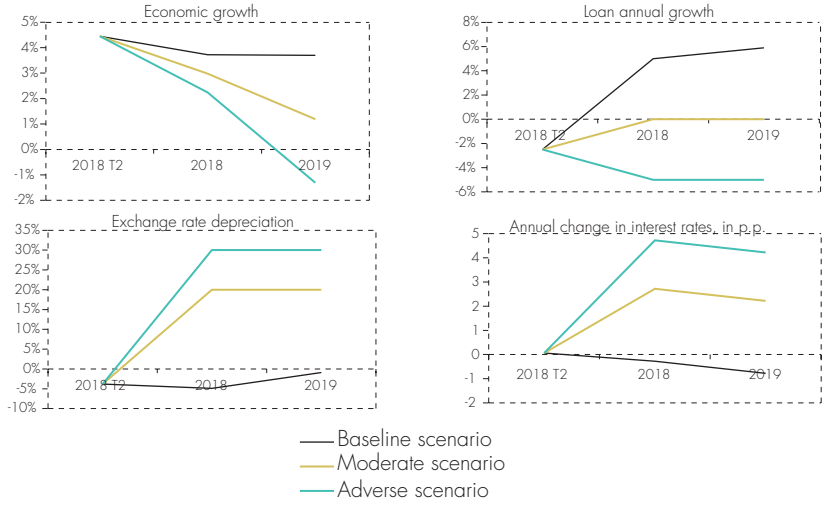
7. ASSESSMENT OF THE BANKING SECTOR RESILIENCE THROUGH STRESS-TESTING

(92) The stress test exercise is used to assess the banking sector resilience in different scenarios of economic and financial developments for the period 2018-2019. The results show that the banking sector remains resilient. In terms of capital adequacy, the impact of these assumptions indicates the need for additional capital in some individual banks, particularly in the case of the adverse scenario, in which the assumptions are also more extreme.

7.1 ASSESSING THE RESILIENCE TO MACROECONOMIC SHOCKS

(93) The stress test exercise assesses the banking sector's resilience in terms of capital adequacy for the period 2018-2019. 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 includes three scenarios: the baseline scenario, the moderate scenario and the adverse one. The last two scenarios have a lower probability of occurrence and are based on more extreme assumptions.

Chart 7.1 Assumptions for stress-testing



Source: Bank of Albania.

(94) The baseline scenario assumes a positive economic growth throughout the time horizon of the exercise. In this scenario, the economic growth is accompanied with positive growth rates of lending, supported also by a significant improvement of the credit portfolio quality until the end of 2019.

The improvement in the non-performing loans portfolio, based on the actual loan recoveries and write offs, is expected to continue in the short run. The moderate scenario is is based on the assumption that economic growth will remain positive over the 2-year horizon of the exercise, but the growth rate is lower than the growth rate assumed in the baseline scenario; the adverse scenario is based on the assumption that economic growth will be positive in 2018 but negative in 2019.

(95) The assumptions on the economic performance in the moderate and adverse scenario are supplemented with assumptions on: a depreciation of the exchange rate of the domestic currency, an increase of the interest rate and a deceleration of the lending growth rate or contraction of the credit stock. The outcome of the exercise indicates a deterioration in the credit portfolio quality, with the NPL ratio increasing by 3.7 percentage points by the end of 2019 (moderate scenario) and 4.4 percentage points (adverse scenario) compared with the values of the baseline scenario. Overall, the materialization of these assumptions would have a negative impact on the capitalisation level of the banking sector.

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

a. In the baseline scenario, the Capital Adequacy Ratio (CAR) of the banking sector is stable, standing at 17.7% at the end of 2019 against 17.9% that was recorded at the end of June 2018. This outcome is contingent upon the assumption of faster economic growth, an improvement in the growth of lending, a significant improvement in the stock of non-performing loans and favourable developments in the exchange rate. The exercise results by banking groups also indicate levels of capital that are well above the minimum level required by the regulatory framework.

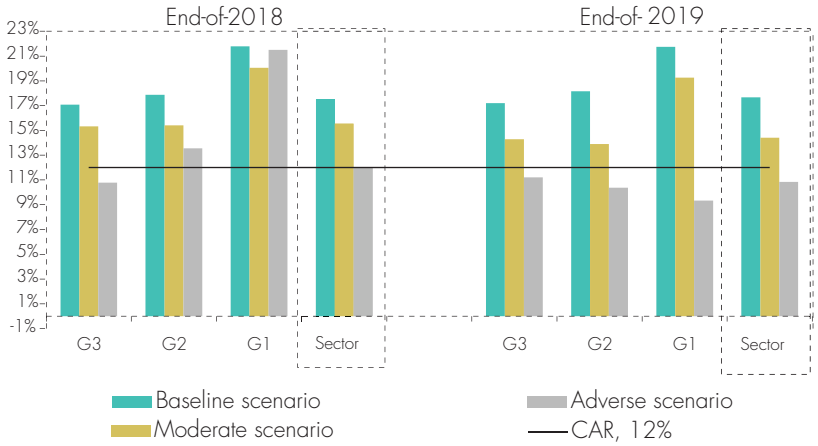
a. In the moderate scenario, the banking sector's CAR is equal to 15.6% at end of 2018 and 14.4% at end-2019. This outcome derives from an assumptions of a lower growth rate of the economic activity; contraction in the credit stock; increase in interest rates; and, depreciation of the domestic currency. In this scenario, the drop in the CAR level points to a need for capital injection by individual banks. The number of banks that are under-capitalised by the end of 2019 is 4 and they account for around 20% of the banking sector's assets. In this case, the need for additional capital until the end of 2019 equals around ALL 0.9 billion.

b. In the adverse scenario, the banking sector’s CAR drops near 12% by end-2018 and to 10.8% by end-2019 as a result of the significantly harsher assumptions included in this scenario. The number of under-capitalized banks increases to ten and these banks account for 50% of the sector’s assets. The significant deterioration in the quality of credit results from the strongly adverse assumptions on macroeconomic trends

as well as the contraction in the lending activity. The adverse scenario assumes losses in the securities portfolio and increased banks' exposure to market and operational risks. In this case, the need for additional capital amount up to ALL 16.5 billion.

To assess the size of additional paid-in capital injection required under each of the stress scenarios, vis-a-vis historical growth in the paid-in capital of the banking sector, the average annual growth in the paid-in capital of the banking sector during 2008-2016 was about ALL 9 billion.

Chart 7.2 Capital Adequacy Ratio, by stress test scenarios



Source: Bank of Albania.