing cost remains relatively low for the banking system given the decrease in the financial leverage. The financial outcome has been positive for quite a long time and it presents a stable source of the capital increase and the expansion of activity. The banking sector shows pronounced dependence on interest income due to the concentration of the banking sector's investments in securities and loans and the inadequate competition. This dependence is expected to continue in the near future given the demand for credit and the banking sector's willingness to grant it. The dependence on interest income makes the banking sector vulnerable to factors that may lead to a slower credit growth or deposits' collection. Hence, the sources of generating income should be expanded, mainly through the expansion of banking products and the improvement of service quality.

The interest margin to gross income (chart 47) has had an upward tendency during the year and at the end of the first quarter of 2008, and reached 100%. This indicator has fluctuated owing to the increase of provisions for non-performing loans. In the first quarter of 2008 there was a higher increase of interest income (10%) relative to the gross income (2%). The decrease in the financial leverage and the increase of provisions due to the deterioration of credit portfolio may have had their say. Meanwhile, the spread between interest rates for all currencies has reduced considerably in the first quarter of 2008.

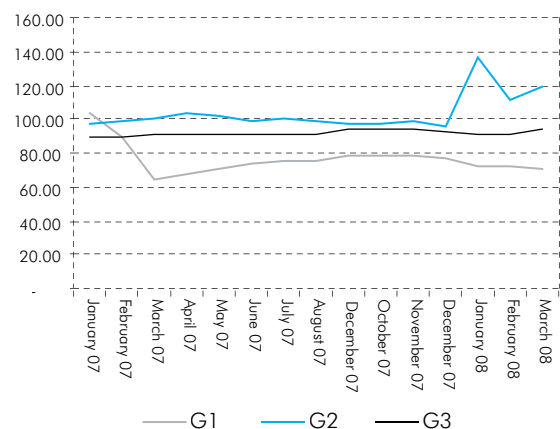
The further cut of interest rates for the US dollar by the Federal Reserve would increase the spread with the lek interest rate and would further encourage the extension of credit in this currency. The financing of the growth of foreign currency-denominated credit by certain banks would encounter difficulties in case of a possible drop in workers' remittances and an enhanced competition in collecting deposits. The banks would have to maintain the existing interest rates for foreign currency-denominated deposits given that the latter are the main way of financing the credit denominated in foreign currency. Otherwise, some of the banks would turn

Chart 47 Interest margin to gross income for the banking system in %



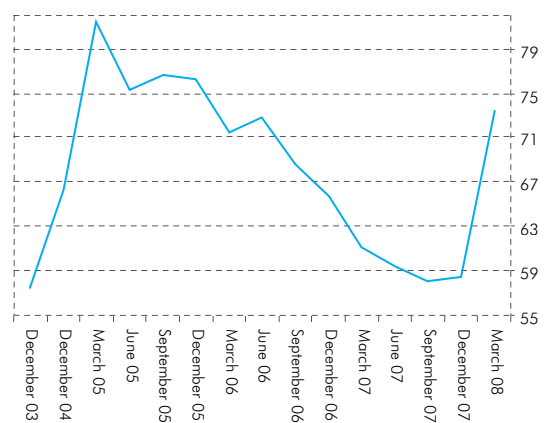
Source: Bank of Albania and FSD

Chart 48 Interest margin to gross income by banking groups in %



Source: Bank of Albania and FSD

Chart 49 Non-interest expenditure to gross income for the banking system in %



Source: Bank of Albania and FSD