1. OVERVIEW OF MAIN RISKS OF FINANCIAL STABILITY

The Financial Stability Map shows the allocation of risk among factors that determine the stability of the financial system. These factors include the surrounding external and internal environment, the banking sector and the real economy agents: government, enterprises and households.

(1) As at the end of the first half of 2018, the map showes a slight increase of risks in the external economic environment, while the risks in the domestic economic environment related to banking activity and the agents of the real economy have moved toward opposite directions. In an analysis where developments are seen on a stand-alone basis, the value of indicators suggests that the risk for "households" and "domestic economy" declined, as part of the surrounding economic environment has been downward, due to positive developments in the performance of macroeconomic and financial indicators during the period. On the contrary, the indicators of banking activity related to the structure of banking sector and liquidity and financing, suggest a slight increase in the risk.

In more concrete terms,

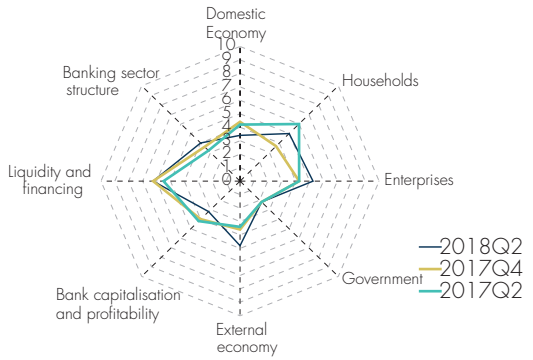
a. Overall economic environment

i. Risk from the "domestic economy" is rated as "low" and downward, following the narrowing of the output gap, and decline in the size of the external debt stock to GDP;

ii. Risk from the "external environment" is assessed again as "moderate", but slightly upward during the period, driven by the moderation of the economic growth rate in our trading partners, the rise of oil prices in international markets and the increase in the short-term interest rates in the money market[7], mainly as a result of the normalization of the Fed's monetary policy stance.

[7] *The indicator related to the short-terms of interest rates is calculated as a simple average of the three-month LIBOR and EURIBOR norms in the international markets, which approximate the costs by which our banks provide funds from foreign banks and holding banking groups. The growth of these rates means increased risk of financing in the foreign markets.*

Chart 1.1 Financial stability map



**Risk is rated: low for scores 0-3 on the map, average for scores 4-5, moderate for scores 6-8 and high for scores 9-10. The farther from the centre the higher the risk.
Source: Bank of Albania.

b. Real economy agents

i. Risk from "households" is assessed as "average" and downward, thanks to the improvement of the registered unemployment rate, the quality of the loan portfolio for households as well as remittances;

ii. Risk from "enterprises", is assessed as "average" and upward, in view of the deterioration in the performance of lending against its long-term trend for this category, the short-term expectations of enterprises; and the index of their financial situation;

iii. For the "government", the level of risk continues to be "low" and unchanged, affirming a fiscal stability for the period.

c. For the banking sector activity

i. Risk from "capitalisation and profitability", is assessed as "low" and downward during the period. On one hand, the improvement of the sector's capitalization and credit quality, and on the other hand, the slight increase in pre-tax income relative to sector's assets have contributed to the further reduction of risk from this category;

ii. Risk from "liquidity and financing" is assessed as "moderate" and trending slightly upward. This reflects the deepening of the banks' assets and liabilities mismatch up to three months[8], the further slowdown of households' deposits growth, as well as a slight increase in financing from non-residents. Notwithstanding the above stated, the liquidity indicator of the sector remains at adequate levels, supportive to the banking activity;

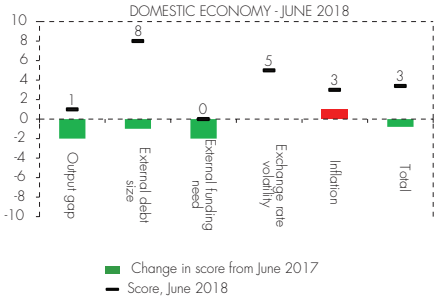
iii. Lastly, the level of risk associated with the "banking sector structure" is assessed as "low", but upward from a year earlier, as a result of a broader distribution of banks' capitalization compared to the average of sector, and the increase of lending concentration for the business sector.

Box 1.1 shows the Financial Stability Map components over 2018 H1, the score for each component and comparison with the scores in the previous year.

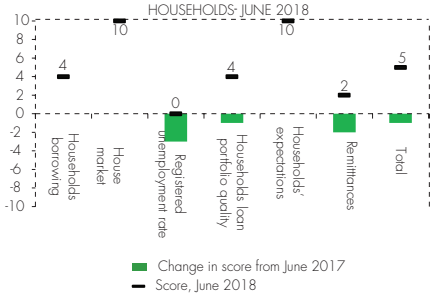
[8] *In this category, which is overall rated with low risk, the deepening of the gap is mainly a result of the change in the definition of the proper term, for the purpose of more detailed analyses by the supervisory authority.*

BOX 1.1 FINANCIAL STABILITY MAP

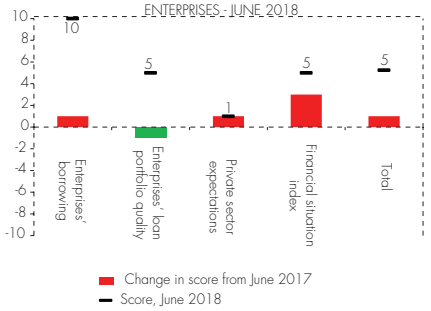
Rsik from "domestic economy is rated "low" and downward, due to the contractionof the output gap, the need for foreign funding and the slight decline of external debt size.



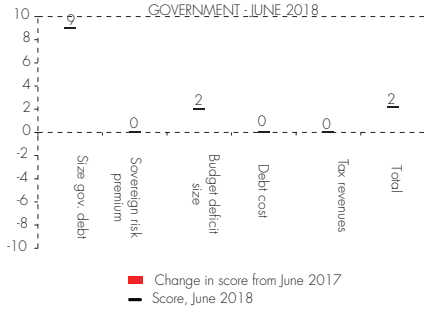
Risk from "households is rated "average and downward, due to the improvement of households' portfolio quality, the decrease of the unemployment rate and the increase of remittances.



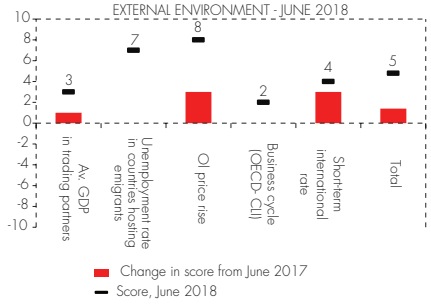
Risk from "enterprises" is rated "average" but upward, reflecting the developments in private sector borrowing, enterprises' expectations and the index of their financial situation.



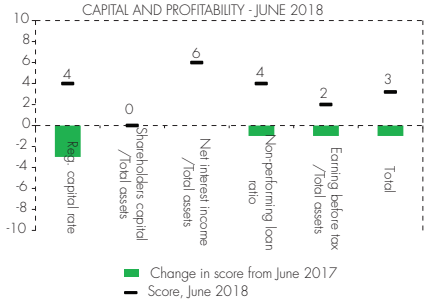
Risk from "government" is rated "low" and unchanged, registering the same assessment for all the indicators, compared with a year earlier.



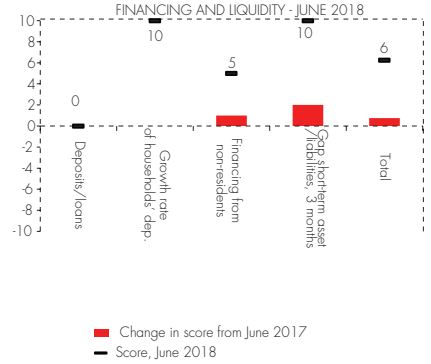
Risk from "external environment" is rated "average" and upward, affected by the slowdown of the economic growth of trading partners, the increase of oil prices in international markets and the increase of the average shortterm interest rate (Euribor, Libor 3 months) in money markets.



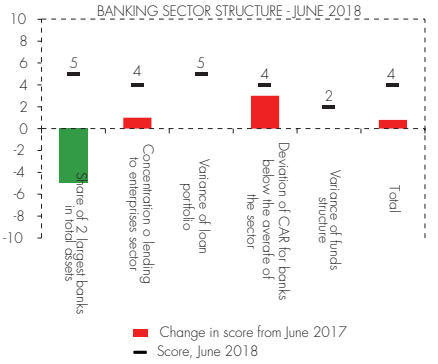
Risk fgrom "capital and profitability" is rated "low" and downward. the increase of banking sector's capitalisation, the improvement of loans' quality and the increase of earning before tax t total assets, have affected the mitigation of risk from this category.



Risk from "financing and liquidity" is rated "moderate" and upward, due to the deepening of the gap between shortterm assets and and liabilities up to 3 months and the increase of financing from non-residents.



Risk from the "banking sector structure" remains low, but upward during the period, as the difference of lower values with the average value of capital adequacy rate has expanded, and the lending concentration to the enterprises sector has increased.



Source: Financial Stability Department, Bank o Albania.

1.1 SYSTEMIC RISK[9]

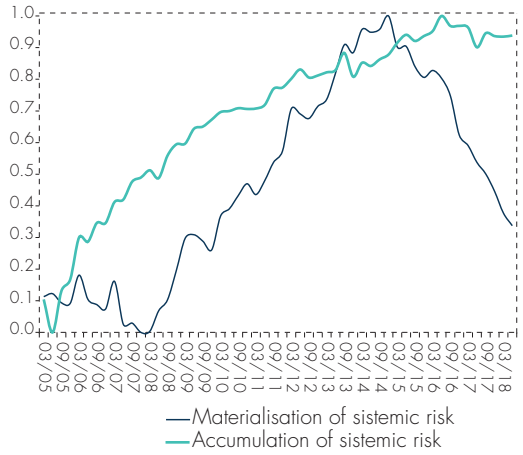
To assess the banking sector's exposure to systemic risk, the performance of indicators related to: a) the materialization and accumulation of the systemic risk; b) the stress level in the financial system; c) the perception of the banking industry regarding the exposure to systemic risks, is analysed.

The materialisation of the systemic risk assesses the actual level of the risk, whilst indices of the risk accumulation, financial stress, and the banking industry perception on it, focus mainly toward the future.

(2) **Materialisation of systemic risk has been downward over the period**. The improved credit quality to households, the decline in the unemployment rate in Albania, and the exchange rate performance have contributed to the performance of this index (see Chart 1.2.). Accumulation of systemic risk has been stable over the period, where the increased contribution of the index from household debt expansion and the increase in the value of loans which are vulnerable to interest rate fluctuations has been offset by the contribution to its decline from the fall in public debt and external debt segment.

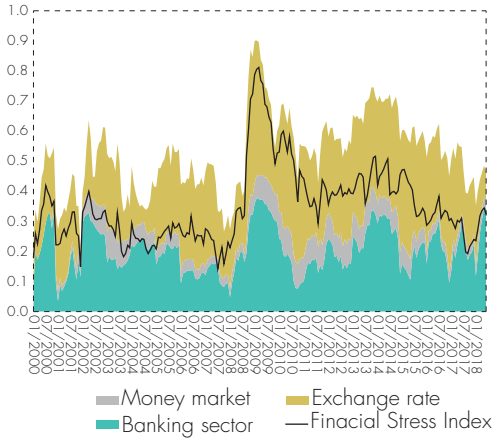
(3) **The financial stress index has increased,** mainly due to the slowdown in the performance of banking sector indicators - deposits, loans and net interest margins – compared to their historical trend (Chart 1.3).

Chart 1.2 Accumulation and materialisation of systemic risk



Source: Bank of Albania.

Chart 1.3 Financial Stress Index



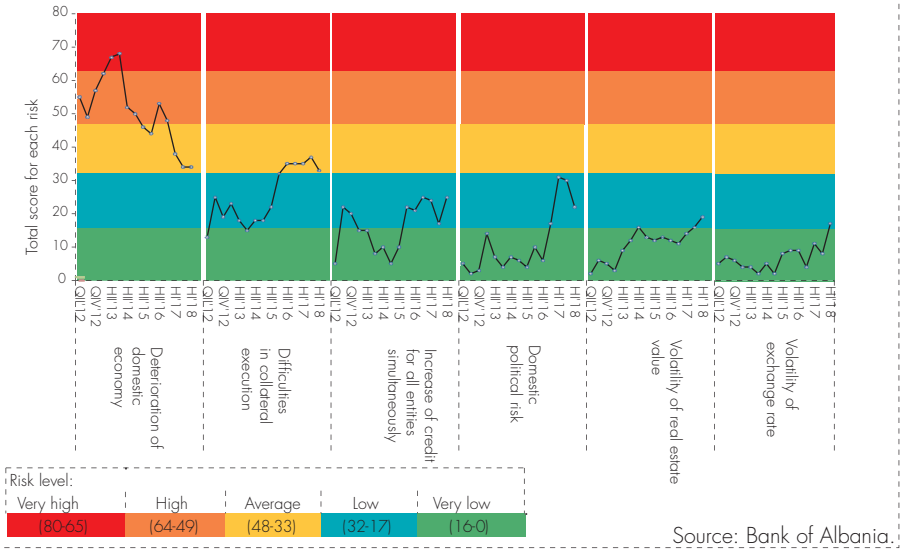
Source: Bank of Albania.

(4) **The perception of the banking industry on systemic risks has not shown significant changes over the period.** The risks of "economic

[9] *Systemic risk is defined as "the possibility for the materialization of shocks that impair the functioning of a financial system to the point where economic growth and welfare are affected materially".*

deterioration" and "collateral execution" remain at the "average" level of perception. The perceptions on the risks associated with "lending" and "volatility of the value of real estate" are at "low" but upward level. During the period, an increase in banks' perception of "exchange rate" risk has been noted, although it is not classified in the group of the five most important systemic risks in the country. The appreciation of the Albanian lek against the main currencies (especially the euro) over the period seems to have contributed to heightening the banks' attention to this phenomenon and its stability.

Chart 1.4 Banks' assessment of key systemic risks



Source: Bank of Albania.