# 6. FINANCIAL SYSTEM

**(43) Banks continue to dominate the structure of the financial system[36]. The share of total assets of the financial system in Gross Domestic Product (GDP) fell at 107.6% at the end of 2018 Q3, from 110.3% at the end of 2017.** The fall was driven by the higher growth of GDP compared to the growth of the financial system's assets. The share of banking sector fell at 96.8%, from 99.4% at the end of 2017; the share of non-bank financial institutions increased slightly at 3.3%, from 3.1%; while the activity of investment funds contracted and their share fell at 4.5%, from 5%.

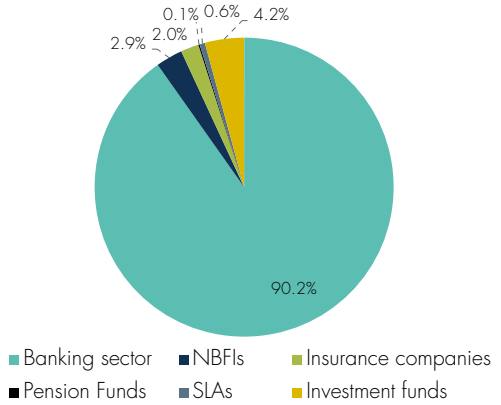
*Table 5 Share of segments of the financial system to GDP over the years*

| Liccencing and Supervising Authority | Financial System | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|---|
| Bank of Albania | Banking Sector | 88.1 | 92.1 | 94.8 | 97.6 | 97.3 | 100.5 | 99.4 | 96.8 |
| | NBFIs | 2.7 | 2.7 | 2.7 | 3.0 | 2.9 | 3.0 | 3.1 | 3.3 |
| | SLAs and their Unions | 0.8 | 0.8 | 0.7 | 0.8 | 0.8 | 0.6 | 0.6 | 0.6 |
| Financial Supervisory Authority | Insurance companies | 1.5 | 1.6 | 1.7 | 1.9 | 2.1 | 2.1 | 2.1 | 2.2 |
| | Pension Funds | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 |
| | Investment Funds | | 1.2 | 3.9 | 4.8 | 5.0 | 4.7 | 5.0 | 4.5 |
| Financial intermediation | | 93.1 | 98.6 | 103.8 | 108.2 | 108.0 | 111.0 | 110.3 | 107.6 |

*Source: Bank of Albania, Albanian Financial Supervision Authority.*

**(44) The activity of the banking and non-banking sector in terms of the financial system performance appears stable.** All segments of the system recorded a growth of the activity, except investment funds. The performance indicators of the financial system, including capitalisation, profitability, liquidity and assets quality, remain at good levels.

Chart 33 Share of financial system segments/total assets of the financial system, December 2018




Source: Bank of Albania, Albanian Financial Supervision Authority

[36] *Balance sheets of the banking sector, investment funds and savings and loan associations, as at end 2018. For the other segments of the financial system, (non-banks, insurance companies and pension funds), the balance sheets belong to 2018 Q3, according to the reporting to the Bank of Albania and to the Albanian Financial Supervision Authority. The GDP value corresponds to September 2018, the latest value published by INSTAT, as at the time of the preparation of this Report.*

*Table 6 Main indicators of the banking system's financial soundness*

| In per cent | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|---|
| Capital-based indicators | | | | | | | | | |
| Regulatory capital to risk-weighted assets | 15.40 | 15.56 | 16.17 | 17.96 | 16.84 | 15.72 | 16.01 | 17.03 | 18.24 |
| Tier 1 capital to risk-weighted assets | 14.52 | 14.30 | 14.57 | 14.88 | 13.79 | 13.45 | 14.10 | 15.53 | 16.99 |
| Shareholders equity to total assets | 9.40 | 8.69 | 8.57 | 8.37 | 8.58 | 9.53 | 9.73 | 10.17 | 10.15 |
| | | | | | | | | | |
| Asset quality | | | | | | | | | |
| Net NPLs to regulatory capital | 35.95 | 52.01 | 55.62 | 40.22 | 38.25 | 24.28 | 23.08 | 15.72 | 15.51 |
| NPLs (gross) to total loans | 13.96 | 18.77 | 22.49 | 23.49 | 22.80 | 18.22 | 18.27 | 13.23 | 11.08 |
| | | | | | | | | | |
| Profitability | | | | | | | | | |
| ROE (annual basis) | 7.58 | 0.76 | 3.78 | 6.43 | 10.53 | 13.16 | 7.15 | 15.71 | 12.96 |
| ROA (annual basis) | 0.72 | 0.07 | 0.33 | 0.54 | 0.89 | 1.20 | 0.69 | 1.54 | 1.32 |
| | | | | | | | | | |
| FX net open position to captial | | | | | | | | | |
| FX net open position to regulatory capital | 5.03 | 3.94 | 3.98 | 4.08 | 8.49 | 7.66 | 7.03 | 6.68 | 7.78 |
| FX net open position to Tier 1 capital | 5.33 | 4.29 | 4.41 | 4.92 | 10.37 | 8.95 | 8.00 | 7.34 | 8.35 |
| | | | | | | | | | |
| Asset-based indicators | | | | | | | | | |
| Liquid assets to total assets | 25.95 | 26.53 | 29.37 | 27.64 | 31.94 | 32.26 | 31.29 | 30.22 | 34.23 |
| Liquid assets to sh.t. liabilities (up to 1 year) | 30.62 | 33.15 | 36.71 | 34.71 | 40.36 | 41.43 | 40.57 | 40.79 | 46.21 |
| Client deposits to total loans | 166.39 | 163.20 | 171.62 | 180.83 | 180.16 | 187.78 | 192.84 | 194.00 | 203.25 |

*Source: Bank of Albania.*

## 6.1. BANKING SECTOR

(45) **During the period, banking sector's assets expanded by 1.9%; meanwhile changes in the balance-sheet structure were insignificant.** The reported value of total assets increased by ALL 27 billion during the period, reaching at ALL 1,453 billion, mainly driven by the expansion by about ALL 17 billion in the item of investment in securities and the fall by around ALL 9 billion in the credit risk provision fund. The slowdown in credit growth is reflected in a low and negative contribution of "customer transactions" in the half-yearly and annual change of the total assets of the sector. The annual growth pace of assets slowed down at 0.6%, from 2.7% a year earlier.

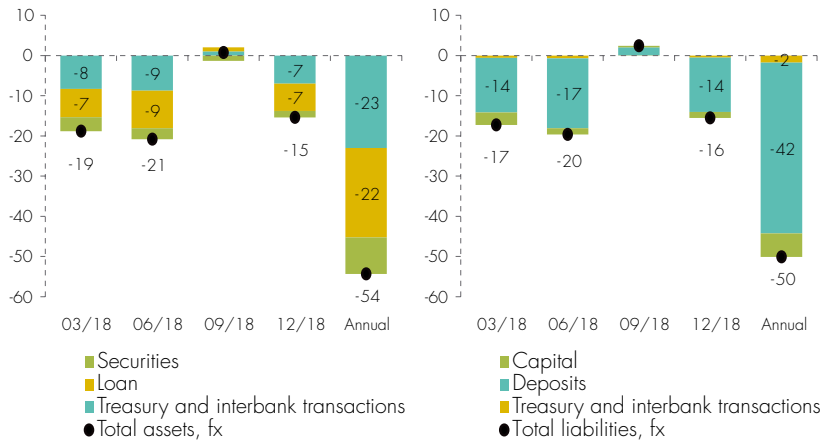
*Table 7 Structure of banks' balance sheet and annual change, December 2018*

| Asset | % of assets | Annual change, % | Liability | % of liability | Annual change, % |
|---|---|---|---|---|---|
| I. Treasury and interbank transactions | 32.6 | -1.8 | I. Treasury and interbank transactions | 5.5 | 3.8 |
| II. Customer transactions (credit) | 39.8 | -3.3 | II. Customer transactions (deposits) | 81.0 | 1.2 |
| Of which: public sector | 1.9 | -26.1 | Of which: public sector | 1.9 | -0.7 |
| Of which: private sector | 38 | -1.8 | Of which: private sector | 79.4 | 1.3 |
| III. Securities transactions | 26.5 | 7.8 | III. Securities transactions | 0.5 | -10.1 |
| IV. Created Reserve funds | -3.0 | -25.3 | IV. Other liabilities | 1.3 | -3.4 |
| V. Other* | 4.1 | -9.3 | V. Permanent sources | 11.8 | -4.3 |
| | | | of which: Subordinated debt | 1.0 | -36.9 |
| | | | of which: Shareholders' equity | 10.1 | 0.6 |
| Total assets | 100 | 0.6 | Total liabilities | 100 | 0.6 |

* "Other" in the balance sheet refers to "Other assets", "Fixed assets" and "Accrued interests"
Source: Bank of Albania.

**(46) The appreciation of lek exchange rate against the main foreign currencies provided an important diminishing contribution to the performance of the reported value of banking sector's assets.** At the end of the period, banking sector's assets in foreign currency account for around 55% of total assets; liabilities in foreign currency account for 53% of total assets. These shares show slight changes from the previous periods. Based on the values of these shares by periods, the impact of lek's exchange rate appreciation, during 2018, has been calculated for the main items in the banking sector's balance sheet. On the asset side, the most important impact is recorded for: Treasury and interbank transactions (ALL -23 billion) and Customer transactions (credit) (ALL -22 billion); on the liability side, almost the entire diminishing impact from the exchange rate is reflected in the performance of deposits denominated in foreign currency (ALL-42 billion); while the impact on the capital in foreign currency of the banking sector was lower (ALL-6 billion). This impact of the exchange rate should be taken into account when analysing the banking sector indicators in the future.

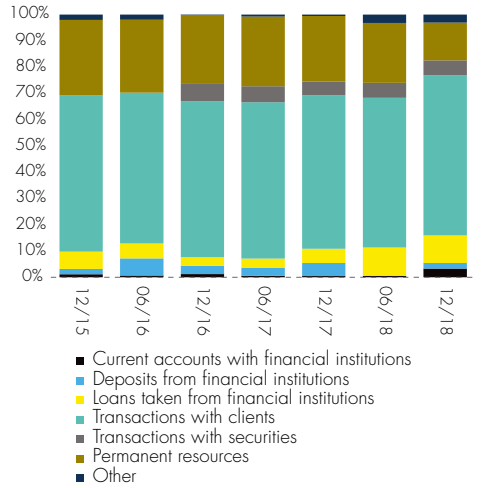
Chart 34 Exchange rate effect in lek equivalent on key items of assets (left) and liabilities (right)




Source: Bank of Albania

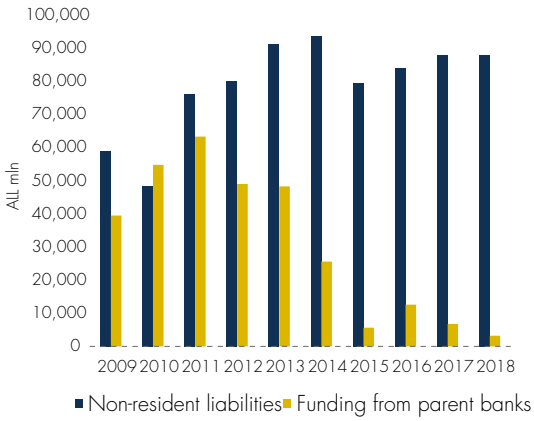
(47) **Deposits and own funds are the main financing sources of the activity of the banking sector; meanwhile, reliance on external financing sources remains limited.** Nevertheless, liabilities to non-residents, in the form of current accounts of non-resident financial institutions and deposits placed by non-residents at domestic banks, expanded. These developments have narrowed the net credit positions of the banking sector.

Chart 35 Structure of non-resident liabilities



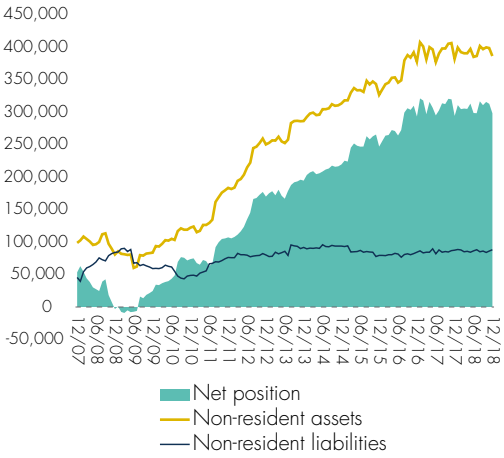

Source: Bank of Albania

Chart 36 Foreign financing




Source: Bank of Albania

Chart 37 Assets and liabilities to non-residents




Source: Bank of Albania

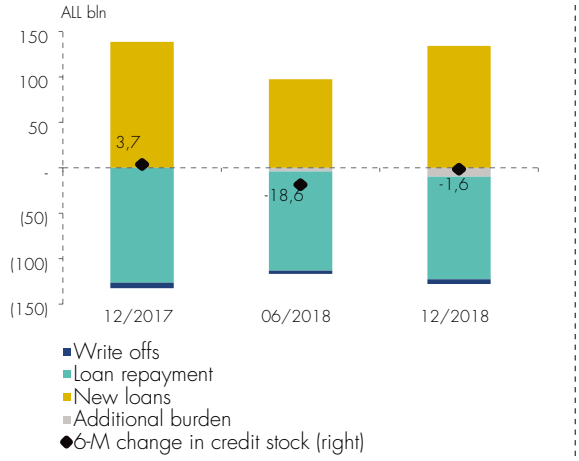
(48) **Claims to non-residents accounted for 27% of total assets, while liabilities to non-residents accounted for 6% of balance sheet total.** In the last two years, the share of claims and liabilities to non-residents has maintained relatively stable levels and the net credit position of the banking sector has remained unchanged, around ALL 300 billion. Interbank transactions and Securities transactions issued by non-resident entities dominate the claims to non-residents; meanwhile, liabilities to non-residents are mainly in the form of customer transactions (deposits) and permanent sources (capital).

### 6.1.1 LOANS

(49) **At the end of 2018, the outstanding loans were ALL 581 billion, standing ALL 1.6 billion or 0.3% lower than at the end of 2018 H1, and around ALL 20 billion or 3.4% lower than in 2017 H2.** Albeit new loans were higher than in 2018 H1, the performance of outstanding loans reflected the high level of loan repayments, which, during the period, reached at around ALL 120 billion. During the period, banks have written off

from their balance sheet in total around ALL 5 billion loans classified as "lost". If written off loans were included in the portfolio of banking loans, then the outstanding loans would have increased by 0.5% during the period.

Chart 38 Change in outstanding loans by element (new loans, loan repayments written off loans)




Source: Bank of Albania

**(50) Loans to enterprises declined by 1.4%, or around ALL 5 billion, and provided the main contribution to the decline of loans, during the period.** The fall in outstanding loans to enterprises is registered in loans both in foreign currency and in lek. Loans to households grew by 1.8%. This performance changed the loans' structure by sector, in favour of loans to households. At the end of the period, loans to enterprises were around ALL 370 billion, accounting for 63% of outstanding loans of the banking sector, from 64% a year earlier, and 70% at the end of 2014[37]. In annual terms, the reported value of loans shrank by 3.4%. In addition to the negative contribution by loans to enterprises, outstanding loans were also affected negatively by the performance of loans to the public sector, which, at the end of year, were 26% lower compared to the previous year[38].

*Table 8 Data on main categories of loans*

| | Indicator and unit | Value (ALL billion) | Share in total loans (%) | | | Change (%) | |
|---|---|---|---|---|---|---|---|
| | Period | 12/2018 | 12/2017 | 06/2018 | 12/2018 | Annual | 6-M |
| By currency | Lek loans | 255 | 44 | 44 | 44 | -2,5 | 0,6 |
| | Foreign currency loans | 326 | 56 | 56 | 56 | -4 | -1 |
| By institution | Public sector | 28 | 6 | 5 | 5 | -26 | 1,3 |
| | Enterprises | 368 | 64 | 64 | 63 | -4,4 | -1,4 |
| | Individuals | 185 | 30 | 31 | 32 | 3,8 | 1,8 |
| By maturity | Short-term | 166 | 31 | 29 | 29 | -11 | -3,1 |
| | Medium-term | 111 | 18 | 18 | 19 | 1 | 3,6 |
| | Long-term | 304 | 51 | 52 | 52 | -0,3 | 0 |
| | Outstanding loans | 581 | 100 | 100 | 100 | -3,4 | -0,3 |

*Source: Bank of Albania.*

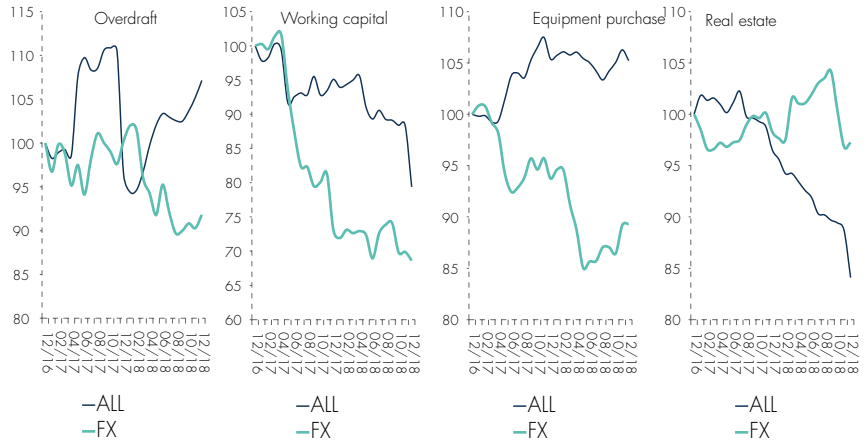
**(51) The structure of loans to enterprises has changed over the last two years.** Hence, loans for working capital contracted, both in lek and in foreign currency. As a result, the share of loans for working capital in outstanding loans to enterprises fell at 14%, from 18% at the end of 2016. Loans for equipment purchase sharing around 1/3 of loans to enterprises grew for the domestic currency, but fell sharply for the foreign currency-denominated portfolio.

[37] *Outstanding loans to enterprises, at the end of 2018, were around 13% lower than the highest value registered during the last 5 years; while loans to households were 23% higher than the one registered 5 years ago.*

[38] *The repayment of a bank loan by the Albanian Electro Energy Corporation, after its financing by a loan granted from the European Bank of Reconstruction and Development, provided an important impact on the fall of outstanding loans to public sector and on the overall annual performance of banking loans.*

The share of loans for real estate purchase in the outstanding loans to enterprises has remained unchanged (around 25%) in the last two years; meanwhile, the share in lek of this portfolio has dropped by around 15%, and the share in foreign currency has remained almost unchanged throughout this period.

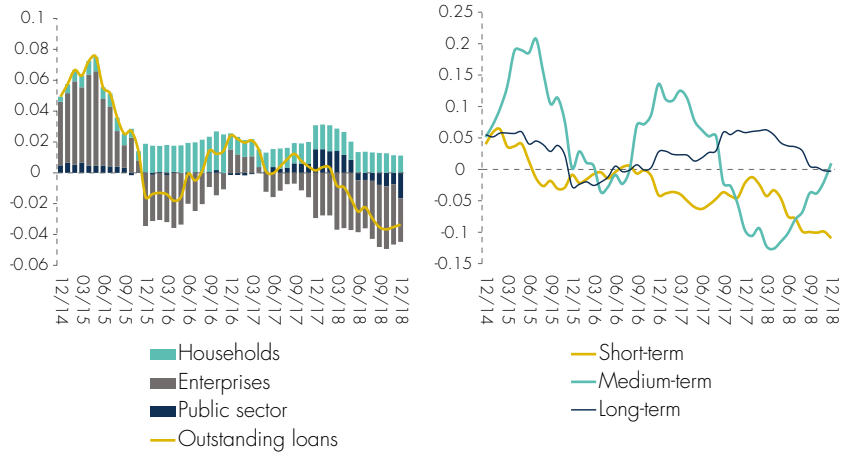
Chart 39 Loans to enterprises by purpose of use and currency (index, December 2016 = 100)




Source: Bank of Albania

(52) **Loans to resident households (sharing 93% of loans to households) grew 1.7%, providing thus the main contribution to the performance of loans to households.** Both loans for real estate, sharing around 65% of outstanding loans to resident households, and consumer loans, sharing 13% of loans to households, recorded faster growth. Outstanding loans for real estate grew by around 2% and reached ALL 110 billion. By currency, growth is affected by the contribution of loans in lek. Foreign currency loans to households were 6% lower compared to 2017 H2, and 2% lower compared to 2018 H1. The loans portfolio expanded (by around 4%) also for non-resident households.

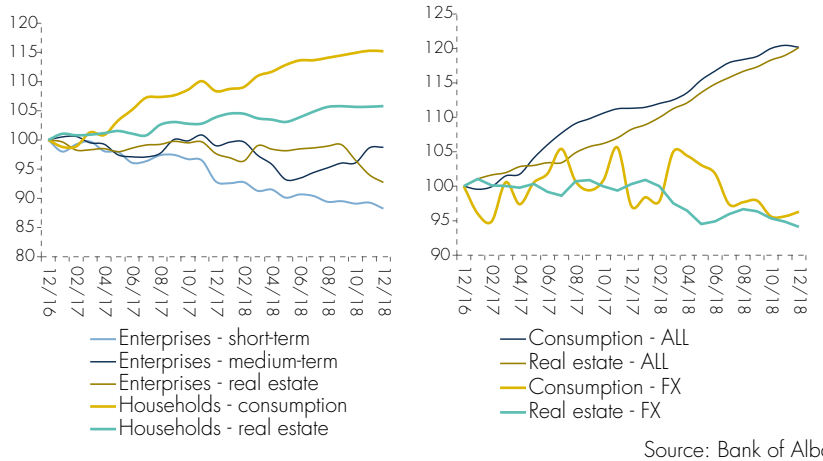
Chart 40 Loans by sector, contribution in percentage points (left) and loans by maturity, annual changes (right)




Source: Bank of Albania

**(53) By maturity, medium-term loans grew, short-term loans fell, while long-term loans did not change, during the period.** The contraction in short-term loans was conditioned by the fall in loans for working capital and overdrafts to enterprises, which share around 30% of the overall outstanding loans to the private sector[39]. Medium-term loans to enterprises, sharing around 20% of outstanding loans increased during the period, approaching the level of the previous year. Loans to enterprises for real estate fell by around 6% during the period.

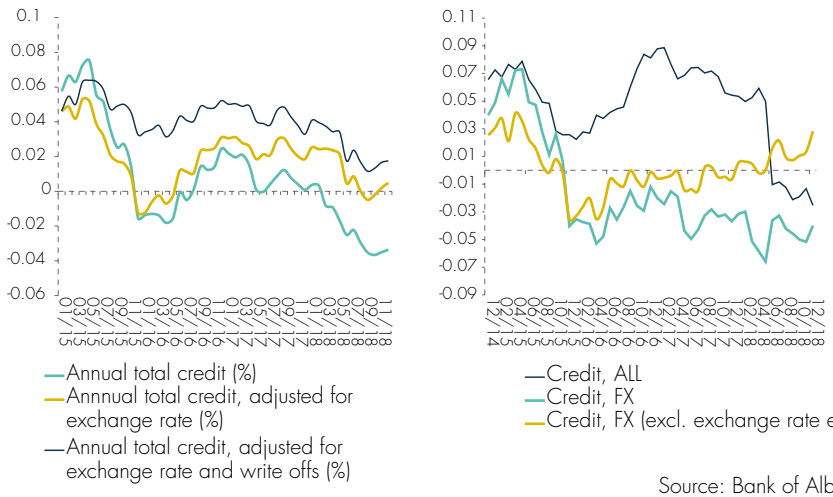
Chart 41 Loans by sector and purpose of use (left), and of loans to households by purpose of use and currency (right) (index, December 2016 = 100)




Source: Bank of Albania.

**(54) Excluding the exchange rate appreciation and the written off loans during the year, the total outstanding loans would have grown by 1.8% in annual terms, against the reported contraction by 3.4%.** Over the last 12 months, ALL 7.6 billion loans have been written off from the banking sector's balance sheet (of which, ALL 6.4 billion represented lost loans to enterprises).

Chart 42 Total loans excluding the effect of the exchange rate and write offs (left), Loans in FX excluding the exchange rate effect (right) (annual changes, in %)



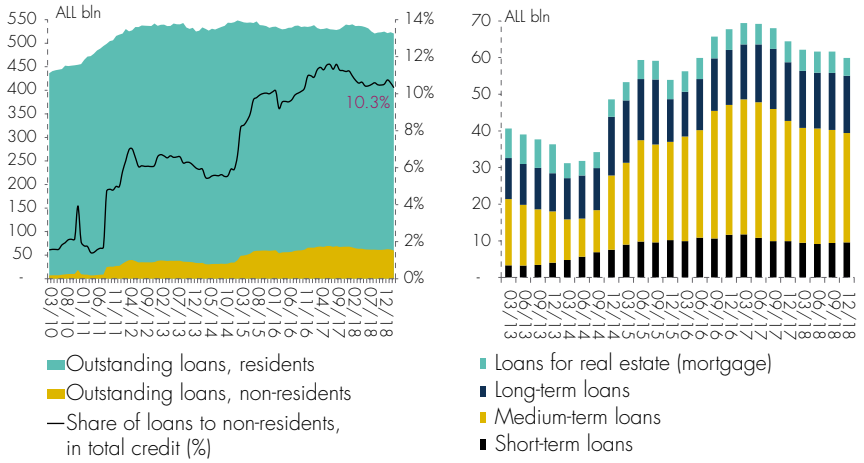

Source: Bank of Albania.

[39] *Enterprises and households.*

If written off loans were included in total loans, then the annual contraction of loans would be 2.1% (from 3.4%). Due to the share of foreign currency loans in total loans, exchange rate volatility[40] affects the outstanding loans value. As a result, movements in the exchange rate are assessed to have provided a negative effect on the reported value of foreign currency loans, by around ALL 23 billion, in annual terms (EUR: - ALL 22 billion and USD: - ALL 1 billion). Excluding this effect, foreign currency loans would have expanded by 2.8% compared to a year earlier, against the reported contraction of around 4%.

**(55) During the period, loans to non-resident entities and their share in total loans were downward.** At the end of 2018, loans to non-residents were around ALL 60 billion, accounting for 10% of outstanding loans of the banking sector, from 11% a year earlier. During the period, loans to non-residents fell by 2.8%, providing the main contribution to the performance of outstanding loans. Loans to non-residents fell by 7%, compared with the previous year, mainly driven by the fall in loans to non-resident enterprises by 11%. Loans in euro dominate the loans to non-residents. Overall, loans to non-residents have long-term maturities, (over 12 months), with the medium-term loans having the main share in outstanding loans to non-residents.

Chart 43 Loans to residents and non-residents (left); loans to non-residents by maturity (right)




Source: Bank of Albania.

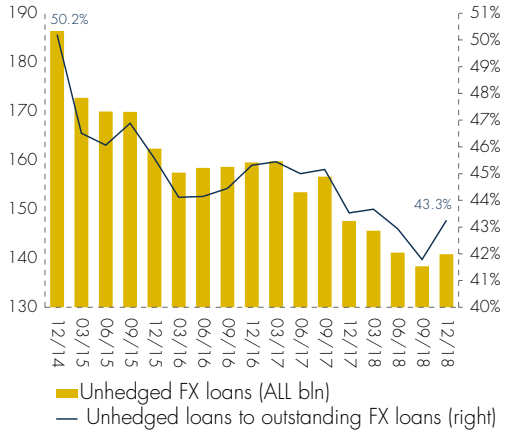
**(56) Unhedged foreign currency loans fell slightly during the period, and 4.6% in annual terms.** The decline of these loans in annual terms reflects the fall of unhedged loans to enterprises and the fall of unhedged loans in euro. In 2018 H2, unhedged loans to households fell by 11%; meanwhile, unhedged loans to enterprises grew by around 4%. The share of unhedged loans in foreign currency, against both loans in foreign currency and total loans, remained almost unchanged compared to the previous year (at 43.3% and 24.3%, respectively), and the indirect exchange rate risk against lending activity remains high.

[40] *The currency in which loans are reported.*

## BOX 6.1: BANKING SECTOR AND UNHEDGED FOREIGN CURRENCY LOANS

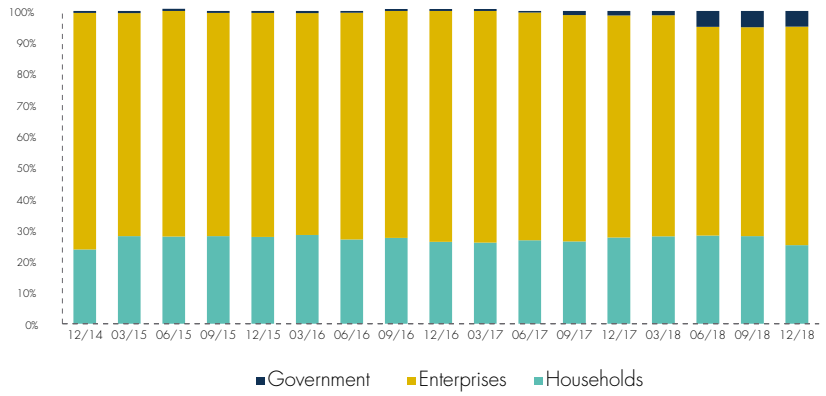
*Banking sector's exposure to indirect exchange rate risk remains high, although, in recent years, the share of loans unhedged against the exchange rate to outstanding loans in foreign currency has trended downward. In December 2018, foreign currency loans unhedged against exchange rate fluctuations accounted for 43% of total foreign currency loans and 24% of total outstanding loans, maintaining the respective shares of the previous year. During 2018 H2, unhedged foreign currency loans slightly decreased by 0.2%, to ALL 141 billion, mainly due to the contraction of unhedged loans in euro[41]. Meanwhile, unhedged loans in US dollar (accounting for 13% of unhedged loans) expanded by 14% during the period. Loans to enterprises have the main share (70%) in outstanding foreign currency loans unhedged against the exchange rate risk, while loans to households and to government share 25% and 5%, respectively. The decline in unhedged loans to households by 11% provided the main contribution to the contraction of outstanding unhedged loans. Unhedged loans to enterprises expanded by 4.4% over the period. In annual terms, unhedged foreign currency loans shrank by 4.6% and reflect mainly the decrease of unhedged outstanding loans to enterprises and in euro.*

Chart 44 Unhedged foreign currency loans




Source: Bank of Albania.

Chart 45 Unhedged foreign currency loans, by subject, %




Source: Bank of Albania.

*By purpose of use, unhedged loans for investments in real estate have the main share (around 48%) in the total stock of unhedged foreign currency loans, followed by loans for trade purposes (30%). The rest of the unhedged foreign currency loans were granted for business development, consumption, to the government and other purposes. Unhedged loans for "investments in real estate" and for "consumption", down by 0.7% and 4.4%, respectively, during the period, provided the main contribution to the performance of outstanding loans unhedged*

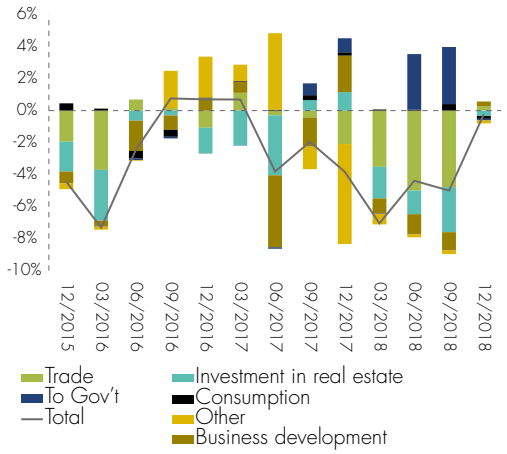
[41] *Outstanding euro loans, when the borrower's income is in Albanian lek, accounts for 86% of the outstanding unhedged foreign currency loans.*

*against the exchange rate risk. Meanwhile, unhedged foreign currency loans for "trade" and "business development" were upward during the period.*

Chart 46 Unhedged foreign currency loans (composition)


Source: Bank of Albania.

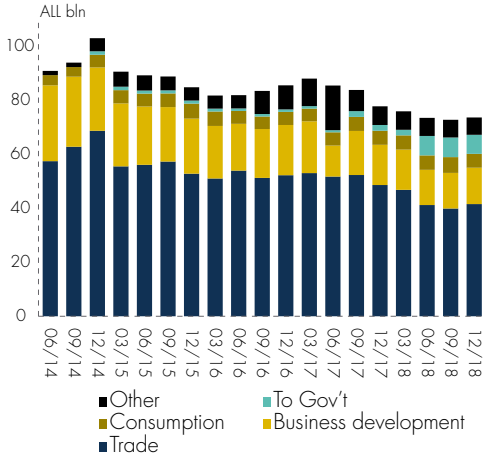
Chart 47 Unhedged foreign currency loans, 6-M performance (contribution by sector)




Source: Bank of Albania.

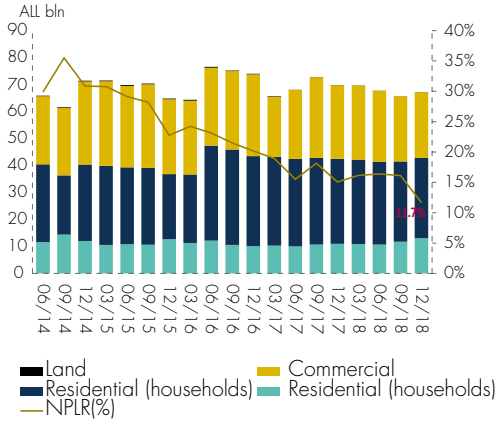
*Unhedged loans for real estate are granted for real estate for: residential, commercial and land purposes. Unhedged loans to households for residential real estate have the main share (44%), down by 3% during the period.*

Chart 48 Unhedged foreign currency loans (excl. real estate)




Source: Bank of Albania.

Chart 49 Unhedged foreign currency loans for real estate and its quality (right)

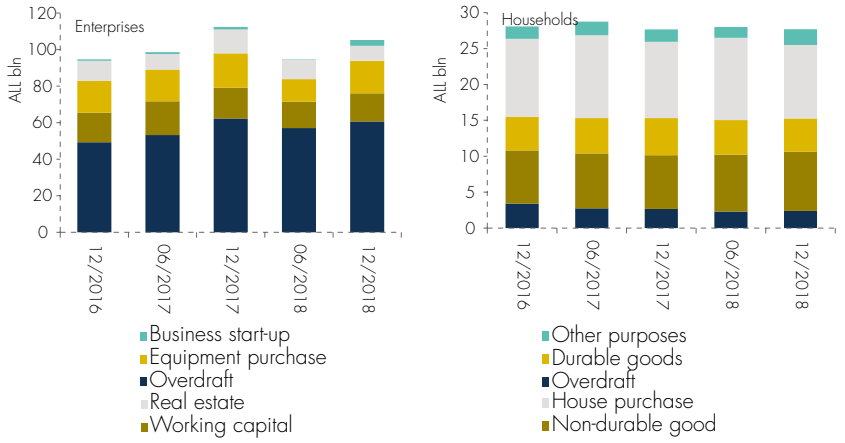



Source: Bank of Albania.

*The appreciation of lek's exchange rate has affected negatively the reported value of unhedged foreign currency loans. Excluding the appreciation of the exchange rate, the unhedged foreign currency loans would have expanded approximately 1.6%, against the 0.2% contraction.*

**(57) New loans granted by the banking sector, during the period, amounted to ALL 136 billion, 9.5% higher compared with 2018 H1.** The performance of loans to enterprises, which was ALL 11 billion higher during the period, determined the performance of new loans. The growth in new loans to enterprises is mainly observed in loans for equipment purchasing, business start-up loans and overdraft loans. The latter has the main share in new loans to them (58%). New loans to households fell by 1.1% during the period, driven by the fall in new loans for house purchase. By currency and maturity, euro loans and medium-term loans had the main contribution to the expansion of new loans during the period. New loans in US dollar, accounting for 7% of the overall new loans during the period reduced by 22% .

Chart 50 New loans to enterprises (left) and households (right) by purpose of use




Source: Bank of Albania.

**(58) The weighted interest rate on new loans during the period[42] was slightly up.** In December 2018, the weighted average interest rate on new loans was 5.7%, around 0.1 percentage point higher than the rate on new loans granted in June 2018. The increase in the average interest rate was mainly reflected on loans in foreign currency (euro and usd) and on loans to households. By currency, the weighted average interest rate on new lek loans stood at 6.8%, in December 2018, higher compared with the interest rates on loans in euro and US dollar, which were 4.4% and 5.5%, respectively at the end of year.

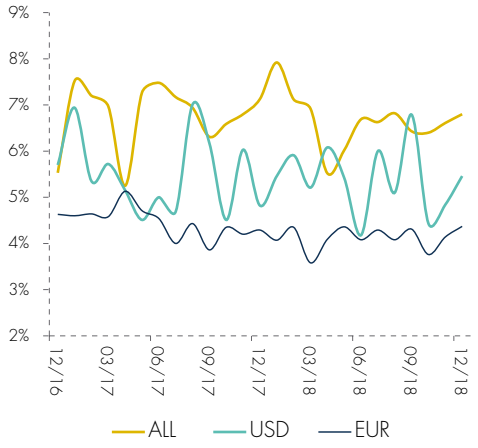
Chart 51 Weighted interest rates on new loans


Source: Bank of Albania.

**(59) The interest rate on new loans to households continues to be higher than interest rate on loans to enterprises.** In December 2018, the weighted

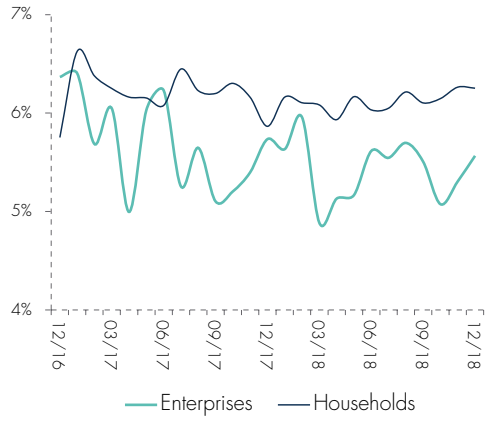
[42] *Calculated as six-month average.*

Chart 52 Interest rates on new loans, by currency




Source: Bank of Albania.

Chart 53 Interest rates on new loans, by entity




Source: Bank of Albania.

interest rate on loans to households was 6.3%, from 6% in June 2018. At the same time, the average interest rate on new loans to enterprises was around 5.6%, unchanged from the average rate at the end of 2018 H1.

***BOX 6.2: REJECTION RATE OF LOAN APPLICATIONS BY BANKS IN ALBANIA***

***General provisions***

*To complete the analyses framework related with the performance and tendency of bank lending to the private sector in Albania, the Financial Stability Department at the Bank of Albania has collected, over recent years, data on the number of loan applications evaluated by banks, classified by the loan application's status (approved, rejected and in process) and by type of client (small and medium-sized enterprises, other enterprises[43] and households). These data have been collected half-yearly, starting from 1 December 2016 and include a total of six half-year periods: 1 December to 31 May; and 1 June to 30 November of each year. The last period is from 1 June 2018 to 30 November 2018 and is included as an analysis of 2018 H2. For the period 2016 H1 - 2018 H1, the analysis includes data reported by 16 banks of the system, while for the last period (2018 H2) the analysis includes 14 remaining banks after the merger by absorption of Veneto Bank by Intesa SanPaolo Bank Albania and the National Bank of Greece by American Bank of Investments.*

*Based on the data submitted by banks on the number of loan applications, the number of applications by both enterprises and households considered by banks during the relevant periods is analysed, as a proxy for market demand for bank loans, and the rejection rate of loans, ("rejection rate") is constructed and analysed for each period, as an indicator of banking sector disposition to respond to this demand. This rate is calculated as a ratio of the number of rejected applications by the bank, against the total number of evaluated applications,*

[43] *"Other enterprises" mainly includes large enterprises and all types of enterprises, which are not included in the group "small and medium-sized enterprises".*

*during the relevant period. The increase of the rejection rate may signal a fall of loan supply and a tightening of credit standards by banks.*

***Number of evaluated applications and rejection rate analysis***

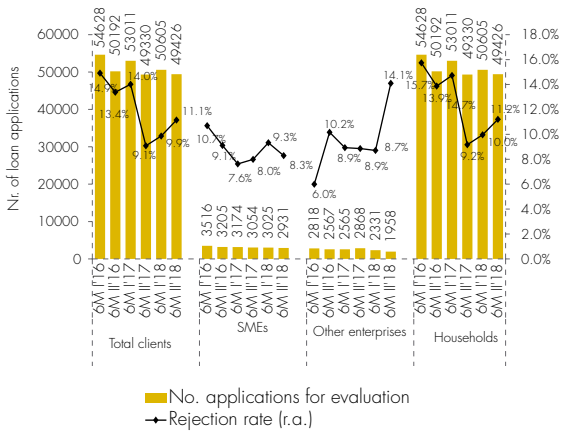
*During 2018 H2 (1 June - 30 November 2018), banks evaluated a total of 49,426 loan applications, of which around 10% from "enterprises" (2,931 applications from "small and medium-size enterprises" and 1,958 applications from "other enterprises") and 90% from "households" (44,537 applications). The total number of evaluated applications was downward (by 3.7%), compared to the previous period (1 December 2017 - 31 May 2018), driven by the segment of "enterprises" (half-yearly fall by 8.7%) and the segment of "households" (half-yearly fall by 1.6%). In annual terms, compared with the period 1 June - 30 November 2017, the total number of evaluated applications remained almost unchanged (increased only 0.2%). By category, applications from households increased by 2.6% and application from enterprises fell by 17.4%[44].*

*In the total evaluated applications during the period, banks rejected around 11%, approved 87 % and 2% are under evaluation. The rejection rate (11%) increased compared to the previous six-month period and the previous year, diverging from the downward trend of the period 2016-2017. The increase in the rejection rate during the period is more notable for the categories of "households" and "other enterprises"; meanwhile, the rejection rate for "small and medium-size enterprises" trended downward.*

*The analysis of the rejection rate by size of banks (peer groups G1, G2, G3) and by category of clients shows that the small and medium-sized banks have the highest rejection rate for all three categories of clients. Nevertheless, the rejection rate of medium-sized banks (G2) showed a downward trend, ranging 12 -13% for all categories of clients. On the other hand, the rejection rate for larger banks (G3) fluctuated at 4 -9% for loans to all three categories of clients, showing a slight falling trend for loans to both groups of enterprises and an upward trend for loans to "households".*

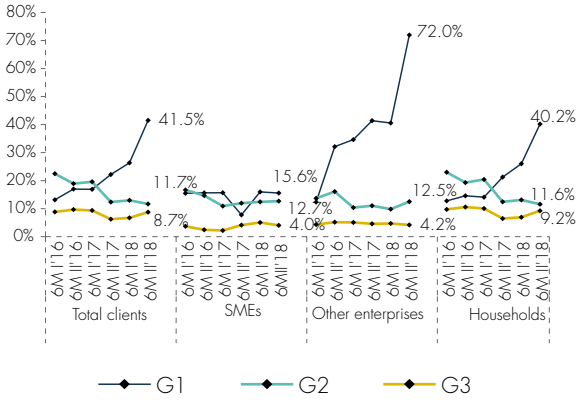
*The analysis of the rejection rate of banks, divided into domestic banks and foreign-owned banks, shows that, in recent years, the rate for domestic banks has been continuously lower compared with foreign-owned banks, across all categories of clients. For 2018 H2, the total rejection rate of applications for loans by foreign-owned banks (against the total applications) remained unchanged at 14%, compared with 2018 H1, and somewhat upward compared with 2017 H2. By segments of clients, these banks mostly rejected the applications for loans to "households" and "other*

Chart 54 Number of evaluated applications and rejection rate analysis




Source: Bank of Albania.

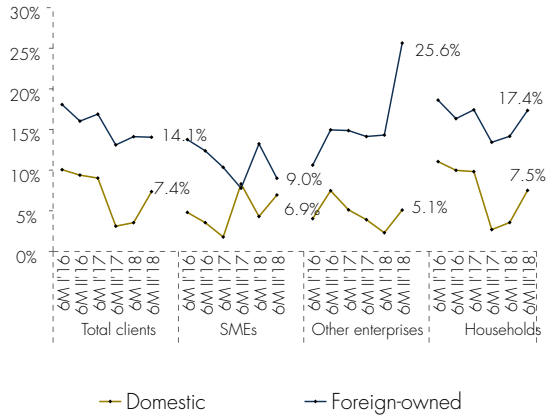
Chart 55 Rejection rate for loans, by bank peer group and category of clients




Source: Bank of Albania.

[44] *Annual fall from "small and medium-sized enterprises" by 4% and from "other enterprises" by 31.7%, respectively.*

Chart 56 Rejection rate of loans, for domestic and foreign-owned banks




Source: Bank of Albania.

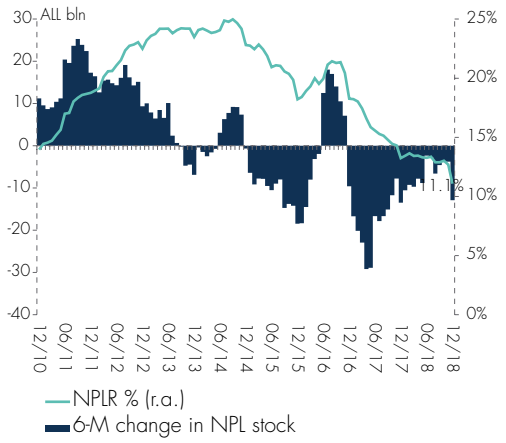
*enterprises"; meanwhile, they were more accepting to "small and medium-sized enterprises". On the other hand, the rejection rate by domestic banks increased during the period for all segments of clients, but more pronounced for the segment of "households".*

*Overall, the analysis concludes that the performance of the evaluated applications by banks, during 2018, is somewhat lower (2.2%) than in the previous year. The preference of banks to lend has resulted, overall, downward for "households" and "large enterprises", and upward for "other enterprises", mainly driven by the group of larger banks (G3) and the group of of smaller banks (G1).*

### 6.1.2 CREDIT RISK

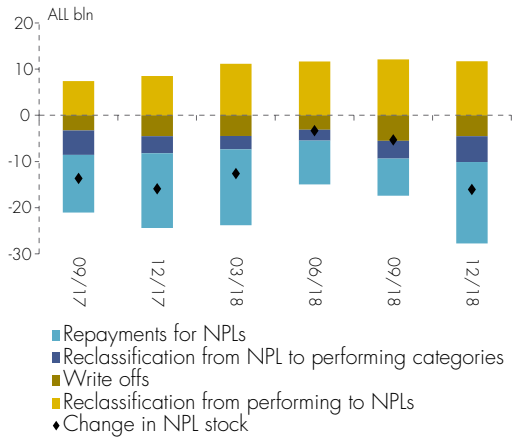
(60) **The credit quality improved considerably, during the period, due to the decrease of non-performing loans stock by 17%, at ALL 64 billion.** This is the lowest rate of outstanding non-performing loans recorded since 2010. Meanwhile, compared to the end of 2014, when non-performing loans peaked, the stock has halved. The decrease in outstanding non-performing loans by size of contribution was driven by: loan repayments; write off of lost loans, and reclassification of some non-performing loans to performing classes of loans (mainly due to restructuring). Since June 2018, around ALL 17.6 billion non-performing loans have been repaid, and around ALL 4.5 billion lost loans

Chart 57 Non-performing loans ratio and outstanding NPLs




Source: Bank of Albania.

Chart 58 Contribution to the change of the non-performing loans stock

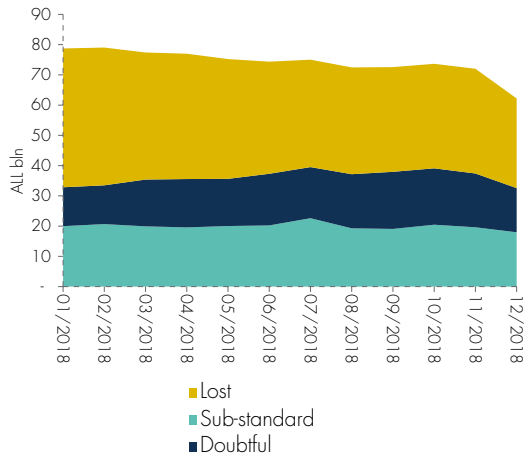



Source: Bank of Albania.

have been written off[45], mainly represented by loans to enterprises in lek. The stock of non-performing loans contracted by ALL 15 billion or 19%, compared with the end of 2017, mainly driven by loan repayments and the lost loans write off.

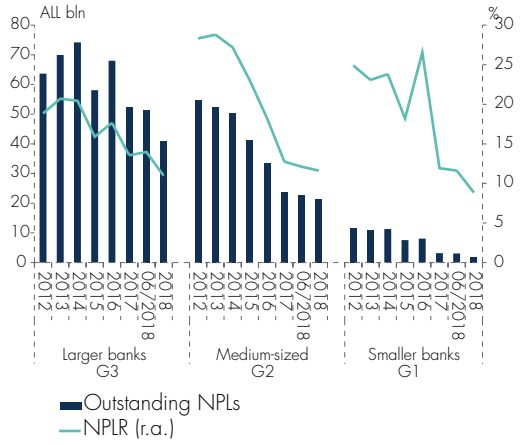
(61) **In December 2018, the non-performing loans ratio stood at 11.1%, down by 2.2 percentage points durin the period from the previous year.** The fall in outstanding lost loans by around 19%, provided the main contribution to the improvement of credit quality during the period. "Lost" loans continue to account for a large share of non-performing loans (48%), but this share has fallen considerably from 58% in the previous year. The non-performing loans classified in two other classes: "sub-standard loans" and "special-mention loans" also were down, due to the repayment of a part of past due loans and the reclassification of some non-performing loans performing classes.

Chart 59 Non-performing loans structure




Source: Bank of Albania.

Chart 60 NPL portfolio by bank groups

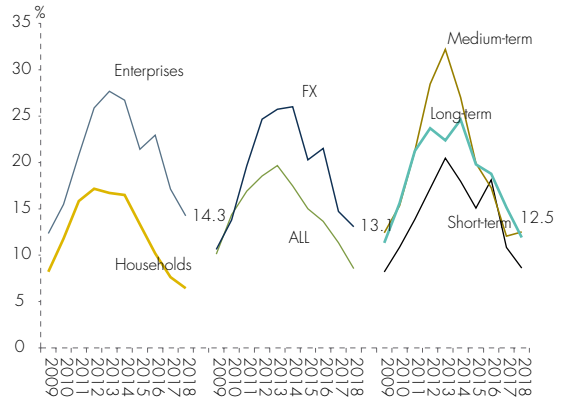



Source: Bank of Albania.

(62) **Larger banks provided the main contribution to the improvement of credit quality.** The outstanding non-performing loans of larger banks decreased, during the period, by ALL 10.4 billion (or by 20%); meanwhile, the non-performing loans ratio for larger banks fell at 11% from 14%. Also, medium-sized and smaller banks reported a contraction in the stock of non-performing loans. Medium-sized banks have the highest non-performing loans ratio (11.6%); while smaller banks have the lowest non-performing loans ratio (8.8%). The structural changes in the group of smaller banks also affected the improvement of credit quality for these banks.

[45] *Starting from January 2015, banks are obliged under the regulatory requirements to undertake the process of balance sheets cleaning - the write off of loans falling under the "lost" category for more than three years. Overall, since the start of the process ALL 55.5 billion of lost loans have been written off.*

Chart 61 NPLs ratio by sector, currency and term

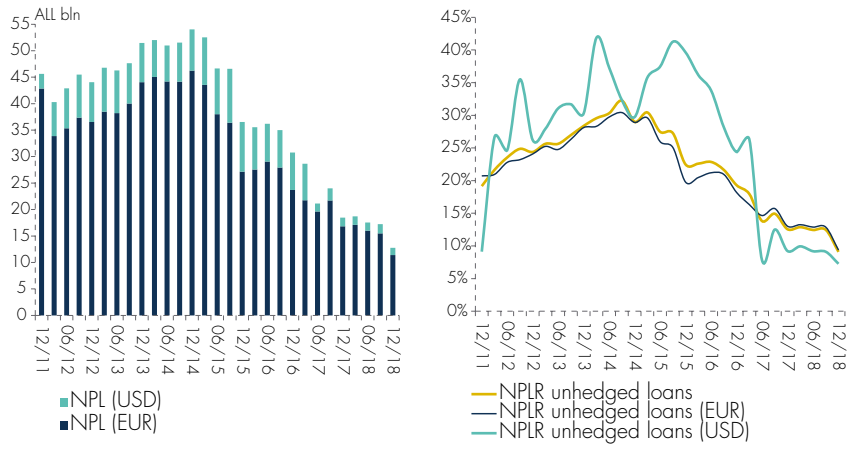



Source: Bank of Albania.

**(63) The credit quality is lower for loans to enterprises, loans in foreign currency, and medium-term loans.** In December 2018, the NPL ratio for each of these loan segments stood at 14.3%, 13.1%, and 12.5%, respectively. All types of loans, by entity, currency and maturity recorded a fall in their NPLs ratio, compared with the end of 2018 H1, and 2017 H2, except of the medium-term loans, whose quality reduced during 2018.

**(64) The quality of unhedged foreign currency loans has slightly improved during the period, and this trend has been observed since 2015.** In December 2018, non-performing loans for unhedged foreign currency loans recorded the lowest level, since 2009, around ALL 13 billion. The ratio of non-performing loans for this category fell to 9.1% from 12.4% at the end of June 2018. Loans in euro provided the main contribution to the improvement of the quality of unhedged loans. The NPL ratio for unhedged euro loans fell from 12.9% to 9.4%, whereas the ratio for unhedged US dollar loans fell to 7.3% from 9.2 %.

Chart 62 Quality of unhedged loans against the exchange rate risk in ALL billion (left); and as a ratio to total unhedged loans by currency (right)

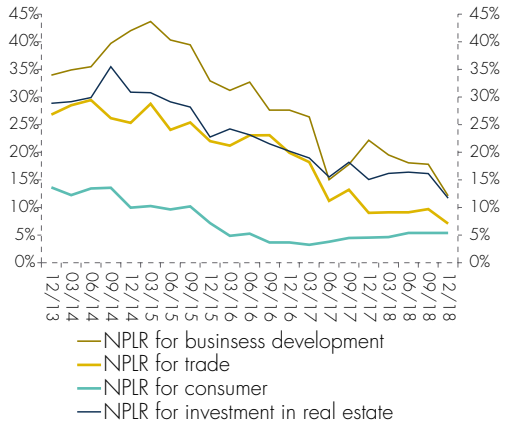



Source: Bank of Albania.

**(65) In loans unhedged against the exchange rate risk, the quality of loans for business development, loans for real estate and loans to trade improved.** Loans for business development improved considerably, whose non-performing loans ratio dropped by 6 percentage points during the period, at 12.1%. Loans for investment in real estate have the main share (around 61%) in unhedged non-performing loans from the exchange rate. The NPLs ratio for this category fell by 4.7 percentage points, during the period, at 11.7%. The NPLs ratio for unhedged consumer loans is low, and it did not change during the period, standing at 5.4%.

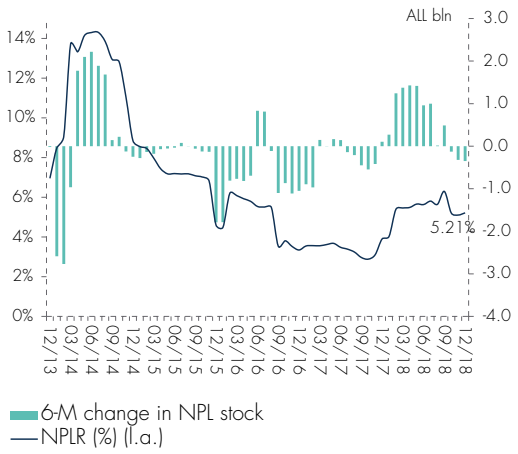
**(66) The quality of loans to non-resident entities continues to be good and improved during the period.** Meanwhile, loans to non-residents accounts for around 10% of total loans. The non-performing loans for this category of borrowers accounts for only 5% of total non-performing loans. During the period, the NPLs stock in this category narrowed 10%, by mainly reflecting the reduction in "sub-standard" loans. As result of these developments, the NPLR for loans to non-residents fell at 5.2%, at the end of December 2018, from 5.6% at the end of 2018 H1. The loans classified as lost have the highest share (47%) within the structure of non-performing loans.

Chart 63 Quality for unhedged loans against exchange rate risk, by purpose of use



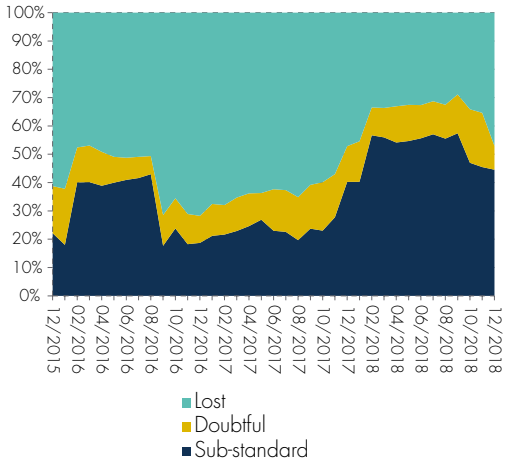

Source: Bank of Albania.

Chart 64 Half-yearly change in NPLs stock and NPLR for loans to non-residents




Source: Bank of Albania.

Chart 65 Structure of Non-performing loans for non-residents



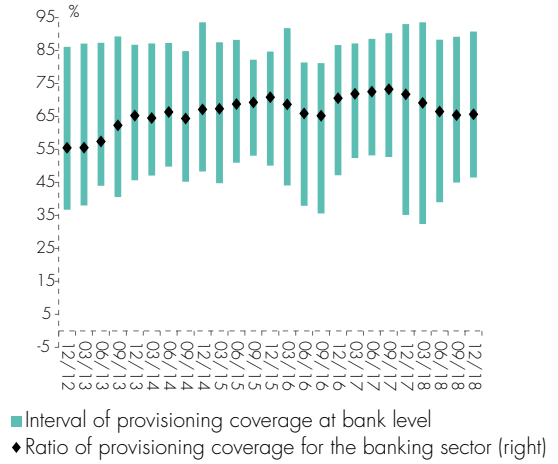

Source: Bank of Albania.

**(67) The provisioning ratio for the non-performing loans fell by 0.8 percentage point, during the period, at 65.6%.** The provisions for credit risk fell faster than the contraction in the stock of non-performing loans. This performance reflects the write off of non-performing loans (lost); a process that has a relatively higher impact on the reduction of outstanding provisions, compared with the reduction of outstanding non-performing loans. In the previous year, this ratio stood at 71.7%.

**(68) During the period, capital coverage of net non-performing loans[46] increased.** As a result of the narrowing in outstanding net non-performing loans by almost 15%, the "net non-performing loans/regulatory capital" fell to 15.5%, from 18% in June 2018. In the previous year, this ratio stood at 15.4%.

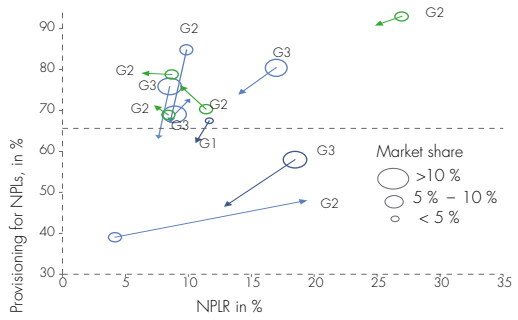
[46] *Non-performing loans after the deduction of provisions.*

Chart 66 Provisioning ratio over years




Source: Bank of Albania.

Chart 67 Annual change in provisioning ratios - arrows show change (Dec 2017 - Dec 2018)*



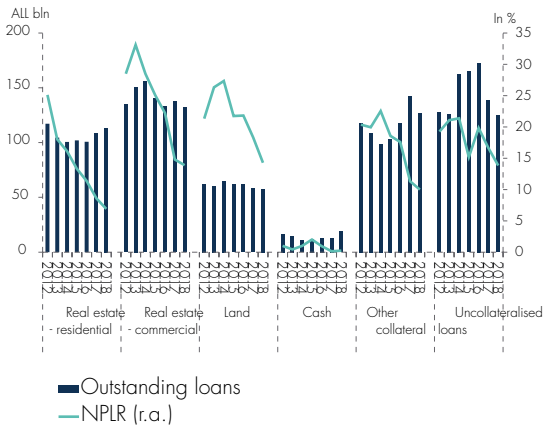

* This includes banks sharing more than 1% in total assets. G2 are medium-sized banks (with 2-7% of banking sector's assets) and G3 are larger banks (over 7% of total assets). Green shows improvement, red shows deterioration, blue shows combined risk. Dotted line shows average ratio of NPL provisioning at sector level, 65.6% at end Dec. 2018.

Source: Bank of Albania.

Also, net non-performing loans ratio to outstanding loans narrowed by 0.6 percentage point, standing at 3.8%, due to the faster fall in net outstanding non-performing loans compared with the fall in outstanding loans. In the previous year, this ratio stood at the same level (3.8%).

**(69) Loan collateralisation remains at high levels and has been increasing since the beginning of 2017.** Maintaining high levels of loan collateralisation contributes to the mitigation of credit risk. At the end of the period, loan collateralisation[47] stood at 78.2%, around 1.3 percentage lower than at the end of the previous period, and 1.5 percentage points higher than a year earlier. Loans collateralised in the form of real estate account for around 68% of collateralized loans, and 53% of outstanding loans. Loans collateralised in the form of real estate and those collateralised with cash increased during the period. Loans collateralised with "other" types of collateral, accounting for about 28% of the overall loans, fell by around 15% during the period.

Chart 68 Outstanding loans and non-performing loans ratio by collateral




Source: Bank of Albania.

**(70) Quality of collaterised loans continued to improve during the period, and the NPLs ratio for this type of loans fell at 10.5% in December 2018.** This ratio fell by around 2 percentage points from the end of 2018 H1 and the end of 2017. The fall in non-performing loans stock for this category has started since 2016. During the period, the fall is noted in all types of loans, by form of collateral, and mainly for loans collateralised with "other" types of collateral and for loans collateralised in the form

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

of commercial real estate. Also, the quality of un-collateralised loans improved compared with the end of the previous period and with a year earlier. The NPLR for un-collateralised loans fell at 13.8%, from 17.6% in June 2018 and 16.6% in December 2017.

### 6.1.3 DEPOSITS

**(71) The deposit base held in the banking sector reached ALL 1,180 billion at the end of the year, up by 3% during the period and 1.2% during the year.** The main contribution during the period came from deposits in foreign currency, demand deposits, current accounts and household deposits, which increased by 4%, 13%, 5% and 3%, respectively. Time deposits continued to register a decrease in annual term, but remained largely unchanged during the period. In 2018 H2, the shares of time deposits and household deposits in total deposits continued to decline. At the same time, due to the acceleration of the increase of foreign currency deposits, their share in the general deposit stock increased to 53% against the 52% average registered in 2018 H1.

*Table 9 Data on the performance of deposits by maturity, sector and currency*

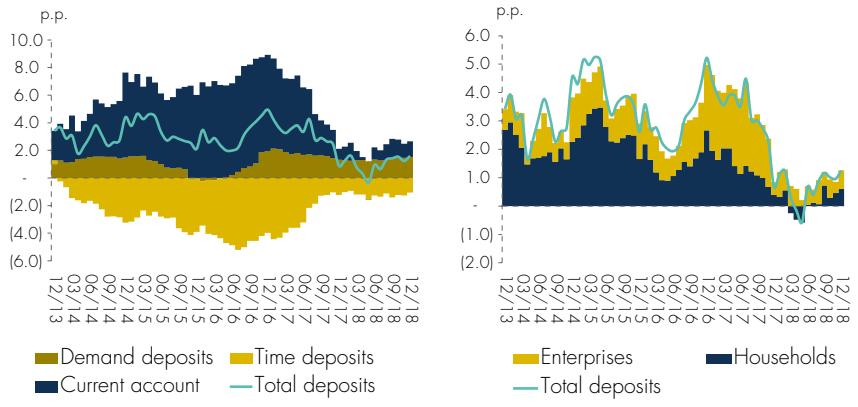
| | Indicator and unit | Value (ALL bln) | Structure (% to total) | Contribution to growth rate (p.p.) | | Change (%) | |
|---|---|---|---|---|---|---|---|
| | Period | 12/2018 | 12/2018 | Annual | 6-months | Annual | 6-months |
| By currency | Lek deposits | 553 | 47 | 0.4 | 0.8 | 0.8 | 1.7 |
| | FX deposits | 627 | 53 | 0.9 | 2.2 | 1.7 | 4.2 |
| By institution | Public sector | 27 | 2 | 0.0 | 0.0 | -0.7 | -0.7 |
| | Enterprises | 176 | 15 | 0.7 | 0.7 | 4.6 | 4.8 |
| | Households | 977 | 83 | 0.6 | 2.3 | 0.7 | 2.8 |
| By product | Current account | 397 | 34 | 1.2 | 1.6 | 3.5 | 5.0 |
| | Demand deposits | 124 | 11 | 1.5 | 1.2 | 16.5 | 12.9 |
| | Time deposits | 643 | 54 | -1.1 | 0.2 | -1.9 | 0.4 |
| | Deposits, Stock | 1,180 | 100 | 1.2 | 3.0 | 1.2 | 3.0 |

*Source: Bank of Albania*

**(72) Households' deposits continue to account for over 80% of the total stock of deposits; but, over the last two years, their growth has been slower compared with the growth of enterprises' deposits.** The slow growth and, in some periods, the contraction of households deposits, when time deposits shared around 65% of the total, has reflected an environment with low interest rates.

**(73) The deposits of enterprises has given the main contribution to the increase of the deposit base in the last two years and continued to register a high growth pace during the period.** This performance is reflected in the structure of deposits maturity. The fall of time deposits, which are preferred by households, is followed by the increase of demand deposits and current accounts, which are preferred by enterprises.

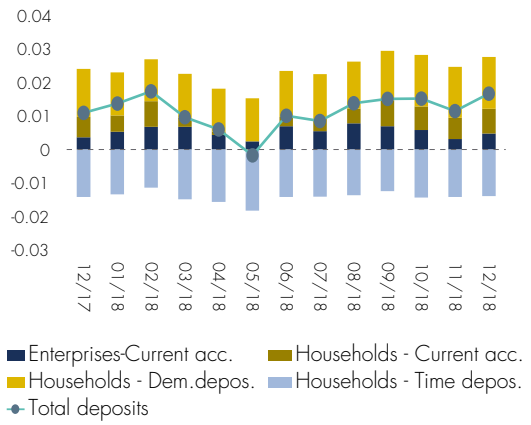
Chart 69 Annual growth of deposits: contribution of deposits by maturity (left) and by sector (right)




Source: Bank of Albania.

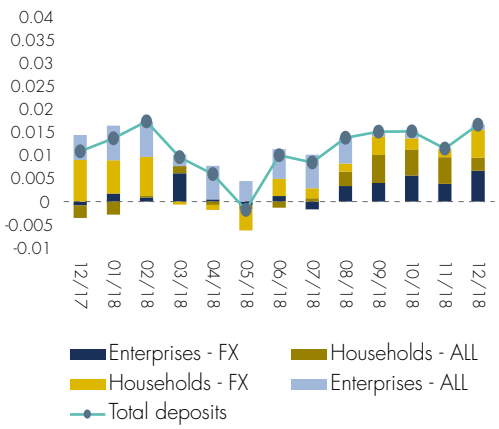
**(74) Households' demand deposits continued to grow rapidly during the period and annually and gave the main contribution to the growth of total deposits.** The annual average growth of demand deposits was around 16% in both half years of 2018, but this pace has somewhat slowed down compared with the performance registered in the previous 2-3 years. The households registered a notable tendency to expand current accounts and demand deposits and contract time deposit. Meanwhile, enterprises continued to expand current accounts, which are mainly used for operational purposes. Due to the negative contribution of time deposits to total deposits and the positive contribution of demand deposits and current accounts, during the last two years, in the structure of deposits by maturity, the share of time deposits fell by 5 percentage points, at 54%, the share of demand deposits increased by 3 percentage points, at 11%, while the share of current accounts remained unchanged at 33%.

Chart 70 Contribution to deposit increase by sector and maturity (p.p.)




Source: Bank of Albania.

Chart 71 Contribution to deposit increase by sector and currency (p.p.)

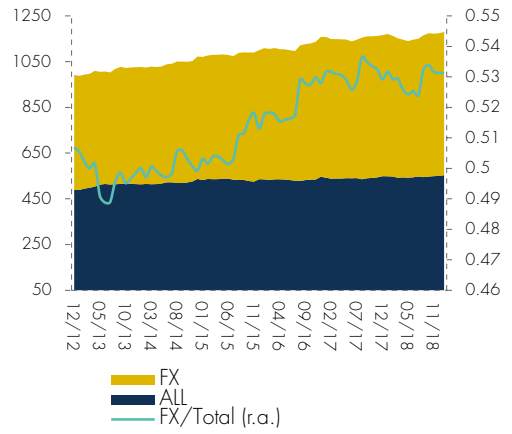



Source: Bank of Albania.

**(75) Foreign currency deposits showed strong signs of recovery during the period, reflecting mainly the increase of enterprises' current accounts denominated in foreign currency.** Foreign currency deposits increased by ALL 25 billion during the period, and by almost ALL 10 billion during the year. The share of foreign currency deposits in total deposits registered 53% at the end of the period. Euro deposits, which account for over 85% of foreign currency deposits, increased by 8% over the period and by 11% over the year, by EUR 330 million and EUR 440 million, respectively.

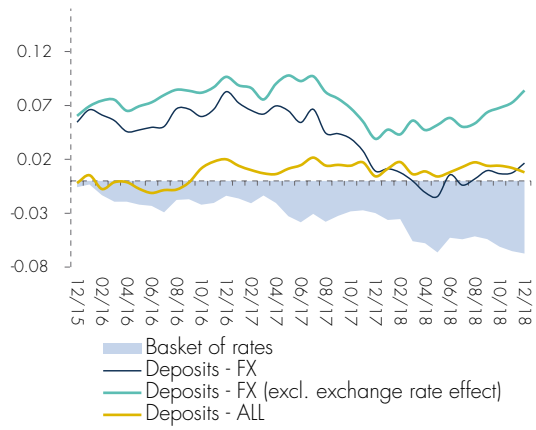
**(76) The appreciation of lek against the main foreign currencies had a significant contracting impact on the performance of deposits over the year and the period.** Excluding the impact of the exchange rate, the half-year and annual growth of total deposits would be 4% and 4.9%, from 3% and 1.3%, which is the change reported in the banking sector balance sheet. This impact is channelled through the effect on foreign currency deposits, for which the appreciation of lek is assessed to have had a downward effect of ALL 42 billion, over the year. Only for the period, this effect is assessed at ALL 12 billion. Excluding the statistical effect of the exchange rate, the growth of foreign currency deposits would be ALL 53 billion over the year, and ALL 36 billion over the period.

Chart 72 Performance of deposits by currency (ALL bln) and share of foreign currency deposits




Source: Bank of Albania.

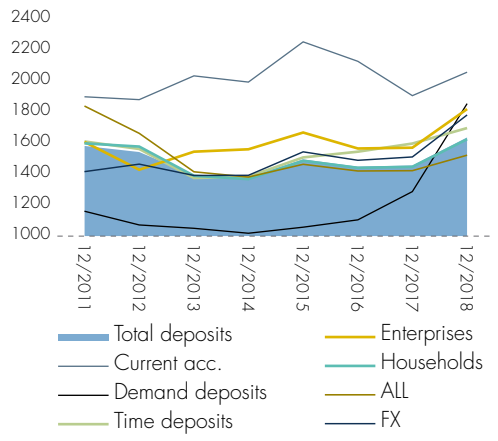
Chart 73 Annual growth of lek and FX deposits, and FX deposits excluding the exchange rate effect




Source: Bank of Albania.

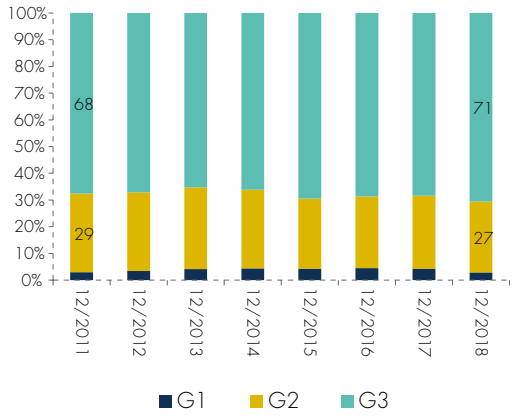
**(77) The concentration of deposits in the banking sector remains low, although trending upward during the period.** This has reflected mainly the increase of the share in some categories of some larger banks. The higher increase of concentration was observed in demand deposits, but the overall coefficient of concentration for the category of deposits remains low. Current accounts have the highest concentration, while deposits in lek and demand deposits have the lowest concentration. Structure of deposits by the size of banks - G1, G2, and G3 - has remained almost unchanged since the end of 2011. Around 70% of deposits is held by G3 banks and 27% by G2 banks.

Chart 74 Herfindahl Index for deposits by maturity, sector and currency




Source: Bank of Albania.

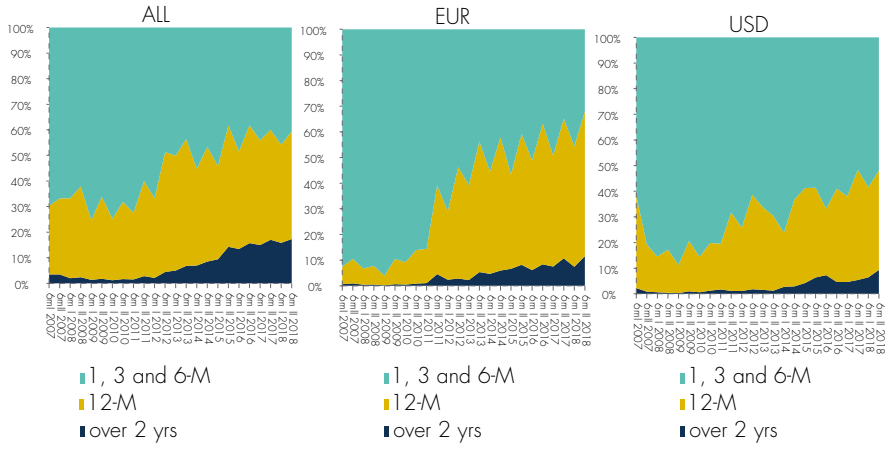
Chart 75 Share in total deposits by banking groups, G1, G2, G3




Source: Bank of Albania.

(78) **Over the period the flow of new time deposits in the banking sector was ALL 277 billion or around 21% higher than 2018 H1.** The share of new time deposits in total new deposits increased by around 14.5%, from 13% in 2018 H1, but it was lower than 16% in the previous year. There was a significant shift to longer-term maturities within the structure of new time deposits, for the three currencies. An increase of new deposits was registered for lek, euro and US dollar. New deposits in lek expanded by around 17%, in euro by 35% and in US dollar by around 8%.

Chart 76 New time deposits by currency and maturity, 6-month flows




Source: Bank of Albania.

(79) **The average interest rates on new time deposits showed negligible volatility during the period.** The average rate on new time deposits in lek was around 1%, and in US dollar and euro were 0.5% and 0.16%, respectively.

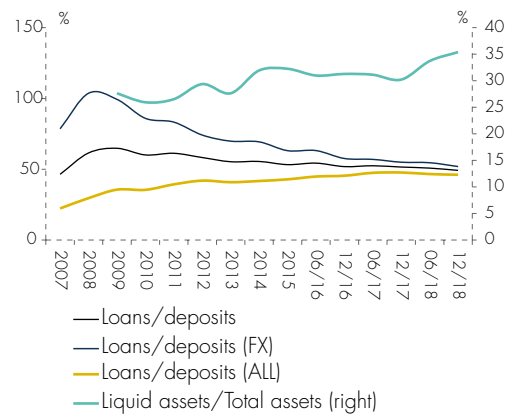
### 6.1.4 LIQUIDITY RISK

(80) **The banking sector's liquidity position is assessed as satisfactory and improved during the period.** The liquidity indicators, both in lek and foreign currency, stand above the minimum regulatory ratios. Deposits remain the main source of funding bank lending, covering almost twice the volume of bank loans. At the end 2018, the loans/deposits ratio registered 49.2%, from 50.8% and 51.6%, in the previous period and in the previous year, respectively. The loans/deposits ratio for foreign currency and domestic currency was 51.9% and 46.1%, respectively, declining for both lek and foreign currency, compared with the previous year and the previous period. Overall, the decline of this ratio compared with the levels at the end of 2018 H1 was caused by the weaker performance of lending against deposits, both in total and by currency.

(81) **Liquid assets in banks' balance sheets remain high, reflecting a slow performance of lending.** At the end of December 2018, the ratio of liquid assets to total assets of the banking sector was 35.4% or around 3.2 percentage points higher than in the previous period. The other liquidity indicator - "liquid assets to total short-term liabilities" - also increased by 4.5 percentage points, to 47.7%.

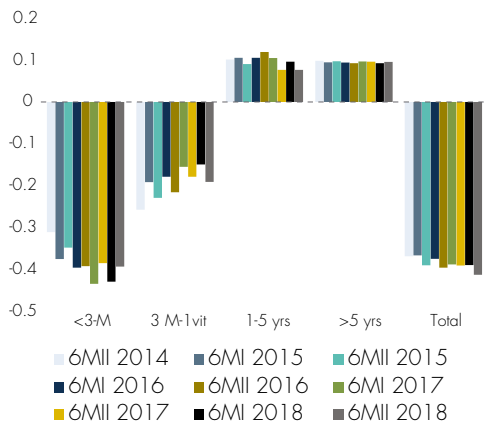
(82) **Although banks are operating under ample liquidity conditions, the negative gap between assets and liabilities by residual contractual maturity segments[48] is relatively high and has been deepening.** At the end of 2018, this indicator registered 42%, or 3 p.p. higher than the end of the previous period and a year earlier. During 2018 H2, the ratio deteriorated due to the deepening of the negative gap for the 3 m - 1 year maturity and the narrowing of the positive gap for the 1 - 5 years maturity. The the gap structure by maturity baskets has changed from period to period, during 2015-2018. However, a deepening of the very short-term maturity gap (up to 3 months) - which has also

Chart 77 Liquidity indicators*




*Off-balance sheet assets and liabilities are also included.
Source: Bank of Albania.

Chart 78 Assets and liability maturity gap*



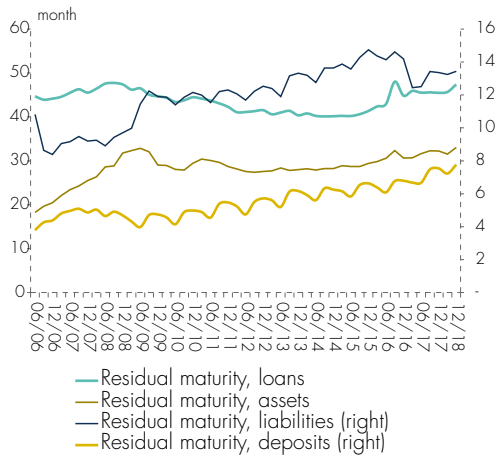

*Off-balance sheet assets and liabilities are also included.
Source: Bank of Albania.

[48] *By residual maturity baskets, it is the difference between assets and liabilities in relation with total assets and expressed in %.*

the largest share in overall gap - and a narrowing in the short-term gap (3-M to 1year) has been observed. Meanwhile, the gap for the other two maturities has remained largely unchanged.

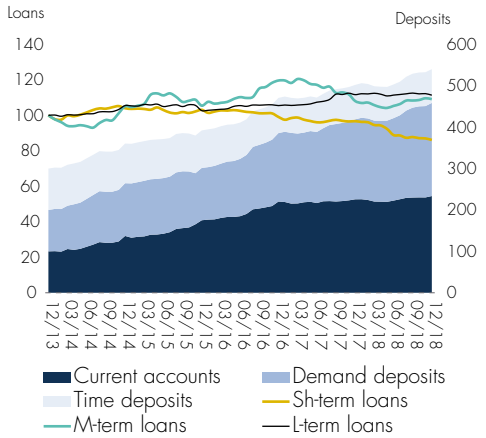
(83) **During the period, an increase in the mismatch of average maturity of assets and liabilities was observed.** At the end of December 2018, this mismatch was around 19.6 months, from 18.3 months at the end of 2018 H1. Deposits' residual maturity, which represent the most significant category of liabilities, increased to 7.8 (against 7.2) months over the period. The performance of this indicator was affected by the increase of the average maturity of time deposits, despite the decline of their share in total deposits. The residual credit maturity also increased to 47.4 months (from 45.7), reflecting the banks propensity to grant credit for longer maturities. During 2018 H2, the decline of short-term credit outstanding strengthened and the increase in medium-term credit granted by the banking sector portfolio accelerated.

Chart 79 Average residual maturity




Source: Bank of Albania.

Chart 80 Performance of loans and deposits by maturity (index, December 2013 = 100)




Source: Bank of Albania.

(84) **The value of credit lines from parent banking groups accounts for a very low share in the banking sector's funding sources.** Over the period, the total value of these lines was ALL 3.2 billion, from ALL 4.8 billion at the end of the previous period. For banks that have credit lines with parent banking groups as at the end of the period, their utilization rate was 16%, from 13.7% in June 2018.

### 6.1.5 MARKET RISKS

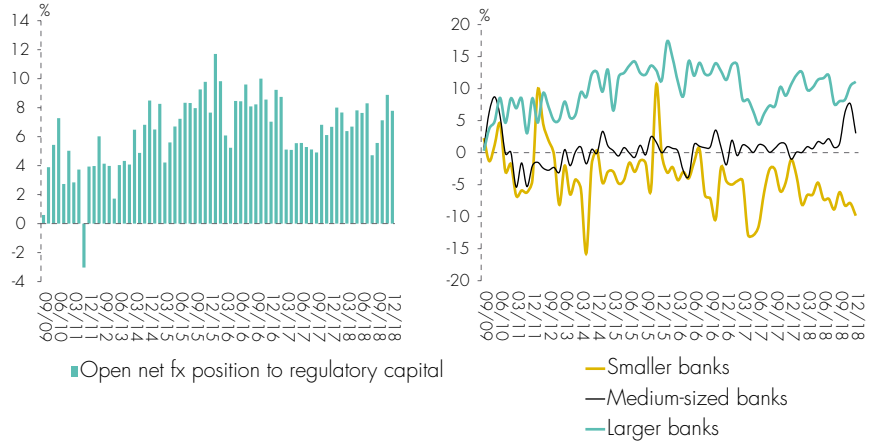
#### *EXCHANGE RATE RISK*

(85) **Net open foreign currency position levels indicate a limited exposure towards direct impacts on the balance sheet from exchange rate fluctuations, despite the slight increase registered during 2018 H2.** The aggregate indicator

for all banks, as well as the indicator for group of banks by size recorded much lower values compared with the 30% cap of regulatory capital established in the respective regulation.

**(86) The net open foreign currency position of the banking sector in relation to regulatory capital has slightly increased compared to the previous periods.** At the end of 2018, the net open foreign currency position of the banking sector was long and at 7.8% of regulatory capital, almost the same as that registered in 2018 H1 and 1.1 percentage points higher than the open position at the end of 2017. The performance of this indicator for the banking sector is driven mostly by the larger banks group, who continue to maintain a long open position. This position was at 11.1% of regulatory capital, significantly higher compared with the previous two periods and affected by the increase of the long position in euro. The medium banks' group also kept a long net position, but with a lower value against regulatory capital, around 3%. On the other hand, the small banks' group deepened its short foreign currency position compared with the previous period, registering 9.8% of regulatory capital, at the end of the period.

Chart 81 Open foreign currency position to regulatory capital for the sector and by size



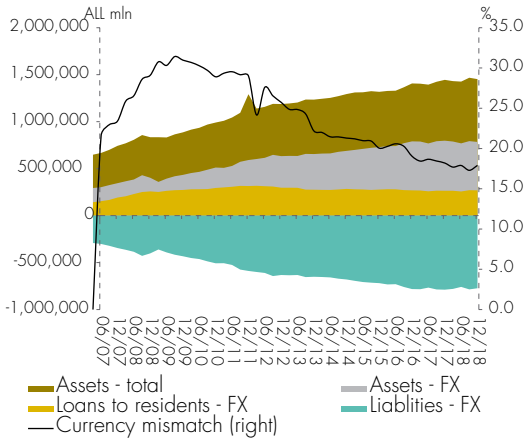

Source: Bank of Albania.

**(87) During the period, the exposure of the banking sector to the exchange rate indirect risk did not have significant fluctuations.** At the end of December 2018, the foreign currency mismatch[49] for all currencies resulted at 17.8% of total assets from 17.3% and 17.7% in the previous period and in the previous year, respectively. The increase of the value of the index reflects the somewhat faster increase of liabilities in foreign currency (2%) compared with the increase

[49] *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 movements in the exchange rate. for the calculation of the exchange rate indicator, refer to the Financial Stability Report 2016 H1.*

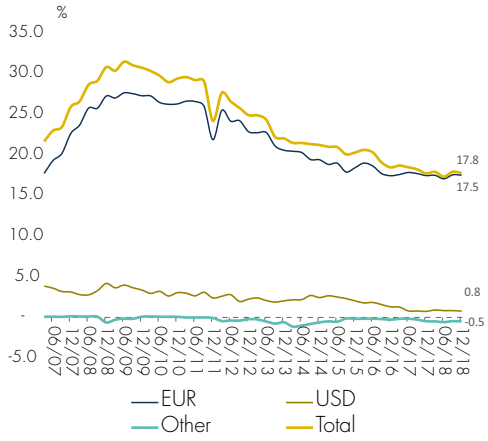
of assets in foreign currency (1.9%). The increase of the value of the index for the banking sector overall is due to the increase of the index for the euro by 0.4 percentage point in 17.5% of total assets.

Chart 82 Indices components for the banking sector




Source: Bank of Albania.

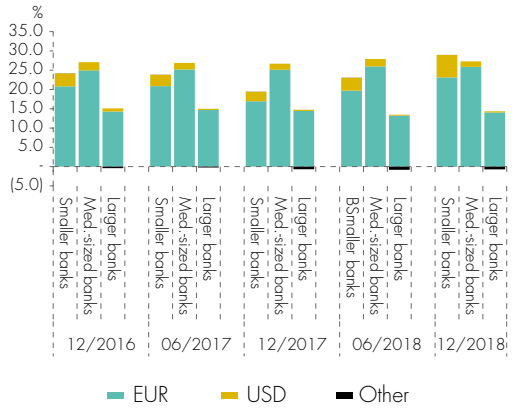
Chart 83 Currency mismatch, by currency




Source: Bank of Albania.

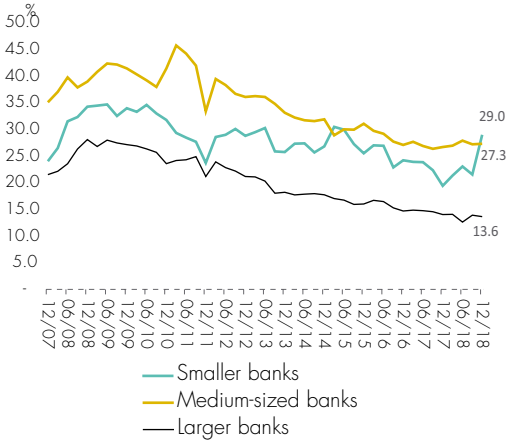
**(88) The performance of the foreign currency mismatch index during the period was affected by the increase of the values of the index for medium and small banks.** At the end of 2018, these indices registered 27.3% and 29%, respectively. The larger banks group continues to register the lowest values of the foreign currency mismatch. The index calculated for these banks declined by 0.4 percentage point during the period and registered 13.6%, at the end of the year. Since the size of the index is in inverse proportionality with the degree of hedging foreign currency liabilities with foreign currency assets, larger banks have lower exposure, while smaller banks have higher exposure

Chart 84 Mismatch by currency




Source: Bank of Albania.

Chart 85 Currency mismatch for groups, by size




Source: Bank of Albania.

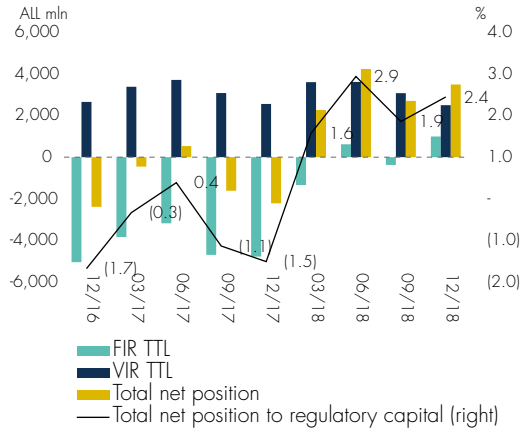
to the exchange rate indirect risk. For small banks, the main impact on the increase of the overall index for the group came from the change of the value of the index for the US dollar; meanwhile, the index for euro also increased.

### *INTEREST RATE RISK*

**(89) The banking sector's exposure to the interest rate risk has been limited.** The weighted total net position in banks' balance sheet against regulatory capital remains low. This position was at 2.4% of regulatory capital[50] at the end of 2018, decreased in half-year terms and increased from the end of 2017. The performance of the indicator is conditioned by the performance of the net position with fixed interest rates (FIR)[51], which at the beginning of 2018 shifted to the positive side. Compared with 2017, during 2018, an expansion of the positive position for lek and US dollar, and a contraction of the negative position for euro were observed. The net position for instruments with variable interest rates (VIR), while downward during the period, maintained positive values and similar levels with the previous year. Although the total net position is positive - as the regulatory capital hedging of these positions remains high and the space for further decrease of the interest rates is objectively limited - the cost that may arise for the banking sector due to further interest rate decrease can be easily absorbed.

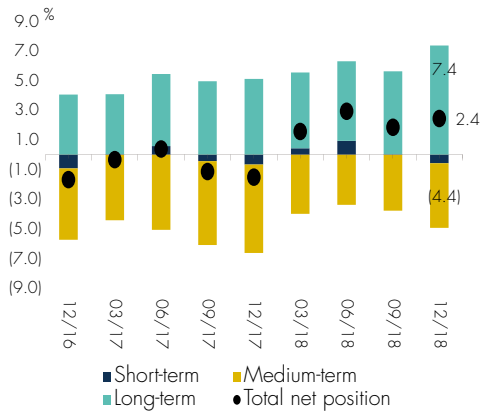
**(90) The shift of the overall position of the banking sector from low negative values during 2017 to low positive values during 2018 was due to the expansion of the positive position in lek and the contraction of the negative position in euro.** The weighted net position in euro for all three bank groups by size has low negative values and, during 2018, contracted significantly

Chart 86 Weighted aggregate net position in bank's balance sheets against regulatory capital, in %




Source: Bank of Albania.

Chart 87 Weighted net position by currencies against regulatory capital, in %




Source: Bank of Albania.

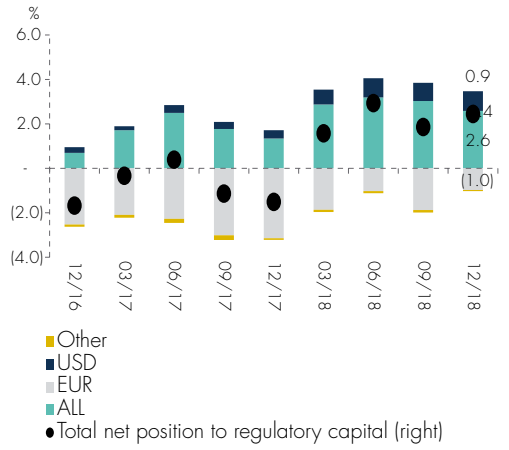
[50] *In accordance with the relevant regulation, the absolute value of this indicator (assets sensitive to interest rate minus sensitive liabilities to interest rate) should not exceed 20% of regulatory capital.*

[51] *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.*

compared with the previous year. The position in US dollar is positive, has very low values and is held by larger banks.

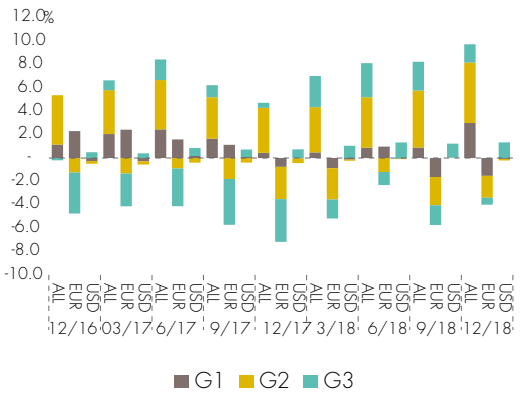
(91) **During 2018, the positive position for long-term maturity expanded and the negative position for medium-term maturity contracted.** At the end of 2018, the weighted net position for long-term maturity registered its highest level against regulatory capital at 7.4%. The main contribution to this development came from the increase by ALL 2.7 billion of the net position with fixed interest rate in euro. The short-term gap held the lowest level of exposure (-0.6%) and did not register significant changes in the last two years. For medium-term maturity, the negative position between assets and liabilities was 4.4% of regulatory capital at the end of 2018, standing higher than in 2018 H1, but around 2 percentage points lower than in the previous year.

Chart 88 Gap by maturity against regulatory capital, in %




Source: Bank of Albania.

Chart 89 Weighted net position by currencies and groups against regulatory capital, in %




Source: Bank of Albania.

(92) **Compared with larger and small banks, medium-sized banks have the highest exposure in the domestic currency.** For these banks, the weighted net position in lek was 5.2% at the end of the year, notably higher compared with the position of the other two groups. This position expanded throughout 2018. Larger banks have a lower net position in lek, at around 2%. This position reduced, compared with the average level registered during the previous two years.

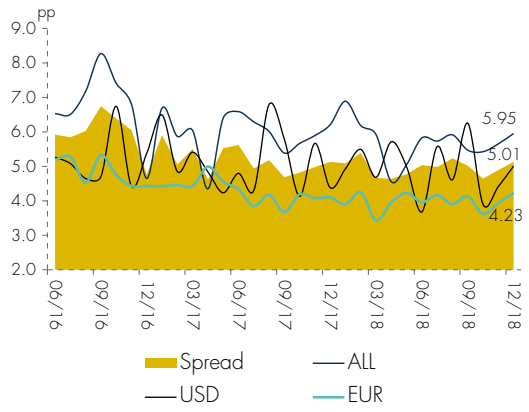
(93) **Indirect risk to interest rate change[52] registered a slight increase during the period.** The weighted credit interest rate increased, while that of deposits did not register changes. As a result, the spread of interest rates expanded,

[52] *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).*

with the main contribution coming from the domestic currency. At the end of 2018, the spread between new credit and new deposits interest rates in the banking sector registered 4.23 percentage points for the euro, 5 percentage points for the US dollar and 5.95 percentage points for the lek.

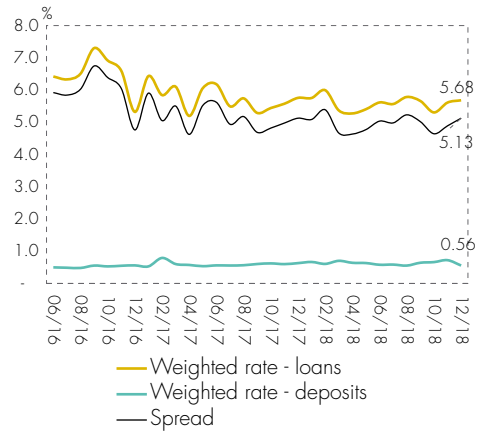
(94) **Compared with the previous year, the spread for all currency has not changed.** By currency, this indicator registered a slight expansion for the euro, a stronger increase (0.6 percentage point) for the US dollar and a decrease by 0.3 percentage point for the lek. At the end of the year, the weighted interest rate for new loans was lower than in the previous year, while the weighted interest rate for new deposits decreased at 0.56% in December 2018, after a several months period of slight but steady increase.

Chart 90 Loans and time deposits weighted interest rates and interest rates spread, in %




Source: Bank of Albania.

Chart 91 Spread of weighted interest rates of loans and term deposits by currency, in p.p.




Source: Bank of Albania.

***BOX 6.3: BANKING SOUNDNESS INDEX***

*The banking soundness index represents an overall assessment of the core conditions and significant factors of risk that affect the stability of the banking sector and of individual banks. The index is composed of five indicators, which represent five dimensions of the banking sector: capital, asset quality, profitability, liquidity and efficiency. (MISHRA et.al (RBI); 2013):*

*The aggregate index of key indicators used to track the performance and the banking stability situation results as improving from the previous year. Its value decreased at 0.43 from 0.46 registered at the end of December 2017.*[53]

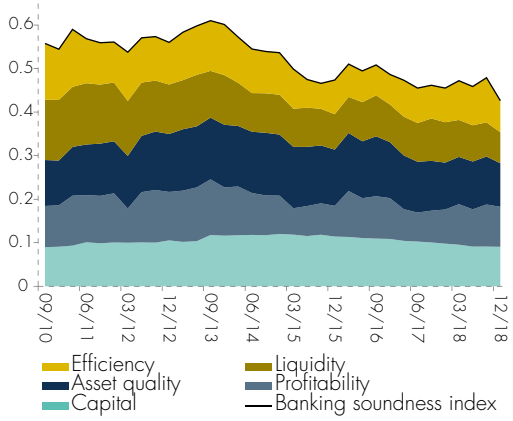
*The components of the index, which registered a better performance in the last year, are: capitalization, asset quality, liquidity and efficiency. Meanwhile, the*

[53] *The decrease of the value of the index implies the improvement of banking soundness and vice versa.*

*decrease of "profitability" against the previous year contributed to the decline of the Banking Soundness Index, which registered 0.46 from 0.39 at the end of December 2017. Compared with a year earlier, banks' income declined, affected mainly by the decrease of net income from interest. Overall, the main contribution to the risk continues to come from asset quality. However, the considerable decrease of the non-performing loans stock, and as a consequence of the non-performing loans ratio, decreased the contribution of this indicator to risk. Meanwhile, "liquidity" registered the most significant improvement during the year, driven by the considerable expansion of its main indicator "liquid assets to total assets".*

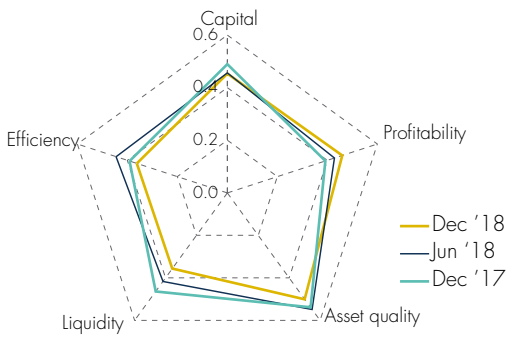
*During the last five years (2013-2018), the aggregate banking soundness index has registered a downward trend, which means better soundness and higher stability for banks.*

Chart 92 Banking Soundness Index*




*Higher index value shows lower soundness. The breadth of each dimension means its contribution to risk.
Source: Bank of Albania.

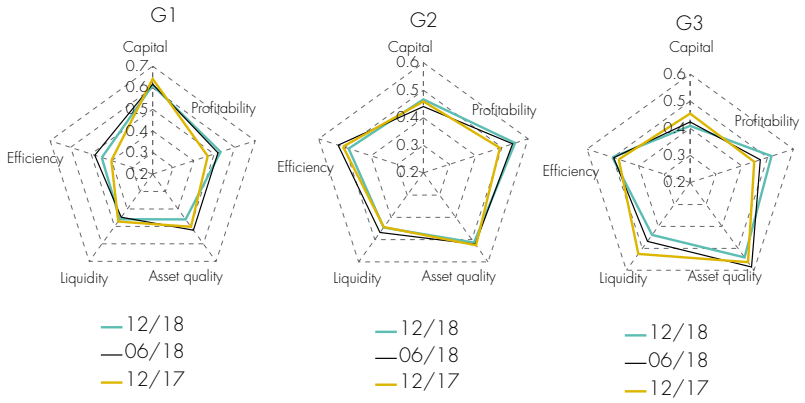
Chart 93 Banking Soundness Map*




*Away from centre means increased risk, at an interval from 0 to 1.
Source: Bank of Albania.

*The overall performance of banks, by size, is presented below. Medium-sized (G2) and small (G1) banks registered the same level of the index (compared with*

Chart 94 Banking soundness map in groups by size*




*Away from the centre means increased risk, at an interval from 0 to 1.
Source: Bank of Albania.

*the previous year), reflecting the same level of soundness. For these two bank groups, a decline was observed in the indicator of profitability, while "assets quality" improved, decreasing the contribution of this indicator to risk. Profitability declined due to the decrease of the net profit value, which also reflected a deterioration of RoA. The improvement of asset quality is attributable mainly to the continuous decrease of the non-performing loans stock. Larger banks (G3) report an improvement of the index, in the last year. The aggregate soundness index for this banking group decreased slightly, driven by the improvement of liquidity, asset quality and the expansion of capitalization, reflecting the increase of the Capital Adequacy Ratio. Larger banks have the lowest level of the Index.*

## 6.2 BANKING SECTOR RESILIENCE

To assess the banking sector resilience, the indicators of financial performance and activity capitalisation are analysed. Stress test exercises are carried out to assess the response of banking sector's capitalisation and liquidity indicators to the proposed scenarios.

### 6.2.1 FINANCIAL RESULT

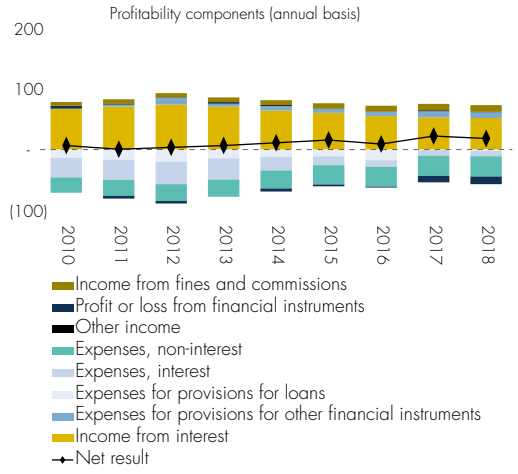
(95) **The banking sector closed 2018 with a positive financial result of around ALL 18.4 billion.** This result was ALL 3.7 billion lower than in the previous year, but higher than the financial result registered during the other years of the last decade. Compared with 2017, the financial result contracted mainly due to the higher losses from financial instruments and the increase of provisions. Net result from interests registered a slight decrease and had a small negative impact on the net result change. The decline of the financial result is reflected in a slight decrease of the average indicators of profitability of the banking sector, with the return on assets (RoA) and return on equity (RoE) declining at 1.3% and 13%, respectively, from 1.5% and 15.7% in the previous year.

(96) **The financial result was adequately distributed by banks and their size.** More concretely, all three banking groups by size reported positive values of the profitability indicators, although only larger banks registered increase, compared with the previous year. The banks that registered a financial loss share around 3% of the banking sector's total assets.

(97) **The net result from interests registered ALL 40.3 billion, or ALL 0.4 billion lower than in the previous year.** During 2018, banks collected around ALL 52 billion from interests and spent around ALL 9 billion to pay interest. Compared with 2017, interests' income and expenditure were ALL 1 billion and ALL 0.5 billion less, respectively. It must be noted that the decrease of interests' income is the result of the decrease of interests' income from transactions with clients (loans), whereas income from securities, the treasury

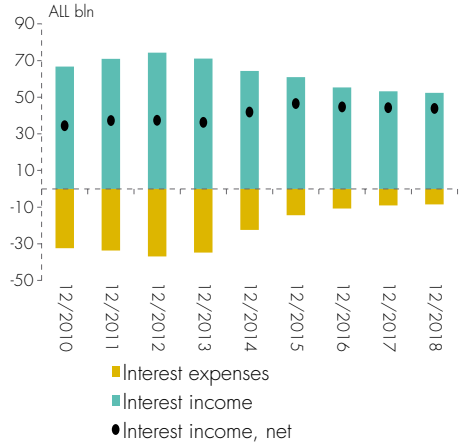
and interbank transactions increased. On the side of expenditures for interests, the decline affected deposit, securities and treasury transactions. Net margin from interests declined at 3.75% from 3.9% in the previous year, reflecting not only the decline of the net result from interests, but also the increase of the level of average income earning assets.

Chart 95 Financial result components




Source: Bank of Albania.

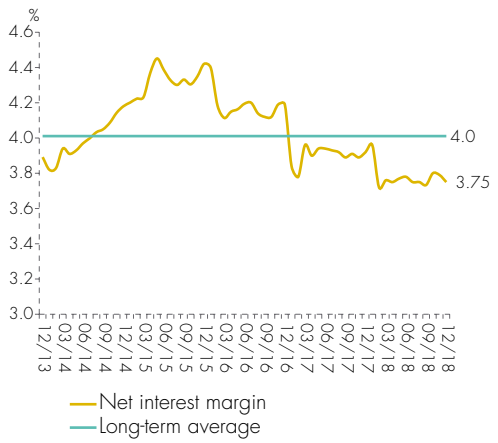
Chart 96 Interest income and expenses, and net interest result




Source: Bank of Albania.

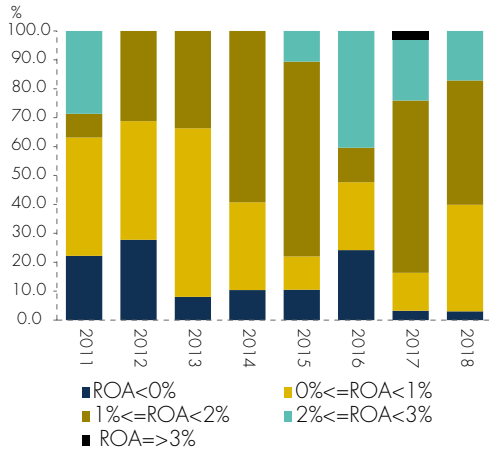
**(98) Income from other activities (not related with interest) declined by around ALL 2.4 billion in annual terms shifting into negative value (ALL -0.4 billion).** This shift was due to higher losses from financial instruments, which expanded by ALL 2 billion compared with the previous year. Overall activity expenditures increased by ALL 0.5 billion. On the other hand, extraordinary income made a positive contribution to the net result, registering ALL 4 billion, or ALL 2 billion more that the value reported in 2017. The latter were affected by the repayments of non-performing loans.

Chart 97 Net interest margin




Source: Bank of Albania.

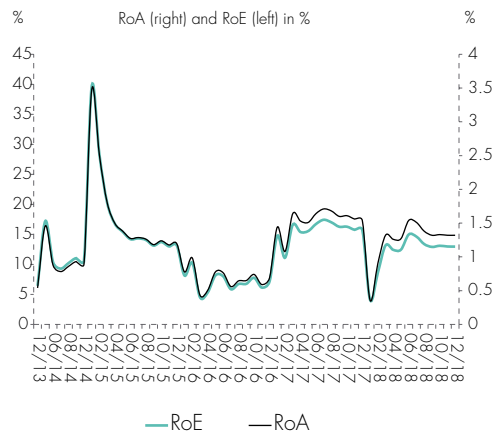
Chart 98 ROA by banks' share in the assets of the sector




Source: Bank of Albania.

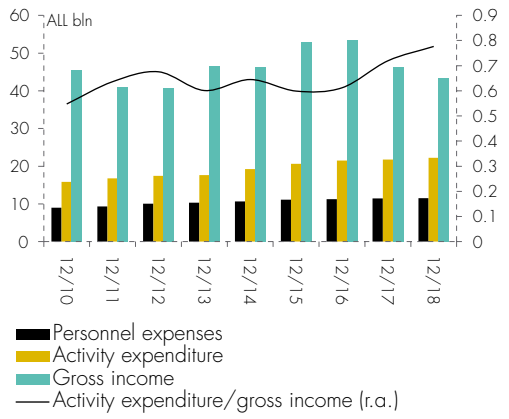
**(99) Banks' expenditures in the form of provisions for credit risk during 2018 were ALL 2.3 billion, remaining significantly below the average level of ALL 15 billion of the period 2012-2016.** However, compared with 2017, these expenditures increased by ALL 1.1 billion and affected negatively the financial result of the banking sector. Expenditures for other financial assets were negative (reversal of provisions). The value of reversal of provisions for these assets was around ALL 9 billion and decreased slightly compared with the previous year. Due to the increase of loans provisioning and the decrease by around ALL 0.7 billion in the value of reversal of provisions for other financial assets, the profit of the banking sector contracted by around ALL 1.8 billion.

Chart 99 Profitability indicators




Source: Bank of Albania.

Chart 100 Activity expenditure and net income




Source: Bank of Albania.

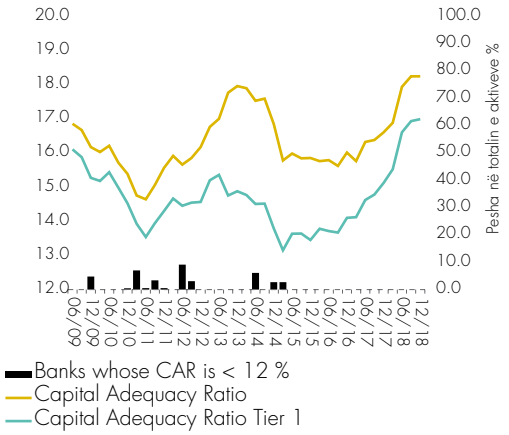
**(100) Activity costs were well covered by activity income.** Overall, personnel costs and other operating expenses maintained stable levels and currently share around 80% of gross income from the banking sector's activity. Interest expenditures also remain low and stable, due to the low level of the interest rates. As a ratio against total income, personnel costs and other operating expenses have increased, in the last two years, mainly owing to the downward trend of gross income. Operating expenses are around twice higher than personnel costs and have registered a faster increase than personnel costs during the last 10 years.

### 6.2.2 CAPITALISATION OF ACTIVITY

**(101) The capitalisation of the banking sector during the period registered a growth.** At the end of 2018, the Capital Adequacy Ratio stood at 18.2%, from 17.9% at the end of 2018 H1 and 17.0% at the end of 2017. Small banks and those with foreign capital have the highest level of Capital Adequacy Ratio. Since mid-2015, in the domestic banking sector there has been no case of the Capital Adequacy Ratio falling below the 12% regulatory minimum,

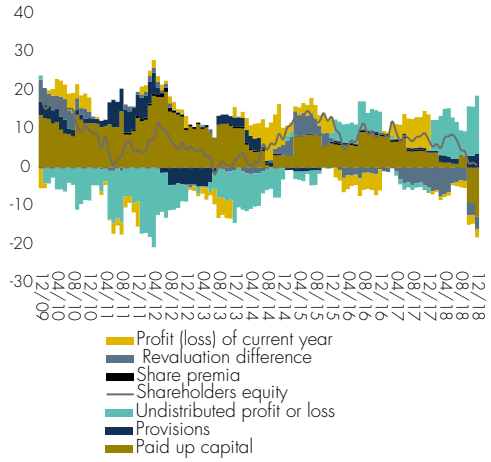
while currently the Capital Adequacy Ratio is above 15% for 10 banks of the system. Compared with the previous period, a higher number of banks have Capital Adequacy Ratios on the 16%-18% and 20%-30% ranges, while during 2018 H1 most banks fell in the 14%-16% range.

Chart 101 Capital Adequacy Ratio




Source: Bank of Albania.

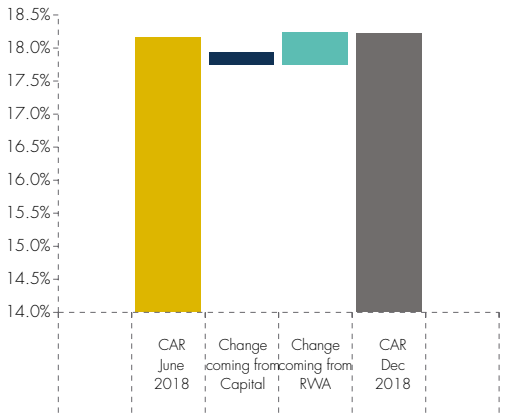
Chart 102 Annual contribution in capital increase by component instruments, in p.p.




Source: Bank of Albania.

**(102) The Capital Adequacy Ratio increased driven by the decline of risk-weighted assets, whereas the regulatory capital decreased slightly.** The decrease of risk-weighted assets is mainly the result of the abrogation of the countercyclical measure in the form of requirement for capital buffers for investments in non-resident financial institutions in foreign currency[54]; capital requirement for credit risk also registered a decrease. At the end of 2018, total risk-weighted assets in the banking sector were around ALL 780 billion. This level was around 2.6% lower than in the end of 2018 H1 and the decrease of risk-weighted assets improved (increased) the Capital Adequacy Ratio by around 0.5 percentage point. The regulatory capital of the banking sector decreased by 1% at ALL 143 billion, as a result of the contraction of paid up capital, which is the main element of the shareholders' equity. The merger by absorption of two banks during 2018 as well the capitalisation of losses determined the behaviour of banking sector's paid-up capital and regulatory capital overall. The decline of regulatory capital provided a negative effect of 0.2 percentage point to the Capital Adequacy Ratio.

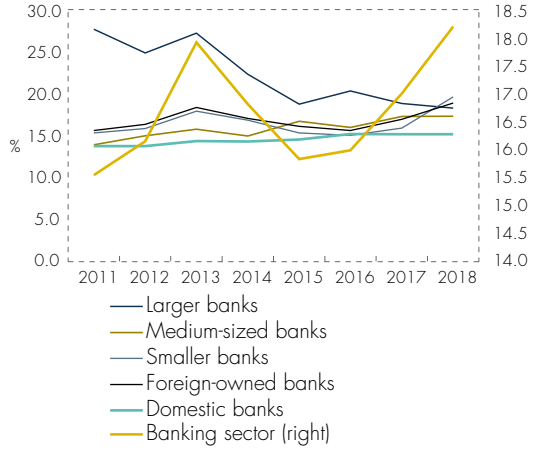
Chart 103 Capital adequacy items, in p.p.




Source: Bank of Albania.

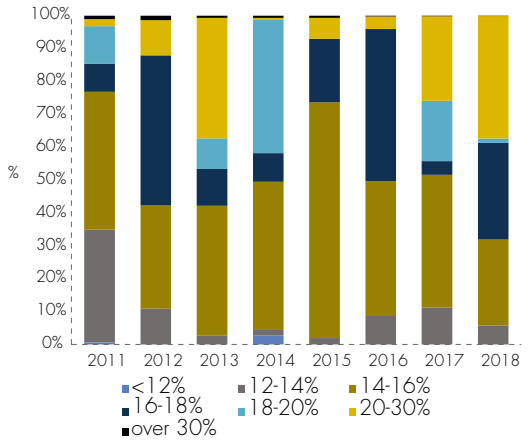
[54] *Decision dated 02.05.2018 "On some changes in the Regulation on capital adequacy".*

Chart 104 Capital Adequacy Ratio of groups by size and by capital




Source: Bank of Albania.

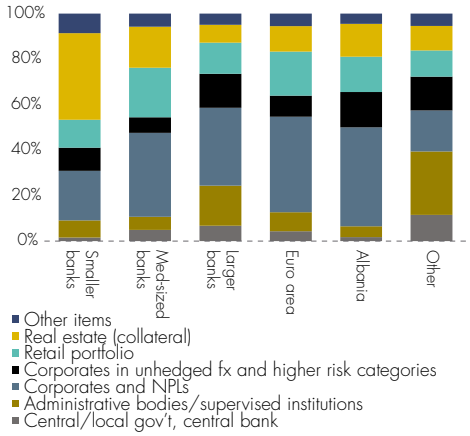
Chart 105 Asset allocation of banking sector by Capital Adequacy Ratio




Source: Bank of Albania.

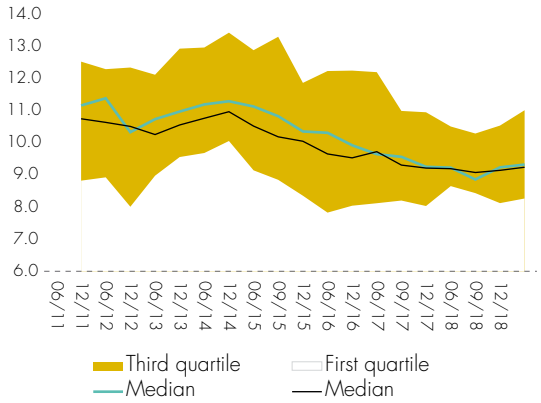
**(103) Assets related with credit risk continue to dominate the banking sector's total riskier assets, accounting for around 90% of them.** At the end of the period, small banks registered a high exposure in loans collateralised with real estate, while medium-sized and larger banks registered a high exposure in loans for corporations and non-performing loans. By capital origin, banks with domestic capital as well as those with European capital have high exposure in "loans to corporations and non-performing loans", whereas banks with domestic capital have a higher exposure in "unhedged loans to corporations in foreign currency and high risk categories" and "loans collateralized with real estate".

Chart 106 Credit classes' exposure of banks by size of activity and origin of capital, December 2018




Source: Bank of Albania.

Chart 107 Financial leverage ratio




Source: Bank of Albania.

**(104) Assets related with market risk increased by almost 15.9% during the period, reaching ALL 17 billion, or 2.2% of risk-weighted assets.** Assets related with operational risk decreased, but maintained the 10% share in total risk-weighted assets.

**(105) The Albanian banking sector is characterized by an adequate financial leverage ratio, thus confirming the good level of capitalisation.** The financial leverage ratio[55], as at December 2018, was 9.8 times, unchanged from the previous year. At bank level, the ratio appears also as stable and without significant shifts.

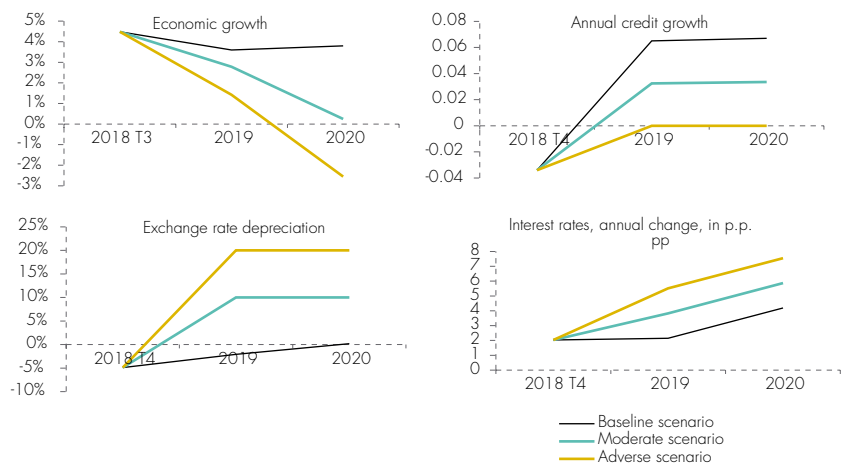
### 6.2.3 ASSESSING BANKING SECTOR RESILIENCE THROUGH STRESS-TESTING

**(106) The stress test exercise assesses the banking sector's resilience in the face of hypothetical economic and financial developments, for the period 2019-2020.** The results show that the banking sector remains resilient. The impact of these assumptions in terms of capital adequacy evidences the need for additional capital in some banks, particularly in the case of the adverse scenario, where the assumptions are also more extreme. Liquidity stress test supports the assessment of a satisfactory liquidity situation of the banking sector, although in the two year horizon, inflows show a higher increase than outflows compared with the results of the previous year.

#### *6.2.3.1 Assessing resilience to macroeconomic shocks*

**(107) The stress test exercise assesses the banking sector's resilience in terms of capital adequacy for the period 2019-2020.** The assessment of the impact from macroeconomic situations on the financial situation of the banking sector excludes the possibility of the increase in paid in capital during the period. The exercise is conducted by applying three scenarios: the baseline scenario, the moderate scenario and the adverse scenario. The last two scenarios have a lower probability of occurrence and more extreme assumptions.

Chart 108 Assumptions for stress-testing




Source: Bank of Albania.

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

(108) **The baseline scenario assumes a positive but downward economic growth throughout the timeframe of the exercise.** In this scenario, economic growth is accompanied with positive growth rates of lending, supported also by a significant improvement of the quality of the credit portfolio by the end of 2020. The value of the non-performing loans portfolio, mainly according to factual collections and expectable write-offs from balance sheets (although the latter with a downward contribute until the end of 2020), is expected to further improve until the end of the exercise.

(109) **The moderate scenario assumes again a positive economic growth for the two years of the exercise, but lower compared with the baseline scenario;** meanwhile, the adverse scenario assumes again a lower economic growth on 2019 and its contraction in 2020. To the assumptions on the economic performance in the moderate and adverse scenarios are also attached the respective assumptions for a depreciation of the exchange rate of the domestic currency, an increase of the interest rate and a decrease of the lending pace until it stops. These developments resulted in the decrease of the credit portfolio quality, which by the end of 2020 deteriorates up to 8.4 percentage points (moderate scenario) and 15.5 percentage points (adverse scenario) compared with the factual values of December 2018. Overall, these assumptions contribute to downward values of the capitalisation indicators of the banking sector.

(110) **Stress test results in terms of capital adequacy show that:**

a. **In the baseline scenario, the Capital Adequacy Ratio (CAR) of the banking sector appears stable and upward against factual values of December 2018**. This rate is assessed to reach around 20.1% at the end of 2020, based on the assumptions of this scenario. This development reflects the assumption on the economic growth pace, the positive growth of lending to the economy, the further improvement of the non-performing loan portfolio and the favourable performance of the exchange rate. The assumed performance of interest rates also gave positive contribution, based on the structure of "assets and liabilities sensitive to the up-to-12 months interest rate" of the banking sector. Developments by banking groups register good levels of capital, significantly above the minimum requirement by the regulatory framework.

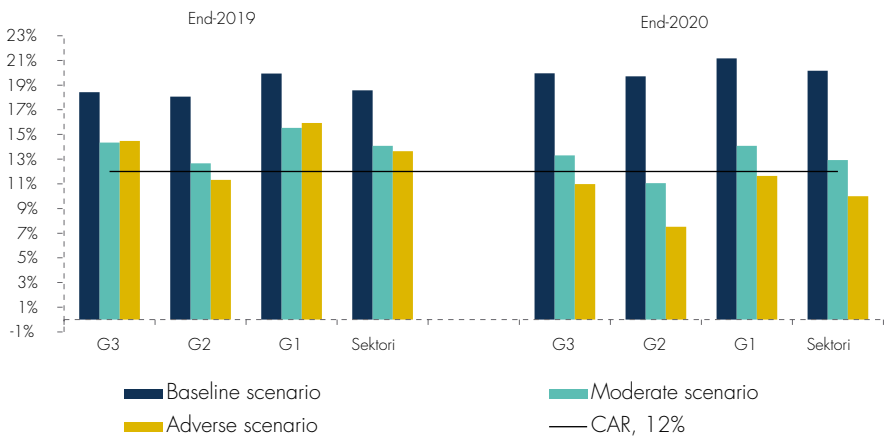
b. **In the moderate scenario, the banking sector's CAR registers 14.1% at end-2019 and 12.9% at end-2020.** This rate is affected by the assumptions on the slowdown of economic growth, the halving of the growth of credit to the economy, the depreciation of the domestic currency and the increase of the non-performing loans ratio. Based on the above assumptions and the results obtained, developments in particular banks evidence the need for capital injection during the second year of the exercise. Specifically, seven banks appear under-capitalised by the end of 2020, accounting for around 22% of the

sector's assets. In this case, the need for additional capital amounts up to ALL 3.7 billion.

c. **In the adverse scenario, the banking sector's CAR declines at around 13.0% at end-2019 and at 10.0% at end-2020 driven by the significantly more adverse assumptions included in this scenario.** The number of banks that fall into under-capitalisation rises to eleven and account for 88% of the sector's assets. The extreme macroeconomic developments included in the scenario, besides the negative trend of lending to the economy, affects the significant deterioration of credit quality. Also, this scenario assumes losses in the securities portfolio and higher exposure towards market and operational risks. In this case, the needs for additional capital are almost six-fold.

To express the required values for additional capital from the point of view of current banking sector developments, we note that the average value of annual growth of banking sector's paid up capital during the 2008-2018 period was around ALL 6.3 billion.

Chart 109 Capital Adequacy Ratio, by stress-test scenarios




Source: Bank of Albania.

### 6.2.3.2 *Liquidity stress test*

(111) **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 certain currencies, instruments or time horizons; assess banks' readiness to cope with extreme liquidity shortfall scenarios; and, assist the supervision authority to undertake specific policies that address liquidity management, including measures aimed at reducing exposures or creating specific buffers.

**(112) The liquidity stress test is implemented according to the "top-down" approach, with data reported by banks, once per year at the end of the year.** The exercise uses data on forecasts for money inflows and outflows 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, the euro and the US dollar and is based on the condition that the liquidity excess in a currency may not be used to cover the liquidity shortfall in other currencies, due to the probability of the fast depreciation of the exchange rate in times of liquidity crises.

**(113) To calculate the liquidity gap, specific coefficients are applied 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 client. For money inflows, the reinvestment coefficient means that part of the amount rights that matures in the relevant basket, which will be converted in money inflow and will not be reinvested by the bank.

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

**(115) The results of the exercise indicate that the banking sector generally successfully passes the liquidity stress test, but the resilience of the banking sector to liquidity shocks is different depending on the currency.** The ability of the banking sector to withstand liquidity shocks is assessed as "very good" for the lek and the US dollar and "good" for the euro. The gap between expected inflows and outflows at the end of the two-year horizon has deepened compared with the previous year, due to the liquidity situation in euro. Expected inflows in euro are significantly lower than in the previous year, while outflows are expected to grow slightly.

**(116) The number of banks that continue to register a negative liquidity gap has risen particularly for euro, but the share of liquidity gap against the assets of the banking sector in each currency in significantly low and does not exceed 2.5% of assets in each respective currency.** The scenario that assumes the use of expanded liquid assets to close the liquidity gap shows that: for the lek, the number of banks that fail to close the gap ranges one to two; for the euro, three banks continue to have a negative gap for all baskets, while the maximum number of banks with negative gap (6 banks) is registered in the 6-12 months maturity; for the US dollar, the maximum number of banks that fail in the test, assessed for the 3-12 months maturity, is three.

**(117) The banking sector is assessed to have strengthened its resilience to liquidity shocks in lek compared with the previous year, but appears weaker**

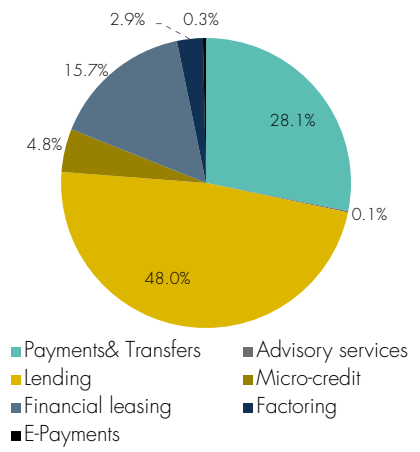
**against potential shocks in euro.** The strengthening of the resilience in lek is related to the increase of the volume of counterweighting capacities, while the weakening of the resilience in euro reflects the deterioration of the ratio between inflows and outflows as well as a slight decrease of liquid assets available for liquidation in the event of a liquidity shock.

## 6.3 MAIN DEVELOPMENTS IN THE NON-BANKING SECTOR

### *INSTITUTIONS SUPERVISED BY THE BANK OF ALBANIA.*

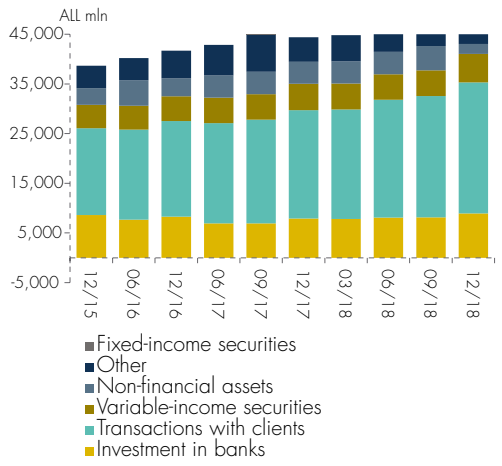
(118) **During the period, non-bank financial institutions (NBFIs) expanded their total assets and registered good indicators of financial performance.** As at the end of 2018 Q3, 30 NBFIs operated in the financial system, mainly engaged in microcredit, lending, leasing, factoring, e-money, etc. Lending NBFIs had the main share followed by those that provide payment and transfer services. NBFIs' assets reached around ALL 50 billion, or around 4% more than the total assets reported at 2018 H1 and around 10% more compared with 2017 H2. NBFIs reported a positive financial result (around ALL 1 billion) somewhat higher than the previous year. The capitalisation of the activity of NBFIs remained at satisfactory levels.

Chart 110 Structure of NBFIs by type of activity




Source: Bank of Albania.

Chart 111 Structure of NBFIs assets

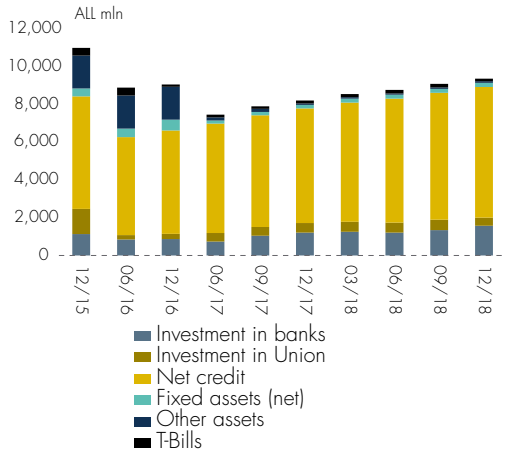



Source: Bank of Albania.

(119) **The activity of Savings and Loan Associations (SLAs) registered an expansion in half-year and annual terms supported by the positive performance of the activity of the members (net loans) and the growth of investments in the banking sector in the form of current accounts.** SLAs financial result was

positive[56] and higher than in the previous year. Net loans to members and investments in banks represent the main items of NBFIs' assets. At the end of 2018, there were 13 licensed Savings and Loan Associations operating in the market.

Chart 112 Structure of savings and loan associations




Source: Bank of Albania.

## *INSTITUTIONS SUPERVISED BY THE ALBANIAN FINANCIAL SUPERVISION AUTHORITY*

(120) **The activity of insurance companies increased during 2018 H2. As at end- 2018, there were 11 licensed companies providing life and non-live insurance and one company providing reinsurance services.** The assets of these institutions recorded 9% annual growth and reached ALL 33 billion. Investments in banks held the main share (around 32%) in insurance companies' balance sheets. Gross written premiums[57], with the main contribution from non-life premiums (92%), which represent the main funding source for the insurance companies activity, expanded by 5.5% in annual terms.

(121) **The activity of investment funds[58] contracted from the end of 2017, as a result of the decrease of investments in government securities.** The value of net assets declined at ALL 66 billion, from ALL 73 billion in the previous year. Currently, five investment funds operate in the Albanian financial system. Investment funds' assets are mainly invested in T-bills and bonds issued by the Government of the Republic of Albania in lek, and others in euro.

(122) **Supplementary Private Pension Funds[59] expanded their activity during the period.** In Albania, three supplementary private pension funds operate in the financial market. The assets of these funds registered ALL 2.2 billion or 26% higher than the end of 2017. The activity of pension funds is dominated by investments in government debt securities.

(123) **The Albanian Securities Exchange (ALSE) licensed by the Albanian Financial Supervision Authority in July 2017, started its activity on 22 February 2018.** In accordance with the limited license for the first year, the activity of the ALSE during the period consisted in transactions with government debt securities. The ALSE counts 4 members, which are banks and one brokerage company. The transactions conducted in ALSE are transactions for the account

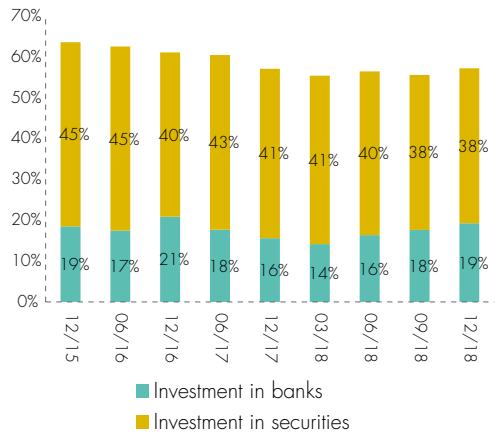
[56] *Around ALL 110 million.*
[57] *AFSA, "Insurance Market Statistical Report: Year 2018", published on 25 January 2019.*
[58] *AFSA, "Collective investment undertakings market", 31 December 2018, published on 14 February 2019.*
[59] *AFSA, Statistical Report "Developments in the private supplementary pensions", 30 September 2018, published on 16 November 2018.*

of ALSE members' portfolio (interbank transactions) and transactions for the account of customers (natural and legal persons). During the first year of its activity in February-December 2018, the volume of trade at the stock exchange was ALL 2.6 billion. The reported statistical data to the AFSA shows that interbank transactions share around 63% of the trade volume; the rest belongs to transactions with clients. Depending on AFSA's decision, the ALSE expects to list and accept for trading other securities in the future.

## *RISKS AND EXPOSURES BETWEEN BANKING AND NON-BANK SECTORS*

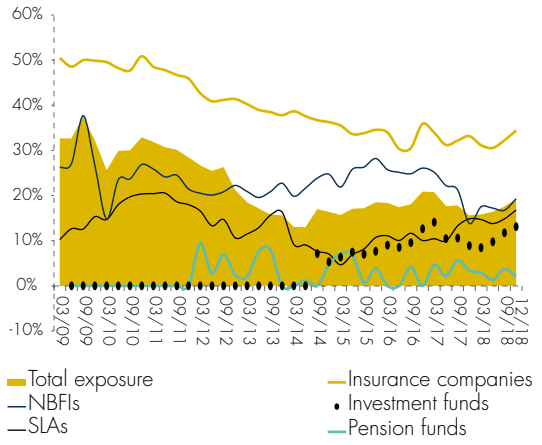
(124) **The banking sector's exposure to the non-banking sector in Albania remained low.** This exposure on the side of banks' assets is represented by loans and participation in the capital of non-bank financial institutions; meanwhile, on the side of liabilities it is in the form of funds collected by them (various accounts). In total, this exposure accounts for only 2% of the value of assets of the banking sector.

Chart 113 Investments of non-banks in banks and gov't securities, to total assets of non-banks (in %)




Source: Bank of Albania, AFSA.

Chart 114 Investments of NBFIs in banks, to their total assets




Source: Bank of Albania, AFSA.

(125) **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 accounts for 18% of the assets of the non-bank sector compared with 16% at the end of 2017. Insurance companies and non-bank financial institutions (NBFIs) show the highest exposure to the banking sector, since their placements in banks in the form of deposits and capital instruments, account for 32% and 17%, respectively, of relevant assets. The exposure of pension funds and investment funds to the banking sector has been increasing as well.