1. OVERVIEW OF MAIN RISKS TO FINANCIAL STABILITY

The Financial Stability Map shows the distribution of risk among factors determining the stability of the financial system, which include the activity of the banking sector, the surrounding external and internal environment, and the real economy agents: government, enterprises and households.

(1) **As at the end of 2017, the financial stability map shows a slight increase in risk to certain categories, and a decrease in risks that may arise from the surrounding economic environment.** The decrease of risks in the overall economic environment reflects the positive economic growth rate and the overall macroeconomic stability. If considering the interaction of the banking sector categories, the performance of indicators mainly reflects an improvement of the banking activity.

(2) In more concrete terms,

a. In the overall economic environment:

i. Risk from "the domestic economy" is assessed as "average", but upward, following the increase in needs for external financing, due to the increase in current account deficit at the end of the year;

ii. Risk from the "external economic environment" is assessed as "low" and downward, driven by the positive economic performance of our trading partners, the improvement in labour market conditions in remittance-sending countries and the performance of CLI index[3]. This index shows the global economy has already entered into its growth stage.

b. Real economy agents:

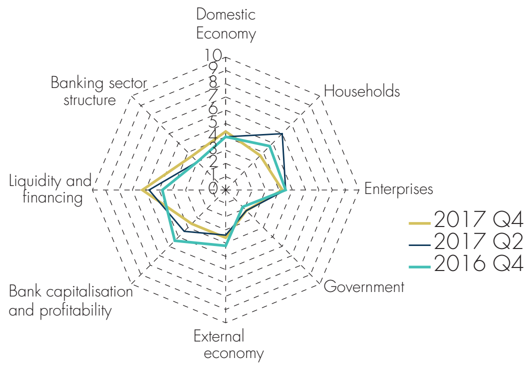
i. Risk from "households" is assessed as "average" and downward, attributable to the improvement in lending against its long-term trend, improvement in the quality of households' portfolio, the performance of unemployment and the improvement of households' expectations for the 2018.

[3] *OECD CLI – The composite leading indicator (CLI), is one of the main indicators, which signals the turning points in business cycles showing fluctuation of the economic activity around its long term potential level. The fall in index prices signals negative turning points in business cycle, meaning a slowdown in the global economic activity and an increase of risk from the "external environment".*

ii. Risk from "enterprises" is assessed as "average" and downward, given the improvement in: the quality of the credit portfolio to this category; the short-term expectations of enterprises; and the index of their financial situation;

iii. For the "government", risk continued to be assessed as "low", but trending upward, due to the developments in the budget balance over the period; in concrete terms, the shift from the positive budget (surplus) to budget deficit;

Chart 1.1 Financial stability map



*Risk is rated: low for scores 0-3 in the map, average for scores 4-5,moderate for scores 6-8 and high for scores 9-10. The farther from the center, the higher the risk.

Source: Bank of Albania.

c. In the banking sector activity:

i. Risk from "capitalisation and profitability" is assessed as "low" and downward over the period. Capitalisation of the sector and credit quality improved, contributing to the decrease of risk from this category. Also, "profit before taxes" as a ratio to "total assets" was up, contributing to the fall of risk from profitability. On the other hand, the continued fall in "net income from interests" contributed positively to the increase of risk to this category;

ii. Risk from "liquidity and financing" is assessed as "moderate" and slightly trending upward, reflecting the deepening of the banks' assets and liabilities gap up to three months[4], and a lower growth of households' deposits. Notwithstanding the above stated, the liquidity indicator of the sector remains at adequate levels, supportive to the banking activity;

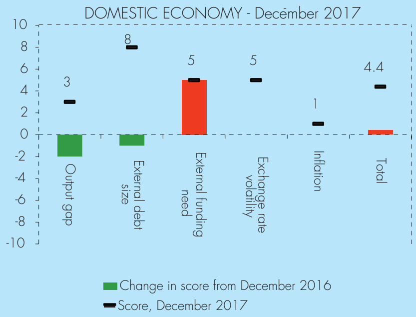
iii. Lastly, the risk related to "banking sector structure" remains unchanged, at "low" level, supported by a better diversification of financing funds and the improved allocation of credit in the banking sector.

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

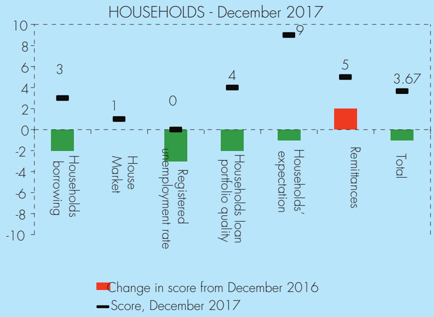
Box 1.1 shows the Financial Stability Map components over 2017 H2, the score for each risk level and comparison with the scores in the previous year.

BOX 1.1 FINANCIAL STABILITY MAP COMPONENTS

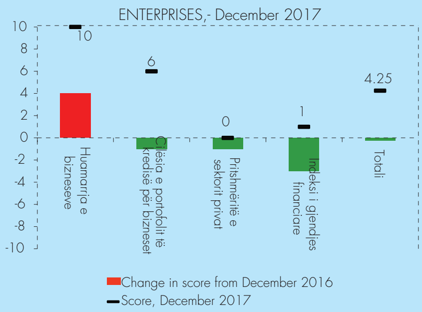
Risk from "domestic economy" is rated as average and trending upward, driven by the increase in needs for external financing.



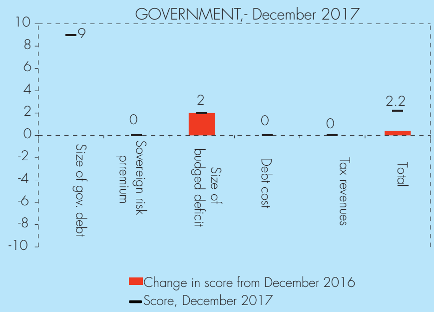
Risk from "households" is rated as "average" and downward, due to the improvement in lending; households' credit portfolio quality; unemployment rate; and their expectations.



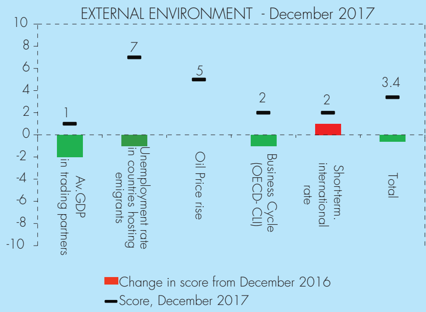
Risk from "enterprises" is rated as "average" and downward, reflecting the improvement in the credit quality, enterprises' expectations and their financial situation index.



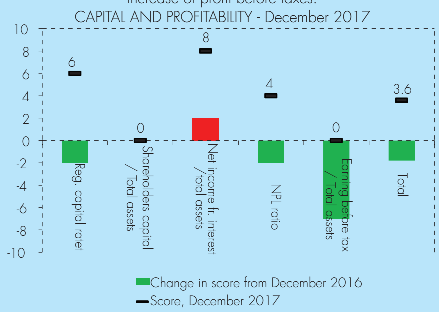
Risk from "Government" is rated as "low", but upward due to the change in the sign of the budget balance.



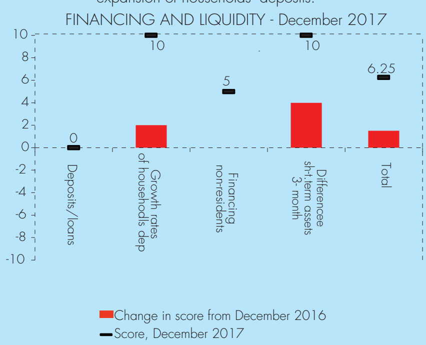
Risk from "external environment" is rated as "low" and downward, driven by the improved economic growth of trading partners and the performance of total CLI index.



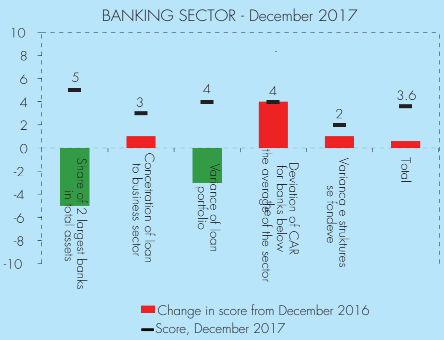
Risk from "capital and profitability" is rated as "low "and downward. The upward risk from the fall of interest income is offset by the improvement of other indicators, such as the f all of NPLs and the improvement of capital and the increase of profit before taxes.



Risk from "financing and liquidity" resulted as "moderate" and upward, due to the deepening of the gap between short-term, up to three months, assets and liabilities, and the slower expansion of households' deposits.



Risk related to the "banking sector structure" remains low and unchanged, given the good diversification of financing funds and the improvement of credit allocation.



Source: Bank of Albania.

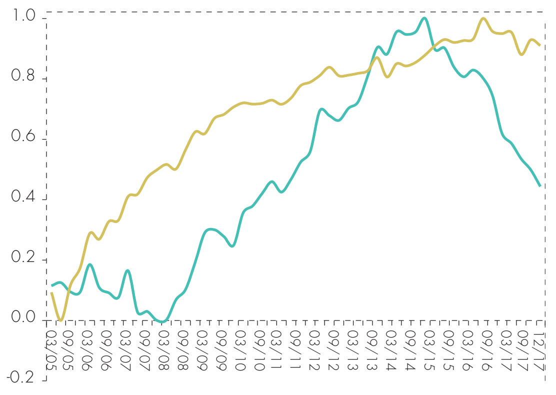
1.1 SYSTEMIC RISK[5]

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; and, c) the perception of the banking industry regarding the exposure to systemic risks, are analysed. The materialisation index 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, are mainly forward looking.

(3) Materialisation of systemic risk has been downward over the period and compared with the previous year. The improved credit quality to households and enterprises, the decline in the domestic unemployment rate, and the diminishing exchange rate volatility have contributed to the performance of this index (See Chart 1.2).

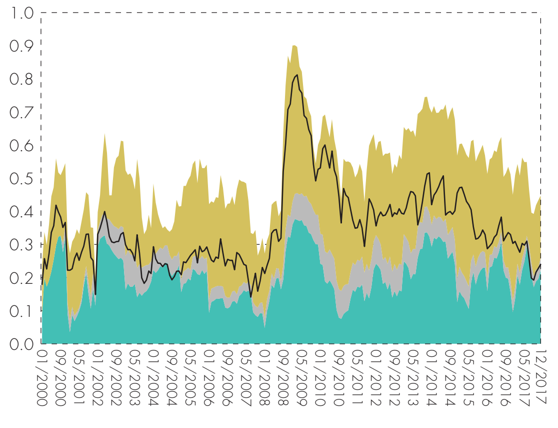
(4) Accumulation of systemic risk and financial stress index were downward over the period. Regarding the systemic risk accumulation index, the reduction of debt level to households, the fall of public debt and the narrowing of external debt provided the main contribution to the decrease of risk accumulation over the period compared with the previous year. Financial stress index was also down driven by the improved performance of banking sector indicators and the appreciation of the domestic currency (see Chart 1.3).

Chart 1.2 Accumulation and materialisation of systemic risk



Source: Bank of Albania.

Chart 1.3 Financial Stress Index



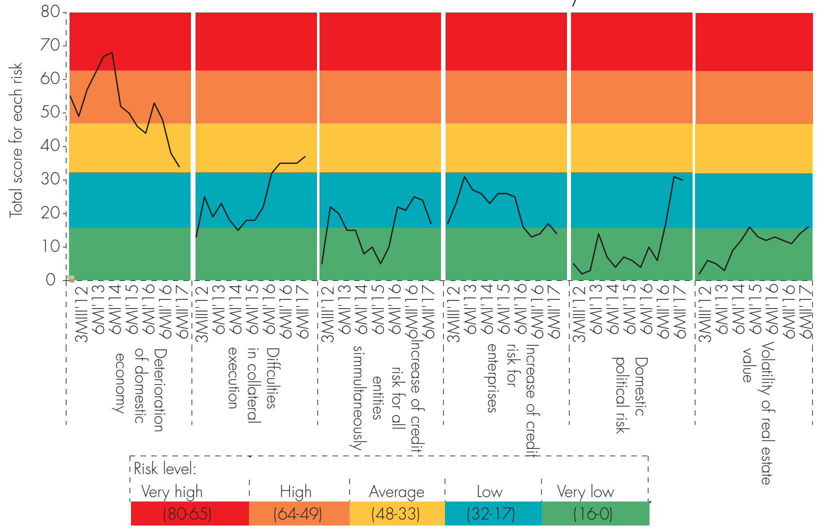
Source: Bank of Albania.

(5) Banking industry's perception provides an overall positive and downward assessment of systemic risk performance over the period. Hence, the potential risk from "Deterioration of the domestic economy" is perceived considerably

[5] *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 suffer materially".*

lower, due to positive and stable economic growth in Albania. Risk perception from the "the execution of collaterals" process remains relatively high and upward over the period, mainly driven by the perception of small and medium-sized banks. "Political risk at home" continued to remain in the group of main systemic risks, but its perception has been downward compared with 2017 H1[6]. Currently, banks perceive this risk mainly related with the performance of economic reforms and business climate in Albania. Risks related to lending continue to be classified as the most important systemic risks, but the perception on them has continued to decrease, particularly driven by the considerable fall of the non-performing loans ratio in the banking sector.

Chart 1.4 Banks' assessment of main systemic risks



Source: Bank of Albania.

[6] *In 2017 H1, banking sector's perception of "political risk at home" increased considerably due to the political climate in the run up to the June 2017 general elections.*