

7. FINANCIAL SYSTEM

(43) The financial system activity expanded over the period. The ratio of financial system assets to GDP³⁵ increased by 0.5 percentage point during the period, to 102.6%. The ratio of the financial system assets to GDP increased as a result of the expansion of the assets of almost all component segments of the system, including non-bank financial institutions, insurance companies and investment funds. The relative increase of these three segments altogether was higher than the GDP growth. The structure of financial system assets is dominated by banks, whose assets account for about 93% of the total assets of the system. Over the period, the share of banks in the financial system has increased.

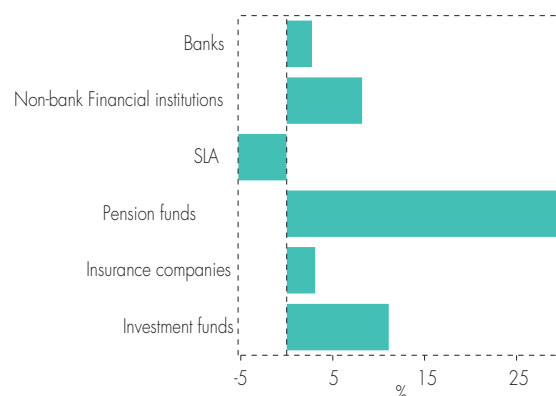
Table 7.1 The share of segments of the financial system to GDP over the years

Licencing and Supervising Authority	Financial system	2011	2012	2013	2014	2015	2016	2017
Bank of Albania	Banking system	84.7	89.6	90.5	91.7	91.3	94.9	92.5
	NBFIs	2.5	2.7	2.5	2.7	2.7	2.9	2.9
	SLAs and Unions	0.7	0.8	0.8	0.8	0.7	0.6	0.5
Financial Supervision Authority	Insurance companies	1.5	1.6	1.6	1.7	1.9	2.1	1.9
	Pension funds	0.01	0.02	0.03	0.04	0.1	0.1	0.1
	Investment funds		1.21	3.7	4.5	4.7	4.4	4.7
Financial intermediation		89.41	95.93	99.13	101.44	101.3	105.1	102.6

Source: Bank of Albania, Albanian Financial Supervisory Authority.

(44) At the end of the period, the share of banking sector assets to Gross Domestic Product (GDP) was estimated at 92.5%. This share has increased during the period, driven by the expansion of interbank transactions and the contraction of provisioning funds. In terms of financial soundness indicators, the banking sector was characterized by higher levels of capitalization, profitability and liquidity. The non-bank sector has maintained its share in GDP and almost all the component segments have contributed positively to its activity. The direct exposure of the banking sector in the non-banking sector is assessed as low, and the performance of the banking sector remains a critical factor for the activity and stability of the non-banking sector. In the structure of the non-

Chart 7.2 Annual growth of segments in the financial system



Source: Bank of Albania, Albanian Financial Supervisory Authority.

³⁵ The financial system consists of banks, non-bank financial institutions, savings and loan associations (SLAs), insurance companies, private supplementary pension funds and investment funds. In this chapter's analysis, please be aware that insurance companies and non-bank financial institutions balance sheet data belong to 2017 Q3 and, for other institutions, to the end of 2017.



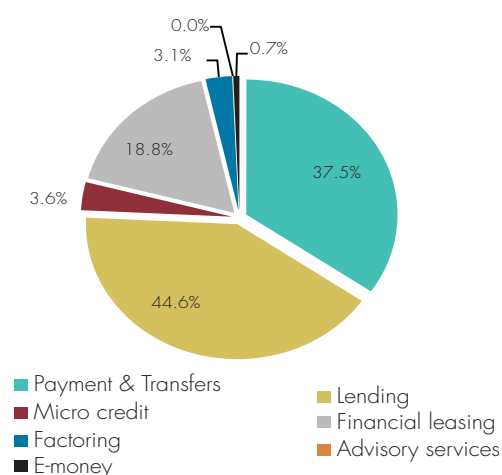
banking sector assets, investments in debt securities of the Albanian Government account for a significant share and marked an increase during 2017.

7.1 NON-BANKING SECTOR DEVELOPMENTS

INSTITUTIONS SUPERVISED BY THE BANK OF ALBANIA

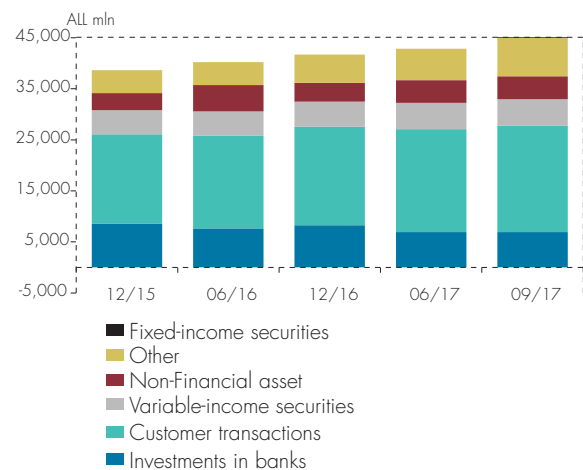
(45) During the period, non-banking financial institutions (NBFIs) expanded their activity and showed good financial indicators. Thus, assets increased mainly supported by the expansion of lending activity and the item "Cash and other receivables" ("other"), while investment in banks maintained the levels of the previous quarter. The NBFIs' financial result was positive, but lower compared to the previous year. The capitalisation level was adequate, although the assets' quality has declined. During the period, the financial system had 28 NBFIs, mainly engaged in the field of microcredit, lending, financial leasing, factoring and electronic money. The NBFIs that perform lending activity account for the main share, followed by payments and transfers. NBFIs' assets were ALL 45 billion, up by 5.2% over the first half of 2017 and 7.3% in annual terms. The main share in the assets structure consists of "customer transactions" that represent lending activity, followed by investments in banks in the form of deposits and current accounts. About 84% of NBFIs' loan portfolio consists of loans to firms operating mainly in the trade sector (22%) and agriculture (14%). The financial result of NBFIs was positive at ALL 1.2 billion, and slightly down from the previous year (ALL 1.3 billion).

Chart 7.3 Structure of NBFIs by type of activity

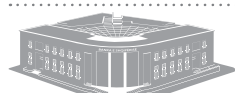


Source: Bank of Albania.

Chart 7.4 Asset structure of NBFIs

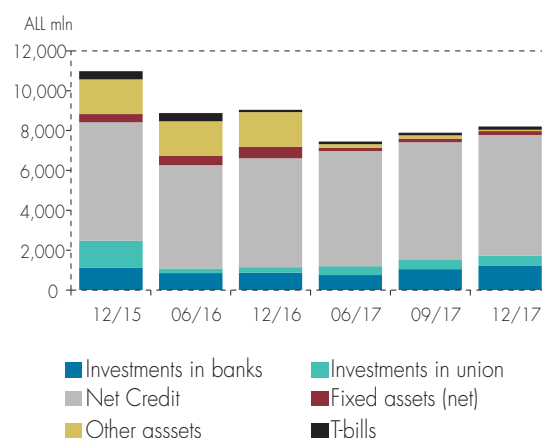


Source: Bank of Albania.



(46) The activity of Savings and Loan Associations (SLAs) was positive during the period; but contracted from a year earlier. The SLAs assets increase during the period was determined by the increase in current account, deposits and net credit, whereas their portfolio of treasury bills has also expanded. The financial result of SLAs was positive (around ALL 0.08 billion) significantly higher compared with the previous year. Loans to customers and investments in banks represent the main items of the assets of these institutions. During the period, 13 active SLAs operated in the market.

Chart 7.5 Asset structure of Savings and Loan Associations

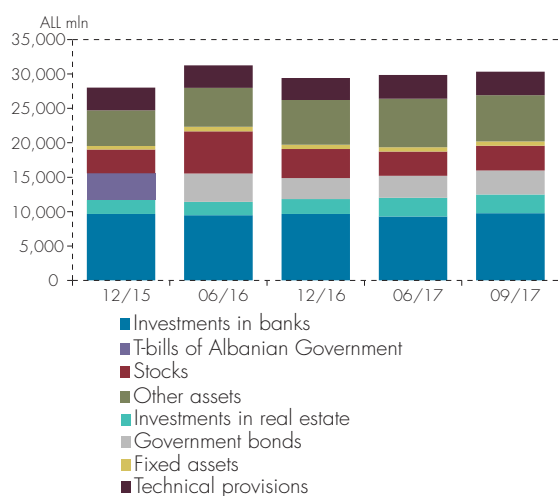


Source: Bank of Albania.

INSTITUTIONS SUPERVISED BY THE ALBANIAN FINANCIAL SUPERVISION AUTHORITY

(47) The activity of insurance companies expanded during the period. The assets of 12 insurance companies³⁶ increased by 1.6%, to ALL 30.3 billion. The increase of investments in the form of time deposits in banks and in government debt securities determined the behaviour of insurance companies' assets. Insurance companies reported a positive financial result and upward in annual terms.

Chart 7.6 Asset structure of insurance companies



Source: Financial Supervision Authority and Bank of Albania.

In the insurance activity, the premium income (paid in advance) is used for the payment of liabilities and the coverage of costs that may arise from the occurrence of an insurance event. Gross Written Premiums³⁷, which represent the main source of financing of insurance companies' activities, expanded by 5.4% in annual terms. The majority of the value of Gross Written Premiums consists of "non-life insurance" premiums of about 92.6%, compared to 7.4% of life insurance.

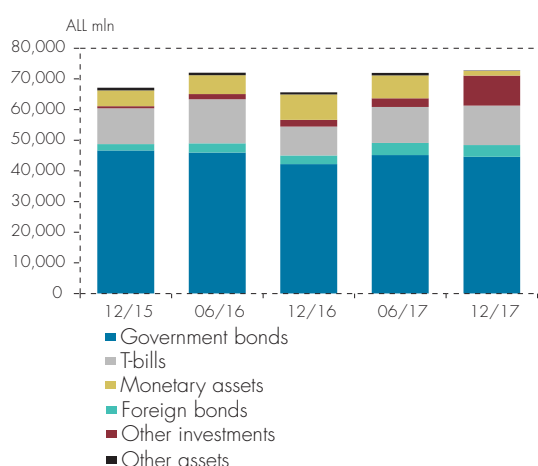
The insurance market penetration, measured as the ratio of \ premiums to GDP, is about 1%, while the average of the countries in the region reaches 2.24% and Europe's average reaches 7.4%. The loss indicator or the ratio of claims paid to gross written premiums increased to 34.1% from 27.6% a year earlier. The value of gross paid claims increased by 15.8% in annual terms to ALL 5.5 billion.

³⁶ 8 non-life insurance companies, 3 life insurance companies and 1 reinsurance company.

³⁷ AFSA, Statistical Bulletin "Insurance Market: 2017", published on 25 January 2018.



Chart 7.7 Asset structure of investment funds

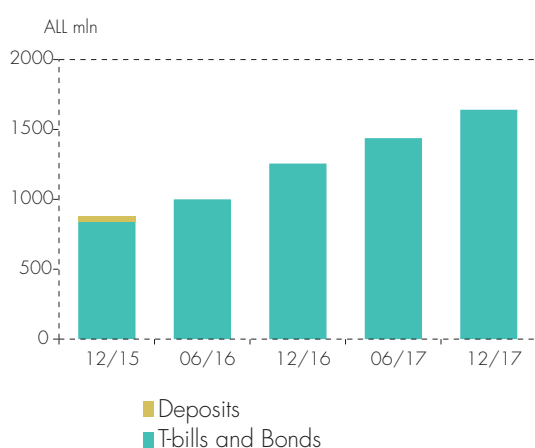


Source: Financial Supervision Authority and Bank of Albania.

(48) The activity of investment funds³⁸ expanded, as a result of the increase of investments in banks and government debt securities. The investment fund is an open-ended undertaking, established by contract, offering units to the public³⁹. The funds' assets are invested by the principle of risk diversification. The yields from participation in investment funds is usually higher than that of deposits in banks, reflecting higher risk⁴⁰ that has been accepted by the investor for participation in the fund. Currently, three investment funds operate in the Albanian financial system. These funds' assets are invested mainly in securities issued by the Government of the Republic of Albania both in lek and in euro.

According to preliminary data from the Financial Supervisory Authority, at the end of 2017, the net value of investment fund assets is estimated at about ALL 72.7 billion or about 4.7% of the country's GDP.

Chart 7.8 Investments' structure of supplementary private pension funds



Source: Financial Supervision Authority.

(49) Supplementary Private Pension Funds⁴¹ expanded their activity during the period. In Albania there are three supplementary private pension funds. At the end of 2017, the assets of these funds amounted to ALL 1.7 billion or 30.5% higher than in the previous year. The activity of pension funds is dominated by investments in government debt securities. The value of these investments was about ALL 1.6 billion or 30.7% higher, in annual terms. According to recent reports, the number of pension fund members is about 21,000.

7.2 ASSESSMENT OF RISKS AND EXPOSURES IN THE NON-BANKING SECTOR

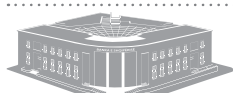
(50) The banking sector's exposure to the non-banking sector in Albania remains low. This exposure on the side of banks' assets is represented by loans and participation in the capital of non-bank financial institutions; meanwhile, on the side of liabilities it is represented in the form of funds collected by them

³⁸ AFSA, "General Investment Fund Data", 31 December 2017

³⁹ Law No. 10 198, date 10/12/2009 on "Collective Investment Undertakings", AFSA.

⁴⁰ Investments in an investment fund are only guaranteed by fund performance as shown in the prospectus document for investors.

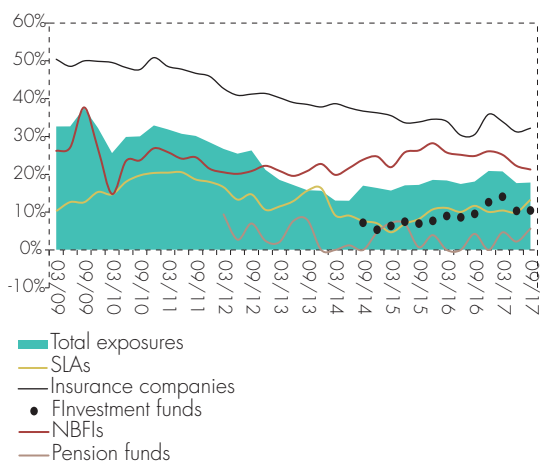
⁴¹ AFSA, Supplementary Private Pension Market Report, 31 December, 2017 published on 13 February 2018.



(various accounts). In total, this exposure accounts for only 2% of the values of assets of the banking sector.

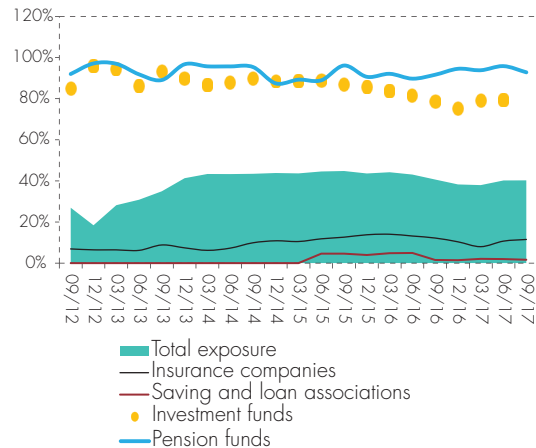
(51) On the other hand, the sensitivity of the non-banking sector to the activity of the banking sector remains high. In total, this exposure stands at 17.8% of the assets of the non-banking sector compared to 20.9% at the end of 2016. The decline in interest rates in the market has prompted non-bank institutions to invest in higher yield products such as government debt securities, resulting in a drop of the investment share of these institutions in banking products. Despite this performance, at the individual level, insurance companies and non-bank financial institutions exhibit greater exposure to the banking sector, as for other deposits they account for 32.2% and 21.3%, respectively, of the relevant assets. Investment funds and savings and loan associations also show upward exposures to the banking sector

Chart 7.9 Exposure of main NBFIs to the banking sector, toward their total assets



Source: Albanian Financial Supervision Authority, data processed by the Bank of Albania

Chart 7.10 Investments of NBFIs in government securities, toward their total assets



Source: Albanian Financial Supervision Authority, data processed by the Bank of Albania

(52) Non-bank financial institutions and saving and loans associations, while active in lending, are exposed mainly to credit risk. In September 2017, the ratio of non-performing loans against total NBFIs loans increased at 12.5% from 11.6% at the end of 2016, while for SLAs the quality indicator registered an improvement at 4.8% from 6.7% at the end of 2016.

(53) Market risk affects investments in investment funds and private supplementary private pension funds. For *investment funds*, market risk, mainly due to interest rate fluctuation, poses the main risk of the activity together with the liquidity risk. Fund assets are invested in financial instruments whose price may change every day. In the structure of their investments, about 80% of the total belongs to T-bills and bonds. Interest rate fluctuations are inversely correlated to the value of these securities. In case interest rates increase, a revaluation of the portfolio of securities that investment funds hold would decrease the value of this portfolio and vice versa. The period of the investments is highly important, realizing that the longer the



duration the more sensitive is the fund value as a result of interest rate fluctuations.

(54) *Supplementary private pension funds rely on defined contribution plans (and performance benefits).* In these cases, the influence of the interest rate is more limited compared to the case of fixed income investments. In their total investments, the main share (almost 100%) is invested in treasury bills and government bonds and in certain periods, bank deposits. The main source of income for supplementary private pension funds is the interest earned from these investments.

