4. FINANCIAL SYSTEM

The share of total financial system assets to Gross Domestic Product (GDP) increased. Banking sector provided the main contribution in this regard.

Financial system performance indicators, in terms of capitalization, profitability, liquidity and asset quality, remain at good levels.

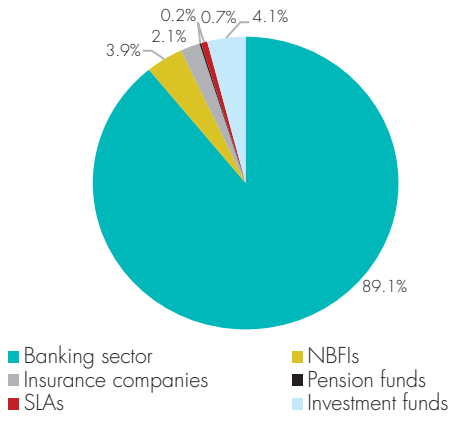
The share of total financial system[24] assets to Gross Domestic Product (GDP) increased to 107% from 104.4% at the end of 2019 H1, but did not change compared with the level of the previous year. The activity of the banking sector and non-bank financial institutions supported the increase of financial system assets, while investment funds assets registered a contraction.

During the period, the share of the banking sector in GDP increased by 2.5 p.p., at 95.5%, whereas the share of the non-bank sector increased by 0.3, at 11.7%. Financial system performance indicators, including capitalization, profitability, liquidity and asset quality, remain at good levels.

Table 5 Share of financial system segments in GDP over the years.

Licensing and Supervising Authority	Financial system	2011	2012	2013	2014	2015	2016	2017	2018	2019
Bank of Albania	Banking sector	88.1	92.1	94.8	97.6	97.3	100.5	99.4	96.0	95.5
	NBFIs	2.7	2.7	2.7	3.0	2.9	3.0	3.1	3.5	4.2
	SLAs and Union	0.8	0.8	0.7	0.8	0.8	0.6	0.6	0.6	0.7
Albanian Financial Supervisory Authority	Insurance compnaies	1.5	1.6	1.7	1.9	2.1	2.1	2.1	2.1	2.2
	Pension funds	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.2	0.2
	Investment funds		1.2	3.9	4.8	5.0	4.7	5.0	4.5	4.3
Financial intermediation		93.1	98.6	103.8	108.2	108.0	111.0	110.3	106.9	107.2

Chart 34 Share of financial system segments to total assets of the financial system, December 2019



Source: Bank of Albania and Albanian Financial Supervisory Authority.

[24] *Financial system is composed of banking sector and non-banking sector (non-bank financial institutions, savings and loan associations, insurance companies, pension funds and investments funds). The database for insurance companies is for the period 2019 Q3, while for the other segments of the end of year 2019.*

4.1 BANKING SECTOR

4.1.1 MAIN DEVELOPMENTS IN THE BANKING SECTOR

During the period, banking sector assets expanded by around 4%, while compared with the previous year assets' increase is around 1.5%. The reported value of assets increased by ALL 52 billion during the period, reaching around ALL 1,476 billion. The main contribution in assets' increase came from the expansion of securities investments by ALL 38 billion and the reduction of reserve funds by around ALL 10 billion. Lending and interbank activity affected positively assets performance due to the expansion of long-term loans and deposits in banks, credit institutions and other financial institutions.

Deposits and own funds remain the main funding sources of the banking sector's activity. The dependence on foreign funding sources remains limited, and records a further fall. The lowering impact of the exchange rate appreciation decreased considerably.

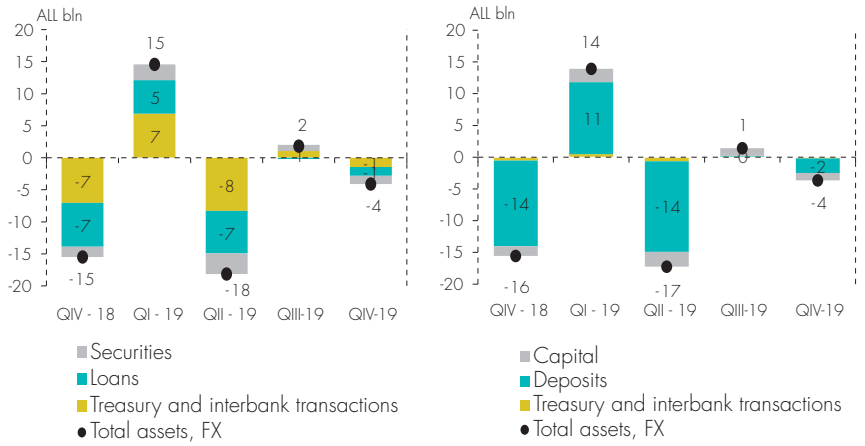
Table 6 Structure of banks' balance sheets and annual change, December 2019.

Asset	% of assets	Annual change,%	Liability	% of liabilities	Annual change,%
I Treasury and interbank transactions	31.9	-0.9	I. Treasury and interbank transactions	6.0	9.7
II Customer transactions (credit)	38.9	-0.8	II Customer transactions (deposits)	80.6	1.1
Of which: public sector	2.1	8.2	Of which: public sector	1.9	1.3
Of which: public sector	36.8	-1.3	Of which: public sector	78.8	1.1
III Securities transactions	27.4	5.1	III. Securities transactions	0.2	-63.6
IV Created Reserve funds	-1.9	-33.9	IV Other liabilities	0.9	-7.5
V. Other*	3.8	-5.6	V. Permanent sources	12.1	4.0
			Of which: Subordinated debt	1.0	3.5
			Of which: Shareholders' equity	10.5	4.2
Total assets	100	1.5	Total liabilities	100	1.5

Source: Bank of Albania.
** The item "Others" in the balance sheet refers to "Other assets", "Sustainable assets" and "Calculated interest".*

During the period, the statistical impact of the exchange rate on the value of foreign currency balance in banks decreased significantly compared with the previous two six-months, but has continued to affect the decline of reported values

Chart 35 The exchange rate effect on the lek equivalent amounts of main items in assets (left) and liabilities (right)

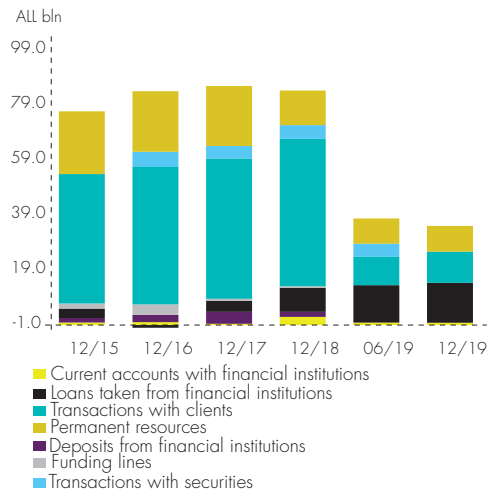


Source: Bank of Albania.

for foreign currency transactions. Foreign currency assets and liabilities in the banking sector constituted 53% and 51%, respectively of total balance, with a slight increase compared with 2019 H1. Regarding assets, the exchange rate has affected the main activities of banks in the same measure, while regarding liabilities, almost the entire statistical impact of the exchange rate (of ALL -2 billion) is reflected in the equivalent value in lek of foreign currency deposits.

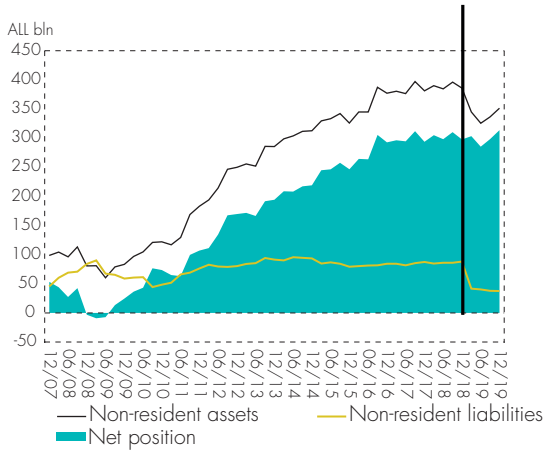
Deposits and own funds continued to be the main funding sources of banking sector's activity, accounting for over 90% of total liabilities and this structure did not register significant changes during the period. Reliance on external funding sources remained limited and declined further during the period. Liabilities to non-residents in the form of deposits and REPO purchased/sold securities continued to decrease. At the same time there has been an increase of deposits in the form of interbank deposits in non-residential entities and securities investments, which has affected the expansion of net credit position of the banking system. At the end of the period, claims against non-residents were 24% of total assets while liabilities were lower than 3% of total balance sheet. Net credit position expanded in both absolute and relative terms, reaching around 21.3% of total balance from 20% in the previous period.

Chart 36 Structure of non-resident liabilities



Source: Bank of Albania

Chart 37 Net position with non-residents



*The vertical black line (right) reflects the period of transformation of the NCB branch in subsidiary.

Source: Bank of Albania

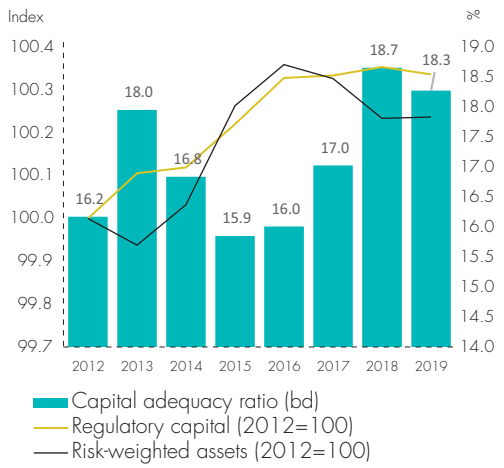
The faster growth of risk-weighted assets compared with the growth of regulatory capital, affected the slight fall pf capital adequacy ratio. Systemically-important banks, as a group, show high indicators of activity capitalisation. The performance of financial leverage indicator affirms that the sector's capitalisation shows at pleasant levels.

4.1.1.1 Capitalisation of activity

The banking sector continues to be characterized by high level of capitalisation indicators and at the level of individual banks no bank of the sector result with an adequacy ratio below the regulatory minimum of 12%. At end-2019, the Capital Adequacy Ratio registered 18.3% from 18.5% in July 2019 and 18.7% in the previous year.

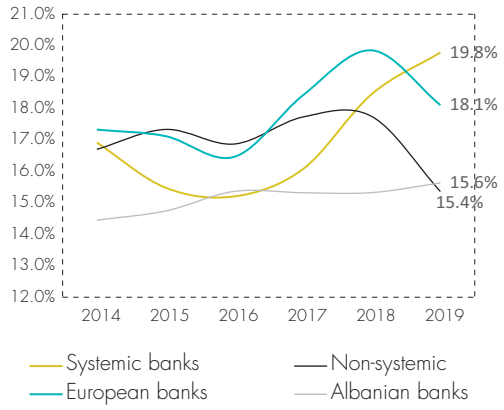
Banks classified as with systemic importance and banks with European capital have the highest level of Capital Adequacy Ratio. The decline of the number of banks from 14 in 2019 H1 to 12 at the end of the year was reflected in the changes in the distribution of Capital Adequacy Ratios according to certain ranges. Currently, 9 out 12 banks have a Capital Adequacy Ratio over 15% and there also an increase of the share of banks with Capital Adequacy Ratio in the ranges 18%-20% and over 20%.

Chart 38 Capital Adequacy Ratio



Source: Bank of Albania.

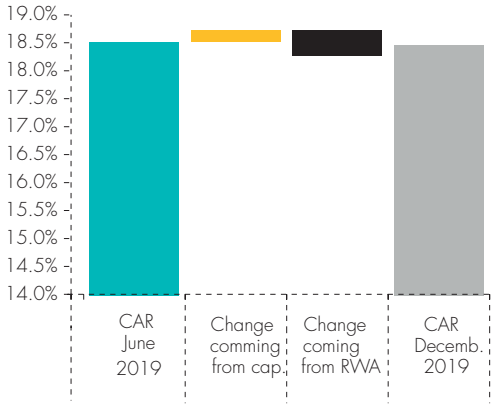
Chart 39 Capital Adequacy Ratio for groups by size and by origin of capital



Source: Bank of Albania.

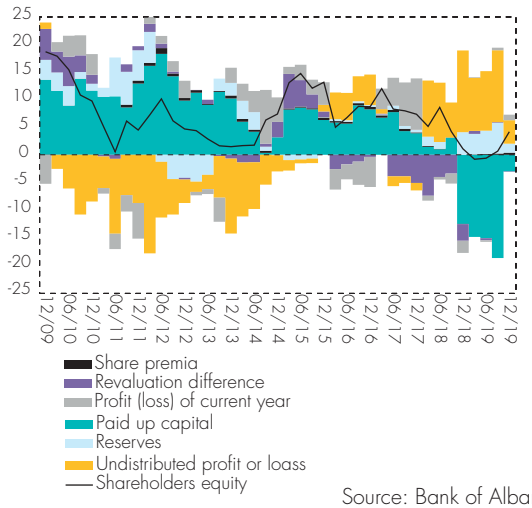
In the performance of the Capital Adequacy Ratio, the negative impact of the increase of risk-weighted assets was higher compared with the positive impact of the increase of regulatory capital. During the period, regulatory capital increased slightly at ALL 143 billion, giving an upwards impact of 0.2 p.p. to Capital Adequacy Ratio. Its performance was supported by the increase of reserves and retained profits and by the positive performance of financial result. These factors together mitigated the impact of the structural changes in banks' ownership, which resulted in a slight decline of paid capital. On the other hand risk-weighted assets reached around ALL 790 billion or ALL 20 billion more than in July 2019, as result of increased exposure to trade companies (corporations). The increase of this factor gave a declining contribution of 0.5 p.p. to Capital Adequacy Ratio.

Chart 40 Contribution of capital adequacy items (in p.p.).



Source: Bank of Albania.

Chart 41 Annual contribution in capital increase by component instruments (in p.p.)

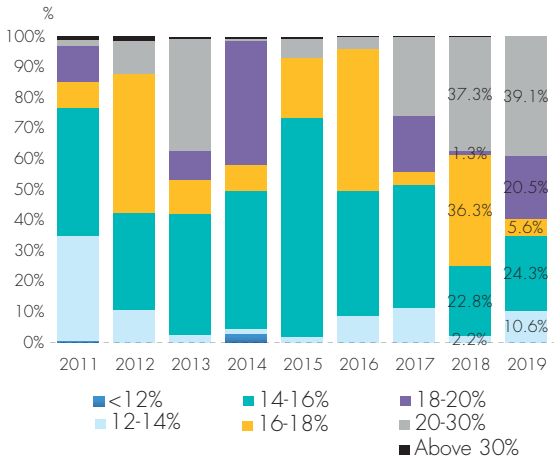


Source: Bank of Albania.

The structure of risk-weighted assets by risk has not changed and continues to be dominated by risk-weighted assets for credit risk (88%). Risk-weighted assets for market and operational risks expanded by ALL 5 billion and ALL 2 Billion, respectively, compared with the previous six-month, but maintained their shares in total risk-weighted assets of 2% and 10%, respectively.

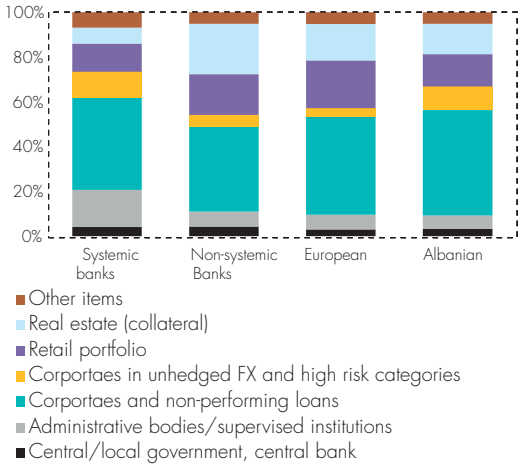
Compared with the previous two six-months, no significant changes have been reported in the distribution of weighted assets for credit risk, both for the sector as a whole and for banks grouped by systemic importance and origin of capital. Banks classified as with systemic importance register high exposure for credit to trade companies (corporations), non-performing loans, and loans to other institutions supervised by the bank of Albania and the Albanian Financial Supervisory Authority.

Chart 42 Banking sector asset distribution by Capital Adequacy Ratio



Source: Bank of Albania.

Chart 43 Credit classes' exposure of banks by systemic importance and origin of capital for December 2019

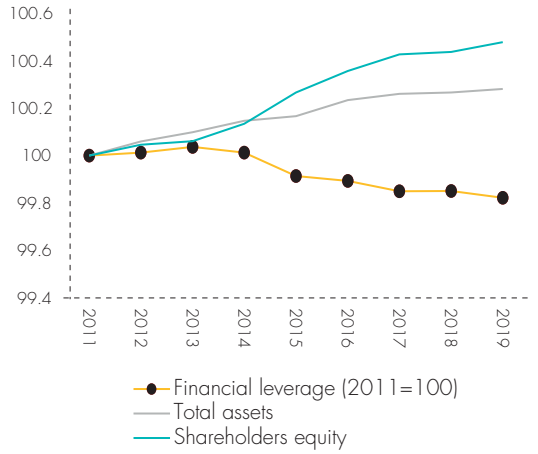


Source: Bank of Albania.

Other banks (non-systemic) register exposure towards real estate (collateral) as well, in addition to the exposure to corporation loans. By origin of capital, banks with European capital have a higher exposure towards the classes "corporation loans and non-performing loans" and "retail portfolio", while banks with domestic capital in addition to the above-mention exposures register also exposures towards portfolios classified with higher risk and uncovered from exchange rate fluctuations.

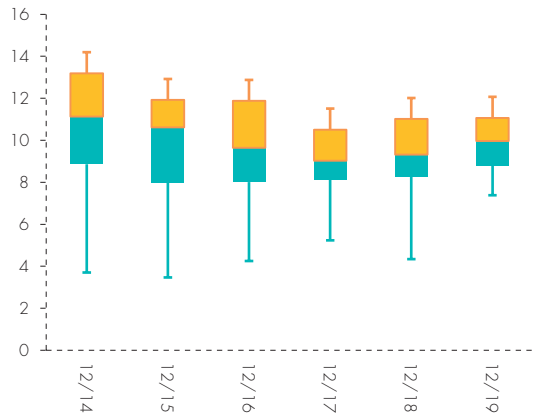
The Albanian banking sector is characterized by an adequate financial leverage ratio, thus confirming the good level of capitalisation. The financial leverage ratio[25] in December 2019 was 9.6 times, marking a decline compared with the end of 2918 and unchanged compared with 2019 H1. The declining trend in annual terms reflects the faster increase of equity compared with asset performance. At bank level, the values of the indicator have trended towards the average value, constituting a positive development for the funding structure of the banking sector.

Chart 44 Financial leverage performance by components



Source: Bank of Albania

Chart 45 Distribution of financial leverage at bank level



Source: Bank of Albania

4.1.1.2 Financial result

The banking sector closed 2019 with a positive financial result of around ALL 20 billion. This result was around ALL 1.5 billion higher than the previous year. The factor that mainly affected the increase of financial result was profit from financial instruments. Net income from costumer interest – the main source of banking sector's income – continued to decline, while general expenses for provisions increased. The increase of the profit of the sector was also reflected in growth of the profitability indicators of the banking sector, where Return on Assets (RoA) increased at 1.4% from 1.3%, while Return on Equity (RoE) reached 13.5% from 13% in the previous year.

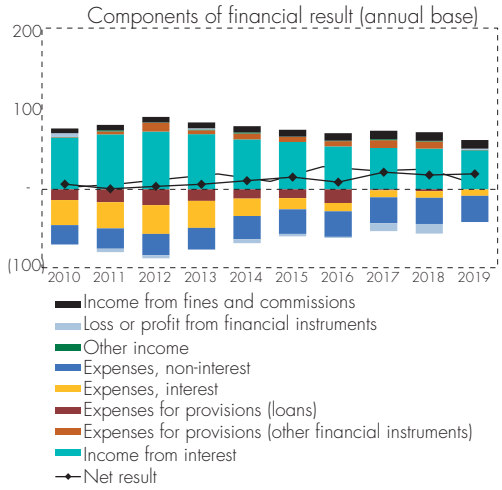
The banking sector expanded the positive financial result during 2019, being reflected in the upward values of profitability indicators. Profit from financial instruments provided the main contribution in this regard.

The continuous contraction of net interest result provided the main contribution in the further narrowing of net interest margin.

[25] *The financial leverage is measured as the ratio of assets to equity.*

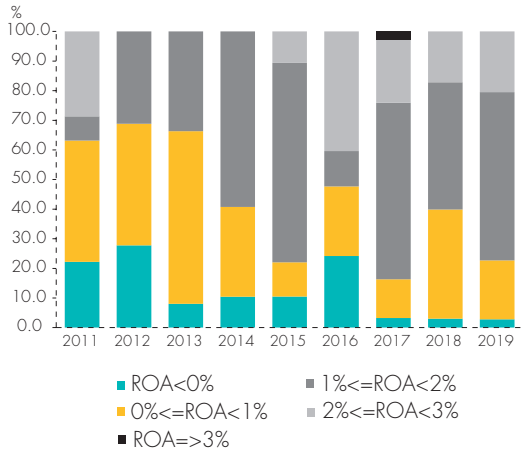
Net result from interests declined by 4.8%, at ALL 41.7 billion, with a joint contribution from the decrease of interest expenditure and the income from them. Income from interest declined at a level significantly higher (around ALL 3 billion) than expenses for interests. Despite the fact that income from interests have decreased for all items, the declined focused on interests from customers, while on the expenditure side, the decline has been registered in both interests on deposits and paid interests on securities.

Chart 46 Financial result components



Source: Bank of Albania

Chart 47 RoA by banks' share in sector assets

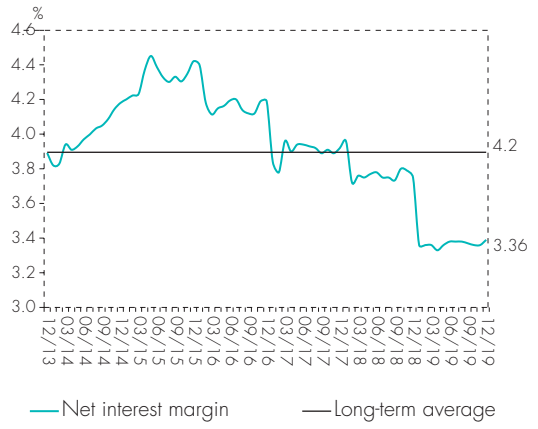


Source: Bank of Albania

The decline in net interest result is reflected in the decrease of net margin from interests at 3.4%, from 3.7% in the previous year. The decline came not only as a result of the contraction of interest income, but also due to the increase of the denominator: the average assets that bring in income. Income from other activities registered a high increase of around ALL 14 billion, registering a positive value due to the return to a profit around ALL 2 billion of the losses of the previous year. General activity expenditure did not register changes.

Expenses in the form of provisions were ALL 7 billion higher than the previous year, affecting the contraction of the financial result. The item "Provision for other financial assets", unlike the previous year when it improved the sector's profit with a return value of ALL 9 billion, during 2019 played a negligible role. On the other hand, expenses for potential credit losses declined significantly at ALL 0.2 billion from ALL 2.3 billion registered during 2018, bringing a positive impact in the net result of the banking sector. The banks' asset share that registered financial losses against banking sector assets was around 4%.

Chart 48 Net interest margin



Source: Bank of Albania.

Chart 49 Profitability indicators

Source: Bank of Albania.

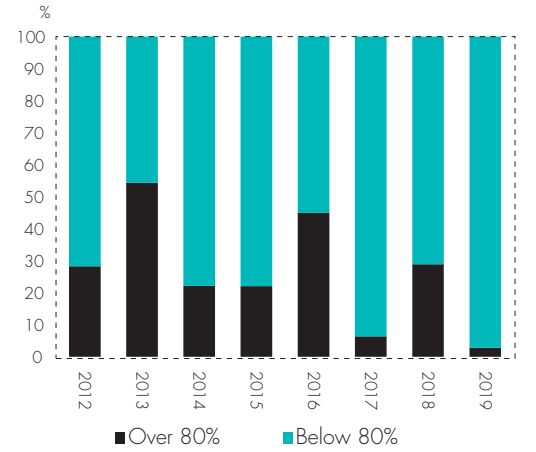
Activity costs were covered at good levels by activity income. The ratio of activity expenditure to income at the end of the year was around 60% and registered a significant decline compared with the previous year, where this ratio approached 80%. The strong increase of gross income contributed to the decline of this indicator, reflecting the increase of income from other activities. Activity expenditure, within which personnel and operational expenses carry the main share, maintained similar levels to 2018. An improvement in the distribution of banks by this indicator was observed during the last years. In the period 2012-2015 the average share of banks' activity with this indicator above 80% was around 30%, while in the period 2016-2019 this value has declined to 20%.

The efficiency of sources was improved mainly driven by the result of the increased gross income and the controlled activity expenses.

Chart 50 Expenditure to activity income

Source: Bank of Albania.

Chart 51 Banks' distribution by expenditure/income ratio (% of total assets)



Source: Bank of Albania.

BOX 5 BANKS' ACTIVITY IN DOMESTIC AND FOREIGN CURRENCY

In the balance sheet of the banking sector, assets and liabilities in foreign currency account for around 50% of overall values, income and expenditure statements indicate that the banking sector during the previous two years has generated a significantly higher profit from foreign currency activity compared with domestic currency activity. Thus, in 2018, from the profit of ALL 18 billion, around ALL 11billion resulted from foreign currency activity. In 2019 domestic currency activity generated a profit of ALL 5 billion while that in foreign currency a profit of around ALL 15 billion. A more detailed analysis of income and expenditure indicates that, despite the fact that domestic currency activity generates around 1.5 to 2 times more income than foreign currency activity, the latter ensures to the banking sector a higher profit due to the significantly lower value of operational and personnel expenditures compared with domestic currency activity.

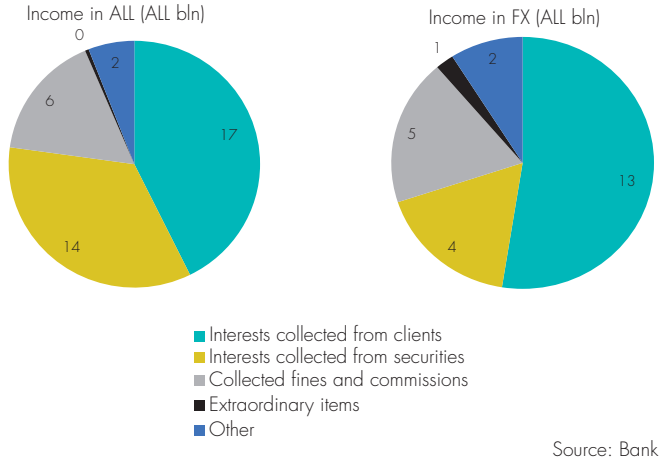
Table 7 Main income and expenditure of the banking sector for 2018-2019 currencies.

ALL bln	2018		2019	
	ALL	FX	ALL	FX
Interest from customers	16	15	17	13
Interest from securities	14	4	14	4
Fines and commissions	6	5	6	5
Other	4	-9	3	3
Income	40	16	40	24
Interest disbursed to customers	5	1	5	1
Personnel expenditure	10	1	11	1
Operational expenditure	15	7	15	7
Other expenditure	3	-6	4	1
Expenditure	33	4	35	9
Financial result	7	11	5	15

Source: Bank of Albania.

On the income side, interests collected from customers represent the main source of income for both domestic and foreign currency activities, but income from interests in the domestic currency are somewhat higher than those from

Chart 52 Structure of income in domestic and foreign currencies by main items (2019)

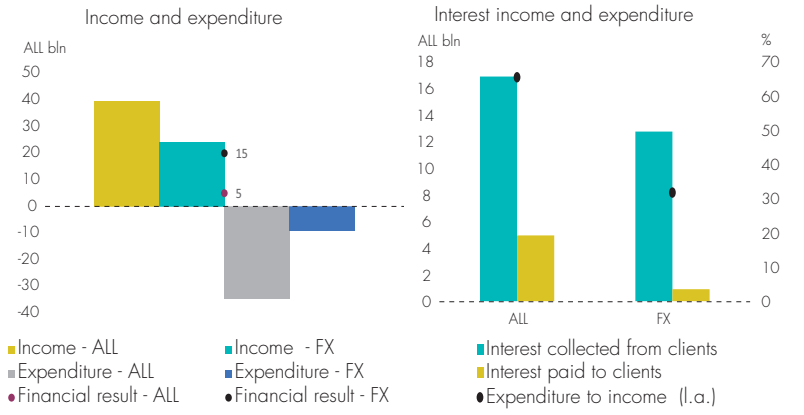


Source: Bank of Albania.

foreign currency due to the positive difference of interest rates in domestic and foreign currency. Incomes from fines and commissions for domestic and foreign currencies have comparable values and have registered no changes during 2018-2019. Albanian Government's securities investments represent a continuous and significant source of profit for the banking sector and income from this investments in domestic currency are significantly higher that income from securities interest issued by resident and non-resident entities in foreign currency.

The difference between the expenditure for interest disbursed to customers in domestic and foreign currency is comparable with the respective difference of income collected from customers (around ALL billion), but while for domestic currency activity the disbursed/collected interest ratio is around 30%, for the foreign currency activity this ratio is lower than 10%. This trend indicates that the financial intermediation efficiency of the banking sector in foreign currency is higher compared with the financial intermediation in domestic currency. At the same time personnel and operational expenditures against total income are assessed at around 30% for foreign currency activity and at over 65% for domestic currency activity. This difference is explained with the fact that salaries and other operational expenditures of banks in domestic currency are significantly higher than those carried out in foreign currency. On the other hand foreign currency activity is characterized by a higher degree of unpredictability related with the impact of the foreign exchange rate on financial instruments and the performance of provisions for investments in financial instruments and lending, particularly in conditions when lending unhedged for exchange rate risk continues to have an important place in outstanding loans in foreign currency and overall lending granted by the banking sector.

Chart 53 Income and expenditure for the total and for interests by currency (2019)



Source: Bank of Albania.

4.1.1.3 Loans

The expansion of outstanding loans was mainly affected by the increase of new loans. In annual terms, the increase of loans would have been higher if excluding the effect of the exchange rate and the written off loans from banks' balance sheets.

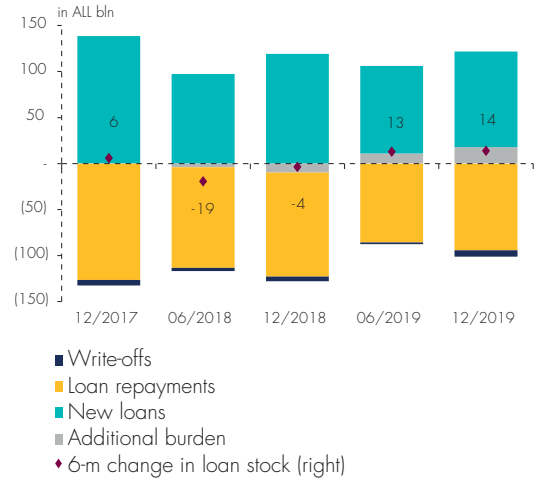
At the end of the period, the amount of outstanding loans of the banking system expanded in six-month and annual terms by 2.5% and 4.8%, respectively, reaching the level of around ALL 574 billion[26]. The performance of lending was mainly affected by the increase of new loans flow. Positive improvements were also registered in the quality of the portfolio, where the non-performing loans stock in banks' balance sheets decreased significantly over the period.[27] The best performance was registered for loans with long-term maturity; loans in domestic currency and for enterprises, while in foreign currency have continued to decrease. In annual development of lending as well, the main impact on its growth came from the expansion in the performing classes of loans to enterprises and those with long-term maturity.

Table 8 Loans performance by maturity, sector and currency

		Value (ALL bln)	Share to total loans (%)		Change (%)	
	Period	12/2019	12/2018	12/2019	6-M	Annual
By currency	Lek loans	281	46	49	6.5	10.0
	Foreign currency loans	295	54	51	-1.1	0.3
By entity	Public sector	30	5	5	9.1	8.7
	Enterprises	359	63	62	1.7	3.7
	Households	187	32	32	3.0	6.5
By maturity	Short-term	163	29	28	2.0	2.2
	Medium-term	95	17	17	0.4	-0.9
	Long-term	317	53	55	3.4	8.1
	Loans stock	576	100	100	2.5	4.8

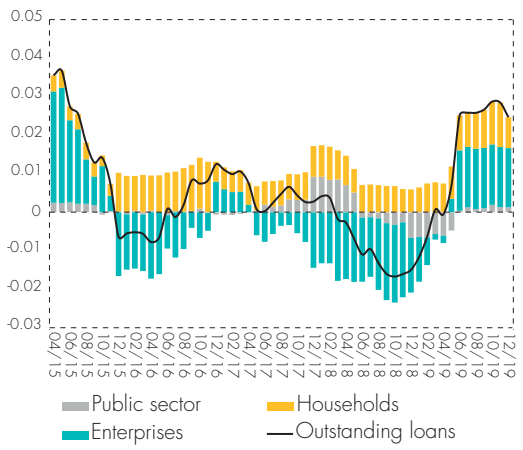
Source: Bank of Albania

Chart 54 Six-months change in outstanding loans by component elements



Source: Bank of Albania

Chart 55 Loans performance, by sector, contribution in p.p., six-months change



Source: Bank of Albania

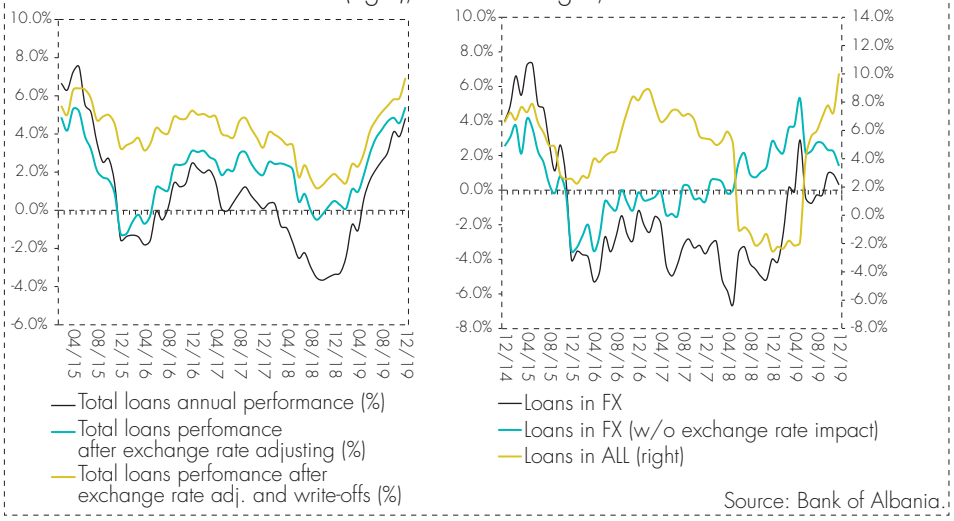
The slight appreciation of lek has given a downward impact of around ALL 3.4 billion in the equivalent value in lek of loans in foreign currency during the year.

[26] *The positive rates of the increase of outstanding loans are calculated excluding the statistical impact of the structural breakdown in the banking sector.*

[27] *For more detailed information, see the analysis on credit risk in the relevant session.*

The main contribution to this downward impact came from the appreciation of against euro. Overall, in annual terms[28], it is assessed that the downward impact of the appreciation of lek to loans and foreign currency and total loans has been 1.1 p.p. and 0.5 p.p., respectively.

Chart 56 Performance of total loans excluding the impact of the exchange rate and write-offs (left) and loans in foreign currency excluding the exchange rate (right), annual changes, in %



Source: Bank of Albania.

During the period, the banks continued the process of removing lost loans from balance sheets. The regulatory approved during 2019 affected the increase of write-offs flow, particularly in 2019 H2. The value of written-off loans during the last 12 months was ALL 8.4 billion, where ALL 7.4 billion were realised in 2019 H2. Written-off loans stock during 2019 accounted for around 17% of total outstanding non-performing loans reported by banks at the end of December 2019. If these loans had not been written-off over the year, the annual growth of loans stock would be 6.4% (from 4.8%). Excluding the impact of the exchange rate and that of write-offs at the same time, credit annual growth would register 6.9%.

LOANS TO RESIDENT ENTITIES - ENTERPRISES

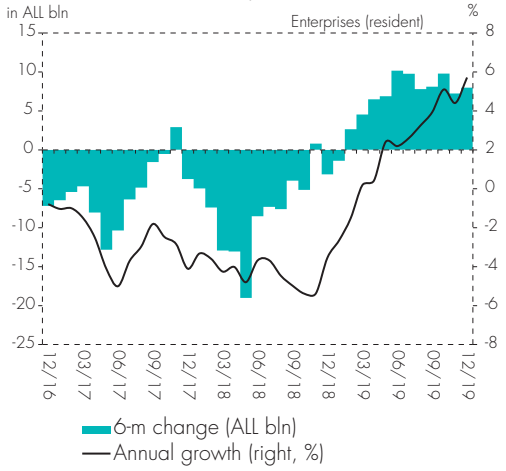
Loans to resident entities increased by 3% over the period. This credit accounts for around 96% of total loans. Over 60% of loans to resident entities are held by the enterprises sector. Loans to this sector expanded by around ALL 8 billion and at the end of the period accounted for around ALL 336 billion. The increase in this category was due to the increase of mortgages and loans for short-term purposes (such as loans for circulatory capital and overdraft). Loans for investments in real estate have the main share (around 27% of outstanding loans to enterprises, and during the period expanded by 5%.

The expansion of loans to residents was driven by the common contribution from loans to households and enterprises, mainly in the national currency. Resident enterprises, with the main share in credit portfolio, report an expansion of loans for the first time since 2014. Loans were mainly provided to sectors with the better performance.

Over the year, loans to resident enterprises expanded by 5.7%. This is the first year since 2014 during which enterprises report an annual growth of credit

[28] *Excluding the statistical impact of the structural changes in the banking sector.*

Chart 57 Performance of loans to resident enterprises



Source: Bank of Albania.

stock. The contribution in this positive performance came from the rapid expansion of loans for investments in real estate (+14%) and those for circulatory capital (+37%). During 2019, the banking sector granted around 50% more new loans for investments in real estate compared with the previous year, and this growth provided the main impact on the annual change of credit stock for this category.

The structure of loans to enterprises has changed over the last years. For "overdraft" loans and "equipment purchase", a shift of loans from foreign currency to the domestic currency was observed[29] At the same time, the share of "overdraft" and "equipment purchase" loans in total loans to enterprises has declined. These loans accounted for 25% and 26%, respectively, of loans to enterprises, from 28% and 30% registered two years ago. Meanwhile, the share of loans for "circulatory capital" and "real estate" has increased over the previous two years, affected by the increase of around 10% and 6% of foreign currency portfolios.

Chart 58 Annual performance of loans to enterprises by purpose of use and currency (in %)

Source: Bank of Albania.

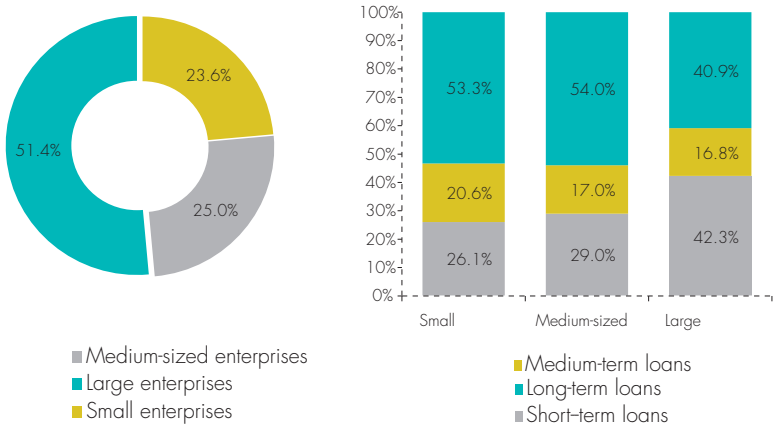
By size, the structure of loans shows an increase of the share of medium-sized enterprises against the decline of small enterprises. Large enterprises did not register significant changes[30]. Meanwhile, the analysis by maturity indicates that medium-sized and large enterprises have increased the share pf short-term loans, whereas small enterprises have slightly increased long-term loans[31].

29 *Affected by the rapid contraction of foreign currency loans.*

30 *These values marked, respectively: 50.8% (large enterprises); 23.0% (medium-sized enterprises) and 26.2% (small enterprises) in December 2018; whereas in June 2019 they were respectively: 51.9%; 23.1%; and 25.0%.*

31 *In annual terms, small enterprises have increased the share of medium-term and long-term loans, while medium-sized and large enterprises have increased the share of short-term loans.*

Chart 59 Structure of loans to enterprises by size and maturity



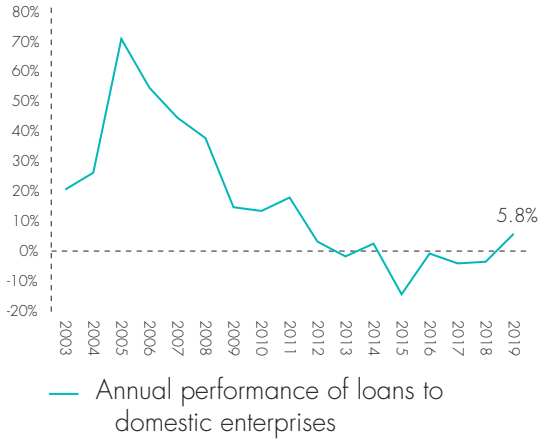
Source: Bank of Albania.

BOX 6 STRUCTURE AND EFFICIENCY OF LOANS TO ENTERPRISES BY SECTORS OF THE ECONOMY

Loans granted by banks to domestic enterprises represent a significant share of total loan portfolio, albeit its share has decline from over 80% in 2002 to around 60% at the end of 2019. The period 2003-2006 was characterised by a very rapid increase in the in the portfolio of loans to domestic enterprises. The positive performance, albeit at a slower pace, continued until the end of 2013. Later, the performance of loans to enterprises registered negative values (with contraction) for six years consecutively. Meanwhile, in the last year, we observe a recovery in these loans, where annual growth registered 5.8% in December 2019.

Currently, loans to domestic enterprises account for e relatively low share of Gross Domestic Product (around 20%), compared with EU countries. Almost half of enterprises' debt is in the form of loans from the banking sector. The rest is funded through enterprises' securities and loans from other sources. The accommodative policies undertaken by central banks, which have affect the decline of loan interest rates in the last years, seem to have affected enterprises borrowing as well in the previous two years. The share of loans taken by banks in total enterprises debt has increased at 48% in December 2019 (from 45% in 2017). The rapid decline of the ratio loans/investments to enterprises since 2010 reflect a relatively faster increase of investments compared with credit growth. During this period enterprises have significantly expanded their investments, affecting positively the economic growth of Albania. During 2019, the loans/investments ratio has increased due to the annual growth of loans to domestic enterprises. Loans to domestic enterprises are 1/5 of banking sector's total assets. Despite the

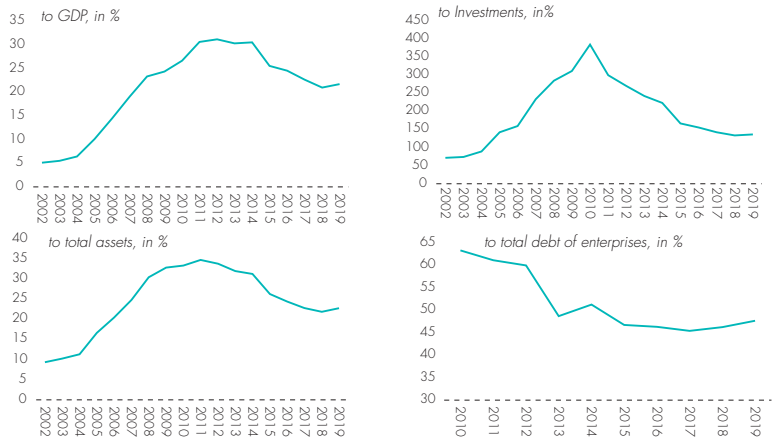
Chart 60 Annual performance of loans to domestic enterprises



Source: Bank of Albania.

increase registered during 2019, the share of loans to enterprises against total assets remains far from the peak of 35% registered in 2010.

Chart 61 Loans to domestic enterprises 2002-2019



Source: Bank of Albania and INSTAT.

The following analysis addresses the performance of manufacturing sectors by several macroeconomic indicators for the period 2018-2019 and the performance and quality of banking loans, focusing on the relation between sectoral productivity and credit efficiency. The analysis also addresses the borrowing sectors' risk characteristics and impact of borrowers with high risk potential in the overall performance of lending.

What can be observed is the dominance of the energy sector in the annual expansion of loans to enterprises during 2019. While this sector is responsible for around 40% of the expansion of ALL 18 billion in loans to enterprises during the year, its contribution to economic growth was negative. Although it seems that credit growth is not accompanied by production increase in this sector, it is relevant to highlight that considerable share of new loans to the sector over the year was granted for investment purposes and the impact of loans for investments in economic growth materialise after a longer period of time compared with loans for circulatory capital and equipment purchase. Overall, the energy sector has a low level of credit risk, a low intensity of loans and a level of profitability significantly higher than the average of the other sectors. The non-performing loan ratio for this sector is around 6%, being around 1/2 of the NPLR for enterprises (11.3%). On the other hand, only 36% of investments in the sector are funded through banking lending.*

The sectors that contributed to the annual growth of lending, and at the same time, gave a positive contribution to economic growth over 2019 are: services, trade, transport, accommodation and food services.

Trade has the main share in total loans to enterprises and its contribution to the annual credit growth is moderate (around 7%). This sector at the same time gave the main contribution to GDP annual growth (around 30%), and is characterised by a high intensity of lending, high productivity, lower profitability than the average of the other sectors, moderate risk and continuous decline in the loan portfolio.

Around 60% of the annual increase of loans to enterprises is related with the sectors of the economy, for which productivity ("net sales to number of employees" ratio) is higher compared with the other sectors. Profitability, which has a positive correlation with the ability of a company to settle liabilities, is a significant indicator. Enterprises' profitability indicators are the share of profit in the annual turnover of the company, and the share of profit in debt. Over 90% of the annual growth of lending is the share of those sectors which report the highest levels of profitability. Overall, loans to sectors with high profitability support both economic growth and financial stability, due to the support of economic agents with good solvency.

In conclusion, we analyse the main indicator directly related with credit risk. Credit quality has improved for eight of the ten sectors of the economy and the overall non-performing loan ratio declined at 11.3% from 15.7% in the previous year. Sectors with NPLR higher than average gave a small contribution to annual credit growth, during 2019. The processing industry is the sector with the highest level of non-performing loan ratio. However, credit quality for this sector has improved continuously over the last years. At the same time, this sector is characterised by a high level of profitability.

Table 9 Performance of loans to enterprises and economic indicators by manufacturing sectors

	Loans to enterprises			Added value		Intensity of loan[1]	Profitability[1]		Productivity	Credit risk indicator		
	annual growth 2018-2019 (in %)	contribution in annual growth of loans to enterprises (2019)	share to total loans to enterprises, in % (2019)	real annual growth, in % (09/2018-09/2019)	contribution in annual growthre	loans to investments (in %)	profit to net sales (in %)	profit to debt (in %)	net sales to employees' number	share of loan loss to total NPLs	annual change of NPLs(%)	NPLR % (2019)
Agriculture, forest and fishing	(10.2)	(0.2)	1.5	1.2	0.3	n/a	n/a	n/a	n/a	45.8	(29.4)	5.3
Quarrying industry	18.9	0.5	3.0	(0.3)	(0.0)	46	14	123	6.7	3.6	(13.6)	2.3
Manifacturing industry	(5.3)	(0.8)	14.4	5.0	0.4	152	9	44	2.4	19.5	(7.8)	21.3
Electricity, natural gas, steam, and water supply, waste management and remediation activities	38.4	2.4	8.3	(1.9)	(0.1)	36	13	100	7.0	42.3	(33.5)	5.8
Construction	(0.8)	(0.1)	13.5	1.4	0.2	117	11	60	5.7	24.4	(45.8)	9.5
Retail and whole trade; vehicle reparing	1.0	0.4	35.6	5.2	0.6	268	6	46	7.9	44.6	(23.5)	12.5
Transport and storing	63.5	1.2	2.8	5.2	0.2	38	10	267	4.1	19.0	31.6	6.4
Accomodation and food service	17.8	0.8	4.8	5.2	0.1	178	7	31	1.1	30.9	10.5	17.0
Other (services)	10.9	1.7	16.0	3.5	1.3	199	12	59	2.1	30.1	(43.6)	5.4
All industries	5.8	5.8	100.0	3.1	3.1	133	8	58	4.2	32.7	(23.9)	11.3

Source: Bank of Albania and INSTAT.
**Calculation are done with the latest data of 2018.*

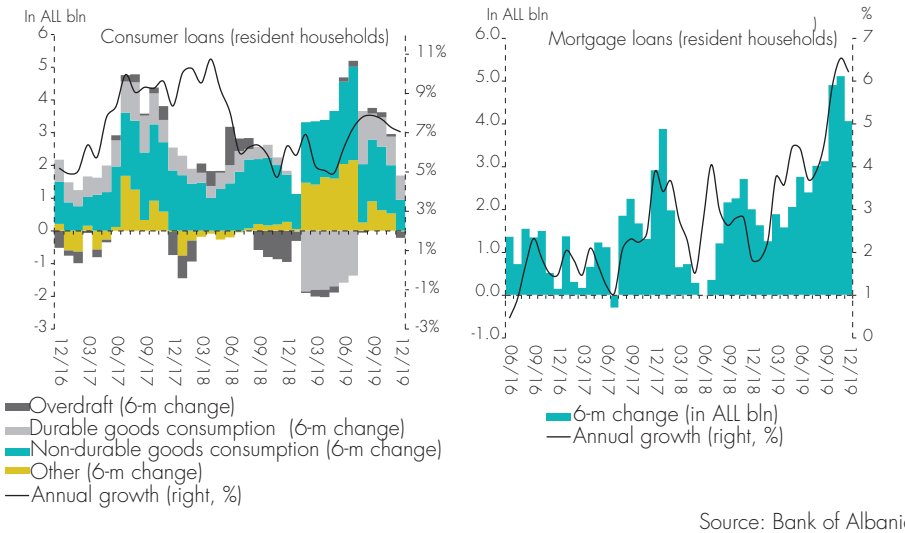
In conclusion, during 2019, banks granted loans mostly to sectors of the economy with higher profitability, high productivity and low non-performing loan ratio. At the same time, the sectors of the economy which were credit the most such as: energy, extractive industry and transportation, report higher levels of investments in relation to the value of lending. This is tightly related with an upward efficiency of economy's funding from the banking sector in the last year.

** The data refer to the annual growth until 2019 Q3.*

LOANS TO RESIDENT ENTITIES - HOUSEHOLDS AND PUBLIC SECTOR

Loans to resident households expanded by 3% during the period and by 6.5% compared with the previous year, where the main contribution to this growth came from the increase of loans in lek, mortgages and consumer loans for non-durables. The last two account for 63% and 17%, respectively, of loans to households. Outstanding loans for real estate grew by around 3.6% and reached ALL 117 billion. During 2015-2018, there has been a steady increase of loans to households on one hand, and a decrease of loans to enterprises on the other. This performance drove to changes in loans structure by sectors, in favour of loans to households. Loans to households in December 2019 accounted for 34% of outstanding loans, from 27% in 2015.

Chart 62 Loans to resident households performance by purpose of use



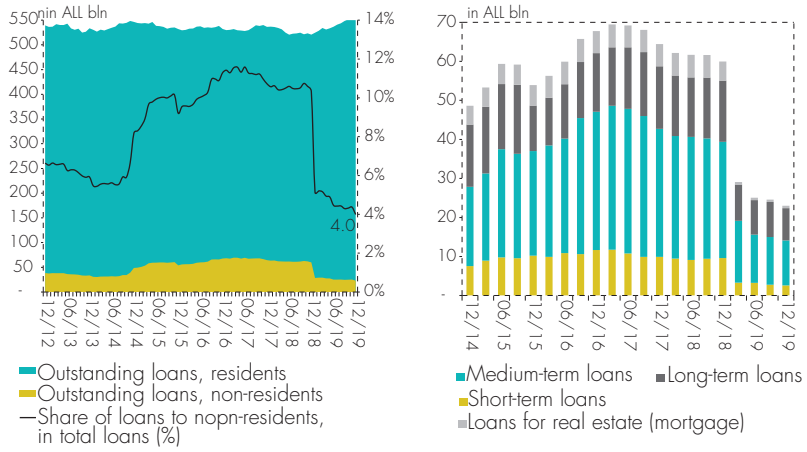
Source: Bank of Albania.

Loans to public sector account for a very small share of loans (5%), against the high share of loans to private sector (enterprises and households). However, in the last year it was observed an expansion of around 9% in the stock of loans to this sector.

LOANS TO NON-RESIDENT ENTITIES

During the period, loans to non-resident entities registered a decline. In December 2019, loans to non-residents were around ALL 23 billion and accounted for 4% of outstanding loans of the banking sector, from 4.5% at the end of the previous six-month. By sector, currency and maturity, the highest decrease was registered in loans to enterprises, in foreign currency and medium-term, which were the categories with the highest share in the stock of loans to non-resident entities.

Chart 63 Loans to residents and non-residents (left) and loans to non-residents by maturity (right)



Source: Bank of Albania

UNHEDGED FOREIGN CURRENCY LOANS

The exposure of the banking sector to the indirect exchange rate risk, reflected in the share of loans in foreign currency unhedged against unfavourable changes of the exchange rate (unhedged foreign currency loans), continues to remain at relatively high levels, and requires constant monitoring. Unhedged foreign currency loans declined by 3% over the period, and continued to contract for the third six-month consecutively. The annual decline was 5% and the contraction is registered in unhedged loans to enterprises and the government sector. Meanwhile, households report a slight expansion in stock of unhedged foreign currency loans during the year. The share of unhedged loans to total outstanding loans has contracted slightly over the period, by 1.4 p.p., at 23%, while its share to foreign currency loan portfolio decreased by 1p.p., at 45%.

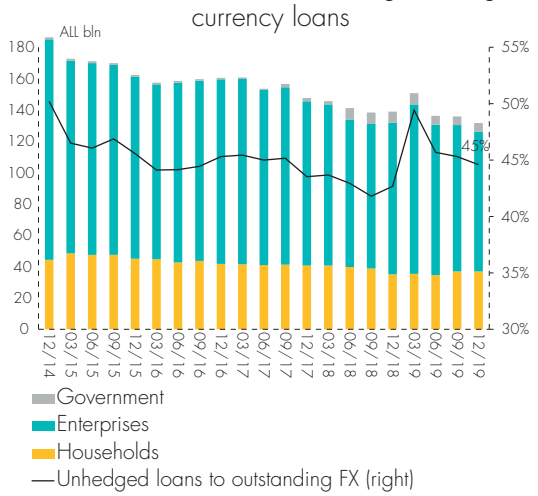
Notwithstanding the contraction in the values of values of unhedged foreign currency loans for the third successive semester, the exposure of the banking sector to the indirect exchange rate risk requires constant monitoring.

BOX 7 BANKING SECTOR AND UNHEDGED FOREIGN CURRENCY LOANS

During 2019 H2, unhedged foreign currency loans decreased by ALL 5 billion, at ALL 132 billion, mainly due to the contraction of unhedged loans in euro (by 4.6%, whereas unhedged loans in US dollar registered a slight increase.*

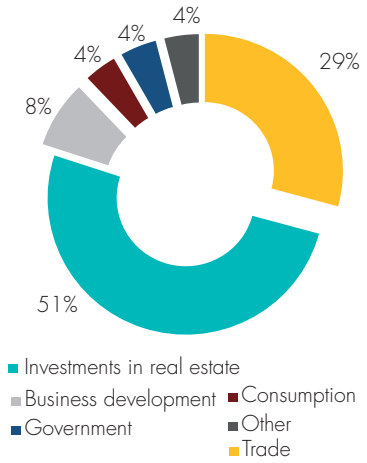
Loans to enterprises constitute 68% of outstanding foreign currency loans unhedged from the exchange rate risk, while loans to households and to government account for 28% and 4%, respectively. The contraction of outstanding unhedged loans is related with the decline by 7% of unhedged loans to enterprises. Unhedged loans to households during the period registered an increase by around 7%, while those to government did not change. In annual terms, unhedged foreign currency loans contracted by 5.3%, due to the decline of loans to enterprises and loans in euro.

Chart 64 Performance of unhedged foreign currency loans



Source: Bank of Albania.

Chart 65 Unhedged foreign currency loans, by purpose of use, %

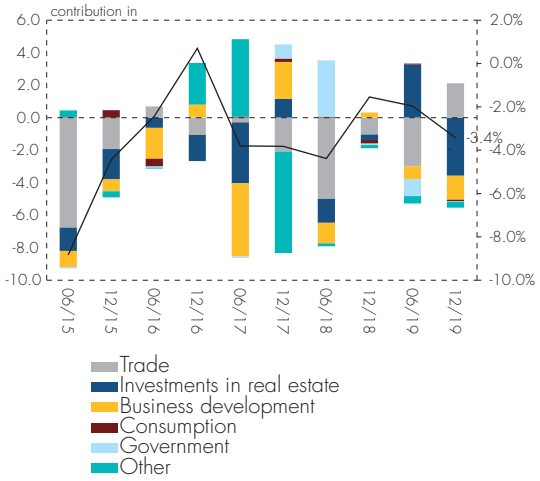


Source: Bank of Albania.

By purpose of use, unhedged loans granted for investments in real estate continue to account for the main share (around 51%) of total unhedged foreign currency loans, followed by loans for trade (29%). The rest of the unhedged foreign currency loans were granted mainly for trading and business development purposes. The main contribution to the performance of outstanding unhedged loans against the exchange rate risk over the period came from the decline of unhedged loans for "investments in real estate" and business development", which decreased by 7% and 16%, respectively. Unhedged foreign currency loans for "trade" were the only category of unhedged loans that registered an increase over the period, by 8%.

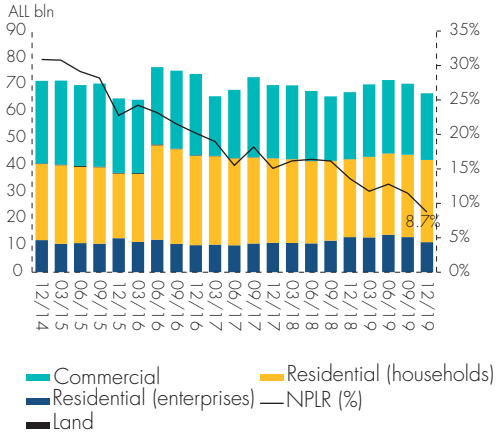
Unhedged loans for real estate are granted in the purchase of residential, commercial real estate and land. Unhedged loans for residential real estate granted to households have the main share (46%), which expanded slightly during the period.

Chart 66 Six-month performance of unhedged foreign currency loans (contribution by sectors)



Source: Bank of Albania.

Chart 67 Unhedged foreign currency loans for real estate and its quality (right)



Source: Bank of Albania.

Loans for residential real estate to enterprises and those for commercial real estate registered a decline 2019 H2, affecting almost at the same level the decline of outstanding unhedged loans for the period. The appreciation of lek's exchange rate has affected negatively, but not significantly, the reported value of unhedged foreign currency loans. Excluding the appreciation of lek's exchange rate, unhedged foreign currency loans would have contracted by 2.9% from 3.4% over the period.

* *Outstanding euro loans, when the borrower's income is in Albanian lek, account for 87% of the outstanding unhedged foreign currency loans.*

NEW LOANS

New loans granted over the period registered around ALL 130 billion, increasing by almost 12% compared with the previous six-month but being around 3% lower than the same period in the previous year. The expansion of the flow of new loans during the period was due mainly to the increase of loans to enterprises (around 14%), within which the main impact came from the increase of long-term loans. For the households sector, new loans expanded by 7% compared with the previous six-months. The lower growth rate compared with loans to enterprises and the lower share to total lending also made it that its contribution to the performance of new loans was lower. New loans to households went mainly for housing purchases. By currency, new loans registered an expansion in all three main currencies. Around 60% of the value of new loans was in lek.

The increase in new loans was mainly driven by loans to enterprises, within which the main impact came from the increase of long-term. New loans expanded-in all three main currencies, but the preference for loans to households was in lek.

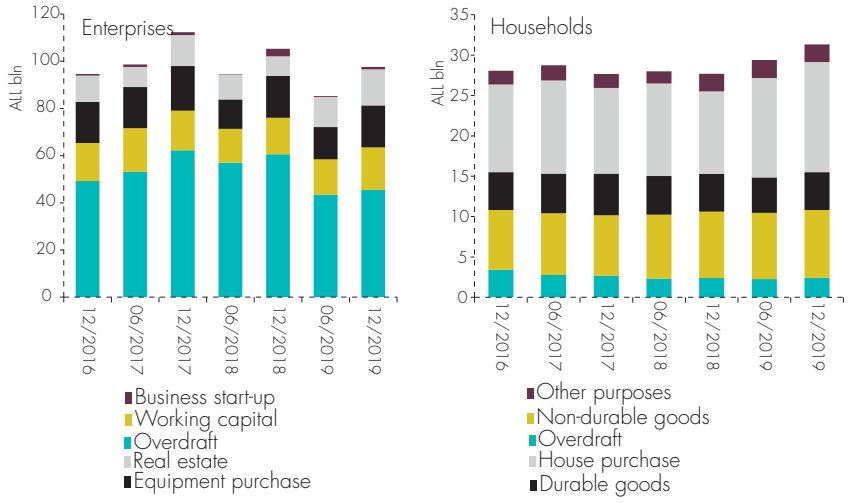
The weighted interest rates on new loans granted over the period[32] registered a decline at 5.5% and the decline was for all types of loans. The average weighted rate of new loans during 2019 H2 was around 0.2 p.p. lower than that registered in 2019 H1. The stronger decline in the average interest rates was registered in rates on new loans in US dollar and on new loans to enterprises.

The weighted interest rates on new loans recorded a downward trend during the year.

By group of loans, the interest rate on new loans in lek and the new loans to households show higher levels.

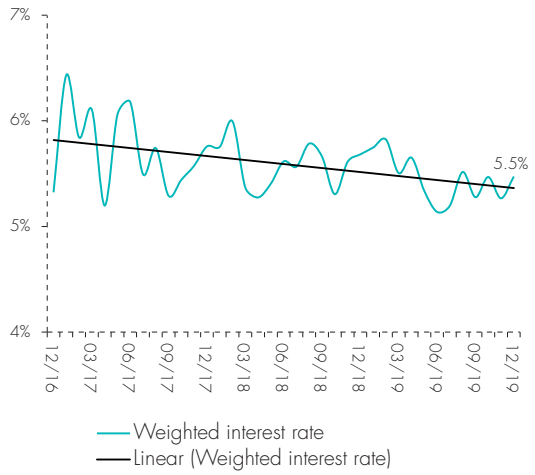
[32] *Calculated as six-month average.*

Chart 68 New loans to enterprises (left) and households (right) by purpose of use



Source: Bank of Albania.

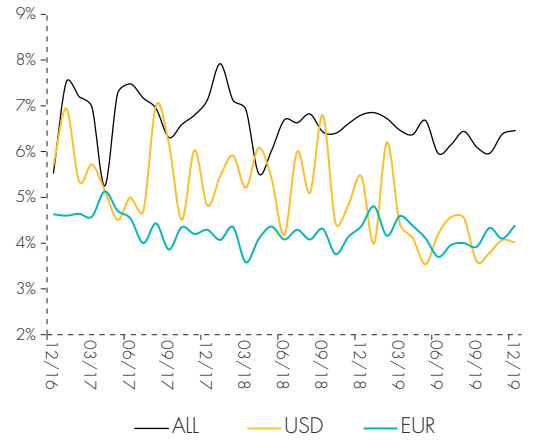
Chart 69 Weighted interest rates on new loans



Source: Bank of Albania.

By currency, the interest rate of new loans in lek continued to register higher levels than the other two currencies (euro and US dollar), but this interest rate has shown a significant downward trend throughout the year. In December 2019, the interest rate of new loans in lek registered 6.4% from 6.9% at the beginning of the year. The interest rate on new loans to households continues to be higher compared with the interest rate on loans to enterprises. In December 2019, this rate registered the highest level of the year with around 6.3%, affected by the performance of the interest rate on consumer loans.

Chart 70 Interest rates on new loans, by currency



Source: Bank of Albania.

Chart 71 Interest rates on new loans, by entity

Source: Bank of Albania.

The average interest rate on new loans to enterprises continued to fluctuate around an average value of 5% throughout the year.

4.1.1.4 Deposits

At the end of 2019, the level of deposits in the banking system registered ALL 1,193 billion, with an increase of ALL 50 billion (or 4.1%) during the period and ALL 60 billion (or 5.4%) compared with the previous year[33]. The stronger increase of deposits during the period, but also throughout the year, is supported by the increase of demand deposits and current accounts, the increase of households' deposits and the increase of foreign currency deposits. The increase of lek deposits has continued, but their growth rate was lower compared with foreign currency deposits. The statistical impact of the exchange rate during 2019 H2 has been negative but at very low levels.

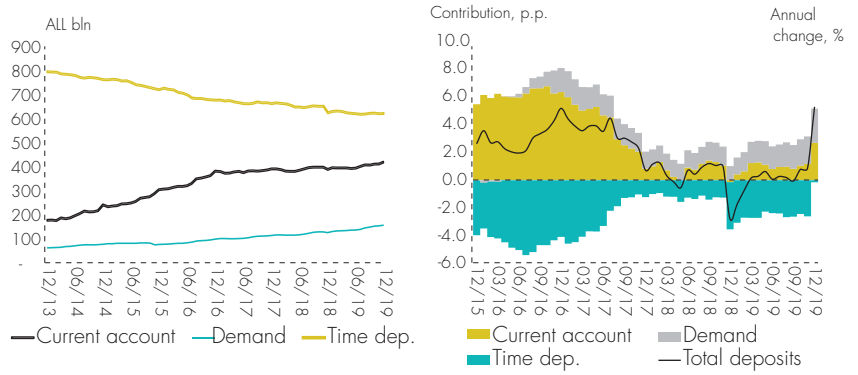
Deposits grew strongly during the period, mainly supported by demand deposits, households' deposits and foreign currency denominated deposits.

Table 10 Data on the performance of deposits by maturity, sector and currency

		ALL mln	% to total	Change in %		Contribution in growth rate (p.p.)	
		12/19	12/19	6-M	Annual	6-M	Annual
By maturity	Current account	412	35	6.6	8.2	2.2	2.8
	Demand deposits	149	13	15.1	25.9	1.7	2.7
	Time deposits	614	51	0.2	(0.3)	0.1	(0.2)
By entity	Public sector	27	2	3.9	13.8	0.1	0.3
	Enterprises	163	14	4.6	4.0	0.6	0.5
	Households	1,003	84	4.1	5.4	3.4	4.5
By currency	Lek deposits	579	49	3.1	5.1	1.5	2.5
	FX deposit	614	51	5.2	5.6	2.6	2.9
	Deposits, stock	1,193	100	4.1	5.4	4.1	5.4

Source: Bank of Albania.

Chart 72 Deposits performance by maturity (in ALL bln, left) and contribution to annual change (in p.p., right)

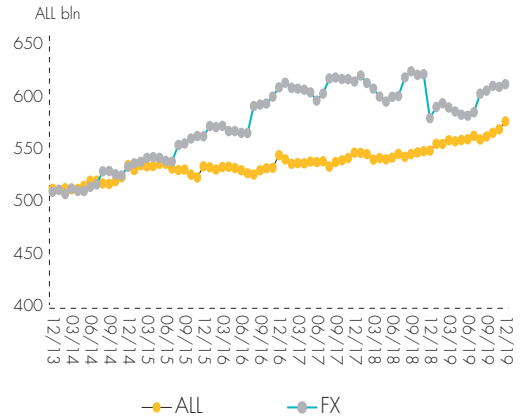


Source: Bank of Albania.

[33] *The value of deposits excludes the impact of structural breakdown.*

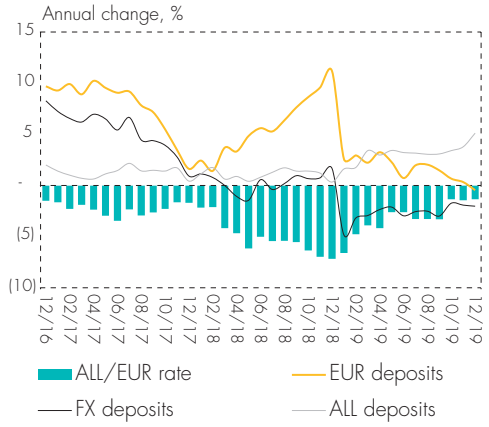
During 2019 H2 as well, demand deposits and current accounts gave a positive contribution deposit performance, while time deposits continued to register negative rates of annual changes. Demand deposits and current accounts expanded by 26% and 8%, respectively, in annual terms, while the decline of time deposits has shown sign of slowdown.

Chart 73 Deposits in lek and foreign currency



Source: Bank of Albania.

Chart 74. Annual changes of exchange rate and deposits in lek, foreign currency and euro



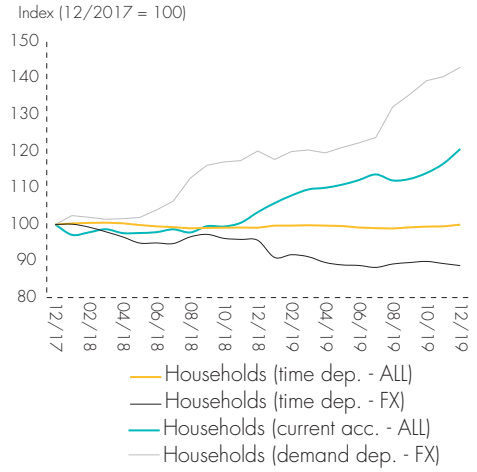
Source: Bank of Albania.

Since middle 2016, households' demand deposits have given a stable and almost constant contribution (of 2 p.p.) to the overall growth of deposits, while the contribution of current accounts has been higher but less stable. In comparison with five years before, the share of time deposits to total deposit stock has declined at around 50% from around 70%, while current accounts have increased their share from 20% to around 35%.

The environment with low interest rates continues to support the preference of consumers for demand deposits and current accounts against time deposits, and this preference is more pronounced for savings in foreign currency. Time deposit held mainly by the households sector have the main share in lek deposits (around 60%), but they account for less than 45% of total foreign currency deposits. Current accounts and demand deposits taken together account for around 40% of lek deposits, 54% of foreign currency deposits and 47% of total deposits. Current accounts and demand deposits in foreign currency, held mainly in euro, reached up to 28% of total deposits.

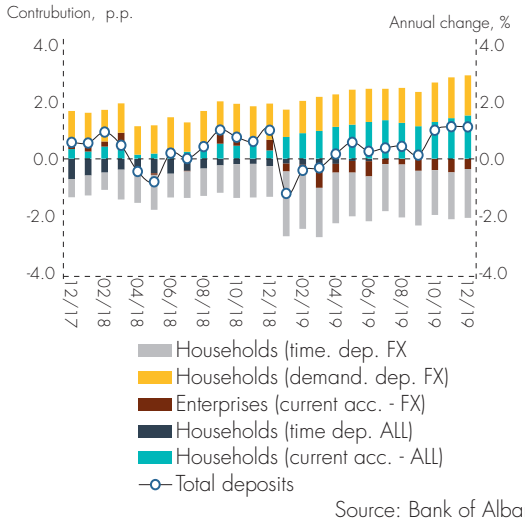
The households sector holds over 80% of total deposits and has continued to expand its deposits in the banking sector. The increase of households' deposits is supported by the expansion of demand deposits in foreign currency and current accounts in lek. At the same time, households time deposits in foreign currency account for around 23% of total deposit and have continued to contract in annual terms, but have maintained almost an unchanged level over 2019 H2.

Chart 75 Performance of households deposits by maturity and currency



Source: Bank of Albania.

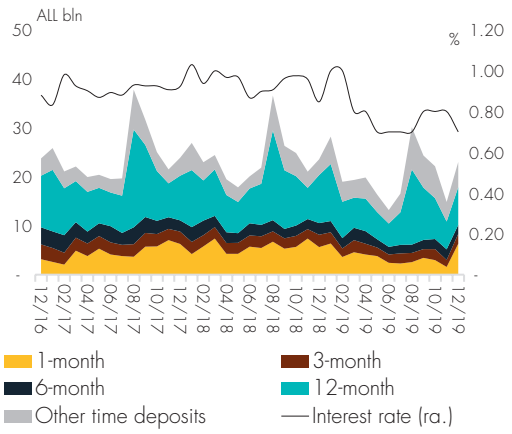
Chart 76 Composition of deposit growth by maturity, sector and currency



Source: Bank of Albania.

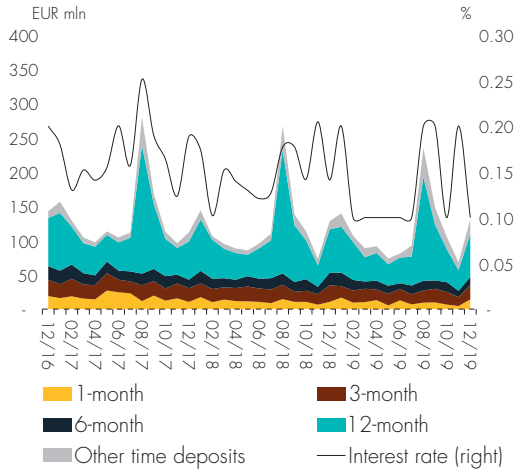
Interest rate for time deposit in lek and euro registered 0.7% and 0.1%, respectively, at the end of the year and returned to the levels of the beginning of the period, after a slight increase during 2019 H2. New deposits have maintained their seasonal behaviour registering higher values during August, but for both this currencies it is observed a downward trend compared with the performance reported during 2016-2018. The quantity of new time deposits reported during 2019 was around 8% smaller compared with new deposits in 2018 and the strongest decline (around 13%) was registered in new time deposits in lek, whereas time deposits in euro were also around 6% lower compared with the flow of 2018.

Chart 77 Flows and average interest rate for new time deposits in lek



Source: Bank of Albania.

Chart 78 Flows and average interest rate for new time deposits in euro



Source: Bank of Albania.

4.1.2 RISKS TO THE ACTIVITY OF THE BANKING SECTOR

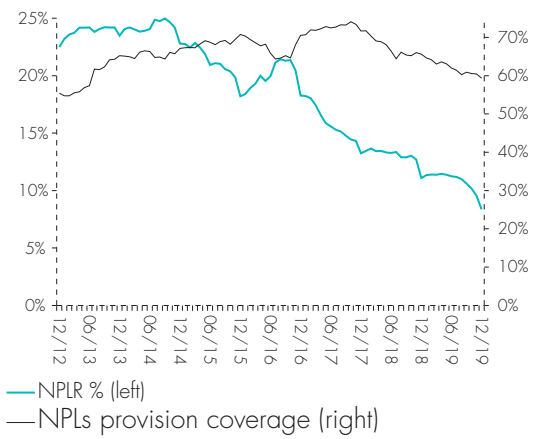
4.1.2.1 CREDIT RISK

The considerable improvement of credit portfolio quality was a joint contribution of the non-performing loans written off, payment and restructuring.
The improvement of credit quality was more notable in loans to enterprises, loans in foreign currency and long-term loans.

Non-performing loans ratio (NPLR) fell in one-figure level for the first time in a decade, staying at 8.4% in December 2019, from 11.2% in June 2019. NPLs stock fell at ALL 48 billion[34], around 24% lower in semi-annual and annual terms, with a contribution from written off loans and their restructuring. The written off of loss loans from banks' balance sheets was intensified in 2019 H2[35], mainly affected by the regulatory amendments undertaken by the Supervisory Council of the Bank of Albania. The improvement in loans quality is mainly noted in credit portfolio to enterprises, loans in foreign currency and in loans with longer maturity terms. The Bank of Albania will continuously monitor the performance of credit portfolio, particularly under the circumstances of a possible impact from the consequences of earthquake in November 2019 and further from the coronavirus pandemic.

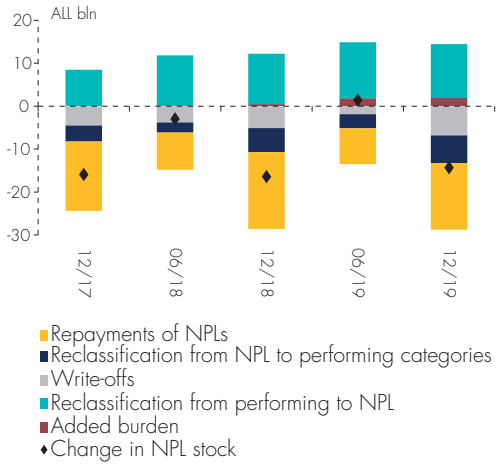
During the period, the improvement of credit portfolio quality was accompanied by the improvement of non-performing loans structure, together being reflected in their lower provisioning. At the end of year, provisioning ratio fell at 59.4%, from 62% respectively in June 2019.

Chart 79 Non-performing loans ratio and provisioning



Source: Bank of Albania.

Chart 80 Contribution in the annual change of non-performing loans stock



Source: Bank of Albania.

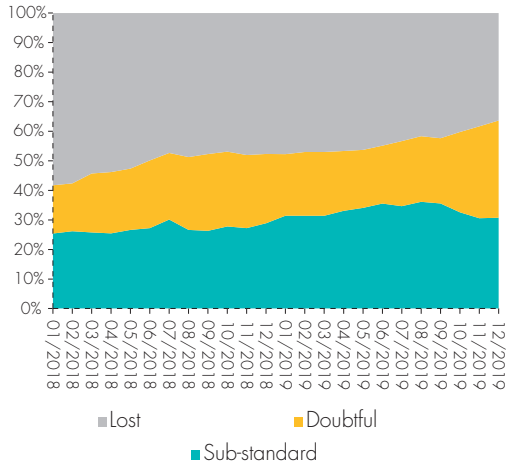
Compared to the previous year, the ratio of non-performing loans fell by 3 percentage points and the decline mainly reflects the contraction in the stock

[34] *The stock of non-performing loans which are paid during 2019 H2 doubled, compared with 2019 H1, being the main source of the fall of non-performing loans stock.*

[35] *During 2019, around ALL 8.4billion loss loans are written off, mainly represented by loans tin foreign currency to enterprises. The flow of written off loons from banks' balance sheets during 2019, is equal with the flow which are reported during the two previous years. In total, since the beginning of the written off process (January 2015), ALL 65 billion loss loans are written off.*

of non-performing loans. In recent years, there has been share shift between non-performing loans classes, from the "lost loans" to those with lower risk. The share of lost loans in the non-performing loan stock declined at 36% from 48% in the previous year and from 60% in middle of 2017. This performance mainly reflects the write-off of lost loans, the payment of arrears and the restructuring of some of them. Over the last 12 months, the non-performing loan stock has seen a significant increase of the share of "doubtful" loans by 10 pp, at 33%.

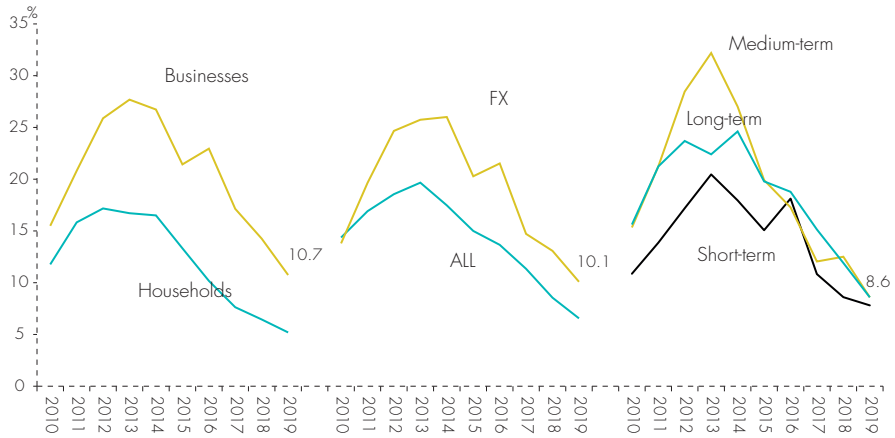
Chart 81 Non-performing loans structure



Source: Bank of Albania.

For all categories by term, entity and currency, a significant improvement in the quality of assets during 2019 was observed. The quality of loans is weaker for loans to enterprises, foreign currency loans and medium-terms loans; however these are also the divisions with the strongest decline in the stock of non-performing loans.

Chart 82 NPLs ratio by sector, currency and term



Source: Bank of Albania.

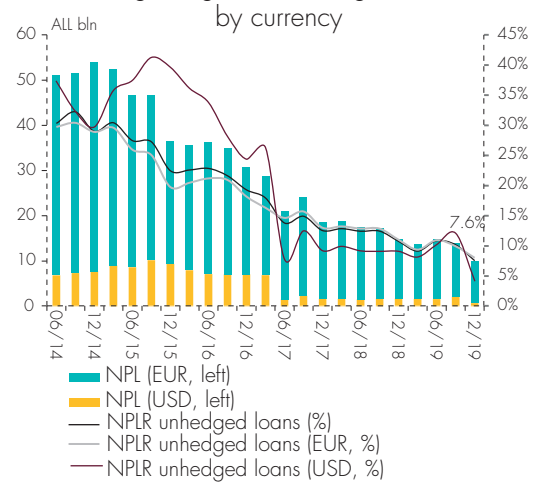
For foreign currency loans unhedged from exchange rate fluctuations, the quality improved significantly compared to a year ago and during the period, with the main contribution from the reduction of the stock of non-performing loans. The non-performing loan ratio for this type of loans marked 7.6% at the end of the period, driven by the performance of unhedged loans in euro, for real estate purchase.

By purpose of use, during the period, NPLs decreased:

- for unhedged loans granted for the purchase of real estate at 8.7%, from 12.8%;
- for loans for business development at 8.7%, from 13%;
- for trade at 7.2%, from 10.3%; and

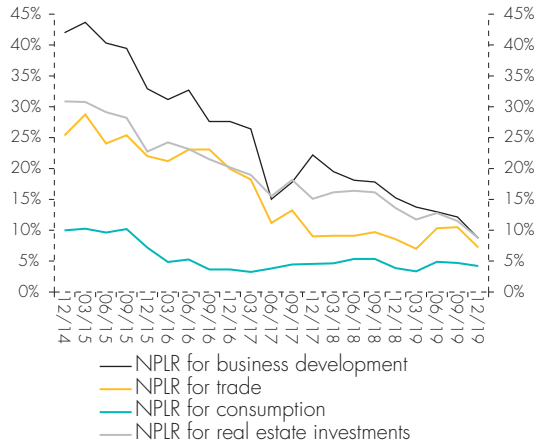
- for consumption - which also has the lowest ratio of non-performing loans - to 4.2%, from 4.9%.

Chart 83 Non-performing loan performance for loans unhedged against exchange rate fluctuation, by currency



Source: Bank of Albania

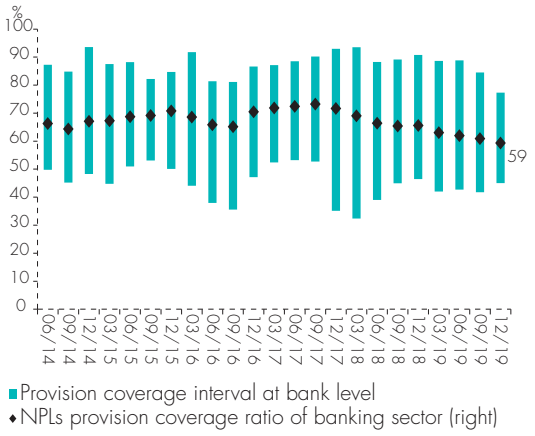
Chart 84 Non-performing loans for unhedged loans against exchange rate fluctuations, by purpose of use



Source: Bank of Albania

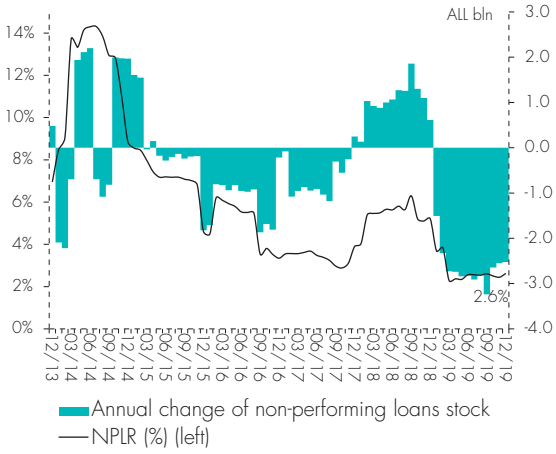
For the non-resident loan portfolio, which has been halved due to structural break, the quality of the loan remained unchanged during the period and the non-performing loan ratio reached 2.6%. Non-performing loan stock for this category is split almost equally between lost and doubtful loans. Almost the entire stock of non-performing loans for non-resident entities is held by businesses and these loans have been disbursed in Euro.

Chart 85 Provisioning ratio over time



Source: Bank of Albania

Chart 86 Annual change of the non-performing loans stock and NPLs for non-resident entities



Source: Bank of Albania

Over the period, the level of hedging of non-performing loans with reserve funds declined by 2.6 percentage points, at 59%, reflecting the higher decline of reserve funds compared with the decline of non-performing loan stock. Due

to the high weighting coefficient, a certain decrease in the lost loan stock within the non-performing loan portfolio is reflected in a higher decrease of the reserve fund stock for the loans.

During the period, the main contribution to the significant decline in the stock of reserve funds was given by the significant contraction in the surplus of lost loans.

Capital coverage of net non-performing loans[36] expanded to 7.3 times from 5.9 times at the end of the first half of the year. This expansion reflected the rapid decline in the net non-performing loans[37]. In December 2019, the net non-performing loan ratio against outstanding loans registered 3.4% or 0.9 percentage point lower than June 2019.

One of the most positive developments of the period was the further increase of the collateral coverage ratio of loans. At end-December 2019, this indicator marked the highest level of the last seven years (about 80%). Compared to the previous period, the collateral coverage ratio of loans[38] expanded by about 2.7 pp. Loans with collateral in the form of real estate account the main share by around 66% of collateralized loans, and 53% of outstanding loans. Outstanding uncollaterized loans contracted by 10% during the period.

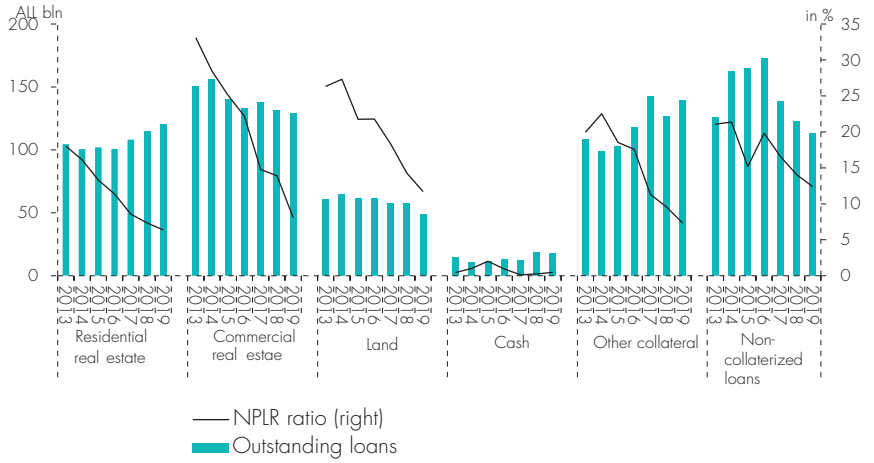
The collateralized credit quality, defined by the performance of loans collateralized with real estate, improved during the period. NPLs ratio for collaterized loans was 7.5% at the end of the year, from 10.5% in the previous year. The decline in non-performing loans stock for collateralized loans has started since 2016. Compared to the end of 2018, the non-performing loan ratio for loans collateralized with commercial real estate marked the most rapid decline by 5.8 percentage points, at 8.1%. This is the lowest level reported in the last ten years. The quality of credit is constantly improving for other loans collateralized with real estate as well, recording the lowest levels of non-performing loans since 2013. Loans collateralized with cash, continue to maintain the lowest level of non-performing loan ratio (0.5%). The quality of non-collateralized loans also improved compared with the end of the previous period and with the previous year. However, this type of loan holds the highest level of non-performing loan ratio (12.4%).

[36] *Non-performing loans after the deduction of provisions.*

[37] *As a result of the contraction in outstanding net non-performing loans by nearly 18% and the expansion of regulatory capital by around 1.2%, the "net non-performing loans/regulatory capital" ratio decreased to 14%, from 17% in June 2019.*

[38] *Collateral in the form of real estate (residential, commercial or land), cash etc.*

Chart 87 Outstanding loans and non-performing loans ratio by collateral



Source: Bank of Albania.

4.1.2.2 Liquidity risk

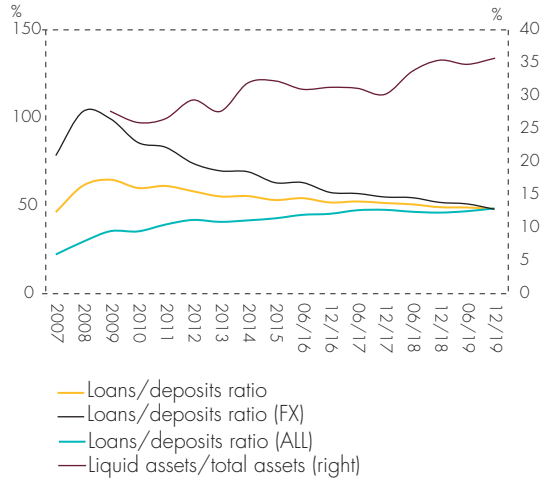
The liquidity position of the banking sector continued to maintain good levels and remains significantly above the regulatory limits.
The abundant presence of liquid assets mitigates the risk signals coming from negative values in the maturity gap between assets and liabilities in the short -term.

The liquidity position of the banking sector has continued to maintain good levels. The liquidity indicators, both in Lek and foreign currency, stand notably above the minimum regulatory ratios. Deposits remain the main source for funding bank activity, and they cover almost twice the volume of sectors' loans. At the end of 2019, the loans/deposits ratio registered 48.3%, a slightly lower value compared to the previous year. By currency, this ratio stands at 48.5% for the national currency and 48% for foreign currency. The "loan / deposit" ratio for the Lek is higher compared to the values of 2019 H1 and the previous year. The same ratio for the foreign currency shows a decrease against both periods. During 2019, loans in national currency have grown at a higher rate than the deposit base. During 2019 H2, foreign currency loans declined slightly, while foreign currency deposits expanded by about 5%. These developments have resulted in a decline in the foreign currency index from 51% at the end of the first half of the year to 48% at the end of the year.

Liquid assets in banks' balance sheets remain high, reflecting the possibility for the increase of lending activity. At the end of December 2019, the ratio of liquid to total assets of the banking sector was 36% or around 1 percentage points higher than the end of the previous half of the year. This performance reflects the faster growth of liquid assets in banks' balance sheets compared to the expansion of total assets. Liquid assets to total short-term liabilities also increased by 2 percentage points, up to 49%. Although banks are operating under ample liquidity conditions, the negative gap between assets and liabilities by segment of residual contractual maturity, vis-a-vis the total assets in the short-term, remains high.

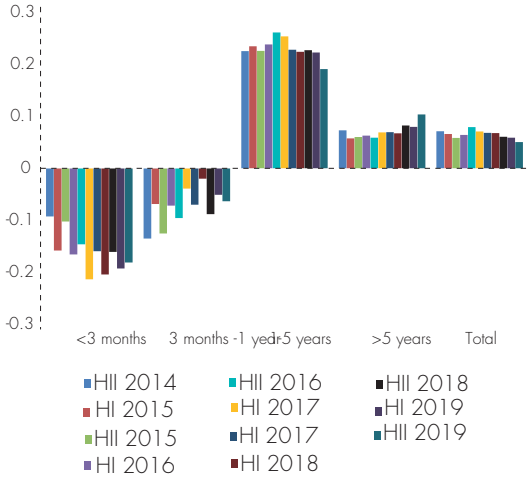
The negative gap between assets and short-term liabilities by segments of residual contractual maturity[39] for the period up to 3 months has narrowed slightly during the period. The overall gap[40] continues to be positive and has also narrowed, toward the end of June 2019, from 6% to 5% of banking sector assets. On the other hand, the gap between assets and liabilities for the period of 3 months - 1 year, during the period, expanded by about 30% and reached 6% of total assets from 5% six months ago. Negative values generally indicate an accepted characteristic of the banking activity, where the average term of investments (securities, deposits, loans) is longer than the average term of liabilities that fund these investments (deposits from the public).

Chart 88 Liquidity indicators



Source: Bank of Albania

Chart 89 Maturity mismatch between assets and liabilities

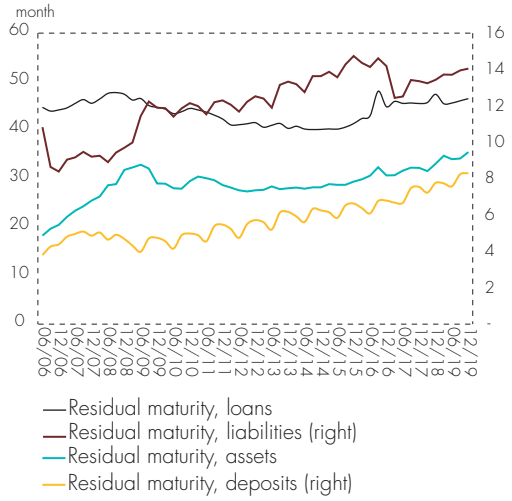


Source: Bank of Albania

In Albania, the presence of liquid assets in high values, serves to mitigate the signals transmitted by the mismatch in the balance sheet by maturity terms.

During the period it was observed an increase in the mismatch of average maturity of assets and liabilities. At the end of December 2019 this mismatch was around 21.4 months, from 20.3 months in June. Deposits' residual maturity, which represents the most significant category of liabilities, has increased by 8.3 month from 7.6 months. The residual credit maturity also increased at 46.5 months from 45.6, reflecting the banks propensity to grant credit for longer-term periods. Unlike the previous six months, the banking sector did not report the use of funding lines by the parent groups.

Chart 90 Average residual maturity



Source: Bank of Albania

[39] *Calculated as the ratio of 'difference between assets and liabilities' to 'total assets' for each basket of residual maturity. Off-balance sheet items are included in the value of assets and liabilities.*

[40] *Off-balance assets and liabilities are also included.*

4.1.2.3 Market risks

EXCHANGE RATE RISK

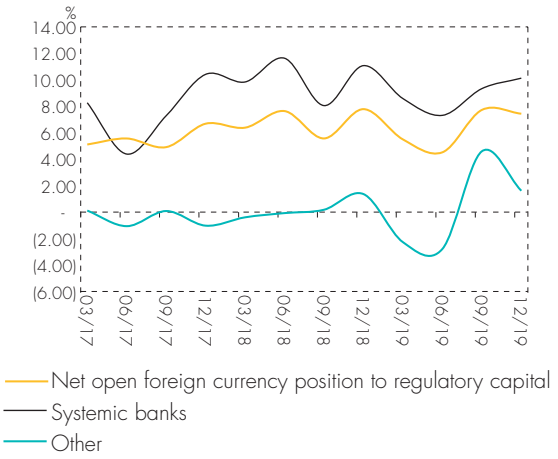
Net open foreign currency position of the banking sector, despite an upward trend, remains at limited levels and significantly below the regulatory limit.

The banking sector's exposure to indirect exchange rate risk also decreased, with the main contribution from the group of banks of systemic importance.

The levels of the net open foreign currency position indicate an increasing but still limited exposure to the direct impact of the exchange rate fluctuations on the balance sheet. The aggregate indicator for all banks, as well as the indicator for group of banks by size, has very low values compared with the upper limit of 30% of regulatory capital defined by the respective regulation.

During the second half of the year, the open foreign currency position increased by about 3 pp reaching 7.4% of regulatory capital. Compared to a year ago, the indicator was about 0.3 pp lower. The performance of the indicator is dictated by the group of systemic banks, which have maintained an open foreign currency long position. This position was as much as 10% of the regulatory capital, a value higher than the 7% of the end of previous period, but lower than the 11% of the end of the previous year. The group of other banks (non-systemic) presents a lower exposure to the exchange rate, with a net open foreign currency long position less than 2% of regulatory capital. During the first half of the year, non-systemic banks recorded a net short position of 3% of their regulatory capital.

Chart 91 Open foreign currency position to regulatory capital for the sector and groups

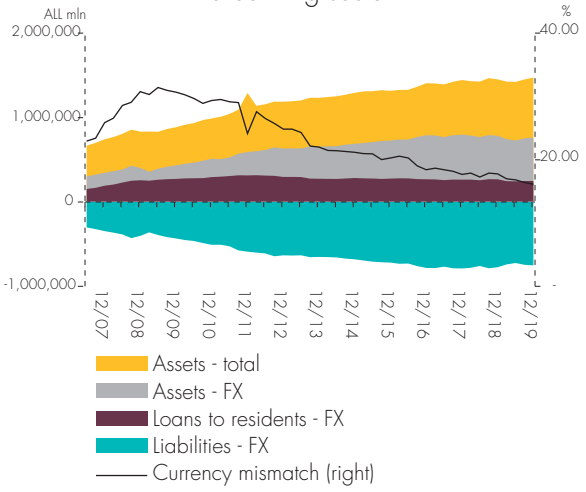


Source: Bank of Albania

The exposure of the banking sector to the indirect exchange rate risk decreased compared to the previous six months and the previous year. At the end of the period, the foreign currency mismatch[41] for all currencies was equal to 16% of total assets, from 17% and 18% at the end of 2019 H1 and at the end of 2018. Foreign currency assets and liabilities marked the same growth rate (about 6%), but the main impact on the decline of the indicator was given by the increase in bank assets. Due to the significant share in the balance sheet and activity of banks compared to other currencies, the European currency has a much higher contribution and correlation with the overall index. However, the main contribution to the decline in the value of the index during the period was given by the decline by 0.5 pp of the US dollar index at the level of 0.1%. The Euro index fell slightly during the period and marked 16% at the end of the year. At the end of last year, the index values for the Euro and USD were 17.5% and 0.8%, respectively.

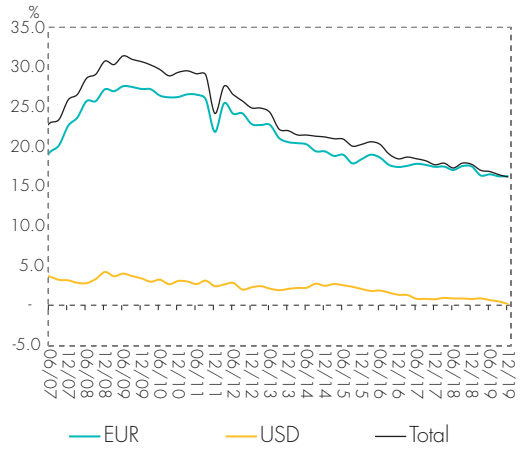
[41] *The foreign currency mismatch indicator measures the hedging rate of the banking sector's liabilities with assets set off by resident credit in foreign currency. A low value of this indicator's ration to assets shows a low exposure to fluctuations in the exchange rate. The methodology for calculating the mismatch indicator has been published in the Financial Stability Report 2016 H1.*

Chart 92 Performance of Indexes components for the banking sector



Source: Bank of Albania.

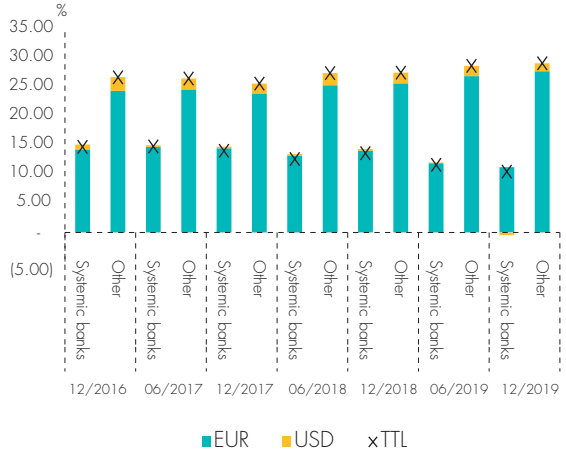
Chart 93 Performance of foreign currency mismatch indicator by currencies



Source: Bank of Albania.

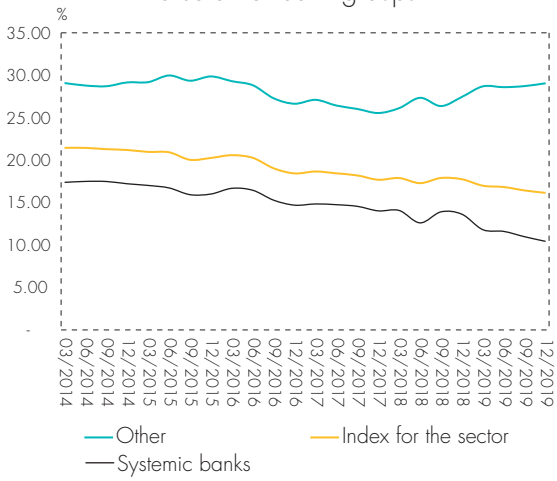
By groups, the performance of the currency mismatch index during the period was influenced by the decrease in the values of the indices for the group of systemic banks. The group of systemic banks records lower index values compared to the group of non-systemic banks. At the end of the period, the total index for systemic banks was as much as 10% of the group's assets, from 12% and 14% at the end of 2019 H1 and the end of last year. The main contribution came from the decline of the index in the European currency by 0.7 pp to about 11%. Other banks show a higher exposure to the indirect exchange rate risk. The mismatch index for this group was 29.1%, about 0.5 and 1.5 pp higher than the level of the previous six months and the previous year. The main contribution came from the similar growth rate of the Euro index.

Chart 94 Currency mismatch by groups and currency



Source: Bank of Albania.

Chart 95 Performance of foreign currency mismatch indicator for bank groups



Source: Bank of Albania.

INTEREST RATE RISK

Although increasing, the banking sector's exposure to interest rate risk remains limited and at low levels to regulatory capital, and significantly below the regulatory limit.

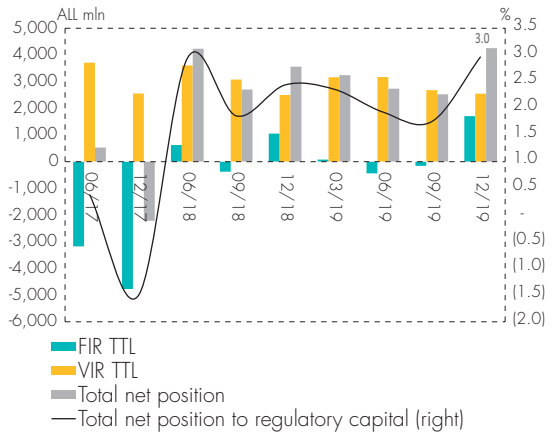
However, the banking sector shows an increased sensitivity to possible interest rate fluctuations for the net position in the national and long-term currency.

The banking sector exposure to the interest rate risk increased during the period, but remains at limited levels. The weighed total net position in the bank's balance sheet against regulatory capital of the banking sector stands at low levels, about 3%, close to the level of a year ago. The weighted spread of assets with fixed interest rate liabilities (FIR)[42] at the end of the period, shifted toward a positive direction. On the other hand, the net position with variable interest rate (VIR) declined in semi-annual and annual terms, but continued the positive direction of the last two years.

When the total net position is positive, i.e. the volume of claims that collect interest is greater than the liabilities for which interest is paid, the banking sector would be exposed to an immediate decline in interest rates. However, under conditions where the regulatory capital hedging of these positions remains high and having limited room for further decrease of interest rates, the cost that may come to the banking sector due to the further decrease of interest rates can be easily absorbed.

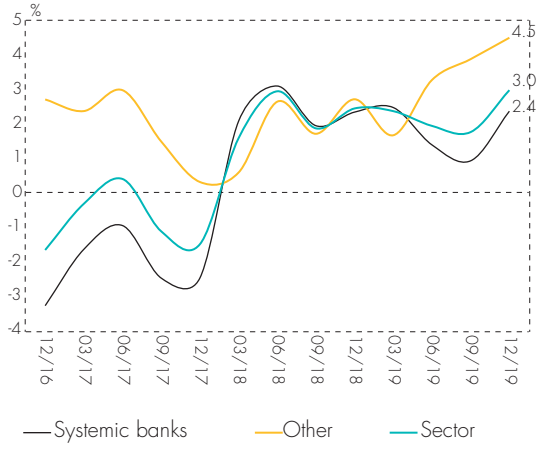
By groups of banks classified by importance, the group of other banks (non-systemic) exhibits higher exposure compared to the group of systemic banks. The second of half of 2019 was characterized by an increase in the exposure of other banks, as the exposure indicator reached the highest level of recent years, about 4.5% of regulatory capital. Systemic banks have expanded their exposure by 1 pp compared to the previous six months, at 2.4% of regulatory capital, but the indicator is at a comparable level with last year. The performance of the banking sector indicator is driven mainly by the systemic banks. The latter have higher exposure in the spread between assets and liabilities with variable

Chart 96 Weighted total net position in bank's balance sheets against regulatory capital, in %



Source: Bank of Albania

Chart 97 Performance by groups of weighted net position against regulatory capital, in %



Source: Bank of Albania

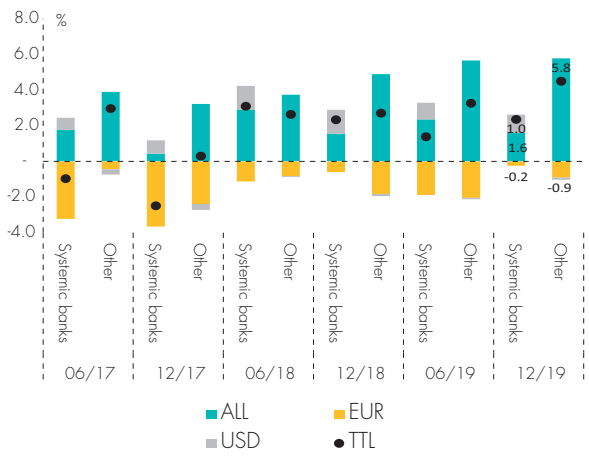
[42] *Positions sensitive to interest rate are classified in positions with fixed interest rate (FIR) and positions with variable interest rate (VIR), by maturity and currency.*

interest rate (VIR) and this position is as much as 1% of regulatory capital. For other banks, exposure is higher in assets and liabilities with fixed interest rate (FIR) and this position was 5.4% of regulatory capital at the end of the period.

By currency, the value of total net position against regulatory capital is affected by the narrowing of the negative position in the European currency by 1.5 pp, at (-0.4%) of regulatory capital. Net position in euro has negative values for both, the group of systemic banks (-0.2%) and the group of other banks (-0.9%). Both bank groups have the highest exposure to interest rate fluctuations, in the national currency, the position in which was at about 3% of regulatory capital. Compared to the last six months, the indicator has fallen by 0.5 pp, but remained at the same level of last year. The US dollar position is positive for systemic banks and relatively stable over time, about 1% of regulatory capital. For the group of other banks, this exposure is very small and negative.

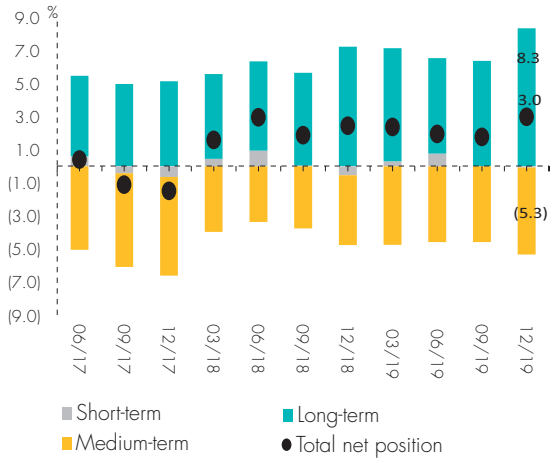
By maturity, the value of the total net position to the regulatory capital has been affected by the expansion of the position for long-term maturity. At the end of the period, the weighted net position for long-term maturity was as much as 8% of regulatory capital, upward compared to the previous six-months and previous year[43]. The main contribution to this development was given by the increase by ALL 3.7 billion of the weighted net position in Euro. Medium-term maturity continues to hold a negative position between assets and liabilities sensitive to the interest rate. This indicator was as much as 5% of the regulatory capital at the end of the period and expanded by about 1 pp compared of the previous six-months and previous year. The short-term gap held the lowest level of exposure (0.1%) and did not registered significant changes in the recent years.

Chart 98 Gap by group and currency against regulatory capital, in %



Source: Bank of Albania.

Chart 99 Weighted net position by maturity against regulatory capital, in %

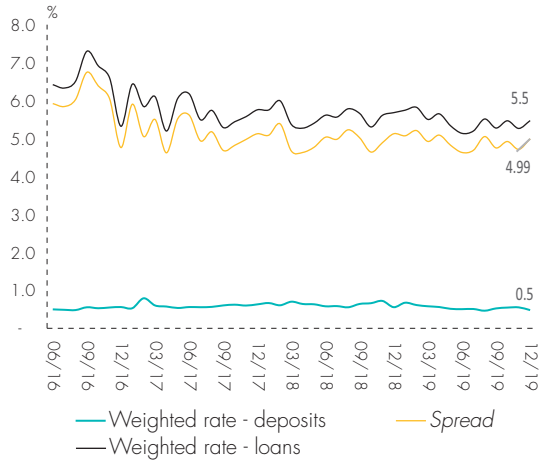


Source: Bank of Albania.

[43] *Respectively 5.8% and 7.2% of the regulatory capital.*

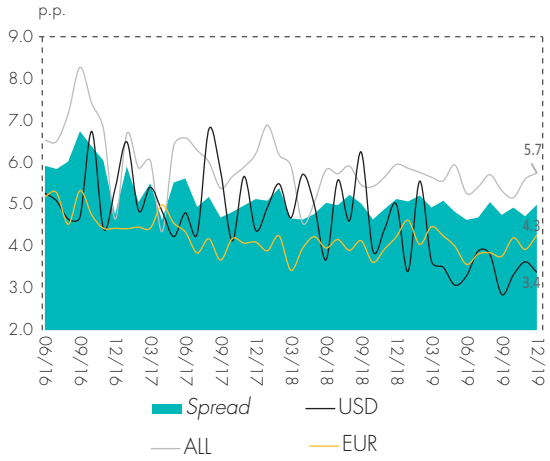
Indirect risk to interest rate change[44] increased during the period. The weighted interest rate on credit increased by 0.3 pp compared to six months ago, while the weighted deposit rate did not change significantly. Compared to the last value of the first half of the year, the overall spread expanded by 0.4 pp. Spread has expanded for all three currencies, but the main contribution to the expansion of the overall spread came from the interest rates in national currency. At the end of 2019, the spread between credit interest rates and new deposits interest rates in the banking sector was 5.7 percentage points for the Lek, 4.4 percentage points for the euro and 3.4 percentage points for the US dollar.

Chart 100 Loans and term deposits weighted interest rates and interest rates spread, in %



Source: Bank of Albania.

Chart 101 Spread of weighted interest rates of loans and term deposits by currency, in p.p.



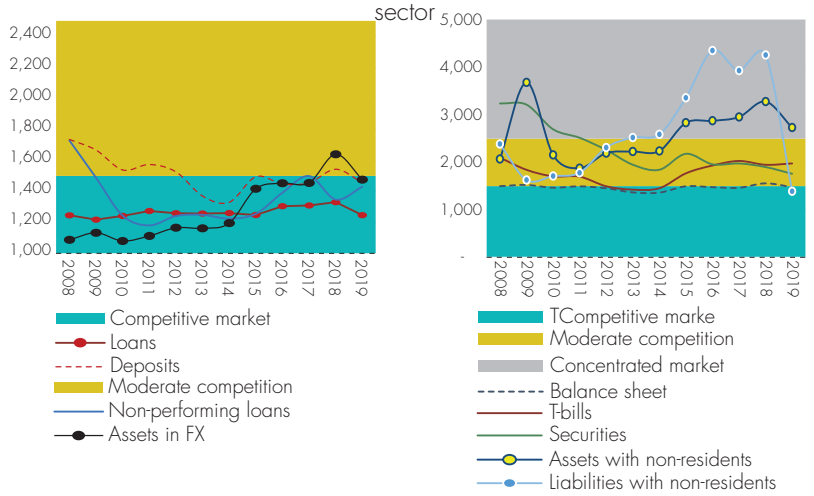
Source: Bank of Albania.

44 *This risk refers to the impact that the change in the interest rate has on banks' clients. For example, despite the fact that the increase of the interest rate may have a positive impact on bank's balance sheet (due to positive value of the net position between assets and liabilities sensitive to the interest rate), this increase will have a negative impact on the solvency of bank's borrowers when the loans is granted with variable interest rates (indirect risk).*

BOX 8 INDICATORS OF CONCENTRATION FOR THE BANKING SECTOR

The domestic banking sector continues to be a competitive market in terms of the main financial intermediation activities, which are the receipt of deposits and the granting of credit. Credit activity has the lowest concentration rate compared to all the other activities of the banking sector, and the concentration indicator for this activity has maintained stable and low levels throughout the last decade. The concentration indicator for the excess of non-performing loans records levels comparable to the concentration indicator for loan, but has shown higher volatility, especially during the period of financial crisis and during periods of restructuring within the banking sector. The banking sector has a good level of competition also for the activity of receipt of deposits, but the concentration rate is slightly higher compared to the lending activity, remaining, however, below the lower limit of the area indicating moderate competition (1,500 - 2,500 points).

Chart 102 Concentration indicator (HHI) for the main activities of the banking sector



Source: Bank of Albania.

*Indicators for which the concentration rate is particularly high are assets and liabilities to non-residents, while for the activity of banks in the securities market and treasury bills and for foreign currency assets, concentration indicators signal for a moderate competition. The rate of concentration of liabilities to non-residents*recorded particularly high values during 2015-2018, but at the end of 2019 it dropped significantly, falling in the area that implies competitive market. For assets with non-residents, which shows the claims of domestic banks to non-resident entities (loans for non-residents and deposits held abroad) and accounts for about 24% of total assets, the concentration indicator remains high, but has dropped significantly from 2018 to 2019 as a result of structural changes in the banking sector.*

Table 11 Indicators of concentration and connection between bank size and profit

	2015	2016	2017	2018	2019
Coefficient p: Assets/net result	0.67	0.51	0.89	0.81	0.87
Correlation coefficient: Assets/Interest income	0.99	0.99	0.99	0.99	0.98
Herfindahl–Hirschman Index Total assets	1.496	1.477	1.465	1.558	1.478
Number of banks	16	16	16	14	12

Source: Bank of Albania.

A more complex analysis of the concentration and efficiency of the financial institutions address the correlation between the size of banks and the size of the financial result. In general, the analysis of the Bank of Albania finds that proportionality between profit distribution and size distribution is relatively high. This means that at average levels and under normal conditions, banks' profits are in direct proportion to their size. During 2015-2019, the linear correlation between the banks' share in the banking sectors' total assets and the banks' share in the net interest result was stronger than the correlation measured for the years 2008-2014. The Spearman indicator (coefficient p) that measures the correlation between rankings for asset size and net result 6 shows that the ratio between bank size and their profitability is positive, and that this ratio has been particularly strong starting from 2017. It is generally estimated that the domestic banking sector is competitive and has a low concentration on key indicators of banks'' balance sheet and activity. At the same time, the distribution of profits between banks is in direct proportion to their size and the relation between the two indicators has been strengthening with the number of banks reducing and the banking sector consolidating over the past 2-3 years.

Chart 103 The ratio between bank size (bank's assets / sector's assets, (in %) and the net interest income (net interest income for the bank / net interest income for the sector, (in %)

Source: Bank of Albania.

* *Liabilities to non-residents at the end of 2019 accounted for less than 3% of the overall liabilities of the banking sector.*

4.1.3 BANKING SECTOR RESILIENCE

To assess the banking sector resilience the resilience test exercises are carried out, assessing the reaction of banking sector's key indicators to the proposed scenarios.

This time, the exercise does not contain the previous model of resilience test, but it is focused on assessing the degree of interconnectedness between banks, and between banks and the largest borrowers in the sector, as well as on analysing the liquidity situation. This change was driven by the following factors:

a) at the end of 2019, the results of the resilience test exercises continue to show good situation of financial capacity of the banking sector able to cope with the risks. However, the existing model of resilience test exercises, calibrated against conventional risks, needs to be reviewed and recalibrated under the conditions of an unconventional event, such as the pandemic that the world is currently facing is being outlined. The process of recalibrating the model itself is complicated by the fact that the assessment of the impact of pandemics on the economy currently has many unknowns and a high degree of uncertainty. For this reason, the recalibration process that will be carried out by the Bank of Albania for the existing models of resilience test exercises will require more time, so that the assessments obtained from the exercise are supported by experts as well.

The same process needs to be performed in parallel by the banks for the models or analyses they use to assess their capacities for risk measurement. To this end and referring to the current situation, it is necessary that banks:

- Increase the priority and frequency of these exercises, adapting the nature, severity and complexity of the scenarios;
- Assess the suitability of the capacities they own, to withstand the eventual shocks produced by those scenarios, not only in the short-term but also in a longer term;
- Provide a quick and effective decision-making process to strengthen these capacities. The focus should be on taking actions that not only maintain but also further improve the situation of capital and liquidity reserves;
- Strengthen communication with the Bank of Albania, for the analysis of developments and results.

b) The interaction is assessed as a structural element in the financial activity, and as such, it makes a stable and important contribution to risk monitoring. For this reason, the Bank of Albania has worked on to build models and assesses the spill-over of financial risks in the banking sector. The analysis can be found below.

The exercise to assess the resilience of the banking sector against the liquidity shocks is conducted once a year, and has previously been part of the financial stability reports for the end of the year.

4.1.3.1 Contagion risk[45] and financial interconnectedness[46]

The recent global financial crisis, in addition to the impact on the local economy, had its impact on the economies cross-border. It affected international financial markets, where the banking sector played a key role in the transmission of this phenomenon. The negative impact of these shocks was multiplied through the effect it had on the financial performance of bank balances sheet- the so-called "balance sheet effect" - causing significant losses up to bankruptcy.

This phenomenon prompted a wave of research to better understand the sources of systemic risk and potential determinants of financial crises, oriented in two directions. The first emphasizes the identification of risks that are accumulated over time and that are monitored through "leading indicators". Whereas, the second investigates the interbank dimension of risk spread. In the case of banking crises, it is essential to assess not only the transmission mechanism of economic or financial shocks, but also the level of vulnerability of the banking sector thanks to its financial interconnections, in the form of various domestic or cross-border exposures.

The analysis of financial interaction and the contagion risk is an important part of a country's financial stability and assessment of its systemic risk. Given the central role that the banking sector plays in mediating funds for the real economy, our focus is on the banking sector in the country. Its exposure to various types of risks - as a direct holder or their mediator - is assessed through a "macro-network"[47] of financial interaction. The macro-network visually presents a map of exposures in the banks' balance sheet and the direction of the transmission of the financial risks that accompany it.

More concretely, the analysis of the financial interaction between the banks in the country and the possibility of risk transmission was done based on the data of:

- direct balance sheet exposures against a sample of 5 borrowers - the largest in terms of regulatory capital in each of the individual banks, based on the balance sheet data as of November 2019;
- direct exposures to the balance sheet of each bank against all other banks, based on data as of 23 December 2019.

The above macro-network tracks the implications that arise from a stress event in terms of credit and financing, on the entities selected as part of the sample. Stress events from the viewpoint of credit, are analysed through ''failure'' of entity ''A'', and the consequence that this brings to the entity ''B'' (and other

[45] *The contagion risk, as a type of systemic risks, is defined as the risk that financial difficulties at one bank spill over to other banks, to the financial system itself or beyond, to the real economy as a whole.*

[46] *The term "financial interconnectedness" implies the network of relations between financial agents, mainly in the form of credit exposures, securities, deposits or trade relations and other dependence relations between them. Financial interconnectedness is considered an important mechanism in risk observation.*

[47] *The construction of macro-network is based on Espinosa-Vega dhe Sole, (EVS), 2010 method: For more information see: Espinosa-Vega, Marco A. and Sole, Juan A., "Cross-Border Financial Surveillance: A Network Perspective" (April 2010). IMF Working Papers, Vol. 10/105..*

entities of the sample), which has claims against entity ''A''. Meanwhile, Stress events in terms of financing are analysed through the implications of a "failure" of the entity "A" and how it will affect the entity "B" that has obligations to "A", to find alternative sources of financing. The algorithm tracks the implications of failure through several phases, until there are no more such events.

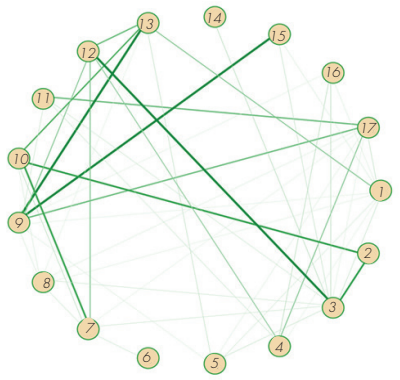
RESULTS

The following matrix presents the exposures of each of the sector's banks against 11 other banks and at the same time the balance sheet exposures of each bank against the five largest individual borrowers.

In the above macro-network, the interaction between banks or between banks and larger borrowers are shown through the green lines, the thickness of which is related to the level of interaction.

The low interaction level is reflected by the fact that only a few entities appear to have relatively stronger interaction to others, while the rest of the map displays a relatively low interaction level.

Chart 104 Large and interbank exposures, 2019



Note: The numbers from 1-12 belong to the banks and are randomly assigned. While the numbers from 13-17, despite being marked as "bank", belong to the five largest non-financial borrowers; these numbers are randomly assigned as well.
Source: Bank of Albania.

Chart 105 Macro-network analysis of exposures and shock / failure tracking process

Source: Bank of Albania.

Individual banks feel the shock over different phases, based on the assumption that in the event of a stress event, the losses experienced will have to be absorbed only by using the additional capital above the required regulatory minimum, i.e. above the minimum level of 12%. We emphasize that, in terms of regulatory capital, large and interbank exposures remain relatively low.

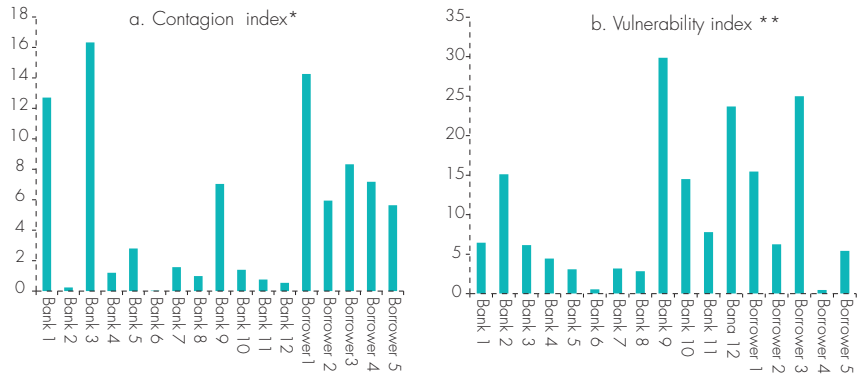
The above chart assumes two scenarios:

a. simultaneous failure of the five largest borrowers. In this extreme scenario, their failure affects the banking sector, through the higher sensitivity that a sector's bank presents due to its exposure to these borrowers. In this case, the additional capital over the regulatory one is lower than the total exposure of this bank to these borrowers. In this scenario, loss and shock in the regulatory capital materialize in a single phase.

b. failure of the largest borrower. In case of the failure of this borrower, a bank is again affected in the conditions when its exposure to this borrower is significant and the weight of this exposure in the bank's additional capital is high. In this case, the effect of this shock is transmitted in two phases, affecting another borrower owing to the fact that the bank's claims against this borrower exceed the company's capital. For this second phase, it is assumed that the bank, under conditions of stress, intensifies efforts to collect the claim it has against the second borrower and the latter finds it impossible to quickly find another bank to refinance the obligation to the stressed bank, thus being forced to restructure the activity. The exercise shows that transmission of stress to other borrowers, in this case, is irrelevant.

The summary of the results of the macro-network analysis is illustrated through two indices, the contagion and vulnerability index. Specifically, the "contagion index" identifies the impact (in percentage) on the additional capital of the banking sector or on the share capital of non-bank entities, in case of failure of one of the entities (bank or non-bank entity); whereas, the "vulnerability index" identifies the average level (in percentage) by which the capital of each entity is affected in case of failure of other entities individually.

Chart 106 Risk transmission analysis (cascade effect)



**The contagion index represents the ratio between the total losses in the sample additional capital to their total additional capital, not including the failed entity.*

***The vulnerability index represents the average loss of each entity in terms of its additional capital, in case of failure of all other entities in the sample, individually.*

Source: Bank of Albania.

From the graphical presentation, it results that the contagion and vulnerability indices show low transmission of risk. Currently it is estimated that banks with higher contagion index (bank 3), causes greater loss of entities' capital in the event of its bankruptcy (16%). On the other hand, the vulnerability index was higher for bank 9, which suffers an average shock in its additional capital by about 30%.

Focusing on interbank exposures, they are estimated to be minor compared to the banks' capitalization levels. For each bank, the total gross exposure to the rest of the banks is smaller than their regulatory capital. For this reason, a single failure of a domestic bank would not cause the failure of another bank and consequently, no "cascade effect" would happen in this representative sample.

4.1.3.2 Liquidity Stress test

The purpose of the liquidity stress test is to assess the capability of individual banks and of the banking sector overall to withstand extreme but possible shocks in financing their activity. These tests aim to evidence weaknesses or deficiencies of the sector and particular banks in particular currencies, instruments or time periods; assess banks' readiness to cope with extreme liquidity shortfall scenarios; as well as assisting the supervision authority to undertake specific policies that address liquidity management, including measures aimed at reducing exposures or creating specific reserves.

The results of the liquidity stress test show that the banking sector resilience to potential liquidity shocks is assessed strong and better compared to the previous year.

The liquidity stress test is implemented according to the "top-down" approach, with data reported by banks annually, at the end of the year. The exercise uses data on inflows and outflows forecasts of money according to the main instruments and for a time period constituted by 8 maturity baskets that cover a period from "up to 1 day" to "over 1 and up to 2 years". The test is implemented for the Lek, Euro and US dollar and is supported on the condition that the liquidity outstanding on a currency may not be used to cover the liquidity shortfall in other currencies, due to the probability of fast depreciation of the exchange rate over liquidity crises. In real situations, this is not a limiting element.

For the calculation of the liquidity gap are used specific coefficients for the withdrawal of funding sources (of deposits) and for the reinvestment of assets (loans) by all the maturity baskets. For financing sources, the coefficient shows only that part of the liabilities amount that matures in the relevant basket, which will be withdrawn to be reinvested by the customers. For money inflows, the reinvestment coefficient means that part of the amount rights that mature in the relevant basket, which will be converted in money inflow and will not be reinvested by the banks.

A bank is considered as failing the stress test only if expanded liquid assets that are sold with haircuts defined by the exercise shrink to the level when additional liquidity is needed by the Bank of Albania in the form of "loan for liquidity support".

RESULTS

The results of the stress test show that the resilience of the banking sector to possible liquidity shocks according to the data of November 2019, for the time horizon up to 2 years, is assessed as strong and appears better compared to the previous year.

The improvement of the resilience of the banking sector was influenced by the significant increase (by about 20%) of the expanded liquid assets (counterweighting capacities), while the expected inflows and outflows of money for the three currencies and the gap between them remained almost unchanged compared to the previous year. The gap between inflows and outflows continues to be negative, and the highest negative values are recorded in the baskets' up to 1 day ',' 1 to 2 months' and '6 to 12 months', while for the basket' 1-2 years' expected inflows are higher than outflows.

The resilience of the banking sector to liquidity shocks depends on currency. The ability of the banking sector to face liquidity shocks is assess as "very good" for lek and US dollar and "good" for euro. The simple gap between the inflows and outflows in Lek is generally higher compared to that in Euro, but the extended liquid assets of banks in the Lek are about 2 times higher compared to those in the Euro. For the US dollar activity accounting for less than 10% of total money inflows and outflows, the gap between inflows and outflows is positive and the banks' resilience is quite good.

The number of banks that continue to record a negative liquidity gap compared to a year ago has not changed for Lek and US dollar, and has slightly decreased for the Euro, while the maximum value of the liquidity gap in relation to banking sector assets ranges from 0% (Lek and USD) to 3% (Euro). But using extended liquid assets helps close the liquidity gap.

Compared to a year ago, the strengthening of resilience in Lek is related to the increase of the volume of expanded liquid assets, available for liquidation to fill the gap (as counterweighting capacities). On the other hand, the improvement of the Euro is related not only to the increase in the volume of counterweighting capacities, but also to the expected improvement in money inflows and outflows that mainly reflect credit inflows and deposit outflows.

4.2 NON-BANK SECTOR

4.2.3 MAIN DEVELOPMENTS IN THE NON-BANKING SECTOR

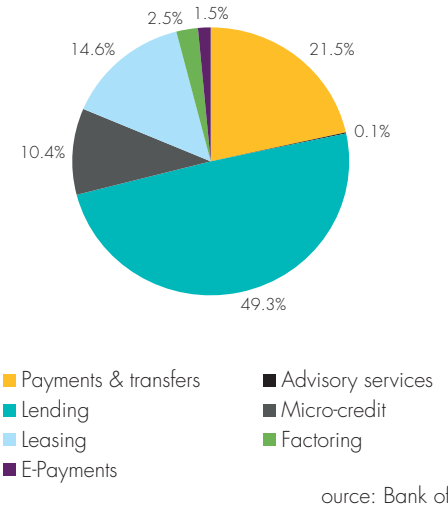
4.2.3.2 Institutions supervised by the Bank of Albania.

During the period, non-bank financial institutions (NBFIs) expanded their activity due to the positive performance of lending activity and investments in the form of current accounts in banks. At end-2019, the financial system contained 32 NBFIs, with total assets of ALL 65 billion. Their balance was 9% and 23% higher compared to June 2019 and the end of the previous year. Domestic capital dominates by 88% the total shareholders' equity of NBFIs, where the NBFIs that carry out lending activities account for the main share, followed by those that carry out payments and transfers. NBFIs are more active in lending to service activities (about 30%) and wholesale and retail trade (16%) NBFIs ended 2019 with a positive financial result (about ALL 3 billion), higher compared to the previous year. The activity capitalisation of these entities continued to remain at satisfactory levels. The portfolio quality of loans declined slightly, since the ratio of non-performing loans at the end of the year, was 10% from 9% and 9.5% in the previous six months and year.

Non-bank financial institutions (NBFIs) expanded their activity following the intermediation increase in the lending activity. The positive financial result is upward and has contributed to the satisfactory level of activity capitalization.

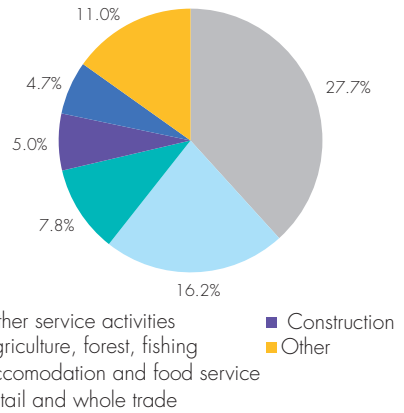
However, the quality of portfolio should be monitored when non-performing loans record higher values than the level of the banking sector.

Chart 107 The NBFIs structure by type of activity, December 2019



ource: Bank of Albania.

Chart 108 The Portfolio structure of loans by economy sectors, December 2019



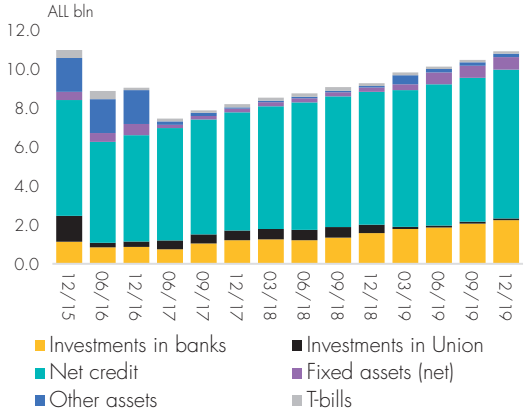
Source: Bank of Albania.

The activity of Savings and Loan Associations (SLAs) expanded in semi-annual and annual terms, supported by the growth of net loan (activity of the members) and the growth of investments in the banking sector in the form of current accounts. The financial result of the SLAs was positive and improved compared to the previous year, when this segment of the financial system did not report profit. Net loans to members and investments in banks represent the main items of these institutions' assets. The sector with the largest funding from the activity of the members is the agricultural sector, followed by service activities. The quality

The activity of Savings and Loan Associations (SLAs) was positive in terms of lending and financial result of the period. The quality of loan portfolio continued to improve, leading to the decrease of non-performing loans.

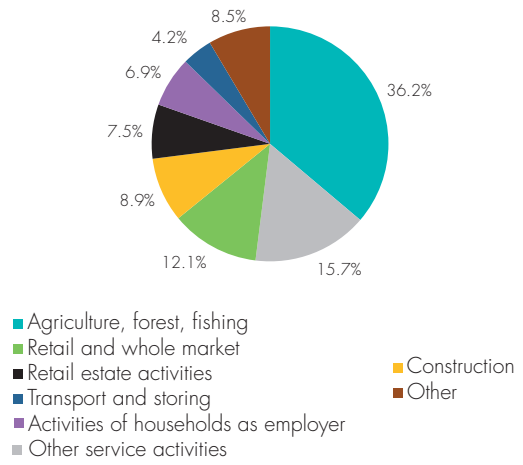
of the loan portfolio improved further and the ratio of non-performing loans at the end of the year decreased to 4.7% from about 5.0% in the previous six-months and the previous year, respectively. At the end of 2019, fourteen Savings and Loan Associations and one Union operated in the Albanian market.

Chart 109 The assets' structure of Savings and Loan Associations



BaSource: Bank of Albania.

Chart 110 Loan portfolio structure by economy sectors, December 2019



Source: Bank of Albania.

4.2.3.3 Institutions supervised by the Albanian Financial Supervision Authority

The activity of the insurance companies supervised by the AFSA reflects a more volatile performance. Despite the expansion in terms of assets and the number of entities licensed in the insurance companies and supplementary private pension funds, the investment funds contracted.

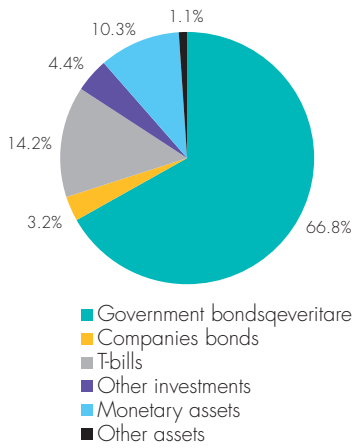
The activity of insurance companies increased during the period, supported by the increase of technical provisions, stocks and time deposits in banks. There are 12 licensed insurance companies operating in the domestic market that carry out life insurance (4 companies) and non-life insurance (8 companies). The assets of these institutions[48] grew by 4% annually, reaching ALL 34 billion. Investments in banks held the main share (around 32%) in insurance companies' balance sheets. Gross written premiums[49], with the main contribution from non-life premiums (92%), which represent the main funding source for the insurance companies activity, expanded by 4% in annual terms.

The activity of investment funds[50] contracted during the period as a result of the decrease of investments in government securities in the form of T-bills and deposits in banks. The value of net assets declined at ALL 67 billion, from ALL 69 billion at the end of June 2019. Currently, five investment funds operate in the Albanian financial system and one new fund, licensed in 2019, which is expected to report its activity regarding collective investment. The investment fund market is market with relatively high concentration, where two of the investment funds own about 80% of the total net assets of funds. Investment

[48] *The insurance companies' balance sheets belong to 2019 Q3.*
[49] *AFSA, Statistical Report, 2019. Published on 28 January 2020.*
[50] *AFSA, "Collective investment undertakings market", 31 December 2019, published on 24 January 2020.*

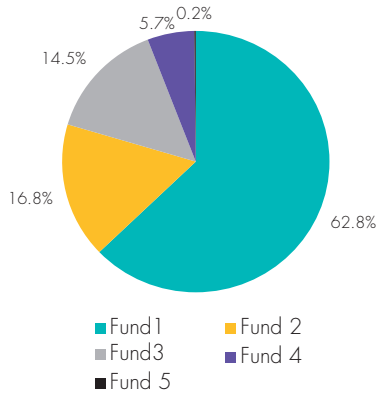
fund' assets are mainly invested in bonds issued by the Government of the Republic of Albania, with higher return, compared to alternative investments.

Chart 111. Structure of the assets of investments' funds, December 2019



Source: Bank of Albania.

Chart 112. Share of investments' fund in the market, according to assets' net value, December 2019



Source: Bank of Albania.

Supplementary Private Pension Funds[51] have expanded their activity during the period. In Albania, three supplementary private pension funds operate in the financial market, and one new fund, licensed in October 2019, which is expected to report its activity regarding supplementary private pensions. The assets of these funds, at the end of 2019 registered ALL 3 billion, or 13.5% more compared to end-2017. The activity of pension funds is dominated by investments in government debt securities.

The activity of the Albanian Securities Exchange (ALSE), during the period, consisted in transactions with government debt securities. The ALSE counts 4 members which are banks and one Brokerage Company. According to the statistical data of the AFSA[52], the value of traded bonds was about ALL 2 billion and the value of T-bills about ALL 0.3 billion. Regarding the instruments traded in AFSA, both in number and value, the transactions conducted for the account of customers, are dominant.

4.2.4 FINANCIAL SYSTEM INTERACTION

The exposure of the banking sector to non-banking sector in Albania is limited with no changes during the year. This exposure on the side of banks' assets is represented by loans granted to non-bank financial institutions, which accounts for only 1% of the total assets of the banking sector. On the side of liabilities the exposure is in the form of funds collected by banks (various accounts, time

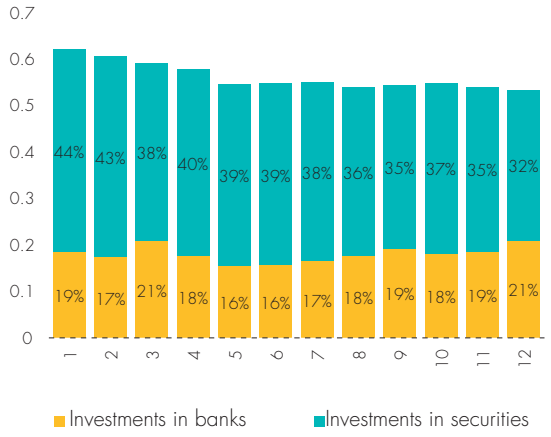
The banking sector's exposure to the non-banking sector in Albania remains limited, unchanged during the year. Whilst, the sensitivity of the non-bank sector to the activity of the banking sector is high and upward during the period.

[51] *AFSA, Statistical Report "Developments in the private supplementary pensions", 31 December 2019, published on 26 February 2020.*

[52] *AFSA, Monthly Publication No. 130, December 2019.*

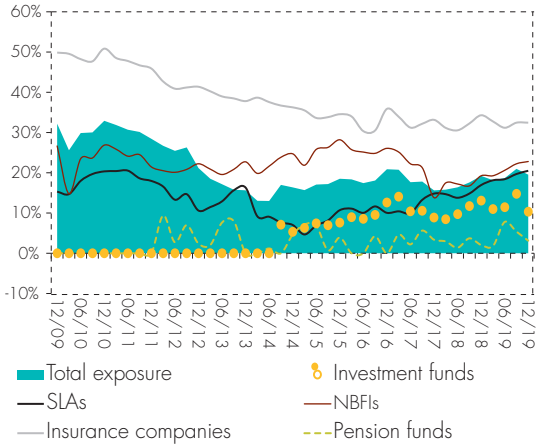
deposits or demand deposits), and accounts for only 2% of the value of assets of the banking sector. This ratio has slightly increased during the recent years,

Chart 113 Investments of non-bank sector in banks and government securities, to total assets of the non-bank sector (share, in %)



Source: Bank of Albania, Albanian Financial Supervisory Authority.

Chart 114 Investments of non-bank sector financial institutions in the banking sector to their total assets (in %)



Source: Bank of Albania, Albanian Financial Supervisory Authority.

but it is considered very low compared to the threshold-level applied by the Bank of Albania for the monitoring of the risk of exposure and concentration of activity between different segments of the financial system.

The sensitivity of the non-banking sector to the activity of the banking sector remained high and upward during the period. In total, this exposure at the end of third quarter accounted for 21% of the assets of the non-bank sector, compared with 19% at the end of 2018. Insurance companies and non-bank financial institutions (NFBIs) show the highest exposure to the banking sector, since their placements in banks in the form of deposits and capital instruments, account for 33% and 22%, respectively, of relevant assets. Regarding the Savings and Loans Associations, the exposure and sensitivity to the developments in the banking sector increased, given that these entities increased the deposits in the banking sector. The exposure of the non-banking sector to the banking sector is regularly monitored by the Bank of Albania in the context of periodic assessment of systemic risks and monitoring of the fulfilment of the intermediate objectives of macro-prudential policy.