

BANK OF ALBANIA
ANNUAL
REPORT
2014

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Bank of Albania,

Sheshi "Skënderbej", nr. 1, Tiranë, Shqipëri

Tel.: + 355 4 2419301/2/3; + 355 4 2419409/10/11

Faks: + 355 4 2419408

E-mail: public@bankofalbania.org

www.bankofalbania.org

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GOVERNOR OF THE BANK OF ALBANIA, MR. GENT SEJKO.



SUPERVISORY COUNCIL OF THE BANK OF ALBANIA (from left to right)

*Ms. Denada Prifti, Member
Ms. Ermelinda Meksi, Member
Mr. Petraq Milo, Member
Ms. Elisabeta Gjoni, Deputy Chairwoman
Mr. Gent Sejko, Chairman
Ms. Natasha Ahmetaj, Member
Mr. Dhor Kule, Member
Ms. Ela Golemi, Member
Mr. Tonin Kola, Member*





MISSION AND MAIN TASKS OF THE BANK OF ALBANIA

- According to the Law "On the Bank of Albania", the main objective of the Bank of Albania is to achieve and maintain price stability. By achieving this objective, the Bank of Albania contributes to establishing the right conditions for economic growth, improved employment and welfare, as well as preserves the values of savings, and contributes to the stability and development of the financial system. The objective is achieved through the independent formulation and implementation of the monetary policy. A number of other supporting functions of the Bank of Albania help achieve this objective.
- The Bank of Albania is responsible for licensing, regulating and supervising banking activities. Based on market principles, it aims at promoting the normal, effective and sustainable functioning of the banking system. The Bank of Albania is committed and provides direct contribution to safeguarding Albania's financial stability through its macroprudential policy; prudential regulation and supervision of the banking sector and non-bank financial institutions; its role as lender of last resort and authority responsible for handling and liquidating troubled banks; and regulation and oversight of payments infrastructure.
- The Bank of Albania has the exclusive right for the issue and circulation of the national currency – the Albanian lek. With a view to accomplishing its legal responsibility, it promotes the smooth operation of payment systems, to support monetary policy implementation and safeguard financial stability and public confidence in the national currency.
- The Bank of Albania has the right to hold and manage the foreign exchange reserves of the Republic of Albania. Foreign exchange reserves serve the country as a guarantee to withstand unexpected shocks on the real or financial sector of the economy. The management of foreign exchange reserves is guided by the principle of prudence and safeguarding the value.
- The Bank of Albania has the right to compile the Balance of Payments for Albania, and organises and manages the statistics system of this Balance. It cooperates with other national statistics agencies to coordinate statistical activities and compile and adjust statistical methodologies.

The Bank of Albania is also tasked with a number of other duties and institutional commitments, such as: supporting Albania's integration process; financial literacy; enhancing cooperation with international counterpart institutions; broadening the knowledge and actively participating in academic debates.





FOREWORD BY THE GOVERNOR

In the framework of the compliance with its legal obligations, the Bank of Albania continued to contribute to promoting the country's economic and financial stability in 2014. Through its monetary policy and operational instruments for its implementation, the Bank of Albania continues to provide an economic environment with stable prices. By implementing ongoing supervision and regulation of the banking system, and exercising its unique role in the area of currency issue and development of the payments system, it has supported the country's financial stability and has promoted the development and enhancement of financial markets efficiency. The accomplishment of these objectives by the Bank of Albania is an important precondition for the country's sustainable and long-term development. In parallel, during 2014, the Bank of Albania continued to support the country's European integration process, the further institutional development, and the improvement of statistics, research and communication. These topics are elaborated in more detail in Bank of Albania's Annual Report 2014.

In this brief foreword, I would like to introduce the main messages of this Report.

Bank of Albania's primary objective is to achieve and maintain price stability.

The Albanian economy has faced a challenging external environment, amid supply shocks which damaged production in specific sectors of the economy and the impossibility to use the fiscal stimulus. Economic growth, however, improved during 2014 thanks to the growth in domestic demand and private sector activity. Nonetheless, inflationary pressures remained low, reflecting the cyclical weakness and downward imported inflation. In 2014, the average inflation rate was 1.6%. In an environment with weak inflationary pressures, the stimulating stance of the monetary policy was further strengthened. The key interest rate was lowered from 3% at year start, to 2.25% at year end. To transmit the monetary stimulus, the Bank of Albania used the common framework of liquidity injection instruments and the forward guidance.

The increase in the monetary stimulus by the Bank of Albania helped cut financing costs and expanding lending in lek, supporting thus the expansion of demand and acceleration of economic growth. These developments created the premises for the return of inflation to target in the future.

In parallel with its main objective, the Bank of Albania exercises its legal obligations for supervising and regulating the banking system and safeguarding the financial stability.

Our analyses and stress-test exercises show that the financial system is - overall - stable. The banking system registered improved profitability, ample liquidity and well-capitalised levels.

Year 2014 saw significant changes in the banking supervision regulatory framework. These changes reflect the fulfilment of Financial Sector Assessment Program recommendations and compliance with international principles for effective supervision.

To address lending-related issues, the Bank of Albania has undertaken a series of regulatory changes and initiated, in cooperation with the Ministry of Finance and Ministry of Justice some legal and sublegal improvements on collateral execution and fiscal treatment of loss loans in banks' balance sheets. Moreover, in cooperation with international financial institutions, the Bank of Albania has undertaken a programme which aims at supporting the loan restructuring process. These measures have helped decelerate non-performing loans and have supported credit growth.

In addition to these objectives, during 2014, the Bank of Albania has developed other legal duties and has complied with its institutional commitments. In particular, technical capacities improved further thanks to the ongoing research work and exchange of information in the framework of assistance with national and international partners.

The Bank of Albania was part of an assessment and cooperation project implemented by the European Central Bank, which assessed institutional capacities of the Bank of Albania and its framework of policies, organisation and management, for the gradual approximation with European Central Bank standards. The project assessed that the Bank of Albania is a transparent and focused institution with good technical capacities. Following, the recommendations of the project will serve to guide the future institutional development of the Bank of Albania, as preparations for membership in the European System of Central Banks.

Lastly, I would like to mention an extraordinary event that happened in 2014, which affected the institution's activity throughout the second half of the year. In July, the Bank of Albania was informed on the appropriation of a considerable amount of monetary values from its premises, by the employees responsible for safeguarding and processing those values. The Bank of Albania conducted a full transparency process on the event and, conform to the legal requirements, supported the actions by justice bodies. Furthermore, the Bank of Albania took the measures for preserving the financial markets calmness and for the normal functioning of the banking system. Staying on the same subject, I would like to reassure the public that the Bank of Albania is undertaking all the necessary regulatory and operational changes to prevent such events from happening again.

Dear reader,

I believe that reading this Report will help you create a comprehensive understanding on the work and achievements of the Bank of Albania in 2014. For the future, I am confident that the development platform, results of our work, dedication and commitment of the professional staff of the Bank will reinstate and boost the confidence of the public in this institution.

Gent Sejko

Governor





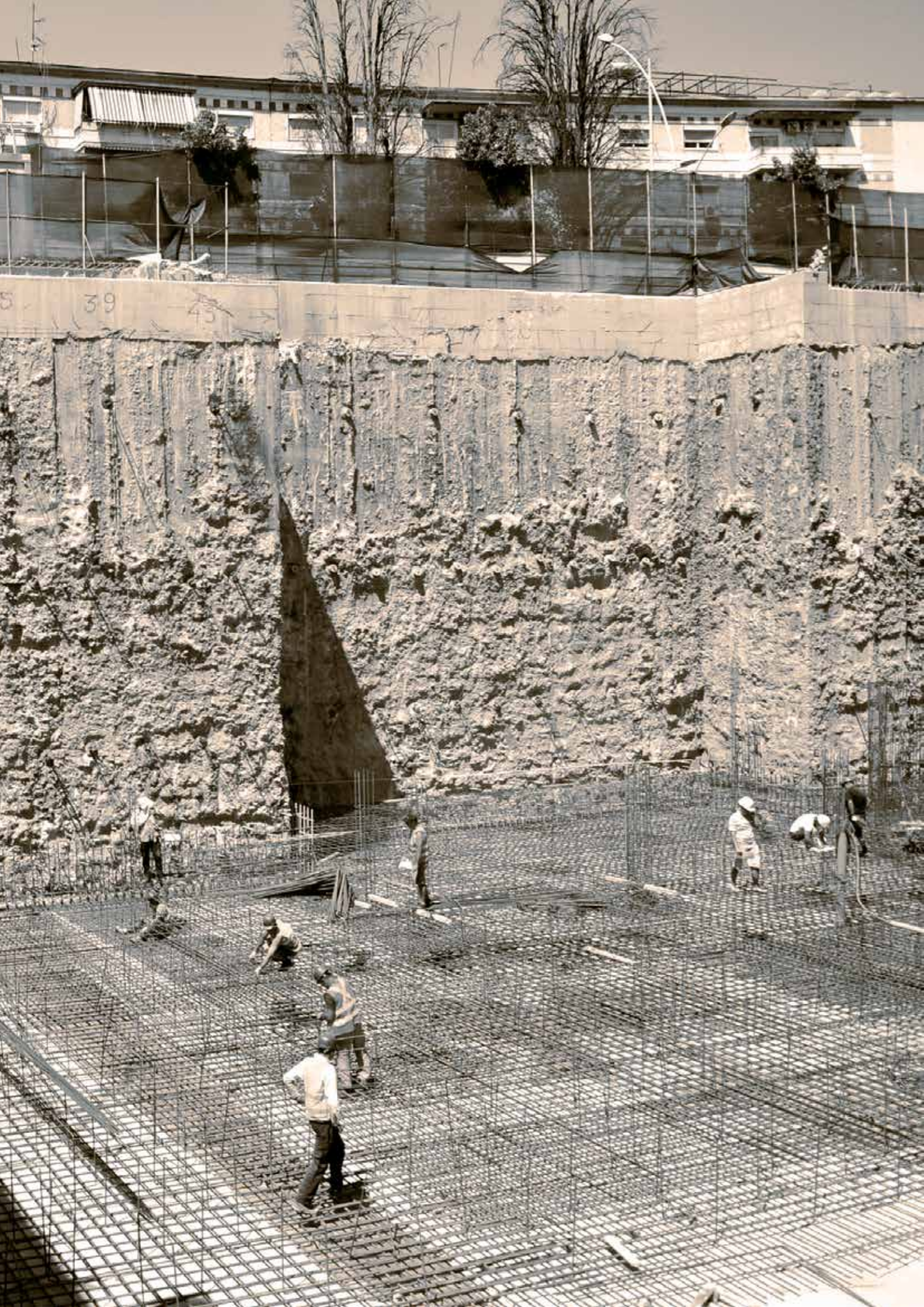
HIGHLIGHTS OF 2014

- Gross Domestic Product growth is assessed at 1.4% for the first nine months, improving from the previous year. The performance of investments and private consumption improved driven by the increase of confidence in the economy and better lending standards. On the other hand, the external economic environment remained unfavourable.
- The annual inflation rate averaged 1.6% for 2014, remaining below the 3.0% target of the Bank of Albania. In the presence of low demand-side inflationary pressures, the fall in inflation in global markets led to lower inflation at home, compared to the previous year.
- Amid an economic environment with low inflation rates and below-potential economic growth, the Bank of Albania continued to implement an accommodative monetary policy. The Supervisory Council lowered the key interest rate in February, May and November. At the end of 2014, the key interest rate settled at 2.25%.
- Fiscal policy was consolidating during 2014. The high level of public debt does not allow for pursuing a stimulating fiscal policy.
- The performance of the banking sector is assessed as stable. The financial result improved, and capitalisation and liquidity indicators were stable. The banking sector remains relatively hedged against the direct market risk, but is exposed to the credit risk.
- The regulatory framework on banking supervision was further improved, aimed at alignment with Basel Committee principles for effective supervision and fulfilment of recommendations from the Financial Sector Assessment Program.
- During the year, the regulatory framework of the payment systems was revised and the existing technical infrastructure of the payment systems was updated. The regulatory amendments aim approximation to the European practices and international principles for the oversight of financial market infrastructures.
- With the support of the World Bank, in May, the project for the implementation of the Portfolio Management System was finalised. Its implementation helps create more adequate working conditions for a better control of risks faced during the foreign currency reserve management process.
- In June, Albania was granted the status of the candidate country for membership in the European Union. This event is expected to further reduce the risk premiums and will serve as an anchor of confidence for foreign investors.
- On 28 February 2014, the Executive Board of the IMF approved the three-year arrangement for SDR 295.42 million (about EUR 330.9 million) under the Extended-Fund Facility program for Albania.

The arrangement will provide support for the medium-term fiscal consolidation, mitigation of risks related to the high public debt level, and adjustment of the economy in the short-term period.

- During April-September, a European Central Bank-coordinated project for the Needs Analysis for Bank of Albania was implemented. The report finds the Bank of Albania as a transparent and focused institution with good technical capacities. The proposed recommendations serve as guidelines for the Bank of Albania for approximation to European standards and principles.
- In July, the Bank of Albania was informed on the appropriation of a considerable amount of monetary values from its premises, from the employees in charge of those values. The Bank of Albania made a full transparency on the event and, in accordance with the legal requirements, supported procedural actions of the relevant justice bodies, and took the measures to administer the situation. These measures ensured a normal functioning of the financial markets.





ORGANISATIONAL STRUCTURE OF THE BANK OF ALBANIA

| SUPERVISORY COUNCIL | | | | | | | | | | | | | |
|---------------------|--------------|-----------------------|---------------------|---------|---------------------------------------|------------------------|-------|----------------------------------|----------------|----------|-----------------|---------------------------|-------|
| Governor | | | | | | | | | | | | Inspector General | |
| Governor's Office | SC Secretary | First Deputy Governor | | | | Second Deputy Governor | | | | Research | Human resources | | Legal |
| | | Monetary policy | Monetary operations | IT | Payment systems, accounting & finance | Supervision | Issue | Financial stability & statistics | Administration | | | Security & protection | |
| | | | | | | | | | | | | Internal Audit Department | |
| Branches | | | | | | | | | | | | | |
| Shkodra | | Elbasan | | Lushnja | | Korça | | Gjirokastra | | | | | |



I. ACTIVITY OF THE SUPERVISORY COUNCIL OF THE BANK OF ALBANIA

The decision-making process at the Bank of Albania is guided by the principles of independence and transparency.

The activity of the Supervisory Council for 2014 was conducted in line with the competences set out in the Law on the Bank of Albania and procedures established in the regulation for the organisation and functioning of this body.

The Council held 16 regular meetings. In 12 of them, the monetary policy reports were reviewed and approved and the respective monetary policy decisions were also made.

During 2014, some 80 decisions were made, of which 56 for acts approved for the first time and 24 for amendments to existing acts. The improvement of governance has been at the focus of the activity of the Supervisory Council. To this end, seven internal regulations on the organisation and functioning of departments were approved.

To fulfil its duties, the Council has constantly analysed periodic information on the implementation of the institution's management policies, including the manner and procedures for using financial means for the realisation of the operational activity of the institution. The reports on the financial position and result have been scrutinised monthly, whereas the reports on the realisation of investments and their future quarterly. The Council reviewed the monthly Investment Committee reports on the performance of the foreign currency reserve, investment and return on investment. In December 2014, the Supervisory Council, after considering the responsibility with which the departments revised down their budgets, approved the budget of the Bank of Albania for 2015.

The Council has been regularly informed, through the quarterly reports of the Inspector General, on findings and recommendations from audits by the Audit Department, on the effectiveness and quality of internal control systems, risk management and Bank of Albania management. During 2014, to enhance the efficiency of the external audit, the Council changed the procedure for its selection. The new procedure was applied for selecting the external audit for the period 2014-2018.

In July 2014, the Supervisory Council established the Audit Committee, in accordance with the recommendations from the International Monetary Fund. The Committee is composed of five Supervisory Council members who do not

have executive functions at the Bank of Albania. The Committee will assist the Supervisory Council in exercising better its responsibilities related to the financial management of the institution, the internal audit system and compliance with the law, by-laws, and code of conduct at the Bank of Albania. The Council was also informed on the findings and recommendations of the Supreme State Audit report for 2013 and the measures taken by the relevant Departments to address them.

For the purposes of fulfilling its legal obligations on accountability and transparency, the Council approved the annual report of the Bank of Albania, which covered the operations of the institution for 2013 and the financial statements as audited by the external auditor.

Moreover, the Council approved 4 quarterly monetary policy reports and 2 half-yearly financial stability reports, which were submitted to the Parliament, Council of Ministers and other central institutions.

A significant part in the activity of the Supervisory Council of the Bank of Albania consisted in addressing responsibly the event at the Issue Department. After the finding of the appropriation of monetary values by two former employees of the Bank of Albania, the Council met intensively in extraordinary sessions to decide on measures that needed to be taken and monitor their implementation, including the activity of the administrators and personnel to normalise the situation.

Since September, after the dismissal of Mr. Ardian Fullani and resignation of Mr. Ardian Civici, the Supervisory Council operated with five members. In December 2014, the Assembly appointed three new members of the Supervisory Council of the Bank of Albania: Ms. Natasha Ahmetaj, Mr. Tonin Kola and Mr. Gent Sejko. As at the end of the year, the Supervisory Council composition consisted in eight members of total nine members as stipulated in the law "On the Bank of Albania"



II. BANK OF ALBANIA DURING 2014

II. 1 MACROECONOMIC ENVIRONMENT AND MONETARY POLICY

- *Economic activity and financial and economic stability indicators improved in 2014. INSTAT data for the first three quarters and Bank of Albania's estimates for the fourth quarter show that economic growth was higher than in the previous year, driven mainly by the recovery of domestic demand. However, the Albanian economy continued to operate below capacity and faced an unfavourable external environment. The cyclical weakness and the downtrend of imported inflation have created an environment with weak pressures on the rise of consumer prices. The rate of inflation and inflation expectations remained low, below Bank of Albania's 3.0% target. In response to these developments, the monetary policy emphasised its accommodative stance. The Bank of Albania lowered the key interest rate three times, signalled the markets on maintaining the accommodative monetary policy trend and continued to inject liquidity. The monetary policy contributed to creating a liquid economic environment with low interest rates, providing thus adequate monetary conditions to boost demand and keep inflation close to Bank of Albania's 3.0% target.*

II.1.1. INTERNATIONAL DEVELOPMENTS

The global economy recorded positive growth rates in 2014, albeit below the initial projections and economic agents' expectations. Economic growth picked up in the US and continued to record modest growth rates in the euro area. In emerging countries, the economy performed unevenly and, in many of them, shrank. The main central banks continued to implement an accommodative monetary policy, contributing to the improvement of liquidity in financial markets and supporting economic growth. On the other hand, oil prices, food prices and energy products prices have been downward, subsequently transmitted to low inflation rates globally. Lastly, world trade decelerated during this year and remained below the levels recorded in 2013. Despite positive developments, the global markets and economy remain surrounded by uncertainties related to both geopolitical tensions in certain regions and persisting effects of the crisis.

The first half of the year was characterised by stable economic growth in developed countries, but the growth rate of these economies lost vigour in the third quarter. Leading indicators of advanced economies, GDP dynamics and those of businesses and households' confidence were positive in the last quarter, supporting the judgement for a stronger economic growth in this period. The decelerating effects of consolidating fiscal policies in many

developed countries diminished. The unemployment rate in the euro area was down for the first time since 2008; however, it remains high and appears concentrated among the youth.

The economic situation in the main trading partners has been slightly improving. The Italian economy entered in recession in the second quarter, but the annual contraction for 2014 is expected to be lower than in the previous year. The economy of Greece left recession in the second quarter and is expected to shift into positive territory for 2014. Inflationary pressures have been low in these two countries, recording even negative rates during the year.

The downtrend of risk premiums in the financial markets continued in this year, reflecting the accommodative monetary policy and the results achieved with regard to fiscal consolidation. The interest rates fell in the euro area and the assessment of investors for the economies in South East Europe was more positive. However, these developments were not translated into evident investment inflows, illustrating again the low appetite of financial markets for investments and the still-fragile situation of recovery.

Table 1 Selected macroeconomic indicators

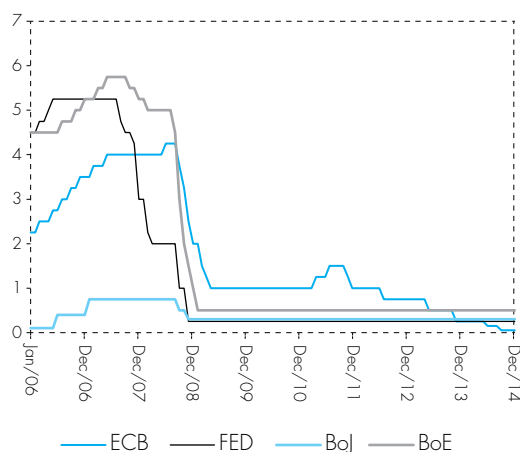
| Countries | GDP change | | Unemployment rate (average) | | Inflation rate (average) | |
|----------------|------------|-------------------|-----------------------------|-------------------|--------------------------|------|
| | 2013 | 2014 ² | 2013 | 2014 | 2013 | 2014 |
| USA | 2.2 | 2.4 | 7.4 | 6.2 | 1.5 | 0.8 |
| Euro area | -0.4 | 0.9 | 12 | 11.6 | 1.3 | 0.4 |
| Germany | 0.1 | 1.5 | 5.2 | 5.0 | 1.6 | 0.8 |
| France | 0.2 | 0.4 | 10.3 | 10.2 | 1.0 | 0.6 |
| Italy | -1.9 | -0.4 | 12.2 | 12.8 | 1.3 | 0.2 |
| Greece | -3.9 | 0.9 | 27.5 | 26.7 ² | -0.9 | -1.4 |
| United Kingdom | 1.7 | 1.9 | 7.6 ¹ | 6.3 ² | 2.6 | 1.5 |

Source: Eurostat, respective statistical institutes.

¹ According to major economic institutes' projections and preliminary estimates.

² Preliminary estimates.

Chart 1 Key interest rates



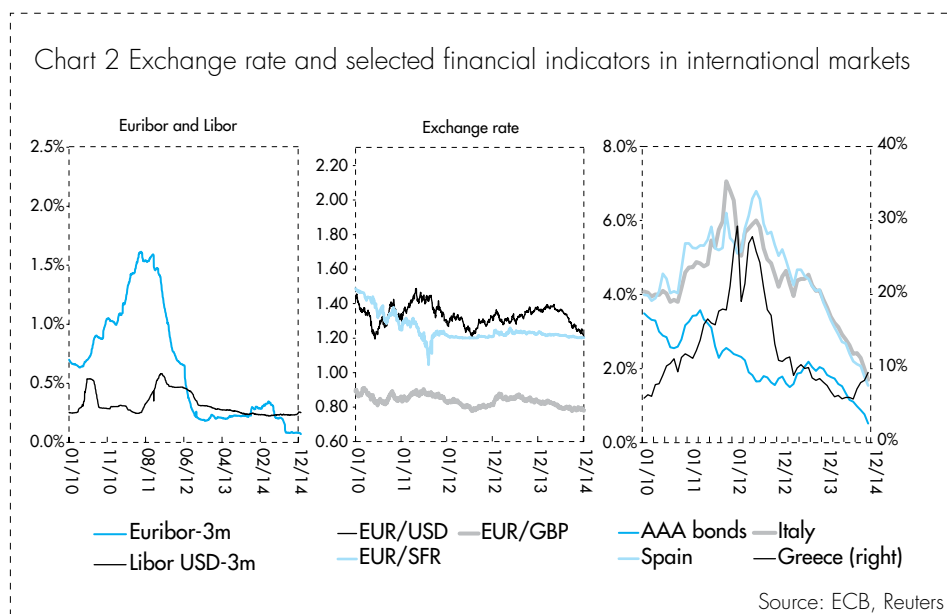
Source: ECB, Fed, Bank of England, Bank of Japan.

Monetary Policy and Financial Markets

The major central banks kept their key interest rates unchanged during 2014. The European Central Bank, however, lowered the key interest rate twice, by 0.25 percentage points, to 0.05%. In other central banks, the key interest rates stand as follows: Federal Reserve at 0.25%, Bank of England at 0.5%, and Bank of Japan at 0.1%.

The lowering of the interest rate by the ECB and the implementation of special liquidity-injection programmes and quantitative easing by the Federal Reserve have contributed to lowering uncertainties and interest rates in financial markets. Except for Greece, debt securities' spreads narrowed and risk

premiums fell in euro area countries. However, the lowering of ask premiums in capital markets was not followed by overall lowering of interest rates on lending. These rates varied depending on the business size, favouring larger firms and entities. For smaller businesses and households the rate lowering was either insignificant or absent. In assessment terms, the approach of foreign investors towards CESEE countries has been more positive, recording lower yields and ask insurance premiums, though investment inflows remain below historic levels.



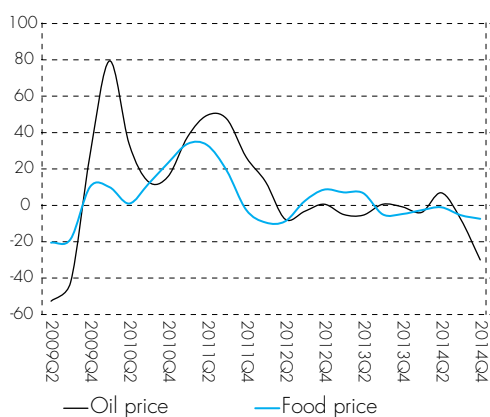
The 1, 3, 6 and 12-month Euribor rates averaged 0.13%, 0.21%, 0.31% and 0.48%, respectively, in 2014, down 0.03 percentage points on average from the previous year. The 3-month US dollar Libor interest rate fell to 0.23% from 0.27% in the previous year.

In the foreign exchange market, the euro depreciated slightly in average terms against the British pound and Swiss franc, and appreciated against the Japanese yen and Chinese renminbi. In bilateral terms, the average value of the euro for 2014 (USD 1.328) was the same as in 2013; however, in recent months, the euro fell below USD 1.200, depreciating 10% compared to the same period in the previous year, reflecting the effects of the accommodative policy of the ECB and the market's conviction for quantitative easing beginning in the near future (verified later in January 2015).

International Prices

Commodity prices in the global markets fell significantly in 2014. The European Brent Crude Oil Index dropped 8.8% in annual terms, declining even faster in the last quarter. The average price per barrel was significantly volatile, ranging USD 112-62, reaching the lowest level in the last five years in December. These developments were mainly dictated by the increase of clay oil production in the US, ample supply by OPEC countries and contained global demand for oil.

Chart 3 Global oil and food prices
(annual change of indices)



Source: EIA and IMF

Mostly affected by the dynamics in the oil market, the IMF index for commodity prices pursued a downward trajectory. In line with the appreciation of the US dollar in foreign exchange markets, the ample supply and absence of demand-side pressures, food prices contracted by 4.1% compared to 2013.

II.1.2. ECONOMIC DEVELOPMENTS IN ALBANIA

The economic activity in Albania improved in 2014. According to INSTAT data, the gross value added was up 1.4% during the first three quarters of the year and indirect indicators suggest that it accelerated in the fourth quarter. Overall, economic

and financial stability indicators were improved, although the Albanian economy continues to operate below its capacity and to face an unfavourable external environment. From the macroeconomic aspect, inflation and inflation expectations remained low. In the area of public finance, year 2014 was characterised by a consolidating fiscal policy. Fiscal revenues were up and, excluding the payment of government arrears, budget deficit was reduced. In the area of economic and financial relations with abroad, year 2014 did not see a change from previous trajectories. The current account deficit increased, but the balance of payments was positive and the exchange rate appeared stable. From the financial aspect, the Albanian economy and financial system saw progress in 2014, with regard to improvement of liquidity indicators, profitability and asset quality. However, the banking sector intermediation remains low and its balance sheets continue to suffer from non-performing loans.

Bank of Albania estimates suggest that economic growth in 2014 will be higher than in the previous year. This growth was mostly driven by the increase in private consumption and investments, as a result of the improved businesses and consumers' confidence, private sector's balance sheets, and lending standards. The consolidating fiscal policy resulted in the reduction of the fiscal stimulus, while foreign demand did not contribute to economic growth. Economic difficulties in Albania's trading partners did not favour growth of demand for Albanian goods and services; in the presence of certain supply-side shocks, they were reflected in low increase of Albanian exports.

Albeit upward, aggregate demand was insufficient to fully utilise production capacities of the economy. The cyclical weakness of demand has created an economic environment with weak pressures on the rise of wages, labour costs, profit margins and consumer price inflation. In addition, imported inflation was downward and added disinflationary pressures in the economy. Consumer price inflation averaged 1.6% in 2014, remaining below Bank of Albania's target.

Table 2 Selected economic figures over the years

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|--|-----------|-----------|-----------|-----------|-----------|-----------|-------|
| Inflation (y-o-y, average for the period) | | | | | | | |
| Headline inflation (in %) | 3.36 | 2.28 | 3.56 | 3.45 | 2.04 | 1.94 | 1.63 |
| Economic growth | | | | | | | |
| Real GDP growth, in % ¹ | 7.5 | 3.70 | 3.75 | 3.17 | 1.00 | 1.45 | 1.45 |
| GDP (at current prices, in ALL million) | 1,080,676 | 1,143,936 | 1,239,645 | 1,300,624 | 1,335,488 | 1,364,781 | |
| Labour Market | | | | | | | |
| Number of employed (in thousand) | 974.1 | 909.8 | 895.7 | 948.0 | 962.4 | 926.6 | 947.0 |
| Unemployment rate ² | 12.7 | 13.6 | 13.8 | 13.1 | 12.8 | 13.4 | 12.9 |
| Unemployment rate according to the survey ³ | 13.2 | 13.8 | 14.2 | 14.3 | 13.9 | 16.10 | 17.40 |
| Fiscal sector | | | | | | | |
| Budget balance (including grants, as a percentage of GDP) | -5.6 | -7.1 | -3.1 | -3.5 | -3.4 | -4.9 | -5.1 |
| Budget revenues (as a percentage of GDP) | 26.9 | 26.1 | 26.2 | 25.4 | 24.7 | 24 | 25.9 |
| Budget expenditure (as a percentage of GDP) | 32.5 | 33.2 | 29.3 | 28.9 | 28.2 | 28.9 | 31 |
| External sector | | | | | | | |
| Current account (as a percentage of GDP) | -15.7 | -15.4 | -11.3 | -13.2 | -10.2 | -10.6 | -12.1 |
| Imports of goods (fob, as a percentage of GDP) | 38 | 35.3 | 36.2 | 39.4 | 36.7 | 35.7 | 36.6 |
| Exports of goods (fob, as a percentage of GDP) | 10.4 | 8.7 | 13 | 15.2 | 15.9 | 18.2 | 18.6 |
| FDI inflows (as a percentage of GDP) | 7.6 | 8.3 | 8.8 | 6.8 | 6.9 | 9.7 | 8.3 |
| International reserve (in EUR million, end of period) | 1.675 | 1.646 | 1.904 | 1.912 | 1.972 | 2.015 | 2.192 |
| Monetary and financial sector | | | | | | | |
| Repo rate (end of period) | 6.25 | 5.25 | 5 | 4.75 | 4 | 3 | 2.25 |
| M3 aggregate (annual growth, end of period) | 7.7 | 6.8 | 12.5 | 9.2 | 5 | 2.3 | 4 |
| Lending to the private sector (annual growth, end of period) | 32.1 | 10.3 | 10.1 | 10.4 | 1.4 | -1.4 | 2.0 |
| 12-month yield (annual average) | 8.16 | 9.17 | 7.98 | 7.34 | 7.03 | 5.16 | 3.41 |
| ALL/USD average exchange rate | 83.9 | 95 | 103.9 | 100.8 | 108.2 | 105.7 | 105.5 |
| ALL/EUR average exchange rate | 122.8 | 132.1 | 137.8 | 140.3 | 139 | 140.3 | 140.0 |
| NEER | 99.7 | 107.1 | 113.4 | 113.8 | 113.3 | 113.7 | 112.2 |

Source: INSTAT, Ministry of Finance, IMF estimates and Bank of Albania.

¹ For 2012, data are semi-final and for 2013 data are preliminary. For 2014, the figure refers to the annual growth for nine months. Labour market and external sector data are as at end of third quarter.

² According to administrative INSTAT data.

³ Labour Force Survey Results, published by INSTAT.

* GDP ratios are based on annual projections.

In response to low inflationary pressures and the cyclical weakness of the economy, the Bank of Albania strengthened further the stimulating nature of its monetary policy. The Bank of Albania lowered the key interest rate three times, supplied the banking system with the necessary liquidity and signalled the markets on maintaining the accommodative monetary policy stance in the future. The monetary stimulus in the economy was strengthened in parallel with a consolidating fiscal policy. Conditioned by the high level of public debt, the space for pursuing a stimulating fiscal policy is limited. However, the fiscal adjustment has contributed to reducing risk premiums and expanding the spaces for private sector financing. Also, the payment of government arrears has helped improve private sector's balance sheets.

The monetary policy and liquidity management operations contributed to creating a liquid economic environment with low interest rates, responding on time to risks to price stability and ensuring the right monetary conditions to boost demand. In response, the cost of lending to the private and public sector fell to their historic minimum levels and lending in lek expanded, thus supporting domestic demand better. The increasing use of bank credit and its downward costs helped stimulate domestic demand and were reflected in the downward trend of core inflation during the year.

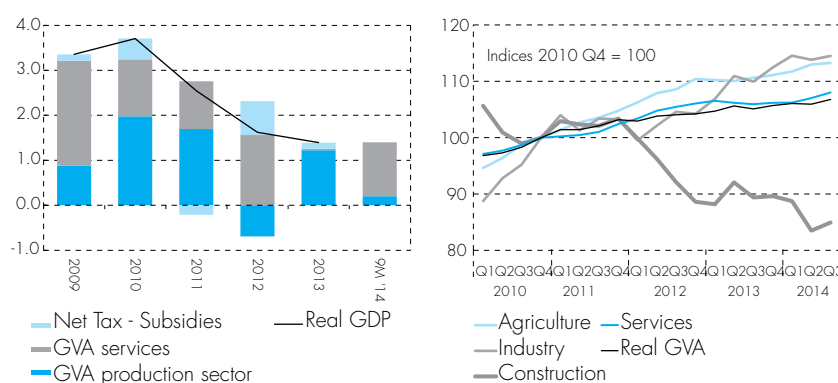
Beyond driving domestic demand, the transmission of the monetary stimuli in the economy contributed positively to financial soundness indicators. The deceleration of the increase in non-performing loans, improvement of liquidity in the system, preservation of sound balance sheets in the financial sector and stability of the exchange rate have all contributed to the country's financial stability.

II.1.3. ECONOMIC ACTIVITY AND ECONOMIC GROWTH

Year 2014 was characterised by a gradual recovery of economic activity.

Economic activity in Albania improved during 2014.¹ According to INSTAT data, the gross value added² increased 1.4% during the first nine months of the year and indirect available data suggest a faster growth in the fourth quarter. Economic growth was driven by higher consumption and private investments and was reflected mostly in the expansion of activity in the services sector. Economic activity expanded unevenly³ during the year, reflecting the

Chart 4 Annual real GDP (in %) and contribution of production-side components (in p.p.) Real GVA trend in the economy and sectors*



* Indices of the real GVA for the economy and its sectors reflect the trend of the relevant value added, calculated as the moving sum of quarterly values for four quarters, based on 2010 Q4.

Source: INSTAT and Bank of Albania.

¹ The analysis of economic activity by sector is covered with direct statistical data only for the first three quarters of 2014.

² In the absence of data for the GDP, the performance of the economy for 2014 is analysed only in terms of the real value added, quarterly.

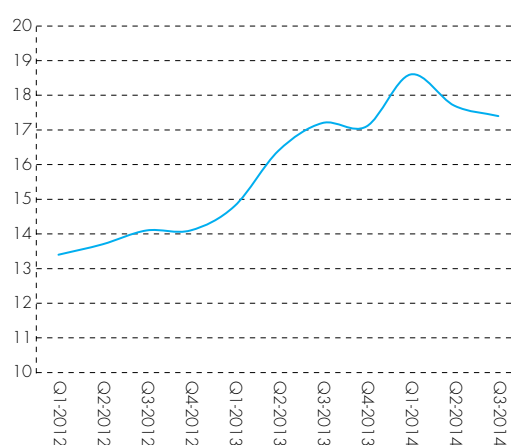
³ Annual growth rates of the value added were 1.4%, -0.4% and 3.3%, respectively, in the first, second and third quarters.

comparative base effect, temporary supply-side shocks, and volatility of fiscal indicators throughout the quarters.

In contrast to the previous year, the performance of the economy was driven by the services sector⁴, whereas the production sector contributed less to growth. The activity of the services sector showed a tendency of improvement during the year, contributing 1.2 percentage points to the growth of value added during the first nine months. Among the services branches, 'Other services'⁵ and 'Trade, hotels and restaurants' contributed most. The production sector contributed 0.2 percentage points to the growth of the total value added in the economy, but this contribution was 1 percentage point lower than in the previous year. Agricultural⁶ and industrial⁷ production is estimated to have contributed by 1 percentage point to growth. In the meantime, the sluggishness of the construction sector⁸ was translated into negative contribution by around 0.8 percentage point to the annual growth of the total value added.

The improvement of the economic activity was also reflected in labour market indicators. The rate of employment and that of the labour force participation were up annually by 3.7 and 4.8 percentage points as at the end of the third quarter. Administrative data corroborate the positive developments in the labour market. Despite the noted improvements, the labour market is characterised by spare capacities expressed in the still-high unemployment rate.

Chart 5 Unemployment rate (%)



Source: INSTAT.

AGGREGATE DEMAND AND ECONOMIC GROWTH

Economic activity was driven by the domestic demand of the private sector. The improvement of confidence indicators, balance sheets and the

⁴ Services sector includes branches 'Trade, hotels and restaurants', 'Transport', 'Post and communications' and 'Other services'. Other services include: 'Financial activities', 'Real estate, leasing and business services', 'Public administration and defence', 'Education', 'Healthcare', and 'Other collective, social and personal services'.

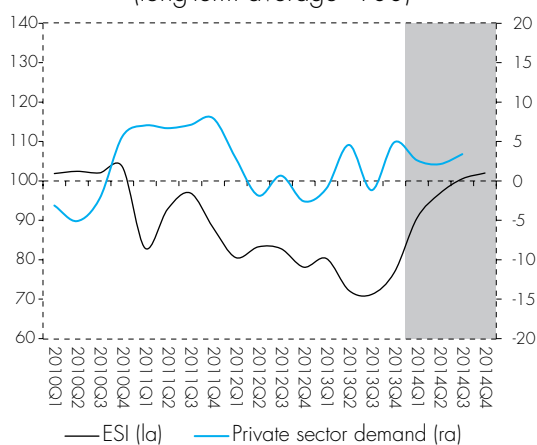
⁵ The performance of the branch of other services reflected the more positive developments in healthcare and other collective, social and personal services.

⁶ Added value in the economy by the agricultural sector was up 2.3% on average, but remained below the historic average of expansion around 5% during 2010 – 2013.

⁷ The rapid expansion of value added by the extractive industry was countered by the contraction of electrical energy, gas and water production and distribution. This resulted in the industrial sector contributing 0.4 percentage point to annual growth of total value added, lower compared to the 1.1 percentage points it contributed in the same period a year earlier.

⁸ Value added in the construction sector was highly volatile throughout the quarters. The strong decline in the value added in construction during Q2, weakened the positive performance in Q3. More positive developments in this sector in Q3 owe to the comparative base effect, granting of a higher number of construction permits in this quarter, and the positive impact related to the payment of government arrears to construction companies for realised infrastructure projects.

Chart 6 Private sector demand (annual change in %) and ESI (long-term average=100)



stimulating monetary conditions contributed to economic activity recovery during 2014.

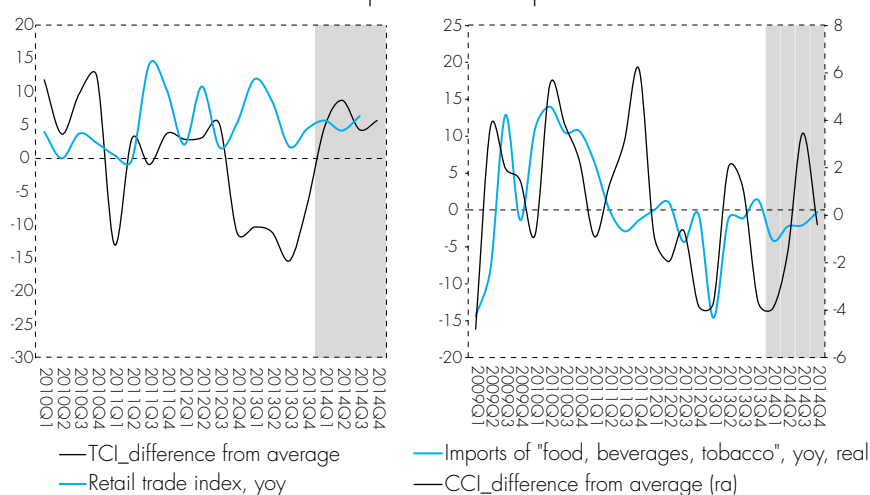
From the perspective of aggregate demand, economic growth was driven by private sector demand, whereas the fiscal stimulus and foreign demand were sluggish. Obtained data show that both components of private domestic demand, consumption and investments, provided positive contribution to growth, especially in the second half of the year. For the first time after many years, the Economic Sentiment Indicator increased progressively during the quarters and settled around the historic average in the fourth quarter.

Increase of private consumption - main component in aggregate demand - was reflected in higher expenditure for non-durables and higher demand

for services. The higher consumption of non-durables is suggested by the increase in the retail trade index (5.4% during the first nine months of 2014) and increase in the trade confidence indicator in the fourth quarter. On the other hand, the consumption of durables did not increase. Notwithstanding the improvement in the third quarter, the consumer confidence survey reveals that the balance of 'large purchases' has remained below the historical average. The preference for imported goods has continued to decline throughout the year.⁹

Private consumption was positively affected by boosted confidence, positive developments in the labour market and low inflation rates that support real

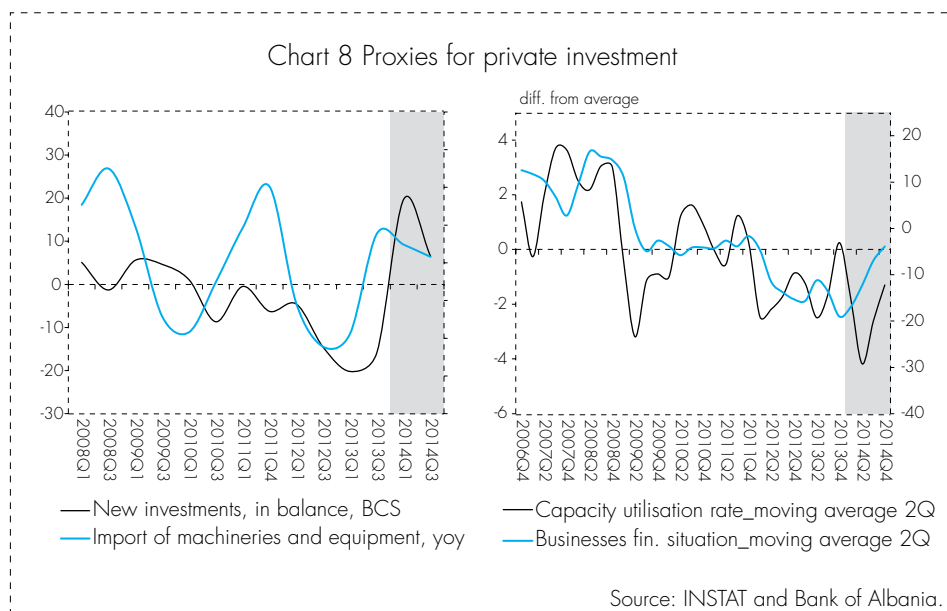
Chart 7 Indirect private consumption data



⁹ Confidence surveys reveal a shift of the Albanian consumers' preference for domestically-produced goods.

income. The growth in consumer credit, easing of lending standards and increase of income in the form of remittances contributed positively to financing consumption. On the other hand, the below-potential performance of employment and the slow growth in wages has rendered consumers more reluctant to spend. For that reason, the sustainable recovery of private consumption remains unconsolidated.

Private investments rose during the year, as a result of the improved business confidence, consumer demand recovery and private sector liquidity improvement, reflecting the payment of government arrears. Recovery of demand for final products of businesses has contributed to the improvement of businesses financial situation and consistent increase in the capacity utilisation rate. According to national accounts data, investments in the construction sector marked an upward turning point in the third quarter. Also, the increase in machineries and equipment, rise in new orders, and improvement of the balance of investments in the confidence survey point to the recovery of this component of aggregate demand in the fourth quarter.



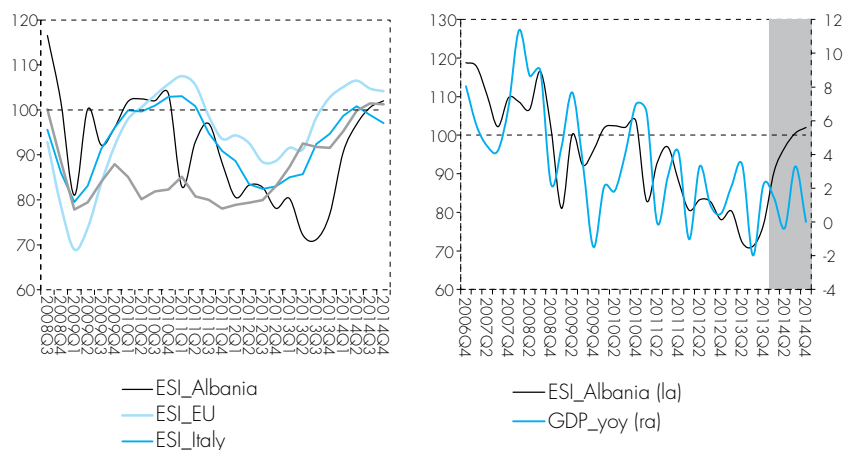
BOX 1 THE ALBANIAN ECONOMY FROM THE BUSINESSES AND CONSUMERS PERSPECTIVE

Through qualitative questions confidence surveys collect the opinion and expectations of industry, construction, services and trade firms, and of consumers. Data from these surveys are aggregated and expressed quantitatively through confidence indicators for each sector.***

Confidence indicators pursued an upward trend during 2014. The Economic Sentiment Indicator (ESI), which aggregates the confidence of five sectors in a single one, for the first time in three years, recorded values above the historic average.

Chart 9 shows that the improvement of ESI in our two main trading partners, Italy and Greece, as well as in European Union countries has preceded the increase in the aggregated confidence indicator at home. ***

Chart 9 Economic Sentiment Indicator in Albania and the European Union, and comparison to GDP annual growth rates

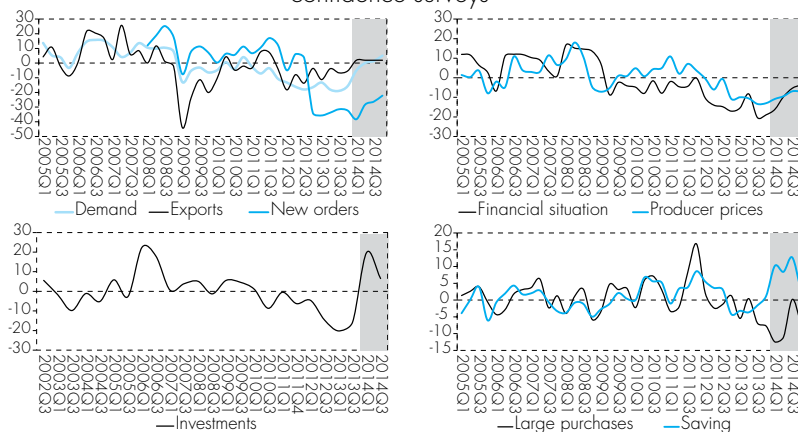


Source: INSTAT, European Commission and Bank of Albania.

The increased confidence across all the sectors of the economy, especially the marked improvement of confidence in construction contributed positively to the recovery of the economic sentiment indicator. The confidence indicator in this sector increased throughout all four quarters of the past year, interrupting the downward trend of a three-year period. On the other hand, the consumer confidence indicator showed higher volatility during 2014. After improving in the second and third quarters, consumer confidence fell in the fourth quarter, as a result of the decline in the balance of large purchases and that of income and expenditure.

From the businesses survey, the growth of demand has contributed to the improvement of confidence across four sectors: industry, construction, services and trade. Demand growth for final products and new orders relied mainly on domestic demand, which

Chart 10 Main balances of business (average for the economy) and consumer confidence surveys*



* All balances are expressed as the difference from their historical average.

Source: Bank of Albania.

has dominated over the slower growth of external demand. The balances of domestic and foreign demand stand close to the historical average, for the first time after three years. The businesses financial situation has improved, but the balance of the financial situation stands below the historical average.

Driven by the increase of confidence and improvement of the financial situation, businesses stated they have undertaken more investments in 2014. The balance of new investments, which jumped to high levels above the historical average in the first half of the year, slowed somewhat down in the second half.

* Qualitative questions require answers in the form of opinion or judgement on the direction of change in certain aspects of economic activity from businesses or consumers, unlike quantitative questions which require data on these activities.

** The confidence indicator is the simple arithmetic mean of three or four balances for each sector, which have the highest coefficient of the correlation with economic growth.

*** The leading effect of confidence indicators in trading partners on confidence indicators in Albania is supported also by the correlative analysis.

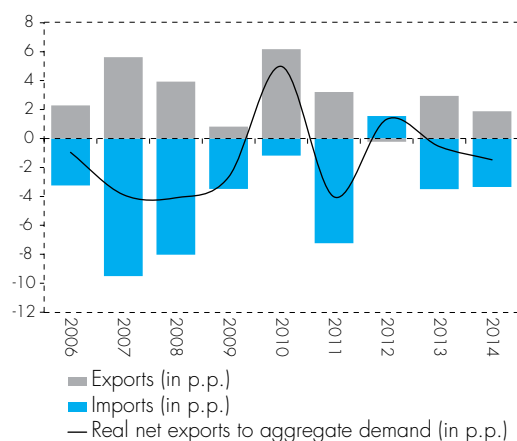
Foreign demand was sluggish and net exports did not support economic growth during 2014.

Activity in trade expanded during 2014, but the growth reflected mostly the increase in imports. Trade deficit in goods expanded 9.4% in annual terms, and was estimated at around 20.8% of the GDP. The annual growth in imports of goods contributed most this performance, around 6.7%, while exports of goods grew only 3.8%. The growth rate of exports was significantly lower compared to 2013.

Trade exchanges with abroad provided negative contribution to aggregate demand growth.¹⁰

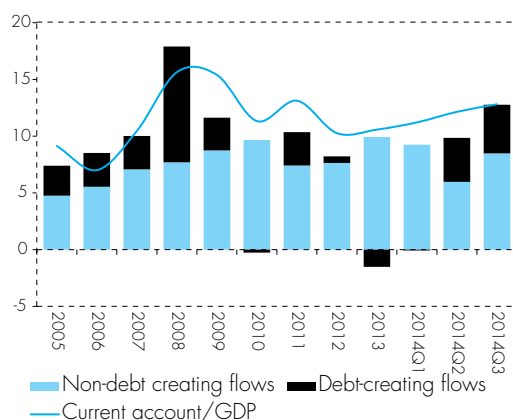
Expansion of net exports deficit has also contributed to the further deepening of the current account deficit during the first nine months of the year. Expansion of the income account deficit has also contributed to the same direction. Higher income from the secondary income account, as a result of the slight increase of remittances, did not succeed to offset the negative effect of the other two accounts.

Chart 11 Contribution of real net exports to GDP



Source: Bank of Albania.

¹⁰ Judgement is based on the performance of export and import of goods and services in volume that is corrected by price volatility. In real terms, net exports deficit for goods and services expanded by 6.7% annually. The final data on real net exports of goods and services are available as at 2014 Q3.

Chart 12 Current accounts financing
(as a share to nominal GDP)

Source: Bank of Albania.

The current account deficit was financed mainly through non-debt creating flows, in the form of foreign direct investments and capital account inflows. However, in contrast to the two previous years, an increase has been noted in financing through debt-creating flows. The expansion of financial obligations in the form of other investments was the main contributor to the growth of current account financing through foreign debt. At the end of 2014, the level of foreign currency reserve assets was sufficient to cover 5.3 months of imports of goods and services and 179.8% of the short-term foreign debt.

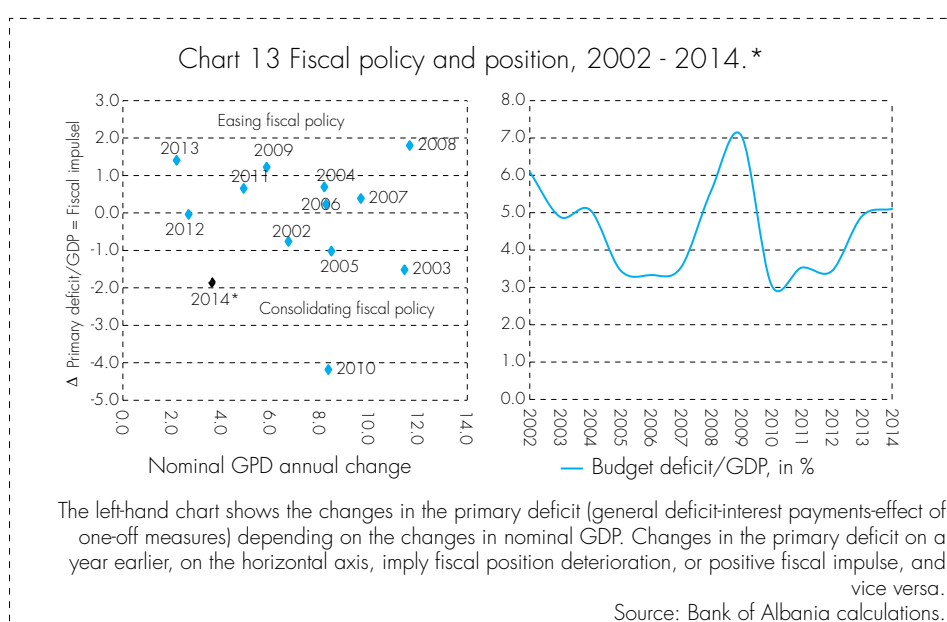
Table 3 Main Balance of Payment items (in EUR million, unless otherwise stated)

| | 2013 Q2 | 2013 Q3 | 2013 Q4 | 2014 Q1 | 2014 Q2 | 2014 Q3 |
|----------------------------------|---------|---------|---------|---------|---------|---------|
| Current account (in EUR million) | -285.0 | -190.4 | -336.2 | -260.8 | -324.6 | -316.4 |
| y-o-y (%) | 13.2 | -23.2 | 63.3 | 16.7 | 13.9 | 66.2 |
| / GDP (%) | -10.9 | -8.2 | -13.4 | -11.1 | -12.2 | -12.8 |
| Goods and services | -442.5 | -394.9 | -518.1 | -396.8 | -468.8 | -459.8 |
| Exports, f.o.b. | 805.6 | 981.0 | 960.3 | 609.7 | 753.0 | 842.1 |
| Imports, f.o.b. | 1248.1 | 1375.9 | 1478.4 | 1006.5 | 1221.8 | 1301.8 |
| Travel - net | -31.5 | 26.1 | 34.0 | -21.8 | 10.6 | 32.0 |
| Primary income | -11.0 | 22.2 | 0.0 | -7.1 | -28.6 | -44.5 |
| Credit | 35.7 | 40.2 | 33.4 | 29.2 | 25.8 | 28.3 |
| Debit | 46.7 | 18.0 | 33.4 | 36.3 | 54.3 | 72.8 |
| Net FDI income | -20.1 | 6.2 | 6.9 | -15.9 | -31.4 | -51.3 |
| Secondary income | 168.4 | 182.3 | 181.9 | 143.0 | 172.9 | 187.8 |
| Credit | 200.5 | 216.5 | 213.5 | 170.2 | 201.7 | 221.0 |
| Debit | 32.0 | 34.2 | 31.6 | 27.3 | 28.8 | 33.2 |
| Net remittances | 129.6 | 152.5 | 140.1 | 115.9 | 134.8 | 155.4 |
| Capital account | 4.8 | 15.0 | 18.2 | 22.5 | 15.3 | 20.7 |
| Net borrowing/net lending | -280.2 | -175.4 | -318.0 | -238.3 | -309.3 | -295.8 |
| Financial account | -262.4 | -70.9 | -226.1 | -231.3 | -225.4 | -140.7 |
| y-o-y (%) | 213.8 | 78.4 | -16.2 | 82.5 | -14.1 | 98.5 |
| / GDP (%) | -10.0 | -3.0 | -9.0 | -9.8 | -8.5 | -5.7 |
| Direct investments | -270.5 | -307.0 | -231.2 | -192.6 | -144.5 | -188.9 |
| Portfolio investments | 104.4 | 6.2 | -18.1 | 12.8 | 12.3 | -14.2 |
| Financial derivatives | 1.1 | 0.0 | -2.4 | 0.0 | 0.0 | 0.0 |
| Other investments | -183.8 | 195.4 | 18.6 | -11.1 | -115.8 | -91.6 |
| Reserve assets | 86.4 | 34.5 | 7.1 | -40.3 | 22.5 | 154.0 |
| Errors and omissions | 17.8 | 104.5 | 91.9 | 7.0 | 83.9 | 155.1 |
| Net borrowing/net lending | -280.2 | -175.4 | -318.0 | -238.3 | -309.3 | -295.8 |

Source: Bank of Albania.

Fiscal consolidation was accompanied by limited space for economic stimulus during 2014¹¹

Fiscal policy maintained a consolidating profile during 2014.¹² Excluding the payment of government arrears, the primary deficit¹³ in terms of GDP narrowed by about 1.9 percentage points from the previous year. The fiscal consolidation was driven by the increase in tax income, while the fiscal impulse generated by primary current expenditure was countered by the downward pace of capital expenditure. Total budget deficit was estimated at around 5.1% of the GDP standing slightly higher than the 4.9% registered in the previous year; however, 47% of this deficit was formed by the payment of government arrears.



Budget expenditure for 2014 amounted ALL 438.8 billion or around 11.3% higher than in the previous year. The size of public sector, as a ratio of total expenditure to GDP, was estimated at around 31% at the end of the year, from 28.9% in the previous year. Expenditures concentrated most in the last quarter, especially in December¹⁴. Primary current expenditure resulted around ALL 301.3 billion or around 5.6% higher in annual terms, whereas capital expenditure amounted around 7.5% lower than in the previous year.

Budget revenues increased by around 12.1% during 2014. Their ratio to GDP was up by around 2 percentage points from a year earlier, to 25.9%.

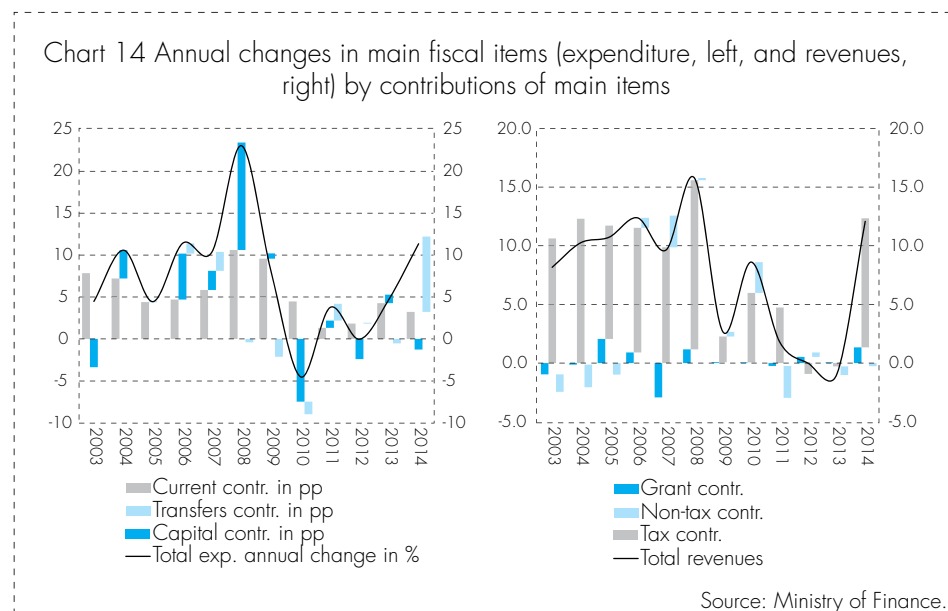
¹¹ Fiscal data for 2014 are preliminary and may be subject to revision in the future.

¹² Judgement on the fiscal policy direction is based on the concept of discretionary fiscal policy. This concept excludes, from fiscal indicators, the effects of cyclical volatility of the economy and temporary one-off measures. Payment of arrears is such measure taken during 2014. According to the EC, Public Finances in EMU (2006) definition, these measures are temporary and do not affect the interim budget position.

¹³ Refers to total budget deficit, excluding expenditure for interests on the public debt.

¹⁴ In Q4, around 32.3% of total expenditures were carried out, whereas in December around 15.6% of total expenditures were carried out.

The upward trajectory of budget revenues is a result of amendments to the tax legislation¹⁵; increasing formalisation of the economy and improved efficiency in the collection of income tax; and the statistical effect of comparison with the previous year.



At the end of the year, budget deficit resulted around ALL 72.1 billion, or around ALL 16.3 billion less than planned. The financing of the budget deficit during the year was based on the issue of securities and the IMF loan for the payment of government arrears. These two instruments financed by 53% and 42%, respectively, the general budget deficit.

Table 4 Fiscal Indicators

| | ALL billion | | | To GDP, in % | | |
|-----------------------|-------------|-------|-------|--------------|------|------|
| | 2012 | 2013 | 2014 | 2012 | 2013 | 2014 |
| Total revenues | 330.4 | 327.2 | 366.7 | 24.7 | 24.0 | 25.9 |
| Grants | 5.6 | 5.7 | 10.1 | 0.4 | 0.4 | 0.7 |
| Tax and customs | 232.6 | 229.0 | 253.5 | 17.4 | 16.8 | 17.9 |
| VAT | 116.5 | 111.9 | 123.8 | 8.7 | 8.2 | 8.8 |
| Profit tax | 16.9 | 15.1 | 21.5 | 1.3 | 1.1 | 1.5 |
| Excises | 36.4 | 38.2 | 40.9 | 2.7 | 2.8 | 2.9 |
| Personal income | 28.0 | 29.6 | 28.9 | 2.1 | 2.2 | 2.0 |
| Local government | 10.9 | 10.8 | 12.4 | 0.8 | 0.8 | 0.9 |
| Contributions | 57.4 | 60.0 | 69.9 | 4.3 | 4.4 | 4.9 |
| Non-tax | 24.0 | 21.6 | 20.7 | 1.8 | 1.6 | 1.5 |
| Total spending | 376.2 | 394.1 | 438.8 | 28.2 | 28.9 | 31.0 |
| Current | 312.6 | 328.6 | 343.0 | 23.4 | 24.1 | 24.3 |
| Personnel | 69.4 | 70.7 | 71.4 | 5.2 | 5.2 | 5.0 |
| Interests | 41.5 | 43.3 | 40.1 | 3.1 | 3.2 | 2.8 |
| Operational exp. | 31.5 | 32.4 | 31.3 | 2.4 | 2.4 | 2.2 |
| Social security exp. | 120.3 | 127.6 | 138.5 | 9.0 | 9.4 | 9.8 |
| Local government exp. | 27.3 | 29.8 | 32.9 | 2.0 | 2.2 | 2.3 |
| Other expenditure | 20.7 | 23.2 | 25.5 | 1.5 | 1.7 | 1.8 |

¹⁵ For details on amendments to the fiscal package, refer to the monetary policy reports, published during 2014.

| | | | | | | |
|--------------------|-------|-------|-------|------|------|------|
| Capital | 61.7 | 65.5 | 60.5 | 4.6 | 4.8 | 4.3 |
| Arrears | 0.0 | 0.0 | 33.8 | 0.0 | 0.0 | 2.4 |
| Support for energy | 0.0 | 0.0 | 1.5 | 0.0 | 0.0 | 0.1 |
| Budget balance | -45.9 | -66.9 | -72.1 | -3.4 | -4.9 | -5.1 |
| Domestic borrowing | 24.8 | 46.3 | 38.2 | 1.9 | 3.4 | 2.7 |

Source: Ministry of Finance.

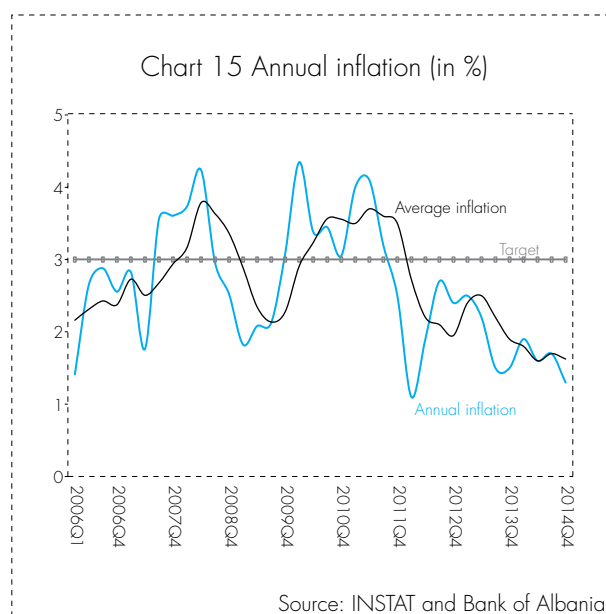
II.1.4. PRICE STABILITY

Consumer price inflation remained low throughout 2014.

Annual inflation averaged 1.6%, standing below Bank of Albania's target. Annual inflation ranged 1.4-2.2%, but in December it recorded an unusually low rate of 0.7%. Compared to the previous year, inflation fell due to the positive shocks from the domestic and external costs, in the presence of demand-side low inflationary pressures.

Food prices made major contribution to inflation, whereas the downward oil price drove the rate of inflation down at the end of the year.

'Unprocessed foods' continued to determine the performance of inflation in 2014. This category formed around 80% of the average headline inflation. 'Unprocessed foods' prices, however, rose more slowly than in the previous year, as a result of the growth in supply with domestic agricultural products and the fall in their prices in trading partner countries. The strong deceleration of this category's inflation during the last quarter¹⁶, owes mostly to the external economic environment that has exercised disinflationary pressures and materialised in downward imported inflation. 'Unprocessed foods' inflation continues to be dictated by their downward prices in global markets. By contrast, the rise in tax and excise rates for some of these items has exercised pressures on their price rise.



¹⁶ Inflation in December 2014 stood at 0.7%, falling sharply dictated by the low rise in foods and the continuing decline in oil price. The latter lowered further the production and transport costs in goods and services.

Table 5 Annual contributions of key items to annual inflation (in p.p.)

| | 2012 Q4 | 2013 Q1 | 2013 Q2 | 2013 Q3 | 2013 Q4 | 2014 Q1 | 2014 Q2 | 2014 Q3 | 2014 Q4 |
|---------------------------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|
| Processed foods (pp) | 0.6 | 0.5 | 0.3 | 0.1 | -0.1 | -0.1 | -0.2 | -0.1 | 0.1 |
| Bread and grains (pp) * | 0.0 | 0.1 | 0.1 | 0.1 | 0.0 | -0.1 | -0.1 | -0.1 | -0.1 |
| Alcohol and tobacco (pp) | 0.2 | 0.1 | 0.2 | 0.1 | 0.1 | 0.3 | 0.3 | 0.3 | 0.3 |
| Unprocessed foods (pp) | 1.0 | 1.7 | 2.0 | 1.5 | 1.5 | 1.6 | 1.3 | 1.5 | 0.8 |
| Fruit (pp) | 0.5 | 0.3 | 0.4 | 0.8 | 0.5 | 0.7 | 0.7 | 0.2 | 0.4 |
| Vegetables (pp) | 0.2 | 1.2 | 1.5 | 0.5 | 1.1 | 0.9 | 0.6 | 1.2 | 0.2 |
| Services (pp) | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.2 |
| Regulated prices (pp) | 0.1 | 0.1 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 | -0.1 | 0.1 |
| Fuels and energy (pp) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Housing (pp) | -0.2 | -0.1 | -0.1 | 0.0 | 0.3 | 0.3 | 0.2 | 0.1 | 0.1 |
| Non-food consumer goods | 0.5 | 0.0 | -0.3 | -0.4 | -0.2 | 0.2 | 0.2 | 0.2 | 0.0 |
| Durable consumer goods (pp) | 0.2 | 0.1 | 0.1 | 0.0 | 0.0 | -0.1 | -0.1 | 0.0 | 0.0 |
| Consumer Price Index (y-o-y, %) | 2.4 | 2.5 | 2.2 | 1.5 | 1.5 | 1.9 | 1.6 | 1.7 | 1.3 |

Source: INSTAT and Bank of Albania.

*The table presents some of the main items.

The steady decline in oil prices¹⁷ led not only to downward contribution by items in 'Non-food consumer goods', but also in reduced costs for the production and transport of other goods and services. Moreover, services inflation was slightly up, reflecting the improved consumer demand. Prices of other CPI basket items resulted, overall, stable and provided minimum contribution to the formation of annual inflation.

The cyclical weakness of demand has created an economic environment with weak pressures on the rise of wages, labour costs, and domestic inflation.

While upward, aggregate demand was insufficient for the return of the economy to potential. This tendency was reflected in the low rise in wages and labour costs, as well as in low core inflation rates during 2014.

In the presence of the negative output gap, pressures from the labour costs and production costs on consumer prices resulted weaker than in the previous year¹⁸. The average annual increase in the unit labour cost index in the first nine months of the year was 4%. The labour productivity in non-agricultural sector fell 9%, while real wages recorded 5% average decline during the period.¹⁹

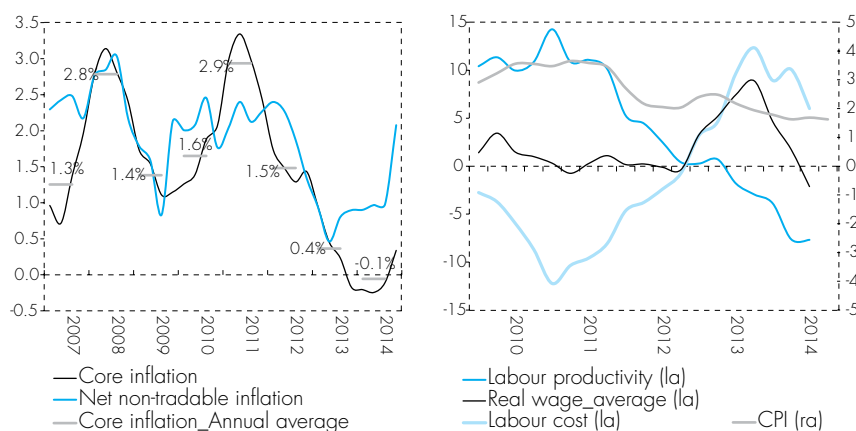
Annual core inflation averaged -0.1%, illustrating once again low inflationary pressures generated by the domestic economy. Core inflation ranged in a narrow interval with negative values throughout the first three quarters, but recorded low positive values in the fourth quarter of the year. Non-tradable inflation of goods in the CPI basket performed similarly to core inflation, recording the average rate of 1.2%.

¹⁷ In particular, annual inflation of the sub-group 'Fuels' stood at about -6%, in December, lowering the contribution of 'Non-food consumer goods' to headline inflation by 0.2 p.p.

¹⁸ Indices of labour productivity, unit labour cost, and real average wage are proxies for non-agricultural sectors of the economy, through short-term statistical indices (SHTS, INSTAT).

¹⁹ Labour market data may have been affected, to a large extent, by the tendency of the increasing formalisation of the economy. Businesses reporting of a higher number of employees lead to downward indicators for productivity and wages, beyond the real effects in the economy.

Chart 16 Long-term inflation expectations (left) and domestic pressures from cost as annual change of indices (right)*



Note: *Annual change of cost indices are flattened by the four-term moving average.
Source: INSTAT and Bank of Albania calculations.

Pressures from imported inflation have been downward.

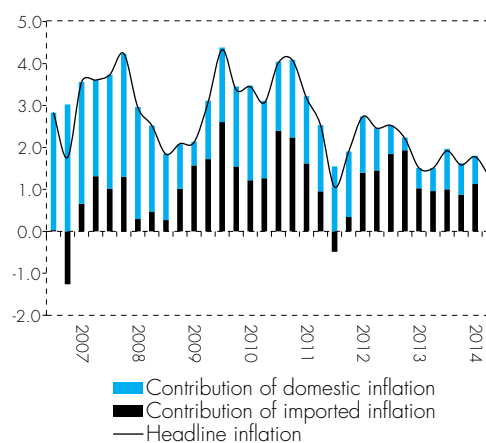
Low inflation in trading partners, fall in oil prices and core food items in international and regional markets, supported also by the stability of the national currency against the euro, curbed imported inflation during 2014.

The fall in imported inflation contributed to the fall in headline inflation during the year. In average terms, the contribution of imported inflation to headline inflation was around 0.73 percentage point. It ranged from 1 percentage point in the first three quarters of the year, to -0.07 percentage point in the fourth quarter, signalling imported deflation. This phenomenon appeared more evidently in the last month of the year, reducing headline inflation by -0.6 percentage point.

Inflation expectations continued to trend down.

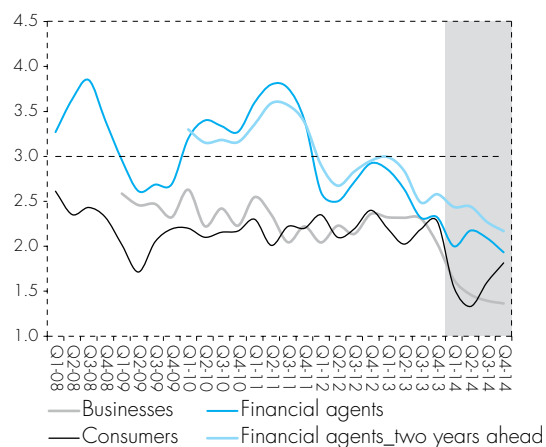
Inflation expectations of various economic agents trended down throughout 2014. Businesses expectations, which showed the most pronounced decline in the past year, settled at 1.4% in 2014 Q4. Consumer expectations appeared more volatile during the year; after falling in the first two quarters, they made a slight upturn in the last two quarters. Financial agents' expectations, both short

Chart 17 Contribution of imported and domestic inflation to headline inflation



Source: INSTAT and Bank of Albania calculations.

Chart 18 Inflation expectations from different economic agents



Source: Bank of Albania.

(one-year-ahead inflation) and medium-term (two-years-ahead inflation), stand close to Bank of Albania's 3.0% target.

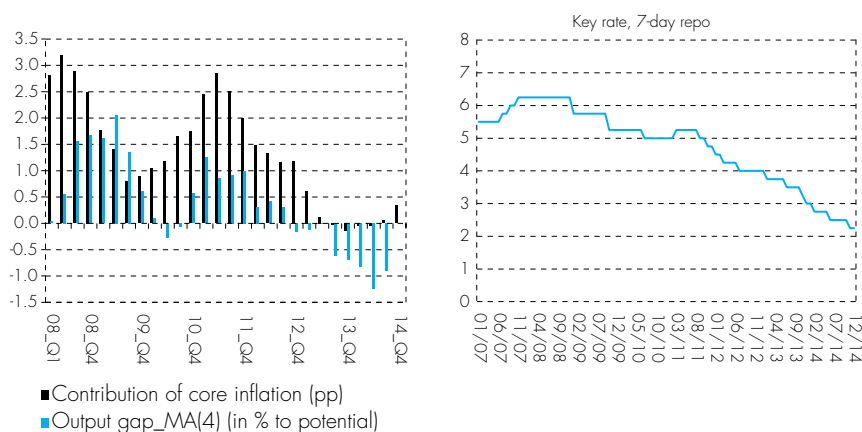
II.1.5. MONETARY POLICY OF THE BANK OF ALBANIA AND FINANCIAL MARKETS

The primary objective of Bank of Albania's monetary policy is to achieve and maintain price stability. In quantitative terms, the Bank of Albania aims at keeping consumer price inflation at 3.0%. To realise this objective, the Bank of Albania implements inflation targeting and a free floating exchange rate regime. The monetary policy of the Bank of Albania is forward looking, flexible, prudent and transparent.

Low inflationary pressures dictated the continuation of an accommodative monetary policy.

Low inflationary pressures required the further easing of the monetary policy during 2014. The Supervisory Council of the Bank of Albania lowered the key interest rate three times, bringing it down to 2.25% at the end of the year. These signals have been transmitted to financial markets, which have operated under sufficient liquidity conditions and have cut interest rates on lending to the private and public sectors.

Chart 19 Output gap and core inflation (left); Key interest rate (right)



* MA (four-term moving average to flatten short-term volatility).
Source: Bank of Albania calculations.

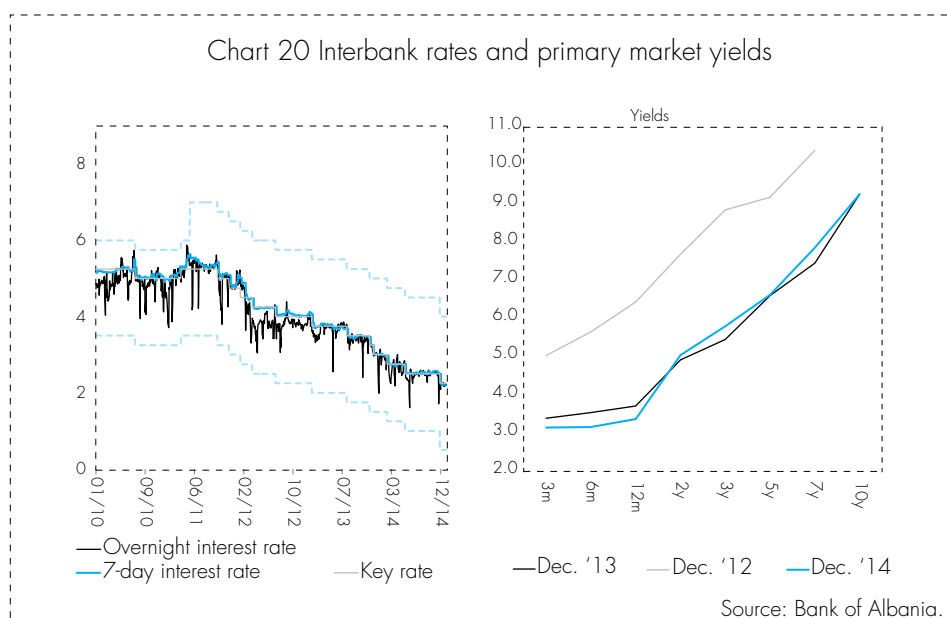
Instruments for the implementation of the monetary policy did not change during 2014. The Bank of Albania continued to inject liquidity in the banking system, through its standard refinancing operations. Pressures for liquidity in the system were contained and reflected in low volatility of interest rates in the interbank market. The one-week reverse repurchase agreement was the main liquidity injection operation. In addition, one-month and three-month reverse repurchase agreements were employed to fulfil optimally liquidity needs in the banking system.

Amid high uncertainty premiums, the Bank of Albania continued to use the forward guidance instrument. Through this communication, the Bank of Albania affirmed its engagement that the monetary policy stance will remain accommodative and that interest rates will remain low for some quarters ahead. The use of this instrument has helped improve monetary policy clarity, lower risk premiums in the markets, and reduce long-term interest rates.

Monetary policy was reflected in lower interest rates in financial markets.

Financial markets have responded to the accommodative monetary policy and engagement to maintain this direction for a period of time. In particular, this year saw the steady decline in interest rates on lek loans both for businesses and households, creating therefore stimuli for credit growth in the national currency.

Interest rates in the interbank market ranged very close to the key rate, in accordance with the operational target of the Bank of Albania²⁰. The average overnight interest rate in this market fell to 2.56% in 2014, from 3.50% in 2013, while the one-week rate fell to 2.65%, from 3.62%. Interbank rates were less volatile compared to the previous year.²¹ The behaviour of ask yields in the primary market of central government debt securities differed. By maturity, primary market yields showed a diverging trend, resulting in a more sloping curve at the end of the year. The 12-month yield fell to 3.37% in December, from 3.71% in December 2013. By contrast, bond yields stood approximately 22 basis points²² higher than in the previous year.



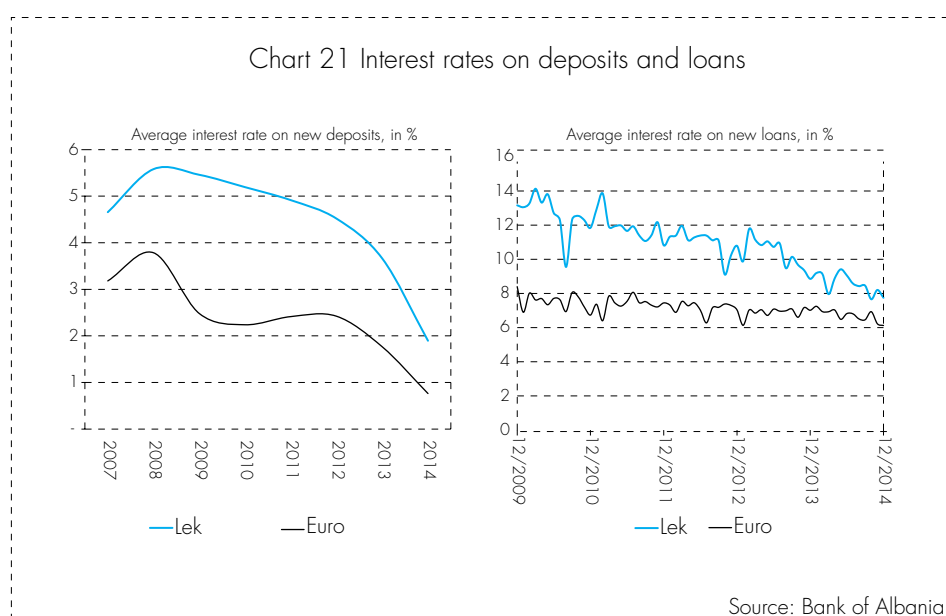
²⁰ The operational objective of the Bank of Albania is addressed in more detail in the chapter on "Financial market operations and foreign currency reserve management".

²¹ The standard deviation of the overnight interbank rate for this year was 0.2626, from 0.4219 in 2013.

²² Bond yields of 2-, 3-, 5- and 7-year maturity with fix interest rate increased on average 0.12pp, 0.34 pp, 0.02 pp and 0.40 pp, respectively.

In the first half of the year, banks were interested in tradable public debt instruments, leading to an overall yield drop. Since September, public sector demand for funds has been up, whereas bank's participation in primary auctions tended to fall, as a result of restrictions from parent banks. These tendencies led to upward sloping yield curve. In parallel, the strategy to extend the public debt maturity and increase the issue in the long-term segment of securities has contributed and still contributes to the sloping of the yield curve.

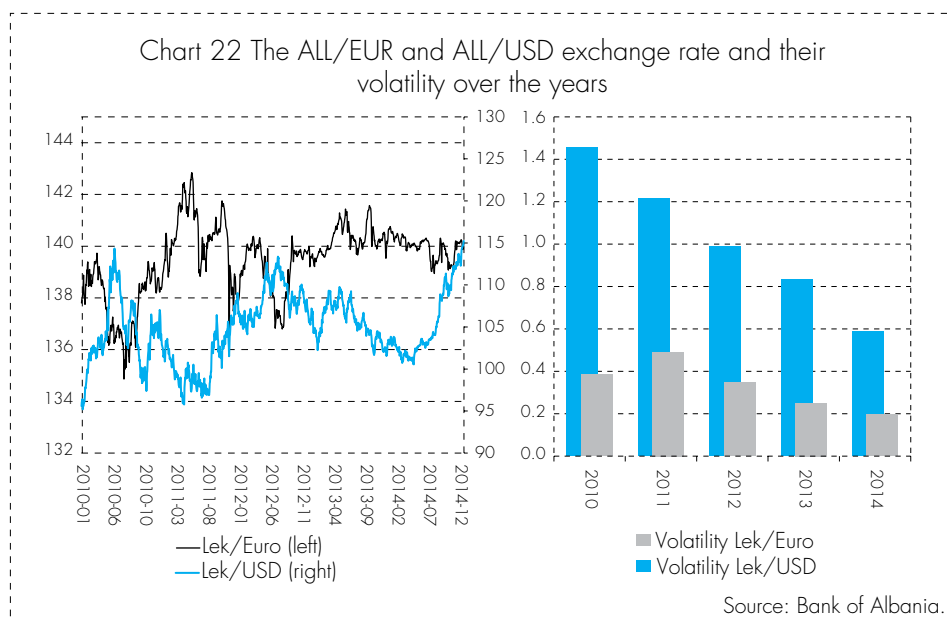
The lowering of the key interest rates has been also transmitted to the deposits market. The average interest rate on new lek deposits for 2014 was 1.9%, down by around 1.8 percentage points from 2013. The fall was noted across all types of deposits, but was more significant in longer-term maturities. In parallel, the interest rate on new euro deposits fell, down on average to 0.76% or 1.0 percentage point from 2013.



In 2014, the transmission of the lowering of the key rate to lending improved, especially during the second half of the year. The interest rate on new lek loans pursued an evident downward trend throughout 2014 and resulted on average in 8.6% (1.8 percentage points lower from the previous year). The drop is evident across all maturities and types of loan. The spread between the lek loan rate and the 12-month yield, which is quoted as the reference rate, narrowed in this period, mainly as a result of the drop in interest rates on loans. The drop in interest rates has supported the growth of credit demand in the national currency and improvement of credit indicators. On the other hand, the interest rate on new euro loans was on average unchanged from the previous year, at 6.7%. Reflecting this performance, the spread of interest rates on loans for both currencies narrowed.

Lek exchange rate showed low volatility.

During 2014, one euro was traded on average for 140 Albanian lek, at similar rates to those in 2013 (140.3 lek/euro). In spite of the seasonal effect notably in August, the exchange rate fluctuated closely to the range of 138.9-140.8 lek, signalling a balanced supply/demand ratio for foreign currency. For the same period, the performance of the US dollar against the Albanian lek, in response to the performance of the US dollar in international markets, appears more volatile. Until August, the US dollar's position against the Albanian lek weakened on average 3.7% in annual terms, to appreciate until the end of the year by 7.1% from the previous year.



BOX 2 MONETARY POLICY AND ITS TRANSMISSION TO THE ECONOMY

*The global economic and financial crisis extended gradually, but inevitably, its effects in Albania. As a result of direct and indirect effects of this crisis, the Albanian economy saw a progressive slowdown and downward inflationary pressures. In response to these developments, taking into account the intensity of the shocks, the direction and resultant intensity of macroeconomic policies, strength of the transmission mechanism, and other considerations on the financial soundness indicators, the monetary policy of the Bank of Albania has been increasingly accommodative. This direction was maintained and further strengthened during 2014. The key interest rate was lowered three times to settle at 2.25%, at the end of the year. * Moreover, the Bank of Albania continued to apply the forward guidance strategy, consolidating and improving this instrument even further in 2014.*

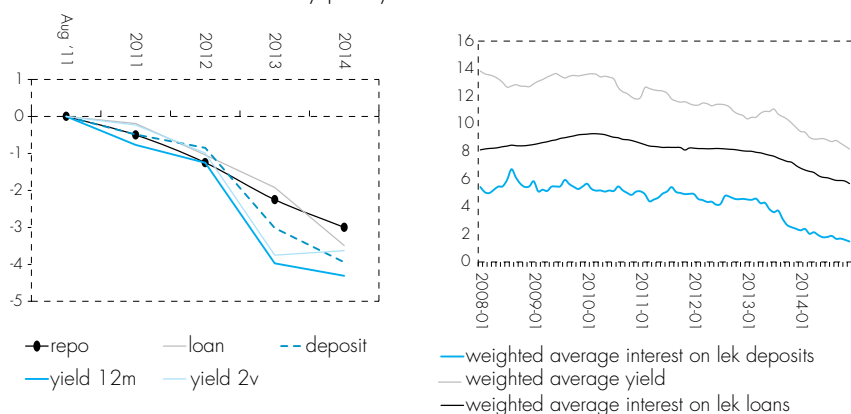
The main purpose of the accommodative policy was to cut lending costs and administer economic agents' inflation expectations, creating thus adequate premises for economic growth and return of inflation to target. Judging from the strong negative pressures arising from the external sector of the economy, and shocks on certain

sectors of the Albanian economy and economic agents' confidence, the monetary policy implemented by the Bank of Albania has been successful in managing the situation and changing the direction of the economic development.

Line in any free-market economy, the connection between monetary policy instruments and the ultimate achievement of its objectives is realised through a chain of financial stimuli and responses of economic agents, which is also known as the transmission mechanism. In simpler terms, this mechanism includes two stages: (i) transmission of the monetary stimulus to financial markets; and (ii) promotion of investments, consumption, lending and risk appetite in response to better lending standards. Judging from available data, the Bank of Albania deems that the first element of this mechanism, on which it has a faster and more direct impact, has worked. In the meantime, the functioning of the second element of the transmission mechanism remains incomplete.

As shown in the charts, the lowering of the key interest rate has led to the decline across all interest rates in financial markets. During 2014, the interest rate of banking system financing, interest rates on lek loans, and yields on government securities fell to their historical minimum (see Chart 23). Better lending standards increase the stimuli for new loans, and ease the cost of servicing existing loans.

Chart 23 Monetary policy transmission in financial markets*



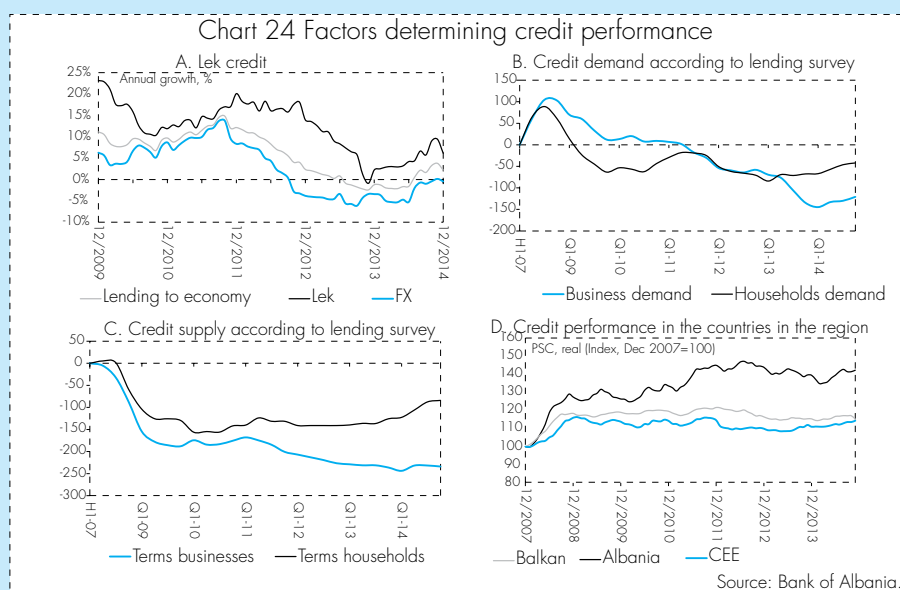
* The right panel shows the cumulative change (in p.p.) of interest rates in financial markets in response to the lowering of the key interest rate by the Bank of Albania. The left panel shows the dynamics of the main interest rates in the economy: weighted average interest rate on lek loans, weighted average interest rate on lek deposits and weighted average yield on government securities. Source: Bank of Albania, Ministry of Finance.

On the other hand, the reduction in financing costs has contributed to lek credit growth and supported consumption and investments (see panel A in Chart 24). However, lending and the response of the economy to the accommodative monetary policy remain both below Bank of Albania's target and incomplete. This behaviour is motivated by at least three factors.

First, credit demand appears sluggish, across all levels of interest rates. Businesses and consumers are reluctant to undertake additional consumption and investments, as a result of uncertainties for the future. Regardless of the improved confidence during the last quarters, credit demand remains low (see panel B in Chart 24).

Second, the financial sector's risk appetite appears low. The high level of non-performing loans, parent bank conservative policies, and sector-specific problems make the banking system apply rather prudent lending policies and practices (see panel C in Chart 24).

Third, the slow recovery of consumption, investments and credit demand is related to structural factors, which dictate its slow growth. Thus, the need for restructuring the economy and shifting financial, human and managerial resources to more productive sectors of the economy, tend to reduce aggregate demand growth. This phenomenon is present in all the countries in the region and, coupled with parent bank conservative policies, determines a sluggish credit and economic growth in them (see panel D in Chart 24).



Taking into account the strength of the shocks and above-mentioned restrictions, the monetary policy of the Bank of Albania has been successful in accomplishing its mission of maintaining price stability in the economy. However, the functioning of the transmission mechanism has been and remains incomplete, due to factors outside the scope of monetary policy. Alone, the monetary policy is an insufficient instrument for addressing all problems in the way of economic growth. The solution or mitigation of supply-side limitations, improvement of the business climate and acceleration of the structural reform agenda would contribute to enhancing the efficiency of this policy and to the faster return of the economy to equilibrium.

* The key rate was lowered twice in 2011, three times in 2012, four times in 2013 and three times in 2014.

III.1.6. MONETARY INDICATORS²³

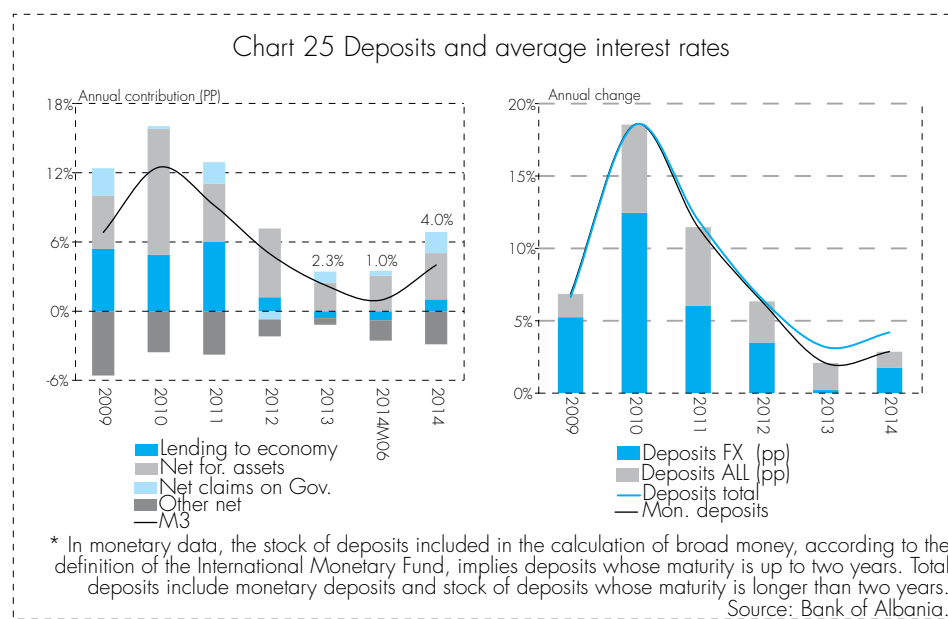
Monetary assets showed moderate growth rates, in line with the performance of economic activity and banks' prudent behaviour.

Monetary indicators showed a sluggish performance in most of 2014, as a result of the moderate lending activity and of structural changes of holding money in the economy. After a sluggish annual performance during the year, the M3 aggregate posted 4% annual growth in December. This performance was driven by added fiscal activity in this period.²⁴ Monetary expansion was driven mainly by the foreign currency component of demand for money throughout the year, whereas private sector demand for financing provided moderate contribution, only in the second half of the year.

The banking system maintained its ability to attract the public's savings, although the latter tends to shift to longer-term maturities or other instruments with higher yields.

Residents' deposits performed positively, with an annual growth rate of 4.2% or 1 percentage point higher than in the previous year. In 2014, deposits stood close to moderate historic levels, driven by the low creation of money in the economy. Deposits expanded mainly in foreign currency deposits, whereas national currency deposits provided low contribution.

Households' deposits of less-than-two-year maturity were up by ALL 4.6 billion, slowing their annual growth rate to 0.5%. In the presence of interest rate lowering of lek and foreign currency deposits, households invested their savings in longer-term financial instruments, with higher yields. Thus households'



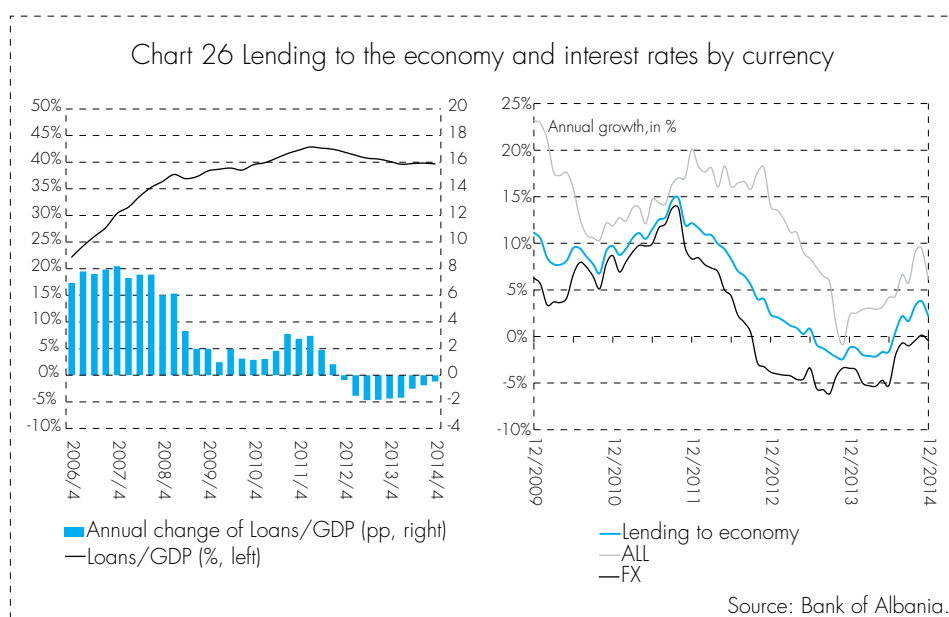
²³ Data for December are preliminary and subject to revision until the publication of this report.

²⁴ Fiscal activity contributed negatively to the annual growth of M3 aggregate for the most part of the year; however, this contribution jumped to positive territory registering 1.8 percentage points in December.

investment in longer-than-two-year deposits and securities surged in total by ALL 27 billion. Overall, households' investments in financial instruments during the year were up 3.2%.

Notwithstanding the growth of the credit portfolio, its recovery appears weak and segmented²⁵

Credit developments are characterised by the gradual recovery of growth rates during 2014, from the significant reduction of lek interest rates and growth of lending in the national currency. The shift of the portfolio toward the national currency has enabled a better transmission of the monetary stimulus and has helped reduce the exchange rate risk in the balance sheets of both borrowers and banks. Overall, the slow credit recovery has reflected the sluggish demand by the economy for funding and banks' prudent approach to lending. As a result of these developments, the annual change of the credit to nominal GDP ratio continued to be negative, but narrowed from the previous year.



Credit outstanding grew ALL 12 billion and its annual change was 2.2% at the end of 2014²⁶, from -1.2% at the end of 2013²⁷. The steady recovery of lek credit, whose annual growth was 6.1% at the end of 2014, was a positive development in this year. In the meantime, foreign currency credit continued to contract, but at a slower pace than in the previous year.

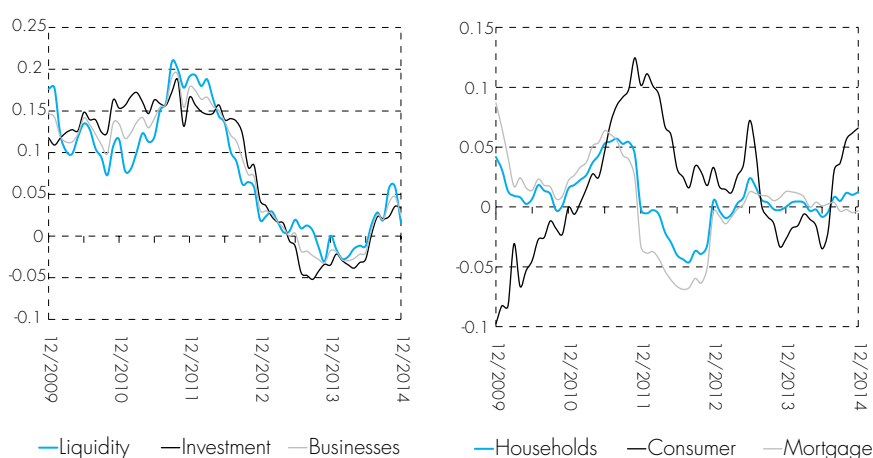
²⁵ The following lending activity analysis refers to lending to residents in accordance with the methodology of monetary statistics.

²⁶ Excluding the exchange rate effect, the net credit flow was around ALL 7.2 billion and its annual growth 1.6%.

²⁷ Credit growth recovery, in addition to the good performance, owes to less credit sale and write-offs from banks balance sheets in 2014. In particular, the return to positive rates of the annual change after 12 months of contraction has also reflected the cancelling out of the base effect as a result of the sale of some loans in July, August, and October of 2013.

Most of credit growth was used to boost lending to businesses, both for liquidity and investment purposes. The annual change of lending to businesses was 2.4% at the end of 2014, from -2.0% at the end of 2013. On the other hand, lending to households was sluggish during 2014. Its annual change, after fluctuating close to zero in the first half, rose gradually to 1.2% at the end of the year. Despite the further easing of lending standards for all products, households responded with additional demand only for consumer loans. Demand for mortgage loans was low and its annual change fluctuated close to zero throughout 2014.

Chart 27 Credit performance and purpose of use (annual change, in %)



Source: Bank of Albania.

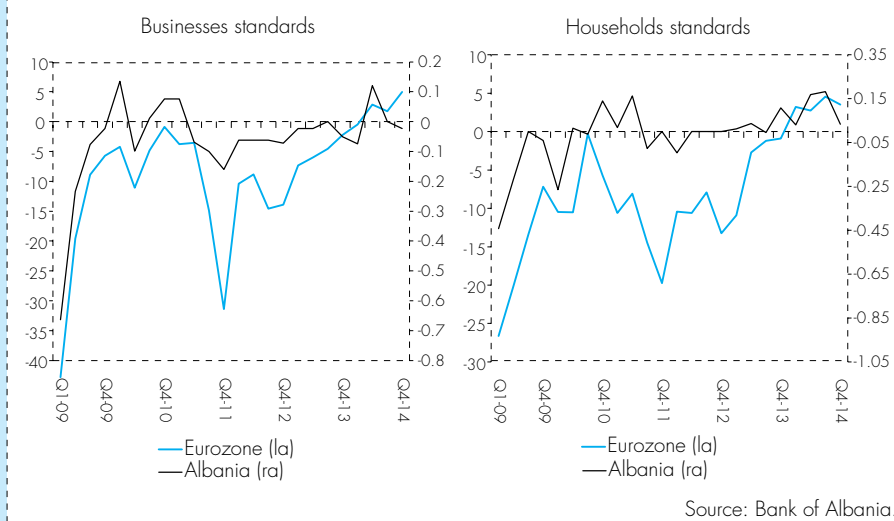
BOX 3 SUMMARY OF RESULTS FROM THE LENDING SURVEY DURING 2014

The Bank Lending Survey makes a qualitative analysis of aspects related to bank lending standards and business and household credit demand. This box summarises the survey data and describes the factors affecting the lending standards and criteria, applied to banking system customers during 2014*.

The data processing shows that banks tightened slightly the lending standards applied to businesses in the first half, and tightened them in the second half of 2014. On average the net balance was 2.3% in the first and -1.1% in the second half. On the other hand, standards of lending to households eased throughout the year, although the extent of easing slowed down in the second half of the year. The net balance of standards, at the end of the year, stood at 3.4%. Lending standards during the first half of the year performed in line with the easing tendency of standards in euro area countries, continuing to ease in the second half of the year, both for businesses and households.

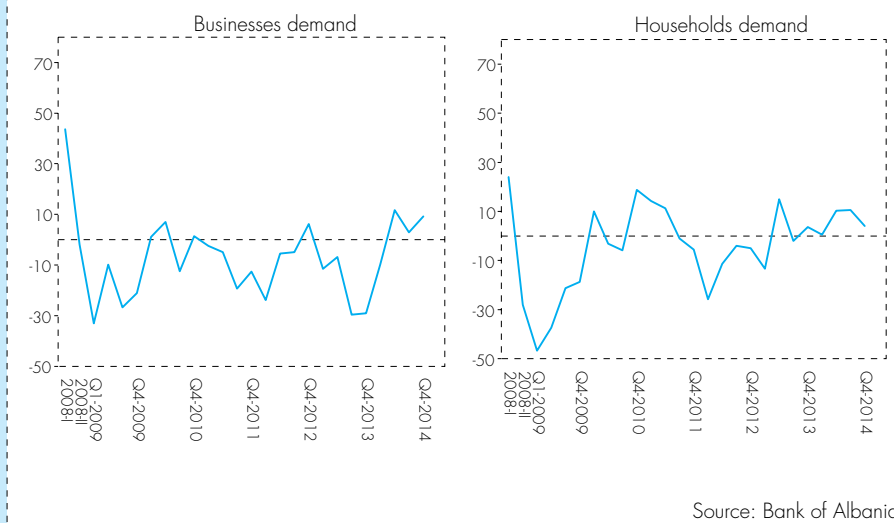
Overall, the change in business and households standards, analysed by purpose of use, was in the same direction**. The liquidity amount and competitiveness in the market continued to drive the easing of standards for businesses and households during 2014. In this year, Bank of Albania decisions contributed significantly to the easing of lending standards.

Chart 28 Lending standards applied to economic agents



Bank lending policies were reflected both in the downward interest rates on loans, and in the easing of other lending standards, except for the margin on risk-bearing credits, which tightened for all economic agents.

Chart 29 Credit demand



Based on bank experts' assessments, during 2014, businesses and households demand for credit was slightly up. The net balance of households demand*** recorded low positive rates throughout the year. Businesses demand took an upturn in the second quarter, after the decline during 2013.

* The aggregation of bank lending survey results is based on a standardised methodology, which is widely used by central banks. The results are, therefore, comparable to other central banks' surveys. Some of the major central banks conducting the bank lending survey include the Federal Reserve (since 1967), European Central Bank (since 2003), Bank of England (since 2007), and Bank of Japan (since 2000).

** Businesses: working capital and investments; Households: house purchase and consumption.

*** Measured as the difference in percentage points between the responses showing its growth and those showing its fall.

II.2. FINANCIAL STABILITY AND BANKING SYSTEM PERFORMANCE

- Safeguarding financial stability and the well-functioning of the financial system in the Republic of Albania are key objectives for the Bank of Albania, in addition to the primary objective to maintain price stability. The role of the Bank of Albania on safeguarding financial stability is set out in the law "On the Bank of Albania" and in the law "On banks in the Republic of Albania". These objectives are achieved through licencing, regulation and supervision of banking activity, as well as through the monitoring and implementation of initiatives for technological improvement of payment systems. The global financial crisis emphasised the need for complementing the traditional financial supervision, which focuses on risks to individual institutions, with the overall financial system supervision, by expanding the scope of work for safeguarding financial stability.*

The Bank of Albania defines financial stability as a situation in which the financial system operates in the absence of serious failures or undesirable effects on the actual and future development of the entire economy. To fulfil this commitment, the Bank of Albania conducts analyses on the stability of the financial system in general and the banking system in particular; it monitors risks to which banking activity is exposed, including systemic risk, and communicates regularly with all public authorities, the financial industry and the public.

In the framework of inter-institutional cooperation as part of the Financial Stability Advisory Group, during the first quarter of 2014, a memorandum of understanding was signed between the Ministry of Finance, Bank of Albania, Financial Supervisory Authority and Deposit Insurance Agency. This memorandum lays down the modalities of cooperation between the institutions for the prevention and management of extraordinary situations in the activity of the financial system.

II.2.1. RISK ASSESSMENT AND MANAGEMENT

The assessment of the banking activity exposure to credit, market, and liquidity risks underlies the monitoring of developments in this sector. In the context of financial stability assessment, the Bank of Albania analyses also developments in the financial system in Albania, banking sector exposure to non-bank financial institutions or the effects of the real economy and financial markets on financial stability.

CREDIT RISK

The most significant impact of the global crisis on the Albanian banking activity was reflected in the deterioration of the credit portfolio quality. The

credit risk remains the main concern for the banking activity accompanied by the significant slowdown of lending to the economy. The Bank of Albania has closely monitored credit risk developments, taking relevant measures to contain this risk. In concrete terms:

- To address the significant deceleration of lending and the deterioration of credit quality, in May 2013, the Bank of Albania introduced a package of countercyclical measures which envisaged: (1) changes to capital requirement related to: i) annual increase of the credit stock (within a certain interval) and; ii) flow of investments of the banking sector with non-residents, as well as (2) changes to requirements for standard credit restructuring. Upon entry into force, countercyclical measures helped support lending and contain the further deterioration of credit quality. Banks have increased the use of auxiliary measures for credit restructuring, which has helped maintain the quality of the credit portfolio. As the application of these measures expired at the end of 2014, the Bank of Albania decided to extend their effectiveness to 2015. In concrete terms, capital requirements on the annual increase of credit stock shall be in effect until June 2015, whereas changes related to the flow of investments in the banking sector with non-residents shall be in effect until the end of 2015.
- During the first quarter of 2014, the Supervisory Council of the Bank of Albania approved some amendments to the regulation "On credit risk management". According to these amendments, from 1 January 2015, the writing off of non-performing loans shall become mandatory for banks, three years after they have been classified as 'loss loans'.
- To facilitate the process of loss loan write off, upon the proposal by the Bank of Albania, in May 2013, the Ministry of Finance amended the relevant bylaws which define provisions for loan write offs as deductible expenditure for fiscal purposes. In April 2014, these amendments became effective in the law "On income tax".
- In the same direction, to alleviate the burden of banks on collateral execution, some amendments were made to the Code of Civil Procedure aimed at accelerating this process. Since their entry into force in September 2013, the success rate of collateral execution has hiked by around 10%. However, the full impact of these amendments in terms of concrete results requires more time and experience and the overall success will depend significantly on the real estate market performance.
- The Bank of Albania has approved a new regulation "On risk management from large exposures of banks". Among others, this regulation has introduced requirements to increase the responsibilities of the steering councils on large exposure management. Recovery and resolution plans at system level should be drafted, when these exposures are present in more than one bank. In cooperation with World Bank

FinSAC project, a platform is being implemented, which is expected to prepare the infrastructure for drafting recovery and resolution plans in the future.

- Finally, in response to low inflationary pressures, and to boost economic growth and lending, the Bank of Albania has steadily implemented an accommodative monetary policy. As a result, during 2014, the interest rates on lek loans were downward, reflected also in the improvement of credit growth pace during the second half of the year.

MARKET RISKS

The Bank of Albania is closely monitoring developments in the market risk. The banking sector appears less exposed to direct market risk arising from unfavourable fluctuations in the exchange rate and interest rates. However, exposure to indirect market risk from unhedged foreign currency borrowings remain relatively high, as loans to unhedged borrowers account for 31.3% of total loans.

LIQUIDITY RISK

Liquidity risk in the banking sector in Albania is assessed as low, since liquidity indicators stand significantly above the minimum level required by the regulatory framework. Bank deposits continued to grow reflecting low reliance of the banking sector on foreign financing.

RISK OF FOREIGN SHOCK SPILLOVER

Monitoring and analysing macroeconomic and financial developments in global markets is crucial for understanding the extent of exposure of the Albanian economy to risks arising from them. The Bank of Albania has compiled methodologies to assess the effect of external shocks on the Albanian financial system. Moreover, the stress test exercises are regularly used to assess the exposure of the banking sector to the volatility of foreign security prices, to holding groups, and to investments with non-residents. Results of exercises conducted in 2014 show that the banking sector maintains a good capitalisation level against shocks in terms of these risks.

SYSTEMIC RISK MONITORING

In the aftermath of the latest financial crisis, in line with contemporary international practices on financial supervision, we have worked to construct appropriate indicators for identifying the systemic risk, through specific indicators and methodologies that assess various aspects of it.

Results are then complemented with conclusions obtained from surveys with the banking industry in terms of systemic risk perception. In the meantime, business and household surveys provide additional information on the size of their debt burden and the potential of the transmission of potential shocks to the financial system.

Furthermore, the Bank of Albania has developed an identification methodology for systemic banks in the country, initiating a process for gradually introducing higher supervisory requirements for these institutions.

Overall, systemic risk assessment indicators in the banking sector show that it remains at considerable levels, but it has fallen during 2014 due to improved profitability, liquidity and asset quality indicators. Results are also verified through the stress test exercises with some commercial banks, which offer extensive information on their exposure to various macroeconomic and financial risks.

COMMUNICATION WITH THE PUBLIC

Communication with the public is another important aspect of the work of the Bank of Albania regarding financial stability. Half-yearly, the Bank of Albania publishes the Financial Stability Report and Financial Stability Statement. In particular, the Financial Stability Statement draws the attention of financial institutions and of the public on the situation of the financial system and potential risks that may threaten its stability. The latest Statement, published in October 2014, iterates that the situation and performance of the banking sector and financial system is stable. The Statement highlights, however, the importance of the careful monitoring of the credit risk, urging banks to make assessments based on a conservative analysis of future developments. It also emphasises the need for banks to assess additional costs that may be incurred during the restructuring and management of collateral they take in possession, following the execution process. The statement underlines the need to monitor carefully developments in the external environment related to actions by European authorities on the reassessment of asset quality, capitalisation levels and restructuring measures of larger European banking groups.

Financial stability issues are also addressed in other publications or in speeches by administrators of the Bank of Albania. Press releases on the meetings of the Financial Stability Advisory Group (FSAG), with a summary of the agenda, are published regularly on the official web page of the Bank of Albania.

Fulfilment of recommendations by the Financial Sector Assessment Program (FSAP²⁸)

During 2014, an important part of the work of the Bank of Albania focused on fulfilling recommendations left by the Financial Sector Assessment Program (FSAP) of the IMF and the VWB, in November 2013. In this regard, we may mention: improvement of some techniques related to the stress-test exercise,

²⁸ Financial Sector Assessment Program.

identification and monitoring of low-frequency indicators, which serve as “leading/forecasting” ones on systemic risk; improvement of the effectiveness in relations with the Albanian Financial Supervisory Authority (AFSA) in the framework of information exchange on exposure and risks between the banking and non-bank financial sectors; establishment of the framework of procedures for public authority actions in the event of a systemic risk in the financial system and the role of the Bank of Albania in safeguarding financial stability; and functioning and stronger support to the FSAG by reviewing the cooperation agreement between the members.

II.2.2. BANKING SECTOR PERFORMANCE

The performance of the banking sector during 2014 is assessed as stable. The volume of its activity increased and the financial soundness improved. Liquidity and capitalisation indicators remained steady throughout the year. The credit portfolio quality remains concerning, albeit improving slightly compared to the previous year. Loan loss provisions and collateralisation of non-performing loans were at adequate levels. Banking sector exposure to market risks is more contained than exposure to credit risk.

The banking sector remains the main segment of financial intermediation in Albania. Its assets, as at end-December 2014, rose to 91.7% of the Gross Domestic Product, up by 1.2 percentage points from the previous year. This sector is dominated by five banks, which altogether account for 68.4% of the system’s loan portfolio and 73.4% of deposits.

As at end-2014, the banking sector assets rose to ALL 1.294 billion, registering 4.8% annual growth, from 3.9% a year earlier. The expansion of the credit portfolio and of the securities investment portfolio were the main contributors to the rise in assets, reflecting the increase in the participation of the sector in government debt securities auctions.

The activity was financed through the increase in deposits of the public, which account for 82.3% of total banking sector assets. Aggregated, deposits in banks, as at the end of the year, surged 4.6% from 3.6% in the previous year²⁹.

Banking sector exposure to non-resident institutions was similar to the previous period, reflecting weak reliance on foreign financing sources. The net position of the sector to non-residents remains markedly on the crediting side, with a slight increase during the period.

FINANCIAL RESULT AND PROFITABILITY INDICATORS

The net financial result of the banking sector was positive throughout the year,

²⁹ This figure reflects total accepted deposits, including those from non-residents.

reaching ALL 11.2 billion in December 2014. Compared to the end of 2013, the net financial result improved by 70.5%. Banks have lowered financing costs, which, together with the downward provisions, have led to improved average indicators of banking sector profitability. The net result from interests hiked up 12.9% to ALL 44.6 billion, as a result of the higher decline in expenditure for interests than in income from interests. Net result from the activity fell to ALL 8.2 billion.

Table 6 Profitability indicators, in per cent (cumulative)

| Indicators | December 2011 | December 2012 | December 2013 | December 2014 |
|--|---------------|---------------|---------------|---------------|
| Interest income/average earning assets (1) | 7.78 | 7.73 | 7.32 | 6.28 |
| Interest expenses/average earning assets (2) | 3.57 | 3.72 | 3.42 | 2.14 |
| Net Interest Margin (NI M) {(1)-(2)} | 4.20 | 4.01 | 3.89 | 4.15 |

Source: Bank of Albania.

The annual rate of return from average earning assets and capital were 0.89% and 10.53%, respectively, improving significantly from the previous year, mainly due to the improvement of profitability of the system.

BANKING BUSINESS CAPITALISATION

The structure of regulatory capital appeared favourable in terms of the banking sector's capacity to cover potential losses, as core capital continues to account for the most part of it, 81.9%. The higher growth rate of risk-bearing assets against the regulatory capital contributed to the capital adequacy ratio falling to 16.84% from 17.96% in the previous year. However, the current level stands evidently higher than the 12% minimum requirement.

CREDIT QUALITY

In December 2014, non-performing loans accounted for 22.8% of the credit portfolio, improving 0.7 percentage point compared to the end of 2013. Businesses non-performing loans improved 1 percentage points to 26.7% of the respective credit portfolio; for households it improved 0.2 point to 16.5% of the respective portfolio.

The migration of loans toward the "loss" category continues in the non-performing loans portfolio. This tendency increases the reliance of banks performance on collateral execution and loan loss write offs. The classification of loans to a lower category was accompanied with an increase by around 4.8% to the reserve funds.

LIQUIDITY SITUATION

The liquidity situation in the banking system is adequate and the Bank of Albania deems that the banking system exposure to liquidity risk is low. At the end of 2014, the ratio of liquid assets to current liabilities resulted 40.4%, aggregated, and 55% for the national currency (or up by 12.3 percentage points from the same period in the previous year) and 26.1% for the foreign currency (unchanged from the previous year). Each indicator stands significantly above the minimum regulatory threshold. The liquidity indicator in lek increased also owing to the amendments to Bank of Albania regulation "On guarantees in lending operations of the Bank of Albania" and "On repurchase and reverse repurchase agreements", which were indirectly reflected in the asset criteria to be considered as liquid.

During the year, the commitments by parent banks in the form of line of financing narrowed; however, the part that was used from it remains at moderate levels. Deposits remain the main source of funding the banking sector activity. Overall, their concentration is low. At the end of 2014, the 10 largest depositors accounted for 6.1%, 20 largest ones accounted for 8.2% and 50 largest ones accounted for 11.6% of total deposits in the banking system.

EXPOSURE TO EXCHANGE RATE AND INTEREST RATE VOLATILITY

At the end of December 2014, the net open position in foreign currency was "long" at 8.5% of the regulatory capital, suggesting a limited risk exposure to the exchange rate. Banking sector exposure to interest rate volatility is considered as relatively limited as the share of this difference in total assets is not considerable. In the meantime, foreign currency credit accounts for 59% of total credit portfolio, and unhedged foreign currency credit accounts for 31% of the credit portfolio, which indirectly exposes the sector to market risk for households and businesses.

STRESS TEST EXERCISE AND OUTCOME

Stress-testing exercises assess the financial system stability and the banking sector's capital adequacy over a period of up to end-2015. The exercise assesses the impact of macroeconomic situations on the banking sector's financial standing, excluding the possibility of an increase in the paid-in capital during the period under review. The analysis employ three scenarios: baseline scenario, which is based on projections of economic and financial indicators in accordance with their historic performance; and two adverse scenarios which include increase in interest rates, slowdown or contraction of lending and depreciation in the exchange rate. The outcome of the exercise in terms of capital adequacy, reveals that, overall, the banking sector remains well capitalised. However, medium-sized banks have lower capital adequacy rates, compared to the other banking groups.³⁰

³⁰ Banks in the Albanian banking sector are classified by their size of activity as follows:
 - Group 1 banks (smaller banks) each accounting for 0-2% to total assets of the sector.
 - Group 2 banks (medium-sized banks) each accounting for 2-7% to total assets of the sector.
 - Group 3 banks (larger banks) each accounting for above 7% to total assets of the sector.

As regards banking sector exposure to market risk, the exercise is based on the haircut applied to the value of investments in securities. Results show that the sector continues to be sensitive to exposure of commercial debt securities, whereas risk arising from exposure to sovereign debt securities is limited.

Finally, the exercise which assesses the exposure of the banking sector to parent banking groups, confirms that individual banks are exposed to this risk, but, overall, the banking sector remains hedged against this risk due to sound capitalisation positions.

II.3. BANKING SUPERVISION

- *Bank of Albania's supervision is based on three pillars: licencing, regulation and supervision. The latter is carried out through off-site surveillance and on-site inspections³¹. The constant supervision and regulation of financial activities, mainly of banking activities, is at the focus of this function and represents its main activities.*

During 2014, licenced financial entities were constantly examined, through both on-site inspections and off-site surveillance. Also, we have been in constant communication with the banking industry to discuss and collect its opinion on regulatory improvements and potential effects.

In response to higher credit risk, a proactive supervisory approach has been employed, channelling the analysis at the macro level (individual borrowers) to find sustainable solutions of mutual benefit for both parties. This platform for addressing non-performing loans aims at finding suitable solutions for borrowers, creates more space for cooperation between the banks and contributes to the economic activity by generating the necessary liquidities for investors and corporates to continue their business operations.

II.3.1. REGULATORY FRAMEWORK

During 2014, new regulatory acts were drafted and existing ones were reviewed aimed at approximation to Basel Committee standards and European directives, and alignment with domestic developments. Also, during the year, some amendments to the supervisory framework were made following the recommendations left by the Financial Sector Assessment Program of the International Monetary Fund and World Bank, during 2013, to assess the implementation of 29 Basel Committee Principles for Effective Supervision³².

³¹ The Bank of Albania publishes detailed information on developments in the banking system and banking supervision process in annual supervision reports.

³² Basel Core Principles for Effective Banking Supervision.

New and comprehensively revised regulatory acts during 2014

- Document on "Supervision Policy", which defines a risk-based supervision policy for banks and banking or financial groups, for which the Bank of Albania is the responsible supervisory authority. The main objective is to ensure an efficient process for assessing the financial situation and stability of banks.
- Regulation "On risk management from large exposure of banks", which sets out the rules and criteria for calculating, supervising and reporting bank's large exposures to a person/client or group of persons/clients connected between them or with the bank, for the purpose of managing the risk arising from concentrated exposure to them. It entered into force on 1 January 2015.
- Guideline "On Recovery Plans", which sets out the core principles and supervisory requirements on the structure and content of banks recovery plans and their reporting to the Bank of Albania.
- Regulation "On banks regulatory capital", which sets out the structure, components, and methodology for calculating banks regulatory capital and determines the capital minimum requirement.

Regulatory acts partially revised during 2014

- Regulation "On credit risk management from banks and branches of foreign banks" was partially amended, in accordance with IMF/WVB recommendations on credit risk management. These amendments entered into force on 1 January 2015.
- Regulation "On licensing, organisation, activity and supervision of foreign exchange bureaus" was partially amended to strengthen supervisory processes and enhance discipline in this market related to consumer protection in foreign exchange activities.
- Regulation "On Capital Adequacy Ratio" was partially amended, in the framework of the package of measures to improve the lending setting in Albania and add reporting forms on capital requirements (COREP) and methodology instructions for filling them out.
- Regulation "On licensing and the exercise of banking activity by banks and branches of foreign banks in the Republic of Albania", was partially amended, in accordance with the recommendations by the FSAP Mission (2013), related to additional criteria for the approval of the transfer of the qualifying holding in banks and some criteria for the provision of cross-border banking and/or financial services.

II.3.2. LICENSING AND APPROVALS

The structure of the Albanian banking system remained unchanged in 2014, consisting of 16 commercial banks with both foreign and Albanian capital. The major part of the banking sector is controlled by subsidiaries of EU-based banking groups that exercise their activity in accordance with the Albanian legislation and in accordance with Bank of Albania's regulatory framework in force.

Table 7 Banks' ownership structure (number of banks at period-end)

| | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|------|------|------|------|------|
| Banks in Albania, of which: | 16 | 16 | 16 | 16 | 16 |
| Branches of foreign banks | 2 | 2 | 0 | 0 | 0 |
| Majority privately owned ¹ as follows: | | | | | |
| Majority foreign-owned: | 14 | 14 | 14 | 14 | 14 |
| Majority owned by EU-based groups ² | 10 | 10 | 10 | 10 | 10 |
| - Majority Turkish owned ³ | 1 | 1 | 1 | 1 | 1 |
| - Majority owned by an international financial institution (Saudi Arabia) | 1 | 1 | 1 | 1 | 1 |
| - Majority Kuwaiti owned ⁴ | 1 | 1 | 1 | 1 | 1 |
| - Majority Swiss Confederation owned ⁵ | 1 | 1 | 1 | 1 | 1 |
| Majority Albanian owned ⁶ | 2 | 2 | 2 | 2 | 2 |

Source: Bank of Albania.

1 "Majority" means, in any case, the simple majority of 50% of votes plus 1 vote.

2 EU-based banks are: Italy (Intesa Sanpaolo Albania, Banka Veneto), Austria (Raiffeisen), Germany (Procredit), France (Societe Generale Albania, Credit Agricole Albania), Greece (Banka Tirana, Alpha Bank Albania, NBG Albania), and Bulgaria (First Investment Bank).

3 Banka Kombëtare Tregtare [Eng: National Commercial Bank].

4 Credit Bank of Albania.

5 International Commercial Bank, shareholder: Financial Group ICB Holding.

6 Albanian-owned banks: Banka Union (88.82%) and Banka Credins (76.92%).

In accordance with and pursuant to requirements arising from Law No 9662, dated 18.12.2006 "On Banks in the Republic of Albania" and the normal functioning of banking activities, the Bank of Albania, through the assessment of requirements set out in supervision regulations has supported banks in their applications throughout 2014.

Approvals for additional activities in annexes to bank licences consisted in the assessment and approval of request by a bank for the additional activity of trading on behalf of the bank in foreign exchange, in a self-organised market of transferable securities. During this year, the Bank of Albania continued to assess requests by banks for intermediation in insurance and reinsurance, which are still in the process of application at the Bank of Albania. It has also supported the banks who were interested in fulfilling the legal/regulatory criteria for this activity.

Banks submitted applications for changes to their bank network, regarding both expansion and reduction (closure, merger/transfer) of branches/agencies in the country. As at end 2014, banks operated with 500 branches/agencies.

With regard to licencing, the Bank of Albania has paid particular attention to implementing the core principles and rules for responsible and effective bank management, assessing the organisational structure of the banks, their management and division of responsibilities. In accordance with the Regulation "On the core management principles of banks and branches of foreign banks and the criteria on the approval of their administrators", the Bank of Albania approved 65 new administrators. Their positions are as follows: 18 Steering Council members, 10 Audit Committee members and 37 executive directors. Administrators of non-bank financial institutions were also subject to approval.

During 2014, based on the applications, the Bank of Albania granted licenses and its approval for financial institutions subject to its licencing and supervision.

Table 8 Number of financial institutions licensed by the Bank of Albania (end of period)

| | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|------|------|------|------|------|
| Branches of foreign banks | 16 | 16 | 16 | 16 | 16 |
| Non-bank financial institutions | 17 | 19 | 21 | 21 | 22 |
| Foreign exchange bureaus | 284 | 301 | 322 | 333 | 356 |
| Unions of savings and loan associations | 2 | 2 | 2 | 2 | 2 |
| Savings and Loan Associations | 126 | 126 | 126 | 121 | 113 |

Source: Bank of Albania.

In 2014, one non-bank financial entity was licenced for financial lease, bringing the number of non-bank financial institutions to 22. For non-bank financial institutions the transfer of the qualifying holding to 100% of shares and reduction of capital for one institution was approved.

Licencing of foreign exchange bureaus continued in 2014, at a faster pace than in the previous year. Thus 33 new entities were licenced to conduct foreign exchange activities. Ten licenced entities that exercised foreign exchange activities returned their licences to the Bank of Albania for termination of activities. As at end 2014, some 365 licenced foreign exchange bureaus operated in the foreign exchange market. Approvals were given for additional cambists exercising their activity in existing foreign exchange bureaus.

In this year, no new Savings and Loans Association was licenced. Their number continued to fall after the revocation of licences for eight Savings and Loans Associations that had initiated winding-up procedures.

II.3.3. ON-SITE EXAMINATIONS

On-site examinations, a very important part of the supervisory process, aimed at closely examining and evaluating the risk profile of institutions licensed by the Bank of Albania. Their planning and organisation is based on several main pillars, such as moving towards a risk-based supervision, ensuring compliance of licensed institutions' operations with the effective legal and regulatory framework, and enhancing the effectiveness of supervision instruments. Off-site surveillance is also substantial in the process of planning on-site inspection. Off-site surveillance monitors dynamically and pro-actively the financial situation of licenced entities, as well as the entire banking system, by identifying existing and potential problems, and serves as an early warning system.

During 2014, nine inspections were carried out in bank and non-bank financial institutions. They include four full-scope examinations for the overall situation of bank institutions and one full-scope examination for a non-bank financial institution. Also, two separate examinations were carried out to assess specific risks facing bank institutions, mainly credit risk. Compliance and level of implementation of the plan with corrective measures is another element

of on-site inspections. For that purpose, one examination was carried out in a bank institution and one examination in a non-bank financial institution. Cooperation with other supervisory authorities, such as the Albanian Financial Supervision Authority has also been at the attention of the Bank of Albania. During the year, four examinations were carried out in depository banks and administrators of common funds.

The resulting conclusions from on-site inspections reveal that the activity of licenced entities is overall carried out in conformity with the requirements of the legal, supervisory and regulatory framework. Recommendations aim at improving risk-management practices with regard to:

- Strengthening the governance in licenced entities, especially supervisory and management structures;
- Enhancing internal audit systems in examined entities for identifying, measuring and monitoring risks. Particular attention was paid to various levels of control such as the internal audit, risk and compliance function, etc.:
- Constant revision of the internal framework that regulates risk management practices in accordance with supervisory requirements;
- Improvement of credit approval standards, steady monitoring of the past-due portfolio and strengthening efforts for their recovery;
- Ensuring regulatory compliance related to treatment of investments in securities.

Credit risk remains the main risk to which licenced entities are exposed, due to both external factors (economic conditions, competition, etc. and internal factors (structure of balance sheets, lending standards, control systems etc.). Thus, higher attention and more human resources have been committed to this risk during on-site inspections. Examinations required reclassification of risk type for certain borrowers, improvement of identification procedures, measuring and monitoring of bank exposure to a borrower or group of related borrowers. In recent years, licenced entities have seen slow credit growth rates compared to previous periods, focusing more on past-due loan recovery and lending standard tightening. Under these conditions, examinations have aimed at identifying factors and internal responsibilities contributing to credit quality deterioration, in order to address weaknesses and find new ways for sound lending processes, which support the economy in general and the activity of the licenced entities.

In accordance with the philosophy for prudential supervision and prevention of negative phenomena, we have asked for measures to be taken to address the problem of past-due portfolio through strengthening the early monitoring of past dues, drafting strategies for problematic client resolution, enhancing the efficiency in credit restructuring, etc. For a transparent and sound process of non-performing loan recovery, during on-site inspections particular attention has been paid to the treatment of assets obtained through legal processes, efforts to sell them, estimation of their value, etc.

A part of recommendations aimed to improve qualitative requirements for liquidity and market risks management, although entities' exposure to such risks is assessed as adequate.

Stress test analyses, an important element for monitoring entities risk exposure, both in normal and not normal situations in their activity, were at the focus of on-site inspections. Recommendations have addressed the need to improve their frequency and transmit the results to the entities steering bodies, in order to further improve the internal policies on risk management.

An integral part of inspections were also the assessment of transparency with the public and exposure to operational and IT risks.

TRANSPARENCY AND DISCLOSURE OF INFORMATION

With regard to transparency, monitoring, identification, measuring and assessment of compliance with obligatory requirements for implementation by banks to inform clients on bank products and services were a priority of the Bank of Albania. We have found that banking sector awareness is raised on matters pertaining to transparency and disclosure of information. Elements of credit agreements have been revised, in accordance with regulatory requirements, as well as the pre-contractual information of clients. Actually, all banks publish the annual and quarterly reports on their websites.

During 2014, the Bank of Albania has steadily paid due attention to publishing on its website banks reporting on fees and interest rates on loans and deposits.

OPERATIONAL RISK

Banking system made progress in terms of monitoring and managing the operational risk.

On-site inspections in banks found that senior management was more involved in developing an adequate system of policies that regulate the management of this risk. This contributed to the further progress related to both the identification and assessment and to the monitoring and reporting of the operational risk. Overall, the system responded positively to the requests of the authority by implementing mitigating techniques and compiling and implementing the relevant internal procedures.

On-site inspections on banks' information and communication technology consisted in four full-scope examinations and one targeted inspection. They found difficulties, particularly in the management of information technology-related risks, implementation of business continuity plans in case of disasters, and management of information security incidents. Respective recommendations were given with regard to the deficiencies identified during inspections.

PREVENTING MONEY LAUNDERING AND TERRORISM FINANCING

In 2014, issues related to preventing money laundering and terrorism financing continued to be rigorously supervised through on-site inspections.

Important aspect of the work was the signing of a cooperation agreement, on 10 June 2014, between the Bank of Albania and the General Directorate on Preventing Money Laundering and Terrorism Financing, in the framework of combating money laundering and terrorism financing. The implementation of the measures plan and recommendations provided by the Moneyval Committee of the Council of Europe and the Financial Action Task Force (FATF) were regularly monitored and reported to the relevant institutions.

The measures undertaken in 2013 for the implementation of the legal amendments and the alignment of legislation with international standards and recommendations from international bodies enhanced the efficiency of anti-money laundering and terrorism financing measures.

II.3.4. NON-BANK FINANCIAL INSTITUTIONS, UNIONS AND SAVINGS AND LOANS ASSOCIATIONS

During 2014, Bank of Albania continued its institutional communication with non-bank financial institutions licensed by the Bank of Albania, focusing particularly on their compliance with the regulatory framework. Considerable supervisory capacities were engaged with the review of the legal framework on the Savings and Loan Associations and their Unions. For the purposes of the Law review, consultative meetings were held with the Savings and Loan Association and their Unions, in close collaboration with the Albanian Deposit Insurance Agency, the World Bank and the Financial Services Volunteer Corps (FSVC). Year 2014 marked the groundwork for the compilation of the draft-law on the Savings and Loan Associations and their Unions, to be finalised in the next year, after consultations with the respective sector.

II.3.5. CREDIT REGISTRY

Credit Registry continues to function successfully accomplishing its main function to facilitate credit risk management and enhance the effectiveness of Bank of Albania's supervisory process.

As at end 2014, Credit Registry contained data as reported by 31 banking and financial entities for 1,042,276 reported loans, of which 405,573 were active loans, while the rest were loans closed along the years, including written-off loans. The loans reported to the Credit Registry, which have been for five years either closed by the borrower or written off the balance sheet of the reporting entity, are written off the registry in compliance with the respective procedures.

Banking entities have reported 327,694 active loans; non-bank financial institutions that conduct lending and financial lease have reported 58,622 active loans; while the savings and loan associations and their unions have reported 19,257 active loans in total, of the loans reported to the financial system.

II.3.6. SPECIAL SUPERVISORY ACTIVITIES

FULFILMENT OF WORLD BANK CRITERIA ON DEVELOPMENT POLICY LOAN

Development Policy Loans (DPL) is an instrument of the World Bank to meet certain development objectives, in the context of supporting loans for the Albanian Government. The Bank of Albania has fulfilled all its obligations in the framework of this instrument.

- Supervision Policy and Risk Assessment Manual were approved, and entered into force on 1 January 2015.
- The Regulation "On the Risk Management from Large Exposures of Banks" was approved³³.
- The Regulation "On credit risk management" was amended laying down criteria on writing off loss loans after a determined term³⁴.
- During 2014, work has been done to draft a new Law on Savings and Loan Associations. This work continues during 2015 and is within the term foreseen in the DPL.

TRANSITION TO RISK-BASED SUPERVISION

Efforts for the complete implementation of risk-based supervision methodology intensified in 2014. Two important documents, "Supervision Policy³⁵", and "Risk Assessment Manual", were approved.

The new Supervision Policy aims at further increasing banking supervision efficiency. The document lays down a set of priorities for both supervisors and banks, focusing on the supervision of banks and activities that pose higher risk or negative tendencies. It urges banks to improve their capacities in identifying, measuring, monitoring and controlling risks and to correct the deficiencies identified during these processes. Also, the Policy document promotes more frequent and open communication between banks and supervisors, which are provided through meetings at different stages of the process and enable supervisors to better understand the strategy of the bank, the risks it faces, the risk management quality, and the results in addressing the deficiencies identified during the supervision process.

³³ For further information, refer to Section "II.2.1.Risk assessment and operations for their management".

³⁴ For further information, refer to Section "II.2.1.Risk assessment and operations for their management".

³⁵ Approved by Decision of the Supervisory Council No. 9, dated 26.02.2014

At the same time, the Supervision Policy improves the quality of banking supervision work, as the new developments and strategic changes in a certain institution or sectorial developments in specific risks are monitored in details throughout the supervision cycle. It ensures a better management of human resources in terms of time, reducing the time spent during on-site inspections, while conducting off-site analysis.

The Risk Assessment Manual was approved along with the Supervision Policy, and entered into force on 1 January 2015. The main objective of the risk-based supervision is to ensure an effective assessment of the financial situation and the stability of banks. The new Manual contains qualitative changes compared to the previous manual, related to the implementation of new examination and risk assessment procedures (strategic and organisational risk, interest rate risk at banks books and operational risk, which should contain modules on information technology and compliance risk, AML/CTF and transparency). A new risk assessment system introduces a structured algorithm to determine the assessment of general risk of the bank based on the individual assessment of each risk.

PLATFORM FOR ADDRESSING NON-PERFORMING LOANS

Year 2014 recorded interesting developments for the management of the non-performing loans portfolio, in particular, the initiative to analyse and compile recovery and resolution plans for the largest borrowers of the system, which face payment difficulties and are exposed to several banks at the same time. Related to the selected borrower, after the prior consent for information sharing among banks, the best options were proposed for a sustainable solution of the borrower's payment capacity and business continuity. This initiative is supported by World Bank FinSAC, which has engaged an experienced international company. The initiative will continue to be implemented during 2015.

TRANSITION FROM BASEL I TO BASEL II

In the framework of approximation to 2006/48/EC Directive "On the taking up and pursuit of the business of credit institutions" and 2006/49/EC Directive "On the capital adequacy of investment firms and credit institutions", the new Regulation "On capital adequacy ratio" was approved.

The Regulation marks the transition from Basel I standard, to New Capital Accord also known as Basel II. The purpose of this Regulation is to align the regulatory framework of the supervisory authority, for calculating the capital adequacy ratio, to better address banks' capital needs for monitoring, mainly: credit risk, market risk and operational risk, to ensure, in any case, an adequate ratio.

New capital requirements and COREP reporting tables approved during 2014, in accordance with the EU Directive on the business of credit institutions, will be implemented by banks during 2015, following a parallel testing period of new requirements with the existing ones (in force) during 2014.

RECOVERY AND RESOLUTION PLANS

At the beginning of 2014, the Supervisory Council of the Bank of Albania approved the document on "Recovery Plans". The document outlines potential recovery measures to ensure the return of banking business to normality, in case various adverse scenarios to it materialise. These measures are conceptualised as solutions for extraordinary situations, which will not apply during the normal business. Recovery Plans aim to reduce the probability of failure of systemically important banks.

II.4. PAYMENT SYSTEMS AND CURRENCY ISSUANCE

II.4.1. PAYMENT SYSTEMS

- *To accomplish its legal responsibilities on payment systems, the Bank of Albania promotes the smooth functioning of the internal payment system in Albania. In order to reach this objective, the Bank of Albania implements three approaches that are complementary and cooperative. The Bank of Albania acts as: (i) system operator, (ii) system overseer, and (iii) system reformer.*

During 2014, Bank of Albania accomplished its functions as operator, overseer and catalyser of the payment system. The Document "Oversight of payment and settlement systems" was reviewed for approximation with the international and European practices in the field of payment systems oversight³⁶. The review provided alignment of the oversight policies of the Bank of Albania with the Law "On Payment System" and approximation of Bank of Albania's functions and policies to those of the European Central Bank. Also, this review provides information to the market on the Principles for financial market infrastructures, published by the Bank for International Settlements in April 2012, implemented in Albania as well.

To accomplish its function as operator and administrator of payment systems, during 2014, the Bank of Albania implemented a set of measures to improve the existing infrastructure (AECH and AIPS), and establish new infrastructures, such as the central Albanian Financial Instrument Settlement and Registration (AFISaR) system. These developments are assessed to contribute considerably in enhancing security and efficiency of the payment systems, and in establishing new premises for the development of the financial markets infrastructure. In this regard, the applicable regulatory framework was updated and improved.

The Regulation "On the organisation and functioning of the National Committee on Payment and Settlement Systems" was compiled with the purpose to promote the Bank of Albania's role as catalyser in the field of payment systems and inter-institutional consolidation of cooperation³⁷. This initiative is based on

³⁶ Decision No. 32, dated 30.04.2014 of the Supervisory Council of the Bank of Albania.

³⁷ Decision No.35, dated 25.06.2014 of the Supervisory Council of the Bank of Albania.

the rights and obligations arising from Article 4 of the Law No. 133/2013, dated 29.04.2013 "On Payment System". The formalisation of interaction among stakeholders will enhance the effectiveness of reforms in the field of payment systems and will accommodate the needs for collaboration beyond the traditional actors in this field. Such a practice is considered indispensable in the light of the international practices, and more concretely those of European Union.

Year 2014 marked improvements related to the quality and range of statistical data for the payment instruments. The Bank of Albania, guided by the best international practices and developments in the services market and payment systems, reviewed the methodology "On Reporting Payment Instruments". The review of the methodology aims at approximating the reporting practices to European Central Bank and Bank for International Settlements standards and provides possibility to extend the analysis and studies at regional and international levels.

Particular attention was paid to research in the field of payments, more concretely to measuring the costs of various payment instruments in the Albanian economy. The Bank of Albania collaborated closely with the World Bank to design the methodology of this research study and collect the necessary data³⁸. This study has been considered as very effective by the central banks of advanced countries in terms of both the fight against using cash in economy, and of identifying the possibilities to cut the costs of using payment instruments in the economy. The study in Albania will support the analysis and understanding of real and social costs of using the payment instruments, the decision-making process in the framework of modernising the payment systems and services, the identification of possibilities for cutting costs depending on the results, and the promotion of the dialogue among market actors based on concrete results.

The basic infrastructure for national payments in lek functioned safely and efficiently.

During 2014, the basic infrastructure for the settlement and clearing of national payments in lek functioned safely and efficiently, hence contributing to supporting the efficient implementation of monetary policy, safeguarding financial stability and upholding public confidence in the national currency. The systems operated and managed by the Bank of Albania - "Albanian Interbank Payment System (AIPS) for large payments" and "Albanian Electronic Clearing House (AECH) for clearing small-value payments" - have operated in line with the relevant rules and procedures, preventing thus extraordinary situations.

The regulatory and infrastructural improvements undertaken by the Bank of Albania during 2014 provided added contribution to enhancing the security and efficiency of both systems, AIPS and AECH.

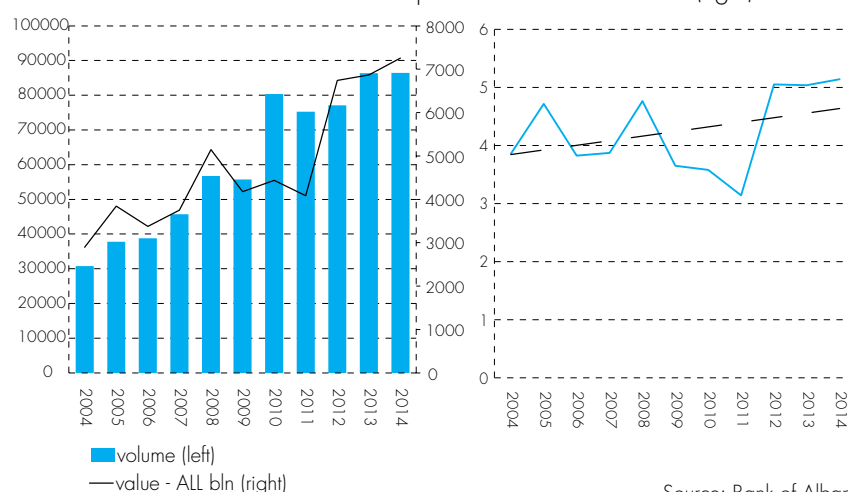
³⁸ Surveys are being conducted for 1 000 individuals and 700 businesses and at different public institutions that receive and deliver payments.

BOX 4 AIPS AND AECH SYSTEMS

AIPS - Albanian Interbank Payment System for large-value payments

During 2014, the value of transactions increased slightly, by 5.56% in annual terms, whereas the volume of transactions processed in AIPS was at the same levels with those in 2013. The ratio of the value of transactions processed in AIPS to the Gross Domestic Product increased as well.

Chart 30 Value and volume of transactions processed in AIPS (left); ratio of value of transactions processed in AIPS to GDP (right)

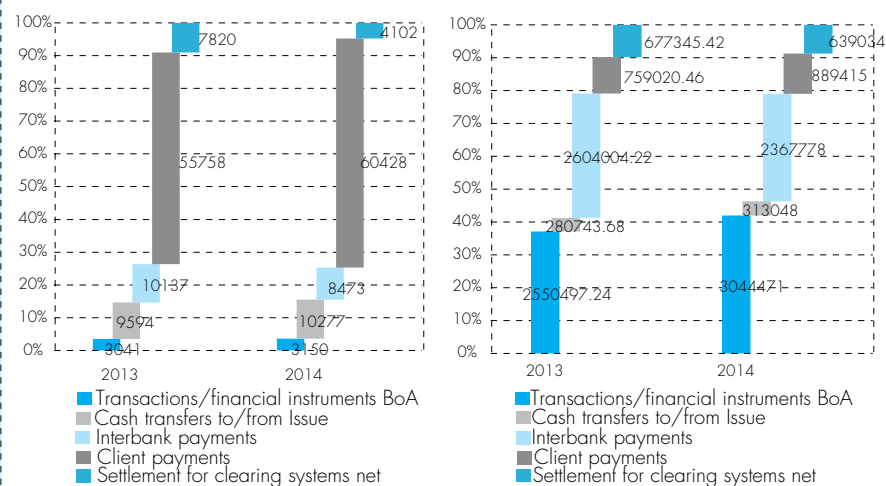


Source: Bank of Albania.

By typology of transactions processed in the AIPS the volume of payments for clients has been increasingly upward. This development is assessed to reflect the transmission of measures taken by the Bank of Albania in March 2011*. In terms of value, the presence of the monetary authority in the market increased, while interbank market activity decreased relatively slightly.

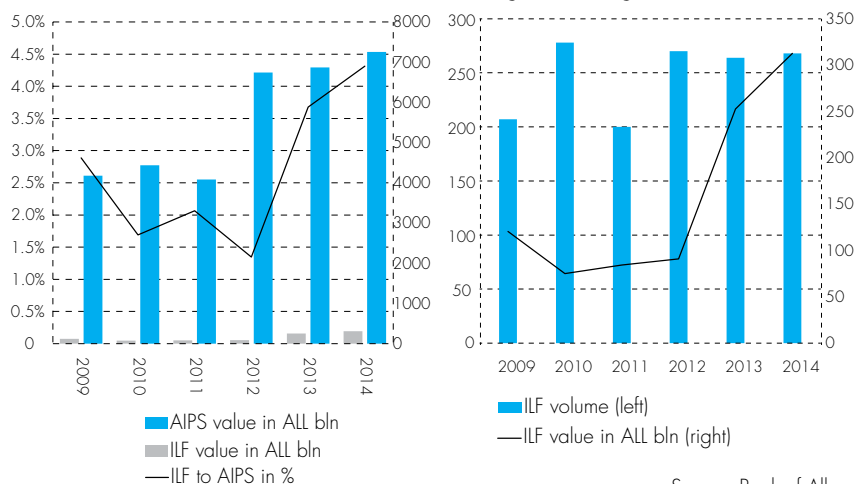
During 2014, Intraday Loan Facility (ILF)** increased 33.4% annually in terms of value, but remained almost unchanged in terms of number from the previous year.

Chart 31 Payments processed in AIPS, number (left) and value (right)



Source: Bank of Albania.

Chart 32 Performance of ILF and AIPS and their ratio (left);
number of ILFs and the average value (right)



Source: Bank of Albania.

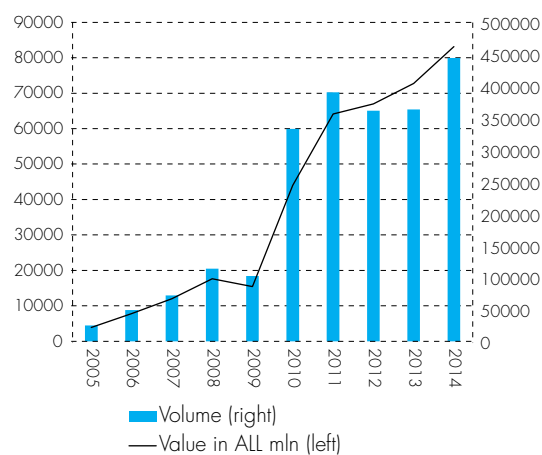
Notwithstanding the increase in terms of value, the ratio of financing the transactions processed in AIPS through this instrument remains considerably low (0.4%), implying a limited exposure of the system against liquidity risk. Also, liquidity needs were concentrated in limited time and segments, thus not reflecting the overall market behaviour.

AECH- Albanian Electronic Clearing House

During 2014, AECH increased in terms of both the volume and value. The volume of cleared transactions rose by 22.13% and their value 14.24%

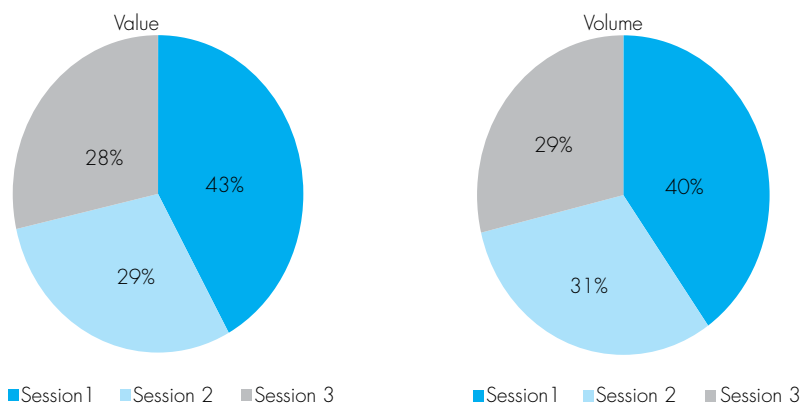
The increase of payments cleared in AECH was due to the combined effect of the increased payments by the Ministry of Finance (the participant with the main share in the system, 54% in terms of volume and 49% in terms

Chart 33 Volume and value of transactions cleared in AECH



Source: Bank of Albania.

Chart 34 Share of AECH transactions by sessions, in 2014



Source: Bank of Albania.

of value) and of payments cleared by banks for the account of their clients. The increase of payments cleared by banks for the third successive year is assessed to reflect the measures taken by the Bank of Albania in March 2011***.

The payments cleared in AECH during the sessions, reveal higher concentration in the first session****, compared to the other two clearing sessions. Prevention of the overload in payment flows during the last clearing session minimises the additional risks in the framework of a smooth operation of the payment systems

* By decision No. 12, dated 23.02.2011, Bank of Albania's Supervisory Council decided on the AIPS the reduction of commissions and tariffs for this system, as well as setting of a maximum value of ALL 1500 for bank commissions for ALL payments cleared and settled in the AIPS.

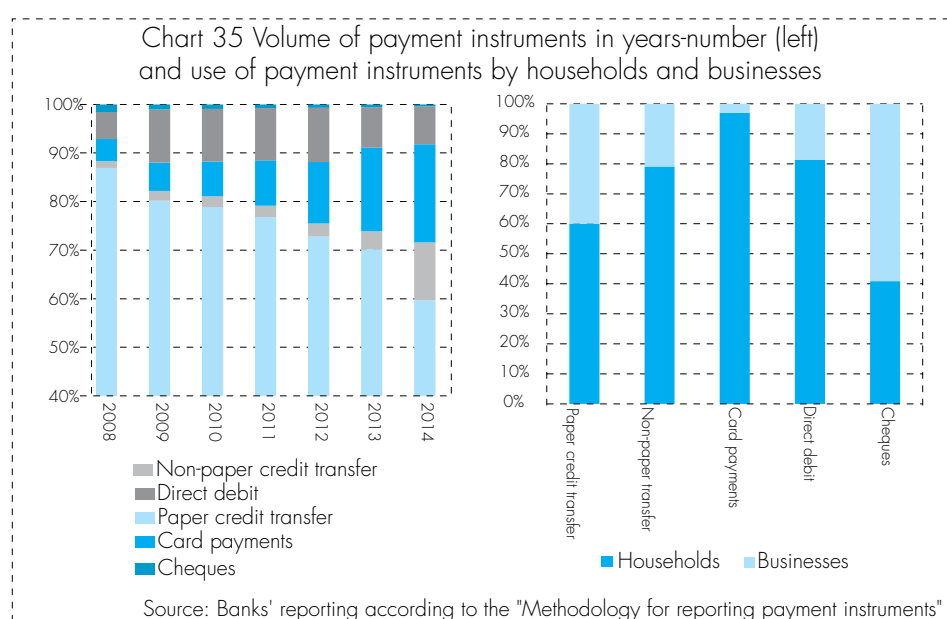
**An important instrument in AIPS is the Intraday Loan Facility (ILF) provided by the Bank of Albania to participating banks for the intraday management of liquidity and to guarantee the continuing smooth interbank functioning of payments.

***By decision No. 12, dated 23.02.2011, Bank of Albania's Supervisory Council decided on the AECH: increase in value of the limit from 1 million to 1.5 million in the AECH, addition of a third clearing session in the AECH, differentiated tariffs during the sessions and reduction of commissions and tariffs for this system, as well as setting of a maximum value of ALL 500 on bank commissions for ALL payments cleared in the AECH.

****To be highlighted the fact that, tariffs applied on payments settled during the first session are considerably lower than those applied in the third session.

Use of payment instruments, especially of electronic ones, trended up

During 2014, banks' statistics show that about 10.5 million customer payments were made, totalling ALL 4,289 billion, reflecting the 21% annual growth in volume and 18% in value. In 2014, the use of electronic payments instruments, particularly "Home banking" and bank cards services, increased faster.

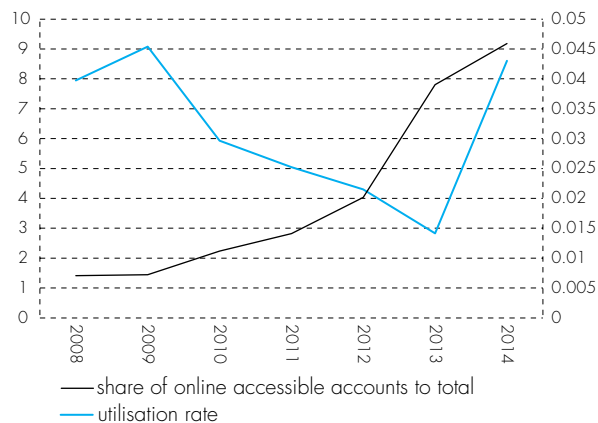


"Home banking services are increasingly expanding in the Albanian market. After their introduction in 2005 by one bank of the system, as at end-2014, 11 banks provided home-banking services.

The increasing number of online accessible customer current accounts, by 27% compared to 2013 (after doubling in 2013), is followed by a quadrupling of home-banking transactions volume during 2014. In addition to the increased market agent's understanding and the broader access³⁹ of the public to this service, it reflects to some extent the more regular reporting by banks, due to the change of the reporting methodology.

Use of online accessible accounts was up. In 2014, averagely 9 transactions were conducted per account, compared to 3 in 2013. This service continues to be more used by businesses (11 transactions per account), compared to households (7 transactions per account).

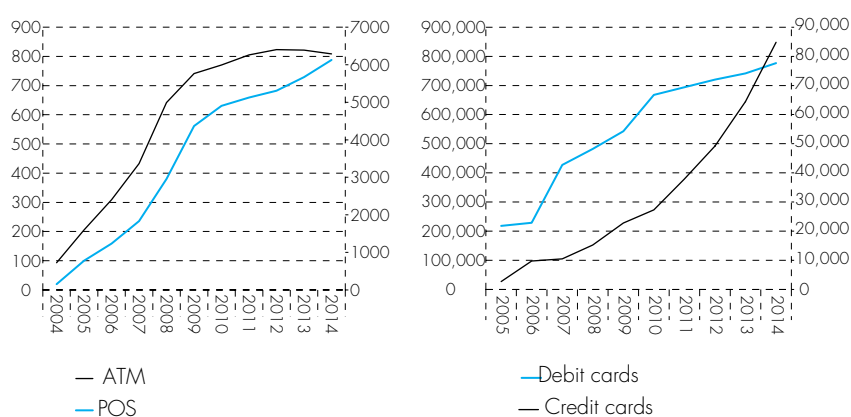
Chart 36 Share of online accessible accounts against total accounts and online accessible accounts utilisation ratio



*Utilisation rate shows the average use of an online accessible account for transactions.
Source: Bank of Albania

Analysis of the infrastructure of banks licensed as card issuers⁴⁰ in 2014 indicates a slightly lower number of ATMs, down by 2% in annual terms. The fall in ATMs number reflects the decisions of banks to close some of their branches. On the other hand, the number of POS terminals offered by banks licensed as card acceptors⁴¹ increased considerably, at 8% in annual terms.

Chart 37 Number of ATMs and POS terminals 2004-2014 (left); and number of debit and credit cards 2004-2014 (right)



Source: Banks' reporting according to the "Methodology for reporting payment instruments"

³⁹ In 2005 this service was introduced as a service mainly tailored for businesses; currently this service is increasingly provided to households as well.

⁴⁰ The number of banks licensed as card issuers in the Republic of Albania, as at end-2014, was 14. These banks provide cash withdrawal services from ATMs.

⁴¹ As at end-2014, 7 banks were also cards acceptors. These banks accept payments via cards through POS terminals in shops, restaurants, hotels or shopping centres.

Notwithstanding the increased POS terminals, their concentration continues to be high in Tirana,⁴² 78%. Out of the total of companies which potentially⁴³ may own a POS terminal, only 12% of them currently own terminals. This figure may be lower when considering that, in some cases, companies own more than one POS.

In 2014, the number of cards in circulation was up by 7% from the previous year. By function, credit cards increased faster, by 32%, compared to debit cards, by 5% in annual terms. Referring to banks reports, as at end-2014, debit cards' share to total cards in circulation decreased slightly, down to 90%, compared to 92% as at end-2013. Notwithstanding the positive growth paces of debit and credit cards, the percentage of accounts accessible through a debit or credit card is relatively low (25%).

Table 9 Share of card transactions by terminal

| | Volume | | | Value (ALL millions) | | |
|-------------------------------------|------------|------------|------------|----------------------|---------|---------|
| | 2012 | 2013 | 2014 | 2012 | 2013 | 2014 |
| 1- ATM cash withdrawals | 11,300,261 | 11,729,920 | 12,205,989 | 109,609 | 117,195 | 125,048 |
| 2- ATM depositing | 5 | 21 | 6 | 0.03 | 0.09 | 0.01 |
| 3- ATM transfer orders | 80 | 61 | 40 | 0.68 | 0.75 | 0.65 |
| 4- Cash withdrawal at POS terminals | 3,450 | 3 | 881 | 475 | 460 | 113 |
| 5- Card payments at POS terminals | 1,107,425 | 1,496,640 | 2,124,304 | 13,396 | 12,511 | 17,921 |
| of which: | | | | | | |
| - payments through debit cards | 656,000 | 864,730 | 1,212,278 | 4,739 | 5,738 | 7,914 |
| - payments through credit cards | 451,425 | 631,910 | 912,026 | 8,657 | 6,772 | 10,006 |
| Total card transactions | 12,411,221 | 13,226,645 | 14,331,220 | 123,481 | 130,167 | 143,084 |

Source: Reports submitted by banks according to the "Methodology for reporting payment instruments"

The increasing number of debit and credit cards was associated with the increase in card transactions, mostly for cash withdrawal in 2013, about 14.3 million (ATM and POS) card transactions were processed, equal to ALL 143 billion. Of total transactions, about 85% in number and 87% in value were transactions from ATMs.

Notwithstanding the dominance of cards use for basic services, even during 2014, payments with cards at both physical and virtual POS terminals increased⁴⁴. The allocation of payments at physical or virtual POS terminals shows domination at 70% of payments with cards at physical POS terminals. This development dictates an increasing familiarisation of the Albanian market with the use of banking cards in their daily transactions. On the other hand, it highlights the fact that the development of e-commerce in Albania is a potential factor for increasing card payments, by raising the chances for buying online.

⁴² District division according to the branches of the Bank of Albania.

⁴³ Companies operating in retail trade and hotels and restaurants.

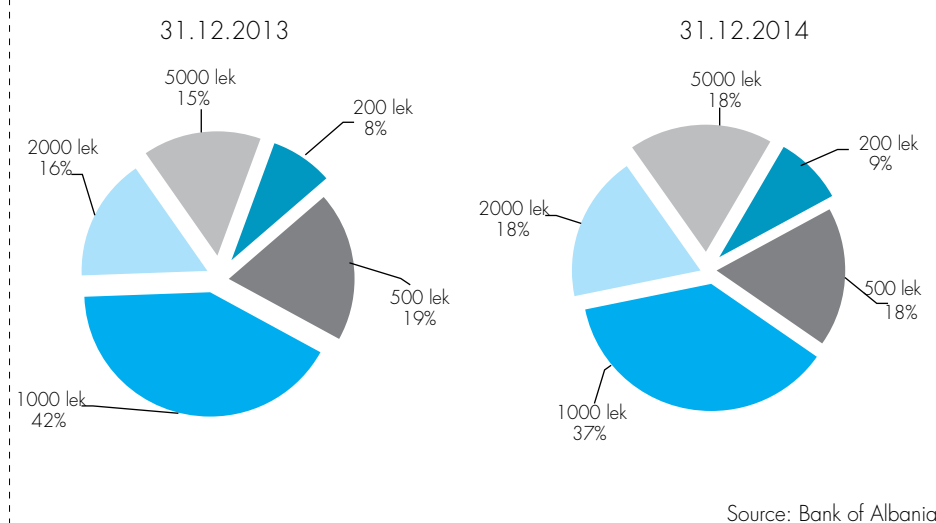
⁴⁴ It functions similarly to a regular POS terminal but makes transactions via internet or by phone, through online accessible bank cards.

II.4.2. MONEY ISSUANCE

BANKNOTES IN CIRCULATION⁴⁵

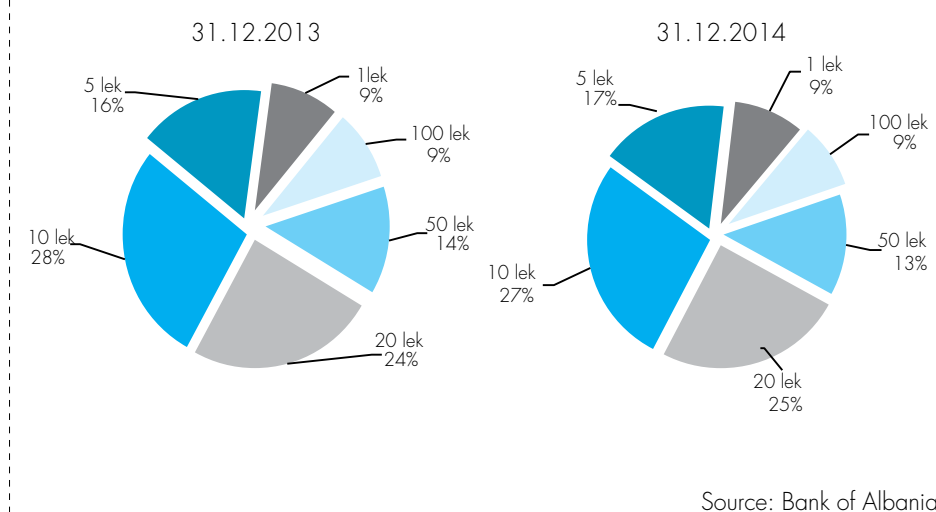
As of end-2014, there were 130,654,519 banknotes in circulation, worth ALL 222.896 billion. Compared to 2013, the number of banknotes is almost the same, while their value increased by 9.06%. This increase shows the change in the structure in favour of banknotes with a nominal value of 5000 Lek and 2000 Lek. Also, the volume of payment requests from commercial banks increased.

Chart 38 Banknote in circulation, by type (pieces)

*COINS IN CIRCULATION*

As of end-2014, there were 147,222,518 coins in circulation, worth ALL 3.511 billion. Compared to 2013, the number of coins increased by 5.1% and their value increased by 3.45%. As of end-2014, the coin structure

Chart 39 Coin in circulation, by type (pieces)



⁴⁵ It is the number and value of banknotes put in circulation by the Bank of Albania.

showed relatively equal to that in the previous year. As of end-2014, the overall coin to banknote value ratio was lower than a year earlier.

INDICATORS OF CURRENCY IN CIRCULATION

At end-2014, the ratio of currency in circulation to M2 aggregate was 31.3%, from 29.97% at end-2013. Further, the coefficient of currency in circulation at the Bank of Albania in 2014 was 0.568, from 0.535 in 2013. In addition, the average value of a banknote in circulation was ALL 1706 at end-2014, from ALL 1566 at end- 2013.

RECYCLING OF CASH AND QUALITY OF BANKNOTES IN CIRCULATION

In 2014, 127 million banknotes were processed, which were checked for their authenticity and fitness for circulation. The processing showed about 36, 6 million banknotes (28.8% of the processed total) unfit for use, which were withdrawn from circulation.

PROTECTING BANKNOTES AND COINS AGAINST COUNTERFEITING

During 2014, the Bank of Albania, in the framework of public education and protecting banknotes and coins against counterfeiting, published the web application "Albanian money", as a tool to learn to distinguish genuine banknotes and to know their security features. Also, the Bank of Albania provided for the first time training in the field of protecting banknotes and coins against counterfeiting to the employees and processors of cash in the banking system, helping to enhance detecting and preventing skills and prevent the circulation of counterfeit banknotes and coins.

During 2014, the number of counterfeit banknotes and coins resulted almost at the same level as in 2013. Overall, the number of counterfeit banknotes and coins was lower and insignificant in relation to the quantity of coins and banknotes in circulation.

Banknotes evidenced as counterfeit by the technical analysis are mainly reproductions with ink-jet toner in reproducing colour machines (scanner or photocopiers), and in less cases by offset, combined with the application of artisanal methods for the imitation of some security elements of visual features or fluorescent circles.

SPECIFIC ISSUES ON MONETARY VALUES MANAGEMENT

In July 2014, the Bank of Albania was informed on a serious event at the cash processing and storage premises. A former employee of the Issue Department of the Bank of Albania, expecting the fact would be soon discovered, confessed to have appropriated considerable monetary values from the premises where they were stored and kept. Immediately upon such information, the Bank of

Albania filed the relevant complaint with the Prosecution office, which, on this basis, recorded the criminal proceeding. In the course of investigations, 18 additional Bank of Albania employees were taken in custody and later arrested, including the former Governor and former Inspector General. The initial verifications by the Bank of Albania and later procedural actions by the prosecution office found that the missing amount of the cash, for which the employees were in charge of administering, amounted to ALL 713 million.

The Bank of Albania has offered its full cooperation for the complete discovery of the criminal activity of the persons responsible for the appropriation of the monetary values. Moreover, the Bank of Albania has filed a civil suit with the court to recover the appropriated cash from the persons charged with the theft.

The management staff of the Bank of Albania took immediate measures to normalise the situation, guarantee the supply of the banking system with the necessary amount of currency in circulation, and continue with performing the legal functions of the Bank of Albania, coping with the difficulties that were created during this extraordinary period. In particular, strict measures were taken to strengthen the security and control in the premises where the Bank of Albania exercises its activities.

Bank of Albania has undertaken a number of steps and adjustments to minimise the materialisation of operational risk in all the stages involving the storing, processing, destroying, controlling and physical security of cash.

II.5. FINANCIAL MARKET OPERATIONS AND FOREIGN EXCHANGE RESERVE MANAGEMENT

II.5.1. INTERVENTIONS IN THE DOMESTIC MONEY MARKET

- The Bank of Albania implements its monetary policy by using indirect market instruments. They include open market operations, standing facilities and the required reserve. Open market operations play a key role in the monetary policy transmission to the banking system. The Bank of Albania exclusively determines the conditions for applying them. The main open market operation is the repurchase and reverse repurchase agreement of seven-day maturity, whose interest rate of represents the key interest rate. Other operations are repurchase agreements (reverse repo) of one and three-month maturity and outright transactions.

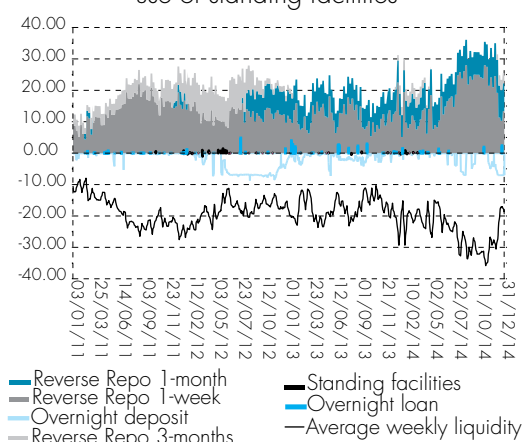
OPEN MARKET OPERATIONS

Open market operations consist in three sub-items: the main operations; fine-tuning operations; and structural operations. They are used for short-term liquidity management in the money market, aiming at achieving Bank of Albania's operational objective - orienting short-term interbank rates close to Bank of Albania's key interest rate and limiting liquidity fluctuations.

During 2014, the overnight interbank rate ranged close to the key rate. Our operational framework provided the anchoring of interbank market rates closer to the key rate.

During 2014, the average injected level increased by ALL 7.18 billion, averaging ALL 24.56 billion. The Bank of Albania continued to maintain a diverse structure for the injection of liquidity. The liquidity-providing structure averaged 64% through the main instrument and 36% through the fine-tuning instruments of a longer-than-one week maturity, from 60% and 40% in the previous year

Chart 40 Open market operations and use of standing facilities*



*The negative values in the use of instruments reflect the liquidity-withdrawing operations, while the positive values correspond to liquidity-providing operations.
Burimi: Banka e Shqipërisë.

Table 10 Structure of injection by instruments

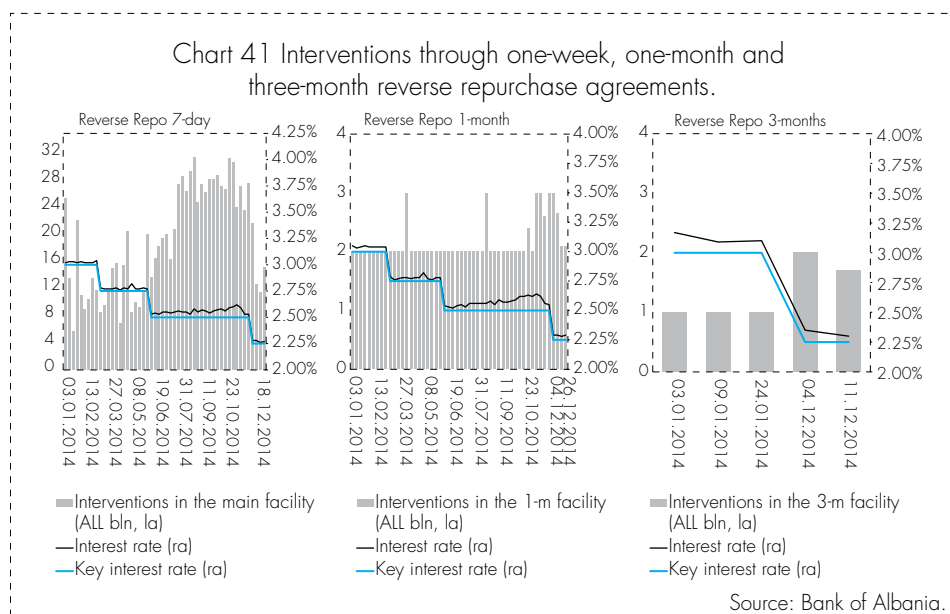
| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|--|------|------|------|------|------|------|
| Main instrument | 55% | 58% | 74% | 55% | 60% | 64% |
| Long-term liquidity providing instrument providing instruments | 45% | 42% | 26% | 45% | 40% | 36% |

Source: Bank of Albania.

One-week reverse repurchase agreement is the main instrument for conducting open-market operations. The interventions through the main operation were conducted through fixed-amount and variable-price auctions. During 2014,

the liquidity injected through the reverse repurchase agreements of one-week maturity averaged ALL 19.14 billion a week.

Besides one-week liquidity-providing operations, one-month operations continued in 2014. The liquidity provided through reverse repurchase agreements auctions of one-month maturity averaged ALL 2.15 billion per week, from ALL 1.94 billion a year earlier. The reverse repurchase agreements of a three-month maturity were conducted only in five cases, in the first and last month of 2014.



With the purpose to manage liquidity and short-term interest-rates, mainly concentrated in the last days of holding the required reserve, during 2014, the overnight operations were applied too. The overnight reverse repurchase agreement was applied in 12 cases for an average of ALL 2.01 billion, from 18 cases in 2013 for an average of ALL 1.45 billion.

The Bank of Albania intervened in the market through structural operations, aiming to enhance competition in the short-term security market segment. The Bank of Albania was active in the secondary security market by offsetting the decreased participation in 3- and 6- month securities through the purchase of newly-issued 12-month Treasury bills. Completing the outright purchases in 2014, Bank of Albania's portfolio resulted ALL 35 million lower than the level at the beginning of the year.

STANDING FACILITIES

Standing facilities – overnight deposits and overnight loans at the Bank of Albania are instruments available to commercial banks to manage liquidity on a daily basis. The facilities interest rate is set by Bank of Albania's Supervisory Council. During 2014, they followed the key interest rate movements, creating

an upper corridor (+1.75 percentage points from the key rate) and a lower corridor (-1.75 percentage points from the key rate), wherein the short-term interbank rates fluctuate.

In 2014, the use of overnight deposit continued to be high. The use of the overnight deposit was concentrated in the two last months of the year due to the concentration of banks' structural liquidity surplus. During 2014, overnight deposit was used during 74 days, averaging ALL 4.57 billion.

The overnight loan facility was employed 14 times, averaging ALL 0.77 billion, against 19 times in the previous year when it averaged ALL 1.46 billion. The use of overnight loan was concentrated mainly on the last days of the required reserve maintenance period.

REQUIRED RESERVE

The required reserve in lek is a monetary policy instrument to adjust liquidity in the banking system and stabilise the interest rates. The required reserve corresponds to 10% of commercial bank deposits of up to two years in the three currencies – lek, euro and U.S. dollar. The Bank of Albania allows banks to use up to 40% of the required reserve in lek daily, provided they keep the monthly average level of the minimum required reserve not lower than the limits set for it, as calculated on the last day of the maintenance period.

The required reserve in lek increased annually 2.87%. The annual change of foreign currency-denominated required reserve was positive at 6.41% for euro-denominated reserve and negative at 20.59% for the USD-denominated reserve. The remuneration rate on the required reserve in lek reflected the performance of Bank of Albania's key interest rate (70% of the key interest rate), while the foreign-currency denominated required reserve is not remunerated.⁴⁶

During 2014, the regulation on the required reserve included the possibility of remunerating the account surpluses denominated in both foreign currency and lek. The remuneration rate applied to lek and USD surplus in 2014 was 0%, while remuneration rate of surpluses denominated in euro, is 0.10% lower than the interest rate on deposits set forth by the European Central Bank. The need to adjust the remuneration of surpluses arose due to the transition into negative territory of ECB deposit interest rates. Thus, banks cover themselves the expenses deriving from this movement, at least concerning euro-denominated liquidity surplus held with the Bank of Albania. In addition, the regulation stipulates that surpluses will be remunerated only when exceeding EUR 500 000, thus avoiding the minimum fluctuations deriving from the change in the required reserve level.

⁴⁶ As of 24.07.2011, the remuneration rate on the required reserve in foreign currency is zero.

II.5.2. FOREIGN-EXCHANGE RESERVE MANAGEMENT

- *The objectives and criteria on foreign exchange reserve management to be met during this process are laid down in the regulation "On foreign exchange reserve management policy", approved by the Supervisory Council. The primary objective is to ensure liquidity and security. Ensuring revenues from reserve funds management is another objective as long as it does not infringe the objective for liquidity and security. The names permitted for investing the foreign exchange reserve include USA, Japan, Great Britain and Eurozone governments, as well as government-related agencies or institutions that are generally rated at least AA- (for Eurozone governments the accepted minimum rating is BBB-). The names permitted for investment include also multilateral institutions or other institutions rated at least AA-.*

HIGHLIGHTS OF FOREIGN EXCHANGE RESERVE MANAGEMENT IN 2014

Following the decision taken in 2013 on lowering the minimum rating threshold and inclusion in the permissible investment universe for euro-area countries, ranked in "For investment", during 2014, the exposure against the governments rated BBB was maintained, although to a lesser degree, compared to 2013. Positions taken in these names and the investment results are rigorously monitored, in the framework of the special mechanism established for the management of credit and market risks for this part of reserve portfolio. Return on investment for this part of portfolio was positive during 2014. It should be emphasised that, given the continued negative rates on treasury issues in the euro area, investment possibilities at a positive rate of return for the euro-denominated portfolio are significantly less compared to a year earlier.

Regarding cooperation with the World Bank, in the framework of the agreement "On the Reserves Advisory and Management Program (RAMP)", the project on the Portfolio Management System was finalised at the beginning of May. The system designed with World Bank resources is dedicated only for the foreign exchange reserve portfolio management, providing a more comprehensive automatized solution to all tasks conducted by the units, in the framework of this process. The new system provides better support for: accounting the result established under the International Accounting Standards; using derivative instruments in investment; calculating and analysing the return on investment; assessing and monitoring risks generated during the process. The implementation of new additional functionalities to meet the needs of institutions participating in this project represents one of the most important objectives of the World Bank, in the framework of developing initiatives to support central banks participating in RAMP. During the past year, World Bank provided technical assistance on the review and improvement of the framework on credit risk management, during the foreign reserve portfolio investment.

In addition to the above, the World Bank continued to provide specialised training and educational programs, such as CFA (Chartered Financial Analyst), CIDA (Certified Investments and Derivatives Auditor) and (Professional Risk Manager), in compliance with the needs of the Bank of Albania's staff. These qualifications have aimed at consolidating and enhancing the professionalism of the employees engaged in foreign-exchange reserve management and of the staff supporting or monitoring this process.

BOX 5 STATISTICS ON FOREIGN-EXCHANGE RESERVE IN 2014

During 2014, the gross foreign-exchange reserve, estimated and reported in euro, increased by about EUR 177.35 million in 2012, registering EUR 2,192.34 million as at end-December.

The key factors affecting the gross reserve are presented in the following:

- A. Transactions with the Ministry of Finance provided a positive impact, at EUR 124.30 million, according to the following items:
 - Net inflows originating from foreign exchange operations with the Bank of Albania for EUR 24.10 million;
 - Net inflows from loans disbursed by the International Monetary Fund, International Development Agency, and renovation of short-term securities, etc., amounting to EUR 350.18 million;
 - Inflows from foreign currency purchase in the market, EUR 25.82 million;
 - Transfers (including debt servicing), at EUR 275.80 million.
- B. Commercial banks and other entities' transactions provided a negative impact, at EUR 51.17 million, according to the following items:
 - Commercial banks' deposits at the Bank of Albania to comply with the required reserve and transactions related to their capital, etc., at EUR 161.22 million;
 - Transfers, EUR 211.28 million;
 - Net outflows for the account of other entities (DIA, etc.), EUR 1.11 million.
- C. Bank of Albania's transactions provided a positive impact, at EUR 32.68 million, according to the following items:
 - Foreign currency purchasing from commercial banks and other institutions, at EUR 17.20 million: (EUR 10.30 million banks; EUR 6.90 million other institutions);
 - Receipts from foreign-exchange reserve investments, estimated at about EUR 31.86 million. These receipts represent mostly payments in the form of interests and coupons, which are calculated based on cash;
 - Settlement of Bank of Albania's dues to the IMF, at EUR 6.60 million;
 - Transfers, at about EUR 9.78 million.
- D. Market factors provided a positive impact, at EUR 71.54 million, according to the following items:
 - Exchange rate fluctuations of the foreign reserve currencies had positive impact on the gross reserve value reported in euro, registering an effect of about EUR 80.25 million;
 - Portfolio revaluation effect, as a result of interest rate fluctuations, is estimated at a negative value of EUR 8.71 million.

II.6. STATISTICS

- *The Bank of Albania, besides being a regular user of official statistics, mainly of economic and financial ones, is one of the most important statistical agencies in Albania. On Bank of Albania's website and in its periodic publications, users can find banking supervision statistics, monetary statistics and external sector statistics compiled by the Bank of Albania. In 2014, the Bank of Albania continued to compile and deliver its statistics regularly in accordance with the calendar published at its website.*

During 2014, the Bank of Albania continued to compile and disseminate monetary and financial statistics, consisting in sectorial balance sheets and the monetary presentations of depository corporations, deposits and credits aggregates, interest rates on deposits and loans in the banking system, and various tables and other indicators on the granted loans and accepted deposits by the banking system. Indicators on banking system, compiled for the purpose of banking supervision and financial stability are processed, compiled and disseminated, strictly complying with the release calendar. External sector statistics were compiled and disseminated, including statistics on the balance of payment consisting in the current account and the financial and capital account, statistics on the gross external debt, statistics on international position of investments, statistics of reserve module, and statistics on foreign direct investments.

In addition to compiling, we have regularly reported monthly and quarterly to international institutions statistics on monetary indicators, balance of payments, external debt, liquidity and international reserve, foreign direct investments and the international position of investments.

STATISTICS HIGHLIGHTS

One of the priorities of statistics was the approximation to the European Union standards, in terms of compiling the financial accounts and preparing the respective methodology. The construction of financial accounts started with those of the banking system, to continue later with the financial accounts of the financial corporates. During 2014, the financial account of the central bank for 2013 was compiled. Based on certain assumptions and estimations needed to calculate unavailable data, the financial account of other depositing corporates was compiled as an experiment. In addition, efforts are made to compile the annual financial accounts for other financial entities and the insurance and pension fund companies. Notwithstanding the efforts made to provide the adequate relevant information, obviously the construction of financial accounts is a current challenge for the monetary and financial statistics, whose successful realisation, in addition to devotion, requires close cooperation with the Institute of Statistics (INSTAT).

To enhance the quality of the information collected to develop the monetary statistics, intensive work has been done to improve the reporting forms for

the reporting entities - banks. In this regard, the European System Accounts (ESA-201) standard was considered for the classification of institutional units and respective financial instruments, in compliance with ECB requirements on statistical reporting, which is particularly important for the countries aspiring membership in the European Union.

During 2014, for external sector statistics, we worked intensively to implement the new methodology, Balance of Payments and International Investment Position Manual (BPM6) - BPM6⁴⁷, related to the statistical data of 2013-2014. Methodological improvements were made to external sector statistics, starting with the current, financial and capital account of the balance of payments, external debt statistics, international investments position and the reserve module.

Also, in cooperation with IMF experts, we worked to improve the calculation of data flows of remittances, by using the data of the new survey on emigrants, the methodology based on these data, and the data reported from banks and money transfer operators.

For compliance with international requirements and standards, the timeframe for the compilation and publication of international investment position statistics and foreign direct investments statistics, by countries and sectors for 2013-2014, was cut from 15 to 9 months after the reference period, as requested by IMF and the Eurostat International standards.

IMPLEMENTED PROJECTS

Participation in some important projects and missions in the field of statistics during this year supported the efforts for the implementation of the best international standards and practices on statistics.

- In the framework of the medium-term objective of improving technological infrastructure, to raise banks reporting efficiency, lessen the reporting burden, and to enhance the statistics quality particular attention was paid to the project on the automatisisation of reports (RRS).
- European Central Bank Project "Analysis of the Bank of Albania needs⁴⁸", provided a detailed analysis of monetary and financial statistics vis-à-vis the ECB requirements for the statistical reporting. At its conclusion, European experts prepared the respective medium and long-term recommendations, which will be part of the main directions of the work for the monetary and financial statistics.
- In the framework of IPA 2012 project on Statistics of International

⁴⁷ The sixth edition of the Balance of Payments and International Investment Position Manual-BPM6, prepared and released by IMF.

⁴⁸ "Needs analysis for the Bank of Albania". For further information about the project, please refer Chapter IV "European Integration and International Cooperation".

Trade in Services, work continues for the implementation of the recommendations by the EUROSTAT mission for approximation to the respective regulation of the European Union.

- In April 2014, the IMF Mission provided a two-week visit of IMF experts to offer technical assistance for the compilation of balance of payments statistics and international investment positions, pursuant to the Balance of Payments and International Investment Position Manual (BPM6).

INTER-INSTITUTIONAL COOPERATION

Throughout 2014, we cooperated with other statistical agencies for strengthening and improving of the National Statistical System. Cooperation with the Institute of Statistics continued, by sharing FISIM data (Financial Intermediation Services Indirectly Measured), as well as the tables with balance of payment statistics. We actively cooperated and discussed with INSTAT on issues pertaining to the financial account of the general government. The cooperation with INSTAT was also very active in the framework of surveys conducted by INSTAT and commissioned by the Bank of Albania.

The efforts to establish a regular relationship with the Albanian Financial Supervisory Authority and the National Registration Centre are intensified through official meetings and communication, in the framework of the Financial Accounts compilation.





III. RESEARCH

- *The Bank of Albania aims to base its decision-making process on sound foundations of tested knowledge about the Albanian economy. Investment in creating solid research capacities helps improve Bank of Albania's reputation and reliability as an institution that owns the respective methodologies and required knowledge for guaranteeing the country's macroeconomic equilibriums. Therefore, Bank of Albania's development strategy regards the active scientific research as a priority. Therefore, the development and active use of scientific research assumes a primary role in Bank of Albania's development strategy.*

During 2014, Bank of Albania's research focused on the monetary policy effectiveness and issues related to financial stability safeguarding. Research work maintained the direction toward policy making, contributing not only to deepening the understanding of economic developments, but also to discussing issues of concern to the Albanian economy, being thus useful to the decision-making process of the Bank of Albania. In compliance with the medium-term strategy of scientific research, a set of research studies focused on the methodological development or empirical analysis of either regional or international developments.

Macro-modelling remains an important aspect of research. During 2014, the Macro-econometric Model for the Albanian Economy (MEAM) was re-assessed by employing a new quarterly dataset, for the period 1996-2012. The reassessment was triggered by the need to publish the latest data for national account indicators by INSTAT and the revisions to some time series used in the model. At the same time, the explanation of economic behaviour is intensified, by including new connections in the equations of consumption behaviour, fiscal sector, etc. Research work outcomes contributed to improving the indicators of external demand, potential output and natural rate of unemployment.

The projections derived from such research, and others related to trade in goods, contributed to the analysis and forecasting of the expected performance of aggregate demand and its components, inflationary pressures at home and developments in the financial market. The MEAM enabled the assessment of exogenous "shocks" and the analysis of risks related to the exchange rate, rise in foreign prices or other changes in the external economic environment.

Monetary policy transmission mechanism remains an essential issue in the empirical analyses and studies at the Bank of Albania. The research in this regard has aimed to identify the effect of traditional transmission channels of the interest rate and exchange rate and to test the sustainability (over time) of

the assessed parameters in the model. The results of the empirical studies and analysis are combined to assess the extent of transmission of monetary policy decisions to interest rates in the primary and secondary interbank market, and ultimately in the economy.

During 2014, research focused on the financial market and its stability, especially on the residual effects of the crisis, their implications to financial stability and consequences for the transmission of conventional monetary policies. Thus research concentrated on studying the connection between stability and financial market indicators and the overall macroeconomic equilibrium and vice versa. The obtained conclusions provide valuable recommendations for compiling and implementing financial policies to ensure Albania's macro-financial stability.

A financial system stress index and its implications in economy and financial market were also in the focus of our research. Another subject of research was the identification of main determinants of the behaviour of foreign currency lending. Having been addressed earlier as well, this topic was revised in 2014 including and enriching the analysis with supply and demand indicators such as: interest rates spread, foreign currency deposits, and fluctuation of inflation and exchange rates.

Research works and discussion papers of the Bank of Albania also dealt with other important of theoretical and empirical analysis aiming to introduce new methodologies in financial and economic research. Research concentrated on the density estimation for economic variables and the use of co-word analysis as a tool of empirical study. The development, formalisation and application of these methods is beneficial and aims at their future implementing in the decision-making process and analysis at the Bank of Albania.

Research analysis published on the official website of the Bank of Albania, under the section "Publications/Research and Working Papers". Several articles are also published in the half-yearly Bulletin of the Bank of Albania. Since 2009, the half-yearly "Research Newsletter of the Bank of Albania" briefs on newly-completed research materials or those still in process. These materials are presented in "Friday Seminars" or in other activities organized by the Bank of Albania and the Research Department throughout the year. The research work at the Bank of Albania has attracted the interest of international forums and are presented and discussed in such forums. During 2014, various scientific and training activities took place. These activities focused on discussions of economic studies carried out at the Bank of Albania and the implementation of research results in its decision-making. The cooperation with the University of Oxford and the Graduate Institute of Geneva contributed to expanding and strengthening interaction with international academic institutions, and regional and euro area central banks in the field of research.

The opening to research and academic community in the region, Europe and beyond remains a key priority for 2015 along with the publication of the research work in authoritative economic magazines.





IV. EUROPEAN INTEGRATION AND INTERNATIONAL COLLABORATION

- *On 24 June 2014, Albania was granted the status of a candidate country for EU accession. Periodic European Commission reports commend the contribution of the Bank of Albania to safeguarding the macroeconomic and financial stability, improving supervisory practices, and promoting market and payment systems development in Albania.*

EUROPEAN INTEGRATION

On 24 June 2014, European Union (EU) member states granted to Albania the candidate country status. This decision was ratified by the heads of states and governments in the European Summit of Luxembourg (26-27 July 2014). The decision to grant Albania candidate status is recognition for the reform steps undertaken. It is an important signal that the country is moving to the next stage of the European integration process and takes the relationship with the EU to a new level.

In October 2014, the European Commission published its annual progress report for Albania, welcoming the efforts of the country to meet the Copenhagen and stabilisation and association criteria.

The report commends the contribution of the Bank of Albania to maintain the macroeconomic stability. The low inflation rate created room for further monetary policy easing. However, the impact of monetary policy on aggregate demand remains limited due to banks' risk aversion. The banking system is assessed as well capitalised and liquid, but the need for other measures to address the existing proportion of non-performing loans remains. The latter are considered as barriers for deepening of financial intermediation.

The Commission states that progress has been made in the field of free movement of capital thanks to the implementation of the Law on Payment Systems. The Report also mentions the licensing of the national card payment operator and the adoption of the Regulation on the organisation and functioning of the National Committee of Payment Systems.

The report commends the progress made in the field of financial services, mainly related to the legislative framework for the banking and non-banking supervision. Particularly, the adoption of the new supervisory policy and the new risk assessment manual by the Bank of Albania contributed to the progress

made to align this with the EU risk assessment system. Also, the report notes the amendments to the regulation on credit risk management, the set of criteria on the writing off of bad loans, approval of the regulation on risk management from large exposures of banks and the guideline on recovery plans. The report finds that Albania continued to implement the Basel II principles in accordance with the relevant action plan.

In the field of monetary policy, the report commends the maintaining the policy of targeting price stability by keeping inflation within Bank of Albania's target range under a free-floating exchange rate. It also mentions that the Law on the Bank of Albania still needs to be aligned with the EU acquis.

During April - September 2014, the Bank of Albania implemented successfully the technical assistance programme with the European Central Bank (ECB) together with 11 central banks of the European System of Central Banks⁴⁹ (ESCB). The purpose of the programme was to assist the Bank of Albania in strengthening the capacities, the legislative and administrative reform in the framework of preparation for ESCB membership. The programme provided a set of recommendations to the institution regarding changes and improvements to approximate to the European Union standards and the best European practices.

BOX 6 "NEEDS ANALYSIS FOR THE BANK OF ALBANIA" PROJECT

The project "Needs Analysis for the Bank of Albania", was designed and headed by the Central European Bank (ECB), in partnership with 11 central banks of the European System of Central Banks. This project took place within a broader context of ECB "Technical cooperation with central banks of Western Balkans countries, in their preparations for joining the European System of Central Banks (ESCB)", once the respective economies have qualified for EU membership.

The project, funded from EU Instrument for Pre-Accession Assistance, was implemented simultaneously at the Central Bank of the Republic of Kosovo (CBRK) and the National Bank of the Republic of Macedonia (NBRM). In this regard, the promoting and informing activities related to the project, took place jointly with representatives of the three central banks and the representatives of European counterparts. At the launch of the programme, held in Tirana, on 17 April 2014, that marked the start of the program, Mr. Yves Mersch, member of the Executive Board of ECB, highlighted: "Strong central banks are key for monetary and financial stability in Europe and around the world. With this joint initiative, the central banking community in the EU stands ready to support our colleagues in the Western Balkans in their endeavour to introduce the highest standards, for the benefit of their countries and people."

The purpose of this project was to strengthen the institutional capacity of the Bank of Albania, through the identification of the legal and organisational criteria, as

⁴⁹ Deutsche Bundesbank, Banque de France, Banca d'Italia, the Central Bank of Malta, De Nederlandsche Bank, Oesterreichische Nationalbank, Banco de Portugal, Banka Slovenije, Národná Banka Slovenska, Central Bank of the Republic of Bulgaria and the Czech National Bank.

well as the needed resources for approximation to the standard institutional and operational framework of the European Central Bank, taking into consideration the vision of Albania's integration in EU and, consequently, of the Bank of Albania in the European System of Central Banks.

The project with the ECB and partner central banks was implemented in three stages and focused on 13 functions of the Bank of Albania. Some 23 experts from 11 central banks in the EU engaged in this project. First, benchmark operational objectives for the next stages were identified, which reflect the standards/minimum requirements that Bank of Albania should meet in the context of the country's EU membership. During the second stage, after defining and agreeing on the benchmarks, the European experts met with the employees and managers of each function to assess the actual operational and institutional framework. At the conclusion of assessment visits, experts prepared reports on the main findings. During the final stage, the gap between the actual framework of the Bank and the set benchmark operational objectives was assessed.

In line with the agreement with the European institutions, a resident Coordinator was deployed at the Bank of Albania during the six months of the project implementation. The Coordinator was elected by ECB and partner banks, for the daily management of the project, to coordinate the visits of experts and to compile the final report.

"Need Assessment Report", the final product of the project, provides recommendations and findings for each function analysed during the project. The report finds the Bank of Albania as an institution with good technical capacities. A considerable part of the implemented regulations and practices are in line with the European Union standards. The proposed recommendations serve as guidelines for the Bank of Albania aiming at the approximation to the European standards and principles. It must be noted that the ECB technical assistance programme envisages continuing the project in the future through the implementation of the second component of the programme. The second component, which was implemented in some central banks in the countries of our region, is about the compilation of a plan for the implementation of the recommendations identified during the first component.

The Bank of Albania has participated actively in meetings of the Stabilisation and Association Committee. Also, Bank of Albania representatives have participated in the regular meetings of EU-Albania Subcommittee on Economic and Financial Issues and Statistics, reporting on overall economic developments, inflation and monetary policy, external sector, developments and reforms in the banking and financial sector. In the meeting of the Subcommittee on the Internal Market and Competitiveness, it was reported on the work done for improving the regulatory framework on the banking system and capital movement.

Under the Technical Assistance and Information Exchange (TAIEX) instrument, the Bank of Albania has conducted three activities with experts from EU central banks related to the alignment of the legal framework with the EU acquis in the fields of external sector statistics management, monetary and financial statistics management, and the regulatory framework of payment systems.

INTERNATIONAL COOPERATION

Relations with the International Monetary Fund

The quota of the Republic of Albania at International Monetary Fund (IMF) remained unchanged at SDR 60 million, during 2014. Albania owns 1,337 votes (or 0.05% of the total amount of all IMF members). It is in the same constituency with Italy, Greece, Portugal, Malta, and San Marino and is represented by the Italian representative, Mr. Carlo Cottarelli, who serves as the Executive Director of the constituency for the period 2014-2016. This constituency has a total of 106,404 votes (or about 4.22% of total votes of all IMF members).

In the framework of IMF resolution "The 14th General Review of Quotas and the Reform of the Executive Board", which aims at changing the quota for all IMF members, in line with the changes of the share and role of different countries in the last years, the quota of the Republic of Albania will increase to SDR 139.3 million. The Bank of Albania has undertaken all the necessary legal and institutional actions for the finalisation of procedures for the increase of this quota. Albania is waiting on the IMF to inform it on the the payment for the increase of the quota once the required majority is achieved to proceed with the relevant increase of the member countries' quotas.

On 28 February 2014, the Executive Board of the IMF approved the three-year arrangement for SDR 295.42 million (about EUR 330.9 million) under the Extended-Fund Facility program for Albania, supporting the program of the Government reforms. It is extended in the form of direct support for the budget, and is aimed at the medium-term fiscal consolidation, the mitigation of risks related to the high public debt and the adjustment of the economy in the short run. As end-2014, two instalments were disbursed, totalling SDR 47.1 million.

In March, the IMF published its report at the conclusion of the mission in Albania in the framework of Article IV of the Fund's Articles of Agreement. The report notes that Albania weathered the global financial crisis relatively well and incurred an easier shock to growth, compared to the neighbouring countries. Inflation was low and stable, while banking system appeared adequately capitalised and liquid, owing to the fiscal stimulus, the effective monetary policy and macro-prudential actions. The IMF highlighted that authorities have strengthened the financial sector supervision. The IMF mission suggested that the further easing of monetary policy may help lending, if the high foreign currency exposure and credit risk quality remain unchanged. The main solution to accelerate lending remains the addressing of non-performing loans, which would help restore confidence in the banking system.

In February 2014, the IMF published the report at the conclusion of the mission according to the Financial Sector Assessment Program. The report lists specific recommendations to the relevant institutions, for supporting them to identify the main sources for systemic risks and the implementation of the necessary policies to guarantee the financial system's resilience against shocks and possibility of their spillover.

During 2014, the Bank of Albania continued to benefit from the IMF technical assistance, in the form of consultancy on banking supervision, statistics and financial stability. In this regard, IMF experts conducted various working visits, addressing issues such as: regulations on non-performing loans, implementation of the Sixth Edition of the Balance of Payments and International Investment Position Manual (BPM6), and stress-test exercises.

Relations with the World Bank Group

The World Bank Group continuous to be committed in the Republic of Albania through the implementation of the Partnership Strategy, which aims at furthering the implementation of priorities identified by the Government through the support for economic recovery and growth, improvement of governance and agenda for the European integration of the country.

As detailed in the respective chapters, the cooperation with the World Bank focused on the field of foreign reserve management and banking supervision.

Relations with other central banks and technical cooperation

During 2014, Bank of Albania paid particular attention to expanding and further strengthening its bilateral and multilateral relations with respective institutions in the region and beyond. The Bank of Albania participated actively in all the meetings held by various organisations and groups.

During the last year, many personalities of the central banking and academia visited the Bank of Albania, while the administrators and its staff have carried out intensive informative and promoting activities in various international meetings and conferences.



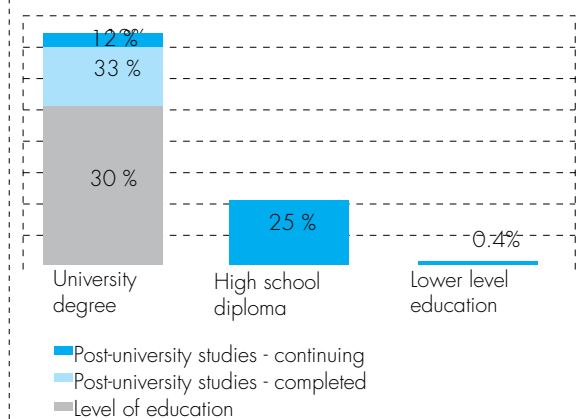
V. HUMAN RESOURCES MANAGEMENT AND BANK OF ALBANIA INFRASTRUCTURE

- Human resources policies aim at providing a motivating work environment, to enhance professional capacities for Bank of Albania's staff, adopt best standards for a modern central bank, and strengthening, and ensure long-term stability for institution's administrative capacities.

HUMAN RESOURCES

As at 31 December 2014, the number of employees at the Bank of Albania is 503, of which 448 at the central administration and 55 at branches. During 2014 were hired 28 new employees, all holding a university diploma, and 26 ended the employment relations with the Bank of Albania. The average age of employees is 43-years old, and 58% of employees are women. The role of women in managing the institution has been increasing over the years. As at end-2014, women held about 52% of the executive positions at the Bank of Albania.

Chart 42 Employees by level of qualification



Source: Bank of Albania.

The human resources quality is considered as a priority. Thus, the Bank of Albania has constantly made efforts to draft staff simulating policies with regard to enhancing professional capacities, earning academic titles and scientific degrees and obtaining international professional certificates.

Bank of Albania's staff has been up to date with central banking trends and novelties through trainings in Albania and abroad, organised mainly by other central banks and international financial institutions. The major part of professional trainings were on banking supervision (13%), monetary operations (10%), statistics (9.5%), econometry and modelling (7.5%), and monetary policy (7.5%).

NEW INFRASTRUCTURE

Bank of Albania's building, situated at the centre of Tirana, is now renovated and complete. Both renovation and new construction work has been carried out, to upgrade the existing building and add new sections. In the end, the old part was connected to the new wings, and the whole integrated building

is now transformed into a sole modern administrative complex - a central bank that conforms to standards of other European central banks. Presently, the major part of Bank of Albania's staff carries out its activities in the new building.

BOX 7 BANK OF ALBANIA'S RENOVATION AND CONSTRUCTION PROJECT

This important investment for the new administrative complex of the Bank of Albania was realised through three important moments:

- 1 Preparation of the project-design task, or "terms of reference", as a platform for organising an international contest to select the architectonic idea.*
- 2 Realisation of the Project selected out of the contest and detailing in compliance with contemporary standards, in two phases: Project-design Idea and Project Implementation.*
- 3 Construction, realisation and implementation of the Project in compliance with the engineering discipline: foundations, building frame and construction, coating and fine works and the more detailed interior desing, until the finalisation of all works and completion of the administrative complex.*

Project-design task and the international contest

The requirements for the project-desing task consisted in four main points:

- *"Morpurgo" identity and architectonic features of this building must be preserved*
- *The existing height, style and character, and architectonic language of the building should be maintained*
- *The new sections must respect the existing one, taking into consideration the axis of the building and emphasising this axis as a crucial element.*
- *The new sections shall be built in four underground floors, providing underground services and parking. Also, facilities were requested for other functions such as the numismatic museum and conference hall.*

The Projection-design task required contemporary standards. The architectonic language, the communication dilemma between the old and the new was left opened to be resolved by the international contest.

The Bank of Albania opted to organise an international contest to select the best project-design idea, which would provide solutions to the functional, technical and technological requirements. The contest notice was published in the "Financial Times" as well as in the national press. In addition, it was sent to foreign embassies and professional associations and was published in the official website of the Bank of Albania.

After these publications, 27 project-design studios and international architects expressed their interest. An international jury composed of distinguished national and international experts was selected for the artistic and technical assessment, while the identity of participants was kept confidential.

The contest was organised in three phases. In phase one, the legal eligibility criteria were verified for the 27 applying studios. At this phase, 17 studios were

qualified. In phase two, 8 architecture project-design ideas were qualified; again, the identity of participants was kept confidential. Subject to strict judging regulations and scrupulous assessment by the jury, three best proposals were selected. In the last phase, the three best contestants presented their project idea to the jury. At the conclusion, the jury defined the winners:

| | |
|---------------|---|
| First place: | Prof. Arch. Marco Petreschi |
| Second place: | Dini & Architettura Associati srl |
| Third Place: | Associazione Professionale Studio Valle Progettazioni |

The winner for the best project-design idea was announced on 29 February 2008. The public welcomed the decision of the jury. Many architects, artists, engineers, and intellectuals stated that the winner was the best possible selection of the Bank of Albania. Press and critics supported the winning project design.

The Project-design Idea

The project for the "Renovation and Construction of the Bank of Albania" realised by Arch. Marco Petreschi and his associates is a comprehensive project, in the light of the renovation and the state-of-the art technology of the new corpus, as well as of the engineering and construction aspects of project implementation.

The project worked out the architectonic dilemma between the existing and the new one, the traditional and the modern through dialogue and continuity, coupled with the sensitivity of the architect specialised in Italian culture restoration, such as Prof. Arch. Marco Petreschi. The old building of the Bank of Albania in Tirana, whose architecture was designed by Morpurgo, remained intact and is part of the history. The complexity of the project is reflected in renovation and integration of the existing building with the new sections, the skilful and organic connection between the two parts to form a continued and functional administrative complex. The external shape, the rotunda as the heart of the entire body; the atrium created to separate but also join the old to the new along the "axis"; the grand entrance, its positioning and orientation; the plan, positioning of the main stairway and its shape related to the primary axis of the old part; the façade, shape and rhythm of window openings and its materials, are all elements in the realisation of the project.

The Project Implementation

The project implementation consists in two key components: the existing building, which was renovated, and the new sections consisting of four underground floors and four upper floors, rising at the same height as the existing one. The old part was subjected to a conservative restoration process. The construction of two wings, in the southern and western side, was subject of a contemporary technology, particularly in anchoring the surrounding underground wall, which, from engineering point of view, is the most important part for the project implementation.

In parallel with the works conducted by the group of implementing engineers, work continued for installing the main appliances and of fine works in the existing building. They mainly consisted in masonry works, electrical installations, ICT installations, repair and insulation works in the existing roofs.



VI. PUBLIC COMMUNICATION

- *Public communication is an important pillar in Bank of Albania's activity both for fulfilling the responsibility for utmost transparency on decision-making and its effectiveness and enhancing the public's confidence in the central bank. In this framework, the Bank of Albania sees the interactive communication with the public as a primary and strategically important matter, to transmit its monetary policy directly and comprehensively to the public.*

PUBLIC INFORMATION

The Bank of Albania uses a number of communication instruments to inform the public and explain clearly its objective. Following are some instruments:

Monthly press conferences

The Bank of Albania organises a monthly press conference, following the Supervisory Council's monetary policy decision making. In the conference, the Governor explains the decisions to the public and the analysis that lead to the decisions. In 2014, the Bank of Albania organised eight press conferences, according to the dates published in the annual schedule at year-start. The Governor's speech and respective questions and answers at the press conference are also published, both in Albanian and in English.

Monetary Policy Report

This report is the main written monetary policy instrument used for communication with the public. It presents a comprehensive description of the latest macroeconomic developments and factors that have affected and are expected to affect consumer prices in Albania. In 2014, this report was published quarterly, both in Albanian and in English.

Presentation of the Annual Report to the Parliament

The Annual Report is a publication that provides an overview of Albania's economic and financial situation as well as the activity of the Bank of Albania during the reporting year. The Annual Report is presented to the Parliament of Albania, following a preliminary presentation by the Governor to the Parliamentary Committee on Economy and Finance.

Media relations

The Bank of Albania considers communication with media as an important element for real-time information of the public about the decisions and activity of the Bank of Albania and of the entire banking system. In this regard, media is informed and made aware continuously on issues related to the central bank and on the economic and financial developments. In 2014, communication with media consisted in monthly press conferences and other public activities. Also, the Bank of Albania held seven informal presentations of its regular report to the media, during 2014. These "off the records" meetings aim at guiding the media to read the Bank of Albania decision-making correctly and are seen as an effective tool for the transmission of Bank of Albania activities to the public.

Public addresses

The Governor and other representatives of the Bank of Albania communicate with the public through speeches, presentations and lectures delivered in various activities organised by the Bank of Albania or other national or international institutions.

Dialogue with the banking system, business and academia

The forums and round tables held with representatives of the banking system, business and academia were part of the communication with the public, during 2014. In addition to discussions on key current issues, they provide the Bank of Albania with the possibility to obtain information on problems related to various sectors or regions in the country.

Publications

The Bank of Albania publications provide detailed and updated information on Albanian and global economy developments in the banking and financial system, currency and financial stability, amendments to and enrichment of the banking legislation and regulatory framework, as well as other relevant issues. Bank of Albania publications are consolidated sources of accurate and reliable information for the public.

Periodic and non-periodic publications, in 2014, consisted of about 5000 pages of analyses, statistics and research both in Albanian and in English. The set of periodic reports was the same as in the previous year: Annual Report, Monetary Policy Report (quarterly), Financial Stability Report (half yearly) and Annual Supervision Report. In addition to periodic reports, the following were published: the monthly Official Bulletin, the half-yearly Bulletin of the Bank of Albania, the half-yearly "Research newsletter".

In order to intensify relations with economic, financial and research institutions, and with any other interested parties, and to fulfil the Bank of Albania's obligation to publish, inform and explain its objectives, policies, procedures,

and opinions, the Bank of Albania continued to distribute its publications free of charge, during 2014.

Official website

Throughout 2014, the Bank of Albania provided full transparency, by publishing real-time on its website information about its work and of the banking system, speeches by its administrators, statements and press releases, periodic reports, surveys, analyses and research work, statistics and various indicators. Also, considering public information as part of its priorities, since 7 May 2014, the Bank of Albania publishes preliminarily the Monetary Policy Report Calendar.

Statistics

The Bank of Albania has a rich statistics system for many sectors of the Albanian economy, such as: banking sector, fiscal sector, real sector and external sector, which are published according to a predefined schedule, and are updated half-yearly. The main goal for collecting this information is related to central bank goals: drafting the monetary policy, compiling the balance of payments, and analysing the banking and financial system for its further development. Bank of Albania statistics are published in the monthly statistical reports, in the quarterly monetary policy reports and on the official website.

PUBLIC EDUCATION

The Bank of Albania's strategy aims to, inter alia, educate the public about a great number of issues, ranging from personal finance and banking to direct or indirect impact of the Bank of Albania on supporting the country's economic development. Financial literacy is now a necessity, taking into consideration not only the level of economic, banking and technological development, but also the importance and weight of information on today's global world.

Though public education is not a legal obligation, the Bank of Albania pays special importance to expand and deepen financial literacy in the country, particularly among the younger generation. The measures planned under the communication strategy were fully implemented in 2014, especially the establishment of the Museum of the Bank of Albania, a inside the central building.

BOX 8 EDUCATIONAL ACTIVITIES DURING 2014***Activities in the framework of the Global Money Week***

On March 10 - 17, the Bank of Albania, in cooperation with the Ministry of Education and Sports and the Albanian Association of Banks became part of the celebrations in the framework of Global Money Week celebrations. Global Money Week is a worldwide money celebration that aims to make children and youth money conscious and financially literate citizens. During this week, partners across the world, coordinated by the Child and Youth Finance International, held various activities to increase financial inclusion of children worldwide, teaching them about money, saving, understanding changes in the economic systems they live in, earning money through entrepreneurship, and building their foundations for the future. Related to Global Money Week 2014, the Bank of Albania introduced a challenging educational programme, involving a high number of pupils from elementary, secondary, as well as high schools. Among others, these activities included a puppet show "Çufo and Tipi - An adventure with goldlets", "My money" drawing contests, visits at commercial banks.

Bank of Albania participates at the XVII Book Fair Tirana 2014

The Bank of Albania participated at the XVII Book Fair Tirana 2014, organised by the Association of Albanian Publishers in Tirana. The Bank of Albania has a three-year experience of participation in similar events and considers the Book Fair as an adequate activity to introduce and deliver Bank of Albania publications and to maintain a direct communication line with the public at large.

During the fair days, copies of periodical publications, scientific and research papers and educational and informative brochures were made available to members of the public, of different ages and academic backgrounds.

During the five days of the fair, about 2 000 copies of periodic publications, 3 500 copies of scientific research publications and 11 000 copies of educational publications to the public were distributed.

"Albanian Money" app

During 2014, the Bank of Albania created its first official application, the "Albanian Money" app, which aims to inform and educate the public on the Albanian currency in general and its security features in particular. In an interactive way, this app provides the possibility to:

- Learn about the Albanian coins and banknotes in circulation;
- Check the security features of Albanian banknotes;
- Find the updated official exchange rate of the Albanian lek against major currencies.

This app is available both in Albanian and in English, and is accessible from PC over the internet or as an app on iOS or Android devices.





VII. INTERNAL AUDIT

- *Internal audit at the Bank of Albania is carried out by the Internal Audit Department, whose main objective is to ensure compliance with the laws and by-laws in the activity of the Bank of Albania. Another objective of the Internal Audit Department is to act as an overall controller and a consultant to the administrators and the Supervisory Council, contributing to maintaining the integrity of information, efficiently using the resources and the effectiveness of internal audit systems at the Bank of Albania.*

Administrators and heads of department are responsible for the compilation, implementation and monitoring of the adequate internal audit systems. The audit function provides bank administrators, regularly and independently, the verification and assessment of internal audit systems, by testing the determined control and procedures, without being a substitute for them.

The activity of the Internal Audit Department during 2014 was conducted in compliance with the internal audit plan, which was approved by the Inspector General, after being presented to the Governor and the Supervisory Council of the Bank of Albania. Throughout 2014, 16 audits on granting a guarantee were planned, of which 2 are regular quarterly audits and 2 two advisory audits.

During the first half of 2014, the Internal Audit Department conducted its activity in compliance with the internal audit plan. Eight audits were completed and reported to the Administrators in 8 audit reports. Two audits, planned for the year 2013, were completed and reported during January 2014.

For each of the conducted audits, the adequacy assessment of placed audits and the findings for improvement were first addressed to the heads of the organisational units subject to the audit, for comments, and then to the Administrators of the Bank of Albania. In compliance with the legal and regulatory stipulations, the summary of the main problems of the audits for the period, the work analysis of the Internal Audit Department and the observation of the implementation of the recommendations were reported by the Inspector General to the Supervisory Council, on quarterly basis (in May 2014 for the activity conducted in the first quarter and in August for the activity conducted in the second quarter 2014).

During 2014, the audit plan was reviewed to address the recommendations and requirements of the International Monetary Fund, and to assess the shortages/failures in the control system of "Currency Issue and Management",

after the event of the illegal appropriation of monetary values, in July 2014.

In absence of the Inspector General, the legal and regulatory obligations and responsibilities directly related to this position could not be fulfilled. During the last quarter of 2014, the Audit Department continued the audits started upon the approval of the Inspector General, which were in process during September 2014.

In total, 67 new recommendations were addressed during 2014. A summary of these findings in the form of periodic reports was presented by the Inspector General to the Supervisory Council of the Bank of Albania.

During this period, the Internal Audit Department was engaged in non-auditing tasks, such as:

- Review of regulatory framework – after the final drafting, two documents were proposed for approval: (1) The “Policy on the Internal Audit at the Bank of Albania”; and (2) “On the organisation and functioning of the Internal Audit Department”. Review of the regulatory framework aims at setting out the objective, authority and responsibilities of the internal audit at the Bank of Albania, in compliance with the Definition of the Internal Auditing, Code of Ethics and the International Internal Auditing Standards. The “Policy of Internal Auditing at the Bank of Albania” is drafted based on the Statute of the Internal Auditing proposed by the Institute of Internal Auditors (IIA) and in similar documents of other central banks. Two projects were proposed for approval to the Supervisory Council of the Bank of Albania in March 2014, and their reviewed versions were proposed for approval in June and August 2014;
- Participation in working groups and commissions of inventories. Following the event of July 2014 at the Bank of Albania, the Internal Audit Department oriented its focus and commitment to the assessment of the situation and proposal of the necessary measures for strengthening the control systems in the affected processes. During July-December 2014, the inspectors of the Internal Audit Department, upon the order of the Administrator, were engaged in the different commissions for the inventory of monetary values, commissions for the assessment of the classified information, etc. They participated in these groups/commissions in the quality of members or observers of the process to assess the implementation of the procedures and to identify the needs to improve these processes.

External assessments for the activity of the internal audit

During 2014, the function of the internal audit at the Bank of Albania, realised from the Internal Audit Department, was subject of some assessments by national and international Institutions/Financial Organisations, such as the International

Monetary Fund (March 2014), the European Central Bank (May 2014), the Supreme State Audit (June 2014) and the Financial Services Volunteers Corps (November 2014). These assessments concluded that, overall, the activity of the internal audit at the Bank of Albania is in compliance" with the IPPF Standards (International Professional Practices Framework) and the Code of Ethics of Internal Audit.



VIII. BANK OF ALBANIA OBJECTIVES FOR 2015

- *The objectives of the Bank of Albania are laid down in the medium-term development strategy of the Bank of Albania.⁵⁰ The Bank of Albania, through this strategy, aims to: (i) proactively respond to challenges to the environment in which the central bank operates; (ii) encourage an effective and efficient allocation of resources; and (iii) promote the Bank's accountability. The strategy is a concrete and transparent plan serving as a means of communication both with the Bank's staff and other interested persons.*

During 2015, the main objectives of the Bank of Albania to accomplish its mission and legal obligations, will be the following:

- The Bank of Albania's monetary policy will remain oriented toward achieving and maintaining price stability. The monetary policy will aim further improvements in the field of strengthening the analysing, forecasting and decision taking capacities, as well as in enhancing the effectiveness of its transmission in economy. In parallel, the monetary policy will aim at fostering coordination with fiscal policy and the regulatory and supervisory instruments.
- The development of the macro-prudential policies will aim to identify and implement the measures to prevent, contain and handle financial systemic risks. It will aim at the further strengthening of analysis capacities, assessment and identification of the appropriate intervention instruments. Also, it will provide an increasing collaboration with the national and international supervisory and regulatory institutions, with the financial agents at home and other stakeholders.
- Banking supervision core objective will continue to be to ensuring a sound banking activity in Albania, to guarantees citizens' savings, support financial stability and contribute to the positive performance of the whole economy. The regulatory framework development will be oriented by the core objective of approximation to Basel II and Basel III principles and the European Union legislation.
- The main functions of the Bank of Albania will be supported by a comprehensive development of institutional capacities, aiming to adopt best practices of central banks. A special attention, in this regard, will placed on meeting the recommendation from the European Central Bank project and the Financial Sector Assessment Program, as well as on accomplishing other institutional engagements and tasks.

⁵⁰ This chapter summarises the main aspects of the medium-term Development Strategy of the Bank of Albania for 2013-2015. The full version of the document is published at the Bank of Albania web page: www.bankofalbania.org

- The Bank of Albania will aim to improve notably the transparency of its policies and activity, contributing thus to strengthening accountability of the institution and enhancing the public confidence in it.

The above-stated direction of our work will be developed in compliance with and in the context of further development of objectives set out in the Medium-Term Development Strategy of the Bank of Albania.







IX. FINANCIAL STATEMENTS AS OF AND FOR THE YEAR ENDED 31
DECEMBER 2014 (WITH INDEPENDENT AUDITORS' REPORT THEREON)





KPMG Albania Shpk
"Dëshmorët e Kombit" Blvd
Twin Towers Buildings
Building 1, 13th floor
Tirana, Albania

| | |
|-----------|--------------------|
| Telephone | +355(4)2274 524 |
| | +355(4)2274 534 |
| Telefax | +355(4)2235 534 |
| E-mail | al-office@kpmg.com |
| Internet | www.kpmg.al |

INDEPENDENT AUDITORS' REPORT

To the Supervisory Council
of Bank of Albania

Tirana, 23 March 2015

We have audited the accompanying financial statements of Bank of Albania ("the Bank") as set out on pages 1 to 43, which comprise the statement of financial position as at 31 December 2014, the statements of profit or loss and other comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the accounting policies adopted by Bank of Albania as disclosed in Note 2 (a) to the accompanying financial statements, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting principles used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

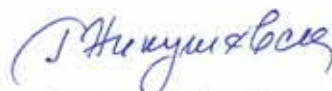
In our opinion, the financial statements give a true and fair view of the financial position of the Bank as at 31 December 2014, and of its financial performance and its cash flows for the year then ended in accordance with the accounting policies adopted by Bank of Albania as disclosed in Note 2 (a) to the accompanying financial statements.

Other Matter

The financial statements of the Bank for the year ended 31 December 2013 were audited by another auditor who expressed an unmodified opinion on those statements on 18 March 2014.



Tzvetelinka Koleva
Statutory Auditor
KPMG Albania Sh.p.k.



Gordana Nikushevska
Managing Director
KPMG Macedonia DOO

STATEMENT OF FINANCIAL POSITION

| In millions of Lek | Note | 31 December 2014 | 31 December 2013 |
|---|------|---------------------|---------------------|
| ASSETS | | | |
| Assets denominated in foreign currencies | | | |
| Gold and precious metals | 5 | 9,569 | 8,474 |
| Accounts with the International Monetary Fund | 6 | 21,792 | 20,220 |
| Deposits with non-resident banks | 7 | 30,003 | 21,661 |
| Available-for-sale investment securities | 8 | 242,419 | 230,588 |
| Held-for-trading investments | 9 | 14,378 | 12,591 |
| Other foreign assets | 10 | 779 | 577 |
| Total assets denominated in foreign currencies | | 318,940 | 294,111 |
| Domestic assets | | | |
| Gold and precious metals | 5 | 4,483 | 4,021 |
| Loans to resident banks | 11 | 25,548 | 21,502 |
| Available-for-sale investment securities | 12 | 63,948 | 63,920 |
| Balances with the Albanian Government | 13 | 7,398 | - |
| Other domestic assets | 14 | 13,009 | 12,388 |
| Total domestic assets | | 114,386 | 101,831 |
| Total assets | | 433,326 | 395,942 |
| LIABILITIES | | | |
| Liabilities denominated in foreign currencies | | | |
| Due to the International Monetary Fund | 6 | 25,330 | 18,633 |
| Due to non-resident financial institutions | 15 | 1,255 | 1,256 |
| Other foreign liabilities | 16 | 230 | - |
| Total liabilities denominated in foreign currencies | | 26,815 | 19,889 |
| Domestic liabilities | | | |
| Currency in circulation | 17 | 226,407 | 207,766 |
| Due to resident banks | 18 | 106,311 | 100,031 |
| Due to the Albanian Government | 19 | 17,578 | 23,779 |
| Other domestic liabilities | 20 | 1,826 | 1,546 |
| Total domestic liabilities | | 352,122 | 333,122 |
| Total liabilities | | 378,937 | 353,011 |
| CAPITAL AND RESERVES | | | |
| Capital | | 2,500 | 2,500 |
| Legal reserve | | 12,500 | 12,500 |
| Revaluation reserves | 21 | 21,930 | 10,421 |
| Property revaluation reserve | | 1,711 | 1,750 |
| Other reserves | 22 | 15,748 | 15,760 |
| Total capital and reserves | | 54,389 | 42,931 |
| Total liabilities, capital and reserves | | 433,326 | 395,942 |

The notes on pages 129 to 167 are an integral part of these financial statements.

The financial statements were authorized for issuance by the Supervisory Council on 4 March 2015 and signed on its behalf by:

Gent Sejko

Governor

Anjeza Beja (Harizaj)

Director of Payment
Systems, Accounting and
Finance Department

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE
INCOME
For the year ended 31 December

| In millions of Lek | Note | 2014 | 2013 |
|--|------|----------|---------|
| Operations with non-residents | | | |
| Interest and commission income | 23 | 4,640 | 5,171 |
| Interest and commission expense | 24 | (3,457) | (4,158) |
| Operations with non-residents, net | | 1,183 | 1,013 |
| Operations with residents | | | |
| Interest and commission income | 25 | 3,095 | 4,387 |
| Interest and commission expense | 26 | (856) | (930) |
| Operations with residents, net | | 2,239 | 3,457 |
| Other operating income, net | 27 | 970 | 654 |
| Net trading income | 28 | 182 | 56 |
| Net gain/(loss) from foreign exchange and from revaluation of gold | 21 | 10,478 | (9,660) |
| Total income/(loss) from banking activities | | 15,052 | (4,480) |
| Other administrative expenses | | | |
| Personnel expenses | 29 | (1,051) | (1,116) |
| Depreciation | 14 | (519) | (244) |
| Amortisation | 14 | (269) | (126) |
| General and administrative expenses | | (675) | (690) |
| Other expenses | 30 | (713) | - |
| Total other administrative expenses | | (3,227) | (2,176) |
| Net profit/(loss) from banking activities | | 11,825 | (6,656) |
| Other Comprehensive Income: | | | |
| Items that are or may be reclassified to profit or loss | | | |
| Fair value reserve of available-for-sale financial assets | 21 | 1,003 | (754) |
| Other revaluation reserve | | - | 9 |
| Other comprehensive income/(loss) for the year | | 1,003 | (745) |
| Total comprehensive income/(loss) for the year | | 12,828 | (7,401) |
| Profit distribution: | | | |
| Net profit/(loss) from banking activities | | 11,825 | (6,656) |
| Transfer (to)/from revaluation reserve | | (10,478) | 9,660 |
| Profit before allocation and distribution | | 1,347 | 3,004 |
| Allocation/(use) of profit by Bank of Albania | | | |
| Reversal of property revaluation | | 39 | 39 |
| Creation of a reserve fund | | - | (12) |
| Total distribution of profit to Albanian Government | | 1,386 | 3,031 |

The notes on pages 129 to 167 are an integral part of these financial statements.

STATEMENT OF CHANGES IN EQUITY

For the years ended 31 December 2014 and 2013

| In millions of Lek | Capital | Legal reserve | Revaluation reserves | Property revaluation reserve | Other reserves | Retained earnings | Total |
|---|---------|---------------|----------------------|------------------------------|----------------|-------------------|---------|
| Balance at 1 January 2013 | 2,500 | 12,500 | 20,826 | 1,789 | 15,748 | - | 53,363 |
| Total comprehensive income | | | | | | | |
| Net loss from banking activity | - | - | - | - | - | (6,656) | (6,656) |
| Other comprehensive income | | | | | | | |
| Revaluation of available-for-sale investment securities (note 21) | - | - | (754) | - | - | - | (754) |
| Other revaluation reserves | - | - | 9 | - | - | - | 9 |
| Transfer of property revaluation surplus | - | - | - | (39) | - | 39 | - |
| Total other comprehensive loss | - | - | (745) | (39) | - | 39 | (745) |
| Total comprehensive loss | - | - | (745) | (39) | - | (6,617) | (7,401) |
| Contributions and distributions | | | | | | | |
| Transfer from the revaluation reserve (note 21) | - | - | (9,660) | - | - | 9,660 | - |
| Other reserves | - | - | - | - | 12 | (12) | - |
| Distribution of profit to Government of Albania | - | - | - | - | - | (3,031) | (3,031) |
| Total contributions and distributions | - | - | (9,660) | - | 12 | 6,617 | (3,031) |
| Balance at 31 December 2013 | 2,500 | 12,500 | 10,421 | 1,750 | 15,760 | - | 42,931 |
| Total comprehensive income | | | | | | | |
| Net profit from banking activity | - | - | - | - | - | 11,825 | 11,825 |
| Other comprehensive income | | | | | | | |
| Revaluation of available-for-sale investment securities (note 21) | - | - | 1,003 | - | - | - | 1,003 |
| Transfer of property revaluation surplus | - | - | - | (39) | - | 39 | - |
| Total other comprehensive income/(loss) | - | - | 1,003 | (39) | - | 39 | 1,003 |
| Total comprehensive income/(loss) | - | - | 1,003 | (39) | - | 11,864 | 12,828 |
| Contributions and distributions | | | | | | | |
| Transfer to the revaluation reserve (note 21) | - | - | 10,478 | - | - | (10,478) | - |
| Other revaluation reserves | - | - | 28 | - | - | - | 28 |
| Other reserve | - | - | - | - | (12) | - | (12) |
| Distribution of profit to Government of Albania | - | - | - | - | - | (1,386) | (1,386) |
| Total contributions and distributions | - | - | 10,506 | - | (12) | (11,864) | (1,370) |
| Balance at 31 December 2014 | 2,500 | 12,500 | 21,930 | 1,711 | 15,748 | - | 54,389 |

The notes on pages 129 to 167 are an integral part of these financial statements.

STATEMENT OF CASH FLOWS

For the year ended 31 December

| In millions of Lek | Notes | 2014 | 2013 |
|--|-------|-----------|-----------|
| Cash flows from operating activities | | | |
| Net profit/(loss) from banking activities | | 11,825 | (6,656) |
| Adjustments for: | | | |
| Interest and commission income (non-residents) | 23 | (4,640) | (5,171) |
| Interest and commission expense (non-residents) | 24 | 3,457 | 4,158 |
| Interest and commission income (residents) | 25 | (3,095) | (4,387) |
| Interest and commission expense (residents) | 26 | 856 | 930 |
| Net trading securities income | 28 | (182) | (56) |
| Profit from sale of available-for-sale investment securities | 27 | (834) | (420) |
| Gain from forward foreign exchange contracts and futures contracts | 27 | - | (223) |
| Provision for doubtful loans | | 3 | 13 |
| Net gain/(loss) from foreign exchange and from revaluation of gold | 21 | (10,478) | 9,660 |
| Depreciation and amortization | 14 | 788 | 370 |
| | | (2,300) | (1,782) |
| Changes in: | | | |
| Accounts with the International Monetary Fund | | (1,573) | (1,575) |
| Other foreign assets | | (223) | 135 |
| Other domestic assets | | 259 | 99 |
| Balances with the Albanian Government | | (7,398) | - |
| Due to the International Monetary Fund | | 6,699 | (1,562) |
| Due to non-resident financial institutions | | (1) | 4 |
| Other foreign liabilities | | 230 | (131) |
| Due to resident banks | | 6,286 | 2,976 |
| Due to the Albanian Government | | (5,801) | 9,517 |
| Other domestic liabilities | | 280 | (140) |
| Held-for-trading investments (in foreign currency) | | (149) | (77) |
| | | (1,391) | 9,246 |
| Interest received | | 4,627 | 6,293 |
| Interest paid | | (932) | (965) |
| Net cash from operating activities | | 4 | 12,792 |
| Cash flows from investing activities | | | |
| Purchase of property and equipment | | (1,357) | (1,078) |
| Purchase of intangible assets | | (311) | (567) |
| Purchase of available-for-sale investments (foreign currency) | | (190,850) | (263,295) |
| Purchase of available-for-sale investments (domestic assets) | | (106,642) | (109,395) |
| Proceeds from available-for-sale investments (foreign currency) | | 186,724 | 241,246 |
| Proceeds from available-for-sale investments (domestic assets) | | 106,614 | 112,686 |
| (Increase)/decrease in repurchase agreements | | (4,042) | 281 |
| Foreign exchange gains/(losses) | | 1,327 | (386) |
| Net cash used in investing activities | | (8,537) | (20,508) |
| Cash flows from financing activities | | | |
| Proceeds from currency in circulation | | - | 16,000 |
| Distributed profit | | (1,786) | (4,793) |
| Net cash (used in)/ generated from financing activities | | (1,786) | 11,207 |
| (Decrease)/Increase in cash and cash equivalents | | (10,319) | 3,491 |
| Cash and cash equivalents at the beginning of the year | | 68,934 | 65,443 |
| Cash and cash equivalents at the end of the year | 31 | 58,615 | 68,934 |

The notes on pages 129 to 167 are an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS AS OF AND FOR THE YEAR ENDED 31 DECEMBER 2014

(amounts in millions of Lek, unless otherwise stated)

1. GENERAL

The Bank of Albania (the 'Bank') is the Central Bank of the Republic of Albania and was established according to the Law No. 8269, dated 23 December 1997 'On the Bank of Albania'.

Under the terms of its charter the Bank's main responsibilities are:

- formulating, adopting and executing the monetary policy of Albania, which shall be consistent with its primary objective;
- formulating, adopting and executing the foreign exchange arrangement and the exchange rate policy of Albania;
- issuing or revoking of licenses and supervising banks that engage in the banking business in order to secure the stability of the banking system;
- holding and managing its official foreign reserves;
- acting as banker and adviser to, and as fiscal agent of, the Government of the Republic of Albania;
- promoting an effective operation of payments system.

The Bank is subject to the regulatory requirements of the Parliament of the Republic of Albania and the Law 'On the Bank of Albania'.

2. BASIS OF PREPARATION

(a) Statement of compliance

These financial statements have been prepared in accordance with the accounting policies adopted in the Bank's Accounting Manual approved with the order No. 50 of the Council of Ministers, dated 26 January 2001 and other approved accounting policies and procedures.

Significant accounting policies applied in the preparation of these financial statements are described in note 3. The accounting policies adopted in the preparation and presentation of these financial statements are broadly in line with International Financial Reporting Standards ('IFRS') approved by the International Accounting Standards Board ('IASB').

As part of its conversion to IFRSs, the Bank is in the process of preparing preliminary IFRS financial statements for the year ended 31 December 2014, to establish the financial position, results of operations and cash flows of the Bank necessary to provide the comparative financial information expected to be included in the Bank's first complete set of IFRS financial statements as at and for the year ending 31 December 2015.

(b) Basis of measurement

These financial statements have been prepared on a historical cost basis except for the following:

- derivative financial instruments and non-derivative financial instruments at fair value through profit or loss are measured at fair value
- available-for-sale financial assets are measured at fair value
- gold is measured at fair value
- buildings are measured at revalued amount.

(c) Functional and presentation currency

These financial statements are presented in Albanian Lek ('LEK'), which is the Bank's functional currency. All amounts have been rounded to the nearest million, except when otherwise indicated.

(d) Use of estimates and judgments

In preparing these financial statements, management has made judgments, estimates and assumptions that affect the application of the Bank's accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to estimates are recognized prospectively.

Information about significant areas of estimation uncertainty and critical judgments in applying accounting policies that have the most significant effect on the amounts recognized in the financial statements are described in note 4.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies set out below have been applied consistently to all periods presented in these financial statements.

As part of its conversion to IFRSs, the Bank is in the process of concluding on the selection and application of accounting policies in the preparation and presentation of financial statements in accordance with IFRSs. This includes determining which standards and interpretations are expected to be effective when the first complete set of IFRS financial statements are prepared as at 31 December 2015 and identifying gaps between accounting policies selected and applied under the current financial reporting framework and IFRSs.

There is a possibility that the classification of the assets and liabilities, their amounts and the disclosures in these financial statements may require adjustment before constituting the IFRS financial statements as at 31 December 2015, when the Bank will prepare its first complete set of IFRS financial statements. An explanation of how the transition to IFRS affects the reported

financial position, financial performance and cash flows of the Bank will be provided in the first complete set of IFRS financial statements.

a. Interest and commission

Interest income and expense are recognized in profit or loss using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or financial liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Bank estimates future cash flows considering all contractual terms of the financial instrument, but not future credit losses.

The calculation of the effective interest rate includes transaction costs and fees and points paid or received that are an integral part of the effective interest rate. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or financial liability.

Interest income and expense presented in the statement of profit or loss and other comprehensive income ('OCI') include:

- interest on financial assets and financial liabilities measured at amortised cost calculated on an effective interest basis; and
- interest on available-for-sale investment securities calculated on an effective interest basis.

Interest income and expense on all trading assets and liabilities are considered to be incidental to the Bank's trading operations and are presented together with all other changes in the fair value of trading assets and liabilities in net trading income (see b.)

Fees and commission income and expense that are integral to the effective interest rate on a financial asset or financial liability are included in the measurement of the effective interest rate.

Other fees and commission income and expense relate mainly to transaction and service fees, which are expensed as the services are received.

b. Net trading income

Net trading income comprises gains less losses related to trading assets and liabilities, and includes all realised and unrealised fair value changes, interest, and foreign exchange differences.

c. Other operating income/expense

Other operating income/expense includes gains and losses arising from disposals and changes in the fair value of available-for-sale financial assets.

d. Foreign currency transactions

Transactions in foreign currencies are translated into the respective functional currency at the spot exchange rates at the date of the transactions.

Monetary assets and liabilities denominated in foreign currencies at the reporting date are translated into the functional currency at the spot exchange rate at that date. The foreign currency gain or loss on monetary items is the difference between the amortised cost in the functional currency at the beginning of the year, adjusted for effective interest and payments during the year, and the amortised cost in the foreign currency translated at the spot exchange rate at the end of the year.

Non-monetary assets and liabilities that are measured at fair value in a foreign currency are translated to the functional currency at the spot exchange rate at the date that the fair value determined. Non-monetary items that are measured based on historical cost in a foreign currency are translated using the spot exchange rate at the date of the transaction.

Foreign currency differences arising on retranslation are generally recognised in profit or loss. Net foreign exchange gains or losses include all foreign exchange differences related to spot transactions with settlement dates two business days after the trade date, although such transactions are recognised on the settlement date.

According to the Law No. 8269, dated 23 December 1997 'On the Bank of Albania' and the Decision No. 104 dated 27 December 2006 of the Supervisory Council, exchange differences arising from the revaluation of assets and liabilities denominated in foreign currencies, revaluation of gold and precious metals and balances denominated in SDR are initially recognised in profit or loss in the period in which they arise, and are then transferred from retained earnings to the 'Revaluation reserves' included in Capital and Reserves.

e. Taxation and Profit distribution policy of the Bank

Based on the law 'On the Bank of Albania' the Bank is not subject to income tax.

The Bank's policy of distribution of profit from banking operations is defined in the Law 'On the Bank of Albania' (the 'Law'). According to Article 10.2 of this Law, the Bank allocates all the realised profit to the State Budget after having fulfilled its requirement for the reserve fund pursuant to the Law and as determined by the Supervisory Council of the Bank.

According to Article 64, point (a) of the Law 'On the Bank of Albania' as well as the decision No. 104 dated 27 December 2006 of the Supervisory Council, the net gain / losses arising from the revaluation of assets and liabilities denominated in foreign currencies, revaluation of gold and precious

metals and balances denominated in SDR are initially recognised in profit or loss in the period in which they arise, and are then transferred from retained earnings to 'Revaluation reserves' in capital and reserves section. According to Article 64, point (b), the Government of Albania issues debt securities at market interest rates to cover any negative balance of the revaluation reserve arising from the Bank's activity.

According to Article 11 of the Law 'On the Bank of Albania' no transfer, redemption or payment under Articles 8, 9 or 10 of this law shall be made if the assets of the Bank are less than the sum of its liabilities and paid-up capital. If such conditions arise, based on the Law 'On the Bank of Albania' under article 7, the Ministry of Finance might have to transfer interest bearing negotiable government securities to the Bank, in such amount as would be necessary to remedy the deficiency.

f. Legal and other reserves

According to the requirements of Article 9 of the Law 'On the Bank of Albania', the Bank sets aside 25 per cent of the net profit for the year into a Legal Reserve until the reserve amounts to 500% of the capital. The Bank has complied in full with this requirement as at 31 December 2011 with its legal reserve amounting to LEK 12,500 million.

g. Financial assets and liabilities

(i) Recognition

The Bank initially recognises loans and advances on the date on which they are originated. All other financial instruments (including regular-way purchases and sales of financial assets) are recognised on the trade date, which is the date on which the Bank becomes a party to the contractual provisions of the instrument.

A financial asset or financial liability is measured initially at fair value plus, for an item not at fair value through profit or loss, transaction costs that are directly attributable to its acquisition or issue.

(ii) Classification

Financial assets

The Bank classifies its financial assets into one of the following categories:

- available-for-sale;
- held-for-trading; and
- loans and receivables.

See i., j., k., l., m., n., o. and q..

Financial liabilities

The Bank classifies its financial liabilities, other than financial guarantees and loan commitments, as measured at amortised cost. See o. and p.

(iii) Derecognition

Financial assets

The Bank derecognises a financial asset when the contractual rights to the cash flows from the financial asset expire, or it transfers the rights to receive the contractual cash flows in a transaction in which substantially all of the risks and rewards of ownership of the financial asset are transferred or in which the Bank neither transfers nor retains substantially all of the risks and rewards of ownership and it does not retain control of the financial asset.

On derecognition of a financial asset, the difference between the carrying amount of the asset (or the carrying amount allocated to the portion of the asset derecognised) and the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in OCI is recognised in profit or loss. Any interest in transferred financial assets that qualify for derecognition that is created or retained by the Bank is recognised as a separate asset or liability.

Financial liabilities

The Bank derecognises a financial liability when its contractual obligations are discharged or cancelled, or expire.

(iv) Offsetting

Financial assets and financial liabilities are offset and the net amount presented in the statement of financial position when, and only when, the Bank has a legal right to set off the amounts and it intends either to settle them on a net basis or to realize the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted under IFRS, or for gains and losses arising from a group of similar transactions such as in the Bank's trading activity

(v) Amortised cost measurement

The 'amortized cost' of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between the initial amount recognized and the maturity amount, minus any reduction for impairment.

(vi) Fair value measurement

'Fair value' is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal or, in its absence, the most advantageous market to which the Bank has access at that date. The fair value of a liability reflects its non-performance risk.

When available, the Bank measures the fair value of an instrument using the quoted price in an active market for that instrument. A market is regarded as active if transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. If there is no quoted price in an active market, then the Bank uses valuation techniques that maximize the use of relevant observable inputs and minimize the use of unobservable inputs. The chosen valuation technique incorporates all of the factors that market participants would take into account in pricing a transaction.

The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price – i.e. the fair value of the consideration given or received. If the Bank determines that the fair value at initial recognition differs from the transaction price and the fair value is evidenced neither by a quoted price in an active market for an identical asset or liability nor based on a valuation technique that uses only data from observable markets, then the financial instrument is initially measured at fair value, adjusted to defer the difference between the fair value at initial recognition and the transaction price. Subsequently, that difference is recognized in profit or loss on an appropriate basis over the life of the instrument but no later than when the valuation is wholly supported by observable market data or the transaction is closed out.

If an asset or a liability measured at fair value has a bid price and an ask price, then the Bank measures assets and long positions at a bid price and liabilities and short positions at an ask price.

The fair value of a demand deposit is not less than the amount payable on demand, discounted from the first date on which the amount could be required to be paid.

The Bank recognizes transfers between levels of the fair value hierarchy as of the end of the reporting period during which the change has occurred.

(vii) Identification and measurement of impairment

At each reporting date, the Bank assesses whether there is objective evidence that financial assets not carried at fair value through profit or loss are impaired.

A financial asset or a group of financial assets is 'impaired' when objective evidence demonstrates that a loss event has occurred after the initial recognition

of the asset(s) and that the loss event has an impact on the future cash flows of the asset(s) that can be estimated reliably.

Objective evidence that financial assets are impaired includes:

- significant financial difficulty of the borrower or issuer;
- default or delinquency by a borrower;
- indications that a borrower or issuer will enter bankruptcy;
- the disappearance of an active market for a security; or
- observable data relating to a group of assets such as adverse changes in the payment status of borrowers or issuers in the group, or economic conditions that correlate with defaults in the group.

Impairment losses on assets measured at amortised cost are calculated as the difference between the carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. Impairment losses are recognised in profit or loss and reflected in an allowance account against loans and receivables or held-to-maturity investments. Interest on the impaired assets continues to be recognized through the unwinding of the discount. If an event occurring after the impairment was recognized causes the amount of impairment loss to decrease, then the decrease in impairment loss is reversed through profit or loss.

(vii) Identification and measurement of impairment (continued)

Impairment losses on available-for-sale investment securities are recognized by reclassifying the losses accumulated in the fair value reserve in equity to profit or loss. The cumulative loss that is reclassified from equity to profit or loss is the difference between the acquisition cost, net of any principal repayment and amortization, and the current fair value, less any impairment loss previously recognized in profit or loss. Changes in impairment attributable to application of the effective interest method are reflected as a component of interest income.

If, in a subsequent period, the fair value of an impaired available-for-sale debt security increases and the increase can be related objectively to an event occurring after the impairment loss was recognized, then the impairment loss is reversed through profit or loss; otherwise, any increase in fair value is recognized through OCI. Any subsequent recovery in the fair value of an impaired available-for-sale equity security is always recognized in OCI.

The Bank writes off a loan or an investment debt security, either partially or in full, and any related allowance for impairment losses, when it determines that there is no realistic prospect of recovery.

(viii) Designation at fair value through profit or loss

The Bank has designated financial assets and financial liabilities at fair value through profit or loss in either of the following circumstances.

- The assets or liabilities are managed, evaluated and reported internally on a fair value basis.
- The designation eliminates or significantly reduces an accounting mismatch that would otherwise arise.

Note 9 sets out the amounts and descriptions of financial assets that have been designated at fair value through profit or loss.

(ix) Securities lending agreements

Investments lent under securities lending agreements are reported in the statement of financial position and are valued in accordance with the accounting policies applicable to assets held for trading and assets available-for-sale. Investments lent under securities lending agreements continue to be recognised in the Bank's statement of financial position. The Bank receives cash or securities collateral for such lending. Income arising from the securities lending agreements is reported as interest income.

h. Currency in circulation

Currency in circulation is presented under domestic liabilities by deducting the nominal value of the banknotes and coins on hand from the nominal value of all the banknotes and coins issued.

i. Cash and cash equivalents

Cash and cash equivalents include notes and coins on hand and highly liquid financial assets with original maturities of three months or less from the acquisition date that are subject to an insignificant risk of changes in their fair value, and are used by the Bank in the management of its short-term commitments.

Cash and cash equivalents are carried at amortised cost in the statement of financial position.

j. Trading assets and liabilities

Trading assets and liabilities are those assets and liabilities that the Bank acquires or incurs principally for the purpose of selling or repurchasing in the near term, or holds as part of a portfolio that is managed together for short-term profit or position taking.

Trading assets and liabilities are initially recognized and subsequently measured at fair value in the statement of financial position, with transaction costs recognized in profit or loss. All changes in fair value are recognised as part of net trading income in profit or loss. Trading assets and liabilities are not reclassified subsequent to their initial recognition.

General information on the derivative instruments, which comprise future and forward contracts, is disclosed in Note 35 (d).

k. Derivatives held for risk management purposes

Derivatives held for risk management purposes include all derivative assets and liabilities that are not classified as trading assets or liabilities. Derivatives held for risk management purposes are measured at fair value in the statement of financial position.

If a derivative is not held for trading, and is not designated in a qualifying hedge relationship, then all changes in its fair value are recognized immediately in profit or loss.

General information on the derivative instruments, which comprise future and forward contracts, is disclosed in Note 35 (d).

l. Available-for-sale investment securities

Investment securities are initially measured at fair value plus incremental direct transaction costs.

Available-for-sale investments are non-derivative investments that are designated as available-for-sale or are not classified as another category of financial assets. Available-for-sale investments comprise debt securities. Available-for-sale investments are measured at fair value after initial recognition.

Interest income is recognized in profit or loss using the effective interest method. Dividend income is recognized in profit or loss when the Bank becomes entitled to the dividend. Foreign exchange gains or losses on available-for-sale debt security investments are recognized in profit or loss. Impairment losses are recognized in profit or loss (see g.(vii)).

Other fair value changes, other than impairment losses (see g.(vii)), are recognized in OCI and presented in the revaluation (fair value) reserve within equity. When the investment is sold, the gain or loss accumulated in equity is reclassified to profit or loss.

m. Investments held-for-trading

Investment securities held-for-trading are measured at fair value, with fair value changes recognized immediately in profit or loss as described in g.(viii).

n. Loans and receivables

Loans and advances' are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and that the Bank does not intend to sell immediately or in the near term. Loans and advances to banks and loans to employees are classified as loans and receivables.

Loans and advances are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortized cost using the effective interest method.

When the Bank purchases a financial asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date (reverse repo), the arrangement is accounted for as a loan or advance, and the underlying asset is not recognized in the Bank's financial statements.

o. Repurchase agreements and reverse repurchase agreements

When the Bank sells a financial asset and simultaneously enters into an agreement to repurchase the asset (or a similar asset) at a fixed price on a future date ("repo"), the arrangement is accounted for as a deposit, and the underlying asset continues to be recognized in the Bank's financial statements.

Reverse repurchase agreements are included in Loans to resident banks, whilst repurchase agreements are included in Due to domestic Banks. Based on the Bank's regulation on repurchase agreements, the Bank is not required to put up any collateral for these securities.

Interest earned on reverse repurchase agreements and interest incurred on repurchase agreements is recognized as interest income or interest expense, over the life of each agreement using the interest rate approved by the Supervisory Council of the Bank of Albania.

p. Borrowings from the International Monetary Fund (IMF)

The borrowings of the Government of the Republic of Albania from the IMF are undertaken through the Bank and are shown on the statement of financial position of the Bank. Borrowings from the IMF are denominated in Special Drawing Rights.

q. Gold and other precious metals

Gold and other precious metals are valued at their fair values being the market value based on the official London Bullion Market price at the reporting date. This valuation is in line with measurement policy developed by the Bank.

r. Property and equipment

(i) Recognition and measurement

Items of property and equipment are measured at cost less accumulated depreciation and accumulated impairment losses, except for land and buildings, which are stated at re-valued amount, calculated using the replacement cost method.

Any revaluation increase arising on the revaluation of land and buildings is credited in other comprehensive income to the property revaluation reserve, except to the extent that it reverses a revaluation decrease for the same asset previously recognized in profit or loss, in which case the increase is credited to profit or loss to the extent of the decrease previously charged. A decrease in the carrying amount arising on the revaluation of such land and buildings is charged to profit or loss to the extent that it exceeds the balance, if any, held in the properties revaluation reserve relating to a previous revaluation of that asset. The revaluation reserve is transferred directly to retained earnings as the asset is used. Cost includes expenditures that are directly attributable to the acquisition of the asset.

(ii) Subsequent costs

The cost of replacing a part of an item of property or equipment is recognized in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the Bank and its cost can be measured reliably. The carrying amount of the replaced part is derecognised. The costs of the day-to-day maintenance of property and equipment are recognised in profit or loss as incurred.

(iii) Depreciation

Depreciation is recognised in profit or loss on a straight-line basis over the estimated useful lives of each part of an item of property and equipment. Land and work in progress are not depreciated. The estimated useful lives for the current and comparative periods are as follows:

| | |
|-------------------------------------|--------------|
| · Buildings, Head Office | 40 years |
| · Buildings, branches | 25 years |
| · Vehicles | 5 - 10 years |
| · Furniture, fixtures and equipment | 3 - 20 years |

Depreciation methods, useful lives and residual values are reassessed at the reporting date.

s. Intangible assets

Intangible assets are recognised if it is probable that the future economic benefits that are attributable to the asset will flow to the Bank and the cost of the asset can be measured reliably. Intangible assets are comprised of printing and minting costs and computer software.

(i) Printing and minting costs

Freshly printed banknotes and coins which have not yet been put into circulation are recognized as assets at acquisition cost and classified as banknote and coin stocks. The costs of printing banknotes and minting coins are amortized over 2.5 years and 10 years, from the date of recognition, respectively

(ii) Software

Software acquired by the Bank is stated at cost less accumulated amortisation and accumulated impairment losses.

Subsequent expenditure on software is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

Amortization is recognized in profit or loss on a straight-line basis over the estimated useful life of the software, from the date that it is available for use. The estimated useful life of software is two years.

*t. Employee benefits**(i) Defined contribution plans*

Obligations for contributions to defined contribution plans are expensed as the related service is provided and recognised as personnel expenses in profit or loss. Defined contribution plans include voluntary and compulsory contribution plans.

The Bank makes compulsory social security contributions that provide pension benefits for employees upon retirement. The local authorities are responsible for providing the legally set minimum threshold for pensions in Albania under a defined contribution pension plan.

(ii) Termination benefits

Termination benefits are recognized as an expense when the Bank is demonstrably committed, without realistic possibility of withdrawal, to a formal detailed plan to either terminate employment before the normal retirement date, or to provide termination benefits as a result of an offer made to encourage voluntary redundancy. Termination benefits for voluntary redundancies are recognized if the Bank has made an offer of voluntary redundancy, it is probable that the offer will be accepted, and the number of acceptances can be estimated reliably.

(iii) Short-term benefits

Short-term employee benefit obligations are measured on an undiscounted basis and are expensed as the related service is provided. A provision is recognized for the amount expected to be paid under short-term cash bonus if the Bank has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably.

u. Operating leases

Payments made under operating leases are recognised in profit or loss on a straight-line basis over the term of the lease. Lease incentives received are recognised as an integral part of the total lease expense, over the term of the lease.

v. Impairment of non-financial assets

The carrying amounts of the Bank's non-financial assets are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated.

An impairment loss is recognized if the carrying amount of an asset exceeds its recoverable amount.

The recoverable amount of an asset is the higher of its value in use and its fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

Impairment losses recognized in prior periods are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss had been recognized.

w. Provisions

A provision is recognised if, as a result of a past event, the Bank has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a rate that reflects current market assessments of the time value of money and the risks specific to the liability. The unwinding of the discount is recognised as finance cost.

4. USE OF ESTIMATES AND JUDGEMENTS

These disclosures supplement the commentary on financial risk management (see note 35).

The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgments are continually evaluated and based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

(i) Assumptions and estimation uncertainties: impairment of financial instruments

Assets accounted for at amortized cost and available for sale assets are evaluated for impairment on a basis described in accounting policy 3.g.(vii).

The specific counterparty component of the total allowances for impairment applies to financial assets evaluated individually for impairment and is based upon management's best estimate of the present value of the cash flows that are expected to be received. In estimating these cash flows, management makes judgments about the counterparty's financial situation and the net realizable value of any underlying collateral. Each impaired asset is assessed on its merits, and an estimate of cash flows considered recoverable is independently approved.

(ii) Determining fair values

The fair values of financial assets and financial liabilities that are traded in active markets are based on quoted market prices or dealer price quotations. For all other financial instruments, the Bank determines fair values using other valuation techniques.

For financial instruments that trade infrequently and have little price transparency, fair value is less objective, and requires varying degrees of judgment depending on liquidity, concentration, uncertainty of market factors, pricing assumptions and other risks affecting the specific instrument.

(a) Valuation models

The Bank measures fair values using the following fair value hierarchy, which reflects the significance of the inputs used in making the measurements.

- Level 1: inputs that are quoted market prices (unadjusted) in active markets for identical instruments.
- Level 2: inputs other than quoted prices included within Level 1 that are observable either directly (i.e. as prices) or indirectly (i.e. derived from prices). This category includes instruments valued using: quoted market prices in active markets for similar instruments; quoted prices for identical or similar instruments in markets that are considered less than active; or other valuation techniques in which all significant inputs are directly or indirectly observable from market data.
- Level 3: inputs that are unobservable. This category includes all instruments for which the valuation technique includes inputs not based on observable data and the unobservable inputs have a significant effect on the instrument's valuation. This category includes instruments that are valued based on quoted prices for similar instruments for which significant unobservable adjustments or assumptions are required to reflect differences between the instruments.

Valuation techniques include net present value and discounted cash flow models, comparison with similar instruments for which market observable prices exist, and other valuation models. Assumptions and inputs used in valuation techniques include risk-free and benchmark interest rates, credit spreads and other premiums used in estimating discount rates, bond and equity prices, foreign currency exchange rates, equity and equity index prices and expected price volatilities and correlations.

The objective of valuation techniques is to arrive at a fair value measurement that reflects the price that would be received to sell the asset or paid to transfer the liability in an orderly transaction between market participants at the measurement date.

The Bank uses widely recognised valuation models for determining the fair value of common and more simple financial instruments, such as interest rate and currency swaps that use only observable market data and require little management judgement and estimation. Observable prices or model inputs are usually available in the market for listed debt and equity securities. Availability of observable market prices and model inputs reduces the need for management judgement and estimation and also reduces the uncertainty associated with determining fair values. Availability of observable market prices and inputs varies depending on the products and markets and is prone to changes based on specific events and general conditions in the financial markets.

Fair value estimates obtained from models are adjusted for any other factors, such as liquidity risk or model uncertainties, to the extent that the Bank believes that a third party market participant would take them into account in pricing a transaction. Fair values reflect the credit risk of the instrument and include adjustments to take account of the credit risk of the Bank entity and the counterparty where appropriate.

Model inputs and values are calibrated against historical data and published forecasts and, where possible, against current or recent observed transactions in different instruments and against broker quotes. This calibration process is inherently subjective and it yields ranges of possible inputs and estimates of fair value, and management judgement is required to select the most appropriate point in the range.

Fair values of financial assets and financial liabilities that are traded in active markets are based on quoted market prices or dealer price quotations. For all other financial instruments the Bank determines fair values using valuation techniques. Valuation techniques include net present value and discounted cash flow models, comparison to similar instruments for which market observable prices exist and other valuation models. The objective of valuation techniques is to arrive at a fair value determination that reflects the price of the financial instrument in an orderly transaction between market participants at the measurement date.

The Bank uses widely recognized valuation models for determining the fair value of common and more simple financial instruments that use only observable market data and require little management judgment and estimation. Observable prices and model inputs are usually available in the market for listed securities, exchange traded derivatives like interest rate futures and simple over the counter derivatives. Availability of observable market prices and model inputs reduces the need for management judgment and estimation and also reduces the uncertainty associated with determination of fair values. Availability of observable market prices and inputs varies depending on the products and markets and is prone to changes based on specific events and general conditions in the financial markets.

(b) Financial instruments measured at fair value – fair value hierarchy

The following table analyses financial instruments measured at fair value at the reporting date, by the level in the fair value hierarchy into which the fair value measurement is categorized. These values are recognised in the statement of financial position.

| 31 December 2014 | Total Fair Value | Level 1 | Level 2 | Level 3 |
|--|------------------|---------|---------|---------|
| Assets denominated in foreign currencies | | | | |
| Gold and precious metals | 9,569 | 9,569 | - | - |
| Available-for-sale investment securities | 242,419 | 232,056 | 10,363 | - |
| Held-for-trading investments | 14,378 | 14,378 | - | - |
| Domestic assets | | | | |
| Available-for-sale investment securities | 63,948 | - | 63,948 | - |

| 31 December 2013 | Total Fair Value | Level 1 | Level 2 | Level 3 |
|--|------------------|---------|---------|---------|
| Assets denominated in foreign currencies | | | | |
| Gold and precious metals | 8,474 | 8,474 | - | - |
| Available-for-sale investment securities | 230,588 | 229,186 | 1,402 | - |
| Held-for-trading investments | 12,591 | 12,591 | - | - |
| Domestic assets | | | | |
| Available-for-sale investment securities | 63,920 | - | 63,920 | - |

The information on quoted market prices is obtained from two sources: Merrill Lynch and Bloomberg.

(c) Financial instruments not measured at fair value

The following table sets out the fair values of certain financial instruments not measured at fair value by the level in the fair value hierarchy into which each fair value measurement is categorised.

| | Carrying value 2014 | Fair value Level 2 2014 | Carrying value 2013 | Fair value Level 2 2013 |
|---|---------------------------|-------------------------------|---------------------------|-------------------------------|
| Financial Assets | | | | |
| Assets denominated in foreign currencies | | | | |
| Accounts with the International Monetary Fund | 21,792 | 21,792 | 20,220 | 20,220 |
| Deposits with non-resident banks | 30,003 | 30,003 | 21,661 | 21,661 |
| Domestic assets | | | | |
| Loans to resident banks | 25,548 | 25,548 | 21,502 | 21,502 |
| Balances with the Albanian Government | 7,398 | 7,398 | - | - |
| Financial Liabilities | | | | |
| Liabilities denominated in foreign currencies | | | | |
| Due to the International Monetary Fund | 25,330 | 25,330 | 18,633 | 18,633 |
| Due to non-resident financial institutions | 1,255 | 1,255 | 1,256 | 1,256 |
| Domestic liabilities | | | | |
| Due to resident banks | 106,311 | 106,311 | 100,031 | 100,031 |
| Due to the Albanian Government | 17,578 | 17,578 | 23,779 | 23,779 |

Where available, the fair value of loans and borrowings is based on observable market transactions. Where observable market transactions are not available, fair value is estimated using valuation models, such as discounted cash flow techniques, applying the rates that are offered for instruments of similar maturities and terms.

The fair value of deposits payable on demand is the amount payable at the reporting date.

5. GOLD AND PRECIOUS METALS

| | 2014 | 2013 |
|-------------------------------------|--------|--------|
| Gold – foreign | 9,569 | 8,474 |
| Gold and precious metals - domestic | 4,483 | 4,021 |
| Total | 14,052 | 12,495 |

As at 31 December 2014, the value of gold owned by the Bank placed in gold time deposits and current accounts abroad, included within foreign currency assets was LEK 9,569 million (2013: LEK 8,474 million).

As at 31 December 2014, domestic gold and precious metals of LEK 4,483 million (2013: LEK 4,021 million) include non-monetary gold, platinum and silver held in a domestic vault.

The total increase of LEK 1,557 million compared to the prior year (2013: decrease of LEK 5,506 million) results from the reprising of gold valued at the market price (see 3.q.) at the reporting date, and the reprising of other precious metals, and is initially recognized in profit or loss, and subsequently transferred to the revaluation reserve.

6. ACCOUNTS WITH/due to THE INTERNATIONAL MONETARY FUND (IMF)

The statement of assets and liabilities of International Monetary Fund Membership is as follows:

| | 2014 | 2013 |
|---------------------------------------|--------|--------|
| Accounts with the IMF | | |
| Quotas in the IMF | 9,485 | 9,712 |
| Special Drawing Rights (SDR) holdings | 12,306 | 10,506 |
| Accrued interest | 1 | 2 |
| Total assets | 21,792 | 20,220 |

| | 2014 | 2013 |
|--|--------|--------|
| Due to the IMF | | |
| SDR Allocations | 7,752 | 7,286 |
| IMF securities account | 14,221 | 7,286 |
| IMF account No.1 | 2,301 | 2,379 |
| IMF account No.2 | 1 | 1 |
| Poverty Reduction and Growth Facility ('PRGF') | 1,054 | 1,678 |
| Accrued interest | 1 | 3 |
| Total liabilities | 25,330 | 18,633 |

Quotas in the IMF of LEK 9,485 million or SDR 60 million (2013: LEK 9,712 million or SDR 60 million) originate from the membership of the Republic of Albania in the IMF, according to the Law No.8269, dated 23 December 1997 'On the Bank of Albania'.

The SDR holdings of LEK 12,306 million or SDR 74 million (2013: LEK 10,506 million or SDR 67 million) represent deposits placed with the International Monetary Fund. These rights represents the amounts acquired through the SDR allocations. The SDR holdings bear interest, which is determined on a weekly basis. The interest rate at 31 December is 0.05% p.a. (2013: 0.13% p.a.).

SDR Allocations of LEK 7,752 million or SDR 46 million (2013: LEK 7,286 million or SDR 46 million) represent amounts borrowed from IMF, and their purpose is to provide immediate response to the short term and long term liquidity needs of the member countries.

The IMF accounts represent non-interest bearing liabilities towards Albania's participation in the IMF. The IMF accounts do not have a defined maturity. IMF pays remuneration to members with remunerated reserve tranche positions, at 0.05% p.a. (2013: 0.13% p.a.). The reserve tranche position is calculated as the difference between Quotas in the IMF and the IMF's holdings in the IMF accounts, excluding holdings acquired as a result of the use of the Fund credit and holdings in the account No.2, as presented below:

| | 2014 | | 2013 | |
|---|----------|------|---------|------|
| In millions: | LEK | SDR | LEK | SDR |
| Quotas in the IMF | 9,485 | 60 | 9,712 | 60 |
| Less currency holdings by IMF: | | | | |
| IMF securities account | (14,221) | (90) | (7,286) | (45) |
| IMF account No.1 | (2,301) | (15) | (2,379) | (15) |
| IMF account No.2 | (1) | - | (1) | - |
| Exclude: Account No. 2 and Holdings arising from the use of Fund credit and | 8,069 | 51 | 923 | 6 |
| | (8,454) | (54) | (8,743) | (54) |
| Reserve tranche held with IMF | 1,031 | 6 | 969 | 6 |

The IMF securities account includes the following borrowings that are part of the Extended Fund Facility (EFF) program:

| In millions: | 2014 | | 2013 | |
|--------------------------------|-------|-----|------|-----|
| | LEK | SDR | LEK | SDR |
| EFF: 2014 disbursements | 7,398 | 47 | - | - |
| EFF: 2006 - 2009 disbursements | 670 | 4 | 922 | 6 |
| | 8,068 | 51 | 922 | 6 |

In 2014, the IMF disbursed two tranches granted as part of the EFF facility program approved by IMF in favor of Albania. The facility is repayable within 3 years. The Bank has received promissory notes of ALL 7,398 million, issued by the Albanian Government in favor of IMF, in relation to this borrowing (see note 12).

Certain EFF borrowing were disbursed during the period from 2006 to 2009. The facility is repayable after a grace period of four and a half years and will be repaid within 10 years. The interest on these borrowings is floating and is paid on quarterly basis. At 31 December 2014, the annual interest rate was 1.05 % (2013: 1.12%).

PRGF borrowings of LEK 1,054 million or SDR 6 million (2013: LEK 1,678 million or SDR 11 million) were drawn down on behalf of the Government for macroeconomic reforms. These borrowings consist in the following component facilities:

| In millions: | 2014 | | 2013 | |
|---|-------|-----|-------|-----|
| | LEK | SDR | LEK | SDR |
| Poverty Reduction and Growth Facility 3 | 200 | 1 | 628 | 4 |
| Poverty Reduction and Growth Facility 4 | 854 | 5 | 1,050 | 7 |
| | 1,054 | 6 | 1,678 | 11 |

Poverty Reduction and Growth Facility 3 was granted based on the agreement dated 21 June 2002 and bears an interest rate of 0.5% p.a.

Poverty Reduction and Growth Facility 4 was granted based on the agreement signed on 27 January 2006, and bears an interest rate of 0.5% p.a. This facility had a grace period of five and a half years and is payable in 10 semi-annual equal instalments.

7. DEPOSITS WITH NON RESIDENT BANKS

| | 2014 | 2013 |
|---------------------|--------|--------|
| Current accounts | 12,231 | 13,313 |
| Short-term deposits | 17,751 | 8,315 |
| Future contracts | 17 | 31 |
| Accrued interest | 4 | 2 |
| Total | 30,003 | 21,661 |

The annual interest rates for each currency, for current accounts and short-term deposits at 31 December 2014, are as follows:

- EUR: 0.03% - 0.07% (2013: 0.01% - 0.19%)
- GBP: 0.52% (2013: 0.91% - 0.35%)
- USD: 0.09% (2013: 0.01%)

8. AVAILABLE-FOR-SALE INVESTMENT SECURITIES (IN FOREIGN CURRENCIES)

| | 2014 | 2013 |
|--|---------|---------|
| Foreign Governments Treasury Notes | 156,192 | 169,262 |
| Foreign Governments Treasury Bills | 6,678 | 3,502 |
| Agencies and Corporation long term securities | 67,584 | 55,723 |
| Agencies and Corporation short term securities | 11,965 | 2,101 |
| Total | 242,419 | 230,588 |

The annual yields for each currency at 31 December 2014 and 2013, are as follows:

| 2014: In % | USD | GBP | JPY | EUR |
|--|-----------|-----------|-----------|-------------|
| Foreign Governments Treasury Notes | 0.07-3.93 | 0.31-1.55 | 0.02-0.03 | (0.10)-3.62 |
| Foreign Governments Treasury Bills | - | - | - | (0.07)-0.47 |
| Agencies and Corporation long term securities | 0.25-1.81 | 0.45-1.07 | - | (0.02)-0.54 |
| Agencies and Corporation short term securities | - | - | - | 0.03-0.28 |

As a result of further relaxing monetary policies of certain central banks during 2014, the return rates (YTM) of some of the instruments in the EUR and JPY portfolios, are negative at 31 December 2014. These instruments represent mainly treasury securities issued by Eurozone Governments with high credit ratings, including those issued by the governments of Germany and France with maturities of 5 years and 3 years, respectively.

| 2013: In % | USD | GBP | JPY | EUR |
|--|-----------|-----------|-----------|-----------|
| Foreign Governments Treasury Notes | 0.08-5.57 | 0.33-3.02 | 0.08-0.10 | 0.11-4.59 |
| Foreign Governments Treasury Bills | - | - | - | 0.09-0.54 |
| Agencies and Corporation long term securities | 0.23-1.74 | 0.55-1.69 | - | 0.17-2.13 |
| Agencies and Corporation short term securities | - | - | - | 0.25-0.42 |

9. HELD-FOR-TRADING INVESTMENTS (IN FOREIGN CURRENCY)

| | 2014 | 2013 |
|-------------------------------------|--------|--------|
| Government Treasury Notes | 10,556 | 7,685 |
| Agencies and Corporation Securities | 3,822 | 4,906 |
| Total | 14,378 | 12,591 |

Held-for-trading investments are administrated by International Bank for Reconstruction and Development ("IBRD") as stated in the agreement 'On the administration and technical assistance on investing the foreign reserve of Bank of Albania (Reserves and Advisory Management Program) signed

between Bank of Albania and IBRD on 23 September 2005. Investments from this portfolio are denominated in USD.

The annual interest rates at 31 December 2014 and 2013, are as follows:

| In % | 2014 | 2013 |
|--------------------------------------|-----------|-----------|
| Government Treasury Notes | 0.25-2.75 | 0.12-2.75 |
| Agencies and Corporation Securities: | 0.37-2.00 | 0.37-2.00 |

Agencies and Corporation Securities, have a fixed and variable coupon rates.

10. OTHER ASSETS (IN FOREIGN CURRENCY)

| | 2014 | 2013 |
|--|------------|------------|
| Quotas in international financial institutions | | |
| International Bank for Reconstruction and Development (IBRD) | 365 | 361 |
| International Development Agency (IDA) | 13 | 12 |
| Multilateral Investment Guarantee Agency (MIGA) | 7 | 6 |
| International Finance Corporation (IFC) | 85 | 75 |
| European Bank for Reconstruction and Development (EBRD) | 67 | 60 |
| Islamic Development Bank (IDB) | 27 | 23 |
| Total Quotas | 564 | 537 |
| Accounts with IBRD | 196 | - |
| Cash on hand in foreign currency | 19 | 40 |
| Total other assets in foreign currency | 779 | 577 |

Quotas in international financial institutions comprised subscriptions for participation of the Republic of Albania in these institutions (see Note 32.(i)).

Accounts with IBRD represent amounts receivable from sale of held-for-trading investments (see Note 9).

11. LOANS TO RESIDENT BANKS

| | 2014 | 2013 |
|-------------------------------|---------------|---------------|
| Reverse repurchase agreements | 25,548 | 21,132 |
| Overnight deposits | - | 370 |
| Total | 25,548 | 21,502 |

At 31 December 2014, reverse repurchase agreements signed between the Bank and commercial banks have original maturities from one week to three months (2013: from one week to three months) and annual interest rates varying from 2.25% to 2.58% (2013: 3.00% to 3.29%).

12. AVAILABLE-FOR-SALE INVESTMENT SECURITIES (DOMESTIC ASSETS)

| | 2014 | 2013 |
|---------------------------|---------------|---------------|
| Short-term Treasury Bills | 63,948 | 63,920 |
| Total | 63,948 | 63,920 |

At 31 December 2014, short-term Treasury Bills include Treasury Bills issued by the Government of Albania with zero-coupon rates and original maturities from 3 months to 12 months (2013: from 3 months to 12 months). The yields vary from 3.08% to 3.83% (2013: from 3.27% to 6.60%).

13. BALANCES WITH THE ALBANIAN GOVERNMENT (DOMESTIC ASSETS)

Balances with the Albanian Government of ALL 7,398 million represent interest-free and non-negotiable promissory notes in LEK that are issued by the Ministry of Finance, in the favor of IMF pursuant to the Article No.2 of the Memorandum of Understanding between the Ministry of Finance and Bank of Albania, in relation to borrowings received from IMF in 2014 (see note 6).

14. OTHER DOMESTIC ASSETS

| | 2014 | 2013 |
|-----------------------------|---------------|---------------|
| Property and equipment, net | 10,381 | 9,546 |
| Intangible assets, net | 545 | 500 |
| Loans to employees | 1,730 | 1,822 |
| Other debtors | - | 151 |
| Numismatic | 264 | 264 |
| Inventory | 53 | 58 |
| Other | 36 | 47 |
| Total | 13,009 | 12,388 |

Loans to employees at 31 December 2014, are net of a provision for legal claims of LEK 8 million (2013: LEK 9 million). The total value of registered collateral for long term loans extended to employees at 31 December 2014, is LEK 2,247 million (2013: LEK 2,295 million). At 31 December 2014, commitments for loans to employees amount to LEK 60 million (2012: LEK 79 million).

Other Debtors at 31 December 2013, of LEK 151 million represent amounts blocked with a commercial bank in relation to a Letter of Credit obtained in accordance with an agreed contract with third parties for the printing of banknotes. No such amounts were blocked at 31 December 2014.

The net carrying amounts of property and equipment at 31 December 2014 and 2013 are comprised of:

| | Land, buildings and general constructions | General equipment | Transport vehicles | Other assets | Work in Progress | Total |
|-----------------------------------|--|----------------------|-----------------------|-----------------|---------------------|--------|
| Cost / Valuation | | | | | | |
| Balance at 1 January 2013 | 6,659 | 1,891 | 191 | - | 1,499 | 10,240 |
| Additions | 26 | 219 | 84 | - | 749 | 1,078 |
| Balance at 31 December 2013 | 6,685 | 2,110 | 275 | - | 2,248 | 11,318 |
| Additions | - | 374 | - | 15 | 968 | 1,357 |
| Transfers | 402 | - | - | - | (402) | - |
| Reclassifications | - | (13) | - | 1 | - | (12) |
| Balance at 31 December 2014 | 7,087 | 2,471 | 275 | 16 | 2,814 | 12,663 |
| Accumulated depreciation | | | | | | |
| Balance at 1 January 2013 | 346 | 1,017 | 165 | - | - | 1,528 |
| Charge for the year | 59 | 177 | 8 | - | - | 244 |
| Balance at 31 December 2013 | 405 | 1,194 | 173 | - | - | 1,772 |
| Charge for the year | 110 | 281 | 15 | 1 | - | 407 |
| Adjustment of prior years' errors | 41 | 71 | - | - | - | 112 |
| Reclassifications | - | (9) | - | - | - | (9) |
| Balance at 31 December 2014 | 556 | 1,537 | 188 | 1 | - | 2,282 |
| Net carrying amount | | | | | | |
| Balance at 31 December 2014 | 6,531 | 934 | 87 | 15 | 2,814 | 10,381 |
| Balance at 31 December 2013 | 6,280 | 916 | 102 | - | 2,248 | 9,546 |
| Balance at 31 December 2012 | 6,313 | 874 | 26 | - | 1,499 | 8,712 |

The net carrying amounts of intangible assets at 31 December 2014 and 2013 are comprised of:

| | Computer software | Banknotes printed and coins minted | Work in progress | Total intangible Assets |
|-----------------------------|-------------------|---------------------------------------|---------------------|----------------------------|
| Cost | | | | |
| Balance at 1 January 2013 | 404 | 3,147 | - | 3,551 |
| Additions | 52 | 515 | - | 567 |
| Balance at 31 December 2013 | 456 | 3,662 | - | 4,118 |
| Additions | 27 | 241 | 43 | 311 |
| Reclassifications | 12 | - | - | 12 |
| Balance at 31 December 2014 | 495 | 3,903 | 43 | 4,441 |
| Accumulated amortization | | | | |
| Balance at 1 January 2013 | 396 | 3,096 | - | 3,492 |
| Charge for the year | 19 | 107 | - | 126 |
| Balance at 31 December 2013 | 415 | 3,203 | - | 3,618 |
| Charge for the year | 37 | 232 | - | 269 |
| Reclassifications | 9 | - | - | 9 |
| Balance at 31 December 2014 | 461 | 3,435 | - | 3,896 |
| Net carrying amount | | | | |
| Balance at 31 December 2014 | 34 | 468 | 43 | 545 |
| Balance at 31 December 2013 | 41 | 459 | - | 500 |
| Balance at 31 December 2012 | 8 | 51 | - | 59 |

15. DUE TO NON-RESIDENT FINANCIAL INSTITUTIONS

| | 2014 | 2013 |
|------------------------------------|--------------|--------------|
| Loan from the Republic of Greece | 1,234 | 1,234 |
| Due to international organisations | 16 | 17 |
| Accrued interest | 5 | 5 |
| Total | 1,255 | 1,256 |

The loan from the Republic of Greece, amounting LEK 1,234 million or EUR 8.8 million (2013: LEK 1,234 million or EUR 8.8 million), was granted for the purpose of funding the balance of payments of the Republic of Albania. The interest rate is 1.17% p.a., payable semi-annually, whilst the principal is payable at maturity, in 2018.

Due to international organizations represents amounts payable to IBRD, IDA and MIGA.

16. OTHER FOREIGN LIABILITIES

Other foreign liabilities of LEK 230 million (2013: nil) relate to amounts payable for purchases of securities administered by IBRD.

17. CURRENCY IN CIRCULATION

The exclusive right of issuing Albanian currency is vested with the Bank. This item comprises domestic banknotes and coins in circulation issued by the Bank.

The following banknotes and coins were in circulation as at 31 December 2014 and 2013:

| Nominal value LEK | 2014 | | 2013 | |
|-------------------|--------------------|---------------------|--------------------|---------------------|
| | Number in thousand | Total LEK (million) | Number in thousand | Total LEK (million) |
| Notes: | | | | |
| 100 | 3,410 | 341 | 15,843 | 1,584 |
| 200 | 11,064 | 2,213 | 10,210 | 2,042 |
| 500 | 22,486 | 11,243 | 24,663 | 12,331 |
| 1,000 | 47,168 | 47,168 | 52,643 | 52,643 |
| 2,000 | 23,565 | 47,130 | 20,285 | 40,570 |
| 5,000 | 22,960 | 114,801 | 19,289 | 96,445 |
| Coins | | 3,511 | | 2,151 |
| | | 226,407 | | 207,766 |

18. DUE TO RESIDENT BANKS

| | 2014 | 2013 |
|---|---------|---------|
| Foreign currency | | |
| Compulsory reserve and current accounts | 49,167 | 55,355 |
| Domestic currency (LEK) | | |
| Compulsory reserve and current accounts | 38,978 | 32,070 |
| Compulsory reserve - cash in custody | 11,155 | 12,589 |
| Overnight deposits | 7,000 | - |
| Accrued interest | 11 | 17 |
| Total | 106,311 | 100,031 |

Based on the decision of the Supervisory Council, No. 39, dated 25 June 2014 the compulsory reserve in foreign currency in 2014, will not be remunerated, whilst the compulsory reserve in LEK is remunerated at 1.575 % (2013: 2.45%), calculated as 70% of the yield on the repurchase agreements and reverse repurchase agreements. Based on the Decision of the Supervisory Council, No. 46, dated 26 November 2014, the yield on the repurchase and reverse repurchase agreements was decreased from 2.5% to 2.25%.

Based on the Decision of the Supervisory Council, No. 29, date 16 May 2012 'On the minimum compulsory reserve level held at Bank of Albania by second tier banks' the Bank allows the commercial banks to maintain the compulsory reserve in the form of cash in custody with the Bank. As at 31 December 2014, cash in custody amounted at LEK 11,155 million (2013: LEK 12,589 million).

Overnight deposits of LEK 7,000 million (2013: nil) bear interest rates at 0.5% p.a.

20. DUE TO THE ALBANIAN GOVERNMENT

| | 2014 | 2013 |
|---|--------|--------|
| Profit to be distributed to the Government | 951 | 1,351 |
| Deposits received on behalf of the Government | 16,600 | 22,404 |
| Other | 27 | 24 |
| Total | 17,578 | 23,779 |

Deposits received on behalf of the Government are as follows:

| | 2014 | 2013 |
|------------------------------------|--------|--------|
| Main account in LEK | 6,548 | 12,566 |
| Main account in foreign currencies | 2,171 | 1,656 |
| Others | 7,881 | 8,182 |
| Total | 16,600 | 22,404 |

The Bank does not pay interest for deposits received on behalf of the Government, except for a guaranty deposit of LEK 500 million, based on an agreement between the Bank and the Ministry of Finance, for which the remuneration rate is based on decisions of the Supervisory Council.

21. OTHER DOMESTIC LIABILITIES

| | 2014 | 2013 |
|--|--------------|--------------|
| Deposits of individuals from the participation in Treasury Bills | 1,009 | 725 |
| Pension fund obligation | 15 | 14 |
| Due to non-bank financial institutions | 124 | 208 |
| Other liabilities | 678 | 599 |
| Total | 1,826 | 1,546 |

Other liabilities of LEK 678 million (2013: LEK 599 million) include accrued expenses for services provided to the Bank and provisions for claims and litigations incurred in the normal course of business. The balances and movements in provisions for claims and litigations are presented below:

| | 2014 | 2013 |
|-----------------------------------|-----------|------------|
| Balance at 1 January | 193 | 181 |
| Additional provision for the year | 3 | 13 |
| Provision reversal for the year | (126) | (1) |
| Balance at 31 December | 70 | 193 |

The pension fund obligation relates to the pension plan scheme, which is based on employee contribution and employer contribution. Based on the Decision No. 17, dated 26 February 2014, of the Supervisory Council, the pension fund reports its statement of financial position separately from the Bank.

21. REVALUATION RESERVES

| | 2014 | 2013 |
|---|---------------|---------------|
| Revaluation of foreign currency and gold balances | 20,766 | 10,288 |
| Fair value reserve of available-for-sale financial assets | 1,305 | 302 |
| Other devaluations | (141) | (169) |
| Total | 21,930 | 10,421 |

The net gain arising from the revaluation of foreign currency and gold balances for the year ended 31 December 2014 was LEK 10,478 million (2013: net loss of LEK 9,660 million). The net gain / (loss) arising from the revaluation of assets and liabilities denominated in foreign currencies, is initially recognized in profit or loss and then transferred to the Revaluation of foreign currency and gold balances.

The fair value reserve of available-for-sale financial assets for the year ended 31 December 2014 increased by LEK 1,003 million (2013: decreased by LEK 754 million).

22. OTHER RESERVES

| | 2014 | 2013 |
|---|---------------|---------------|
| Special reserve for the Balance of Payments | 7,209 | 7,209 |
| Reserve of gold and precious metals | 7,042 | 7,042 |
| Other | 1,497 | 1,509 |
| Total | 15,748 | 15,760 |

The special reserve for the Balance of Payments relates to funds provided by the European Community as financial assistance to support Albania in its transition towards a market economy. These funds have been transferred during the period 1992 – 1993 supporting the long-standing of the Balance of Payments and reserve balance and no movement has been incurred in this reserve since 1995.

The reserve of gold and precious metals represents the reserve created based on Law No. 9862, dated 24 January 2008 'On the transfer of ownership of gold and other precious metals from the Albanian Council of Ministers to the ownership of the Bank of Albania'.

Other includes reserves created from the allocation of profits for the years 2004 - 2007 based on the Supervisory Council decisions in the respective following years. In addition, other reserves at 31 December 2013, include an amount of LEK 12 million, which was created based on the Decision No. 530, dated 4 March 2014, of the Supervisory Council and was utilized in 2014. The reserve relates to the adjustment of prior period differences made in 2014 following the implementation of a new information system used to measure the amortized cost of financial instruments using the effective interest method.

23. INTEREST AND COMMISSION INCOME (NON - RESIDENTS)

| | 2014 | 2013 |
|-------------------------------------|--------------|--------------|
| Interest income from securities | 4,515 | 5,106 |
| Interest income from time deposits | 25 | 12 |
| Interest from SDR deposits with IMF | 11 | 9 |
| Interest from Security Lending | 16 | 13 |
| Other (discounts) | 73 | 31 |
| Total | 4,640 | 5,171 |

24. INTEREST AND COMMISSION EXPENSE (NON - RESIDENTS)

| | 2014 | 2013 |
|--|--------------|--------------|
| Amortization of premium on securities | 3,387 | 4,080 |
| Interest expenses on loans from foreign institutions | 15 | 15 |
| Interest expenses on IMF accounts | 15 | 16 |
| Other | 40 | 47 |
| Total | 3,457 | 4,158 |

25. INTEREST AND COMMISSION INCOME (RESIDENTS)

| | 2014 | 2013 |
|---|--------------|--------------|
| Interest income from securities | 2,319 | 3,611 |
| Income from reverse repurchase agreements | 691 | 689 |
| Other | 85 | 87 |
| Total | 3,095 | 4,387 |

26. INTEREST AND COMMISSION EXPENSE (RESIDENTS)

| | 2014 | 2013 |
|--|------------|------------|
| Interest expense on compulsory reserve | 784 | 870 |
| Interest expenses on Government deposits | 50 | 18 |
| Other | 22 | 42 |
| Total | 856 | 930 |

27. OTHER OPERATING INCOME, NET

| | 2014 | 2013 |
|--|------------|------------|
| Net profit from sale of available-for-sale investments | 834 | 420 |
| Net profit from forward contracts | - | 223 |
| Other | 136 | 11 |
| Total | 970 | 654 |

Net profit from forward contracts is included in Net trading income (see note 28) in 2014.

28. NET TRADING INCOME

| | 2014 | 2013 |
|---|------------|-----------|
| Interest income from trading assets | 112 | 78 |
| Gains less loss related to sale of trading assets | 22 | 8 |
| Unrealized fair value changes | (21) | (30) |
| Net profit from forward and future contracts | 69 | - |
| Total | 182 | 56 |

29. PERSONNEL EXPENSES

| | 2014 | 2013 |
|--|--------------|--------------|
| Employee Salaries | 878 | 940 |
| Contributions for health and social security | 88 | 83 |
| Contribution for pension fund | 85 | 93 |
| Total | 1,051 | 1,116 |

As at 31 December 2014, the Bank had 500 employees (2013: 504 employees).

30. OTHER EXPENSES

Other expenses of LEK 713 million (2013: nil) represent losses resulting from the cash embezzlement that was discovered in July 2014. This amount was charged to losses based on the Decision No. 56, dated 1 October 2014 of the Supervisory Council.

31. CASH AND CASH EQUIVALENTS

| | 2014 | 2013 |
|--------------------------------------|---------------|---------------|
| Deposits with foreign banks (Note 7) | 30,003 | 21,661 |
| Domestic currency on hand | 28,593 | 47,233 |
| Foreign currency on hand (Note 9) | 19 | 40 |
| Total | 58,615 | 68,934 |

32. CONTINGENCIES AND COMMITMENTS

(i) Participation in international financial institutions

In the past the Republic of Albania entered into a number of subscriptions with international financial institutions, including IMF, IBRD, IDA, MIGA, IFC, EBRD and IDB. As detailed in Note 10, Other Assets (in foreign currency), the Bank has paid an accumulated amount of LEK 564 million (2013: LEK 537 million) for such subscriptions. In addition, as shown in Notes 6 and 13, the Bank holds assets that originate from the membership of the Republic of Albania in the IMF, whilst the borrowings of the Government of the Republic of Albania from the IMF are undertaken through the Bank and are shown on the statement of financial position of the Bank.

The Bank and the Government of Albania have not signed yet a Memorandum of Understanding on allocating the original contributions and ownership of the subscriptions in the international financial institutions between both parties.

(ii) Reverse repurchase agreements

Reverse repurchase agreements as at 31 December 2014, represented collateralized loans (see note 11). The nominal value of the securities used as collateral as at 31 December 2014 was LEK 28,635 million (2013: LEK 23,960 million).

(iii) Rent agreements

Bank of Albania has entered into rent agreements for its premises. Rent agreements in force at 31 December 2014, expire within the first semester of 2015, whilst rent commitments payable within one year are LEK 17 million (2013: LEK 48 million).

(iv) Capital commitments

Capital commitments for the reconstruction of the Bank's premises at 31 December 2013 amount to LEK 715 million, whilst in 2014 there are no capital commitments.

33. MANAGED ASSETS

At 31 December 2014, the Bank acts as custodian for short-term treasury bills (with maturity from 3 to 12 months) at the nominal value of LEK 263 billion (2013: LEK 254 billion) and EUR 35 million (2013: EUR 24 million) and for long term securities with maturities varying between 2 and 10 years at the nominal value of LEK 269 billion (2013: LEK 252 billion) and EUR 63 million (2013: EUR 25 million). These securities are issued by the Albanian Government.

34. RELATED PARTIES

Parties are considered to be related if one party has the ability to control the other party or to exercise significant influence over the other party in making financial and other decisions.

Considering each possible related party relationship, attention is directed to the substance of the relationship and not merely to the legal form.

The related parties of Bank of Albania include the directors and the members of the Supervisory Council. As at 31 December 2014 and 2013 balances with related parties comprised:

| | 2014 | 2013 |
|--------------------|------|------|
| Loans to directors | | |
| - Directors | 123 | 142 |
| Total assets | 123 | 142 |

Loans to directors have an interest rate of 0.5% p.a. and a grace period of two years, and are repayable within 30 years in equal monthly instalments. The home loans are collateralized.

The decrease in loans to directors of LEK 19 million (2013: LEK 30 million) in 2014, represents repayments of LEK 4 million and reclassifications of the loans after changes in the hierarchy structure of the managing staff during 2014, of LEK 15 million.

| | 2014 | 2013 |
|---|------|------|
| Administrative expenses | | |
| - Mobile expenses | | |
| - Directors and Supervisory Council Members | 3 | 5 |
| - Salaries and Bonuses | | |
| - Directors and Supervisory Council Members | 93 | 120 |
| - Bank contribution to pension plan scheme | | |
| - Directors | 9 | 12 |
| Total of administrative expenses | 105 | 137 |

Balances with/(due to) the Albanian Government are disclosed in Notes 13 and 19, and related interest income from securities and interest expenses are included in Notes 25 and 26, respectively. Contingencies in relation to the participations in international financial institutions are detailed in Note 32 (i), whilst securities issued by the Albanian Government and managed by the Bank are detailed in Note 33.

35. FINANCIAL RISK MANAGEMENT

(a) Risk management framework

The Supervisory Board has overall responsibility for the establishment and oversight of the Bank's risk management framework.

The foreign reserve is under the administration of the Bank of Albania and investments are performed by the Monetary Operations Department, which is based on the regulation "On foreign reserve management policy", approved by the Supervisory Board. Its investment strategy depends mainly on the specific function of a central bank which is strictly regulated and in accordance with the requirements of the Law "On the Bank of Albania".

The reserve, in accordance with the liquidity needs, is invested in short-term instrument, fixed and floating income securities, and derivatives. The remaining portion is held in SDRs, and monetary gold.

The Bank has exposure to the following risks from financial instruments:

- liquidity risk
- credit risk
- market risks
- operational risks

This note presents information about the Bank's exposure to each of the above risks, the Bank's objectives, policies and processes for measuring and managing risk.

(b) Liquidity risk

Liquidity risk is the risk that the Bank will encounter difficulty in meeting obligations associated with its financial liabilities.

Management of liquidity risk

Policies to monitor and address liquidity risk are set by the Supervisory Council of the Bank of Albania. The Bank manages its liquidity risk by investing in short term deposits with foreign banks and in debt securities in liquid and highly controlled and organized markets.

The Bank's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Bank's reputation, and to comply with its monetary and exchange policy. The portfolio is defined annually based on the forecasts of the monthly and annual liquidity needs for each currency. The investments in securities are considered as sufficiently liquid instruments.

Because of the specifics of a central bank, the Bank is not exposed to liquidity risk in relation to liabilities in local currency.

The following table shows the Bank's financial liabilities (including currency in circulation and other liabilities) on the basis of their remaining maturity and the financial assets on the basis of their earliest possible expected maturity. The Bank's expected cash flows on these instruments may vary from this analysis.

| 31 December 2014 | Up to one Month | One to three Months | Three to six months | Six months to one year | One to five years | Over five years | Undefined maturity | Total |
|--|-----------------|---------------------|---------------------|------------------------|-------------------|-----------------|--------------------|---------|
| Due to IMF | 15,919 | 266 | 21 | 328 | 1,043 | - | 7,753 | 25,330 |
| Due to non-resident financial institutions | - | - | - | - | 1,240 | - | 15 | 1,255 |
| Other foreign liabilities | 230 | - | - | - | - | - | - | 230 |
| Currency in circulation | - | - | - | - | - | - | 226,407 | 226,407 |
| Due to resident Banks | 106,311 | - | - | - | - | - | - | 106,311 |
| Due to the Government | 16,100 | - | 952 | - | - | - | 526 | 17,578 |
| Other domestic liabilities | 705 | - | - | - | - | - | 1,121 | 1,826 |
| Total Liabilities 2014 (remaining maturity date) | 139,265 | 266 | 973 | 328 | 2,283 | - | 235,822 | 378,937 |
| Total assets 2014 (expected maturity date) | 85,153 | 48,911 | 47,610 | 62,333 | 144,617 | 9,107 | 35,595 | 433,326 |

| 31 December 2013 | Up to one Month | One to three Months | Three to six months | Six months to one year | One to five years | Over five years | Undefined maturity | Total |
|--|-----------------|---------------------|---------------------|------------------------|-------------------|-----------------|--------------------|---------|
| Due to IMF | 8,898 | 315 | 21 | 437 | 1,640 | 36 | 7,286 | 18,633 |
| Due to non-resident financial institutions | - | - | - | - | 1,240 | - | 16 | 1,256 |
| Currency in circulation | - | - | - | - | - | - | 207,766 | 207,766 |
| Due to resident Banks | 100,031 | - | - | - | - | - | - | 100,031 |
| Due to the Government | 14,558 | 1,351 | - | - | - | - | 7,870 | 23,779 |
| Other domestic liabilities | 138 | 2 | 3 | 7 | 23 | - | 1,373 | 1,546 |
| Total Liabilities 2013 (contractual maturity date) | 123,625 | 1,668 | 24 | 444 | 2,903 | 36 | 224,311 | 353,011 |
| Total assets 2013 (expected maturity date) | 75,889 | 30,514 | 36,963 | 59,002 | 152,580 | 7,653 | 33,341 | 395,942 |

(c) Credit risk

Credit Risk is the risk of the decrease in value of the foreign currency reserve as result of insolvency of a financial institution or the bankruptcy or insolvency of a debt issuer, in whose debt instruments the Bank has invested its own funds.

The Bank sets a system of maximum exposure investment limits to individual financial institutions and debt issuers. These limits are calculated on the basis of credit ratings of the counterparty. The internal credit rating is based on criteria which are approved by the Supervisory Council of Bank of Albania. Credit risk is also mitigated through the diversification of the portfolio.

Loans to domestic Banks are secured by Albanian Government Treasury bills.

The financial assets which represent credit risk at the reporting date are shown below:

| Assets | 2014 | 2013 |
|--|---------|---------|
| Gold - foreign (Note 5) | 9,569 | 8,474 |
| Special Drawing Rights with IMF (see below) | 4,554 | 3,220 |
| Deposits with non-resident banks (Note 7) | 30,003 | 21,661 |
| Available-for-sale investment securities (foreign currency) (Note 8) | 242,419 | 230,588 |
| Held-for-trading investment (foreign currency) (Note 9) | 14,378 | 12,591 |
| Loans to resident banks (Note 11) | 25,548 | 21,502 |
| Available-for-sale investment securities - domestic (Note 12) | 63,948 | 63,920 |
| Balances with the Albanian Government (Note 13) | 7,398 | - |
| Total assets | 397,817 | 361,956 |

An amount of LEK 7,752 million (2013: LEK 7,286 million) which is included in SDR Holdings (see Note 6) does not represent credit risk for the Bank since

it represents the counter-account of the amounts acquired through the SDR allocations. Only the amount of holdings above allocations of LEK 4,554 million (2013: LEK 3,220 million) is included in the assets which represent credit risk.

An analysis of concentrations of financial assets by type of counterparty at the reporting date is shown below:

| Credit rating | Gold | Special Drawing Rights with IMF | Deposits with non-resident banks | Available-for-sale investment securities (foreign currency) | Held-for-trading investments (foreign currency) | Loans to resident banks | Available-for-sale investment securities (domestic assets) | Balances with the Albanian Government | Total |
|--|-------|---------------------------------|----------------------------------|---|---|-------------------------|--|---------------------------------------|---------|
| Central bank | 9,569 | 4,554 | 8,346 | - | - | - | - | - | 22,469 |
| BIS Basle | - | - | 3,239 | - | - | - | - | - | 3,239 |
| Foreign Government & Agencies Securities | - | - | - | 231,855 | 14,378 | - | - | - | 246,233 |
| Commercial Banks | - | - | 18,418 | 10,564 | - | 25,548 | - | - | 54,530 |
| Albanian Government | - | - | - | - | - | - | 63,948 | 7,398 | 71,346 |
| Total 31 December 2014 | 9,569 | 4,554 | 30,003 | 242,419 | 14,378 | 25,548 | 63,948 | 7,398 | 397,817 |

The Albanian Government is rated B, with positive expectation based on the Standard & Poor's ratings and B1, stable based on Moody's ratings.

| Credit rating | Gold | Special Drawing Rights with IMF | Deposits with non-resident banks | Available-for-sale investment securities (foreign currency) | Held-for-trading investments (foreign currency) | Loans to resident banks | Available-for-sale investment securities (domestic assets) | Total |
|--|-------|---------------------------------|----------------------------------|---|---|-------------------------|--|---------|
| Central bank | 8,474 | 3,220 | 6,543 | - | - | - | - | 18,237 |
| BIS Basle | - | - | 3,220 | - | - | - | - | 3,220 |
| Foreign Government & Agencies Securities | - | - | - | 224,950 | 12,591 | - | - | 237,541 |
| Commercial Banks | - | - | 11,898 | 5,638 | - | 21,502 | - | 39,038 |
| Albanian Government | - | - | - | - | - | - | 63,920 | 63,920 |
| Total 31 December 2013 | 8,474 | 3,220 | 21,661 | 230,588 | 12,591 | 21,502 | 63,920 | 361,956 |

The Albanian Government is rated B based on the Standard & Poor's ratings and B1, stable based on Moody's ratings.

An analysis of concentrations of credit risk by geographic location is shown below:

| 31 December 2014 | Europe | USA | Republic of Albania | Other | Total |
|---|---------|--------|---------------------|--------|---------|
| Gold - foreign | 9,569 | - | - | - | 9,569 |
| Special Drawing Rights with IMF | - | - | - | 4,554 | 4,554 |
| Deposits with non-resident banks | 24,628 | 5,375 | - | - | 30,003 |
| Available-for-sale investment securities (foreign currency) | 192,281 | 43,378 | - | 6,760 | 242,419 |
| Held-for-trading investments (foreign currency) | - | 14,378 | - | - | 14,378 |
| Loans to resident banks | - | - | 25,548 | - | 25,548 |
| Available-for-sale investment securities – domestic | - | - | 63,948 | - | 63,948 |
| Balances with the Albanian Government | - | - | 7,398 | - | 7,398 |
| Total | 226,478 | 63,131 | 96,894 | 11,314 | 397,817 |

| 31 December 2013 | Europe | USA | Republic of Albania | Other | Total |
|---|----------------|---------------|---------------------|---------------|----------------|
| Gold - foreign | 8,474 | - | - | - | 8,474 |
| Special Drawing Rights with IMF | - | - | - | 3,220 | 3,220 |
| Deposits with non-resident banks | 20,530 | 1,131 | - | - | 21,661 |
| Available-for-sale investment securities (foreign currency) | 178,178 | 44,005 | - | 8,405 | 230,588 |
| Held-for-trading investments (foreign currency) | - | 12,591 | - | - | 12,591 |
| Loans to resident banks | - | - | 21,502 | - | 21,502 |
| Available-for-sale investment securities – domestic | - | - | 63,920 | - | 63,920 |
| Total | 207,182 | 57,727 | 85,422 | 11,625 | 361,956 |

(d) Market risk

Market risk is the risk that changes in market prices, such as interest rates, equity prices, foreign exchange rates and credit spreads (not relating to changes in the obligor's / issuer's credit standing) will affect the Bank of Albania's income or the value of its holdings of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimizing the return on risk.

The key elements of price risk affecting the Bank are:

- Interest rate risk associated with fluctuations in the fair value of financial instruments due to changes in market interest rates.
- Currency risk associated with fluctuations in the fair value of financial instruments due to changes in foreign exchange rates; and

The Bank of Albania's exposure to currency risk is monitored on a continual basis by the Monetary Operations Department. Financial assets and liabilities denominated in foreign currencies are disclosed in each relevant note of the financial statements.

Interest rate risk

The Bank's operations are subject to the risk of interest rate fluctuations which affect the prices of interest-earning assets (including investments) and interest-bearing liabilities. The Monetary Operations Department of the Bank monitors interest rate risk. The Bank mitigates such risks by maintaining a significant excess of interest bearing assets over liabilities. The Bank maintains a portfolio of interest bearing financial assets and liabilities such that the net interest income is significantly higher than operating needs, in order to minimize the potential adverse effects of interest rate fluctuations. Interest rates applicable to financial assets and liabilities are disclosed in each relevant note of the financial statements.

The assets and liabilities with floating interest rates involve the risk of changes in the base which serves to determine the interest rates.

Floating rate instruments are detailed as follows:

| 31 December 2014 | Average rate | Up to one month | One to three months | Three to six months | Six months to one year | One to five years | Over five years | Total |
|--|--------------|-----------------|---------------------|---------------------|------------------------|-------------------|-----------------|--------------|
| Assets | | | | | | | | |
| Available-for-sale investment securities | 0.25% | - | - | 461 | - | - | - | 461 |
| Available-for-sale investment securities | 0.27% | - | - | - | 577 | - | - | 577 |
| Held-for-trading investments | 1.72% | 346 | - | - | - | - | - | 346 |
| Held-for-trading investments | 0.53% | - | - | 115 | - | - | - | 115 |
| Held-for-trading investments | 0.41% | - | - | - | 231 | - | - | 231 |
| Held-for-trading investments | 0.17% | - | - | - | - | 646 | - | 646 |
| Total | | 346 | - | 576 | 808 | 646 | - | 2,376 |
| Liabilities | | | | | | | | |
| Due to IMF | 1.09% | 68 | 51 | - | 119 | 473 | - | 711 |
| Total | | 68 | 51 | - | 119 | 473 | - | 711 |
| Floating Interest rate gap | | 278 | (51) | 576 | 689 | 173 | - | 1,665 |
| Sensitivity to a 100 b.p. increase | | 3 | (1) | 6 | 7 | 2 | - | 17 |
| 31 December 2013 | | | | | | | | |
| Assets | | | | | | | | |
| Available-for-sale investment securities | 0.39% | - | - | - | 2,778 | - | - | 2,778 |
| Available-for-sale investment securities | 0.33% | - | - | - | - | 918 | - | 918 |
| Held-for-trading investments | 0.72% | - | 408 | - | - | - | - | 408 |
| Held-for-trading investments | 0.39% | - | - | 306 | - | - | - | 306 |
| Held-for-trading investments | 0.45% | - | - | - | 562 | - | - | 562 |
| Held-for-trading investments | 0.38% | - | - | - | - | 1,021 | - | 1,021 |
| Total | | - | 408 | 306 | 3,340 | 1,939 | - | 5,993 |
| Liabilities | | | | | | | | |
| Due to IMF | 1.14% | - | - | - | - | - | 923 | 923 |
| Total | | - | - | - | - | - | 923 | 923 |
| Floating Interest rate gap | | - | 408 | 306 | 3,340 | 1,939 | (923) | 5,070 |
| Sensitivity to a 100 b.p. increase | | - | 4 | 3 | 33 | 19 | (9) | 50 |

A summary of the Bank's interest-earning assets and interest-bearing liabilities (including the floating rate instruments above) by maturity dates is as follows:

| 31 December 2014 | Up to one month | One to three months | Three to six months | Six to twelve months | One to five years | Over five years | Non-interest earning/bearing | Total |
|---|-----------------|---------------------|---------------------|----------------------|-------------------|-----------------|------------------------------|----------------|
| Assets | | | | | | | | |
| Gold and precious metals – foreign | - | - | - | - | - | - | 9,569 | 9,569 |
| Accounts with the IMF | 12,306 | - | - | - | - | - | 9,486 | 21,792 |
| Deposits with non-residents Banks | 14,588 | 15,415 | - | - | - | - | - | 30,003 |
| Available-for-sale investments - foreign | 9,024 | 13,503 | 27,014 | 52,046 | 132,879 | 7,953 | - | 242,419 |
| Held-for-trading investments - foreign | 347 | - | 662 | 2,106 | 11,263 | - | - | 14,378 |
| Other foreign assets | - | - | - | - | - | - | 779 | 779 |
| Gold and precious metals – domestic | - | - | - | - | - | - | 4,483 | 4,483 |
| Loans to resident banks | 22,245 | 3,303 | - | - | - | - | - | 25,548 |
| Available-for-sale investments – domestic | 19,243 | 16,661 | 19,910 | 8,134 | - | - | - | 63,948 |
| Balances with Albanian Government | - | - | - | - | - | - | 7,398 | 7,398 |
| Other domestic assets | 32 | 5 | - | - | - | 1,730 | 11,242 | 13,009 |
| Total | 77,785 | 48,887 | 47,586 | 62,286 | 144,142 | 9,683 | 42,957 | 433,326 |
| Liabilities and equity | | | | | | | | |
| Due to the IMF | 15,919 | 266 | 21 | 328 | 1,043 | - | 7,753 | 25,330 |
| Due to non-resident institutions | - | - | - | - | 1,240 | - | 15 | 1,255 |
| Other foreign liabilities | 230 | - | - | - | - | - | - | 230 |
| Currency in circulation | - | - | - | - | - | - | 226,407 | 226,407 |
| Due to resident Banks | 45,990 | - | - | - | - | - | 60,321 | 106,311 |
| Due to the Government | - | - | - | - | - | - | 17,578 | 17,578 |
| Other domestic liabilities | 48 | - | - | - | - | - | 1,778 | 1,826 |
| Capital and reserves | - | - | - | - | - | - | 54,389 | 54,389 |
| Total | 62,187 | 266 | 21 | 328 | 2,283 | - | 368,241 | 433,326 |
| Gap as at 31 December 2014 | 15,598 | 48,621 | 47,565 | 61,958 | 141,859 | 9,683 | (325,284) | - |
| Cumulative gap – 2014 | 15,598 | 64,219 | 111,784 | 173,742 | 315,601 | 325,284 | - | - |

| 31 December 2013 | Up to one month | One to three months | Three to six months | Six to twelve months | One to five years | Over five years | Non-interest earning/bearing | Total |
|--|-----------------|---------------------|---------------------|----------------------|-------------------|-----------------|------------------------------|----------------|
| Assets | | | | | | | | |
| Gold and precious metals – foreign | - | - | - | - | - | - | 8,474 | 8,474 |
| Accounts with the IMF | 10,508 | - | - | - | - | - | 9,712 | 20,220 |
| Deposits with non-residents Banks | 20,482 | 1,179 | - | - | - | - | - | 21,661 |
| Available-for-sale investments –foreign | 3,796 | 11,704 | 16,380 | 51,006 | 141,871 | 5,831 | - | 230,588 |
| Held-for-trading investments - foreign | 308 | 408 | 459 | 706 | 10,710 | - | - | 12,591 |
| Other foreign assets | - | - | - | - | - | - | 577 | 577 |
| Gold and precious metals - domestic | - | - | - | - | - | - | 4,021 | 4,021 |
| Loans to resident banks | 20,628 | 874 | - | - | - | - | - | 21,502 |
| Available-for-sale investment securities –domestic | 20,158 | 16,349 | 20,123 | 7,290 | - | - | - | 63,920 |
| Other domestic assets | 9 | - | - | - | - | 1,822 | 10,557 | 12,388 |
| Total | 75,889 | 30,514 | 36,962 | 59,002 | 152,581 | 7,653 | 33,341 | 395,942 |
| Liabilities and equity | | | | | | | | |
| Due to the IMF | 8,898 | 315 | 21 | 437 | 1,640 | 36 | 7,286 | 18,633 |
| Due to non-resident institutions | - | - | - | - | 1,241 | - | 15 | 1,256 |
| Currency in circulation | - | - | - | - | - | - | 207,766 | 207,766 |
| Due to resident Banks | 32,087 | - | - | - | - | - | 67,944 | 100,031 |
| Due to the Government | - | - | - | - | - | - | 23,779 | 23,779 |
| Other domestic liabilities | 55 | - | - | - | - | - | 1,491 | 1,546 |
| Capital and reserves | - | - | - | - | - | - | 42,931 | 42,931 |
| Total | 41,040 | 315 | 21 | 437 | 2,881 | 36 | 351,212 | 395,942 |
| Gap as at 31 December 2013 | 34,849 | 30,199 | 36,941 | 58,565 | 149,700 | 7,617 | (317,871) | - |
| Cumulative gap – 2013 | 34,849 | 65,048 | 101,989 | 160,554 | 310,254 | 317,871 | - | - |

Future contracts

A future contract is a standardised contract to buy or sell a financial or non financial asset, at a certain date in the future and at a market determined price. To minimize the credit risk, depended on the type of instrument, the investor should post a margin to the clearing house. This margin or performance bond, is valued every day according to the prices in the market (marked to market), which means that every change in value is shown in the account of investor at the end of each trading day until the expiry day.

The net valuation of future contract transactions as at 31 December 2014 is LEK 17 million (2012 : LEK 31 million) (see Note 7).

Notional value of these contracts as at 31 December 2014 is composed by:

- buy contracts in the amount of LEK 856 million (2013: 3,354 million); and
- sell contracts in the amount of LEK 6,440 million (2013: LEK 8,270 million).

Exchange rate risk

Currency risk exists where there is a difference between the currency structure of assets and that of liabilities. From an accounting point of view, the Bank of Albania is exposed to currency risk when conducting transactions in financial instruments denominated in currencies other than the Bank's base currency.

This risk might affect the size of the Bank's capital. In order to manage this type of risk exposure, throughout the years the Bank has increased its capital, its funds and in specific cases, when the revaluation of the balance sheet items has resulted into a loss, the Government of Albania, as also set in the Law on "Bank of Albania" has issued financial instruments.

The applicable official Bank rate (LEK to the foreign currency unit) for the principal currencies as at 31 December 2014 and 31 December 2013 were as below:

| | 31 December 2014 | 31 December 2013 |
|------------------------------------|------------------|------------------|
| United States dollar (USD) | 115.23 | 101.86 |
| European Union currency unit (EUR) | 140.14 | 140.20 |
| British pound (GBP) | 179.48 | 168.39 |
| Special Drawing rights (SDR) | 166.90 | 156.86 |
| Japanese yen (JPY) | 0.9649 | 0.9698 |
| Gold ('XAU') per 1 onz (LEK) | 138,189.58 | 122,384.79 |

Forward and Swaps

In order to manage its monetary reserve or the liquidity of the Albanian Government, the Bank of Albania uses forward and swap contracts. The risks involved are immaterial considering the parties involved in the contract.

An "exchange rate - forward" type of contract, represents an agreement to convert various currencies at a given future date, at a predetermined exchange rate.

Swap contracts are future contracts which allow parties involved in the agreement to exchange funds in the future.

| | LEK | USD | EURO | GBP | Other | Total |
|---|------------------|---------------|----------------|---------------|---------------|----------------|
| Assets | | | | | | |
| Gold and precious metals – foreign | - | - | - | - | 9,569 | 9,569 |
| Accounts with the IMF | - | - | - | - | 21,792 | 21,792 |
| Deposits with non-residents Banks | - | 4,642 | 19,897 | 3,606 | 1,858 | 30,003 |
| Available-for-sale investment securities – foreign | - | 53,848 | 172,882 | 8,929 | 6,760 | 242,419 |
| Held-for-trading investments – foreign | - | 14,378 | - | - | - | 14,378 |
| Other foreign assets | 335 | 427 | 17 | - | - | 779 |
| Gold and precious metals – domestic | - | - | - | - | 4,483 | 4,483 |
| Loans to resident banks | 25,548 | - | - | - | - | 25,548 |
| Available-for-sale investment securities - domestic | 63,948 | - | - | - | - | 63,948 |
| Balances with Albanian Government | 7,398 | - | - | - | - | 7,398 |
| Other domestic assets | 12,992 | 13 | 4 | - | - | 13,009 |
| Total assets | 110,221 | 73,308 | 192,800 | 12,535 | 44,462 | 433,326 |
| Liabilities | | | | | | |
| Due to the IMF | 16,522 | - | - | - | 8,808 | 25,330 |
| Due to non-resident financial institutions | 15 | - | 1,240 | - | - | 1,255 |
| Other foreign liabilities | - | 230 | - | - | - | 230 |
| Currency in circulation | 226,407 | - | - | - | - | 226,407 |
| Due to resident banks | 57,144 | 6,487 | 42,680 | - | - | 106,311 |
| Due to the Government | 13,918 | 118 | 3,278 | 1 | 263 | 17,578 |
| Other domestic liabilities | 1,237 | 174 | 415 | - | - | 1,826 |
| Total liabilities | 315,243 | 7,009 | 47,613 | 1 | 9,071 | 378,937 |
| Net currency position as at 31 December 2014 | (205,022) | 66,299 | 145,187 | 12,534 | 35,391 | 54,389 |
| Net currency position as at 31 December 2013 | (186,252) | 58,519 | 126,631 | 11,751 | 32,282 | 42,931 |

| | LEK | USD | EURO | GBP | Other | Total |
|---|------------------|---------------|----------------|---------------|---------------|----------------|
| Assets | | | | | | |
| Gold and precious metals – foreign | - | - | - | - | 8,474 | 8,474 |
| Accounts with the IMF | - | - | - | - | 20,220 | 20,220 |
| Deposits with non-residents Banks | - | 3,046 | 15,127 | 3,279 | 209 | 21,661 |
| Available-for-sale investment securities – foreign | - | 49,872 | 163,843 | 8,468 | 8,405 | 230,588 |
| Held-for-trading investments – foreign | - | 12,591 | - | - | - | 12,591 |
| Other foreign assets | 335 | 206 | 36 | - | - | 577 |
| Gold and precious metals – domestic | - | - | - | - | 4,021 | 4,021 |
| Loans to resident banks | 21,502 | - | - | - | - | 21,502 |
| Available-for-sale investment securities - domestic | 63,920 | - | - | - | - | 63,920 |
| Other domestic assets | 12,216 | 13 | 154 | 5 | - | 12,388 |
| Total assets | 97,973 | 65,728 | 179,160 | 11,752 | 41,329 | 395,942 |
| Liabilities | | | | | | |
| Due to the IMF | 9,586 | - | - | - | 9,047 | 18,633 |
| Due to non-resident financial institutions | 16 | - | 1,240 | - | - | 1,256 |
| Currency in circulation | 207,766 | - | - | - | - | 207,766 |
| Due to resident banks | 44,676 | 6,959 | 48,396 | - | - | 100,031 |
| Due to the Government | 21,040 | 196 | 2,542 | 1 | - | 23,779 |
| Other domestic liabilities | 1,141 | 54 | 351 | - | - | 1,546 |
| Total liabilities | 284,225 | 7,209 | 52,529 | 1 | 9,047 | 353,011 |
| Net currency position as at 31 December 2013 | (186,252) | 58,519 | 126,631 | 11,751 | 32,282 | 42,931 |
| Net currency position as at 31 December 2012 | (172,017) | 62,645 | 119,253 | 11,973 | 31,509 | 53,363 |

(e) Operational risk

Operational risk is the risk of direct or indirect loss arising from a wide variety of causes associated with the Bank's processes, personnel, technology and infrastructure, and from external factors other than credit, market and liquidity risks such as those arising from legal and regulatory requirements and generally accepted standards of corporate behavior. Operational risks arise from all of the Bank's operations.

Operational risk management is supported by the internal control systems on several activities of the Bank of Albania and standards for the management of operational risk and a wide range of common policies, staff management regulations and obligatory requirements.

36. SUBSEQUENT EVENTS

There are no significant events after the reporting date that may require adjustment or disclosure in the financial statements.









