8. BANKING SECTOR DEVELOPMENTS

(52) During the period, developments in the banking sector have been positive, despite the overall contraction in the banking activity. *The banking sector's activity relied mainly on the increase of interbank investments, while investments in securities and lending decreased. 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 has led to the slowdown of the increase of the non-performing loans. Despite this development, the banking sector continued to be exposed to credit risk. Exposure to market risks remains subdued, but it should be assessed regularly.*

8.1 BANKING ACTIVITY

(53) The activity of the banking sector contracted during the period, although the growth pace in annual terms remained high. Compared with the end of 2016, the assets of the banking sector decreased by 0.9%, reaching ALL 1.394 billion. The highest decline was registered in "Securities transactions"[37] mainly with non-resident entities, followed by "Transactions with the treasury"[38]. The lending activity has also registered contraction. "Interbank transactions" gave a positive contribution to the performance of assets[39], mainly in the form of deposits with non-resident entities. On the liabilities side, the main items continue to be "Costumer transactions", which represent the depositing activity and "Permanent resources", which represents the capital of banks or their own funds. The Albanian government's debt securities represent around 23% of the total assets from 22% in the previous quarter[40]. In annual terms, total assets of the banking sector grew 4.8%. The growth in assets, in annual terms,

[37] *Investment portfolio in securities decreased by about ALL 11.4 billion or 3.1% compared to the end-2016, down at ALL 356.9 billion. These investments mainly consisted in the form of securities of non-resident placement in foreign exchange, at ALL 71.4 billion, or 24.7% lower than December 2016.*

[38] *Interbank and treasury transactions marked a half year decline by around ALL 9.5 billion, at ALL 452.7 billion. The main contribution in the contraction of this item was the decline of the transactions of banks with the central bank in the form of current accounts. They decreased by around ALL 24 billion, at ALL 33.4 billion. The decline of transactions with the treasury defined the performance of the item "Treasury and interbank transactions".*

[39] *Interbank relations gave a positive contribution to the performance of assets, expanding by around ALL 20.3 billion at ALL 233.7 billion, mainly in the form of deposits into banks, lending institutions and other financial institutions with non-resident entities. These deposits increase by around ALL 23.9 billion, at ALL 112 billion.*

[40] *The increase of investments on government debt securities was totally derived from the expansion of bonds portfolio. In 2017 H1, T-bills portfolio narrowed by ALL 7.8 billion compared with December 2016, at ALL 61.2 billion, while bonds portfolio increased by around ALL 14.7 billion, at ALL 255.4 billion.*

resulted from the increase in interbank and securities investments, mainly in the government debt securities, but also in securities issued by non-resident entities.

Table 8.1 Structure of banks' balance sheet, June 2017

Assets	% of assets	Annual change, %	Liabilities	% of liabilities	Annual change, %
I. Treasury and interbank transactions	32.5	7.5	I. Treasury and interbank transactions	4.6	9.4
II. Customer transactions (credit)	42.9	-0.03	II. Customer transactions (deposits)	81.7	3.5
Of which: public sector	2.2	7.9	Of which: public sector	1.9	-10.3
Of which: private sector	40.7	-0.4	Of which: private sector	79.7	3.9
III. Securities transactions	25.9	5.6	III. Securities transactions	0.5	921.5*
IV. Created Reserve funds	-4.9	-13.6	IV. Other liabilities	0.9	28.7
V. Other**	3.6	6.2	V. Permanent sources	12.2	6.8
			of which: Subordinated debt	1.6	-0.01
			Of which: Shareholder's equity	9.9	8.3
Total assets	100	4.8	Total liabilities	100	4.8

Source: Bank of Albania, Financial Stability Department.

* *Investments in securities pruchased and sold via REPO with non-residents, which are concentrated.*

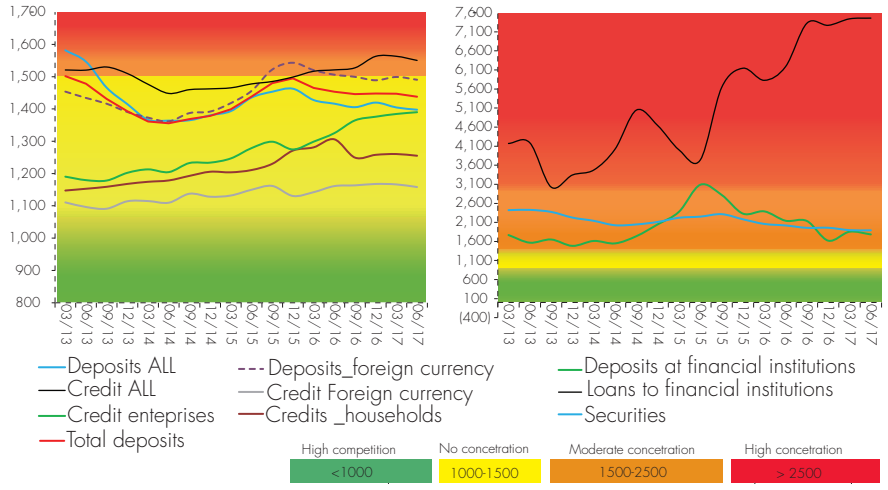
** *"Other" in the balance sheet refers to "Other assets" and "Fixed assets".*

(54) The banking activity was mainly financed by deposits, which accounted for about 81.4% of total assets. In June 2017, the deposit/credit ratio stood at 52.5%. The deposit stock declined in half-yearly terms by around 1.6% and expanded in annual terms by around 3.5%; the main contribution came from foreign currency deposits. The current accounts[41] continued to give the main contribution to the expansion of the deposits base. This development signals a potential weakness regarding the structure of the funding of the banking sector, which, however, is relatively mitigated by the fact that 83.5% of deposits are from households and, overall, the average maturity of the liabilities has increased due to the expansion of the stock of deposits with 12-month maturity. Banks have maintained the capital utilisation ratio to finance their operations, in compliance with the relevant regulatory capital requirements.

(55) The Albanian banking system is characterised by a high concentration for some of its activities. Chart 8.1 (left) shows some of the banking products (in the bank's assets and liabilities) for which the banking sector shows a moderate or lower concentration. Amongst them, for indicators like overall deposits or credit in lek, the degree of concentration has trended down, while for credit to enterprises the concentration has increased significantly since 2015 H2. Chart 8.1 (right) shows the banking sector's activities with a higher concentration, mainly on the assets side of the banking sector's balance sheet, including lending, mainly with non-resident financial entities.

[41] *In June 2017, the share of current accounts was 32.3%, from 28.5% in June 2016. The share of time deposits declined at 57.5% from 62.7% of a year ago. During this period demand deposits have seen an increase of their share at 8.3% from 7.9%.*

Chart 8.1 Herfindahl indicator for the main banking products



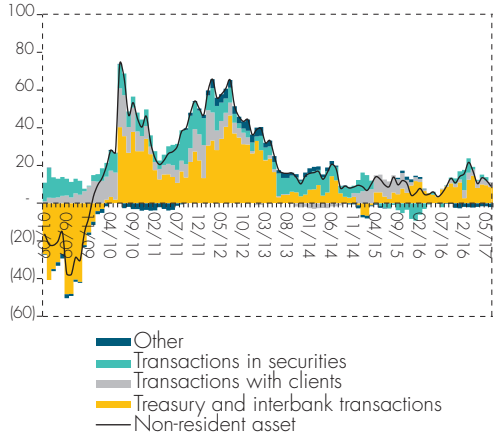
Source: Bank of Albania, Financial Stability Department.

8.2 BANKING SECTOR'S POSITION TO NON-RESIDENTS

(56) As the banking activity continues to be predominantly funded by domestic sources, the reliance of the banking sector on external sources remains limited. Net position of the banking sector to non-residents remained on the crediting side and continued to increase during the period. Borrowing from banking groups remained low.

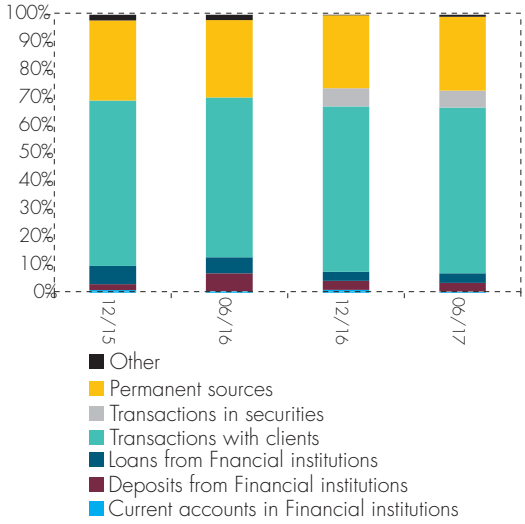
(57) The banking sector has expanded the credit position to non-resident entities. At the end of the period, assets with non-residents accounted for 27% of total assets and liabilities to non-residents only 5.9% of them. As a result, the net credit position to non-residents expanded by around 0.6% in half-yearly terms, and around 11.7% in annual terms, reaching ALL 294.5 billion. The higher annual growth in transactions with non-residents on the asset side is noted in "Treasury and interbank transactions" and "Costumer transactions", altogether by around 15.5%. Liabilities to non-residents consist mainly in "Costumer transactions" (deposits by non-residents in domestic banks), as well as "Permanent sources" or their own funds. During the period "Interbank transactions" decreased, mainly deposits and current accounts by non-resident financial institutions, which shows a further decline of foreign sources of funding.

Chart 8.2 Contribution to the annual growth of assets with non-residents in p.p.



Source: Bank of Albania, Financial Stability Department

Chart 8.3 Composition of non-resident liabilities



Source: Bank of Albania, Financial Stability Department

(58) Claims in the form of placements[42] in parent banking groups constitute only 3.3% of the banking sector assets, while liabilities for the same item account for 0.01%. Placements in the parent banking groups increased by 2% in annual terms. Around 56% of the placements' values were by G3 banks, 36% by G2 banks and around 9% by G1 banks. By capital origin, the Italian groups accounts for 34.3% of the total, while the Greek groups accounts for 23.2% of placements in the parent banking groups.

(59) 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, but this impact has been declining. In June 2017, the 9.1% annual growth pace of banking sector investments in non-residents was significantly lower than the around 25% growth pace of these investments at the time when the measures started to be implemented. However, the share of assets with non-residents, which are subject to the countercyclical measures, increased at 80% of total assets with non-residents, from 78.6% a year earlier. There is an expansion of interbank investments within the group of assets with non-residents that are subject of the aforementioned measures. On the other hand, the annual growth pace of assets with non-residents that are not subject to the countercyclical measures has been lower, registering 4.6% in June 2017. Amid sluggish lending and lack of other investment alternatives, despite the higher capital requirements burdened on banks for the change of placements with non-residents, in January 2017, the annual growth of investments was around 21.6%, the highest historical level after 2013. This significant expansion appeared mainly in the form of increase in interbank and securities investments, and followed the change in the implementation of the

[42] *Securities investments and credit for non-resident non-financial entities are not included.*

regulatory measure at the end of 2016.[43] In the following months, the pace of the expansion of investments in non-resident entities decreased gradually at 9.1%. During the rest of 2017, the Bank of Albania will continue to implement the measures that aim to decrease investments in non-resident entities in order to continuously boost domestic lending.

8.3 LENDING DEVELOPMENTS

8.3.1 OUTSTANDING LENDING

(60) During the period, outstanding loans decreased in the balance sheet of the banking sector. At the end of June 2017, outstanding loans in the balance sheet of the banking sector stood at ALL 597 billion[44], around 0.5% lower (or ALL 3.1 billion) than at the end-2016. Compared with a year earlier, outstanding loans remained almost unchanged. The performance of this activity is characterised by the significant decline of the non-performing loans (as a consequence of repayments, restructuring and partially the writing off of lost loans), the more sluggish performance of new lending and the reducing effect of the appreciation of the exchange rate of lek.

Table 8.2 Lending performance

	Indicator and unit	Value (ALL bln)	Share in total loans (%)	Share in total loans (%)	Change	Change
	Period	06/2017	06/2017	06/2016	from '12/2016	from '06/2016
By currency	ALL loans	256,21	42.9%	39.9%	3.2%	7.4%
	FX loans	341,08	57.1%	60.1%	-3.1%	-5.0%
By entity	Public sector	30,44	5.1%	4.7%	6.2%	8.0%
	Enterprises	393,49	65.9%	67.4%	-2.4%	-2.3%
	Households	173,36	29.0%	27.9%	2.8%	4.2%
By maturity term	Short - term	185,10	31.0%	33.1%	-3.0%	-6.3%
	Medium - term	119,04	19.9%	18.7%	-2.0%	6.3%
	Long - term	293,15	49.1%	48.2%	1.8%	1.8%
	Balance	597,28	100.0%	100.0%	-0.5%	0.0%

Source: Bank of Albania, Financial Stability Department.

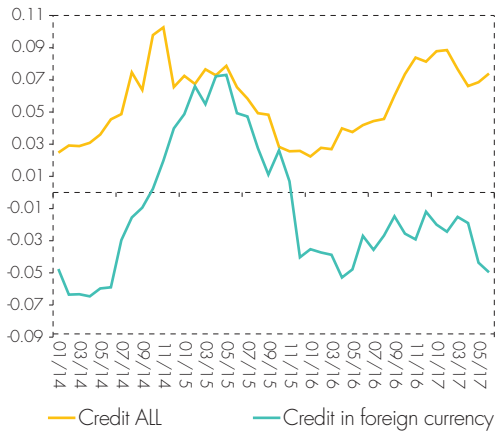
(61) By currency, foreign currency loans decreased by 3.1% (or ALL 11 billion) while lek loans increased by 3.2% (or ALL 7.9 billion), during the period. Because of the considerable share of foreign currency loans (57%), the performance of lek exchange rate affects the nominal value of credit being reported in the domestic currency. About the outstanding loans calculated at the end of June 2017, the appreciation of the lek against the main foreign currencies contributed to the decrease of the reported value of lending by

[43] *At the end of 2016, the Bank of Albania changed the manner of implementation of the regulatory countercyclical measure, where for the measurement of the change in investment with non-residents, is not used anymore a fixed base period (March 2013) but a 2-year moving time period. The aim of the change was to set an upper limit in the growth of capital demand by banks from this activity. The isolated and on-time impact of this change in the balance sheet of banks was expected to appear in the form of the decrease of risk-weighted assets and the improvement of the Capital Adequacy Ratio.*

[44] *Including accrued interests. Without them, credit outstanding is assessed around ALL 593 billion.*

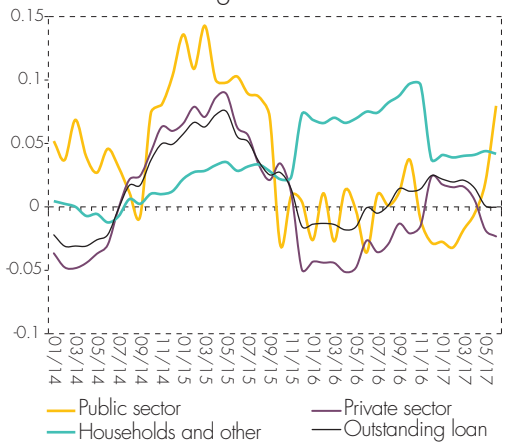
around ALL 8.7 billion. Excluding this effect, outstanding loans, during the period, would increase by 0.9% (from a decrease of 0.5%), while loans in foreign currency would decrease by around 0.7% (from a decrease of 3.1%). In annual terms, outstanding loans in the domestic currency expanded by 7.4%, while that of loans in foreign currency contracted by 5%.

Chart 8.4 Performance of credit by currency, annual growth



Source: Bank of Albania, Financial Stability Department.

Chart 8.5 Performance of credit by maturity, annual growth



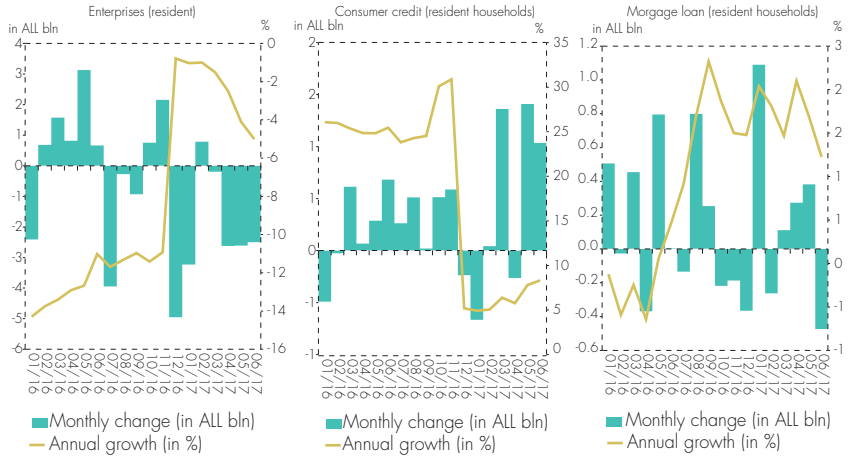
Source: Bank of Albania, Financial Stability Department.

(62) Short-term lending, which represents 26% of outstanding loans, has given the main contribution to its contraction during the period. Compared with the end of 2016, short-term and medium-term lending contracted by 3% and 2%, respectively, while long-term lending expanded by 1.8%. Over the course of a year, short-term lending decreased by 6.3%, while medium-term and long-term lending increased by 6.3% and 1.8%, respectively.

(63) Loans to enterprises, which constitute the main share of outstanding loans (around 66%), contracted during the period by 2.3%, down to ALL 393.5 billion. The decline came from the decrease of the non-performing loans stock, as a consequence of the writing off of lost loans, non-performing loans repayment and loans restructuring. Loans to resident enterprises, which constitute 85% of loans to enterprises, contracted during the period by around 3% (or around ALL 10 billion), while loans to non-resident enterprises expanded by 1.3% and at the end of the period reached ALL 59 billion. Loans to the public sector account for only 5% of overall lending and grew by 6.2% during the first half of the year. In annual terms, loans to enterprises contracted by 2.3% (around ALL 9.4 billion) reflecting the operations for collecting and restructuring loans as well as lost loans write off from the balance sheets. During the last 12 months, around ALL 7 billion in loans classified as "lost", borrowed by enterprises, have been written off. In annual terms, loans to the public sector have grown as well by 8.3% (or ALL 2.2 billion).

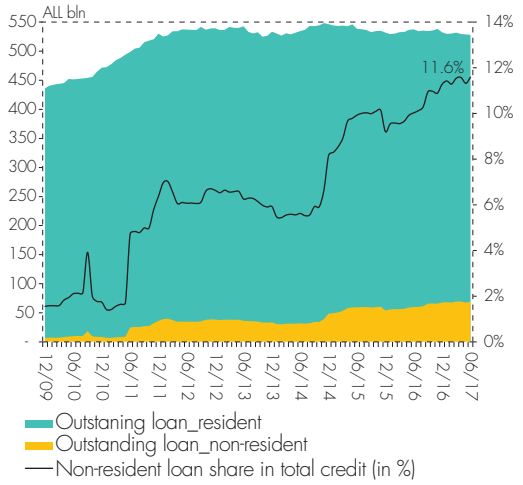
(64) Loans to households increased by 2.8% (or by ALL 4.7 billion) supported by the expansion of new lending for resident entities. Loans to resident households account for 95% of total loans to households and have increased by 2.5% (or ALL 4 billion) during the period. This performance is driven mainly by the expansion of consumer loans 5.2 % and mortgage loans[45] 1.1%. Loans to non-resident households increased by 7.3% over the period. In annual terms, total loans to households output has increased by 4.2% (or by ALL 7 billion). The expansion of loans to households is supported by new loans mainly for consumption.

Chart 8.6 Loans by purpose, annual growth (ra) and monthly change of the stock (la).



Source: Bank of Albania, Financial Stability Department.

Chart 8.7 Performance of loans to non-residents.



Source: Bank of Albania, Financial Stability Department.

(65) The banking sector continued to finance non-resident entities (enterprises and households). The share of loans to non-resident entities increased at 11.6% of the banking sector credit outstanding in June 2017, from 10% of a year earlier. Outstanding loans to non-resident registered ALL 69 billion, up by 2.1% during the period and 15.5% against a year earlier. Loans to non-resident enterprises contributed most to this increase, surging by 1.3% during the period and by 15.8% against a year earlier, accounting for 85% of the total. Almost all loans to non-residents were in foreign currency, and mainly in euro. Overall, loans to non-residents were oriented toward longer-term maturities, with the main share in the medium term (54%) and in the long term (31%). This type of lending was concentrated in a small number of banks.

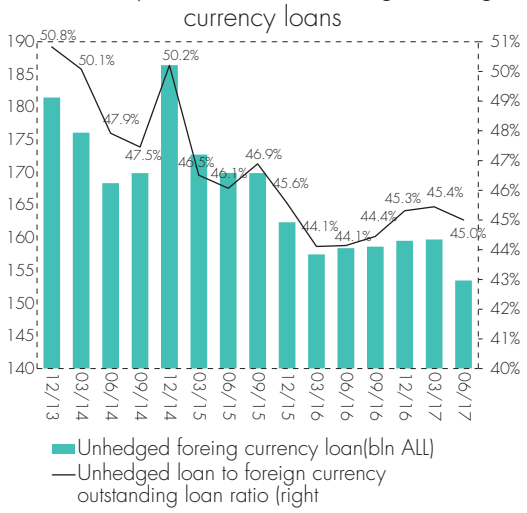
[45] *This type of lending accounts for 64% of outstanding credit to resident households.*

BOX 8.1. BANKING SECTOR AND UNHEDGED FOREIGN CURRENCY LOANS

The exposure of the banking sector to indirect credit risk, mainly in loans to enterprises, remains high. In June 2017, foreign currency loans unhedged against exchange rate fluctuations constituted 45% of total foreign currency loans (0.3 p.p. lower than at the end of 2016 and 1 p.p. higher than a year earlier) and 26% of total outstanding loans. Unhedged foreign currency loans, as part of overall lending, decreased by around 1 p.p. against both the end of the previous year and a year earlier.

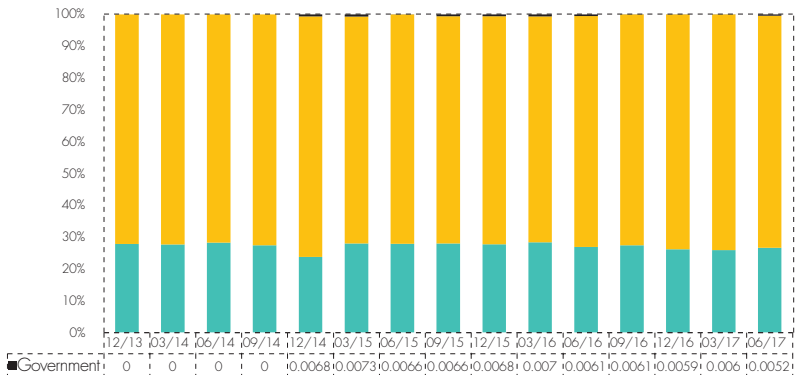
Unhedged outstanding loans during the period contracted by 3.8% at ALL 153.5 billion, due to the significant contraction of unhedged loans in US dollar, by around 41%. By entity, loans to enterprises account for the main share (73%) of foreign currency loans unhedged against the exchange rate risk and its decrease by 5% gave the main contribution to the contraction of unhedged foreign currency outstanding loans. Unhedged loans to households contracted by 2%. In annual terms, unhedged foreign currency loans contracted by 3.1% and reflect the decrease of unhedged credit outstanding for both types of entities, but mainly for enterprises.*

Chart 8.8 performance of unhedged foreign currency loans



Source: Bank of Albania, Financial Stability Department.

Chart 8.9 Unhedged foreign currency loans, by subject, %

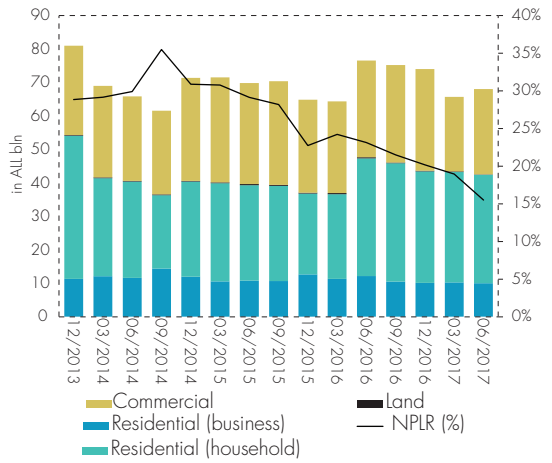


	12/13	03/14	06/14	09/14	12/14	03/15	06/15	09/15	12/15	03/16	06/16	09/16	12/16	03/17	06/17
Government	0	0	0	0	0.0068	0.0073	0.0066	0.0066	0.0068	0.007	0.0061	0.0061	0.0059	0.006	0.0052
Enterprises	0.7213	0.7231	0.7176	0.7257	0.7556	0.7126	0.7208	0.7135	0.7158	0.7093	0.7246	0.7255	0.7382	0.7405	0.7281
Households	0.2787	0.2769	0.2824	0.2743	0.2376	0.2801	0.2792	0.2799	0.2774	0.2837	0.2694	0.2745	0.2618	0.2595	0.2667

Source: Bank of Albania, Financial Stability Department.

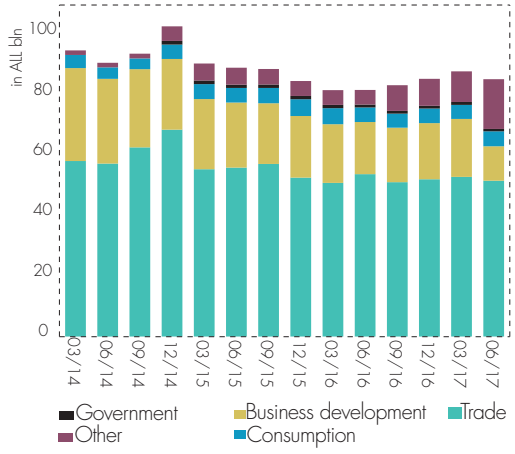
By purpose of use, loans for investments in real estate account for the main share of unhedged foreign currency loans (around 44%). This type of loans has decreased compared with the end of the previous year (8%) as well as compared with a year earlier (11%). The decrease is related to the rapid decline in the non-performing loans stock. Such loans are mainly granted to households for "investments in residential real estate". The rest of the unhedged foreign currency loans were granted mainly for trading and business development purposes (Chart 8.11).

Chart 8.10 Unhedged foreign currency loans for real estate and its quality (right)



Source: Bank of Albania, Financial Stability Department.

Chart 8.11 Unhedged foreign currency loans (not real estate)



Source: Bank of Albania, Financial Stability Department.

* *Outstanding US dollar credit, when the borrower's income is in Albanian lek, accounts for 12.5% of the outstanding unhedged foreign currency loans.*

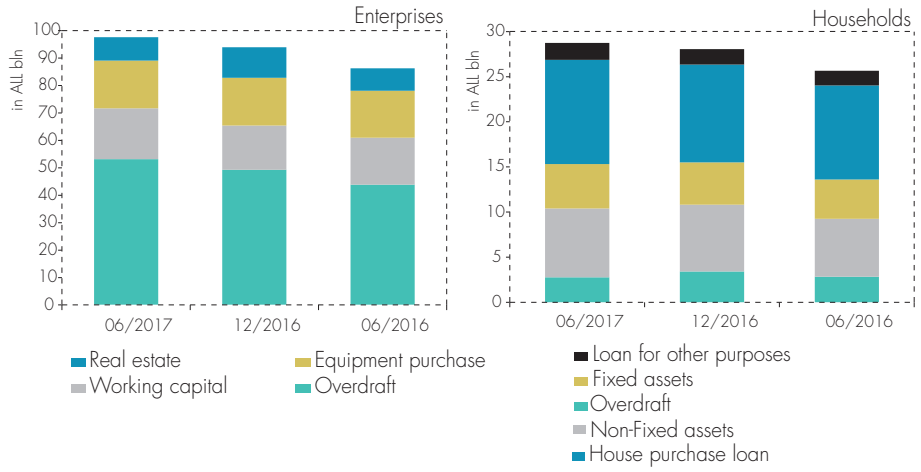
8.3.2 NEW LENDING

(66) During the period, the banking sector granted new loans for ALL 128 billion, while the lending collected during the same period was ALL 132 billion. New lending was around 9% lower compared with the previous period and around 13% higher compared with the first half of the previous year. Collected loans were around 12% lower compared with the previous period and around 23% higher compared with the same period in the previous year. The ratio of collected-to-new loans, declined at 103% from 107% at the end of 2016, and 95% a year earlier. The annual growth of the loan usage ratio came mainly as a consequence of the increase of the value of collected loans.

(67) During the period, the performance of new lending was determined by the change of new lending to the public sector. In the private sector, enterprises account for around 77% of new lending, mainly in the form of "overdraft" (short-term lending). New loans to enterprises were higher compared with 2016 H2 (4.5%) as well as compared with 2016 H1 (13%). The increase was due to the growth of lending in the overdraft form and lending for working capital. New loans to households were also up, mainly due to the increase of new loans for house purchase, which accounts for around 40% of new loans to households. Unlike the previous period, when new loans to the public sector amounted to around 13% of the new lending, loans to this sector accounted for a very small share of the new lending during the period (around 0.3%). The contraction

by ALL 17.3 billion of new lending for this sector contributed to the negative performance of new lending in 2017 H1. This effect is assessed as temporary, since loans to the public sector historically have a small share in total lending.

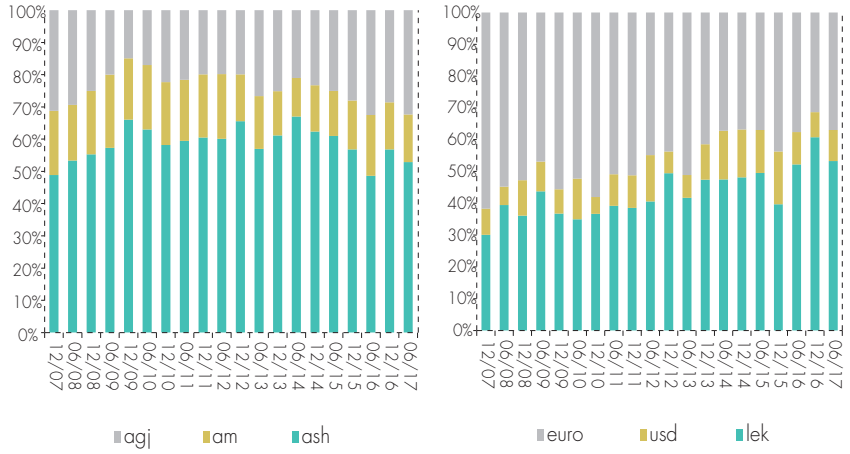
Chart 8.12 New credit by purpose



Source: Bank of Albania, Financial Stability Department.

(68) By currency and maturity, lek loans and short-term loans provided the main contribution to the performance of new lending during the period. New loans in lek accounted for 53% of the overall new lending flow. During 2017 H1, new loans in lek decreased by around 20% (or ALL 17 billion) compared with 2017 H2, but increased by 15% compared with 2016 H1. New foreign currency loans increased by around 10% from the previous period. Around 80% of new loans in foreign currency are euro loans, which were higher from the same period a year ago. By maturity, new short-term lending, which constitutes 53% of the total, gave the main contribution in the performance of new lending during the period. Although these loans increased by 23% in annual terms, they decreased by 15% in the period.

Chart 8.13 Distribution of new credit by maturity (left) and currency (right)

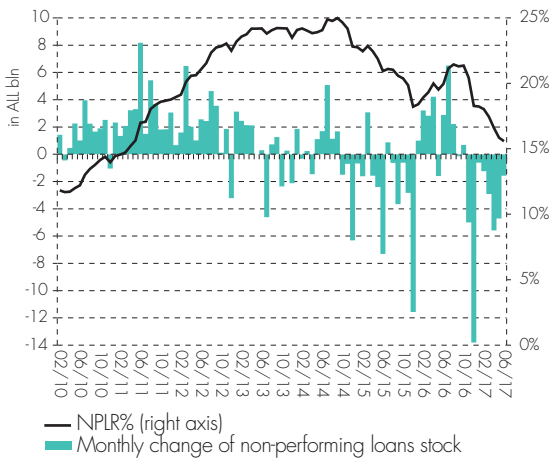


Source: Bank of Albania, Financial Stability Department.

8.3.3 CREDIT RISK

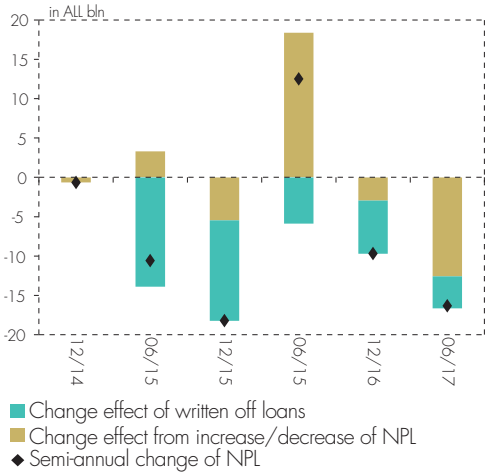
(69) During the period, outstanding non-performing loans[46] decreased significantly. At the end of the period, outstanding non-performing loans amounted to ALL 93 billion, or 15.2% lower than in 2016 H2. The decrease of non-performing loans is a result of restructuring, repayment of overdue loans by enterprises and the lost loans write off from banks' balance sheets. During 2017 H1, ALL 4 billion of lost loans were written off from banks' balance sheets, mainly foreign currency loans to enterprises. Restructured loans during this period were around ALL 6.2 billion. From this amount, ALL 1.7 billion were loans classified as "non-performing", the rest were "standard" and "special mention" loans. Compared with the previous year, non-performing loans stock declined by 22% (or ALL 26.2 billion). During the period July 2016 - June 2017 the banks have written off around ALL 11 billion lost loans[47] from the balance sheets.

Chart 8.14 Non-performing loans ratio



Source: Bank of Albania, Financial Stability Department.

Chart 8.15 Contribution in the half year change of the non-performing loans stock (ALL billion)



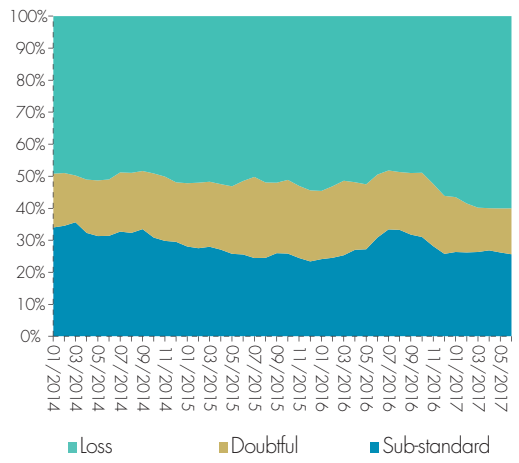
Source: Bank of Albania, Financial Stability Department.

(70) The decrease of outstanding non-performing loans is accompanied with the significant decrease of the non-performing loans ratio (NPLR). At the end of the period, NPLR marked 15.6%, around 2.7 p.p. lower than December 2016 and 4.4 p.p. lower than a year earlier. Within the structure of non-performing loans, due to repayment and restructuring, loans of the categories "substandard" and "doubtful" contracted by 15.6% and 32.8%, respectively. The loans classified "lost", which account for the main share, or around 60% of non-performing loans, contracted by 9.3% mainly due to their write off from the balance sheets.

46 *Non-performing loans include "substandard", "doubtful", and "lost" classes. The criterion to define a loan as "non-performing" is the number of past due days (90 days) and the financial situation of the borrower.*

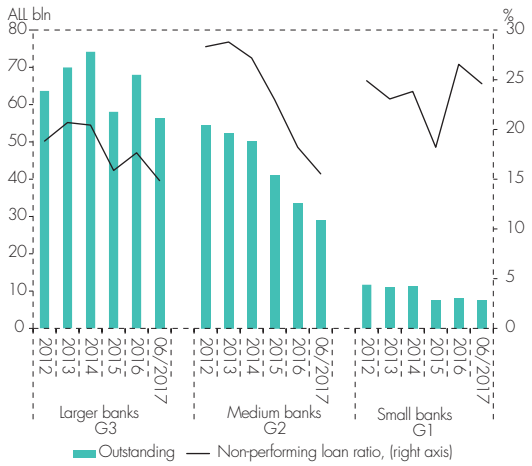
47 *Starting from January 2015, banks are obliged under the regulatory requirements to undertake the process of balance sheets cleaning - the write off of loans falling under the category "lost" for more than three years. In total, in two years and a half, ALL 43.3 billion of lost loans were written off.*

Chart 8.16 Non-performing loans structure



Source: Bank of Albania, Financial Stability Department.

Chart 8.17 NPL portfolio by bank groups



Source: Bank of Albania, Financial Stability Department.

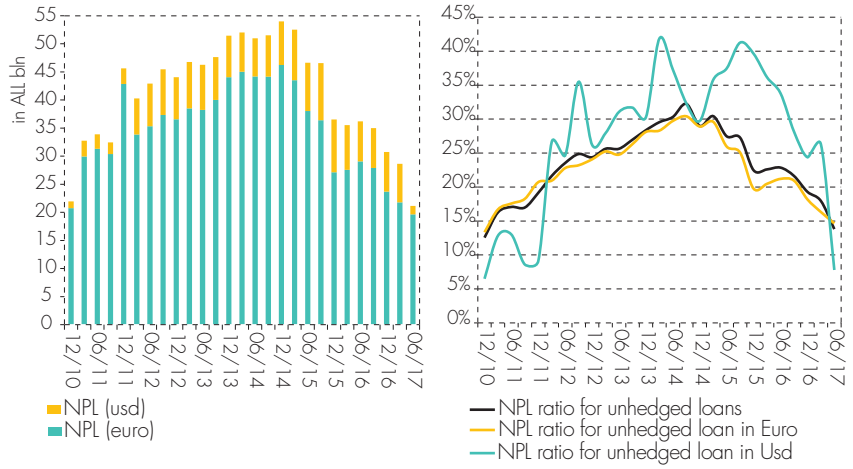
(71) Larger banks made the main contribution to the improvement of credit quality, together accounting for 61% of the outstanding NPLs. The NPLs for this group of banks contracted by 17.2%, whereas the NPLR decreased by 2.8 p.p. to 14.9%. Larger banks (G3) have the lowest non-performing loans ratio, while smaller banks (G1) having the highest NPLR at around 24.6%. The NPLR for this group decreased by 1.9 p.p.

(72) The credit quality appears lower for loans in foreign currency, loans to enterprises, and medium-term loans. At the end of 2017 H1, the credit quality for each portfolio stood at 17.6% (foreign currency), 19.5% (enterprises) and 17.0% (long-term). All these indicators have declined during the period.

Chart 8.18 Non-performing loans in the Albanian banking sector

Source: Bank of Albania, Financial Stability Department.

Chart 8.19 Quality of the loan portfolio unhedged against exchange rate risk

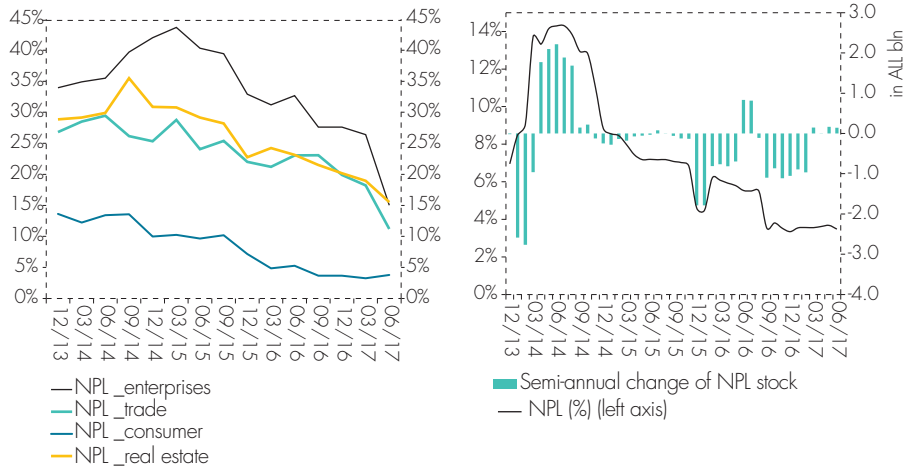


Source: Bank of Albania, Financial Stability Department.

(73) The quality of unhedged foreign currency loans has improved continuously since the beginning of 2015. The non-performing loans ratio (NPLR) for these loans decreased at 13.8% from 19.3% of December 2016, affected by the rapid decrease of the non-performing loans stock. During the period, the outstanding unhedged non-performing loans contracted significantly, by around 31%. By currency, the main impact in the improvement of the quality of unhedged loans came from loans denominated in the US dollar. The quality ratio for unhedged US dollar loans improved by 16.6 p.p., falling at 7.8%, and NPLR for unhedged euro loans improved by around 3.5 p.p., falling at 14.7%.

(74) By purpose of use, the main share in non-performing loans stock within unhedged loans from exchange rate risk were loans for "investments in real estate" (49%), which during the period decreased by 29.3%. This type of loans has the highest level of non-performing loans ratio, around 15.5%, followed by those for business development at 15%. During the period NPLR for these two categories decrease by 4.7 p.p. and 12.6 p.p., respectively. From the category of unhedged loans from exchange rate risk, consumer credit shows the lowest NPLR level, at 3.8%. While consumer credit accounts for 3.2% of total stock of unhedged loans against exchange rate risk, the share of non-performing loans from this credit in the stock of non-performing loans unhedged by exchange rate risk is around 1%.

Chart 8.20 Credit quality for the loan portfolio unhedged against exchange rate risk, by purpose (left) and non-performing loans for non-resident entities (right).



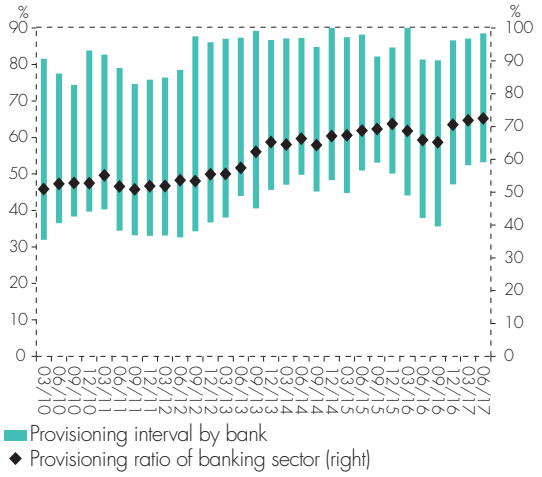
Source: Bank of Albania, Financial Stability Department.

(75) Credit quality for non-resident entities is considered relatively good; the NPLR for this type of credit is 3.5%, significantly lower than the overall outstanding credit NPLR. During 2017 H1 the stock of non-performing loans for non-residents expanded by 6.2%, reaching ALL 2.4 billion, while NPLR increased by 0.1 p.p. Compared with the previous year, the NPLR contracted by around 2.1 p.p. while the non-performing loans stock contracted by 27.4%.

8.3.4 CREDIT RISK MITIGATING FACTORS

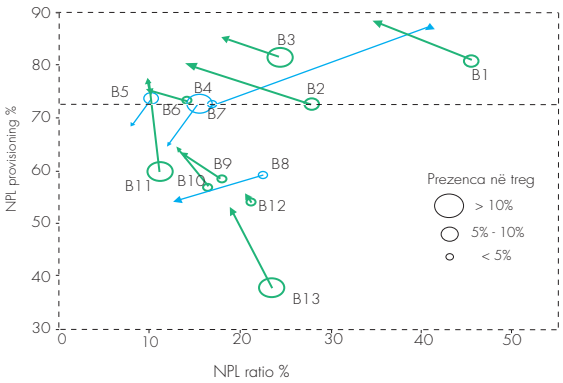
(76) Although the value of provisions for credit risk has decreased, the faster decrease of the non-performing loans stock has increased provisioning at 72.5% (or by 2.5 p.p.) during the period. Compared with the previous year, most of the banks of the system report both improvements in credit quality and a higher level of provisioning (Chart 8.21).

Chart 8.21 Provisioning over time



Source: Bank of Albania, Financial Stability Department.

Chart 8.22*. Annual change in provisioning levels - arrows show change from June 2016 to June 2017, by bank

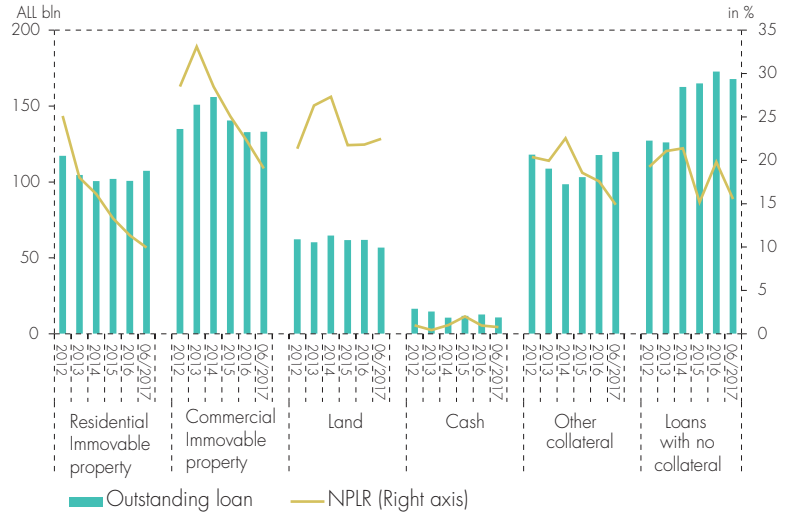


*Note: This includes banks sharing more than 1% in total assets. Green shows improvement, red shows deterioration, blue shows combined risk. Dotted line shows the average ratio of non-performing loan provisioning at sector level, 72.5% at the end of June 2017.
Source: Bank of Albania, Financial Stability Department.

(77) The decrease in the net value of non-performing loans[48] during the period has led to an improvement in their capital coverage. During the period, the ratio of net non-performing loans to outstanding loans contracted by 1.1 p.p., to 4.3%. In the previous year, the ratio stood at 6.8%. At the same time, as a result of the lower exposure to credit risk through the contraction of the outstanding net non-performing loans, the "net non-performing loans/ regulatory capital" decreased to 18.6% from 23.1% at the end of December 2016. In the previous year, the ratio stood at 30.2%.

(78) Collateral coverage of loans remains high and, amongst the different types of collateral used to guarantee the loan, real estate continues to predominate. In June 2017, collateral coverage[49] marked 71.8%, from 71.2% at the end of 2016, and 71% a year earlier. Loans covered with collateral in the form of real estate account for around 70% of collateralized loans, and 50% of outstanding loans. Collateralized outstanding loans have slightly increased during the period (by 0.6%), mainly due to the increase by 7% of outstanding loans collateralized with residential real estate. The quality of collateralized loans has improved during the period compared with a year earlier, and NPLR marked 15.6%. Loans collateralized with cash have the lowest level of non-performing loans (0.8%), while that collateralized with "real estate - land" the highest (22.5%). The NPLR for this type of loans has grown. The quality of non-collateralized loans, which account for 28% of overall outstanding loans, has improved, which has been reflected in the decrease of NPLR at 15.5% from 19.8% of the end of previous year. The high degree of use of real estate as collateral to guarantee loans to enterprises and households highlights the importance of the good functioning and regulation of the real estate market, as well as the transparent and efficient implementation for all the parties of the legal obligations and the execution of liabilities, in the case of loans default.

Chart 8.23 Outstanding credit and non-performing loans ratio by collateral



Source: Bank of Albania, Financial Stability Department.

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

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

8.4 DEPOSITS AND LIQUIDITY RISK

(79) Outstanding deposits declined during the period, mainly due to the appreciation of the lek exchange rate. Specifically, in June 2017, the deposits' stock in the banking sector was ALL 1.138 billion. During the period (compared to the end of 2016), outstanding deposits fell by about 1.7% or by about ALL 19.1 billion. By currency, deposits in lek fell by around ALL 6.6 billion, while outstanding deposits in foreign currency fell by All 12.6 billion. Regarding the performance of deposits in foreign currency during the period, the appreciation of lek provided a negative effect for around ALL 17.3 billion, exceeding the nominal value of the decrease in the outstanding deposits in foreign currency. This means that, according to transactions in their original currencies, foreign currency deposits[50], in total increased by about ALL 4.5 billion. Excluding the exchange rate effect, the total outstanding deposits, marks a much lower fall over the period, by ALL 2.2 billion or 0.2%. In annual terms, the total outstanding deposits grew by 3.5%. Foreign currency deposits account for around 53% of the outstanding deposits of the banking sector.

Table 8.4 Main indicators of deposits in the banking system

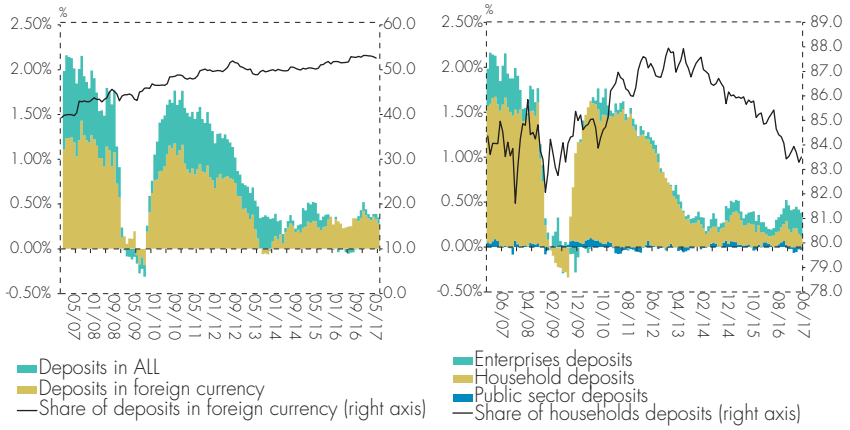
	Indicator and unit	Value (in ALL billion)	Share to total deposits (%)		Change	
	Period	06/2017	06/2017	06/2016	Annual	Semi-annual
By currency	Deposits in lek	540	47.4%	48.4%	1.5%	-1.2%
	Deposits in foreign currency	599	52.6%	51.6%	5.4%	-2.1%
By institution	Public sector	28	2.4%	2.8%	-11.5%	-5.7%
	Enterprises	160	14.1%	11.9%	22.2%	-1.5%
	Households	951	83.5%	85.3%	1.4%	-1.6%
By product	Current account	368	32.3%	28.5%	17.2%	-1.6%
	Demand deposits	95	8.3%	6.9%	24%	3.8%
	Time deposits	655	57.5%	62.8%	-5.1%	-2.2%
	Deposits' stock	1.138	100.%	100.%	3.5%	-1.7%

Source: Bank of Albania, Financial Stability Department.

(80) During the period, households and enterprises' deposits decreased by 1.6% and 1.5%, respectively. Since households' deposits account for 83.5% of the total deposits, with half of them in foreign currency, they were the main contributor to the decrease of the deposit base, narrowing by around ALL 15 billion. Households' deposits in foreign currency fell faster during the period, by ALL 8.8 billion, compared with the fall by only ALL 0.8 billion of enterprises' deposits in foreign currency. In annual terms, both households and enterprises' deposits grew by 1.4% and 22.2%, respectively.

[50] *This excludes the effect of the exchange rate change and only reflects the net (inflow-outflow) movements of deposits by original currencies.*

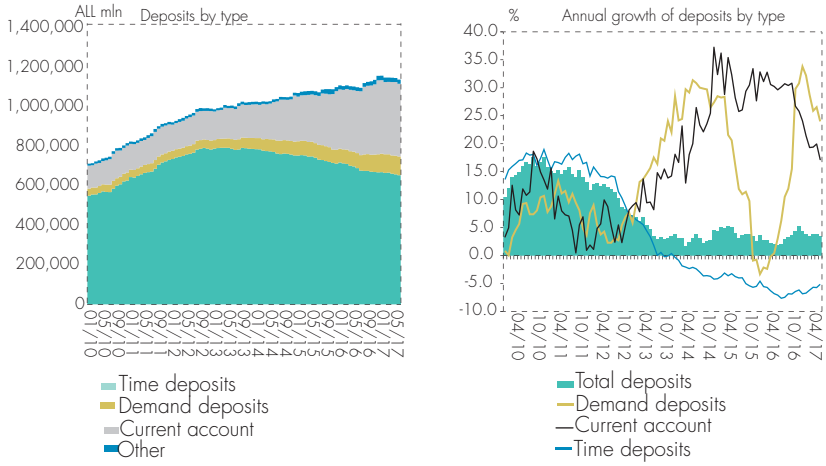
Chart 8.24 Contribution to the performance of deposits



Source: Bank of Albania, Financial Stability Department.

(81) Time deposits continue to have the main share in the total value of deposits, but they shrank in absolute and relative terms to deposit stock[51]. During the period, time deposits fell by ALL 14.5 billion or 2.2%. The stock of current accounts also decreased by ALL 6.1 billion, during the period. Only time deposits contributed to the growth of deposits stock, by ALL 3.5 billion, during the period.

Chart 8.25 Deposits by type



Source: Bank of Albania, Financial Stability Department.

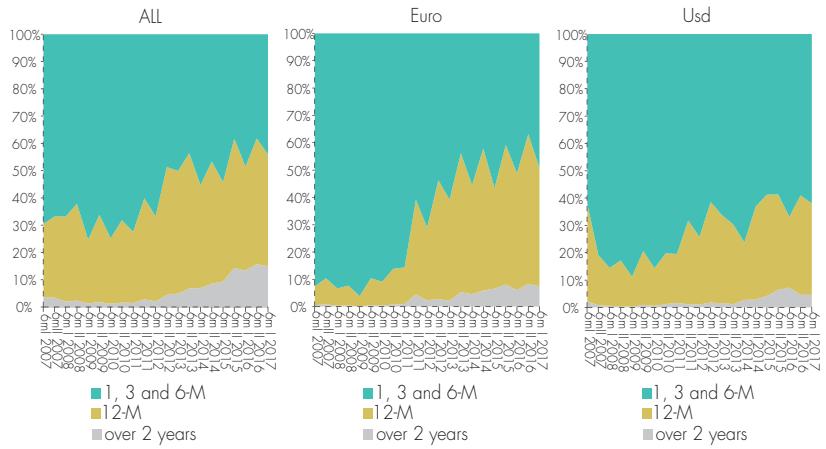
(82) The fall of deposits during the period is concentrated in the large banks group, G3. The narrowing of G3 deposits was higher than the total decrease of the sector's deposits base. This shows the slight increase of deposits (in aggregate) in the group of medium-sized and small banks. According to the

[51] *Since October 2013, while the annual growth of time deposits began to register negative rates, time deposits fell by 17.2%, whilst their share to total deposits decreased from 77% to 57.5%.*

Herfindahl index, the concentration of deposits stands below the moderate levels[52] (1,438 points), showing thus an appropriate concentration level.

(83) During the period, the flow of new time deposits in the banking sector was ALL 243 billion or about 26% lower compared to the previous six months. The share of new time deposits in the total of new deposits decreased down to 16% compared to 19% in the previous six-months and 21% compared with the first six-months of 2016. There was a slight shift of deposits to longer-term maturities within the structure of new time deposits. The inflow of new deposits in lek and euro fell by 13% and 12% respectively, while in US dollar it increase by over 15%. During the period, average interest rates of new time deposits in lek remained at 0.9% almost unchanged from the previous period, whilst the interest rates for new demand deposits in USD and Euro slightly decreased, at 0.2% and 0.3% respectively.

Chart 8.26 New time deposits by currency and maturity, 6-month flows.



Source: Bank of Albania, Financial Stability Department.

8.4.1 LIQUIDITY RISK

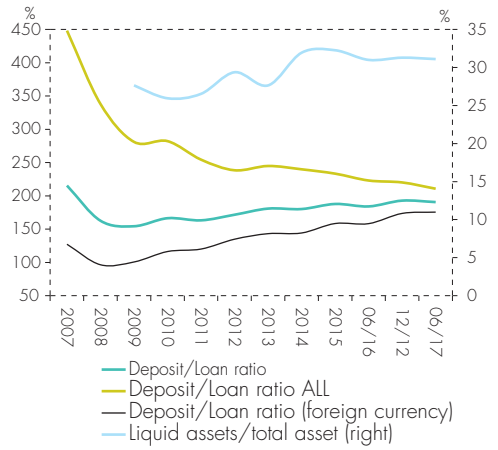
(84) Liquidity position of the banking sector stands at good levels. The liquidity ratios, both in lek and foreign currency, stand above the minimum regulatory ratios. Deposits remain the main source of funding, by covering almost twice the volume of loans for the sector.

(85) The banking sector maintains a good liquidity position with a considerable outstanding client deposits to loans. In June 2017, the deposit-to-loans ratio stood at 190.6%. By currency, this ratio stands at 211% for the domestic currency and 176% for foreign currency.

[52] *Herfindahl's index values up to 1500 indicate a competitive market, values of 1500-2500 show moderate competitiveness, and values over 2500 a high concentration.*

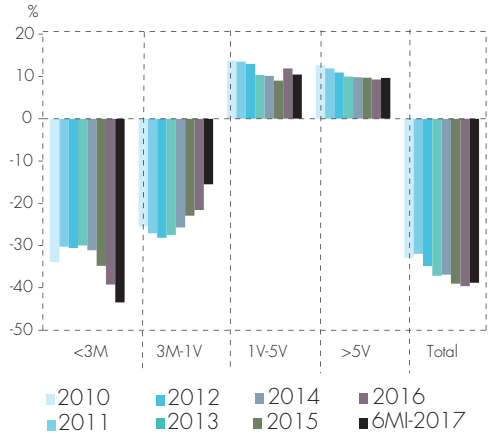
(86) Liquid assets in banks' balance sheets remain high, following the performance of lending below potential. At the end of June 2017, liquid assets accounted for 31.1% of total assets of the banking sector, slightly downward by 0.2 p.p. during the period. The other liquidity indicator, "liquid assets/ total short-term liabilities" increased slightly by 0.5 p.p, at 41.1%. Although banks are operating under ample liquidity, the mismatch between assets and liabilities, by residual maturity segments, against total assets, is considered as high and upward from the previous periods, in the short run.

Chart 8.27 Liquidity indicators



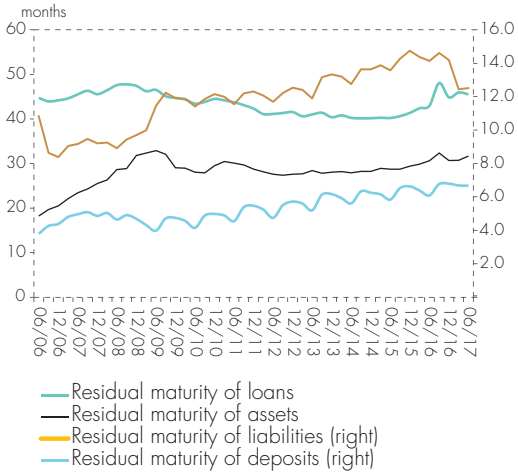
Source: Bank of Albania, Financial Stability Department.

Chart 8.28 Assets and liabilities maturity mismatch*



*Off balance sheet items (assets and liabilities) are also included.
Source: Bank of Albania, Financial Stability Department.

Chart 8.29 Average remaining maturity



Source: Bank of Albania, Financial Stability Department.

(87) The mismatch between medium-term assets and liabilities, increased during the period. It was estimated at around 19.1 months in June 2017, from 16.5 months at the end of 2016, representing the highest value since 2010. The remaining maturity of deposits, as the most representative item of liabilities, narrowed slightly to 6.7 months during the period. The residual maturity for credit, on the assets side, expanded to 45.5 months, from 44.8 months in December 2016, reflecting the banks propensity to grant credit for longer-term periods.

(88) The value of financing lines by parent bank groups has a very low share in the banking sector's financing sources. During the period, the total value of these lines was ALL 8.7 billion, compared to ALL 6.3 billion at the end of 2016. For banks that have credit lines with the parent bank groups, at the end of the period, the level of their usage was 16.3%, from 29.6% in December 2016.

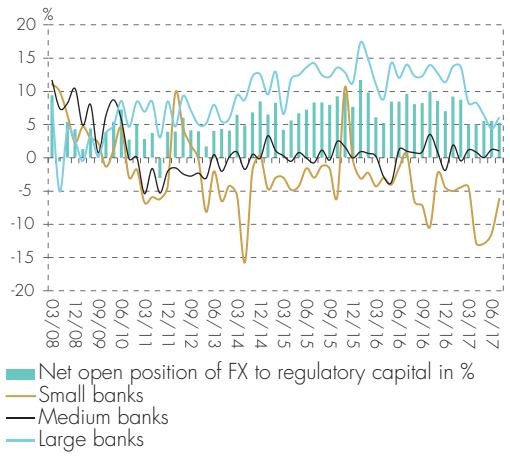
8.5 MARKET AND OPERATIONAL RISK

8.5.1 EXCHANGE RATE RISK

(89) **The banking sector's net open foreign currency position to regulatory capital ranged within long-term levels, pointing to a limited and downward exposure of the banking sector to the direct impact on the balance sheet, from the exchange rate volatility.** At the end of the period, the net open foreign currency position was "long" at 5.6% of the regulatory capital, being 1.5 p.p. lower than in December 2016, and 2.9 p.p. lower than a year earlier. As chart 8.30 shows, the performance of the banking sector indicator is driven mainly by the larger banks. The latter continue to maintain a "long" position at 4.4% of regulatory capital, but this position is considerably lower compared to 12% and 11.4%, recorded in the previous year and six–month period. The medium-sized banks increased their foreign currency exposure by 3.1 p.p. from the previous six months, and positioned "long" at 1.2% of the regulatory capital, but they did now show any change compared to the previous year. The small banks have expanded their "short" foreign currency position as compared to the previous six months and the previous year at 11.4% of the regulatory capital.

(90) **During the period, the banking sector's exposure to indirect foreign exchange risk remains at levels close to the latest values of 2016.** At the end of 2017, the foreign currency mismatch indicator[53] for all currencies stood at the same level of the previous six months, 18.4% of the assets. Contraction of foreign currency assets by 2.8% was offset by the decrease of foreign currency credit to resident entities followed by the contraction of foreign currency liabilities. Also, the contraction of total banking sector assets over the previous six months has contributed to maintaining the foreign exchange mismatch unchanged. Foreign currency mismatch in euro increased by 0.4 p.p. reaching 17.8%, while in US dollar it dropped by 0.5 p.p., at 0.8%.

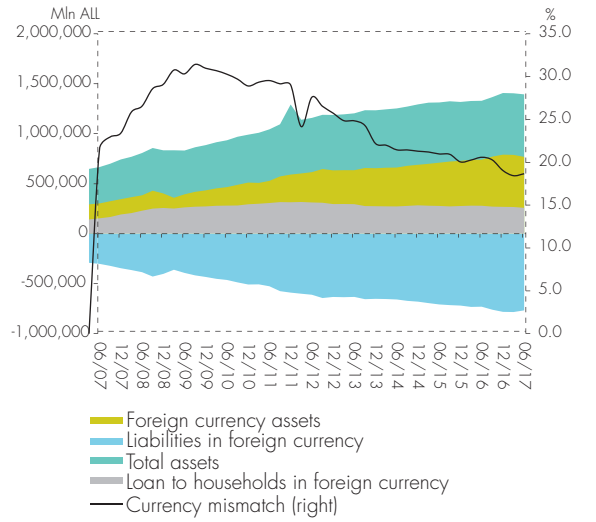
Chart 8.30 Open foreign currency position to the regulatory capital by peer group size



Source: Bank of Albania, Financial Stability Department.

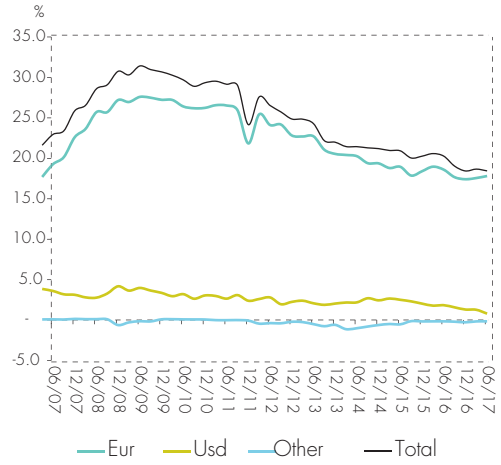
[53] *The foreign currency mismatch indicator measures the level of coverage of banking sector liabilities in foreign currency liabilities with foreign currency assets in net foreign currency resident credit. A low value of the ratio of this indicator to total assets shows a low exposure to exchange rate movements. For more detailed explanations of the foreign exchange mismatch, see the Financial Stability Report 2016 H1.*

Chart 8.31 Foreign currency mismatch by components



Source: Bank of Albania, Financial Stability Department.

Chart 8.32 Foreign currency mismatch by currency

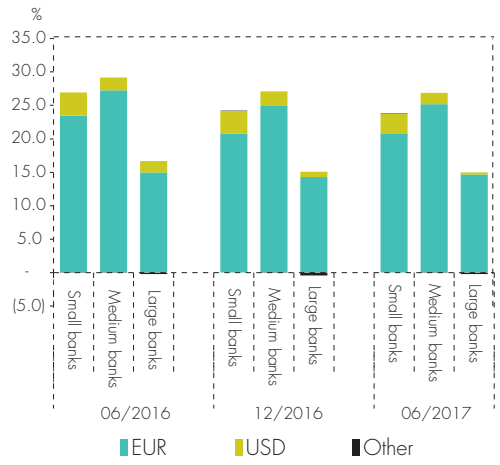


Source: Bank of Albania, Financial Stability Department.

(91) For all three banking groups, the exposure to indirect foreign exchange risk has not changed from the previous six months, but there is a downward trend compared with the previous year. Due to the fact that the foreign currency mismatch is related to the level of exposure to exchange rate indirect risk, the larger banks group has the lowest level of exposure or a higher rate of coverage of foreign currency liabilities with assets denominated in foreign currency, while medium-sized banks show higher exposure or lower coverage of foreign currency liabilities. For these groups, the foreign currency mismatch index at the end of 2017 H1 was 14.8% and 26.9%, respectively, while for small banks the index was 23.8%.

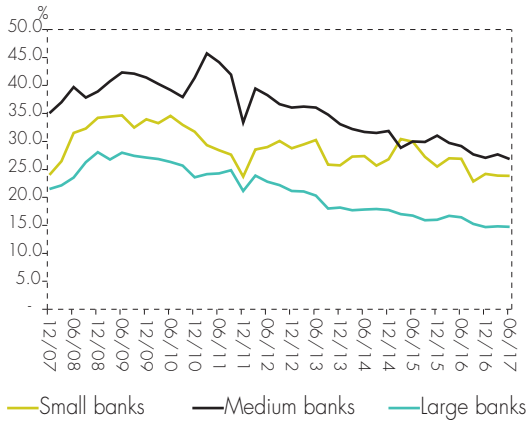
Chart 8.34 shows that in the last five years the exposure to indirect foreign exchange risk has been declining for the medium-sized and large banks, whilst small banks show volatility to this exposure.

Chart 8.33 Foreign currency mismatch by currency



Source: Bank of Albania, Financial Stability Department.

Chart 8.34 Foreign currency mismatch by groups

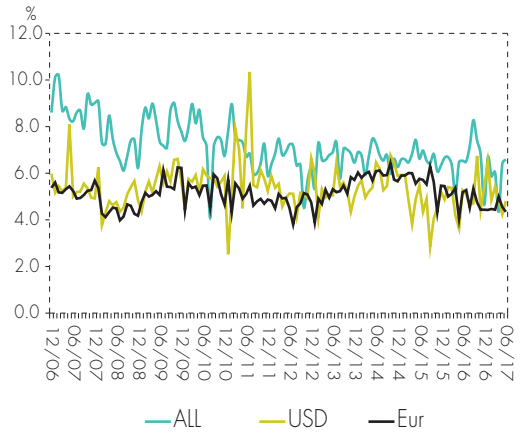


Source: Bank of Albania, Financial Stability Department.

8.5.2 INTEREST RATE RISK

(92) The banking sector remains exposed to interest rate volatility when the mismatch between interest rate-sensitive assets and liabilities, by repricing periods, is relatively high. During 2017 H1, the sector has reduced its exposure to interest rate volatility for the short-term period up to one month and up to 3months, narrowing the cumulative mismatch between interest rate-sensitive [54] assets and liabilities. Compared to 2016 H2, the mismatch between interest rate-sensitive assets and liabilities with up to 1-month maturity, decreased at 10.5% of the assets, from 13.4% in December 2016; whilst the mismatch for the remaining maturity up to 3 months, decreased at 7.2% of the assets, from 16.1% in December 2016. Meanwhile, the "assets - liabilities" mismatch for the remaining maturity up to 12 months expanded by 1.2 p.p., up to 10.2% of the assets of the banking sector. The decrease in the mismatch between interest rate-sensitive assets and liabilities reduces the risk that the banking sector and specific banks will face costs in case economic developments suggest an increase of interest rates in the market. The assessment of the risk that may arise from the interest rates fluctuations, in addition to monitoring the direct impact on the financial result of banks, (through impact on the net interest income and on revaluation income) should take into account the indirect impact from interest rate volatility on borrowers' solvency. A potential increase of the interest rate may affect negatively the borrowers' solvency and may be associated with problems in credit quality.

Chart 8.35 Interest rates spread by currency



Source: Bank of Albania, Financial Stability Department.

7.4.3. OPERATIONAL RISK

(93) The level of capital coverage for the operational risk of the banking sector is satisfactory and stable for the period. Capital requirements to cover operational losses stood at ALL 85.3 billion at the end of the period, same as at the end of 2016. The capital adequacy indicator was not affected by the fluctuation risk of operational losses for the period.

Chart 8.36 Capital requirement for operational risk

Source: Bank of Albania, Financial Stability Department.

[54] *Starting from December 2016 the off-balance sheet items are included in the interest rate –sensitive assets and liabilities.*

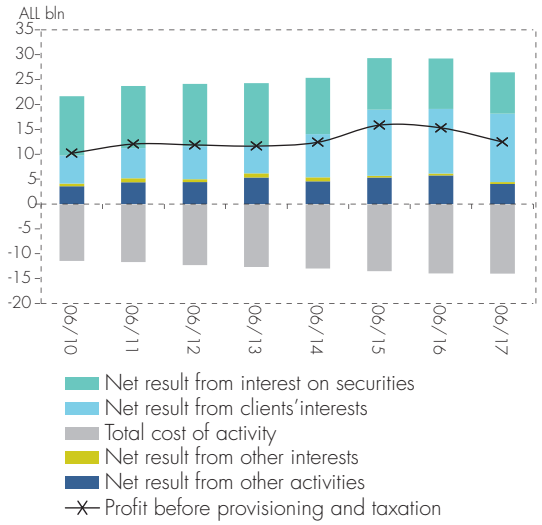
8.6 FINANCIAL RESULT AND EFFICIENCY OF FUNDS

(94) The banking sector reported a positive financial result, significantly upward compared to the previous year.

Due to the faster decline in interest income compared with the declining rate of financing costs, net interest income and net interest margin have declined. Other activities also fell, mainly from income from securities transactions and foreign currency transactions. The costs in the form of provisions for the credit risk, decreased considerably and represent the main factor contributing to the increase in banking sector profitability. This development is in line with the positive performance of the credit portfolio, where the significant decrease in the ratio of non-performing loans contributed to this result.

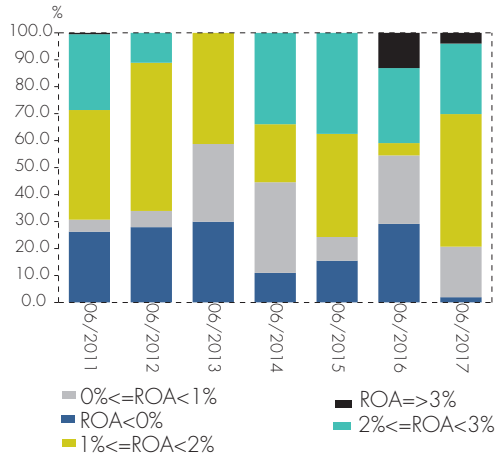
(95) At the end of the period, the banking sector reported a positive financial result of around ALL 11.5 billion or around ALL 6.4 billion higher compared with the previous year. The main profitability ratios , Return on Assets (RoA) and Return on Equity (RoE) resulted at 1.6% and 16.7%, standing 0.9 percentage point and 8.7 percentage points, respectively, higher than in the in the previous year. The small banks group is the only group, whose RoE and RoA declined.

Chart 8.37 Financial result components



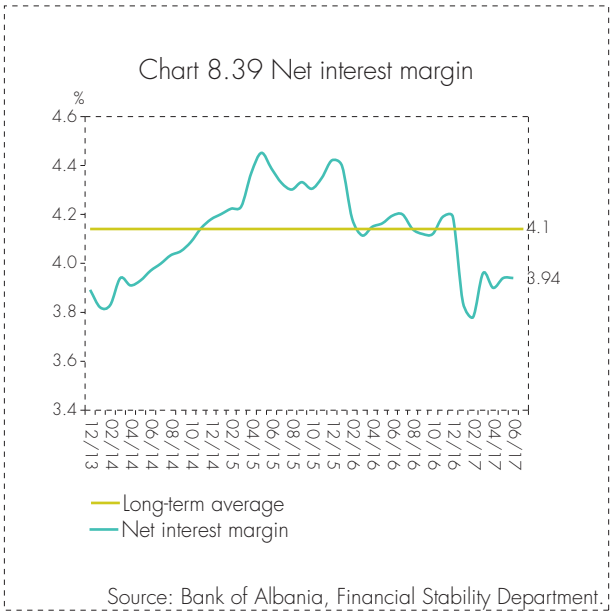
Source: Bank of Albania, Financial Stability Department.

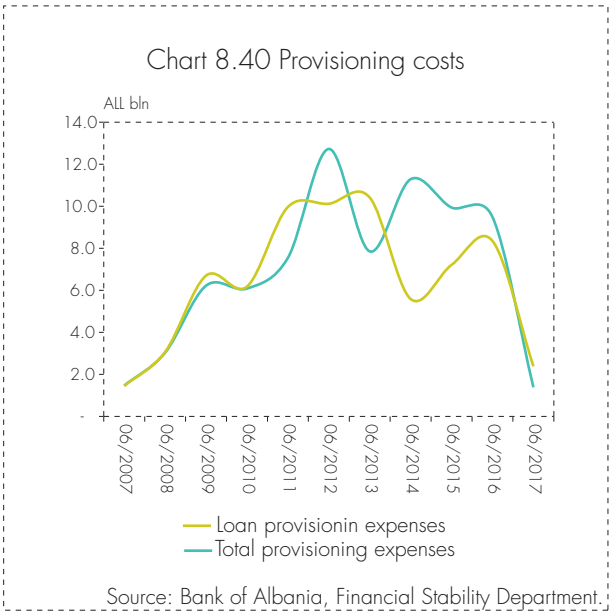
Chart 8.38 RoA by banks' share in the assets of the sector



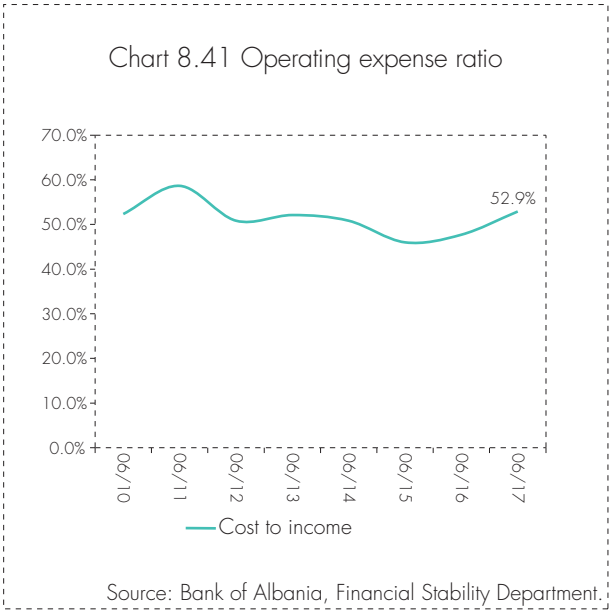
Source: Bank of Albania, Financial Stability Department.

(96) The continuous lowering of financing costs did not sufficiently offset the fall of income from the main banking activity. Thus, net interests result fell by around ALL 1.1 billion, at ALL 22.4 billion, since the decrease in income from interests resulted higher than the decrease of expenses for interests. As a result, the net interest margin also declined to 3.9%, from 4.2% in the previous year.





(97) Provisioning costs recorded ALL 1.4 billion, or ALL 8.1 billion lower than a year earlier, representing the main factor driving to the growth of the after the sector's financial result. Loan provisioning costs fell by ALL 6 billion. For individual banks, given that the net result from the banking activity has not shown significant changes or recorded a decline, the decrease in provisioning costs provided the main impact in the increase of the financial result. The share of banking banks' assets in the banking sector's assets of that recorded a financial loss fell considerably to 2%; practically only 3 small banks reported financial losses, with very low values.



(98) The financial result from other activities fell by about ALL 1.7 billion, as a result of the decline in income from transactions with securities and foreign currencies. At the same time, the activity costs, even though slightly up, were covered adequately by the activity income, thus providing a positive impact on gross operational income (before provisioning). The operating expense ratio was 52.9% and shows a low volatility in recent years.

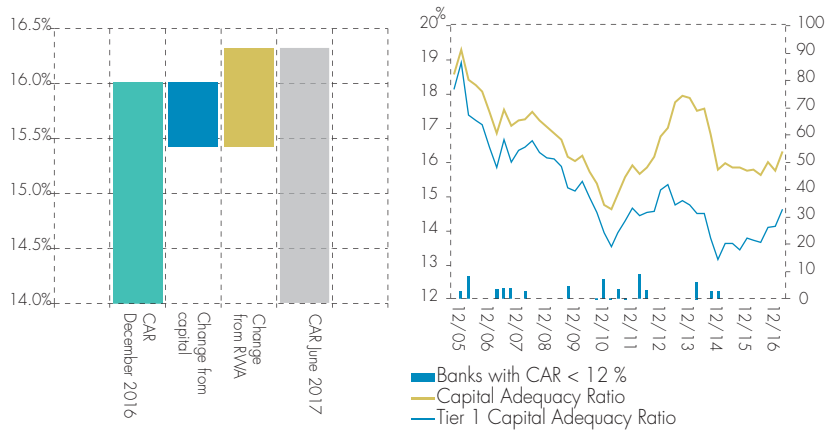
8.7 ACTIVITY CAPITALISATION

(99) The banking sector's capitalization in June 2017 was estimated to be satisfactory, and its performance was determined by the sharp contraction of capital requirements for investments in non-resident entities. Regulatory capital marked a decline despite the capital injection and a positive financial

result, affected by the reduction of subordinated debt and other capital items. On the other hand, the faster contraction of risk-weighted assets due to the decline of risk-bearing assets for investments in non-resident entities has contributed to the maintenance of a high level of capital adequacy ratio. This level is significantly above the minimum regulatory rate allowed for individual banks and the banking sector as a whole.

(100) In June 2017, the capital adequacy ratio stood at 16.3%, from 16.0% as at end- 2016, and 15.8% a year earlier. In 2017 H1, risk-weighted assets were 5.3% lower compared with December 2016, contributing to the increase in the capital adequacy ratio by 0.9 pp. On the other hand, due to the reduction of subordinated debt and other capital items (revaluation differences), regulatory capital fell by 3.5%, contributing to the decline of the capital adequacy ratio by 0.6 percentage points.

Chart 8.42 Capital adequacy ratio

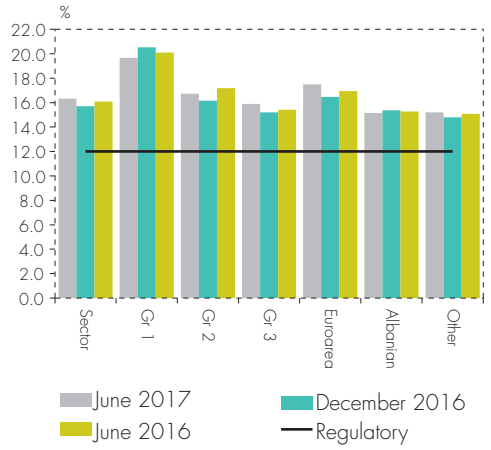


Source: Bank of Albania, Financial Stability Department.

(101) At peer group level, G3 banks have the lowest average capitalisation rate, whilst by capital origin, appears banks classified as "Other"[55] and banks with Albanian capital. For the most part, individual banks maintained capital adequacy ratios in the range of 14% - 18%. However, in the first six months of the year, the adequacy ratio of three banks of the banking sector ranged 18% - 20%.

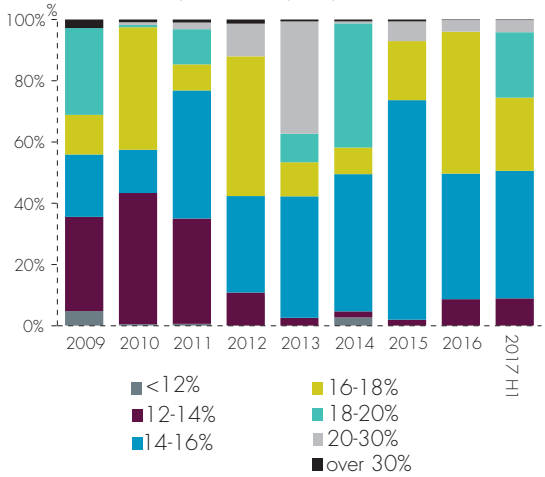
[55] *This group includes banks of Turkish, Arabian, Kuwaiti and Malaysian capital.*

Chart 8.43 Capital adequacy ratio by group, size and origin of capital



Source: Bank of Albania, Financial Stability Department.

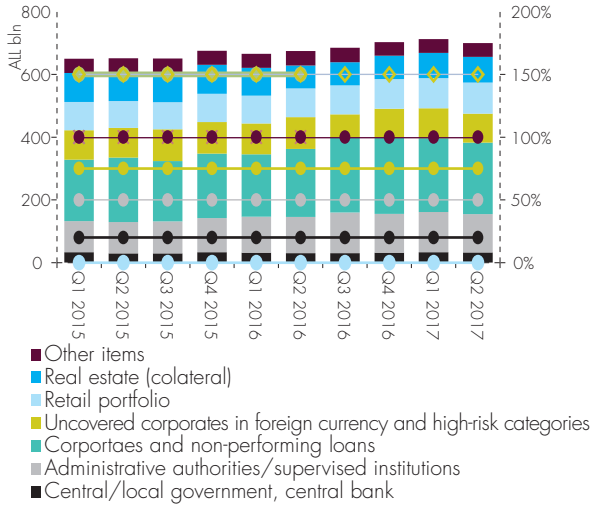
Chart 8.44 Asset allocation of banking sector, by Capital Adequacy Ratio



Source: Bank of Albania, Financial Stability Department.

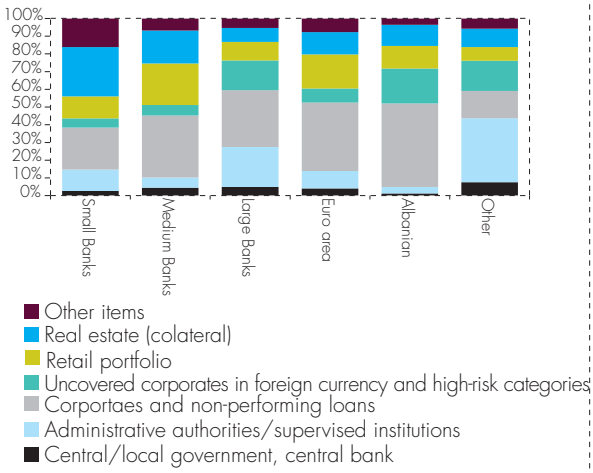
(102) The Banking sector shows a decreasing exposure in terms of credit risk classes. Assets weighted for credit risk reduced by around ALL 1.9 billion, compared to the end of 2016, down to ALL 700 billion. Credit categories that decreased are related to exposures to corporates and non-performing loans which have a 100% risk coefficient (Chart 8.45). By peer bank groups, small banks represent a high exposure to credit collateralised in the form of real estate; medium-sized banks have a higher exposure to credit to corporations and non-performing loans; meanwhile, large banks, besides these categories, remain exposed to lending to managing bodies and supervised institutions. By capital origin, it is noted that banks with Albanian capital have a higher exposure to the class "Credit to corporations and Non-performing loans" (Chart 8.46).

Chart 8.45 Risk-weighted coefficients and size of main credit portfolio classes



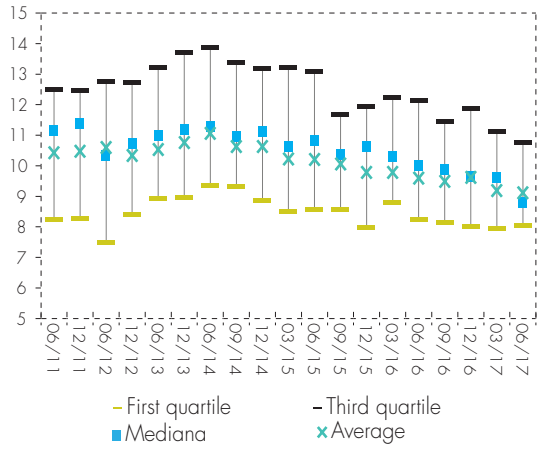
Source: Bank of Albania, Financial Stability Department.

Chart 8.46 Classes of credit exposures for banks by business size and capital origin for June 2017



Source: Bank of Albania, Financial Stability Department.

Chart 8.47 Financial leverage ratio, through the years



Source: Bank of Albania, Financial Stability Department.

(103) Capital requirements for market risk decreased, while those for operational risk remained unchanged during 2017 H1. During the period, capital requirements for market risk registered ALL 14.5 billion, down by ALL 0.6 billion or 4.1%. Capital requirements for operational risk remained unchanged. The latter account for approximately 10.1% of total risk-weighted assets, while capital requirements for market risk account only 1.7%.

(104) The Albanian banking sector is characterized by a low financial leverage ratio, which confirms the maintenance of a good level of capitalization. As of end-June 2017[56], the financial leverage ratio was 10.1, from 10.4 a year earlier. The financial leverage at individual banks level does not show any significant shift.

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