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FINANCIAL STABILITY REPORT 2007

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C O N T E N T S

T A B L E S

C H A R T S

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

of end-year 2007, return on investment of average assets was 1.6%, while return on equity totalled 20.7% being close to end-year 2006. Despite the negative impact of the high credit rate pushed by the market competition, credit quality has changed moderately relative to end June 2007 and is considered as good. Credit denominated in foreign currency continues to dominate in the total credit portfolio while average maturity term of credit has been extended. As a result of investments in higher risk assets, the banking sector has maintained the annual downward tendency of capitalization and liquidity indicators, although the latter are considered in satisfactory levels and are higher than the other regional countries'. The capitalization of the banking sector as of end period, obtained through the capital adequacy indicator, was 17.1%, which is 0.9 percentage points lower than the previous year. Liquid assets of the banking sector share 49.8% of total assets, dropping by about 7.8 percentage points relative to the end-year 2006.

Given the increased level of risk in the Albanian financial system, there is a an ever-increasing need for developing an efficient financial market, which enhances the capacities of the market participants and the economic agents in general to effectively manage the consequences of an unfavourable financial setting. The inadequacy in the current development of the financial market may serve as a natural protection mechanism to the transmission of financial difficulties to the different market mechanisms and in the relations with the international financial markets. However, this effect will be temporary. It is for this reason that the market participants should contribute to building a developed and efficient financial market as in this way they enhance the opportunities to rightly set the price of their products, to identify the exaggerated shifts in the price of different assets and to carry out the necessary transactions in the properly extent and duly time. By acting so, the market will provide an effective and automatic mechanism, which alleviates the consequences of a difficult financial situation. On the other side, by taking certain actions in a market which acts efficiently, the central banks achieve better their monetary policy objectives, hence contributing to the overall financial stability.

2. INTERNATIONAL DEVELOPMENTS DURING THE YEAR 2007

The developments in the international financial markets and the macroeconomic indicators of developed countries generally showed an ongoing deteriorated situation during the year 2007. Meanwhile, emerging countries have displayed a satisfactory resistance to this unfavourable situation. The upsurge of problems related to the non-performing mortgage loans in the USA in July 2007 shoved a deteriorated chain process which peaked with the significant and almost complete reduction of liquidity in the interbank markets and with the thorough absence of trading for certain instruments. The latter were created to facilitate the constant financing of mortgage loans from institutional investors (including banks, investment funds, other intermediators etc.) with different preferences with regard to the level of financial risk or return on investment. Central banks have continuously

intervened to provide the necessary liquidity in the market. At the same time, the growth of global demand for foods, raw material and energy, pushed by the swift development of countries like China, India and Brazil and by the consequences on the supply of foods, increased the inflationary pressures in particular in the EU and the surrounding countries. However, the economic activity in the emerging countries grew at stable rates as a result of the proper macroeconomic policies, the enhanced productivity and the growth of foreign investments. In the foreign exchange markets, the US dollar has reflected the difficulties the US economy is going through and the expectations for the interest rates in the developed markets, and has depreciated to other main foreign currencies and to the euro in particular.

2. 1. MACROECONOMIC ENVIRONMENT

2.1.1 USA

The US financial crisis generated by the fall in the price of real estates spread swiftly in the real economy through the reassessment of risk, the drop in the credit supply and the increase in the costs of debt financing. Subsequently, there is an increased possibility for a twist in the credit cycle and the decline of the economic growth. However, the drop of the US aggregate demand is expected to re-establish a better equilibrium in the international trade.

The deepening of US trade deficit and the relatively low interest rates during 2000-2005 affected the augmentation of capital inflows and the growth of investors' demand for debt securities with high return (and risk), including mortgage-backed securities. The containment of the price rise in real estates and the deterioration of the mortgage loans' quality for non-creditworthy borrowers caused problems not only in this market but also in other financial markets which due to the complexity and the lack of transparency in the recently established financial instruments were closely related to the performance of loans in this sector. The shock derived from the financial market deteriorated sharply the situation of some of the largest financial institutions, including banks reputable for their global activity and subsequently, the influence on real economy is assessed as being considerable.

Households' financial situation experienced a great shock as a result of the fall in the price of real estates, where most of their savings were invested in. Many of them who have been bank borrowers have found it impossible to renew the existing credit terms with more favourable terms and were obliged to accept new terms involving higher interest rates. It is for this reason that the number of household borrowers who have stated their incapacity to pay off the loan has increased significantly. On the other side, the corporates' financial situation may deteriorate in case of a turn in the credit cycle and of the tightening of financing terms as a result of the risk reassessment from the financial institutions and banks. The time extension of the tightening of financing terms for households and corporates will have a significant effect on the economic growth slowdown.

In order to reduce the negative effects the financial crisis may have on economic growth, the Federal Reserve has cut the key interest rates several times within a short period of time. At the same time, the US administration has approved a package for the tax relief of 150 billion US dollars to improve the households and corporates' finances. Despite these measures, there were strong doubts that the US economy would experience an economic recession (a significant decline in economic activity lasting for two quarters in a row), during 2007-2008. However, despite the significant decline in economic growth (which was positive but less than 1%), the US economy has not had a quarter with a negative economic growth yet. On the other side, the drop of demand and the economic slowdown, along with the depreciation of the US dollar in the foreign markets, are expected to affect the capital and merchandise trade inflows. The improvement of the trading terms is expected to reduce the trade deficit and augment the positive contribution of foreign trade to economic growth. Lastly, the continuous price rise in the energy products is propelling inflationary behaviours and has augmented the pressure on the Federal Reserve to attentively revise the loosened monetary policy conducted during the year 2007.

2.1.2 Euro area countries

The European economic growth decreased slightly during the past year, both for developed euro area countries and for emerging countries. As a result of the financial crisis, consumer confidence fell during the second half of the year 2007 and the expectations for the Euro area economic growth during the year 2008 were reassessed as downward. During the last quarter of 2007 and the beginning of 2008 were shown supply-side inflationary pressures which forewarn a neutral or tightening policy of the ECB, regardless of the expectations for the decline of economic growth.

Economic growth in the European countries grew by 3.7% on average in 2007, which is 0.1 percentage points less relative to the previous year (table 1). This decline has affected both developed and emerging countries. Economic growth mainly attributes to the high domestic demand, in particular in construction and transportation, and it has been advocated by a favourable financial environment which has been present in Europe for several years in a row. Reforms in the labour market and the moderate rise of wages in the developed EU countries have encouraged the establishment of new jobs and the fall of unemployment, hence providing a stable flow of remittances to emerging countries. The generated shock in the US real estates market is expected to affect the performance of non-financial corporates in the euro area in the future. The shock will be transmitted through the difficulties that several euro area financial institutions will experience in the form of large financial losses from the exposure to mortgage loans-related instruments in the USA. However, this influence is expected to be moderate.

The transmission of this shock may first occur through the tightening of financing (credit) terms as a result of the spread of shocks to different segments of the financial market, of the expectations for an unfavourable macroeconomic

environment and of the increase in the cost of debt financing. In the period to follow, this could have consequences on the corporates' capital, the productive activity and on the corporates' return. Given the high financial leverage in some sectors – pushed by a stable and historical economic growth and by low debt interest rates – and the increase of debt payment costs, a similar situation increases the probability for the deterioration of financial institutions' loan portfolio, in particular of loans extended to high-risk businesses and to small companies. Corporates' return is expected to remain stable in the future owing to the stable domestic demand. However, there are certain factors such as the price rise of oil and raw materials and the fall of US aggregate demand that may influence the decrease of the return. The swift changes in the market vulnerability which would lead to the risk reassessment/repricing are also a concern. A long period of turbulences in the market may affect the companies and households' capacity to receive loans, hence contributing to the decline of economic growth.

Table 1 GDP growth and inflation in Europe

	GDP (real annual growth)			Inflation		
	2006	2007	2008	2006	2007	2008
Europe	3.8	3.7	3.2	3.5	3.3	3.1
Developed European countries	2.9	2.7	2.2	2.2	2.0	2.0
Developing European countries	6.6	6.3	5.7	7.2	6.8	6
European Union	3.2	3.0	2.5	2.3	2.3	2.3
Euro area	2.8	2.5	2.1	2.2	2.0	2.0
Austria	3.3	3.3	2.5	1.7	1.9	1.9
Italy	1.9	1.7	1.3	2.2	1.9	1.9
Greece	4.3	3.9	3.6	3.3	3.0	3.2
France	2.0	1.9	2.0	1.9	1.6	1.8
Germany	2.9	2.4	2.0	1.8	2.1	1.8
United Kingdom	2.8	3.1	2.3	2.3	2.4	2.0
Bosnia and Herzegovina	6.0	5.8	6.5	7.5	2.5	1.9
Serbia	5.7	6.0	5.0	12.7	6.4	8.8
Croatia	4.8	5.6	4.7	3.2	2.3	2.8
Macedonia	3.0	5.0	5.0	3.2	2.0	3.0
Montenegro	8.3	6.9			4.2	
Kosovo	3.8	1.7	6.2	0.7	1.3	-2.0

Source: European Central Bank estimations

Meanwhile, the inflationary pressures have become more persisting. At end-year 2007 inflation in the euro area jumped considerably over the ECB's objective, standing close to 3.3%, as a result of the price rise of oil and grains in particular in the last quarter of 2007. These unfavourable developments determined the stance of the ECB[1] not to lower the key interest rate of 4% which was maintained until the end-year. Inflation was even higher in the European emerging countries, signalling the risk for the overheating of the economy in particular in those countries which implement a fixed exchange rate regime.

Investments and consumption may drop in 2008 although the projections for households indicate a stable growth in employment and the decrease of the unemployment rate which would improve the available income during the projected time frame. ECB's macroeconomic projections published in March

2008[2] anticipate average annual real GDP growth in the range of 1.3% and 2.1%.

In the short-term future, the conditions of the financial stability in the Euro area cannot be defined with certainty. They will depend on the developments in the economic conditions – in particular of the US house market – and on the way banks will respond to an operational environment with numerous new challenges. The future will also depend on the way various initiatives and measures taken by the decision-makers and the financial industry will be implemented. They will aim at restoring confidence in the financial system and increasing its stability.

The influence of the financial markets turbulences on emerging markets was moderate due to their low exposure to the phenomena that generated the crisis. The velocity at which the situation of the liquidity in the market will return to normality and the extent of risk reassessment will determine in the future the indirect effects that the turbulences in the financial markets will have on emerging markets.

However, there are certain factors which may increase the impact of the financial crisis on the emerging markets as well. They mostly relate to the possible reduction of capital inflows owing to the reassessment of risk from investors; the deterioration of trading terms and remittances as a result of the economic growth slowdown in developed partner countries, the dollarization of the economy and the effects it has on the currency used in lending and of the tightening of financing terms in the domestic market because of the difficulties encountered in financing the activity in the foreign money markets. These factors will certainly have different effects on various countries depending on their production structure, financial market structure, on their position in foreign trade etc.

The Albanian economy is expected to be affected by the developments in the external macroeconomic environment. The Albanian banking system may be affected through the deterioration of households and corporates' financial conditions or through the shocks transmitted by the international financial markets. Consequently, these events anticipate an increasing credit risk, exchange rate risk and interest rate risk. The banking sector's vulnerability to these risks is further elaborated in part 5 of the present report.

2.2 FINANCIAL MARKETS

The relation between different financial market segments in the money markets strengthened, as a result of the return of loans in tradable instruments and of their repackaging and re-sale in several stages for investors with different risk preferentials. This situation caused the financial crisis effects to spread swiftly. Short-term interest rates increased substantially in the USA and in the Euro area, reflecting the shortage of liquidity and the reduced trading volume in a considerable part of the money market instruments. Foreign

monetary authorities responded in order to stabilize the market by injecting liquidity (ECB, Federal Reserve, Bank of England, Swiss National Bank) and by cutting the key interest rates (Federal Reserve). These measures generated a temporary stabilization; however, credit risk and liquidity risk, expressed in the reduction of trading volume and the high interest rates for short-term borrowing, remained high. A gradual recovery of liquidity is expected to occur in the future, after the losses of financial institutions as a result of the risk repricing are made known. These losses may be directly or indirectly related to the mortgage-backed securities market and their liquidity positions.

The US financial crisis that arose in the mortgage market had an enormous impact over the money market given the strong relation between the financial instruments and the business nature of the institutions issuing them (box 2.1). Short-term interest rates in the money markets increased substantially as it is shown by the LIBOR rate (chart 1), although the expectations over the interest rate showed a downward tendency. The Federal Reserve has conducted an aggressive policy with regard to the cut of the key interest rate and the change of the open market operations framework, in order to improve the liquidity conditions in the financial markets and to prevent the excessive tightening of financing conditions and the decline of the economy. In September 2007, the key interest rate began to experience a rapid dropping cycle. By the end of 2007, the key interest rate had dropped to 4.25%, while in the first part of the year 2008 has reached 2.25%. To increase the opportunities for providing short-term liquidity in the market and maintain the trading conditions for some financial instruments, the Federal Reserve expanded the list of instruments to be used as collaterals by the financial institutions which are provided with liquidity by the central bank. It also increased the number of institutions by including non-bank financial institutions which are active in the securities trading and in risk undertaking. Despite the Federal Reserve actions in response to the crisis, the market conditions remained tense and the money market is expected to recover and stabilize at gradual rates. The uncertainties related to the evaluation of financial assets will remain present for as long as the extent of risk reassessment and of losses in the balance sheets of financial institutions and banks in particular, remains entirely unidentified.

Box 2.1 Relation between financial instruments and the spreading of financial crisis to different market segments[3].

The deterioration of mortgage loans in the United States and the decrease in the value of mortgage-backed securities led to turbulences in the financial system that spread swiftly to all its segments.

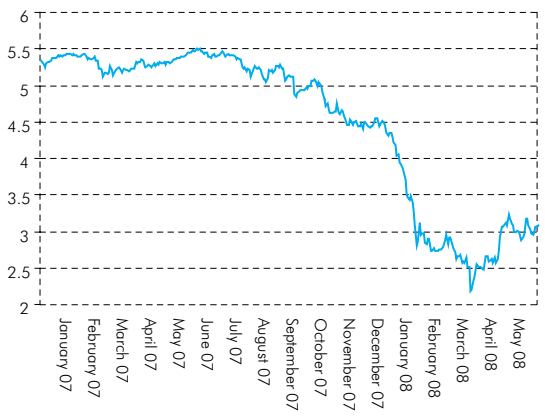
US money market was the most affected market, given that its participants began to worry about the risk of credit that funded these securities and began to collect liquidity in case of abrupt need.

A large part of mortgage loans in the USA is not held to maturity by banks or other institutions. They are sold to other investors in return to liquid funds. This process allows banks to grow their credit portfolio rapidly and fragmentize risk. Investors fund the purchase of these loans through the issuance of some securities known as 'Asset Backed Securities - ABS'). As the name itself indicates, these securities bear the risk characteristics of the credits they fund. Then, some investors repackage the ABSs in Collateralized Debt Obligations – CDO and resell these securities into tranches according to the risk profile. Some CDO investors exposed to credit risk are Structured Investment Vehicles - SIV, which issue debt to finance their investments and widely use financial leverage to increase their profits. A large part of SIV issued debt is in the form of asset-backed commercial papers (ABCP) – short-term debt instrument usually bought by money market funds and related investors from the risk-taking viewpoint. The difficulties in the ABCP renegotiation from SIV allowed the spread of mortgage crisis to the money market. The uncertainty in assessing the assets of ABCP issuers even when it did not relate with the mortgage market obliged the investors to eliminate their ABCP positions, by purchasing government liquid securities. As a result, the treasury bills' yield and the maturity of ABCP that could be re-issued fell considerably. Given the impossibility to find longer-term funds, issuing commercial papers' companies addressed to banks they had signed an agreement with to obtain liquidity, hence causing turbulences in the interbank market. Many banks outside the USA tried to exchange their euro liquidities to dollar in order to meet their agent's needs in the foreign currency swap markets. Since there were very few USD sellers, liquidity issues were sharper in this market segment. This process is known as originate-to-distribute model, implying that a loan only originates from a financial institution but later credit risk is spread through the sale of credit to other investors. Prior to the financial crisis, this model was considered successful due to the opportunity provided to the financial institutions to intermediate rapidly ensuring funds to expand further credit or other investments.

The consequences of the turbulences in the US mortgage-backed securities market on European developed markets affected the approach to investors' risk and as a result they were followed by volatilities in the value of financial assets in all markets. In July 2007, the statements of many reputable European banks that they were directly exposed to the US mortgage market, or indirectly exposed through the position in mortgage-backed securities, increased the expectations for the declining capacity of banks to pay off as a result of their losses. Hence, trade volume in money market instruments of longer-term maturity term and in the repurchase agreements with other institutions, except for governmental ones, reduced considerably. The shocks were also later spread over the instruments of shorter than one week maturity term, in all currencies (euro, British pound and the Swiss franc).

Chart 1 Annual LIBOR rate in USD

(January '07 - May '08)

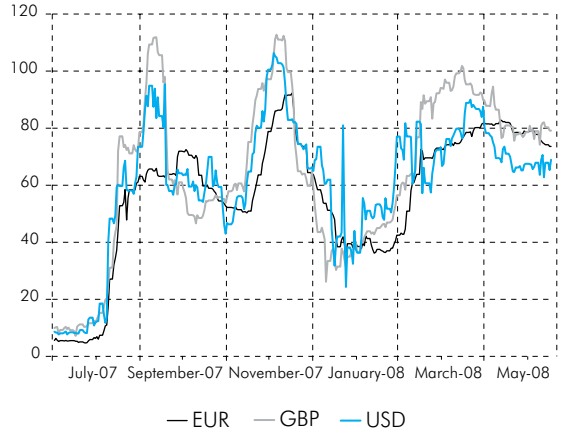


Source: British Bankers' Association web page

The interest rates of money market short-term instruments increased substantially above the key interest rate set by monetary policy and the market conditions tightened further. Banks were reluctant to

lend in the interbank market, even for short durations, for as long as the other party's exposure to the financial crisis effects could not be identified clearly. In response to this situation, the ECB was engaged in re-financing operations, initially of short-term maturity term and later of quarterly maturity term, in order to mitigate the pressures on the longer-term instruments' market. These operations had a stabilizing effect in the short-term market; however, the market activity remains limited in particular in non-guaranteed interbank market instruments.

Chart 2 Difference between the interest rate for 3-month and overnight credit, in basis points (1% = 100 basis points), prior and during the crisis



Source: Bloomberg

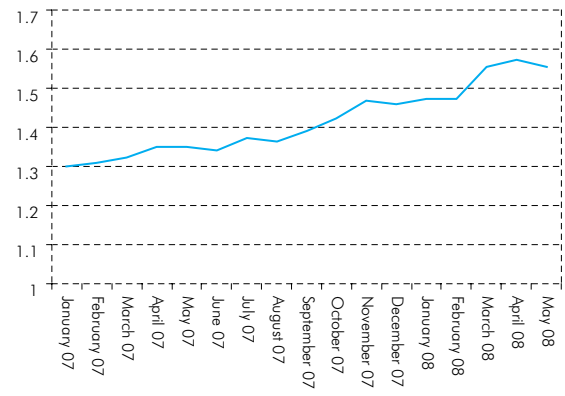
In the beginning stages of the financial crisis, the difference between the interest rates of credit to the non-financial sector relative to the financial sector was narrower. This also reflected the low failures of non-financial companies, the corporates' stable profits and the absence of non-financial companies' direct exposure to segments of the financial market which were mostly affected by the financial crisis. However, during the second half of the year 2007, many rating agencies began to lower the ranking of corporates' debt quality as a result of risk reassessment, especially for other assets-backed securities. In general, the credit markets in the Euro area were characterized by a decline in the corporates' ranking given the general risk reassessment from investors, despite the absence of non-financial sector's direct exposure to the events that generated the crisis. Therefore, an increase in the financing cost for non-financial corporations is expected to occur in the near future.

2.3 FOREIGN EXCHANGE AND RAW MATERIALS' TRADING MARKETS

The different responses of monetary authorities in the foreign exchange markets to the financial crisis threats, the presence of inflationary pressures – in particular in the Euro area, and the price rise of energy were followed by increased volatilities in the foreign exchange rates and by the depreciation of the US dollar to the euro. The appreciation of the euro against the US dollar increased rapidly during the last quarter (chart 3). In the international markets, this appreciation was offset by its depreciation against the Japanese yen, reflecting the differences in the medium-term interest rates and the turbulences in the financial market. A future drop in the perception of liquidity risk, the non-occurrence of negative scenarios with regard to the US economy performance, and the possible measures for halting the price rise of energy may encourage the trading of the US currency in the international markets.

Chart 3 EUR/USD exchange rate

(January '07 - May '08)

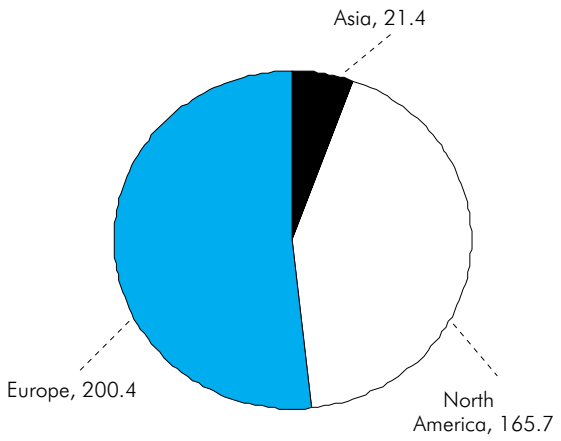


Source: ECB web page

Raw materials' prices, in particular of oil and commodities, went high reflecting the growth of demand in emerging markets (China, India, Brazil and Russia), the more tightened market conditions and the political tensions in some regions (Iraq, Iran, Middle East, Nigeria). Oil prices rose owing to the upward demand and the low supply from the OPEC countries. Future expectations, as indicated in the quotations of the futures markets and the derivatives markets, signal that the oil price will continue to rise in case no changes are made in OPEC's policies or if global economic growth does not decline. However, the upward pressures of oil price are expected to reduce following a possible slowdown in the rates of global economic growth.

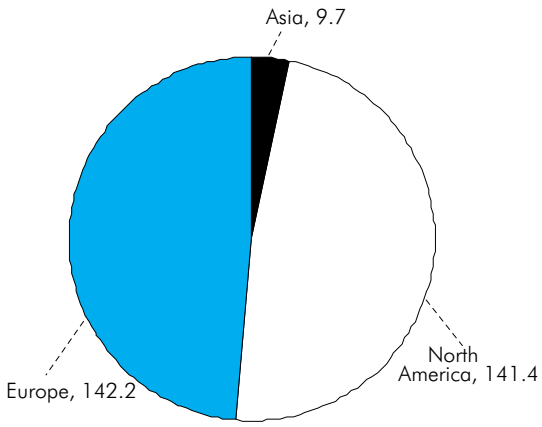
2.4 GLOBAL AND EUROPEAN BANKING SECTOR[4]

Chart 4 Banks losses stemming from the financial crisis since the early 2007 (in billions of USD)



Source: ECB assessment

Chart 5 Capital increase from banks since the early 2007 (in billions of USD)



Source: ECB assessment

Many large banking groups' profits were affected by the financial crisis, through the losses caused by the exposure to instruments and markets hit by the financial crisis. A probable shift in the credit cycle remains an important source of risk and there is great concern for the reduction of interest income. Although the consequences of the crisis on the European banking groups operating in Albania are not completely acknowledged, the available information shows a very moderate influence.

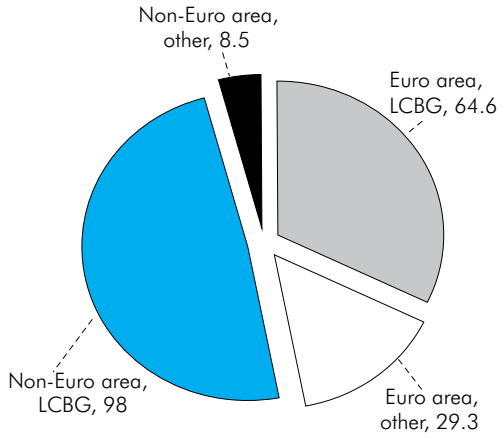
The crisis the credit market is going through has generated financial losses for the banking industry worldwide. These banks were at the same time faced with the need to increase their capital, in order to reset the equilibrium in their balance sheets and meet the regulatory requirements. The European banks seem to have been more affected by this crisis, recording larger losses and higher capital requirements. Asian banks on the contrary have been less exposed.

The further improved financial performance of large and complex banking groups[5] (LCBG) in Europe during the first half of 2007 enhanced their capacity to handle the shocks. However, their ever-increasing dependence on non-interest income sources made their profits more vulnerable to the abrupt changes in the capital markets' conditions and consequently more volatile. In addition, the increasing dependence of some Euro area LCBGs on deposits placed by big clients may have exposed them to a greater liquidity risk. The full influence of the change in the market value as a result of the credit risk that broke in the second half of the year

2007 will be identified only gradually; however, many LCBGs' profits have been affected negatively and these institutions may continue to face liquidity challenges in finding funding sources. At the worst, the loss may reach 300% of the bank's net income or about 15% of its shareholder's equity. The following chart provides assessments on the losses of European banks by origin. The most considerable financial losses were experienced by the LCBGs out of the Euro area, mainly Swiss ones. The European banks' needs for capital have reflected the financial losses caused by the exposure to the financial crisis in the global market. The gradual stabilization or the decelerated growth of lending to households and non-financial companies and the signs of tightened lending standards signal that banks are acting to be protected by the risk of their assets' quality deterioration. However, the share of concerns created by low-income borrowing households and by unrated companies with high debts and the banks' exposure to these borrowers requires careful attention in the future.

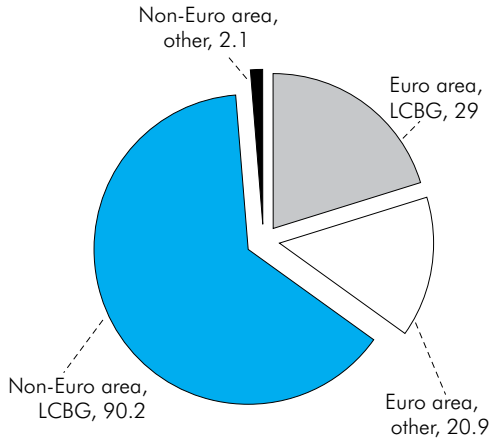
The completion of the implementation phases of Basel II in early 2008 and the IFRS accounting standards[6] will help to further enhance the transparency in financial reporting and risk management practices of the Euro area LCBGs. Despite structural changes, this crisis showed once more the need for banks to have liquidity contingency plans to handle the crisis and to have set aside enough capital for their partners' exposure to credit risk. In addition, constant investments are required from the LCBGs in methods and practices of stress-tests and different scenarios, including here those related to liquidity risk.

Chart 6 European banks' losses since the early 2007 (in billions of USD)



Source: ECB assessment

Chart 7 Capital increase from European banks since the early 2007 (in billions of USD)



Source: ECB assessment

2.5 EUROPEAN BANKING GROUPS OPERATING IN ALBANIA

With regard to the financial situation of European banking groups operating in Albania the available data show that the US mortgage crisis did not have significant consequences on their balance sheets. Boxes 2.2 and 2.3 provide assessments made of these banking groups and statements of the central banks of Italy and Greece on the financial crisis impact over the banks operating in these two countries. In both cases, the influence is assessed as being moderate. However, the final consequences of the crisis on the banks' balance sheets still requires time to be shown clearly and completely.

We assess that the difficult situation the international financial markets are going through represents a new risk for the Albanian financial system. However, its impact on the Albanian economy and more specifically on the Albanian financial system will be more overwhelming if it develops into a global crisis with consequences on the global and the European real economy, which will extend in time. Presently, the influence on the Albanian financial system and the banking sector has been quite moderate since:

a) There is a relatively low development of the domestic financial market where related and sophisticated products, whose value has recently experienced turmoil in the international financial markets, are absent. The regulatory supervisory framework of banking business in Albania does not provide for the differentiated treatment of borrowers (and of credit they are extended) because of the perception as being 'good' and 'less good', including those who apply or receive a loan for the purchase or investment in real estates. On the contrary, the regulatory supervisory framework orients banks towards the financial analysis of the borrower regardless of his/her characteristics and the purpose of the loan, setting some basic and uniform requirements which banks must apply at any case;
b) The provision of funding sources in the international financial markets by the Albanian financial institutions and in particular by the banking sector is quite low, given the fact that there is still enough extent to provide funding for the activity development from domestic sources. The lower share in the banking sector of loans to deposits and to the GDP relative to developed European countries and to some regional countries provide evidence for this fact;
c) There is no direct exposure of Albanian financial institutions and banks to other institutions and financial products, whose value has been impacted negatively by the liquidity concerns in the international financial markets. If such exposure may indirectly stem from a certain category of debt securities' portfolio in foreign currency, its impact becomes insignificant given the low share of these investments for each bank and the banking sector in general, and the good financial performance of the banking sector;
d) There is limited exposure of the European banking groups operating in Albania to the scheme and products financing the subprime loans in the USA and it may be financially handled. The available financial data published by these institutions, different market analysts and by the supervisory authorities of the country of origin confirm this assessment;
e) The good financial performance in the recent years of the financial institutions and the European banking groups has created a sound financial protection through the establishment of necessary reserves and the buoyant business capitalization to absorb such shocks.

Box 2.2 Foreign banking groups present in Albania

1. Raiffeisen Bank (Austria)

Raiffeisen Zentralbank Österreich AG (RZB) is the third-largest bank in Austria. It is headquartered in Vienna and it is the central institution of the Austrian Raiffeisen Banking Group (RBG).

Consolidated profit excluding one-off effects surged in 2007 by 42% or by 248 million euros relative to the previous year. This figure reached 841 million euros this year relative to 594 million euros in 2006. Last year Raiffeisen International sold two bank holdings: Raiffeisenbank Ukraine (486 million euros) and the minority participation in a bank in Kazakhstan (102 million euros). As a result of the non-allocation of last year's profit and the increase of capital in 2007, average equity increased strongly and consequently, the return on equity sank by 1.6 percentage points to 25.7%.

Raiffeisen International operates one of the leading banking networks in Central and Eastern Europe with 12.7 million clients. In eight of the markets in this region, the group's banks are ranked among the first three in the market, while in Albania and Serbia they are ranked first. Raiffeisen International was not affected directly by the financial crisis, however the shares' price was negatively affected by this crisis in the first quarter of 2008. As of March 2008, it totalled 16 banks and 17 leasing companies. The figures of March 2008 exceeded the analysts' expectations, contributing to the increase in the shares' price of Raiffeisen International. Net consolidated profit reached 254 million euros, increasing by 32% relative to the previous year as a result of the organic growth. Return on equity reduced by 3.2 percentage points to 22.5% relative to the entire year 2007. Derivative instruments brought a loss of 37 million euros from depreciation. Provisioning for impairment losses increased by 23% or 17 million euros, reaching 93 million euros.

Raiffeisen Albania accounts for about 2.68% of total assets of Raiffeisen International and about 31% of total assets in the Albanian banking sector (March 2008).

2. Intesa Sanpaolo (Italy)

Intesa-Sanpaolo is the first bank in all Italian banking market segments with a market share of 19% of credits and deposits. In terms of capitalization, it ranks fourth in the Euro area with about 60.7 billion euros as of 31 December 2007. Intesa-Sanpaolo is present in Central and Eastern Europe and in the Mediterranean region, with about 7.2 million clients and over 1200 branches in 12 countries.

Net consolidated income amounted to over 7.2 billion euros in 2007, including the proceeds from the sale of group's shares (2006: 4.7 billion euros). Operating income margin increased by 5.5% to 8,740 million euros. Net exposure to structured credit products, namely subprime credit, is negative totalling 49 million euros as of 31 December 2007 (due to the combination of an 'acquisition' position of 73 million euros with a 'sale' position of 122 million euros). Net income totalled 1.7 billion euros in the first quarter of 2008, while in the first quarter of 2007 it totalled 4 billion euros). Excluding the profit from securities trading which was higher in the first quarter of the previous year, this figure would show an increase of 34.2%. Operating profit margin dropped by 7.1% relative to the previous year. Net exposure to structured credit products, namely subprime credit, remained negative (28 million euros) as

of end March 2008. In order to handle the financial crisis, Intesa-Sanpaolo found support in the strong basis of clients' deposits and in the sound liquidity position of core capital. The main negative effect of the crisis was the depreciation of some securities.

American Bank of Albania accounts for about 0.15% of total assets of Intesa-Sanpaolo group and about 14.5% of total assets in the Albanian banking sector (March 2008).

3. Emporiki Bank (Greece)

72% of Emporiki Bank's shareholder's equity is shared by Credit Agricole banking group. Emporiki Bank is active in capital and money markets in and out of Greece. With 370 branches in Greece and 54 branches in Cyprus, Romania, Bulgaria and Albania, Emporiki offers a wide range of banking and financial services, such as leasing, portfolio management, real estate management, etc. As of end 2007, net profit totalled 48.5 million euros (from a loss of 238 million euros the previous year), and shareholder's equity amounted to 840 million euros. In annual basis, credit portfolio grew by 27% in the first quarter of 2008, relative to the 13.7% growth in 2007. The impact of portfolio revaluation by 24 million euros in the first quarter and the increase in the funding cost caused a negative net result of 15.3 million euros. Total portfolio losses of 24 million euros mainly stem from marking to market its securities and particularly its bond portfolio. With respect to the international presence, total credit portfolio in three Balkan countries (Albania, Bulgaria and Romania) and in Cyprus grew in the first quarter by 7.1%, while total deposits grew by 4.5%. The reputable rating agency Standard&Poor's rated this group from A to A+.

Emporiki Bank in Albania accounts for about 0.64% of total assets of Emporiki group.

4. Credit Agricole SA (France)

In 2007, Crédit Agricole S.A. generated a net profit of 4,044 million euros. These results, representing a 16.8% decline, still demonstrate the Group's resilience in a climate of severe international financial crisis. They reflect the strength of the Group's model, which is based on maintaining an even balance among the three business lines - retail banking, specialised financial services and corporate and investment banking. The negative impact of the crisis on revenues in capital market activities was offset by solid growth across all other business lines. Overall, net banking income rose by 3.6%. Excluding the impact of the crisis, net banking income would have risen by 25.5% and gross operating income would have increased by 30.5%. This very good operating performance attests to the quality of the different business lines' growth engines and particularly international contributions. The group is diversified; however its rapid expansion has displayed some weaknesses: it is still unclear whether the decentralized model of retail banking may be implemented successfully in centralized banks that have been added to the group, as is the case of Emporiki Bank. Fourth-quarter results were severely affected by the crisis in the structured credit markets and Calyon booked 3.3 billion euros in exceptional impairment charges relating to its capital market activities. As a result, Crédit Agricole S.A.'s net income (Group share) was a loss of 857 million euros for the quarter. In order to fully support the business lines' growth going forward, Chief Executive Officer proposed that a part of the capital gains on disposal from two transactions be allocated to strengthening risk management and control systems within the Group.

Net profit amounted to 892 million euros in the first quarter of 2008. Devaluations in the subprime portfolio are considerable: 1,249 thousand euros (2007: 4 290 thousand) and they have had a negative impact on the net income from banking business and on gross operating income (-56.6% relative to the same period the previous year). Business lines, excluding Corporate and Investment Banking, have shown stability. Their gross income totalled almost as much as in the first quarter of 2007 (1.5 billion euros).

Emporiki Bank in Albania accounts for about 0.01% of total assets of Credit Agricole group and about 2.8% of total assets in the Albanian banking sector (March 2008).

5. Piraeus Bank (Greece)

This group's net profit increased by 50% to 652.6 million euros in 2007 relative to the previous year. Return on equity reached 29.5% (from 29% in 2006). The crisis in the international financial markets found Piraeus group with an improved capital adequacy and liquidity situation. As of end 2007, the ratio of credit to deposits was 127% from 130% in the last quarter. Credit portfolio grew by 48% and deposits by 33% relative to the previous year, recording considerable growth in the last quarter of 2007. Non-performing loans accounted for 2.05% (as of end 2006: 2.37%). Coverage ratio of non-performing loans from accumulated provisions is 66%; the same ratio exceeds considerably 100% in case collaterals are considered. In the first quarter of 2008, deposits' growth rate reached 39% (relative to the previous year); credit growth rate remained at 48% and profit growth rate reached 46%, excluding the extraordinary profit from the sale of Bank of Cyprus' shares. In terms of international activities, Piraeus Bank group expanded. Credit portfolio grew by 106% and deposits increased by 71% relative to the previous year. Branches network expanded from 545 in March 2007 to 782 in March 2008 (43%), out of which 322 in Greece and 460 abroad. Only during the first quarter of 2008 were opened 38 new branches. As of end March 2008, the group's non-performing loans amounted to 2.0% (relative to 2.1% as of end 2007). Their coverage ratio from accumulated provisions is 69%; the same ratio exceeds 100% in case collaterals are considered. Credit/deposits indicator improved to 122% as of end March 08 from 127% as of end 2007.

Tirana Bank accounts for about 1.19% of total assets of Piraeus Bank group and about 9.6% of total assets in the Albanian banking sector (March 2008).

6 - National Bank of Greece (Greece)

NBG has the largest banking network in Greece with a total of 571 banks covering the entire country. With its expansion to the South Eastern Europe, foreign network entails 989 banks. NBG has been listed in New York Stock Exchange since 1999.

In the last quarter of 2007, NBG reported a net profit of 312 million euros. Banks operating in South Eastern Europe contributed to this growth by about 41% or 155 million euros, mainly stemmed from the growth in lending. Net profit for the entire year 2007 amounted to about 1,644 million euros.

Although the group's lending activity had recorded as of end year 2007 a growth of 28% relative to the previous year and deposits had grown by 13%, the ratio of credit to deposits was 93%, one of the lowest in Europe. This low ratio provides a funding source for the group's future expansion. Credit portfolio quality improved:

the ratio of non-performing loans dropped to 3.4% (from 3.6% in the third quarter of the year). In South Eastern Europe, this ratio fell to 4.3% (from 4.9% in the third quarter).

In the current conditions of international money and capital markets, NBG has a competitive advantage given the fact that its lending capacity and the funding costs were not affected by the current liquidity crisis. NBG is not exposed to US subprime instruments or other risk-weighted assets. Almost the entire securities portfolio is invested in bonds of the Greek Government.

Group's net profit grew by 25% to 423 million euros in the first quarter of 2008 relative to the same period the previous year. Return on equity reached 28%, which is 5% more than the previous year. Greece's operations grew 8% from last year to 255 million euros and South Eastern Europe operations profitability increased 72%, year on year to 50 million euros, accounting for 12% of the group profit. Despite the strong competition in the deposits market and the increase in funding costs, net interest margin improved to 4.31%, from 4.19% last year and flat quarter on quarter.

Total lending rose by 25% year on year to 57.1 billion euros in March 2008. New loans for all segments doubled relative to the previous quarter. The rapid growth of credit did not affect the assets' quality negatively. Non-performing loan ratio was unchanged from the end-year 2007 at 3.5% and 0.5 percentage points less relative to March 2007. Consumer deposits grew by 13% to 60.5 billion euros, leading to an increase in loans-to-deposit ratio to 92% (from 82% as of March 2007).

The group's solid performance in the first quarter of 2007, in particular in terms of interest income, provides evidence for the stability in the group's main indicators, which remained unaffected by the international credit crisis.

National Bank of Greece, Tirana Branch, accounts for about 0.28% of total assets of NBG group and about 5.9% of total assets in the Albanian banking sector (March 2008).

7. Societe Generale (France)

Group's profit fell by 2.8% in 2007 due to the US financial crisis. Its net profit amounted to 947 million euros which is 81.9% less than the previous year. Due to a gigantic financial fraud by a company trader, the last quarter of 2007 recorded an overwhelming loss of 4.9 billion euros. In addition, the group's Corporate and Investment Banking was affected by the US financial crisis and ended the year with a net financial loss of 2,221 million euros. South Eastern Europe provided a positive contribution: net income in these countries grew by 17.3% excluding Russia and by 58.3% in Russia. The fact that Societe Generale ended the year 2007 in a net profit despite the hard time it went through provides evidence for the stable income sources and the portfolio diversification. During the first quarter of 2008, Societe Generale managed the consequences of the financial fraud. The injection of 5.5 billion euros helped the group to recover the indicators to a satisfactory level and promote a better personnel-client communication. Group's net profit amounted to 1,096 million euros, down -23.4%. Net banking income for the quarter came to 5,679 million euros, down -8.6% versus a very high Q1 2007 comparison base. Developments in the US financial crisis and credit market tensions had a limited impact on the group's consolidated revenues. Overall, the consequences are estimated at -231 million euros and concern Corporate and Investment Banking as well as Asset Management. The group's other businesses have seen generally resilient or increased revenues.

Popular Bank accounts for about 0.03% of total assets of Societe Generale and about 4.6% of total assets in the Albanian banking sector (March 2008).

8. Alpha Bank (Greece)

Alpha Bank is one of the main banks in Greece. With a total number of 675 branches, the group is also present in the international market, Cyprus, South Eastern Europe, USA, United Kingdom, etc. In 2007, the bank had a net profit of 850 million euros, increasing by 44% relative to the previous year. 85% of issued debt in 2007 was qualitative, but in 2008 is planned the exposure of 1.5 billion euros in mortgage-backed securities (covered bonds), which generally have high rating (AAA).

Net profit in the first quarter of 2008 rose 18% to 205 million euros. Net interest income grew 24.9% to 374.4 million euros, while the margin increased by 30 basis points. Net loans grew rapidly by 31.1% to 44.4 billion euros, with new loan balances of 2.3 billion in the first quarter, of which 1.3 billion euros in Greece and 0.9 billion euros in South Eastern Europe. Gross profit in South Eastern Europe amounted to 42.9 million euros, up by 74% and accounting for 16.5% of group's gross profit. Credit and deposits in South Eastern Europe grew considerably by 80% and 34%, respectively, accounting for 18.8% and 14.9% of total groups' credits and deposits. Non-performing loans indicator, measured by IFRS 7 standards, was 3.7% as of end March 2008, improving from 4.8% the previous year. Deposits in Greece amounted to 29.8 billion euros (+8%), while in South Eastern Europe the deposits' base grew by 34%, totalling 5.4 billion euros as of end March. According to bank's officials, during the turbulences in the global financial markets, Alpha generated sustainable profits for shareholders in a risk balanced way. In addition, the group's Agenda 2010 targets remain achievable.

Alpha Bank – Albania accounts for about 0.79% of total assets of the group and about 6.4% of total assets in the Albanian banking sector (March 2008).

Source: According to information obtained from these institutions' reports in their websites.

Box 2.3 Global financial crisis' impact on the Greek and Italian banking sector

Impact of the international financial crisis on the Greek banking sector

According to the Bank of Greece, Greek banks present in Albania were not affected directly and negatively by the subprime credit crisis. In particular, the four largest Greek banks which account for 70% of the Greek banking industry as of end the first quarter of 2008 do not report a direct exposure to non-performing mortgage loans to households or an indirect exposure through investment in related securities. Other institutions have had some inconsiderable indirect exposures to mortgage loans; however, they were not exposed directly.

Impact of the international financial crisis on the Italian banking sector

In a statement of the Governor of Banca d'Italia, Draghi, it is stated that the Italian bank's exposure to subprime mortgage market 'is limited at a global level'. The data

on the largest Italian banking groups show that the value of investments in subprime mortgage market-securities amounted to 1.3 billion euros, which is less than 1.5% of core capital. Meanwhile, no Italian banks have extended non-performing loans to US partners.

3. MACROECONOMIC SITUATION IN ALBANIA

3.1 ECONOMIC GROWTH

The economy grew at stable rates during the entire 2007. The economic sectors which were extended more loans by the banking sector provided most of the contribution to the economic growth. Construction seems to have slowed down, signalling the need for continuous monitoring of the real estates value used as collaterals in the credits lent by the banking sector and for the diversification of the types of the collateral. The future perspective for an economic stability of productive activities will largely depend on the speed of reforms in the key sectors of the economy, the steady improvement in the energy supply and in the production structure through structural reforms in agriculture.

The 2007 economic growth is estimated to be at 6%, despite the increasing costs in production and services as a result of the supply-side shocks stemming from the regional drought and the energy crisis in the second half of the year. Preliminary projections show that economic growth will remain stable during the entire year 2008, given the improved energy supply and exports' performance.

The indicators by production sectors presented in table 3.1 show that the sectors of industry, transportation and telecommunication, trade, hotels and restaurants provided the main contribution to the economic growth, while the sales index indicates a drop in the sector of construction and the sub-sector of energy, gas, steam and water supply. Relative to the previous year, construction sector saw considerable drop by 25% in terms of new constructions and 13.7% in terms of sales during the year 2007, excluding the price effect (table 3).

The annual downward tendency of new constructions during the entire 2007 signals the reduction of companies' demand for real estates, which has generated the price fall in the first quarter of 2008. The performance of real estates' price index for the capital city is given in chart 8, which shows that the sales have continued to fall in real terms. This fall also owes to the high price rise rate in the last quarter and to the expected effects of the change in the tax on real estates' sale. The risk materialization of the fall of demand for houses and a possible further drop of real estate prices implies negative consequences for the wealth of households and companies

and for the collaterals' market value of banks engaged in mortgage lending and lending to construction. This effect is not expected to be considerable in the entire banking sector; however, its level in certain banks should be monitored prudently.

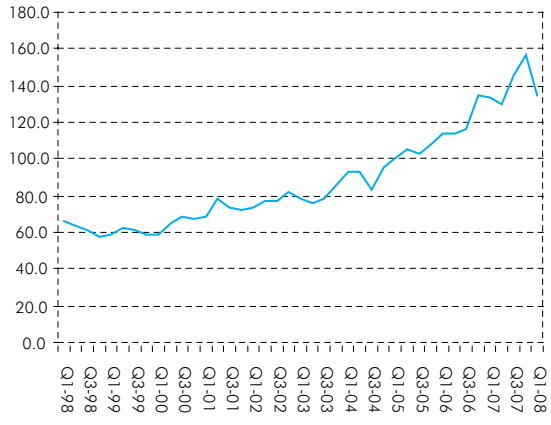
Another factor which is expected to provide its effect on the performance of construction and on the income generated by this sector is the progress of the legalization and registration process of real estates. This process is expected to have a direct effect on the increase of the collateral pledged for different loans, increasing as such the demand for loans and boosting the high credit growth. On the other side, this process is likely to be followed by a fall in the prices of real estates situated in certain areas, leading to the risk exposure of some financial institutions that have lent in these areas. *This element of risk will moderate if the supervisory authority continues to put pressure on the financial institutions to pay careful attention to the financial situation of the credit applicant during the credit application analysis.*

According to the assessments of representatives of construction industry, the poorer financial performance of this sector also relates to some decisions of public decision-making authorities. They state that there has been an unfavourable situation in the demand/supply in the construction market and that this sector is often faced with concerns related to the complete formalization of the activity. However, some of the concerns of the representatives of this sector that are linked with the delays in studying and analyzing the projects, extending construction permits and registering the properties in the real estates registration offices, as well as with the immediate application of some tax measures, which have a negative impact on demand in the construction market, have the potential to intensify the difficulties this sector is experiencing.

The future perspective for economic stability of productive activities will largely depend on the speed of reforms in key sectors of the economy, the steady improvement in the energy supply and in the production structure through structural reforms in agriculture.

Given the considerable share of construction and trade sectors in banking sector's lending to the economy, it is assessed that greater diversification of the sectors would reduce the banking system's risk which stems from specific risks of the industries. Nevertheless, the structure of production is still imbalanced. Sectors such as agriculture and tourism are not yet provided with the appropriate and stable support causing the economic development to be undiversified and vulnerable to the unfavourable regional developments. In addition, this situation curtails the proportional allocation of economic development advantages to the entire population.

Chart 8 House Price Index



Source: Monetary Policy Department, Bank of Albania

Table 2 Annual changes by sectors of production

Indicator in %	III-04	IV-04	I-05	II-05	III-05	IV-05	I-06	II-06	III-06	IV-06	I-07	II-07	III-07	IV-07
	III-03	III-03	I-04	II-04	III-04	IV-04	I-05	II-05	III-05	IV-05	I-06	II-06	III-06	IV-06
Industry														
Turnover indicator	13.7	5	16.3	13.4	3.2	3.5	4.4	2.4	4.8	3.4	16.6	15.9	6.3	12.2
Employed people	-1.5	-2.7	-0.6	-1.2	-1.4	-0.9	-1.5	-0.7	-1.2	2.3	5.8	4.8	7.3	3.6
Wage	5.9	4.3	4.7	4.8	5	5.3	5.1	3.2	6	11.3	15.7	20.4	23	21.1
Extracting industry														
Turnover indicator	6.3	-10.1	-4.5	10.3	-10.9	-4.2	53.6	1.8	35.7	13.4	14.4	42.3	24	31.3
Employed people	-7.4	-8.2	-4.4	-2.4	5	-0.8	-2	-1.2	-0.6	0	4.3	10	10	12.9
Wage	-5.2	-7.7	-1.3	-4.8	17	17.5	11.7	16	10.1	11.5	21.6	27.8	25	24.8
Processing industry														
Turnover indicator	10.6	-4.2	5.8	8.8	1.9	8.4	4.6	10.5	11	13.1	26.5	17.2	8.5	10.5
Employed people	0.1	-1.8	0.8	-1.1	-2.3	-0.9	-3.2	-2.2	-2	4.7	9.9	7.5	11	2.8
Wage	7	8.6	6.2	7.9	4.9	3.6	3.5	-0.7	2	10.6	16.4	22.6	31	22.6
Energy, gas, steam and water supply														
Turnover indicator	22.6	29.6	19.9	27.4	14.5	-3.6	-4.5	-13.6	-14	-16.8	0	3.1	-7	8.5
Employed people	-2.6	-2.5	-2.2	-0.9	0.4	-0.5	2.1	2.9	0.4	-2.3	-2.7	-3.3	-3	1.1
Wage	9.2	2.3	4.7	3.4	0	3.3	5.3	5.9	12	12.8	11.4	12.2	6.7	16.0
Construction														
Turnover indicator	5.8	28.2	15.6	17.3	9.4	-4.2	-1.6	-6	-5.2	16.1	-1.3	-0	-14	-5.1
Employed people	12.9	11.2	12.4	8.1	-0.1	-2.4	-0.7	-1.8	-0.4	1.2	-1.7	-4.5	-7	-4.6
Wage	20.5	19.8	17.5	18.2	5.2	-0.2	5.4	4.2	3.8	10.8	10.2	15	19	22.6
Annual change in hotels														
Turnover indicator	20.6	23.7	-11	7.7	7.6	17.1	3.3	-14.1	8.2	20.7	26.7	34	6.8	2.3
Employed people	35.8	49	-2.2	0.6	0	-7.4	-1.7	-24.3	5.3	9.1	11.5	4	7.8	1.7
Wage	53.9	77	-8.1	0.7	-1.5	-19	1.3	-28.5	42.5	41.3	53	40	12	8.4
Annual change in postal services														
Turnover indicator	12	7.3	1.9	8.9	30.8	42.9	-10.4	-9.2	-12.8	5.2	55.6	57	26	20.4
Employed people	3.4	-0.1	1.6	2.3	4.6	5.1	5.3	5.4	3.3	12.9	18.1	20	21	12.1
Wage	14.7	10.6	9.7	10.9	12.7	10.7	24.6	4	3.6	11.9	17.4	19	21	15.3
Annual change in telecommunication														
Turnover indicator	11	3.2	19.8	18.6	8.6	19.9	-4.9	-16.1	1.6	3.1	17.7	21	12	0
Employed people	-6.5	-3.8	-13.4	-12.5	-3.8	-8.1	2.6	1.4	7	11.9	9.9	9.8	2.2	0.3
Wage	-6.3	-3.6	13.1	14.2	9.4	8.8	8.3	-6.7	6.1	13.8	13.9	12	18	-1.1
Railway transportation														
Turnover indicator	-6.8	-9.1	19.7	-20.9	-20.6	-27.6	-21.9	20.3	36.5	9.3	-4.7	42.9	15	25.1
Employed people	-38.2	-1.9	-0.2	-0.2	-1.5	-1	-35.4	-4	-7.7	-7.7	-5.8	-5.8	-4.1	-5.6
Wage	-29.6	0	5.8	4.4	-3.9	0.4	-24.8	-3.7	2.1	-3.5	-0.3	-2.6	-0.4	-1.0
Sea transportation														
Turnover indicator	0.3	-2	1.2	-5.3	-0.2	-8.1	30.6	105	98.3	30.2	0.7	-22	-18	-3.6
Employed people	7.7	7.7	50	50.6	42.9	42.9	4.8	52.4	60	60	22.9	-11	-6.5	-15.2
Wage	1.5	0.6	38	42.4	48.5	48.2	9.2	74.5	73.3	79.2	25.5	47.5	24	18.5
Air transportation														
Turnover indicator	-4.5	8.8	-0.5	-10.6	18	11.4	-28.5	-42.2	-23.2	-30	-5.2	-17	16	-12.0
Employed people	-7.5	6	-18.5	-22.3	-25.2	0	-28.2	-7.5	-4	0	0	0	0	26.7
Wage	-0.1	2	9.6	16.1	38.8	35.2	18.1	-1.1	44.5	-16.4	0	0	0	21.6

Source: INSTAT

Table 3 Indicators of construction sector

Construction volume	III-04	IV-04	I-05	II-05	III-05	IV-05	I-06	II-06	III-06	IV-06	I-07	II-07	III-07	IV-07
	III-03	IV-03	I-04	II-04	III-04	IV-04	I-05	II-05	III-05	IV-05	I-06	II-06	III-06	IV-06
Construction volume	6.6	36.5	16.8	19.9	13.8	-5.6	5	-7.8	-6.5	16.2	0.3	-1.9	-16	-7.6
New constructions	-2.9	42.4	17.3	6.9	13.5	9.4	23.8	4.3	2.7	8.6	-5.7	-10	-19	-23.3
Reconstructions	25.8	74.2	67.1	47.9	6.3	20.2	7.6	-4.8	-20	22.3	3.9	4.5	-36	-6.1
Engineering works	19	37	30.4	34.1	16.4	-30.3	20.40	-35.3	-11.8	8.8	21.9	19	1.6	15.1

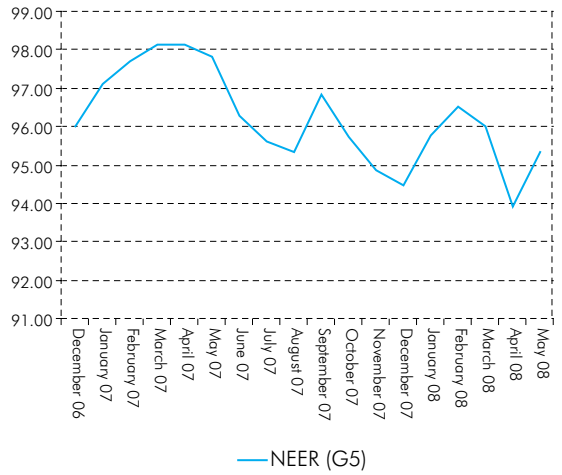
Source: INSTAT

3.2 DEVELOPMENTS IN THE EXCHANGE RATE, INFLATION AND MONETARY POLICY

Inflation rate for year 2007 remained within the Bank of Albania target; however, at end-year 2007 and early 2008 the inflationary pressures, mainly on the supply-side, have increased. Domestic demand was also maintained at stable levels being encouraged among other factors by the considerable growth of credit to the private sector. The increase of the key interest rate to affect the inflationary expectations has increased the spread with the interest rates of the main currencies and it represents a factor that will keep the demand for credit denominated in foreign currency high. Hence, the transmission of this increase to the ALL credit interest rates may precede the increase of the specific share of foreign currency lending, increasing the exposure to the exchange rate. Hence, the credit risk caused indirectly by the exchange rate volatilities will be constantly present.

Average annual inflation rate was 2.9% in 2007, being very close to the 3% target of the Bank of Albania. Following the end of the year 2007, the inflationary pressures have been high, conditioning the maintenance of a tightening monetary policy. Inflation target was reached in average terms, despite the temporary fluctuations as a result of supply and demand-side shocks. The energy crisis, the ever-rising price of oil and grains and of imports in general were the main factors to affect the rise in prices during August – October 2007 (table 4). In addition to supply-side factors, there have also been demand-side factors such as the continuous growth of credit to the private sector and the inflationary expectations.

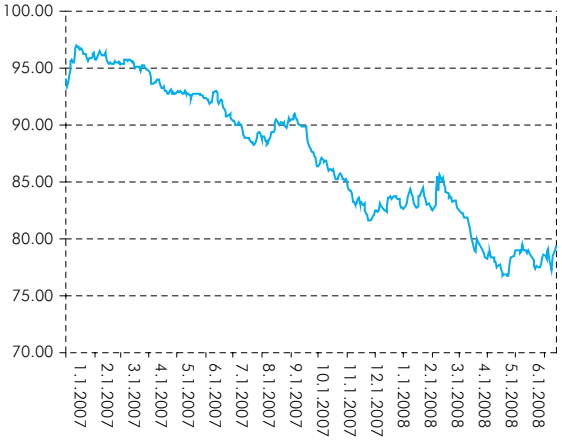
Chart 9 Nominal effective exchange rate



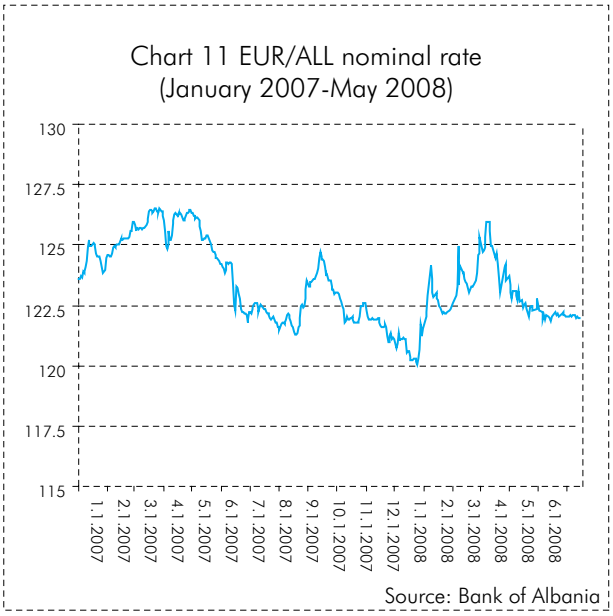
Source: Bank of Albania

The tendency of lek appreciation against the main currencies basket shown in the third quarter of the year 2007 continued to pronounce in the last quarter both in nominal and real terms. This performance reflected the macroeconomic stability at home, the spread deepening of the interest rates between the lek and the foreign currencies and the comparable inflation rates with Albania's main trading partners (charts 9, 10 and 11). Consequently, the lek has appreciated continuously against the US dollar by an average of 12.4 %, being exchanged at 83.38 leks per dollar as of end period. It appreciated by 1.6% in annual terms to the euro exchanging at 121.69 ALL/EUR in the last quarter of the year 2007. However, relative to the previous year, the lek showed higher volatility during the entire year 2007 as a result of the developments in the international markets and

Chart 10 USD/ALL nominal rate (January 2007-May 2008)



Source: Bank of Albania



the more active participation of domestic agents in the foreign exchange market.

In order to contain the inflationary pressures, the Bank of Albania intervened three times during 2007, which resulted in the increase of the key interest rate to 6.25%. *Given that the interest rates provided by the banking system for ALL-denominated assets and liabilities have followed the key interest rate moves and these shifts have increased the spread between the interest rates of the lek and the main currencies, demand for credit denominated in foreign currency will remain high. Consequently, the credit risk caused by the shifts in the exchange rate will be constantly present. In order to contain this risk, the commercial banks should be prudent while lending loans in foreign currency. They should first provide in their balance sheets a change between assets and liabilities denominated in foreign currency which is as small as possible. In addition, they should make a thorough and effective analysis of the borrower's creditworthiness and the collaterals guaranteeing the loan.*

Table 4 Annual inflation rate during 2007

Month	Annual inflation
January 2007	2.9%
February 2007	2.9%
March 2007	2.7%
April 2007	1.9%
May 2007	1.4%
June 2007	2.0%
July 2007	2.1%
August 2007	4.2%
September 2007	4.4%
October 2007	4.2%
November 2007	3.5%
December 2007	3.1%
January 2008	3.0%
February 2008	3.6%
March 2008	4.6%
April 2008	4.4%
May 2008	4.2%

Source: Bank of Albania and INSTAT

3.3 EMPLOYMENT

Households' income continued to grow during the year 2007 owing to the growth of employment, the rise of wages in the public sector and the stable remittances flow. This growth of income has supported the growth of consumer loan, in particular of the loan denominated in foreign currency. However, the materialization of the scenario which considers a shift in the remittances' flow remains a source of risk. The reduction in remittances is a process which should however be gradual and smooth the risk characteristics that it may cause. The growth of income is a factor which has a positive contribution to the

financial system's stability for as long as households' creditworthiness performs better. However, the growth of income allows the increase of debt (in the form of credit received from banks). If this increase becomes hard to handle, debt servicing is put into question, hence transmitting concerns to the lender.

The year 2007 was characterized by a downward tendency in labour forces, increase in employment (mostly in the private sector) and the reduction in the unemployment rate and the number of unemployed workers (table 5). This performance is expected to have provided its influence on the growth of households' income per capita, which in turn affected the upward tendency of consumption and the consumer loan extended by the banking system.

With regard to wages in economy, average wage in the public sector rose during the year 2007. In the last quarter of the same year they rose nearly by 14% relative to the same period the previous year. There is no sufficient information on the performance of average wages in the private sector; however, we may presume that this sector has also maintained the same upward tendency as the public sector.

The growth of income has led to the growth of demand for consumer loan which is expected to accelerate during the year 2008 also as a result of the greater sources in lek for this type of loan. *From the regulatory viewpoint, it may be necessary to treat the risk that this type of loan bears with particular attention.*

Remittances represent another essential source of income to households. Given that migration accounts for 20-25% of labour forces, remittances provide overwhelming support to consumption and savings of households. In addition, it is an important factor which affects the performance of the exchange rate and debt servicing in foreign currency of households. Theoretically, there is a risk of a turning point in remittances, which is explained by the integration of emigrants into the economies they work in and the shift of the centre of economic interest of their families from the country of origin to the host country. So far, statistics on remittances do not seem to indicate this phenomenon. In 2007 remittances totalled 947 million euros, increasing slightly by 1.3% and accounting for 12% of the GDP. However, they remain closely related with the economies of foreign countries and they become a cause for the transmission of shocks present in these economies to the country of origin. *In more concrete terms, in case developed countries experience economic recession, the flow of workers' remittances would reduce the households' welfare and consequently the supply of deposits denominated in foreign currency and their ability to service the debt denominated in foreign currency reduces.*

On the other side, the ongoing preference of the financial sector and the borrowers to lend and borrow in foreign currency during the year 2008 increases the banking sector's exposure to the risk of workers' remittances reduction. *This risk would be gradually diminished if the regulatory requirements on the increase of the cost of credit denominated in foreign currency and the strengthening of risk analysis by banks were set for this type of activity.*

Table 5 Employment indicators

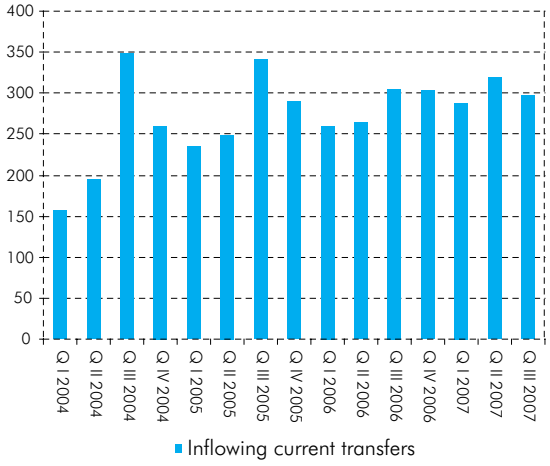
Main indicators	Unit	II-05	III-05	IV-05	I-06	II-06	III-06	IV-06	I-07	II-07	III-07	IV-07
LABOUR MARKET												
Labour forces		1,086,000	1,086,000	1,086,000	1,082,900	1,081,328	1,084,072	1,084,545	1,080,467	1,078,103	1,077,908	1,081,821
Employed workers	number	931,000	931,200	932,000	931,000	931,253	934,405	935,058	932,759	932,960	935,747	939,000
a)In the public sector	number	175,600	175,600	175,000	174,000	172,126	170,500	169,000	167,500	166,800	167,100	167,100
b)In the private non-agricultural sector	number	213,400	213,600	215,000	215,000	217,127	221,905	224,058	223,259	224,160	226,647	229,900
c)In the private agricultural sector	number	542,000	542,000	542,000	542,000	542,000	542,000	542,000	542,000	542,000	542,000	542,000
Unemployed workers	number	155,000	154,800	154,000	151,800	150,075	149,667	149,486	147,708	145,143	142,161	142,821
Receiving unemployment compensation	number	11,500	11,500	11,200	11,500	11,249	11,360	11,297	10,334	9,857	9,659	9,540
Unemployed	%	14.30	14.20	14.20	14	13.90	13.80	13.90	13.60	13.50	13.18	13.20
INCOME												
Average monthly wage in the public sector	leks	26,612	27,197	27,333	27,333	27,606	28,950	31,400	31,850	31,850	35,650	35,650
Minimum monthly base wage	leks	10,800	11,800	11,800	11,800	11,800	14,000	14,000	14,000	14,000	14,000	14,000

Source: INSTAT

3.4 FOREIGN TRADE

Current account deficit grew during the year 2007, reflecting the high demand and the lack of productive capacities at home. Exports covered only ¼ of imports' value. The growth of the latter has mainly derived from the increase in the volume of imports, in particular of energy, and of the general price rise of prices. During the year 2007, the import of consumer products has fallen while the import of capital goods has increased (mainly of machinery and appliances), creating better premises for the increase of productive capacities and the growth of exports in the future. Hence, the relative effect of foreign trade on the general development would be positive and the domestic demand for foreign currency would reduce. Both these developments would be positive in the context of the financial system stability.

Chart 12 Quarterly flows of workers' remittances in millions of EUR



Source: Bank of Albania

The performance of the external sector of the economy shows further growth of domestic demand. Current deficit amounted to 878 million euros in 2007, increasing by 64% relative to the previous year. As of end year, trade volume totalled 3.8 billion euros, which is 26% higher relative to the year 2006, and accounted for 28% of the GDP. The deepening of the trade deficit, as a result of the high demand for import goods, reflected the general price rise in the region, the fluctuations in the exchange rate and the gradual reduction of customs tariffs which is part of the liberalizing trade processes.

The ratio of imports' coverage by exports remained low at the end of the year 2007 (26%). Despite the growth of exports during the year 2007, the low domestic capacities at home and the very high demand for imports decrease the trade deficit vulnerability to specific exports' factors. With regard to the structure of imports, consumer goods which share 30% of total imports have reduced by 7 percentage points. On the contrary, the imports of capital goods increased by 36% and at the end of the year they accounted for 14% of total imports. The high import of machinery and appliances, which increased by 30%, attributes to the development of the construction sector and investments in infrastructure. *This shift in the structure of imports to investment-related goods signals the increase of productive capacities by the companies, which in turn improves their net future value and decreases the credit risk for the banking system. In addition, this shift will in a later time narrow the trade deficit as a result of the growth of domestic demand.*

According to the Balance of Payments data, the unfavourable weather conditions and the high demand of the economy have encouraged the increase of the import of energy by 3.5 times as much relative to the previous year. In terms of value, the import was 6 times higher owing also to the price rise effect of energy in the global markets. *Trade deficit deepening may be a factor which exerts pressure on the exchange rate and increases the exposure*

of the economy to the depreciation risk, which will have consequences on the banking sector's credit portfolio.

3.5 FISCAL INDICATORS

As of end 2007, fiscal indicators met the objectives, although expenditures continued to be concentrated at the end of the year. The deepening of budget deficit by 5.2% for the year 2008 to carry out strategic investments required the pursue of a prudent policy in collecting the income (taxes, the privatization of key sectors and Government borrowing) and better allocation of expenditure to avoid the pressure on the interest rates, liquidity in the interbank market and to prevent the hampering of private companies' business development projects.

As of end 2007, fiscal indicators which relate to the level of income and public expenditure, budget negative surplus (deficit) and to the extent of financing of a part of expenditure with domestic sources of the financial market, met the objectives. Budget revenues grew by 12% relative to the previous year, attributing to the reform in the fiscal package, the application of the flat tax and the good performance of income from VAT. Budget expenditure continued to be concentrated at end-year increasing by 9%, which had its impact on the interbank market liquidity. Following the agreement between the Ministry of Finance and the Bank of Albania which provides for the investment of excess government liquidity in financial instruments offered by the Bank of Albania, the short-term pressure on the level of liquidity and on the interest rates in the interbank market reduced in the last quarter of 2007. Consequently, better conditions were created for the transmission of the change in the key interest rate by the Bank of Albania to the interbank market through open market operations.

Budget deficit is projected to deepen by 5.2% of the GDP in 2008, as a result of the strategic investments in infrastructure. The expansionary fiscal policy is expected to have the following effects:

- The growth of government public borrowing, part of which will be financed by the financial and banking sector; hence, turning the government into the main borrower and probably causing the credit supply to the private sector to reduce. It may occur that the construction sector benefits from the increased Government expenditure on infrastructure. However, the other sectors of the economy may face more difficult conditions in terms of financing the business development needs, in particular in case of time disconcordance between revenues and expenditures. This situation may appear more relaxed if the Government provides a large part of borrowing from the international market or if it results successful in the privatization of some major state-owned companies. Subsequently, the branches of foreign banks operating in Albania may increase lending following their release from the regulatory requirements applied for bank subsidiaries and the entry of large European banks;

- 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

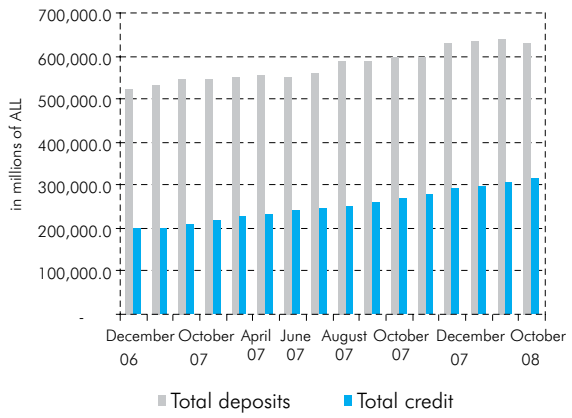
existing and expected tendency of credit growth in foreign currency is of great interest. As shown in charts 15 and 16, almost throughout the year 2007 credit denominated in foreign currency has grown more rapidly than deposits denominated in foreign currency. *This fact signals that the limited sources 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 groups[7] 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.

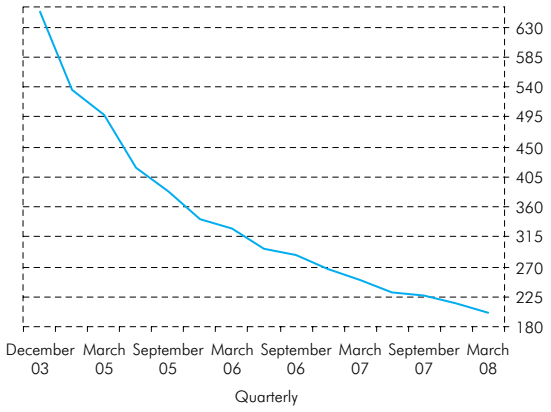
As a share to total credit, credit denominated in foreign currency grew more for G1 and G2 banking groups. Meanwhile for G3 banking group this ratio reflects the change of the exchange rate during the second quarter (chart 18). On the other hand, the ratio of foreign currency-denominated liabilities 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

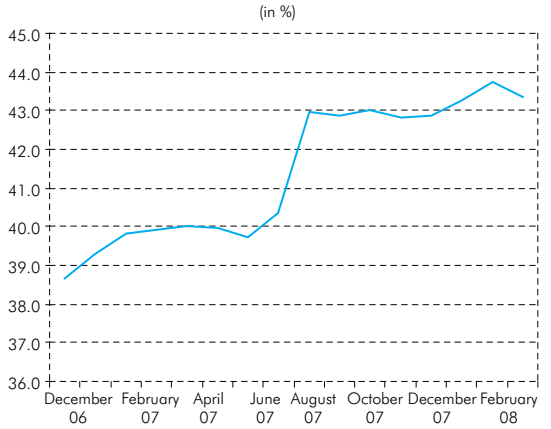


Source: Bank of Albania

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

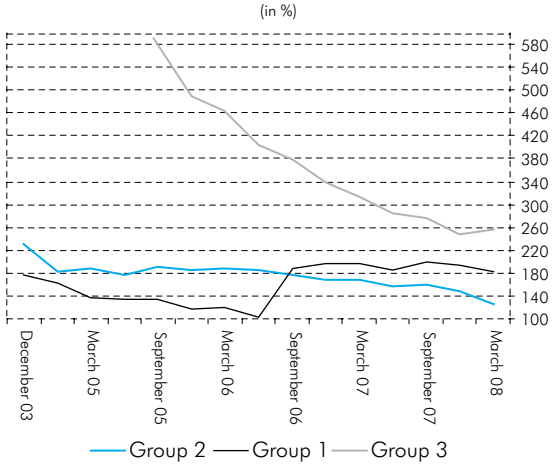
Source: Bank of Albania

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

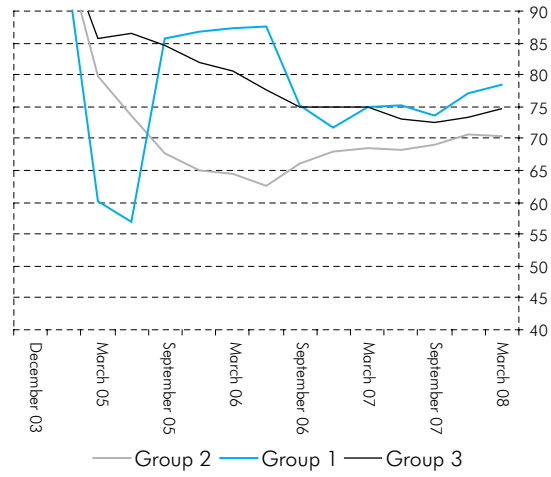
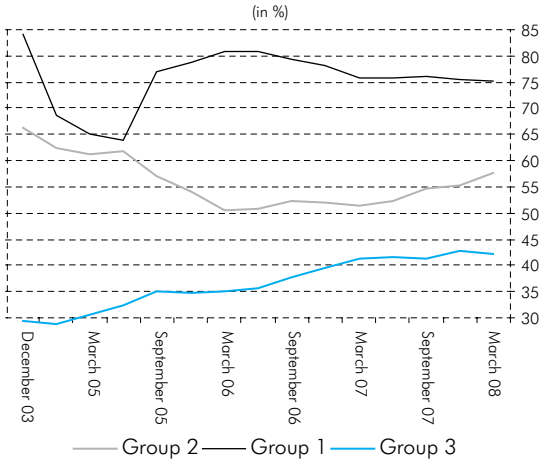


Chart 19 Foreign currency-denominated liabilities to total liabilities by banking groups



Source: Bank of Albania

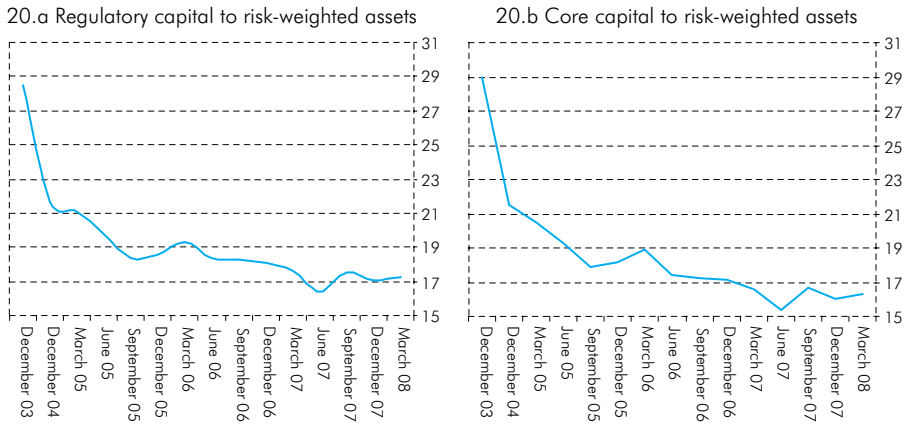
4.2 CAPITAL INDICATORS

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%.

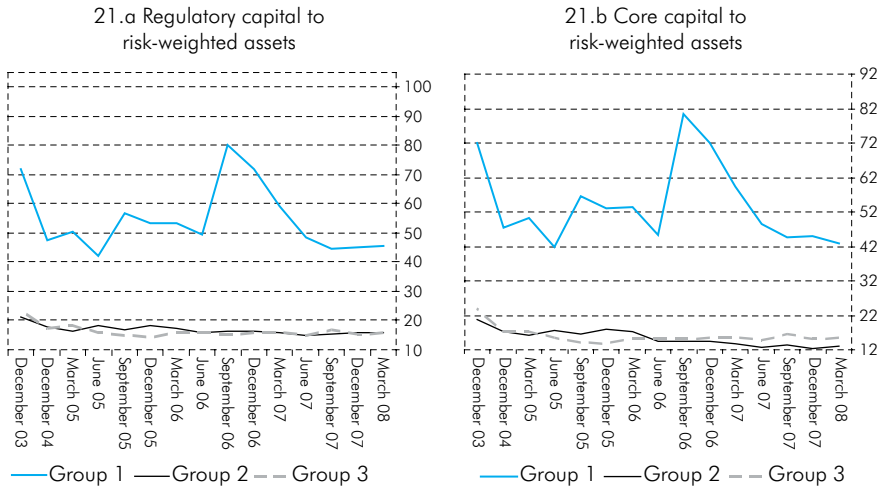
During the year 2007 and the first quarter of 2008 there was a gradual drop in the use of the financial leverage, in particular in the second half of the year as shown in chart 22.a. The drop in the financial leverage while the capital adequacy ratios have generally had a downward tendency suggests that 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.

Chart 20 Capital adequacy rate for the banking system



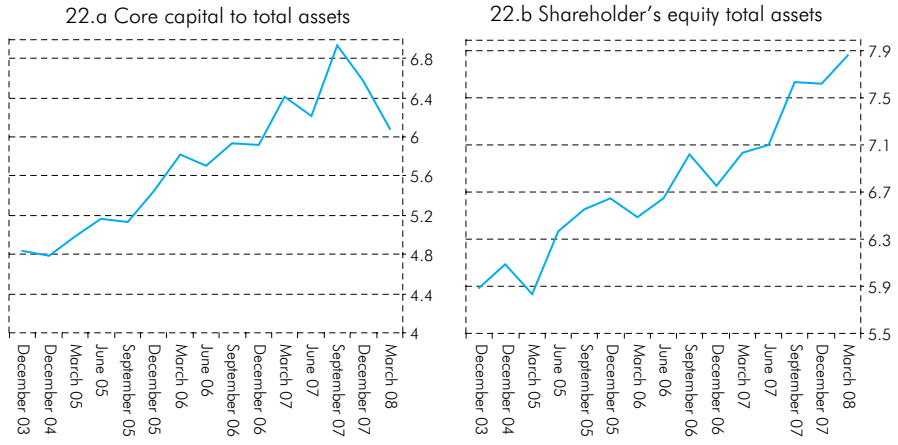
Source: Bank of Albania and FSD

Chart 21 Capital adequacy rate by banking groups



Source: Bank of Albania and FSD

Chart 22 Financial leverage by banking groups



Source: Bank of Albania and FSD

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

	2008				2007	2006
Indicators (in %)	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

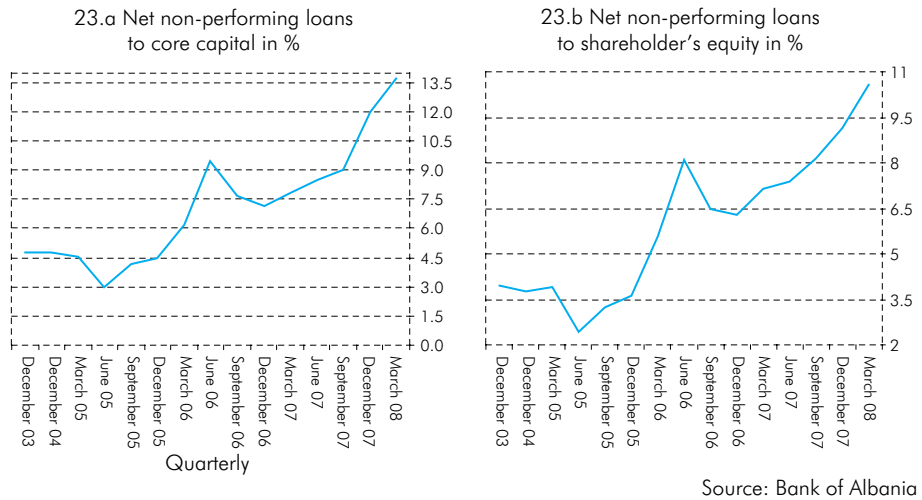
Source: Bank of Albania

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.

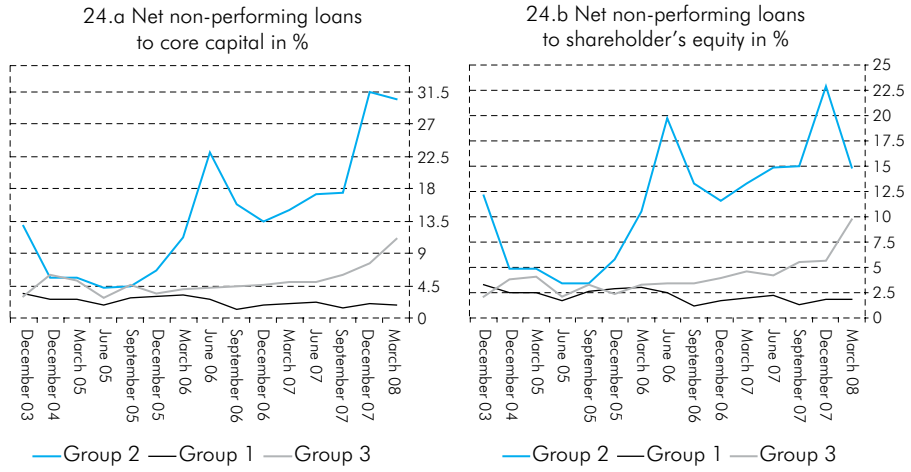
The banking system's exposure to the exchange rate risk as shown by the percentage of the open foreign currency position to the core and shareholder's equity (chart 30) has increased in the first quarter of 2008 relative to the historical values of the last 4 years. In terms of extent per banking group, 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 23 Ratio of non-performing loans to capital in the banking system



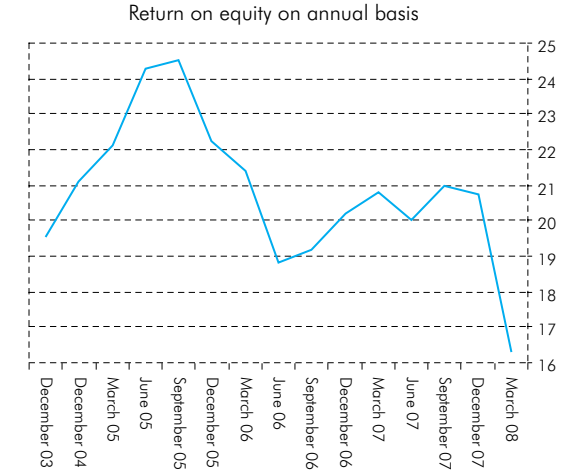
Source: Bank of Albania

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



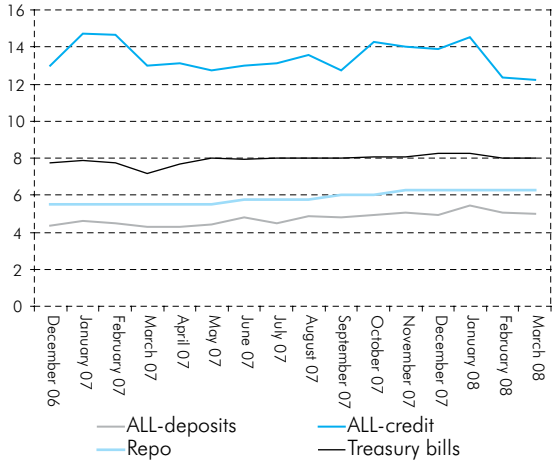
Source: Bank of Albania

Chart 25 Return on equity for the banking system



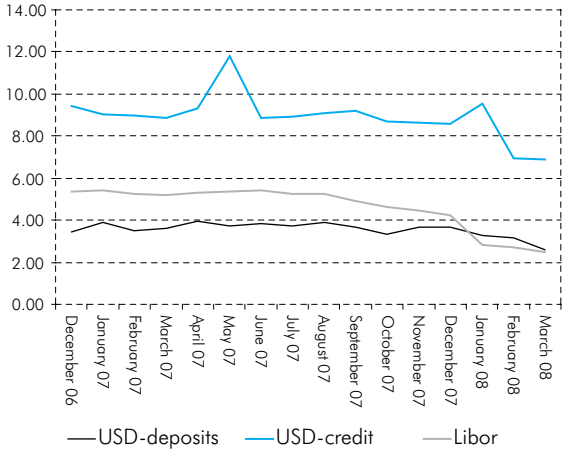
Source: Bank of Albania

Chart 26 Interest rates for ALL-denominated instruments



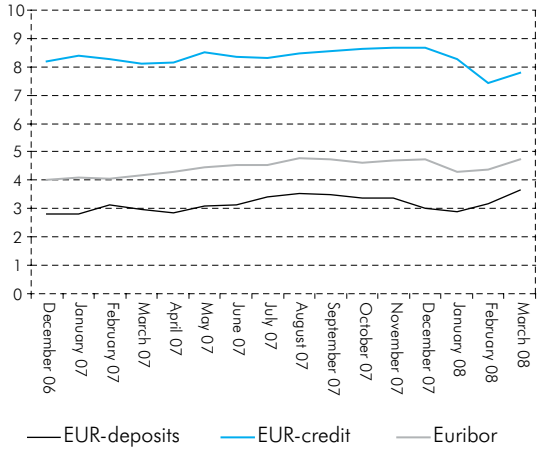
Source: Bank of Albania

Chart 27 Interest rates for USD-denominated instruments



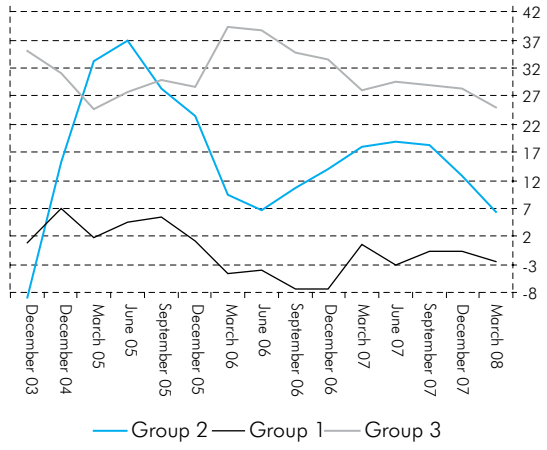
Source: Bank of Albania

Chart 28 Interest rates for EUR-denominated instruments



Source: Bank of Albania

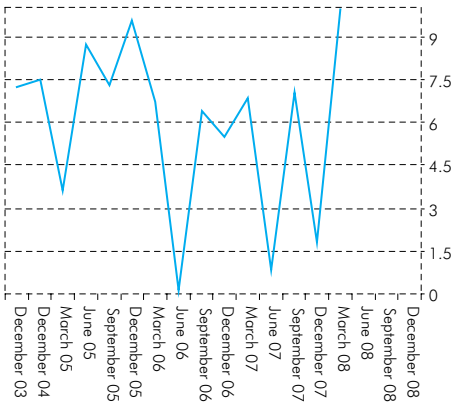
Chart 29 Return of equity by banking groups in %



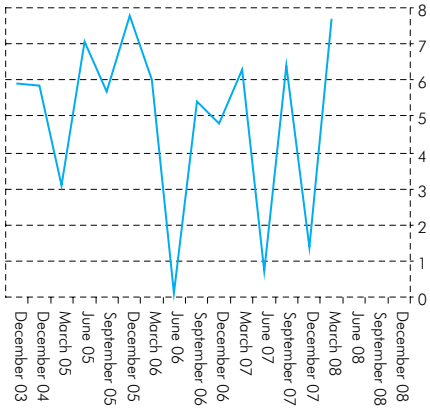
Source: Bank of Albania

Chart 30 Exposure to exchange rate risk for the banking system

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



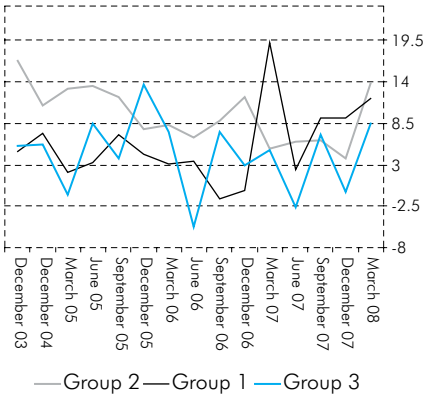
30.b Net open foreign currency position to shareholder's equity in %



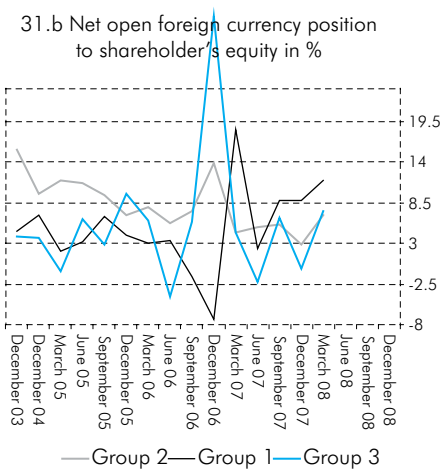
Source: Bank of Albania

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

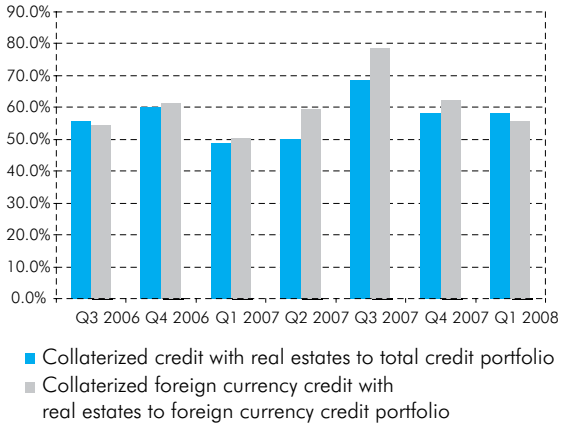
4.3 ASSETS' QUALITY

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).

Chart 32 Credit coverage with collateral

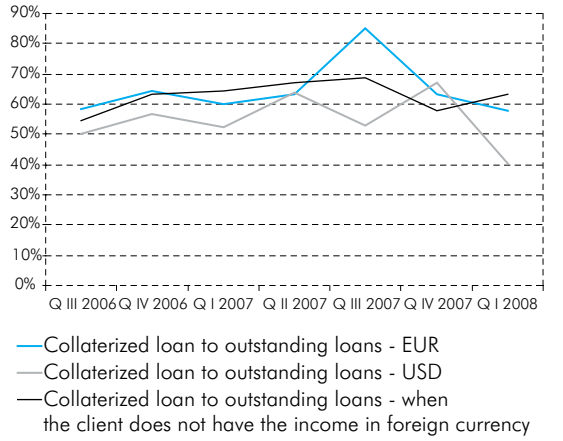
Collaterized credit with real estates to credit portfolio (in total and in foreign currency)



Source: Bank of Albania

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%.

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



Source: Bank of Albania

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

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.

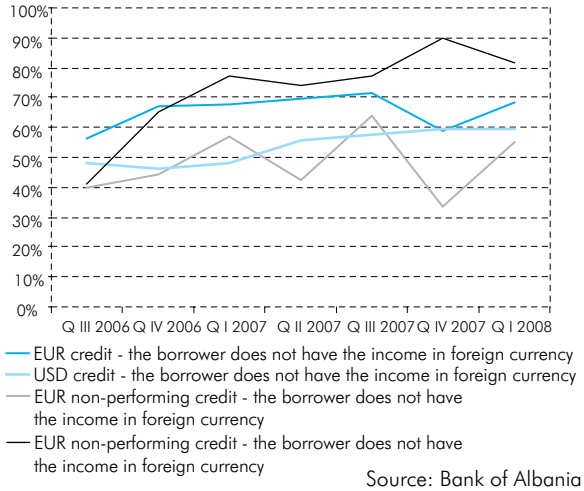
During the year 2007, credit portfolio (stock) grew by 93.7 billion leks or by 34.2% relative to the year 2006. New credit extended during the year 2007 was 246.2 billion leks or 56.8% higher than in 2006. Use of credit (paid credit) was 152.5 billion leks in 2007 or about 75% higher than in 2006. The 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 duration[8] 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.

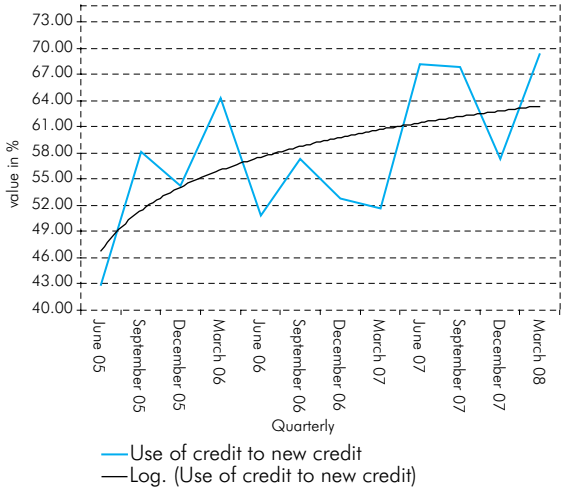
Average duration of credit portfolio is the most important indicator. Its measurement indicates the average maturity term within each segment of credit portfolio. The following chart shows that the average duration of credit portfolio has increased,

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



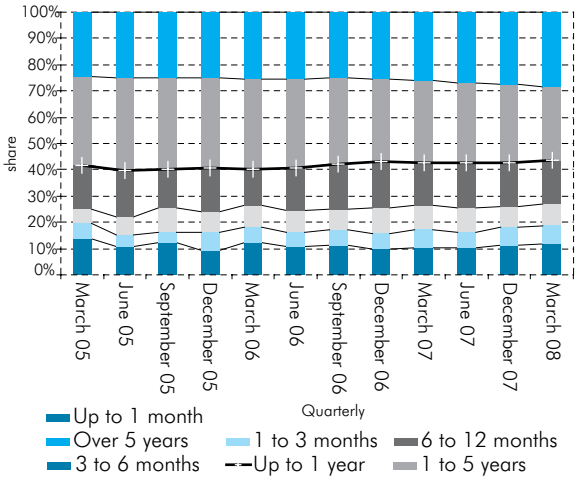
Source: Bank of Albania

Chart 35 Use of credit to new credit



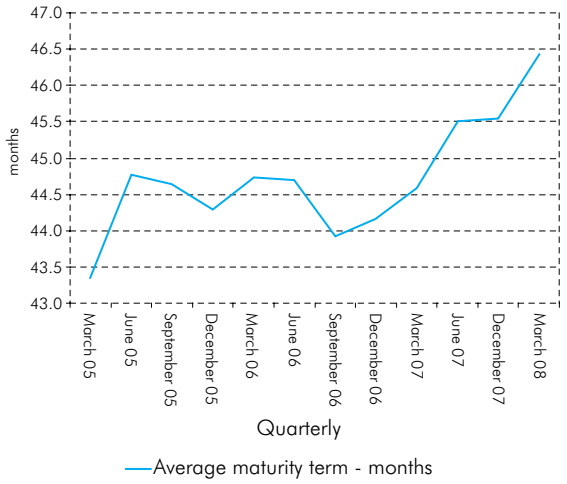
Source: Bank of Albania

Chart 36 Composition of credit portfolio by maturity term



Source: Bank of Albania

Chart 37 Average duration of credit

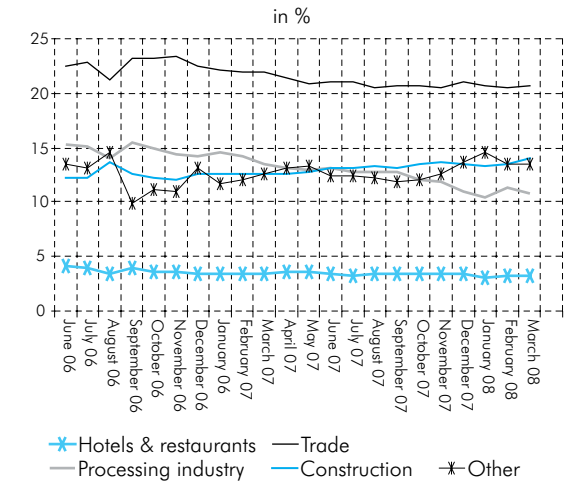


Source: Bank of Albania

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

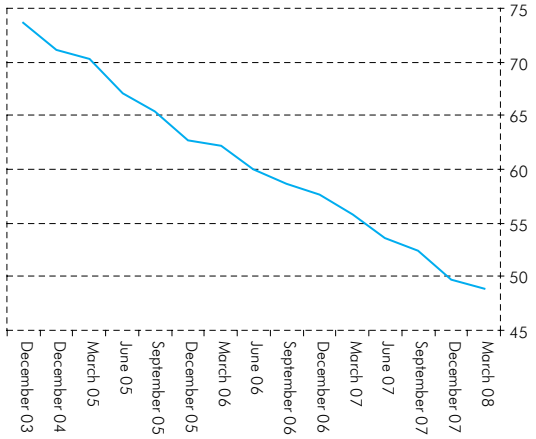
Credit to households (charts 38 and 46) has the main share of nearly 21.4% in the last quarter of the year 2007. There has been a downward tendency in the shares of processing industry and trade sector during the same year although credit to these sectors has the main share in total banking sector lending. 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 levels[9] 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.

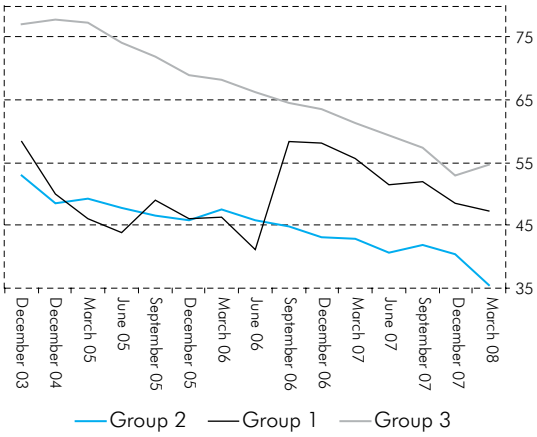
Chart 39 Liquid assets to total assets of the banking system



Source: Bank of Albania and FSD

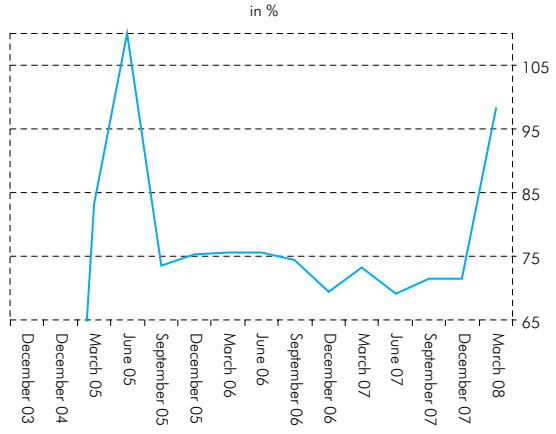
Chart 40 Liquid assets to total assets by banking groups

in %



Source: Bank of Albania and FSD

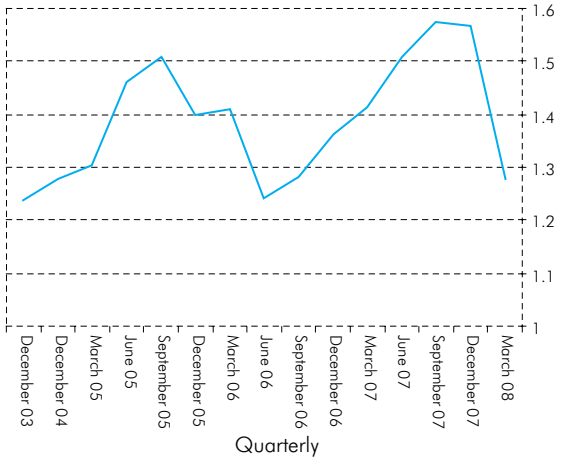
Chart 41 Liquid assets to short-term liabilities of the banking system



Source: Bank of Albania and FSD

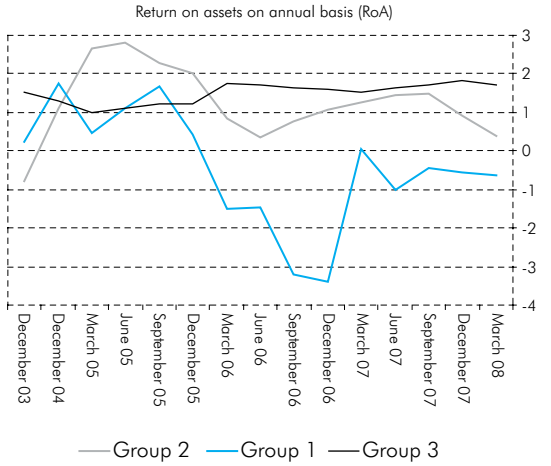
Chart 42 Return on assets for the banking system

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



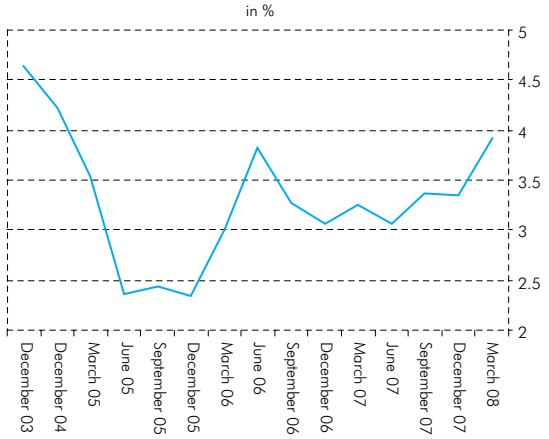
Source: Bank of Albania and FSD

Chart 43 Return on assets by banking groups



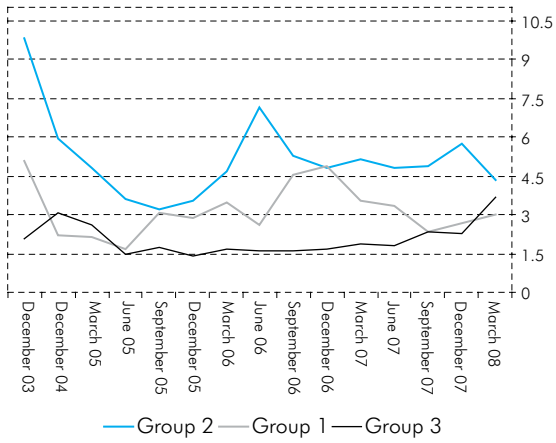
Source: Bank of Albania and FSD

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



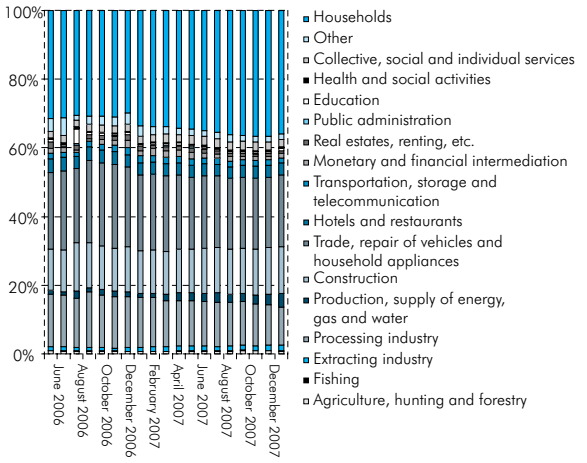
Source: Bank of Albania and FSD

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

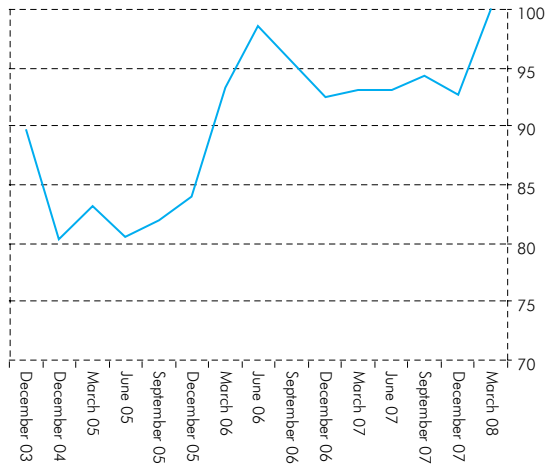
4.4 INDICATORS OF INCOME AND EXPENDITURE

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.

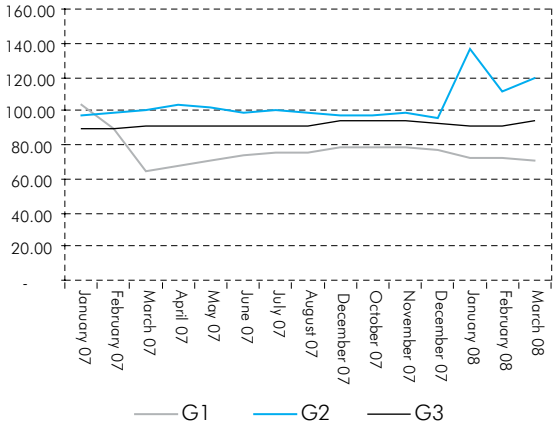
The further cut of interest rates for the US dollar by the Federal Reserve would increase the spread with the lek interest rate and would further encourage the extension of credit in this currency. The financing of the growth of foreign currency-denominated credit by certain banks would encounter difficulties 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 %



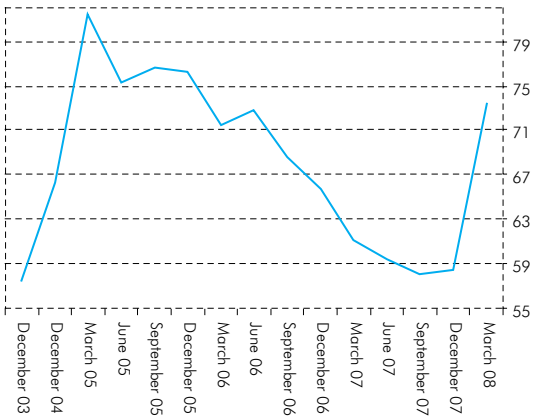
Source: Bank of Albania and FSD

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



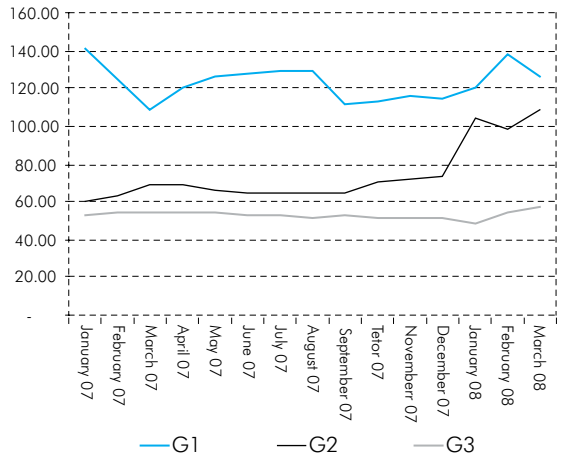
Source: Bank of Albania and FSD

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



Source: Bank of Albania and FSD

Chart 50 Interest expenditure to gross income by banking groups in %



Source: Bank of Albania and FSD

to group borrowing for foreign currency funds with low interest rates. However, despite the difficult liquidity situation in the international financial markets, the cut in the key interest rates for the other main currencies is less probable to occur owing to the presence of continuous inflationary pressures. Hence, the effect of these interest rates oscillations on the encouragement of foreign currency lending in developing countries will be more moderate.

In terms of banking groups, it is evidenced that the increase of the interest margin ratio to gross income (chart 48) in the first quarter of 2008 was higher for G2 banking group.

The ratio of non-interest expenditure to gross income has had a downward tendency during the entire year 2007, reflecting a decreasing exposure to operational risk. However, this ratio has increased considerably during the first quarter, in particular for banks falling under G2 group, owing to the increase of provisions due to the deterioration of credit portfolio.

5. TECHNOLOGICAL INFRASTRUCTURE

A safe and efficient payment system is an important factor in settling transactions in the financial markets and in the financial system's stability. The role of the Bank of Albania in the supervision of payment systems aims to encourage and support the smooth operation of payment systems and instruments, in particular in order to achieve:

a) Stability and credibility of the payment systems, while identifying, preventing and solving the plausible risks timely;
b) Transparency and efficiency of the payment systems' operational framework;
c) Preservation of public confidence in the payment instruments and services;
d) Promotion of automation in using and processing payment instruments and the inter-operationality of supporting systems.

The Bank of Albania owns and manages two payment systems in lek: *'Albanian Interbank Payment System – AIPS'*[10] *and 'Automated Electronic Clearing House System – AECH'*[11]. Both systems started to operate four years ago and they have been under constant improvement, aiming at preserving their efficiency. The technical operation characteristics indicate the safety and efficiency level. AIPS system has been accessible by the participants in 99.85% of its operational business hours; that is in 248 business days, the system has been unavailable for only 2 hours and 35 minutes due to technological or technical issues.

During the year 2007, the number of transactions processed in the AIPS system increased by 17% relative to 2006. While payments processed in the AECH system have almost doubled with a growth of 47% relative to 2006. The greatest number of transactions was concentrated in the last quarter of the year, in particular for the AECH system.

On average, there are around 183 transactions processed every day in the AIPS system, with a total value of 15.1 billion leks. Meanwhile, there are about 290 transactions in the AECH system with a daily total value of 48 million leks. The following tables show the number and total value of processed payments in the AIPS and AECH systems respectively, during 2007 vis à vis 2006:

Table 7 Transactions in the AIPS system

AIPS system	2006	2007
Number of transactions	38,793	45,480
Value of transactions (in billion leks)	3,376	3,745
Average value of transactions (in million leks)	87.01	82.34

Source: Bank of Albania

Table 8 Transactions in the AECH system

AECH system	2006	2007
Number of transactions	48,889	71,857
Value of transactions (in billion leks)	7.77	11.99
Average value of transactions (in million leks)	0.16	0.17

Source: Bank of Albania

In addition to the growing number of processed transactions in these systems, their value has seen considerable growth as well. The values of processed transactions in the AIPS and AECH systems in 2007 are reported to have grown by 11% and 56% relative to 2006. The total value of paid off balances in the payments systems during 2007 is almost four times as high as the value of GDP for the year[12].

In a more detailed fashion, the types of transactions processed in the AIPS system during 2007 and their relative share are presented in table 9:

Table 9 Types of transactions processed in the AIPS system

Type of payment	Volume		Value (in billion leks)	
	Absolute value	Relative share	Absolute value	Relative share
BoA transactions	7,467	16.4%	2,166.55	57.9%
Fund transfer, cash	8,455	18.6%	221.43	5.9%
Interbank payments	7,831	17.2%	664.49	17.7%
Payments to clients	16,506	36.3%	134.93	3.6%
Disbursements (net basis)	3,224	7.1%	8.99	0.2%
Disbursement of government securities	1,997	4.4%	548.46	14.6%
Total	45,480	100%	3,744.85	100%

Source: Bank of Albania

Vis à vis the same indicators of the last year, the number of payments to clients has a considerable share in the increase of the number of transactions.

With regards to the value of transactions, transactions initiated by the Bank of Albania and interbank transactions display high growth rates.

From the perspective of monitoring and assessing the payment systems' stability, it is also assessed the concentration level of payments in particular nods of the net. Concentration indicators for both AIPS and AECH systems are shown in tables 10 and 11:

Table 10 Concentration indicators for the AIPS system

	Transaction volume	Transaction value (in billion leks)
AIPS	Share/Total	Share/Total
3 banks[13]	33%	30%
5 banks	45%	39%
Total (absolute value)	45,480	3,745

Source: Bank of Albania

Table 11 Concentration indicators for the AECH system

	Transaction volume	Transaction value (in million leks)
AECH	Share/Total	Share/Total
3 banks[14]	50%	53%
5 banks	66%	65%
Total (absolute value)	71,587	11,997

Source: Bank of Albania

Banks have made use of the facility provided by the payment system for intra-day loan. Vis à vis 2006, the number and value of intra-day loan transactions have increased by 52% and 47%, respectively, in 2007.

Table 12 Intra-day loan facility

Intra-day loan facility	2006	2007
Number of transactions	444	675
Value of transactions (in billion leks)	146.32	217.51
Average value of transactions (in million leks)	329.55	322.24

Source: Bank of Albania

During 2007, 11 banks have made use of intra-day loan facility, which is 3 banks more than in 2006. Based on the analysis of transaction-concentration by banks, it is observed that 5 banks have actively used this instrument to manage the daily liquidity. Around 85% of total value of intra-day loan has been concentrated in only two banks.

Considering the payment system as a whole, the Bank of Albania offers both the clearance and disbursement services on a net basis of the value of processed cheques by banks. The use of paper-cheques as payment method has been declining during 2007 as well. Results show 45% less disbursed cheques and 65% less disbursed monetary value relative to 2006. The primary reason for this is the increasingly diminishing use of bank cheques.

Table 13 Cheque disbursement in AIPS

Cheque disbursement in AIPS	2006	2007
Number of disbursed cheques	994	544
Cheque value (in billion leks)	3.76	1.33

Source: Bank of Albania

5.1. ELECTRONIC PAYMENT INSTRUMENTS

Electronic payment instruments and the number of electronic-based transactions are increasing ever more. The number of cards in use, primarily debit/cash cards grew considerably during 2007, by 74% relative to 2006. The number of card-operating stations, mainly POS ones, have increased also, by 47% relative to their number at end-year 2006. With regards to geographical distribution of ATM and POS machines made available by banks, we can state that they are mostly concentrated in Tirana. However, it is worthy of note the increasing propensity for their market-stretch to other cities of Albania.

Table 14 Use of banking cards

Banking cards	2006	2007
Number of debit/cash cards	335,856	591,355
Number of credit cards	9,754	12,991

Source: Bank of Albania

Table 15 Number of ATMs and POSs

ATM and POS machines	2006	2007
Number of ATMs	309	443
Number of POSs	1,234	1,832

Source: Bank of Albania

Despite the considerable increase in the number of cards or machines for their use, the number and value of card-based transactions has increased more moderately by 17% and 26%, respectively. This is due to the fact that even though the number of cards in use has increased, card-holders do not have enough confidence and/or the right opportunity to use the card as a payment method. In other words, in proportion with the total population number[15], on average, only 1 in 5 persons is a card-holder and each holder carries no more than 16 transactions a year. Thus, the banking system is still in its first phase of using electronic payments instruments, vis à vis with reported statistics from regional countries.

Table 16 Debit cards

Debit cards	2006	2007
Number of transactions (in thousands)	8,053	9,249
Value of transactions (in billion leks)	47.81	59.04
Average value of transactions (lek)	5,940	6,390

Source: Bank of Albania

Table 17 Credit cards

Credit cards	2006	2007
Number of transactions (in thousands)	176	363
Value of transactions (in billion leks)	3.2	5.3
Average value of transactions (lek)	18,207	14,635

Source: Bank of Albania

There is a positive trend in the use of 'home banking' as an electronic payment instrument. Currently, there are three banks in Albania that offer this

type of service. The number of home banking transactions increased by 122% in 2007 relative to 2006, while the value of processed transactions increased by 188%. This is owed to the fact that two additional banks offered this type of service in 2007.

Table 18 Use of Home Banking

Home Banking	2006	2007
Number of transactions	19,096	42,447
Value of transactions (in billion leks)	16.83	48.49
Average value of transactions (lek)	881.34	1,142.36

Source: Bank of Albania

5.2. OVERSIGHT OF PAYMENT SYSTEMS

'Oversight of payment and settlement systems is a central bank function whereby the objectives of safety and efficiency are promoted by monitoring existing and planned systems, assessing them against these objectives and, where necessary, inducing change'[16].

During 2007, the work of the Bank of Albania with regard to this function was focused on:

The improvement of the regulatory framework on the payment systems, which relates to the review of some existing regulations aiming at improving them in line with the new developments in the payments' market and with the EU directives and the best standards of central banks;

The formulation of the document 'Payment systems oversight policy', which was concluded in the first months of 2008. This document seeks to provide for the legal basis, oversight objectives, the assessment of risks encountered in the payment systems and the application of the oversight through monitoring and analyses. This document provides for the consistency of the payment systems with the core principles for systemically important systems and for the cooperation with other departments in implementing the oversight policy.

The upgrade of payment systems infrastructure and safety assessment. During 2007 several new systems' versions were applied, which helped to improve and modernize them further. In addition, in co-operation with the Ministry of Finance was designed an interface for the electronic communication between the AIPS and AECH systems and the Treasury programme of the Ministry of Finance. This electronic connection between the systems will accelerate the communication and settlement of payments initiated by the Ministry of Finance and will reduce the operational risk stemming from the manual entry of operations in the system. Special attention has been paid to the assessment of safety and efficiency in the systems. For assessment purposes, tests were carried out for the system's safety (Back-up for AIPS and AECH systems). The construction of a back-up in distance would fully fulfil the basic principle for the safety and efficiency of the system, which remains to be accomplished in the future.

The collection, processing and publication of statistics on the payment instruments in Albania. We have focused on collecting data and enhancing the quality of reporting from banks, aiming at unifying the terms and reports. In the following, the focus will be on reviewing the existing methodology of payment instruments' reporting.

In order to further complete the regulatory framework of a modern payment system, a special law on the payment system is required to be drafted. During the year 2008, the Bank of Albania will start working on this aspect in co-operation with other institutions and the banking sector.

6. STRESS-TEST ANALYSIS

Stress-test analysis indicates that the banking sector is by and large protected from the direct exchange rate risk, direct interest rate risk and the indirect credit risk through changes in the interest rates. Direct credit risk and the indirect exchange rate risk through foreign currency lending are handled satisfactorily by the banking sector, while for some particular banks these risks are quite significant.

The application of the stress test methodology on banks' balance sheet helps to identify the plausible difficulties the Albanian banking system could be faced with as a result of extreme but plausible shocks. Among the possible risks are considered the exchange rate risk, credit risk, interest rate risk and the indirect credit risks through foreign currency lending and interest rates changes. Box 5.1 provides more details related to the stress test methodology.

Each of the above mentioned risks may be displayed deeper or less deeper based on the features characterizing our banking system. Presently, most lending is in foreign currency, mostly in euro and in US dollar (about 73%[17]). Exchange rate risk that banks may be faced with in relation to the loans they grant is relatively limited, given that a considerable part of deposits in the banking sector is in foreign currency and the ratio of foreign currency-denominated assets against foreign currency liabilities is 100%. Thus, given the considerable share of foreign positions on both sides of the balance sheet, the direct exchange rate is less significant. However, direct credit risk is present in foreign currency lending.

Credit risk is among the most crucial risks our banking system is faced with. This risk arises from the possibility that the lender losses all or a considerable part of lent funds as a result of the borrowers' incapacity to pay off the loan. This type of risk is measured through the percentage of non-performing loans against total loans. Credit has grown considerably during the last years. Currently, the ratio of credit to total assets of the banking system is 41%.

Interest rate risk is another risk the banking system is exposed to. It relates with the impact the changes in the interest rate for the lek, euro and the US

dollar have on the cost of funding sources and on the investments' value and ultimately, on the capital adequacy rate and the regulatory capital.

Exchange rate risk relates with the impact that changes in the exchange rate have on the financial outcome of an institution with an open foreign exchange position.

The following presents the outcome of the stress tests carried out for each of the risks mentioned above. The analysis considers the banking sector in general, G1, G2 and G3 banking groups and each bank. Table 19 summarizes the outcome of this analysis.

6.1. EXCHANGE RATE RISK

Exchange rate risk assesses the effect that arises from the appreciation/ depreciation of the domestic currency against the two main foreign currencies (USD and EUR) on the adequacy rate and the regulatory capital.

An assumed depreciation of the US dollar to the lek by 50% would decrease the system's capital adequacy rate by 0.3 percentage points. The latter marks a decrease for most of the banks, but not below the minimum required level of 12%. Even in the case of a shock bigger than 100%, the capital results adequate to protect banks from the direct exchange rate risk. In terms of banking groups, capital adequacy rate for G1, G2 and G3 banking groups drops by 0.5, 0.2 and 0.3 percentage points respectively, which indicates insignificant vulnerability to this risk.

In case of a depreciation of the euro to the lek by 50%, capital adequacy rate drops by 0.3 percentage points, remaining above the minimum required level and indicating that the banking sector remains protected against the direct risk of the euro exchange rate change[18]. In terms of banking groups by size, capital adequacy rate for G1, G2 and G3 banking groups has dropped by 1, 0.1 and 0.3 percentage points respectively, remaining above the required level.

In conclusion, the system's capital adequacy rate for G1, G2 and G3 banking groups results to be above the minimum required level even after having applied a depreciation of the US dollar or the euro of higher than 50%. The banking system in general and particular banks are by and large assessed as being protected against the direct exchange rate risk, given that the shock assuming a depreciation of 50% is less probable to occur.

6.2. INTEREST RATE RISK

This scenario tests how the regulatory capital and capital adequacy rate are affected by the change in the funding cost and in the investments' value (assets and liabilities) as a result of a change in the interest rate. The shock is applied

on the three currencies, the lek, the US dollar and the euro. The average weighted interest rate of new deposits and loans in the banking system is considered as the reference interest rate. We add a given value to the current interest rate value for the three currencies, which is a relatively large shock[19] applied on the interest rate.

When the interest rate of the lek increases by 3 percentage points, capital adequacy rate results to decrease by 1.7 percentage points; however, remaining above the required level of 12%. In terms of banking groups, G3 recorded the highest decrease of the capital adequacy rate by about 2.2 percentage points, although remaining above the required level. For individual banks, this rate falls below the required level of 12% even when lighter and consequently more plausible shocks are applied. The minimum level of the capital adequacy rate for a bank is affected if the rise in the lek interest rate is 1.25 percentage points. We can conclude that a shock, which is less likely to occur given its extent, does not affect the indicators of the regulatory capital adequacy. However, individual banks display an increasing exposure to the lek interest rate risk.

The second shock tests the influence that an increase by 3 percentage points in the current interest rate of the *US dollar*, which reaches 6.11% (from 3.11% at the end of December 2007), has on the banking sector's regulatory capital.

According to the test results, capital adequacy rate for the banking system has dropped by 0.1 percentage points after the shock. G1 and G3 banking groups were most affected recording a drop in the capital adequacy rate by 0.2 percentage points. However, it remains above the minimum required level. Individual banks result more affected even by lighter shocks of the interest rate increase; the minimum level of the capital adequacy rate for each bank is affected if the rise in the US dollar interest rate is 2.5 percentage points.

The third shock tests the influence that an increase by 3 percentage points in the current interest rate of the *euro,* which reaches 7.6% (from 4.6% in March 2008), has on the system's regulatory capital.

According to the test results, the banking system's regulatory capital reduces by about 1.2 billion leks while the capital adequacy rate drops by 0.4%, which is above the minimum required level. In terms of banking groups, capital adequacy rate for G1 increases by 0.2 percentage points, for G3 reduces by 0.6 percentage points while it does not change for G2. Worth to note is that the capital adequacy rate does not fall below the required rate for any of the three banking groups.

In conclusion, the capacity of the banking sector's regulatory capital to handle the interest rate risk is adequate. The application of a relatively large shock on the average interest rate of lek, US dollar and the euro indicates that the capital adequacy rate remains above the required level of 12%. However, there is a moderate risk for individual banks when the interest rate in lek and the US dollar changes.

6.3. CREDIT RISK

The test of credit risk assumes the increase of non-performing loans by 100% and considers its impact on the regulatory capital of the entire sector and of individual banks.

The outcomes show that the regulatory capital of the banking sector has declined by about 5 billion leks and the capital adequacy rate has reduced by 1.5 percentage points, remaining above the minimum required level. In terms of banking groups, capital adequacy rate reduces by 2.2 and 1.3 percentage points, respectively, for G2 and G3 banking groups. Even though the rate in these banking groups is in all cases above the minimum required level, for individual banks the adequacy rate falls below 12%, implying that credit risk is significant to them. When a bigger shock is applied, for instance an increase in non-performing loans by 150%, capital adequacy rate results to be an issue for the same banks as in the case above.

In conclusion, the increase of non-performing loans by 100% decreases the capital adequacy rate below the required level for some individual banks, while the decrease of this rate for the banking sector is relatively high, though not below the minimum required level.

6.4. INDIRECT CREDIT RISK THROUGH FOREIGN CURRENCY LENDING

This scenario tests the influence of changes in the exchange rate on the change in the level of non-performing loans in foreign currency when the borrowers do not have their income in foreign currency. Currently, foreign currency-denominated loans to borrowers that do not have their income in the currency of the loan they have applied for account for about 50% of total loans. This impact is measured through the regression equation, which relates the relative change of annual income with the change in the ratio of non-performing loans in foreign currency. The change in annual income relates to the change in the exchange rate, through the leverage ratio. Hence, the ratio of non-performing loans is expressed based on the change in the exchange rate.

Hence, the depreciation of the lek against the euro by 50% affects the decrease of the capital adequacy rate in the banking system by 1.5 percentage points. In terms of banking groups (G1, G2 and G3), the decrease of this rate is 0.6, 2.5 and 1.3 percentage points, respectively, which is above the minimum required. However, worth to note is that for individual banks the indirect exchange rate risk is relatively high. In case of a 10% depreciation, there are banks whose capital adequacy falls below the minimum required level.

The second shock, which consists in the depreciation of the lek against the US dollar by 60%, affects the reduction of the banking system's capital adequacy rate by 0.2 percentage points and the regulatory capital by around

0.6 billion leks. Individual banks and various groups display inconsiderable differences following the application of this shock, except for G1 banking group. The decrease in the capital adequacy rate for this group is by 0.8 percentage points which is above the required level. The application of bigger shocks provides the same outcome.

In conclusion, the entire Albanian banking system does not display high vulnerability to the indirect exchange rate risk both for the euro and the US dollar. However, for individual banks, the indirect risk of the lek depreciation against the euro is relatively high.

6.5. INDIRECT CREDIT RISK THROUGH CHANGES IN THE INTEREST RATES

Borrowers' creditworthiness is closely related with the changes in the interest rates of the respective foreign currencies. The changes in the interest rates do not only reduce the bank's capital when there is a wide gap between the assets and liabilities which are affected by the interest rate, but they also increase the cost of credit for the borrower. This increase leads to the deterioration of borrowers' creditworthiness and consequently to the increase of bank's non-performing loans portfolio. This test considers the influence of interest rates shocks on the credit portfolio (for the euro, US dollar and the lek).

The increase by 5 percentage points to 12.8% of the current (average) interest rate for the euro-denominated credit would reduce the system's adequacy rate by 0.8 percentage points which would result above the required level. In terms of banking groups, this effect is more considerable for banks falling under G1, which suffer a drop by 1.8 percentage points, while G2 and G3 banks experience a drop by 0.8 and 0.7 percentage points, respectively, which is above the minimum required level. However, these effects have high variance for individual banks. The regulatory capital is insufficient for some banks to handle shocks which are larger than an increase of the credit interest rate by more than 1%.

The second shock assumes the increase of the current (average) interest rate for the USD-denominated credit from 6.9% to 11.9%. This rise would increase the liabilities/debt of all USD borrowers by 0.39% and consequently, the system's non-performing loans portfolio would increase by approx. 3.9%. The banking system's regulatory capital would reduce by 196 million leks and the capital adequacy rate would slightly fall by 0.1 percentage points. In terms of banking groups, the effect of this shock on the capital adequacy rate is almost inconsiderable.

The third shock assumes the increase of the current interest rate for the lek-denominated credit by 5 percentage points to 12.3%. This scenario would reduce the banking system's capital adequacy rate by 0.2 percentage points. In terms of banking groups by size and capital origin, capital adequacy rate does not change considerably from this shock.

In conclusion, the increase by 5 percentage points of the current interest rate for credits denominated in lek, US dollar and euro does not have significant effects on the capacity of the banking system's regulatory capital to cover the losses stemming from the increased cost of credit to banks' clients. However, for individual banks, an increase of the interest rate for euro-denominated credit more than 1% would require the increase of the regulatory capital to handle the indirect interest rate risk.

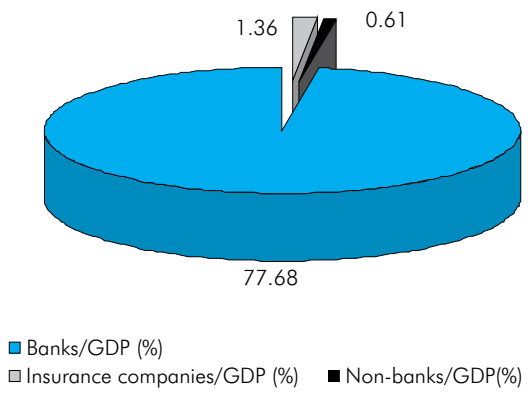
Table 19 Summarized results of stress test analysis

		Shocks	Banking sector	Banking groups by assets' size			Individual banks
				G1	G2	G3	
Credit risk		Increase of non-performing loans by 150%	No risk	No risk	No risk	No risk	Risk
		Increase of non-performing loans by 100%	No risk	No risk	No risk	No risk	Risk
Direct interest rate risk	1. ALL	Increase of ALL interest rate by 3%	No risk	No risk	No risk	No risk	Risk
		Increase of ALL interest rate by more than 1.25%	No risk	No risk	No risk	No risk	Risk
	2. USD	Increase of USD interest rate by 3%	No risk	No risk	No risk	No risk	Risk
		Increase of USD interest rate by more than 2.5%	No risk	No risk	No risk	No risk	Risk
	3. EUR	Increase of EUR interest rate by 3%	No risk	No risk	No risk	No risk	No risk
Direct exchange rate risk	1. USD	Depreciation of USD against ALL by 50%	No risk	No risk	No risk	No risk	No risk
	2. EUR	Depreciation of EUR against ALL by 50%	No risk	No risk	No risk	No risk	No risk
Indirect interest rate risk	1. ALL	Increase of the interest rate of lek-denominated credit by 5%	No risk	No risk	No risk	No risk	No risk
	2. USD	Increase of the interest rate of US dollar-denominated credit by 5%	No risk	No risk	No risk	No risk	No risk
	3. EUR	Increase of the interest rate of euro-denominated credit by 5%	No risk	No risk	No risk	No risk	Risk
		Increase of the interest rate of euro-denominated credit by more than 1%	No risk	No risk	No risk	No risk	Risk
Indirect exchange rate risk	1. USD	Depreciation of ALL against USD by 60%	No risk	No risk	No risk	No risk	No risk
	2. EUR	Depreciation of ALL against EUR by 50%	No risk[20]	No risk	No risk	No risk	Risk
		Depreciation of ALL against EUR by more than 10%	No risk	No risk	No risk	No risk	Risk

7. NON-BANK FINANCIAL INSTITUTIONS AND INSURANCE COMPANIES

Non-bank financial institutions include all financial institutions not defined as 'bank' according to the law 'On banks in the Republic of Albania'. Except for insurance companies, the rest of non-bank financial institutions have an almost negligible share in the system's total. Hence, the business risks of these institutions are not systemically important. They are represented by non-bank financial institutions licensed by the Bank of Albania and other. As of end the last quarter, their financial situation was characterized by a decreased activity relative to the previous quarter, decreased capitalization of their activity and an insignificant increase of non-performing assets. Three foreign companies entered the insurance market through the purchase of the majority of capital and other co-operation modes with the existing domestic insurance companies. Assets of insurance companies have a relatively small share in the assets of the financial system. Insurance sector displays a positive performance in terms of soundness indicators, more specifically capital adequacy, assets' quality and efficiency in capital use for 2007. However, the size of this sector curtails considerably its capacity to financially handle the financial damages that may be claimed due to the difficulties the rest of the financial system may be faced with.

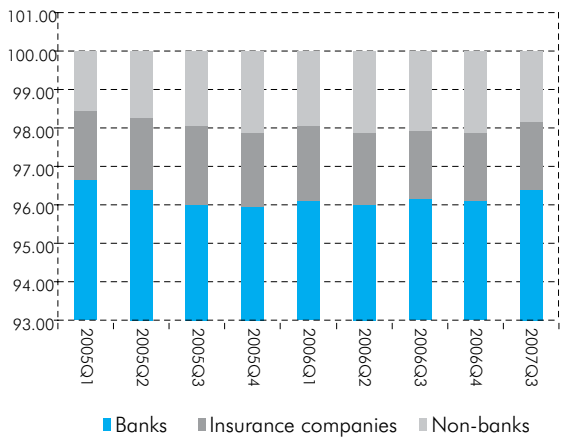
Chart 51 Share of financial system's components to GDP (2007)



Non-bank financial institutions by and large act as financial intermediators that do not accept deposits from the public. In official statistics, they are classified as other financial intermediators excluding insurance companies and pension funds. As of end-year 2007, 7 non-bank financial institutions licensed by the Bank of Albania and 3 other institutions were operating in the market.

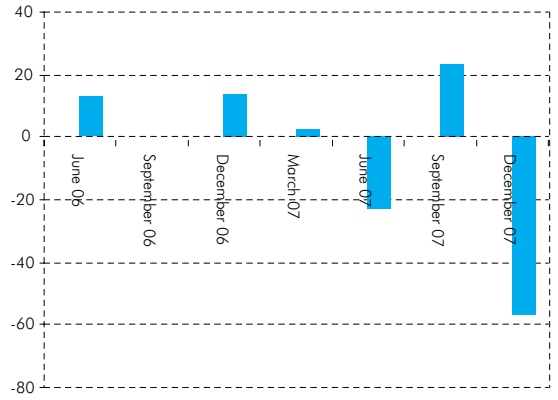
In general, non-bank financial institutions (excluding insurance companies) have a negligible share in the GDP, accounting for nearly 0.61% for 2007 and only 1.83% of the financial system's assets. Meanwhile, the banking sector's assets have the main share in the GDP, accounting for 77.6%, while insurance companies share about 1.36% of the GDP (charts 51 and 52).

Chart 52 Share of financial system's components in %



Non-bank financial institutions' assets dropped by about 56% in the last quarter of 2007 relative to the previous quarter. Operations with clients and cash transactions, deposits and accounts, being the main items in their balance sheets, provided the main contribution to this drop. Chart 53 shows the

Chart 53 Change in assets of non-bank institutions in %



change in the assets of these institutions by quarter of 2006-2007.

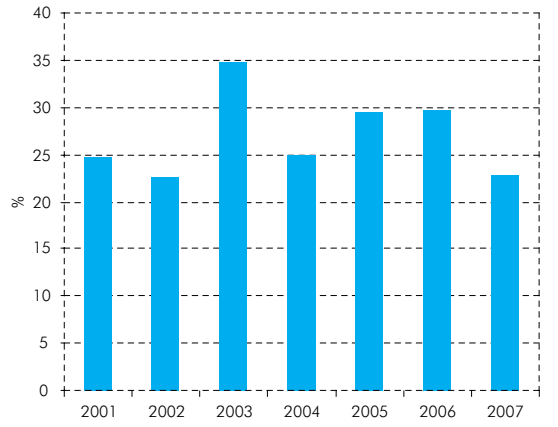
Business capitalization of non-bank institutions, expressed as the percentage of capital accounts with total assets, was about 44% in the last quarter of 2007, dropping by 5 percentage points relative to the third quarter of the same year. With regard to the assets' quality for the last quarter of 2007, credit portfolio accounted for about 83% of total assets. Non-performing loans accounted for 1.17% of their total loans, increasing slightly by 0.23 percentage points relative to the third quarter of 2007.

The ratio of non-financial assets to total assets is another indicator for assets' quality. In the last quarter of 2007 it accounted for about 2%, decreasing by 3.7 percentage points relative to the third quarter of 2007.

Interest income represent the main source of income for these institutions. As of end the last quarter of 2007, they shared about 82.2% of total income. Income from commissions, which shared about 9.6% of total income in the last quarter of 2007, are another source of income. Income from interests and commissions have shown a significant downward tendency in the last quarter relative to the previous quarter by 22.3% and 74.9%, respectively.

Based on the analysis of these indicators, it may be underlined that the activity of non-bank financial institutions has slowed down in the last quarter of 2007 relative to the previous one.

Chart 54 Ratio claims/premiums in the total insurance market



Source: AFSA, Albanian Financial Supervisory Authority

Insurance sector has large development potentials although a lot remains to be done. The entry of three foreign companies is expected to encourage the further development of this sector. They have chosen to position themselves in the Albanian market, where 11 insurance companies are currently operating, through capital acquisition and other co-operation ways with the existing insurance companies. Out of 11, only 3 insurance companies offer life insurance products.

Assets of insurance sector grew by about 17% in the third quarter[21] of 2007 relative to the same period the previous year. According to some estimations, total premium income account for 0.6% of the GDP and their total assets account for about 1.4% of the GDP. Insurance companies' assets have a relative small share in total assets of the financial system (about 1.8% in the third quarter of 2007). Premium income grew by 30.6% in 2007 relative to

the previous year and totalled 5.9 billion leks (out of which 93% is represented by non-life market). The ratio claims/premiums fell by 6 percentage points in 2007 relative to the year 2006 (chart 54).

Business capitalization, which is measured as the percentage of capital to total assets, is another important soundness indicator which shows the capacity of the sector to handle the losses from possible risks. Capitalization was 52.4% in the third quarter of 2007, increasing by 5.4 percentage points relative to the same period the previous year. In addition to this indicator, there is another indicator which is measured as the percentage of capital to technical reserves. In the third quarter of 2007, it accounted for 116.5%, increasing by 20.7 percentage points. Technical provisions, which grew by about 50%, are another element of the system's capacity to pay.

With regard to return on equity (ROE), it reached 19.7% in the third quarter of 2007, which is about 2.1 percentage points higher than the previous year.

In conclusion, insurance sector shows a positive performance in terms of soundness indicators, more specifically, business capitalization, assets' quality and efficiency in capital use for 2007. However, the size of this sector curtails considerably its capacity to financially handle the financial damages that may be claimed due to the difficulties the rest of the financial system may be faced with.

ANNEX 1

Table 20 Losses stemmed from the mortgage loans' crisis in the financial sector in some countries

Country/Region	Total reported losses	Estimated losses on US subprime/ Alt-A loans	Estimated losses on ABS	Estimated losses on CDOs	Estimated losses on SIVs	Total estimated subprime-related losses	Remaining subprime-related losses expected
Europe	80	16	27	53	27	123	43
Of which: United Kingdom	19	16	1	12	11	40	22
Switzerland	23	0	7	15	1	23	0
Scandinavia	0	0	0	0	1	1	1
Euro area	33	0	10	20	15	45	12
Unallocated	5	0	9	6	0	14	9
USA	95	29	12	90	13	144	49
Total	193	44	50	153	40	288	95

Source: Goldman Sachs; UBS; and IMF staff estimates
Note: ABS = Asset-backed securities,
CDO = Collaterized debt obligation,
SIV = Structured investment vehicles,
ALT-A = Mortgage loans with potential higher risk than performing loans, but lower than subprime loans.

Box Macroeconomic risks since October 2007

Table 21 Changes in risks and conditions (Since October 2007)

Conditions and Risks	Changes since October 2007 - GRSR
Monetary and Financial Conditions	↓
Risk Appetite	↓↓
Macroeconomic Risks	↑↑↑
Emerging Market Risks	↑↑
Credit Risks	↑↑↑
Market and Liquidity Risks	↑

Source: IMF, 'Assessing risks to global financial stability'

Monetary and Financial Conditions – The availability and cost of funding linked to global monetary and financial conditions.

Risk Appetite – The willingness of investors to take on additional risk by increasing exposure to riskier asset classes, and the consequent potential for increased losses.

Macroeconomic Risks – Macroeconomic shocks with the potential to trigger a sharp market correction, given existing conditions in capital markets.

Emerging Market Risks – Underlying fundamentals in emerging markets and vulnerabilities to external risks. These risks are conceptually separate to macroeconomic risks, as they focus on emerging markets only.

Credit Risks – Changes in and perceptions of credit quality that have the potential to create losses resulting in stress in systemically important financial institutions.

Market and Liquidity Risks – The potential for instability in pricing risks that could result in broader spillovers and/or mark-to-market losses.

ENDNOTES

[1] The primary objective of the ECB's monetary policy is to maintain price stability. The ECB aims at inflation rates of below, but close to, 2% over the medium term. On the other side, the Federal Reserve and the FOMC are charged with the job of seeking "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." This change in objectives sets different responsibilities for these two central banks and defines their actions in the context of monetary policy.

[2] According to information available until 14 February 2008.

[3] A recent assessment of the financial sector's losses from the financial crisis is provided in Annex 1.

[4] Information and the charts' data are obtained from ECB's assessments and other published materials.

[5] Hereinafter they will be referred to as LCBG.

[6] IFRS: International Financial Reporting Standards.

[7] In terms of total assets, banks are divided into groups: G1 includes banks sharing 0-2% of total banking sector's assets, G2 includes banks sharing 2-7% of total banking sector's assets and G3 includes banks sharing more than 7% of total banking sector's assets.

[8] Weighted-average of credit distribution is measured according to reported maturity items. For each interval is considered its middle point. In more concrete terms, for the interval including up to 1 month loans, average duration is 0.5 months; for 1-3 months loans, average duration is 2 months; for 3-6 months loans, average duration is 4.5 months; for 6-12 months loans, average duration is 9 months; for 1-5 years loans, average duration is 36 months, for over 5-year loans, average duration is 10 years or 120 months (given that the largest part in this segment is represented by mortgage loans of initial maturity term of 15 years).

[9] The increase of the ratio in the first quarter of 2008 owes to a methodological change.

[10] Real-Time Gross Settlement System (RTGS), which is assessed against the Core Principles for Systemically Important Payment Systems (CPSIPS).

[11] Net basis settlement system.

[12] Source: Country Report IMF – February 2008.

[13] Banks having the largest share of payments in number and value, out of 17 banks participant in AIPS system.

[14] Banks having the largest share of payments in number and value, out of 15 banks participant in the AECH system.

[15] INSTAT – Number of population, January 2005.

[16] According to the definition of the Report of the Committee on Payment and Settlement Systems, "Central Bank oversight of payment and settlement systems" May 2005, Bank for International Settlements.

[17] The data refer to March 2008.

[18] The shock application of EUR appreciation against the ALL raises the regulatory capital adequacy rate.

[19] Another negative shock was applied on each currency, but in no case it resulted problematic to the capital adequacy rate.

[20] Excluding Raiffeisen Banks, the system's capital adequacy rate falls to the minimum required level.

[21] The data on the balance sheets of insurance companies are not made available yet.