8. BANKING SECTOR DEVELOPMENTS

(55) During the period, the banking sector expanded its activity with the main contribution from treasury and interbank transactions, as well as by the contraction of the credit risk provisioning fund. The banking sector was characterised by a good level of capitalisation, liquidity and profitability. The continuation of the lost loans write off from the balance sheets of the banks as well as the increase of loan repayment and restructuring has led to the decrease of the non-performing loans. Despite this development, the credit risk must continue to be assessed carefully. Exposure to market risks is presented at limited levels, but needs to be monitored on a continuous basis.

8.1 PERFORMANCE OF BANKING ACTIVITY

(56) During the period, the banking sector expanded its activity, but the growth rate was lower in annual terms. Banking sector assets expanded by about 4%, to ALL 1,445 billion. The performance of assets was determined by the increase of the items ''Treasury and interbank transactions"[42] and "Customer transactions"[43] as well as by the significant contraction of the provisioning funds for credit risks. "Securities transactions" gave a positive contribution[44] to the performance of assets, mainly with non-resident entities. On the liabilities side, the main items continue to be "Customer transactions", which represent the depositing activity and "Permanent resources", which represents the equity of banks or own funds. The Albanian government's debt securities represent around 22% of the total assets from 23% in the previous period.

In the government securities portfolio, the share of T-bills expanded further.[45] In annual terms, the growth rate of total banking sector assets was 2.8%.

[42] *Treasury and interbank transactions marked an increase of about ALL 30 billion at ALL 483 billion during the period. The main contribution to the expansion of this item was from the increase of bank transactions with the Central Bank in the form of current accounts. They increased by about ALL 19 billion, to ALL 150 billion. The expansion of interbank transactions in the form of current and deposit accounts have a positive contribution. They expanded by ALL 4 and 7 billion, respectively, to ALL 61 billion and ALL 119 billion.*

[43] *Customer transactions expanded by about ALL 5 billion to ALL 598 billion. Operations with resident customers increased by about ALL 8 billion, while those with non-resident customers decreased by about ALL 5 billion.*

[44] *Investment in securities maintained the level of the previous 6 month period. They expanded by only ALL 180 million, to ALL 357 billion. These investments were mainly Held to Maturity securities with non-residents, in foreign currency.*

[45] *The increase of investment in government debt securities was a result of the expansion of the treasury bills portfolio. In 2017 H2, this portfolio expanded by ALL 3 billion compared to June 2017, reaching ALL 64 billion; while the bond portfolio marked a slight decline and amounted to ALL 255 billion.*

The expansion of assets in annual terms was supported by interbank investments and contraction of the provisioning funds, while securities transactions contributed negatively to the annual growth of assets.

Table 8.1. Structure of banks' balance sheet, December 2017

Asset	% of asset	Annual change, %	Liability	% of liability	Annual change, %
I. Treasury and interbank transactions	33.4	4.5	I. Treasury and interbank transactions	5.3	24.1
II. Customer transactions (credit)	41.4	0.2	II. Customer transactions (deposits)	80.4	0.8
Of which: public sector	2.2	13.2	Of which: public sector	1.9	-6.4
Of which: private sector	39.1	-0.8	Of which: private sector	78.8	0.9
III. Securities transactions	24.7	-3.1	III. Securities transactions	0.6	23.2
IV. Created provisioning??? funds	-4.03	-26.8	IV. Other liabilities	1.04	14.3
V. Other*	4.5	11.2	V. Permanent resources	12.4	7.3
			Of which: Subordinated debt	1.5	-1.2
			Of which: Equity	10.2	7.7
Total assets	100	2.8	Total liabilities	100	2.8

Source: Bank of Albania,
** 'Other" in the balance sheet refers to "other assets" and "fixed assets", '' Accrued interest'''*

(57) The loan portfolio[46] of the banking sector expanded by 1% in half-yearly terms and remained almost unchanged from the previous year, to about ALL 600 billion. The improvement of the loan portfolio quality, as a result of the ongoing process of lost loans write off and loan repayments led to the decrease in provisioning funds, during the period.

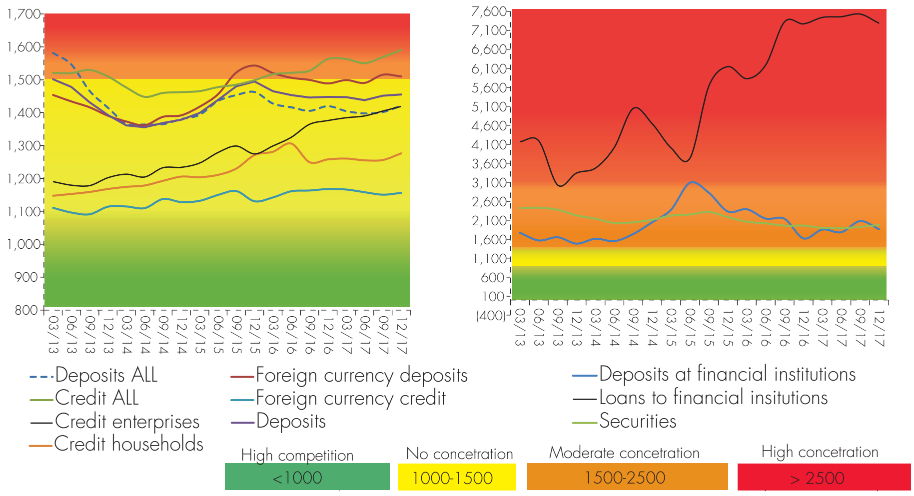
(58) Banking activity is mainly funded by deposits, which account for about 80% of total assets. Current accounts and demand deposits continued to determine the expansion of the deposit base, although their expansion was at lower rates. The change of the funding source structure toward short-term sources affects the ability of the banking sector regarding financial intermediation towards longer-term projects. However, the dependence on short-term funding sources (current and demand deposits, which currently represent 42% of the deposit base)[47], is mitigated by the fact that 83% of the volume of deposits is held by households and, overall, the residual maturity of liabilities has increased due to the increase in the level of deposits with longer-than-one year maturity. Banks have maintained the ratio of their capital use for funding the activity, while respecting the relevant requirements of the regulatory framework.

(59) The Albanian banking sector is characterized by a high concentration for some of its activities. Chart 8.1 on the left shows the banking products (in assets and liabilities of banks), for which the banking sector presents a moderate or low concentration. Among these products (services), the concentration of lending in lek and lending to enterprises increased during the year. Chart 8.1 on the right shows the activities for which the banking sector appears to have a higher concentration, mainly on the assets side of the its balance sheet. The highest concentration is observed in lending activity for financial institutions.

[46] *Excluding accrued interests.*
[47] *In December 2017, the share of current accounts was about 33%, while the share of demand deposits 9%. A year earlier, these shares were respectively 32% and 8%.*

The high concentration reflects the activity of a limited number of banks with non-resident financial institutions.

Chart 8.1 Herfindahl indicator for the main banking products



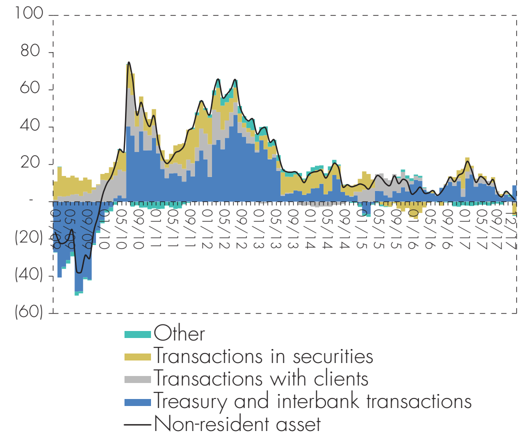
Source: Bank of Albania.

8.2 BANKING SECTOR POSITION TO NON RESIDENTS

(60) During the period, the banking sector has easily narrowed the credit position with non-resident entities. Compared to the end of the first 6 months, the net position with non-resident entities at the end of 2017 was somewhat lower and about ALL 295 billion. Liabilities to non-residents account for about 6% of total assets and are represented to a large extent, by ''Customer transactions'' or by deposits of non-residents in domestic banks, as well as by ''Permanent Resources'' or its own funds. Interbank transactions in the form of deposits and loans from non-resident financial institutions increased during the period, while the credit lines from parent banks decreased. On the assets side of the banking sector, claims on non-residents account for about 26% of total assets. Over the period, these claims grew slightly and at the end of the year they amounted to ALL 380 billion. At the end of the period, the annual growth of assets with non-residents marked a significant slowdown, falling to 1%, from about 16% a year earlier. The main contribution to the decline in the growth rate of non-resident claims has been the contraction of investments in securities issued by non-resident entities and the reduction of loans to non-residents. On the other hand, the increase in the item "Interbank transactions" with non-residents has contributed to the increase of general claims on non-residents.

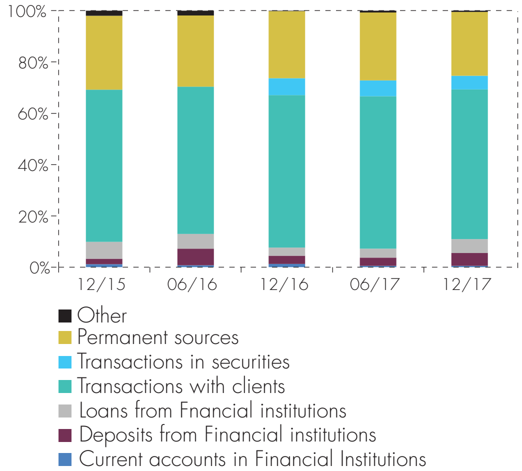
(61) The countercyclical measures taken by the Bank of Albania in May 2013 contributed to the deceleration of the growth pace of banking sector investments in non-resident entities. At the end of 2017, annual growth declined to the lowest historic level of 1%, from 25% in May 2013. Year 2017 was characterized by considerable fluctuations in foreign investments.

Chart 8.2 Contribution of balance sheet items to annual growth of assets with non-residents (in pp)



Source: Bank of Albania.

Chart 8.3 Components of non-resident liabilities



Source: Bank of Albania.

The increase of foreign investments marked relatively high levels during the first half of the year (about 22% in January 2017), but this trend was significantly reduced during the last two quarters. The share of assets with non-residents, which are subject to countercyclical measures[48], increased to 81% of total assets with non-residents, compared to 80% a year earlier. Within the group of assets with non-residents, which are subject to the aforementioned measures, the treasury and interbank transactions expanded 17%, with the main contribution given by the increase of "Deposits with banks, credit institutions and other financial institutions" at 42% in annual terms. On the other hand, the annual growth rate of assets with non-residents, not subject to countercyclical measures, narrowed by 7%.

8.3 LENDING DEVELOPMENTS

8.3.1 OUTSTANDING LOANS

(62) Over the period, outstanding loans increased slightly in the balance sheet of the banking sector. At the end of December 2017, outstanding loans in the balance sheet of the banking sector recorded ALL 600 billion[49], about 0.6% higher (or ALL 3.6 billion) compared to June 2017. Compared to the previous year, outstanding loans grew slightly, by about ALL 1 billion. The higher volume of new loans has contributed positively to this development, whereas the plan of actions to reduce the stock of non-performing loans (loan repayment, restructuring, and write off) as well as the exchange rate effect, which is reflected on the appreciation of lek against the US dollar and euro, have adversely affected the growth of outstanding loans.

[48] *Non-resident foreign currency assets that are subject to the measures relate mainly to investments in securities and treasury and interbank transactions.*

[49] *Including accrued interests. Excluding them, the outstanding loan is estimated at about ALL 598 billion.*

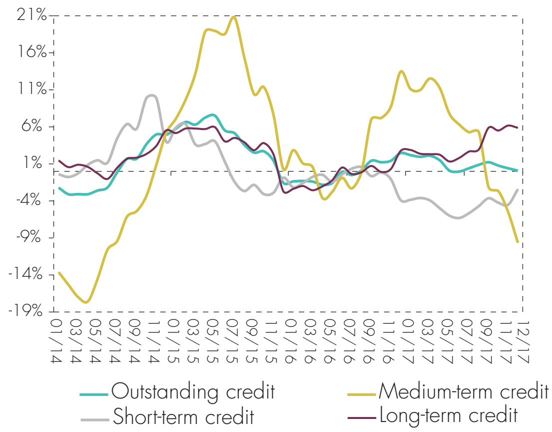
Table 8.2. Loan portfolio developments

	Indicator and unit	Amount (ALL bln)	Share in total credit %		Change	
	Period	12/2017	12/2017	12/2016	Vjetor	Gjashtëmujor
By currency	Credit ALL	262	44%	41%	5%	2%
	Credit FX	339	56%	59%	-4%	-1%
By entity	Public sector	32	5%	5%	13%	7%
	Enterprises	390	65%	67%	-3%	-1%
	Households	178	30%	28%	6%	3%
By product	Short term	186	31%	32%	-2%	1%
	Medium term	110	18%	20%	-1%	-8%
	Long term	305	51%	48%	6%	4%
	Credit outstanding	601	100%	100%	0.2%	0.6%

Source: Bank of Albania, Financial Stability Department.

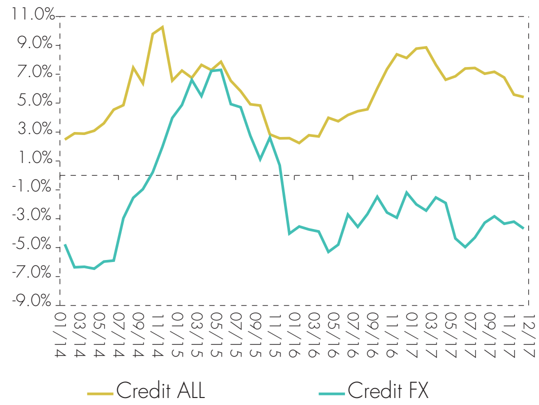
(63) By currency, lek was the only currency that gave a positive contribution to the performance of credit. In fact, lek's credit stock grew during the period by 2.2% (or ALL 5.4 billion), while foreign currency stocks shrank by about 1% (or ALL 1.9 billion). Due to the considerable share of foreign currency credit (56%), exchange rate developments play an important role in its nominal counter value to domestic currency. For the outstanding calculated in December 2017, the appreciation of the lek against the main currencies has contributed to the reduction of the reported loan value by about All 0.7 billion. Excluding this effect, the foreign currency credit would have expanded by 0.5% (from the 0.6% decline).[50] In annual terms, the exchange rate effect for the US dollar and euro is respectively ALL -4.8 billion and ALL -4.6 billion. Excluding the exchange rate effect, the annual growth of outstanding loans would be about 2% (from 0%) and foreign currency loans -1% (from -4%).

Chart 8.4 Loan performance by maturity annual growth



Source: Bank of Albania.

Chart 8.5 Loan performance by currency, annual growth



Source: Bank of Albania.

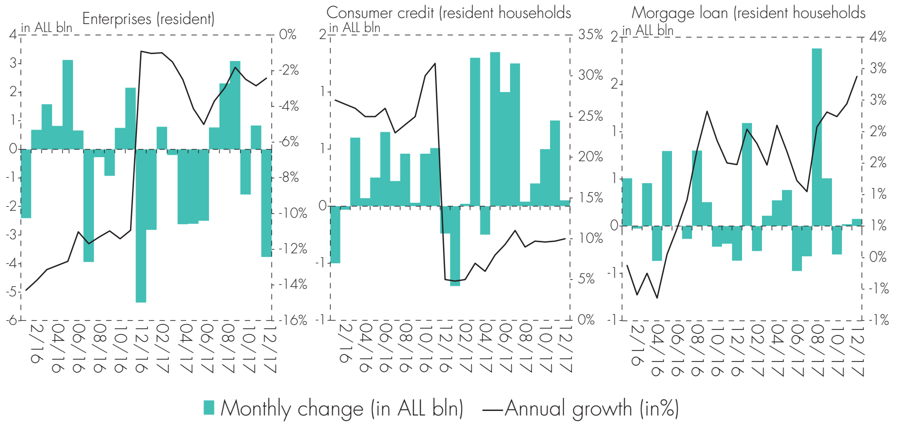
[50] *The exchange rate effects for euro and the US dollar have trended differently. The dollar's effect has been more significant, giving a total negative effect on the growth of loans (and deposits).*

(64) By maturity, long-term debt, representing more than half of the outstanding loans, has provided the main positive contribution to the outstanding loan performance over the period. Compared to the end of 2017 H1, medium-term loans were the only one declining by 8%, while short-term and long-term loans increased by 1% and 4%, respectively. Year on year, short-term and medium-term loans declined respectively by 2% and 10%, whereas long-term loans increased by 6%.

(65) Loans to enterprises, which account for the main share in outstanding loans (about 65%), narrowed during the period by about 1%, to ALL 390 billion. Despite the fact that the new lending is dominated by loans to enterprises, the decline in their outstanding loans has been due to the decline in non-performing loans, as a result of lost loan write offs, loan repayment and loan restructuring. Loans to residents, which accounts for 86% of the loans to enterprises, expanded by about 0.5% (or about ALL 1.6 billion), while loans non-residents narrowed by 9% and at the end of the period recorded ALL 53 billion. Loans to the public sector account for only 5.4% of total loans, increasing by about ALL 2 billion over the period. In annual terms, loans to enterprises narrowed by 3% (about ALL 12.2 billion), reflecting the credit collection and restructuring processes as well as the write off of lost loans from the balance sheet. Public sector credit increased by 13% (or by ALL 3.8 billion). Over the past six months, about ALL 4.5 billion have been written off as "lost" loans to enterprises.

(66) Loans to households grew by 3% (or ALL 4.6 billion), supported by the expansion of new loans to residents. Loans to resident households, which account for 95% of total lending to households, have contributed most to the performance of this loan, although loans have increased also for non-resident households. Consumer credit expanded by 8% and mortgage credit by 2%.[51]

Chart 8.6 Loan performance by purpose of use, annual growth (left axis) and monthly change of stock (left axis).



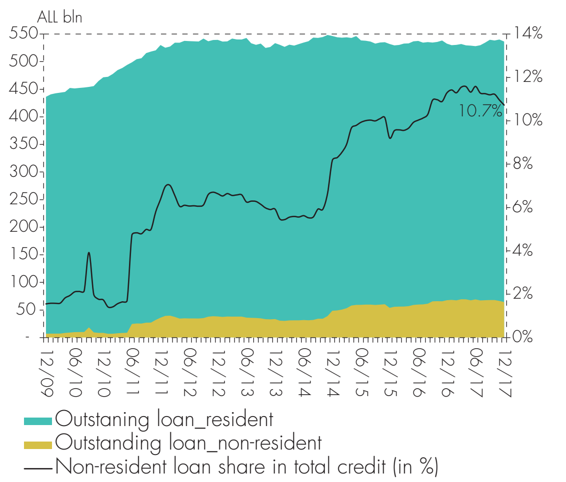
Source: Bank of Albania.

[51] *This loan accounts for about 63% of outstanding loans received by resident households.*

In annual terms, total outstanding loans to households expanded by about 6% (or ALL 9.3 billion). The expansion of loans to households was driven by new loans, mainly for consumption and house purchase purposes.

(67) The banking sector continued to provide loans to non-resident entities (enterprises and households), but its share has declined to 11% of the banking sector outstanding loans in December 2017, down from 11.3% a year earlier. Outstanding loans to non-residents recorded ALL 64.4 billion, narrowing by about 7% during the period and 5% from the previous year. The main contribution to this decline was from loans to non-resident enterprises (83% of total non-resident credit), shrinking by 9% during the period and 8% from the previous year. Almost all loans granted to non-residents are denominated in foreign currency, and mainly in euro. In general, credit to non-residents is oriented toward longer-term maturities, with the main share in the medium term (51%) and long term (by 25%).

Chart 8.7 Loans to non-residents



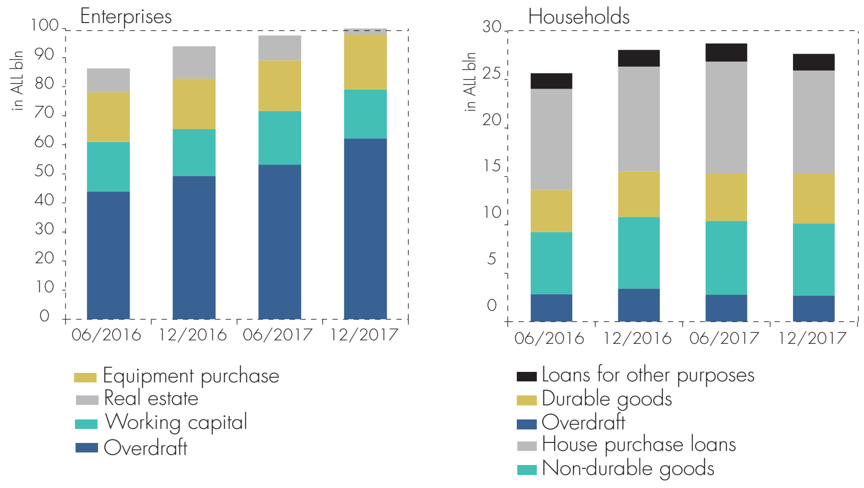
Source: Bank of Albania.

8.3.2 NEW CREDIT

(68) Over the period, the volume of new credit stood at a good level. The value of new credit was around ALL 140 billion, about 10% higher than in 2017 H1, but closer to the levels of the same period in the previous year. Collected credit (repayments) was around 2.3% higher compared with 2017 H1 and around 8.6% lower compared with the same period in the previous year. The loan use ratio (collected-to-extended new loans) registered 95% from 103% at the end of June 2017, and 104% in the previous year. The decrease in the ratio came mainly as a consequence of the increase of the new credit flow.

(69) Credit to the private sector gave the main positive contribution to the performance of new credit. New credit to enterprises was higher compared with 2017 H1 (5%), and 2016 H2 (13%). The increase was due to the growth of credit flow in the form "overdraft" and credit for "purchase of equipment" Over the period, new credit to households was ALL 1.1 billion lower than in 2017 H1, and similar to that in the previous year. The decrease was driven by the performance of new credit for housing, although it maintains the main share of new credit to households. New credit to the public sector continued to account for a very small part of total new credit, although during this period it was twice as high compared with 2017 H1.

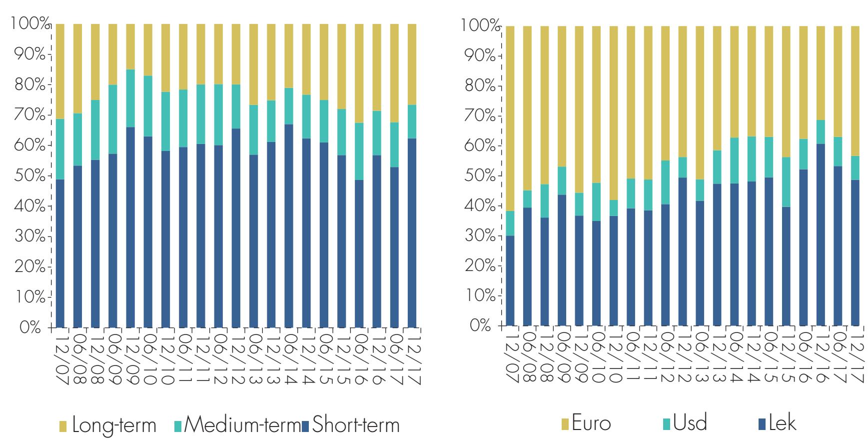
Chart 8.8 New credit by purpose



Source: Bank of Albania.

(70) By currency and maturity, euro credit and long-term credit provided the main contribution to the performance of new credit over the period. New credit in foreign currency increased b y around 20% compared with 2017 H1. Over the period, around 84% of new credit in foreign currency was in euro, while the new credit in US dollar was lower. New credit in euro was around 26% higher (or ALL 12.4 billion) than in 2017 H1 and almost 33% higher than in 2016 H2. The share of new credit in lek was almost half of the overall flow of new credit, and resulted in similar levels with 2017 H1.

Chart 8.9 Distribution of new credit by maturity (left) and currency (right)



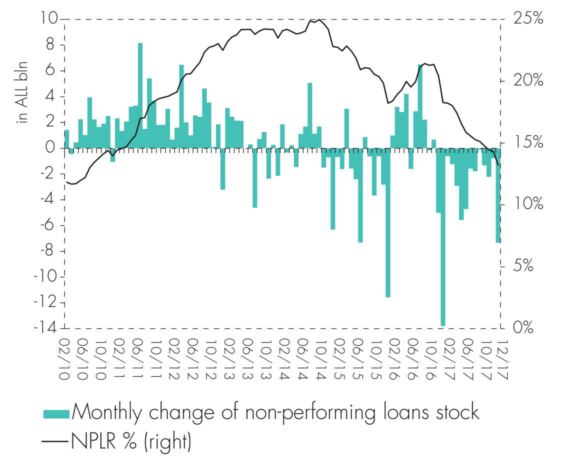
Source: Bank of Albania.

Compared with the same period of the previous year, new credit in lek was around ALL 17 billion lower. By maturity, long-term new credit (42% of the total) increased by 36% (ALL 14.8 billion), while the short-term one (53% of the total) increased by 8.5% (ALL 5.8 billion). Medium-term new credit was at ALL 10.2 billion, or almost twice as low as the previous period.

8.3.3 CREDIT RISK

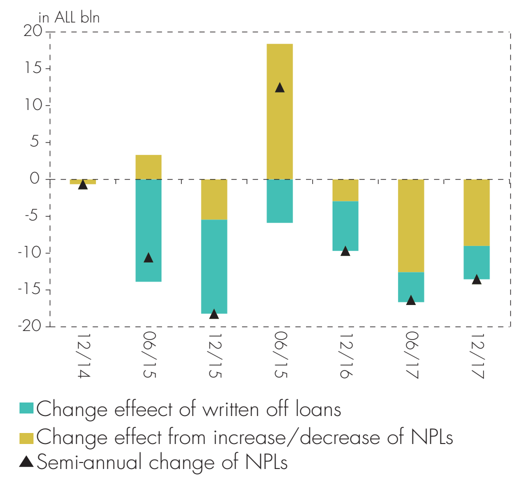
(71) Over the period the non-performing loans stock decreased significantly. In December 2017, the stock reached around ALL 80 billion or around 14.5% lower from the previous period. Compared with the previous year, NPLs contracted by around ALL 30 billion, or by 28%. The NPLs stock declined as a result of the restructuring of these loans, loan repayments in various classes of the NPL portfolio and the lost loans write off from banks' balance sheets. Over 2017 H2, from banks' balance sheets were written off ALL 4.5 billion of lost loans[52], mainly to enterprises and in foreign currency. Restructured credit over this period reached ALL 10 billion, of which around ALL 7 billion in the NPL portfolio. In 2017, the repayments of the banking sector aggregate credit portfolio registered ALL 70 billion. In December alone were repaid ALL 11.6 billion of NPL outstanding.

Chart 8.10 Non-performing loans ratio



Source: Bank of Albania.

Chart 8.11 Contribution in the half year change of the non-performing loans stock (ALL billion)

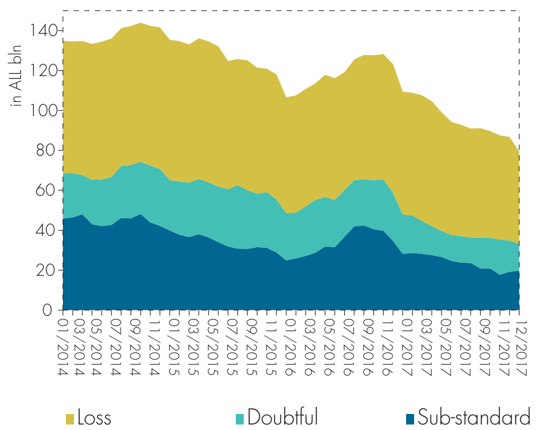


Source: Bank of Albania.

52 *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 category "lost" for more than three years. Overall, since the start of the process ALL 47.8 billion of lost loans have been written off.*

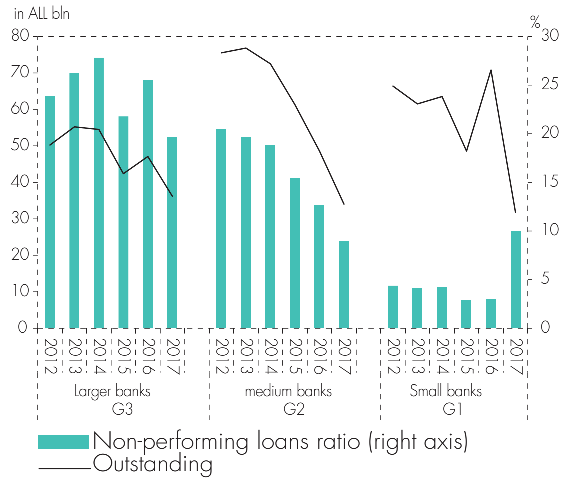
(72) The decrease of the non-performing loans stock is accompanied with the improvement of the qualitative indicator of the portfolio. At the end of the year, the NPL ratio was 13.2% from 15.6% in June 2017 and 18.2% in the previous year. Within the NPL structure, as result of restructuring, repayments and new credit, the outstanding loans in "special mention" and "sub-standard" contracted 14% and 17%, respectively and those in the "standard" category expanded around 6%. "Lost" loans, which account for around 58% of non-performing loans, contracted by 17% (around ALL 10 billion). The decrease was mainly due to the write off of some lost loans from the balance sheet.

Chart 8.12 Non-performing loans structure



Source: Bank of Albania.

Chart 8.13 NPL portfolio by bank groups

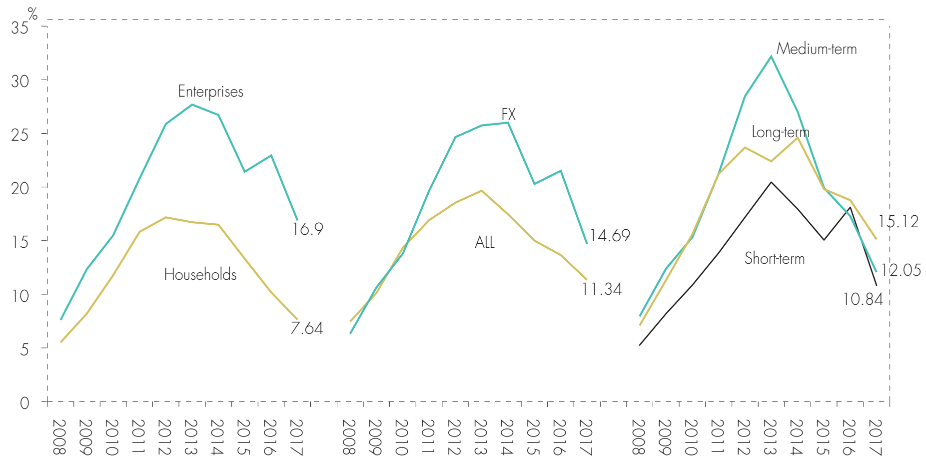


Source: Bank of Albania.

(73) Medium-sized and small banks gave the main contribution to the improvement of credit quality. In absolute values, at the end of the year, compared to the previous period, non-performing loans for this groups contracted by ALL 4 and 4.5 billion, respectively, whereas their NPLR decreased at 12.8% and 11.9% from the 15.5% and 24.6%.

(74) Credit quality appears lower for loans in foreign currency, loans to enterprises, and long-term loans. At the end of 2017, the credit quality for each of these segments stood at 14.7% (foreign currency), 16.9% (enterprises) and 15.1% (long-term). All these indicators have declined over the period.

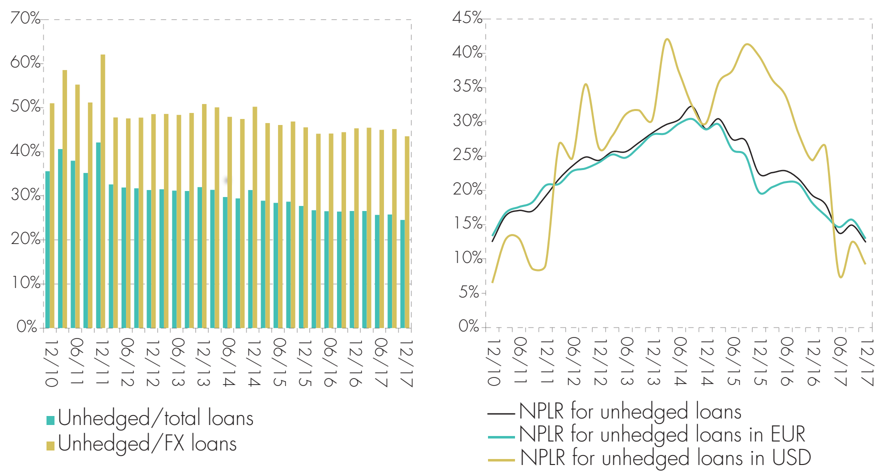
Chart 8.14 Non-performing loans in the Albanian banking sector



Source: Bank of Albania.

(75) The quality of unhedged foreign currency loans has continuously improved since the beginning of 2015. The NPLR for this credit category decreased at 12.5% from 13.8% at the end of 2017 H1, driven by the faster decrease of the non-performing loans stock than the contraction of the outstanding unhedged credit. Over the period, the unhedged non-performing loans outstanding contracted by around 13%. By currency, the main contribution to the improvement of the quality of unhedged credit came from loans in euro. The quality ratio for unhedged euro loans improved by 1.7 percentage points, declining to 12.9%, whereas for unhedged US dollar loans, it deteriorated by around 1.4 percentage points, to 9.2%.

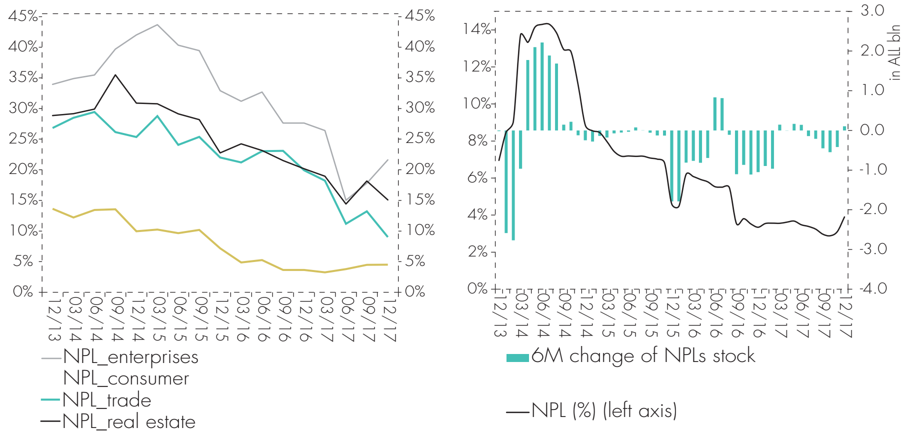
Chart 8.15 Quality of the unhedged loan portfolio against the exchange rate risk



Source: Bank of Albania.

(76) **By purpose,** the main share in the non-performing loans stock within loans unhedged against exchange rate risk were loans for "investments in real estate" (57%), which, during the period, decreased by 15%. This type of credit is classified among the three types with the highest level of non-performing loans ratio (around 15.1%), together with loans for business development (21.6%) and loans to enterprises for real estate - residential development (16.9%). Over the period, only the NPLR for loans for business development registered an increase. From the category of loans unhedged against the exchange rate risk, consumer credit shows the lowest NPLR level, at 4.5%.

Chart 8.16 Quality performance for the unhedged loan portfolio against exchange rate risk, by purpose (left) and non-performing loans for non-resident entities (right)



Source: Bank of Albania.

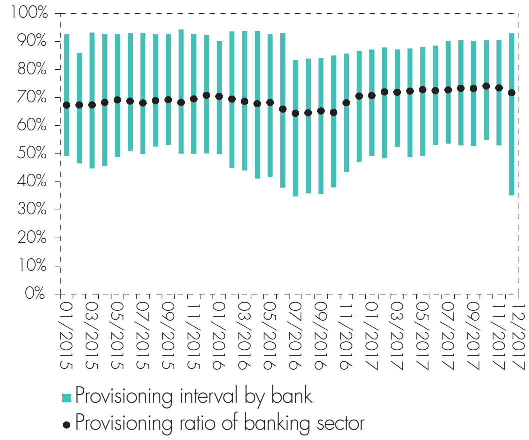
(77) Credit quality to non-residents, while maintaining a good level, registered a decrease over the period. During 2017 H2, credit outstanding for non-residents contracted by around 7%, reaching ALL 64 billion at the end of the year, whereas non-performing loans increased by 4.4%, reaching ALL 2.5 billion. As result of these developments, the NPLR for credit to non-residents increased at 3.9% from 3.3% of the previous year.

8.3.4 MITIGATING FACTORS OF CREDIT RISK

(78) Although non-performing loans have decreased, the even faster decline of provisions for credit risk over the period has led to the decrease of the non-performing loans provisioning ratio by 0.7 percentage point. The provisioning ratio continued to maintain good levels (71.7%). Compared with the previous year, most of the banks of the system report both improvements in credit quality and a higher level of provisioning.

(79) The decrease in the net non-performing loans stock[53] over the period has led to an improvement of their capital hedging. Over the period, the ratio of net non-performing loans to outstanding loans contracted by 0.5 percentage point, to 3.7%. In the previous year, the ratio stood at 5.3%. At the same time, as a result of the lower exposure to credit risk through the contraction of the net non-performing loans outstanding, the "net non-performing loans/ regulatory capital" ratio decreased to 15.7% from 18.6% in June 2017. In the previous year, the ratio stood at 23.1%.

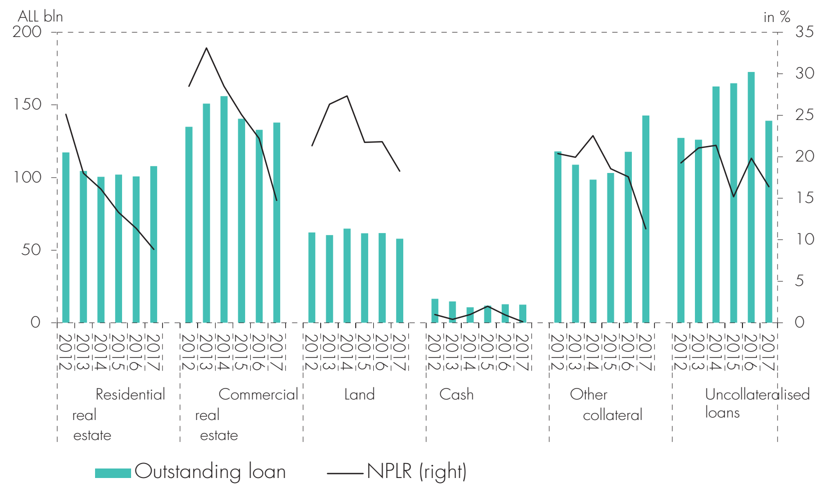
Chart 8.17 Provisioning over time



Source: Bank of Albania.

(80) Credit collateralisation, mainly with real estate, remains at good levels. At the end of 2017, collateralisation[54] registered 76.4%, from 71.6% in 2017 H1 and 71% in 2016 H2. Loans covered with collateral in the form of real estate account for around 66% of collateralized loans, and 50% of outstanding loans. The quality of collateralized loans has improved during the period compared with the previous year, and the NPLR registered 13.3%. Loans covered with collateral in the form of cash have the lowest level of non-performing loans (0.13%), while those covered with collateral in the form of "real estate - land" have the highest level (18.3%). The NPLR for this type of loans has declined. The quality of non-collateralized loans, which account for 23% of overall outstanding loans, has improved thus contributing to the decrease of the NPLR at 16.4% from 19.8% of the previous year.

Chart 8.18 Outstanding credit and non-performing loans ratio by collateral



Source: Bank of Albania.

[53] *Net non-performing loans represent the value of non-performing loans that remains after provisions are deducted for these loans.*

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

8.4 DEPOSITS AND LIQUIDITY RISK

(81) Outstanding deposits grew by 2.4% or ALL 27.2 billion over the period, reaching ALL 1,166 billion. The positive contribution came from current accounts and demand deposits. Time deposits remained almost unchanged compared with 2017 H1, but registered a decline compared with 2016 H2. In annual terms, the deposits' growth rate was 0.7%.

(82) Over the period, outstanding deposits in lek increased 1.7% or around ALL 9 billion, while in foreign currency outstanding increased around 3% or ALL 18.2 billion. In the performance of deposits the net effect of lek exchange rate against the euro and the US dollar was decreasing around ALL 1.7 billion[55]. Since deposits to households dominate the total deposit stock (over 80%), their growth as well as the growth of deposits in foreign currency were the two categories with the higher impact on the expansion of the deposits' base over the period.

(83) Deposits in foreign currency, by transactions in their original currencies[56] increased in total by around ALL 21 billion. In annual terms, the impact of the exchange rate for the US dollar and the euro is assessed at ALL -9.3 billion and ALL -8.7 billion, respectively. Excluding the exchange rate effect, the annual growth of total deposits base would have been 2.3% (from 0.7%), and of deposits in foreign currency 4% (from 1%).

(82) Interest rates on deposits continued to decrease, reflected in a further contraction of time deposits and increase in the share of current accounts and demand deposits.

Table 8.3 Main indicators of deposits in the banking system

	Indicator and unit	Value (in ALL billion)	Share to total deposits (%)		Change	
	Period	12/2017	12/2017	12/2016	Annual	Semi-annual
By currency	Lek deposits	549	47.1%	47.2%	0.5%	1.7%
	Foreign currency deposit	617	52.9%	52.8%	0.9%	3%
By institution	Public sector	27	2.3%	2.5%	-6.4%	-0.8%
	Enterprises	168	14.4%	14.1%	3.3%	4.8%
	Households	970	83.2%	83.4%	0.5%	2.1%
By product	Current account	383	32.9%	32.3%	2.5%	4.2%
	Demand deposits	107	9.1%	7.9%	16.8%	12.5%
	Time deposits	655	56.2%	57.8%	-2.1%	0.05%
	Deposits' stock	1.166	100.%	100.%	0.7%	2.4%

Source: Bank of Albania.

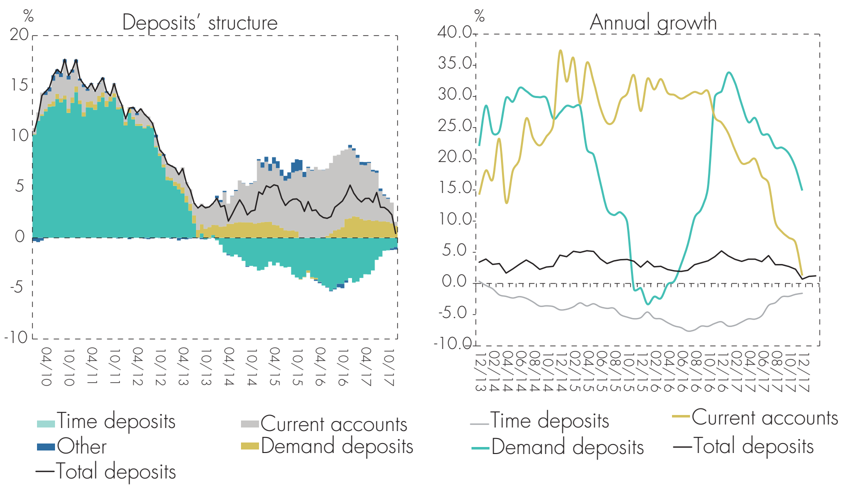
(85) Over the period, households and enterprises' deposits grew by 2.1% and 4.8%, respectively. The increase of deposits in foreign currency, around ALL 17 billion, provided the main contribution in the growth of households' deposits, by around ALL 20 billion. Only lek deposits provided positive

[55] *Excluding the impact of the exchange rate change, the growth of deposits in foreign currency over the period would have been 3.5%.*

[56] *This excludes the impact of the exchange rate, and reflects only net movements (inflows-outflows) of deposits by original currency.*

contribution to the increase of enterprises' deposits. In deposits in lek to enterprises, the main growth, by almost ALL 7.4 billion has been in the form of current accounts and demand deposits. In annual terms, to households and enterprises' deposits increased by 0.5% and 3.3%, respectively.

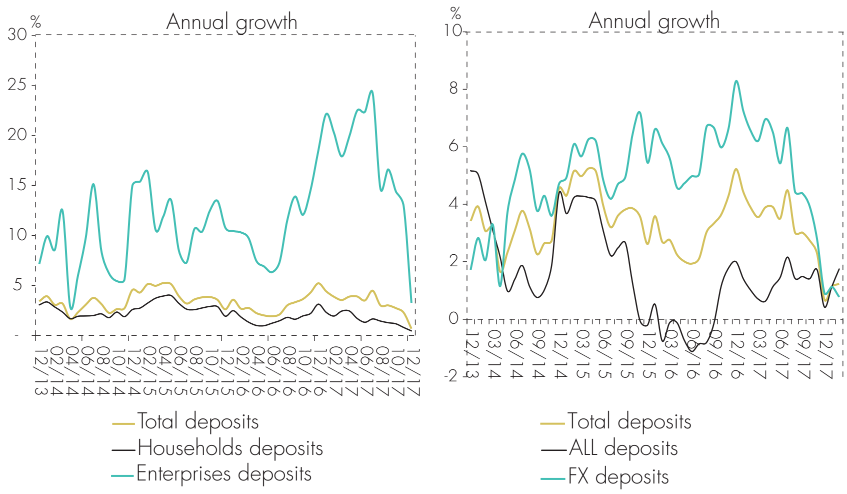
Chart 8.19 Deposits' structure and annual growth



Source: Bank of Albania.

(86) By maturity, time deposits continue to have the main share in total deposit. Although in absolute terms they did not change, the share of time deposits in the deposit stock decreased at 56.2%[57]. On the other hand, over the period, the stock of current accounts and stock of demand deposits expanded by around ALL 15 and ALL 12 billion, respectively.

Chart 8.20 Annual growth of deposits by type



Source: Bank of Albania.

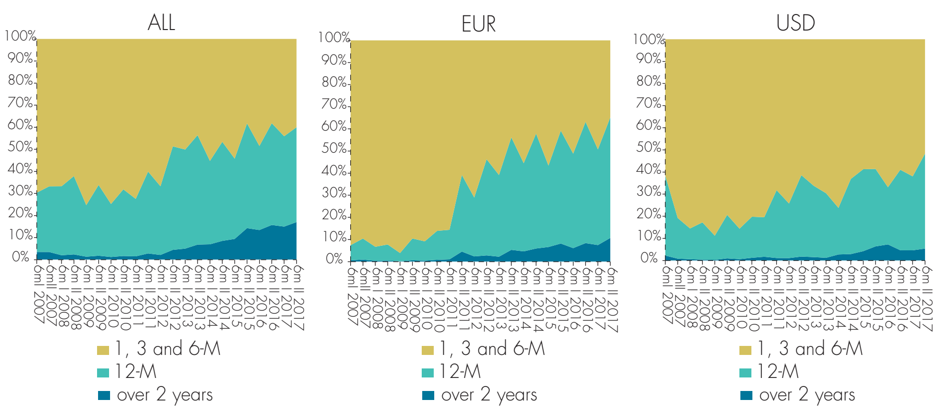
[57] *From October 2013, when the annual growth of time deposits started to register negative rates, time deposits have decreased in value by 17.2% and their share against total deposits decreased from 77% to 56.2%.*

(87) The increase of deposits is concentrated in the larger banks group (G3) and, at a lower degree in medium-sized banks (G2). Deposits in larger banks increased by ALL 19 billion, while those in medium-sized banks by around ALL 7 billion. Small banks registered minimum changes. According to the Herfindahl Index, the concentration of deposits stands below the moderate levels[58] (1.455 points), by showing a competitive banking market regarding the collection of deposits from the public.

(88) Over the period, the flow of new time deposits in the banking sector was ALL 282 billion, or around 16% higher than in 2017 H1. The share of new time deposits against the total new deposits has not changed from 2017 H1, at around 16%, but has decreased significantly against 2016 H2, at 19%. There was a slight shift of deposits to longer-term maturities within the structure of new time deposits for all three currencies.

(89) For the three main currencies, the flow of new deposits was significantly higher compared with 2017 H1, and interest rates showed low volatility. New deposits in lek and euro expanded by around 25% each and those in US dollar by around 14%. Over the period, the average interest rate for new time deposits in all three currencies maintained, overall, the levels of the previous period, registering very small fluctuations. The average rate on new time deposits in lek was around 0.9%, while those for deposits in US dollar and euro were 0.36% and 0.2%, respectively.

Chart 8.21 New time deposits by currency and maturity, 6 month flows



Source: Bank of Albania.

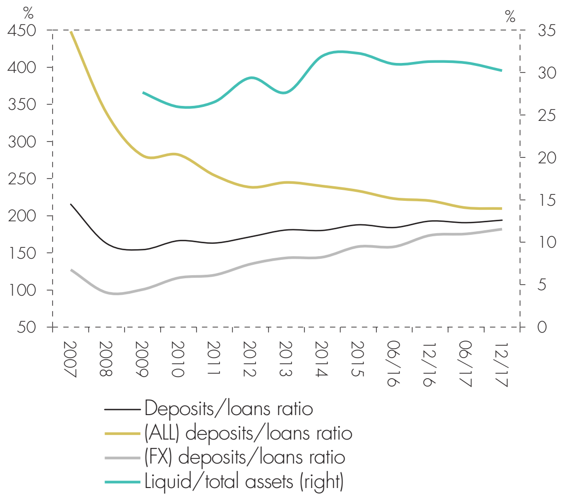
[58] *The values of the Herfindahl index up to 1500 show a competitive market, values 1500-2500 show a moderate competitiveness, and values above 2500 a high concentration.*

8.4.1 LIQUIDITY RISK

(90) Liquidity position of the banking sector is assessed at good levels. The liquidity indicators, both in lek and foreign currency, stand above the minimum regulatory ratios. Deposits remain the main source of funding, by covering almost twice the volume of loans for the sector. In December 2017, the loan-to deposit ratio stood at 51.6%, unchanged from the previous year, and slightly down from the level of June 2017. By currency, this ratio stands at 48% for the domestic currency and 55% for foreign currency. Compared with the previous year and with 2017 H1, the loan-to-deposit ratio increased for the lek and decreased for foreign currency. The increase of the ratio in lek was due to the higher relative increase of loans against deposits in lek, while the decrease of the ratio in foreign currency was due to the contraction of loans and the increase of deposits in foreign currency.

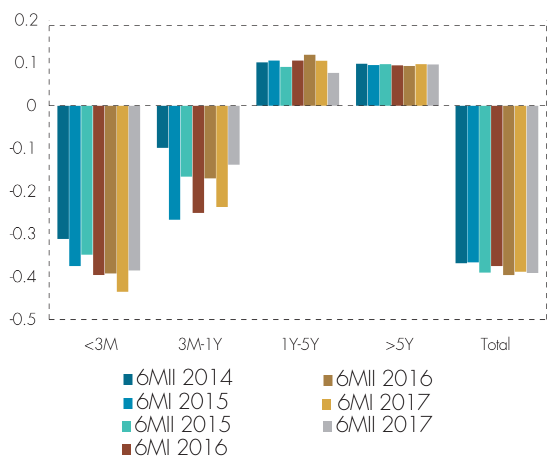
(91) Liquid assets in banks' balance sheets remain high, reflecting the performance below potential of lending. At the end of December 2017, the ratio of liquid to total assets of the banking sector was 30% or around 1 percentage point lower than in 2017 H1. The other liquidity indicator - "liquid assets to total short-term liabilities" - decreased slightly by 0.3 percentage point, down to 40.8%. Although banks are operating under ample liquidity conditions, the negative gap between assets and liabilities, by residual maturity segment, against total assets in the short-term, is considered as high and upward against previous periods.

Chart 8.22 Liquidity indicators



Source: Bank of Albania.

Chart 8.23 Assets and liabilities duration gap*

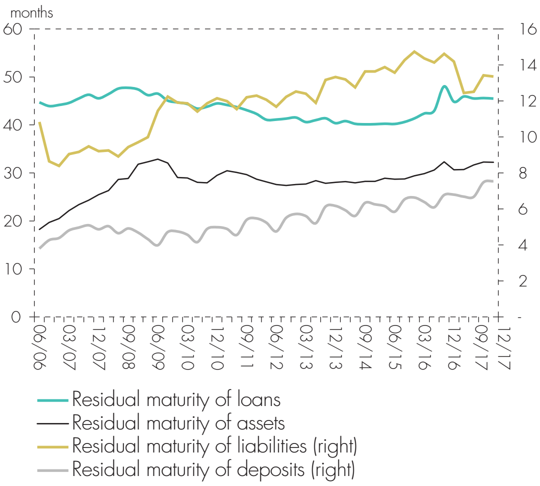


*Off balance sheet assets and liabilities are also included.

Source: Bank of Albania.

(92) The mismatch between medium-term assets and liabilities decreased over the period. At the end of December, this mismatch was around 17.3 months, against 19.1 months of June 2017, when it was registered the highest value of this mismatch since 2010. The reaming maturity of deposits, which

Chart 8.24 Average residual maturities



Source: Bank of Albania.

represent the most significant category of liabilities, increased by 7.5 (against 6.7) months over the period. The residual maturity for credit residual maturity has remained almost unchanged at 45.5 months (against 44.8 months in December 2016), reflecting the banks propensity to grant credit for longer-term periods.

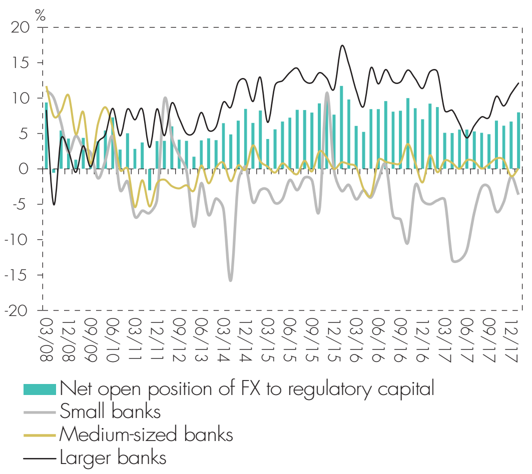
(93) The value of the financing lines by parent bank groups has a very low share in the banking sector's financing sources. Over the period, the total value of these lines was ALL 6.7 billion, from 8.7 billion at the end of the previous period. For banks that had credit lines with the parent bank groups, at the end of the period, the level of their usage was 12%, from 16.3% in June 2017.

8.5 MARKET AND OPERATIONAL RISK

8.5.1 EXCHANGE RATE RISK

(94) Over the period, the banking sector's net open foreign currency position to regulatory capital did not show significant movements. At the end of 2017, the net open foreign currency position of the banking sector was "long" at 6.7% of the regulatory capital, or 1.1 percentage points higher than at the end of 2017 H1, and 0.4 percentage point lower than the previous year. The performance of the banking sector indicator is driven mainly by the larger bank groups. At the end of the period, larger banks showed a net open long position, while medium-sized and small banks showed a net open short position. The values of the positions were relatively limited, suggesting a lower exposure of the banking sector to the direct exchange rate risk.

Chart 8.25 Net open foreign currency position to the regulatory capital by groups size



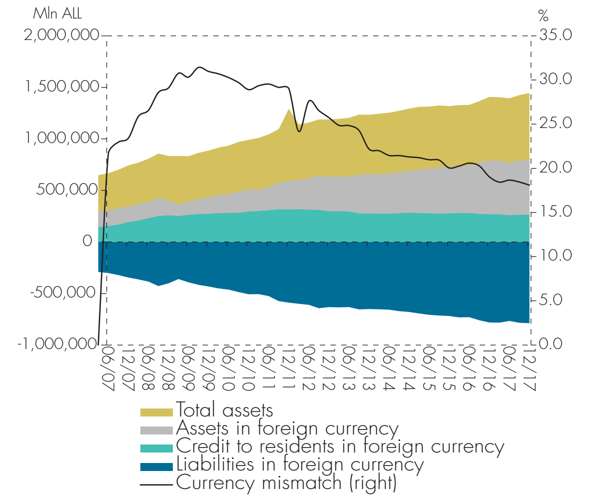
Source: Bank of Albania.

(95) At the end of 2017, the banking sector's exposure to indirect exchange rate risk was lower against 2017 H1 and against the previous year. At the end of December, the exchange rate mismatch indicator[59] for all currencies resulted at 17.7% of total assets, from 18.4% of total assets in 2017 H1 and

[59] *The foreign currency mismatch indicator measures the hedging rate of the banking sector's liabilities in foreign currency with foreign currency assets in in net foreign currency resident credit. A low value of this indicator's ratio to assets shows a low exposure to movements in the exchange rate. For the calculation of the foreign exchange mismatch indicator, refer to the Financial Stability Report 2016 H1.*

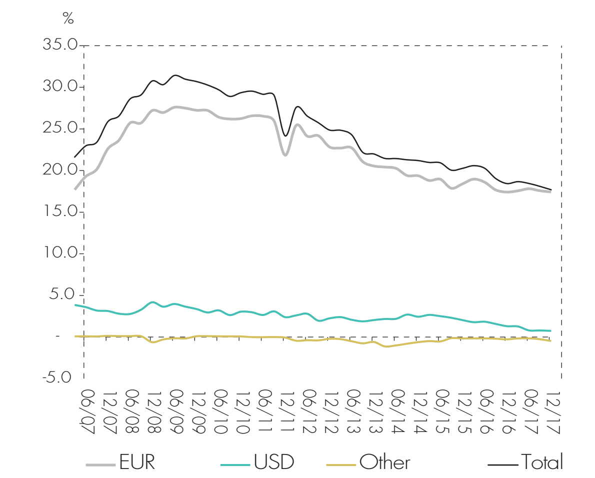
in 2016. The decrease in the value of this index was due to the faster increase of assets in foreign currency (+4%), compared with liabilities in foreign currency (+3%), and the slowdown of credit in foreign currency. By currency, the decrease of the index for the euro by 0.4 percentage point at 17.4% of total assets, dictated the overall performance of the indicator for the banking sector.

Chart 8.26 Foreign currency mismatch by components



Source: Bank of Albania.

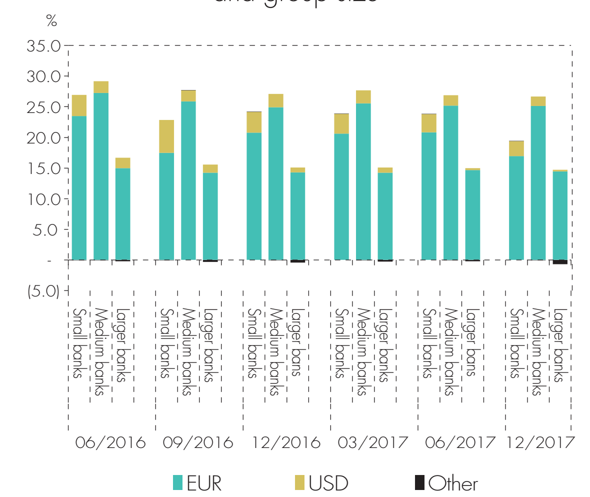
Chart 8.27 Foreign currency mismatch by currency



Source: Bank of Albania.

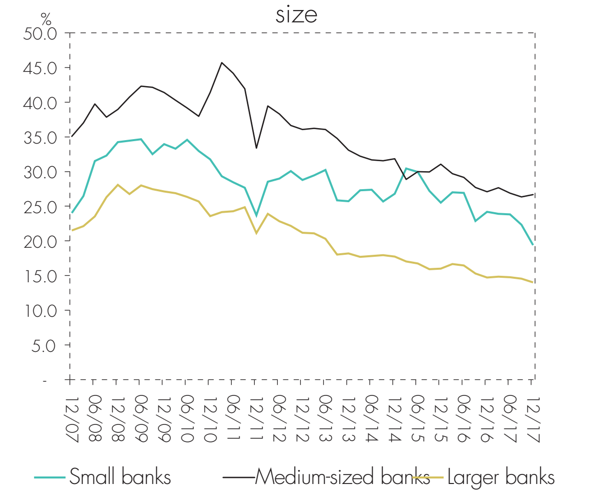
(96) For all three banking groups, the exposure to indirect exchange rate risk decreased over the period. Since the foreign currency mismatch index is related with the level of exposure to the indirect exchange rate risk, the larger banks group has the lowest level of exposure or the higher rate of foreign currency liabilities hedging with foreign currency assets, whereas medium-sized banks have the highest exposure or the lowest rate of foreign currency liabilities

Chart 8.28 Foreign currency mismatch by currency and group size



Source: Bank of Albania.

Chart 8.29 Foreign currency mismatch by group size



Source: Bank of Albania.

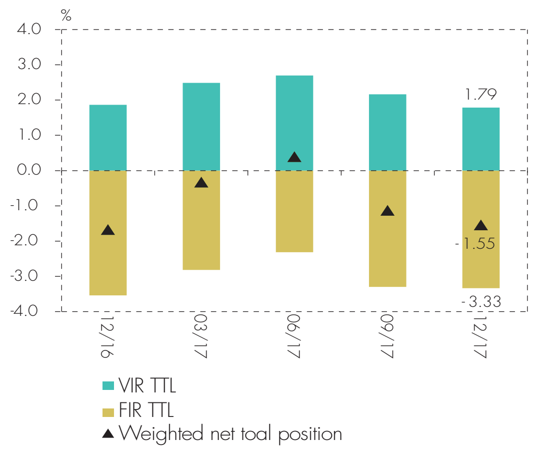
hedging with foreign currency assets. For these groups the foreign currency mismatch index at the end of 2017 H2 was 14.4% and 25.1%, respectively, while the small banks index registered 16.9%. Notably, in the last 5 years the exposure to indirect exchange rate risk has declined for larger and medium banks, whereas the exposure rate for small banks has had higher volatility compared with the exposure of the other two groups.

8.5.2 INTEREST RATE RISK

(97) The exposure to interest rate risk, at both banking group and sector level, is assessed as low, at 1.55% of the regulatory capital[60], reflecting the stability of the banking sector to immediate shocks of interest rates.

The re-pricing risk is the possibility that the bank may suffer financial losses as a result of the maturity mismatch between fixed interest rate (FIR) instruments, and as a result of the re-pricing of the interest rates of the variable interest rate (VIR) instruments[61]. The indicator measured for the calculation of the interest rate risk exposure is the total net position weighted with the relevant coefficients. This position, according the relevant act of the Bank of Albania[62], should not exceed the 20% limit of regulatory capital. At the end of the period, this position registered a negative value of 1.55%, dictated mainly by the negative position of balance sheet items with fixed interest rates at 3.3% of the regulatory capital. In 2017 H1, this position resulted positive, at 0.4% of regulatory capital. When the total net position is negative, meaning the volume of liabilities for which interests are paid exceeds the volume of claims for which interests are incurred, the banking sector is exposed to an immediate increase of interest rates.

Chart 8.30 Fixed (FIR) and variable (VIR) interest rates re-pricing risk, in % to regulatory capital



Source: Bank of Albania.

(98) By maturity, the weighted medium-term net position expanded at -6.1% of the regulatory capital, whereas the long-term gap expanded by 0.3 percentage point reaching 5.3% of the regulatory capital. Also, variable interest rate balance sheet items showed positive weighted position across all maturities, while the short-term maturity had the main share reaching 1.6% of regulatory capital.

[60] *The above indicator is expressed in absolute values.*

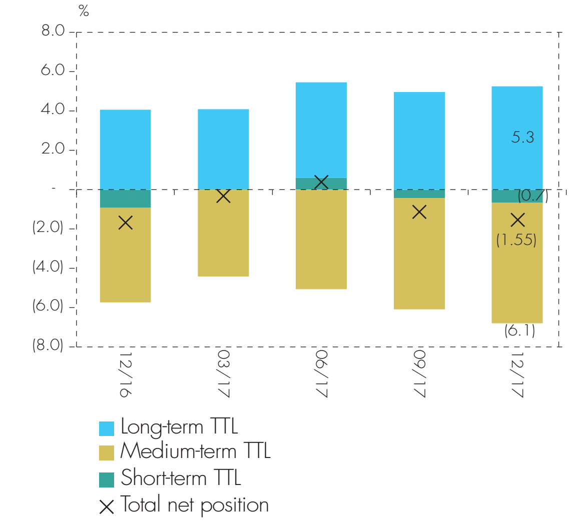
[61] *In FIR and VIR are included expected asset monetary flows (with fixed rate - FIR; and variable rate - VIR), such as relations with *BoA*, inter-banking relations, loans and advances, securities (except trade ones) and participation interests. These flows are set off by liabilities monetary flows (with fixed and variable rates) such as central banks, reserve/repo, inter-banking relations, consumer transactions (deposits), public administration transactions, liabilities from bonds and other securities, specific reserve funds and subordinated debt.*

[62] *Bank of Albania's Supervisory Council Decision No. 33, dated 30.04.2013, "On the approval of the guideline 'On managing the interest rate risk in the banking book'".*

Whereas fixed interest rate balance sheet items showed positive values for the long-term weighted net position (5.2% and negative values for short and medium-term weighted net positions (2.3 and 6.3%, respectively).

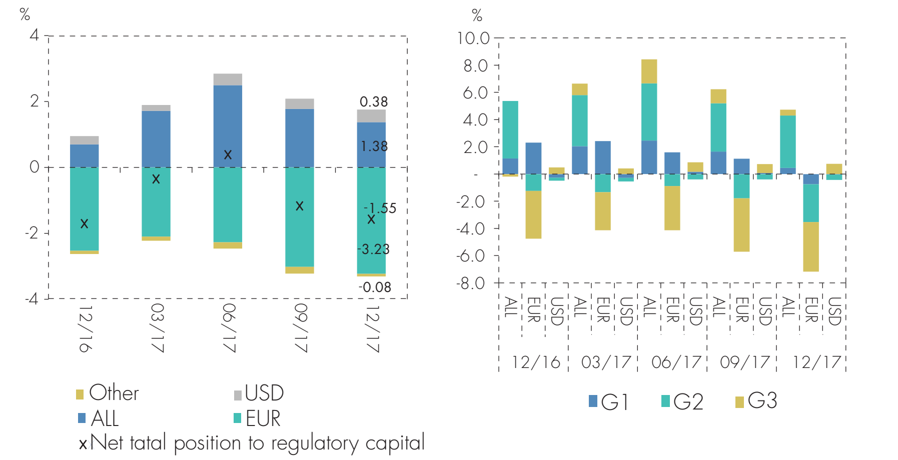
(99) The weighted net position by currency show that the weighted position in euro (-3.2%) has defined the positioning of the indicator for the banking sector. Chart 8.32 by currency and groups, larger and medium-sized banks show negative weighted net positions in euro. For the weighted position in the domestic currency, small and medium-sized banks maintain positive positions, while larger banks do not show significant positions in lek.

Chart 8.31 Duration gap, in % of regulatory capital



Source: Bank of Albania.

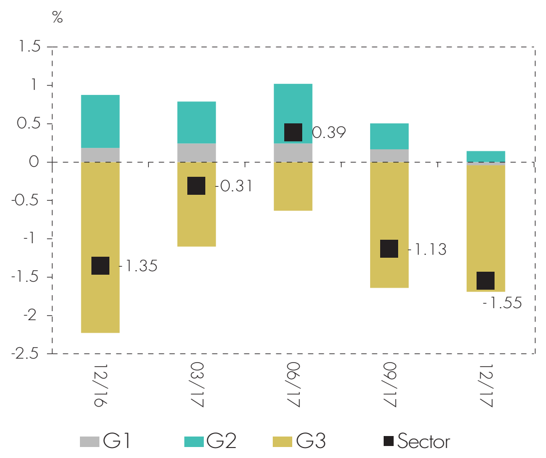
Chart 8.32 Weighted net position to regulatory capital, by currency and bank size



Source: Bank of Albania

(100) In the positions by banks' size, the larger bank group dictates the performance of the indicator for the sector. Small and medium-sized banks show positive weighted net positions to regulatory capital, so they held more interest rate-sensitive assets than. Larger banks have a contrary position since they held more interest rate-sensitive liabilities than assets. Despite the positioning of the banking groups, the exposure to interest rate risk, at group as well as at sector level, remains low, reflecting the stability of the banking sector to immediate shocks of interest rates.

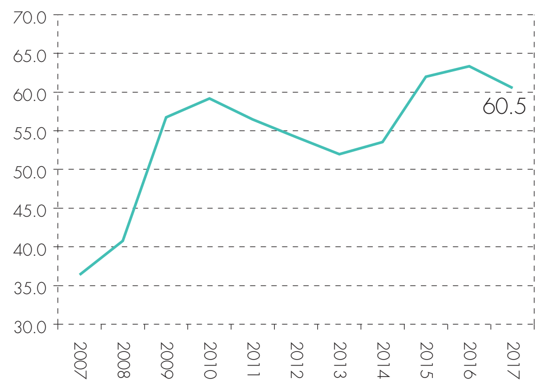
Chart 8.33 Weighted net position by bank size



Source: Bank of Albania.

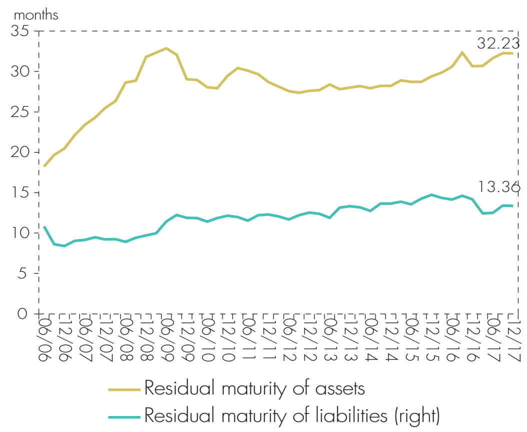
(101) The banking sector has not showed a highlighted preference on the growth of activities with risk, in the existing environment with low interest rates. Chart 8.34 shows the performance of banking sector's risk weighted assets since 2007. Risk-assets are defined by the relevant Regulation of the Bank of Albania and reflect the exposure quality by the point of view of risk. Besides the relatively fast growth in 2007-2010, the growth rate of banking sector's risk-assets in 2011-2015 has been slower, while in 2016-2017 the growth of risk-assets has stopped. The performance of the banking sector's risk-assets was affected by the significant slowdown of lending activity, due to the increase of non-performing loans, as well as the preference for investments in liquid assets with lower risk coefficient. Starting from 2013, the performance of risk-assets with is also defined by the changes in the risk coefficient as part of the regulatory change of the Bank of Albania on counter-cyclical measures.

Chart 8.34 Assets weighted with risk/ Total assets (%)



Source: Bank of Albania.

Chart 8.35 Banking sector's average assets and liabilities residual maturity (in months)



Source: Bank of Albania.

Overall, higher-risk is accompanied also by higher nominal rate of return on investment. In the conditions when risk-assets have not increased, a form of assuming risk by the banks to ensure the stability of rates of return on investment is also the extension of the investment maturity. Chart 8.35 represents the average residual maturity of the banking sector's assets and liabilities in months. Overall, we can observe the same performance for risk-assets. Since 2010 and on, the banking sector has not shown a preference to extend the maturity of its investments.

8.5.3. OPERATIONAL RISK

(102) At the end of 2017, the operational losses of the banking sector did not exceed the operational risk requirements for capital and their share was low.

Operational risk, according to the regulatory definition, means the risk that the entity may suffer losses as a result of the inadequacy or failure of internal processes and systems, human errors or external events. At the end of 2017, the capital requirement for the operational risk was ALL 6.7 billion, down from 2017 H1 and the previous year. The decline of the indicator has been driven by two factors:

- i. first, the way of calculating capital requirement, where 12 banks of the sector use the simple indicator method[63] and 4 banks use the standard method[64];
- ii. second, the continuous decline over the last three years of the net result from interests and non-interests.

Operational losses for 2017 registered ALL 0.7 billion. The average level of operational losses to the banking sector's capital requirement is 10%. In the previous year, this ratio stood at 7.4%.

8.6 FINANCIAL RESULT AND EFFICIENCY OF FUNDS

(103) The banking sector closed 2017 with a positive financial result of around ALL 22 billion, significantly higher than the previous year. The main reason for the increase of the financial result is related to the significant decrease of credit risk provisions, while net interest income continued to contract. The increase of the financial result is reflected in the significant growth of the average profitability indicators of the banking sector: RoA increased at 1.6% while RoE at 15.7%, from 0.7% and 6.8%, respectively, in the previous year. Different from the previous year, when the small banks group (G1) reported financial losses, at the end of 2017, all three banking groups classified by size reported a positive and higher net result than the previous year.

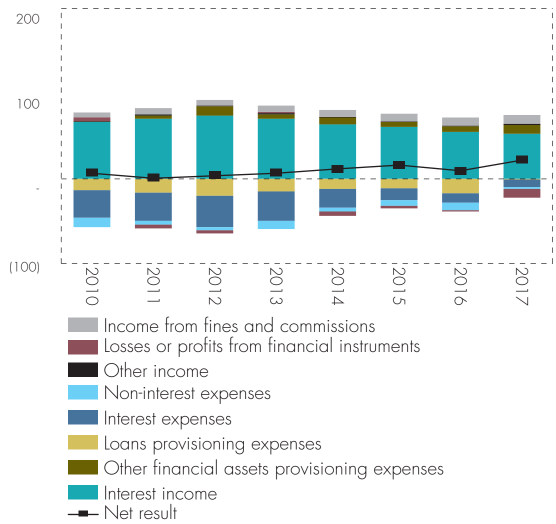
(104) The fall of interest income has brought a decrease in net interest margin at 3.9% from 4.2% in the previous year. This indicator has remained almost unchanged over the period. The decrease of the net interest margin is due to the higher contraction of net interest result than the decline of funding costs. Net interest result registered ALL 44 billion, around ALL 0.4 billion lower than in the previous year. In an overall environment of low interest rates,

*[63] Banks calculate the operational risk capital requirement with the simple indicator method, which considers net income from the banking activity over the last three years of banking activity and a coefficient **α** of 15%.*

*[64] The standard method considers the banking activity net income indicator by business lines and the respective lines' coefficients **β**.*

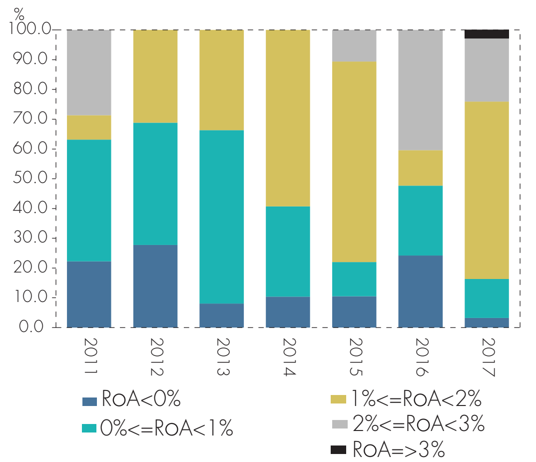
both interests' income and expenditures has continued to decrease, but the decrease of income from interest has been higher compared with the decrease of expenditures for interests. Net income from other activities also was down due to financial instruments' losses, while income from fines and commissions registered a slight increase compared with the previous year.

Chart 8.36 Financial result components



Source: Bank of Albania.

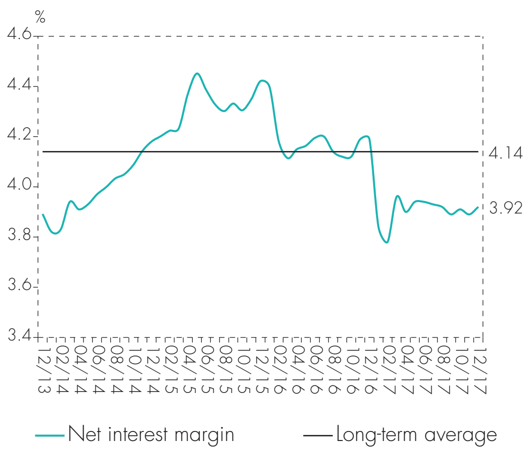
Chart 8.37 RoA by banks' share in the banking sector's total assets



Source: Bank of Albania.

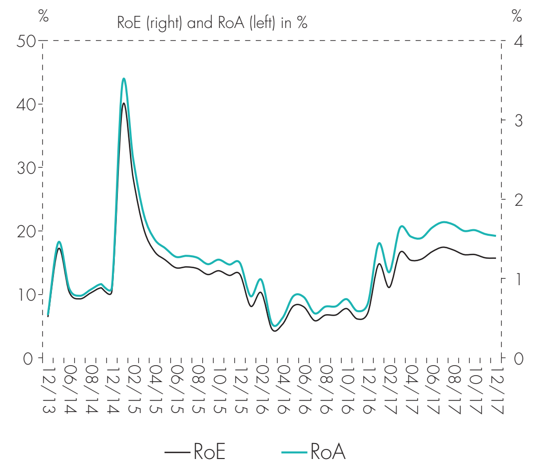
(105) Costs in the form of credit risk provisions decreased considerably by around ALL 16 billion and represent the main factor contributing in the growth of banking sector profitability. The decrease of provisions is due directly to the improvement of the quality of the credit portfolio, as consequence of the significant contraction of the outstanding non-performing loans. Expenditures for other financial assets were negative (reversal of provisions).

Chart 8.38 Net interest margin



Source: Bank of Albania.

Chart 8.39 Profitability indicators



Source: Bank of Albania.

The value of reversal of provisions was around ALL 3.3 billion higher compared with the end of the previous year, which provided an additional impact in the growth of the banking sector profit. The share of banks' assets that registered financial losses against of the banking sector's assets was around 3%; for 2017, only three small banks reported very low financial losses.

(106) **Activity costs were well hedged by activity income.** The operating expense to income ratio was 72%, upward in the last year, after the low volatility in the previous periods.

Chart 8.40 Activity's expenditure to income

Source: Bank of Albania.

BOX 8.3 COST OF EQUITY (CoE) PROXY IN THE ALBANIAN BANKING SECTOR

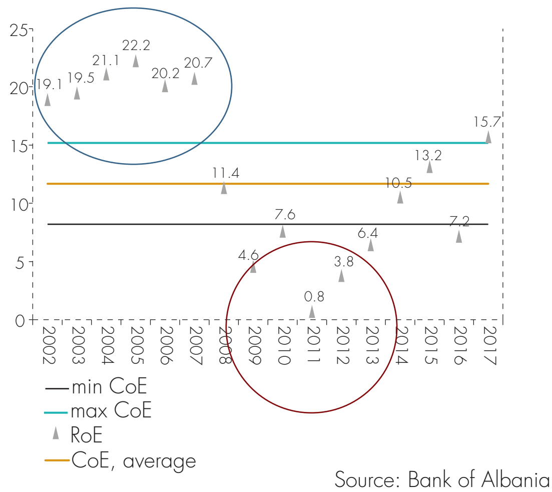
Cost of equity (CoE) refers to the return required by the shareholder for a capital investment. It is the return rate that may have been earned by investing the same money in another investment with the same risk. The difference between this indicator and the actual return on equity (RoE) is a measurement of the sufficiency of a bank's profit from the point of view of its shareholders. The Albanian banking sector presents volatile levels of return on equity, by banks y-o-y. Larger banks, overall, maintained higher RoE compared with small banks.

The literature assesses the cost of equity from the Capital Asset Pricing Model (CAPM), which is a model used to define a theoretically proper return on asset rate, so as to make decisions on adding assets to a well-diversified portfolio. According to CAPM, the cost of equity of a bank operating under a particular jurisdiction is calculated as the sum of risk of the country (typically measured according to the assessment of the sovereign debt) and the individual bank's risk.

In his study, Aswath Damodaran[I] used panel data from many countries to assess the risk of a country expressed as percentage points on the return of a safe asset, such as a US government bond, resulting in an assessment of Albania's risk as a country of 5.19%[II]. The direct measurement of a country risk is the risk of failure when the government of that country is credited. However, to calculate the cost of equity of the bank it is also necessary to include the risk premium of the individual bank itself. In the absence of these assessments in Albania, early studies for developed countries suggest that the specific premium risk for banks is in the range of 3 to 10%[III]. By adding to the assessment of Albania's risk the premium risk of the banks as well, the cost of equity for our banks is within 8.19% -15.19% range, with an *average assessment of 11.7%[IV]. This means that the actual returns (RoE) for a part of the banks that has 28.9% share of total assets of the banking sector do not cover the assessed cost of equity. However, at sector level, return on equity currently (December 2017) is at satisfactory levels, significantly covering the cost of equity at both the average and maximal level (Chart 8.41).*

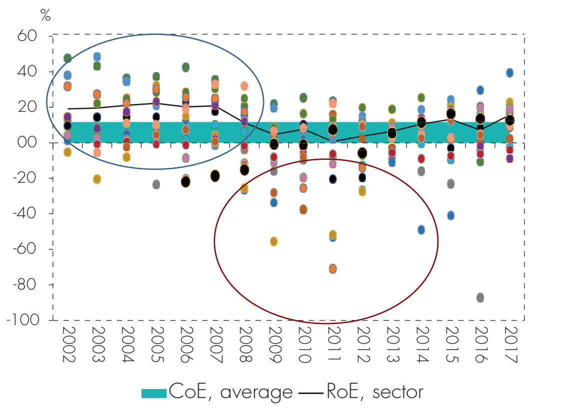
The international financial crisis of 2007 was also reflected in the financial soundness

Chart 8.41 Banking sector's return on equity (RoE) against cost of equity (CoE), pre and post-crisis



Source: Bank of Albania.

Chart 8.42 Return on equity (RoE) against cost of equity (CoE) at bank level, pre and post-crisis



Note: Coloured circles represent individual banks' RoE over the years.

Source: Bank of Albania

indicators of Albania, mainly over the 2008-2012 period, where one of these return on equity (ROE) indicators for the banking sector as a whole, but also for some banks in particular stands below the average CoE level of 11.7% and below the minimum cost of equity of 8.19%. Meanwhile, before 2018, the banking sector and a considerable number of banks had a return on equity above the average level of CoE, having space to expand their activity.

In the last years (2015-2017), although a considerable part of banks have a return on equity (RoE) very near the average CoE level, there are still banks that have difficulty to cover the cost of equity.

I Aswath Damodaran "Country risk: Definers, measurements and implications" - Sterns School of Business, 2016

II http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html

III King, M.R., "The cost of equity for global banks: a CAPM perspective from 1990 to 2009" BIS Quarterly Report, September 2009, http://www.bis.org/publ/qtrpdf/r_qt0909g.pdf.

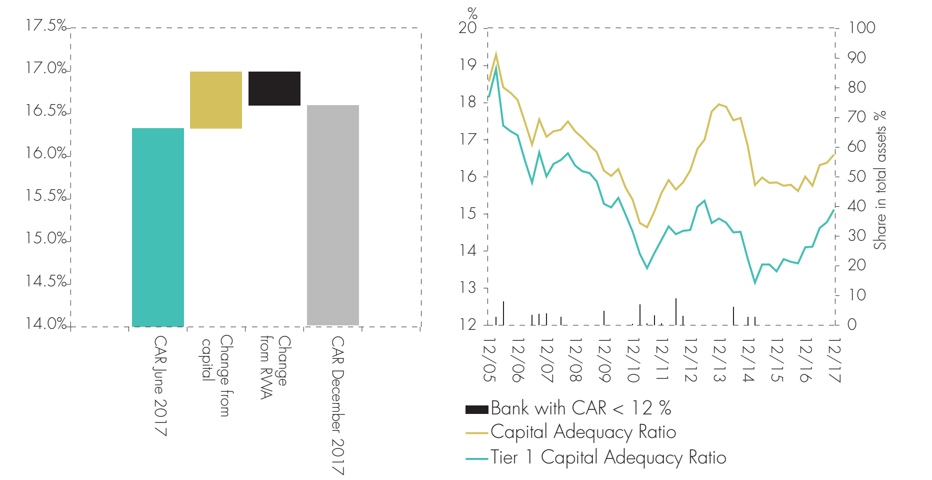
IV The average assessment of the cost of equity is calculated by the formula: 5.19% + 0.5(103) % =11.7%.*

8.7 ACTIVITY CAPITALISATION

(107) The capitalisation of the banking sector in December 2017 is assessed as good and its performance was determined by the increase of regulatory capital. The positive and increasing financial result remains the main factor that has affected the performance of regulatory capital over the period. On the other hand, the expansion of risk weighted assets due to the increase of credit risk capital requirements has given a negative contribution in the performance of the capital adequacy indicator. However, the Capital Adequacy Ratio stands significantly higher than the minimum required level required by the supervision regulatory framework of the Bank of Albania.

(108) In December 2017, the Capital Adequacy Ratio stood at 16.6%, from 16.3% in 2017 H1, and 16% in 2016. At the end of 2017, the risk weighted assets were around 2.5% higher compared with June 2017, contributing to the decrease of the Capital Adequacy Ratio by 0.4 percentage point. The increase of regulatory capital by 4.2% had an impact of +0.7 percentage point in the Capital Adequacy Ratio.

Chart 8.43 Capital adequacy ratio

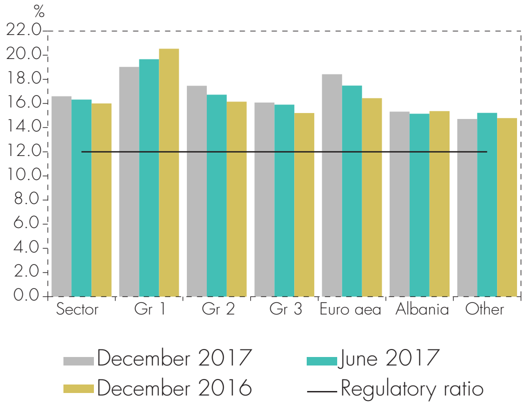


Source: Bank of Albania.

(109) At peer group level, G3 banks show a lower capitalization rate; while by capital origin, banks classified as "Other"[65] and those of Albanian origin show lower capital adequacy ratios. Most, individual banks maintain capital adequacy ratios in the 14-16% range. At the end of 2017 was observed an increase of the number of banks that have capital adequacy ratio in the ranges 18-20% and 20-30%, while the number of banks that have this ratio in the 16-18% range has decreased.

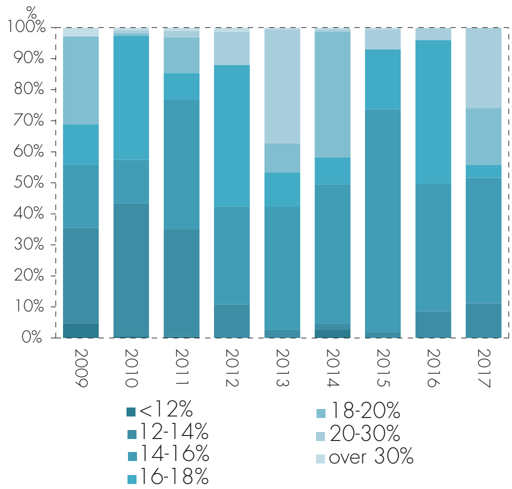
[65] *This group includes banks of Turkish, Arabian, Kuwaiti and Malaysian capital.*

Chart 8.44 The capital adequacy ratio of groups by size and by origin of capital



Source: Bank of Albania.

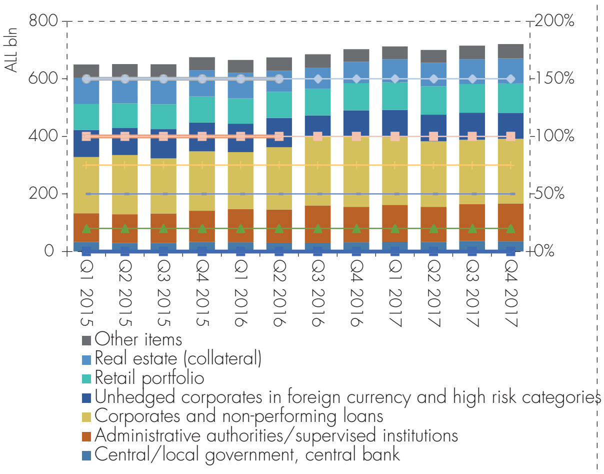
Chart 8.45 Asset allocation of banking sector, by Capital Adequacy Ratio



Source: Bank of Albania.

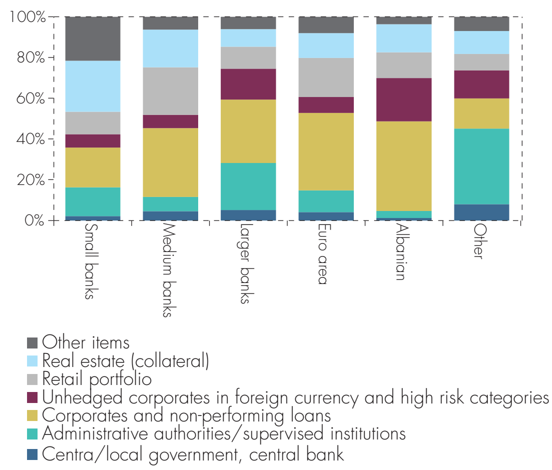
(110) The banking sector shows increasing exposure in terms of some credit risk classes, but this exposure is concentrated in classes with a low risk coefficient. Credit risk weighted assets expanded by around ALL 20 billion, compared with the end of 2017 H1, reaching ALL 720 billion. The categories that have registered an increase are related with exposures to administrative bodies and supervision institutions, which have a 20% risk coefficient (see Chart 8.46). Meanwhile, the categories that have registered an decrease are related with exposures to corporations and non-performing loans, as well as exchange rate risk unhedged loans, which are weighted with a high risk coefficient (100%-150%). Small banks show a high exposure to loans hedged with collateral in the form of real estate; medium-sized banks have a higher exposure to loans to corporations and non-performing loans; larger banks, in addition to the exposures that have medium banks, are exposed to administrative bodies and supervised institutions. By origin

Chart 8.46 Risk-weighted coefficients and the size of main credit portfolio classes



Source: Bank of Albania.

Chart 8.47 Credit classes' exposure of banks by size of activity and origin of capital, December 2017

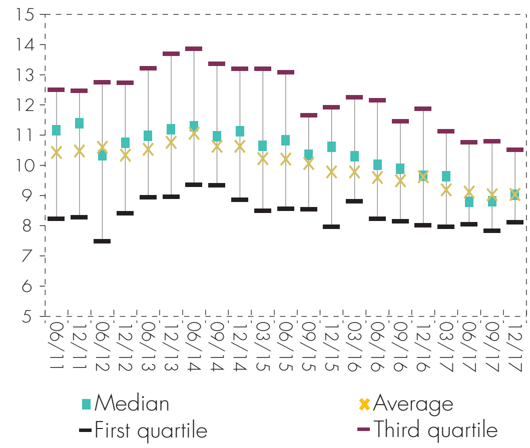


Source: Bank of Albania.

of capital, banks with Albanian capital have a higher exposure to the class "Loans for corporations and non-performing loans" (Chart 8.47).

(111) Capital requirements for market and operational risk decreased. At the end of the period, capital requirements for market risk registered ALL 14.3 billion, slightly down over 2017 H2. Capital requirements for operational risk decreased by ALL 1.6 billion, at ALL 83 billion. Capital requirements for market and operational risks share 1.7% and 9.6%, respectively, of total risk-weighted assets.

Chart 8.48 Financial leverage ratio



Source: Bank of Albania.

(112) The Albanian banking sector is characterized by a low financial leverage ratio, which confirms the maintenance of a good level of capitalisation. As of December 2017, the financial leverage ratio[66] was 9.8 times, from 10.3 times in the previous year. The financial leverage, at individual banks level, does not show any significant shift.

[66] *The financial leverage indicator is measured as the assets to equity ratio.*