

## SUMMARY

*Global economy and financial market highlights.* In early 2011, the pace of global economic growth was slower than its 2010 average. In 2011 Q1, global economy expanded at an annualized rate of 4.3%, from 5% in 2010. In 2011 Q2, the annualized global economic growth declined to 3.7%, down by 1.6 percentage points from a year earlier. These developments have reflected the financial markets' higher funding costs for investments and the private sector's slower aggregate demand, which has reinforced the effect of the decreased public spending as a result of efforts for fiscal consolidation.

The economic growth rates in advanced economies varied significantly from those of emerging and developing economies. At end-2011 H1, advanced economies posted a 1.5% growth rate, from 6.8% posted by emerging and developing economies. During this 6-month period, global inflation rate also rose, mainly driven by upward primary commodity prices. However, the future inflation pressures are expected to be downward, due to mitigated pressures on energy and primary commodity price rises. As a consequence of a higher pace of economic growth, emerging and developing economies are expected to face higher inflationary pressures.

The uncertainty induced by the public debt size, low consumption levels, tight funding conditions, and the significantly limited room to deploy the economic policy stimulus by public authorities, have led to a downward revision of the global growth forecast for 2011, to 4%. Advanced economies will continue to expand modestly, mainly owing to slow progress of the U.S. economy and the Euro area. In the meantime, the decline in foreign demand is expected to be reflected in the economic growth of emerging and developing economies. Subsequently, growth in these economies is expected to moderate to 6.4% in 2011, from 7.3% in 2010.

In 2011 H1, the U.S. economy grew at slow paces. It expanded at an annualized rate of 0.4% in Q1 and 1.0% in Q2, reflecting the significantly weaker consumer spending that grew only 0.1% in Q2. The contribution of public expenditures to economic growth has been downward, since they fell by an annualized rate of 5.8% in Q1 and 1.1% in Q2. Overall, the U.S. economic recovery remains uncertain, under the conditions when the performance of the housing market and of consumer spending remains weak, whereas the public debt level remains too high. Expectations about the outlook of the U.S. economy for the remainder of 2011 reflect the slowdown observed in the first two quarters of 2011. According to the World Economic Outlook<sup>2</sup>, the U.S. is expected to grow by 1.5% in 2011 and by 1.8% in 2012.

<sup>2</sup> September 2011.

The European Union (EU) and the euro-area countries also posted an uneven growth in the first two quarters of 2011. On average, they expanded by 2.5% in 2011 Q1, from 1.9% in the same period in 2010. Sustainable consumption and government spending were key drivers to this growth. Preliminary data on the second-quarter growth of the EU and the euro-area countries show a lower growth rate, about 1.7%. These developments were influenced by the slower pace of economic growth in Germany, which was halved to the annualized rate of 2.8%, as well as by the lack of economic growth in France. During 2011 H1, inflationary pressures in the euro-area countries were upward. Therefore, the European Central Bank (ECB) raised the key interest rate to 1.25% in April 2011, because of the concern that inflation would remain above the 2% target in the next months.

The recovery of economic activity in the Central and South-eastern Europe<sup>3</sup> gained further strength in 2011 H1, mainly due to the external demand. However, at the same time, domestic demand was restrained by weak labour market conditions, higher commodity prices and short-term effects of fiscal consolidation. Real Gross Domestic Product (GDP) recovered steadily in some of these countries. Inflation was higher than at end-2010 in most Central and Southeast European countries, especially over 2011 Q1, reflecting the elevated energy and food prices. However, 2011 Q2 highlighted mitigated inflation rates. Looking ahead, the short-term indicators suggest that the recovery is likely to continue in most countries. Also, the revised projections<sup>4</sup> for the Central and South-eastern Europe appear more optimistic compared to preliminary estimates and the 2010 levels, expecting from this region a 4.3% real GDP growth for 2011.

*The performance of international financial markets.* As at end-2011 H1, global financial markets were volatile, reflecting concerns about sovereign debt sustainability in the Euro area and the sluggish economic activity in the U.S.<sup>5</sup>

In the United States, the accommodating monetary policy and buoyant liquidity contributed to keeping money market interest rates low, whereas in the Euro area, due to upward inflationary pressures, the ECB lifted the key interest rate<sup>6</sup> by 25 basis points, to 1.25%. Interbank interest rates followed an upward trend throughout the six-month period.

Long-term government bond yields in the United States have shown an upward trend since end-2010; however, during the period under review, they showed considerable volatility. The same trend has been observed even in the Euro area, whereas the Japanese government bond yields have declined. Uncertainties about future yields on government bonds have increased, as a consequence of the volatility in global economic situation, inflation expectations and political tensions.

<sup>3</sup> According to ECB's Monthly Bulletin, June 2011.

<sup>4</sup> World Economic Outlook, September 2011.

<sup>5</sup> World Economic Outlook Updated 17/06/2011.

<sup>6</sup> ECB Monthly Bulletin, June 2011.

In capital markets, stock prices in the major stock markets have generally increased compared to end-2010, as a reflection of improvements in the financial situation of traded companies. However, uncertainties about the economic developments and geopolitical tensions have raised the volatility of these markets.

In foreign exchange markets, the Federal Reserve's decision to maintain an easing monetary policy has contributed to the U.S. dollar's depreciation against the major currencies. The European currency was volatile during this six-month period, primarily influenced by developments in the fiscal position across various euro-area countries. However, compared to end-2010, the European currency has appreciated against the major currencies.

In primary commodity markets, in 2011 Q1, prices picked up significantly for all items, compared to end-2010. This pickup appears in opposite direction with their slowing consumption worldwide. Food prices were stabilized following earlier supply-side shocks because of weather conditions. Uncertainties about the future of nuclear energy induced from concerns created in this area following the earthquake in Japan, and the political tensions in some Arab countries heightened the oil price pressure over the period.

The performance of the banking sector, assessed for Global Large and Complex Banking Groups (GLCBG), appears to have improved in 2011 Q1, based on their capacity to cope with the shocks. This improvement is an outcome of a better capital condition, better control of operating costs and earnings recovery. In 2011 Q1, the average return on equity improved to 7.2%, from 4.5% at end-2010. Return on assets registered 0.53% over this quarter, from 0.34% in 2010 Q4. Capital adequacy ratio rose to 13.4% in 2011 Q1, due to non-allocation by some banks of a substantial share of profits, in order to increase the capital. However, for some banks, it is assessed that they should achieve a higher quality of capital and further reduce the level of financial leverage, in order to boost market confidence and to better cope with the shocks and potential losses. Despite the improved conditions, the environment in which these banks operate remains challenging, mainly due to some banks' exposure to the sovereign debt of peripheral euro-area countries.

*Albanian economy highlights.* During 2011 Q1, the Albanian economy expanded, mainly driven by domestic demand, higher pace of growth of exports and moderate growth of imports, which are reflected in an improved trade deficit. However, in 2011 Q2, the negative values of trade deficit picked up and its contribution to economic growth exacerbated. Private consumption continues to take place sluggishly because employment rate and wage incomes have grown moderately and the propensity to save appears stable. Remittances continue to drop, adversely influencing the level of consumption in Albania.

Investment growth in the country has decelerated, due to the slowdown in banking sector credit and capital spending of the fiscal policy. At end-2011

H1, the banking sector outstanding loans rose to ALL 518.7 billion, about ALL 32.5 billion or 6.6% more than at end-2010. The share of outstanding loans made to non-residents was 4.7%, up ALL 5.5 billion or 28.6%, compared with end-2010. Over the period, outstanding loans made to non-residents were only 3.9% of total banking sector credit. Credit growth rate in 2011 H1 was up 2.2 percentage points from the same period a year earlier. The decelerated growth of investments was driven by the slowdown in capital spending. During 2011 H1, they increased by 1.82%, compared to the same period a year earlier.

However, private investments were supported by improved liquidity in the banking sector through deposit growth. All sectors of the economy - industry, services and construction - have increased their capacity utilization, though they remain below their long-term average. Expectations for the remainder of 2011 H1 are positive, mainly due to increased domestic demand in industry or improved economic activity in services and positive developments in the construction sector, which were also reflected in the first quarter.

In 2011 H1, the contribution of fiscal policy was reflected mainly in terms of current expenditure growth. Total revenues increased slightly, only 1.1% y-o-y, while total expenditures increased 7.7%, contributing to budget deficit growth by ALL 26.9 billion. The percentage of annual plan realization is 42.9% for total revenues and 44.5% for total expenditures, reflecting obvious difficulties in revenue growth and prompting their revision for the remainder of the year. Public debt stock increased by 5% in absolute terms, as compared to end-2010, marking a higher increase in the domestic debt stock than in the external one<sup>7</sup>.

In 2011 H1, current account deficit was EUR 588.5 million or 14% of GDP, expanding by about 4.9 percentage points on a year earlier. Compared with end-2010, however, the current account deficit has narrowed by 2.8 percentage points. Trade balance deficit is EUR 1053.4 million over the same period, up 14% on a year earlier. As a share of GDP, the trade balance deficit is 24.5%, up 4.2 percentage points on a year earlier, but down 1.6 percentage points from end-2010. These developments reflect the positive growth rates of exports by 12% y-o-y, compared to 13% growth of imports. During 2011 H1, net foreign inflows of capital and financial account recorded EUR 434.9 million, about 41% more than a year earlier. Foreign direct investments and portfolio investments have narrowed by 15% and 68% y-o-y, respectively. However, the improvement in capital transfers was reflected in a positive capital and financial account balance by 9.7% of GDP, from 7.7% a year earlier.

In terms of price performance in the country, during 2011 H1, inflationary pressures were on the rise. In February and May 2011, the inflation rate was above the Bank of Albania's upper targeted band of 3% (2% -4%). These developments have mainly reflected the impact of food and oil price rises in international markets. In response to these inflationary pressures, at end-

<sup>7</sup> Ministry of Finance, "Debt Indicators as at 2011 H1".

March, the Bank of Albania lifted its key interest rate by 0.25 percentage points, to 5.25%. In 2011 H1, annual inflation averaged 4.0%.

In 2011 H1, business and household borrowing performed positively. In June 2011, business borrowing<sup>8</sup> increased by 14.6%, compared to the same month in 2010. Household borrowing also improved, increasing by 5.3% y-o-y, from 1.5% at end-2010 and 0.7% in June 2010. On the other hand, compared with end-2010, businesses have slowed the pace of deposit placements at financial institutions. In June 2011, businesses increased their deposits by 10.2% y-o-y. Subsequently, businesses' debtor position, which shows the difference between their claims on financial institutions (deposits) and their liabilities to these institutions (loans received) registered ALL 255.6 billion at end-2011 H1, deepening by ALL 35 billion compared with a year earlier. On the other hand, households' creditor position amounted to ALL 559 billion, about ALL 97.6 billion more than a year earlier.

Increased lending to businesses and households ensures the meeting of their financial needs. However, depending even on the form of loan, businesses and households may be unevenly exposed to credit risk. In terms of indirect credit risk arising from adverse exchange rate moves, businesses present a higher exposure. They have a much deeper financial foreign exchange position (net debtor), as compared to their domestic net debtor position. In June 2011, they were debtors to financial institutions for about ALL 191.4 billion in the form of foreign currency loans and about ALL 64.2 billion in national currency. Despite the improved lending in 2011 H1, these developments have been reflected in the increased ratio of outstanding loans unhedged against exchange rate risk to total outstanding loans for businesses.

At an aggregate level, households are by and large hedged against indirect credit risk arising from exchange rate depreciation. At end-2011 H1, households borrowed from the financial system a total of ALL 236.7 billion in foreign currency. It is, however, estimated that about 41% of total outstanding household loans made by banks is unhedged against exchange rate risk, providing evidence for the presence of exposure to this type of risk.

In terms of indirect credit risk arising from adverse interest rate moves, it is estimated that at end-2011 H1, all in all, the total outstanding variable interest rate loans made to businesses and households was up 0.79 percentage points on a year earlier. Again, businesses appear more exposed than households. In fact, 60.8% of outstanding loans made to businesses were at variable interest rate, up 1.6 percentage points on a year earlier. Over the same period, 26.5% of outstanding loans made to households were at variable interest rate, leading to the decline in their exposure to interest rate risk by 1.4 percentage points.

*Financial market highlights.* The Albanian financial market is dominated by operations in the interbank market, government debt securities and foreign

<sup>8</sup> It includes loans granted by deposit-taking financial institutions (commercial banks and savings and loan associations) in the form of pure loans and other debt instruments.

exchange. Other segments that relate to insurance, reinsurance and pension funds account for a small share of total financial market volume.

In 2011 H1, the trading volume in the interbank market decreased by 22.7% compared to 2010 H2, while the weighted average interest rate maintained almost similar levels. In the Government debt security market, the auction ask amount exceeded the bid amount. However, starting from January 2011, the primary market government debt yield started to edge up, as a result of increased government borrowing. The increase was more pronounced in the 12-month debt security yields, followed by bond yields indexed to this indicator.

Concerning the banking sector's intermediation cost, it is noted that the average interest rate spread between loans and deposits for lek-denominated operations narrowed by 0.04 percentage points, as a consequence of a higher interest rate cut in lek-denominated loans against the lek-denominated deposit interest rate. Compared to December 2010, this spread has expanded by 2.04 percentage points for operations in U.S. dollar and 0.44 percentage points for those in euro, respectively due to the increase in average USD-denominated loan interest rate by 2.1 percentage points and higher increase in euro-denominated loan interest rate against euro-denominated deposits.

In the domestic market, in 2011 H1, the euro appreciated against the Lek by 1.9%, whereas the U.S. dollar and Pound sterling depreciated by 6.1% and 3.3%, respectively. The lek's appreciation against the above currencies has mainly reflected the developments in the international foreign exchange markets.

The financial market activity has been supported by the smooth functioning of AECH and AIPS payment systems, which are managed by the Bank of Albania. In 2011 H1, the number of transactions increased by about 3.9% in the AIPS (Real-Time Gross Settlement System) and about 34.7% in the AECH (Automated Clearing House System). During January-June 2011, there was processed a total of about 5.6 million card (ATM and POS) transactions, with a total turnover of ALL 56 billion. Out of the total, about 96% are cash withdrawals from ATMs and only 4% are customer payments executed via POS terminals, thus providing evidence for the large use of cash in the Albanian economy.

Financial system highlights. Financial intermediation in Albania, measured as the ratio of financial sector<sup>9</sup> assets to GDP<sup>10</sup> is estimated at 86.9% in 2011 H1, from 85.9% at end-2010 and 84.4% in 2010 H1. Financial institutions' assets grew about 5% compared to end-2010. The banking sector remains the dominant segment of financial intermediation in Albania. Its assets accounted for about 94.5% of total financial system assets and 82.2% of GDP. Non-

<sup>9</sup> The financial system is composed of: banks, non-bank financial institutions, insurance companies, savings and loan associations and private supplementary pension funds.

<sup>10</sup> IMF's forecast for quarterly nominal GDP based on the quarterly real GDP released by INSTAT. In 2011, GDP totalled ALL 1,321.5 billion.

bank financial sector continues to have a small share in the total financial system. Hence, the non-bank financial sector's total assets<sup>11</sup> accounted for about 5.5% of the financial system assets, a downward share as compared to 5.7% at end-2010. As a share of GDP, this sector's activity accounts for about 4.8%, from 4.9% at end-2010.

*Banking sector highlights.* In 2011 H1, banking sector assets totalled ALL 1,043.9 billion, up about 5.4% from end-2010 and 11.7% from 2010 H1.

In terms of banking sector asset composition, the loan portfolio (excluding accrued interests<sup>12</sup>) has reached ALL 518.7 billion, increasing by 6.6% from end-2010. Foreign currency loans account for about 68.7% of total loans. The banks' foreign currency assets reached ALL 547.9 billion, increasing by 4.3% from end-2010. Banks' investments in non-resident assets rose to ALL 129 billion, up 6% from end-2010 and 23.5% from a year earlier. Banks peer group 3 accounts for 81.7% of the total value of these investments. In the meantime, banking sector placements with non-resident institutions are estimated at ALL 69.4 billion, of which ALL 59 billion are in the form of current and deposit accounts and ALL 10.4 billion are in the form of loans.

In terms of banking sector liability composition, deposits (excluding accrued interests<sup>13</sup>) have reached around ALL 842.5 billion, increasing by 4.6% from end-2010. Equity funds picked up to ALL 105.3 billion, about 0.5% higher than at end-2010. Foreign currency liabilities amounted to ALL 525.4 billion, increasing by 4% compared to end-2010. Banking sector liabilities to non-residents amounted to ALL 66.2 billion, increasing by 37% compared with December 2010 and 7.7% compared with a year earlier. Credit lines extended from bank holding companies and the used proportion are estimated at about ALL 19.5 billion. The committed and unused proportion<sup>14</sup> of credit lines is estimated at around ALL 46.1 billion. As at end-2011 H1, off-balance sheet items represented 97.8%<sup>15</sup> of total banking sector assets, from 88.7% at end-2010, increasing by 16.2% over the period and 12.1% on a year earlier.

As at end-June 2011, the banking sector paid-in capital was ALL 73.1 billion, up by around ALL 2.4 billion or 3.4% from end-2010, due to capital injection carried out in several banks. Paid-in capital represented 7% of total assets, almost equal to end-2010, but higher than a year earlier. With respect to banking sector liquidity position, we note that as at June 2011, the banking sector deposits represent 82.1% of total liabilities, down around 0.4 percentage points from end-2010. Banking sector liquid assets amounted to ALL 266.7 billion, accounting for 25.5% of total assets. This indicator has decreased by about 0.4 percentage points relative to December 2010.

<sup>11</sup> The data on non-bank financial institutions, insurance companies and SLAs refer to 2011 Q1, while the data on supplementary pension funds refer to end-2010 (according to AFSA's release).

<sup>12</sup> Estimated at ALL 4.7 billion.

<sup>13</sup> Estimated at ALL 14.4 billion.

<sup>14</sup> Registered as off-balance sheet item.

<sup>15</sup> As at June 2010, off-balance sheet items represented 97.4% of total banking sector assets.

In 2011 H1, the banking sector net profit was positive at 1.1 billion, down 69% from 2010 H1. It remained concentrated in the largest banks. Annualized Return on Assets (RoA) is estimated at 0.22%, from 0.79% in the same period a year earlier. Annualized Return on Equity (RoE) is estimated at 2.4% from 8.31% in 2010 H1.

*Risk assessment.* The following analysis focuses on the banking sector risks related mainly to market, liquidity and credit risks. The following makes an analysis of the capitalization position of the banking sector activity.

With regard to market risks, it is assessed that the impact of direct exchange rate and interest rate risks on the banks' balance sheets has been low. As regards the exchange rate risk, the impact has been driven by the low open foreign exchange position, whereas as regards the interest rate risk it has been driven by the moderate spread between assets and liabilities sensitive to the interest rate.

In terms of liquidity risk, the situation has been stable, almost similar to end-2010. At end-2011 H1, the ratio of liquid assets to short-term liabilities (of up to one year maturity) was 30.2%, from 30.6% at end-2010 and 32.8% over the same period a year ago. By currency, this ratio is higher for the lek (41.2%) and the dollar (28.5%), but lower for the euro (14.9%). The maturity gap between assets and liabilities<sup>16</sup>, for both balance sheet and off-balance sheet items, has resulted negative. However, the gap has been covered several times by the value of liquid assets, thus providing evidence for a full capacity for paying off the liabilities as they fall due. Against this backdrop, however, the foreign currency liquidity position, especially in euro, requires cautious monitoring. Loan to deposit ratio is estimated at 61%, very close to end-2010's figure, but 2.2 percentage points less than in the same period a year earlier. Over a one-year time horizon, deposits have increased by around 3.9 percentage points more than loans. Loan to deposit ratio for operations in foreign currency was 87.4%, 1.5 percentage points higher than at end-2010 and around 7.8 percentage points lower than in 2010 H1. Loan to deposit ratio for operations in lek was 36.7%, from 35.4% at end-2010. The increase in this indicator is attributed to the higher growth of lek-denominated loans (10.4%) than lek-denominated deposits (6.5%) from end-2010.

Borrowing in the interbank market or from the Bank of Albania is another way banks manage their short-term liquidity needs. This is generally a collateralized borrowing and the type and adequacy of assets that may serve as collateral are additional elements that should be monitored, in order to assess the banks' ability to meet their short-term needs for liquidity.

Credit risk remains the main risk facing the Albanian banking sector. As at end-2011 H1, the ratio of non-performing loans to total loan portfolio, on a gross basis, rose to 17%, from 13.9% at end-2010 and 12.2% in the same period a year earlier. The ratio of non-performing loans, net, to regulatory capital, rose to 48.8%, around 12.5 percentage points more than at end-

<sup>16</sup> Assuming assets and liabilities are held to maturity.

2010. Loan portfolio quality fell for both businesses and households. Non-performing loans to business and household outstanding loans is estimated at 19.1% and 13.9%, respectively, compared with 15.5% and 11.7% at end-2010. Also, in terms of currency, the loan portfolio quality worsened for both lek and foreign currency loan portfolios. The ratios of non-performing loans in lek to outstanding loans in lek and non-performing loans in foreign currency to outstanding loans in foreign currency were 16.7% and 17.1%, respectively, compared with 14.4% and 13.8% at end-2010. With regard to loan quality by economy sectors, the construction sector is pointed out as having the highest value of the above indicator, 28%, followed by trade (20%) and processing industry (18%). The ratio of non-performing loans to outstanding loans is high even for hotels and restaurants sector (27%), although the share of lending to this sector in total outstanding loans is only 2.9%.

In response to the credit risk situation, the banking sector continued to increase its provisions to cope with any potential losses. At the end of 2011 H1, loan loss provisions rose to ALL 46 billion, around 27.3% more than their level as at December 2010. The ratio of provisions to non-performing loans (gross) fell to 51.7%, from 52.7% at the end of 2010 H2, remaining close to the 5-year historical average of around 51%. The ratio of provisions to total outstanding loans (gross) rose to 8.8%, compared with 7.4% at end-December 2010 and 6.4% in 2010 H1. Also, coverage of non-performing loan portfolio with collateral is estimated at 81.7% of the loan portfolio, from 79.3% at end-2010.

The lower credit quality and the need to raise loan loss provisions impairs the banking sector's ability to generate a positive financial profit, adequate to support the growth of capital by means of domestic resources and to allow the normal expansion of banking activity. Actually, the data show that as at end-2011 H1, the total revenues of the banking sector grew by about 2.7% compared with 2010 H1. The main contribution to this growth was provided by interest income, which increased by around 7% compared with 2010 H1. Over the same period, operating expenses of the banking sector picked up by only 1.7%. Therefore, the value of gross operating profit resulted positive, at ALL 10.4 billion, around 3.9% higher than in the same period last year. This indicates that the banking sector has managed to maintain steady levels of net operating income. Furthermore, provisions to cover any probable asset losses (mainly loan losses) over the period were about ALL 8.8 billion, around ALL 3 billion higher than in 2010 H1, leading to decreased net financial profit (after tax) to ALL 1.1 billion. If credit risks remain constant, the banking sector's capacity to earn a sufficient level of gross operating profit may be compromised. Regarding this matter, through its supervisory function, the Bank of Albania has required commercial banks to ensure, in parallel, the duly and timely identification of non-performing loans and the making of provisions, as well as to carry out the specified operations to recover loan loss values through collateral execution. These operations, coupled with the measures to further cut operating costs and accelerate lending, will gradually create the conditions for generating a stable and positive financial profit, which would better support the banks' mid-term needs for capital.

Regarding solvency, as at end-2011 H1, the capital adequacy ratio, which measures the capital coverage of the banking sector's risky activities, resulted 14.6%, around 0.7 percentage points lower than at end-2010 and 1.6 percentage points lower than in the same period a year earlier. The regulatory framework sets a minimum threshold of the CAR of 12%.

Concerning the assessment of risks facing the Albanian banking sector, the Bank of Albania conducts periodic stress-testing exercises, in order to assess the banking sector's resilience to any potential adverse economic events in several macroeconomic and financial indicators, on an individual and combined way.

These exercises have revealed that the banking sector appears sensitive to indirect credit risk arising from exchange rate and interest rate volatility. In the case of exchange rate risk, the pass-through channel is the share of foreign-currency loan portfolio, where the borrower has insufficient income in foreign currency. In the case of interest rate risk, the pass-through channel is the variable interest-rate loan portfolio. In such a case, we should bear in mind the fact that benchmark interest rates, especially on foreign currency, are close to historical lows and the unstable global economic situation suggests that they may settle at these levels in the foreseeable future. However, various factors related to the geopolitical situation, performance of primary commodity prices, exchange rate volatility and monetary policy stimulus, may expose inflation to shocks and may push up interest rates, which serve as benchmarks for the loan portfolio in the country. In the Albanian banking sector, the increase in loan interest rates, although gradually, would couple with increased burden on borrowers, thus affecting, in turn, their ability to service their debts. Therefore, commercial banks should consider the likelihood of these risk scenarios and be willing to make reserves duly.

After applying different scenarios, the stress-test results showed that the banking sector is by and large resilient to various shocks in respect to capital quality and adequacy. However, individual banks' sensitivity to these assumed shocks has increased. The continuation of the downward trend of the capital adequacy ratio would reduce the banking sector's ability to cope with various shocks and be associated with the reduction of this ratio to below the minimum capital required in certain banks. Each bank should, therefore, assess its needs for additional capital, taking into account the outlook on the financial profit and other constituent elements of the capital account, as well as ensure a higher pace of capital growth compared with the pace of risk-weighted asset growth. In this analysis, the banks should apply conservative risk scenarios to ensure a timely and optimal hedging.

The Bank of Albania has assessed and requires the banking sector to strengthen the capitalization of activity in the short term, by raising shareholders' equity. The Bank of Albania has oriented and monitored this process closely, so that it is carried out in accordance with the banking activity development strategies and performance of relevant risks. The process of strengthening the banking sector capitalization indicators includes the creation of adequate

capital sizes above the minimum required ratio. The process is performing in line with the recommendations provided by the Bank of Albania in its communication with the banking sector. As an outcome of these measures, the banking sector remains robust and will create the conditions for enhancing its contribution to economic development.