

FINANCIAL STABILITY STATEMENT FOR 2018 H2

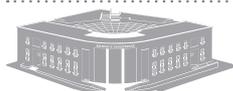
Pursuant to provisions under Article 69 of the Law No. 8269, dated 23 December 1997 "On the Bank of Albania", as amended, and Article 8 of the Law No. 9962, dated 18.12.2006 "On banks in the Republic of Albania", as amended, to inform the Assembly of the Republic of Albania and the Council of Ministers, and draw the attention of financial institutions and of the public on the situation of the Albanian financial system and the potential risks that may jeopardise its stability, the Bank of Albania releases this periodic statement. This statement is an integral part of the Financial Stability Report for the same-stated period.

The Financial Stability Report and the Statement prefacing it assess the exposure of the banking sector to risks arising from its interaction with the external and internal economic environment, real economy agents, financial markets in Albania, as well as operational risks in the activity of the banking sector. Furthermore, these risks are subjected to stress tests and placed vis-à-vis the financial situation of the banking sector to assess its resilience.

The Bank of Albania assesses that in 2018 H2 (hereinafter, the "period"), the banking sector remained stable. Similar to previous periods, its activity was characterised by restrained risk exposures and good indicators of performance and financial resilience. As a result, banking sector's capability to withstand activity risks is assessed as robust. Economic developments and the performance of financial markets supported the overall activity of the financial system.

HIGHLIGHTS IN ECONOMIC AND FINANCIAL DEVELOPMENTS

The growth rate of global economic activity slowed down during the period, under the influence of trade tensions between advanced economies. As a result, financial conditions in these countries were somewhat tighter, in comparison with emerging economies, where financial conditions showed a greater variety. Global inflationary pressures remained subdued, reflecting the weaker economic expectations and the decrease in oil prices in international markets. Amid higher uncertainty surrounding economic growth, central banks in advanced economies lowered expectations for the monetary policy normalization. In the Balkans region, the slowdown of economic growth did not stop the overall improvement of employment indicators. Expectations for global economic developments reflect the increased uncertainty of the markets about the way economic and political constraints will be solved. Emerging economies may be more sensitive to the potential slowdown of economic growth.



In Albania, the annual economic growth rate was 4.5%⁸ in 2018 Q3, driven by the sectors of production and services. Aggregate demand growth was sustained by the expansion of final consumption of the population and investments, particularly private investments. In annual terms, the deficit of the current account expanded in 2018 Q4, but it was fully covered by surpluses in the capital and financial accounts. Positive developments continued in the labour market, as confirmed by the reduction of the unemployment rate to 12.3%, at the end of the year. During the period, the Bank of Albania maintained its accommodative monetary policy and intervened in the foreign exchange market to curb the effect of the Albanian lek's appreciation in view of achieving its inflation target. The inflation rate was 1.8% at the end of the period, unchanged from the previous year. Fiscal policy maintained the consolidation trend.

FINANCIAL MARKETS AND PAYMENT SYSTEMS

The financial market activity developed normally during the period. In the market for government's debt securities the interest rates fell by almost 1 percentage point as the government's borrowing needs were regularly exceeded by the bidders' offer for securities purchase. The extension of the average maturity of the government debt continued during the period. In the interbank market, the average volume of transactions increased, while overnight interest rates remained close to the Bank of Albania's policy rate. In the foreign exchange market, the Albanian lek appreciated against the euro and the US dollar. The appreciation pace of the lek against the euro was significantly lower compared to 2018 H1. The indices that monitor the performance of the housing market in the country and in Tirana increased during the period. Developments in some determining factors point to growth of both demand and supply in this market. The operation of the payment systems was optimal during the period. Regarding payments instruments, electronic payments increased.

HOUSEHOLDS AND ENTERPRISES

During the period, households' creditor positions expanded, while enterprises' debtor positions narrowed. This performance was driven by the faster growth of deposits, mainly in foreign currency, for both households and enterprises. Households' preference for deposits was higher than for investments in government debt securities or participation in investment funds. The level and quality of loans to households improved during the period, mainly as a result of the performance of loans in lek. The NPL ratio for households fell to 6.4%.

⁸ This is the value published by the Institute of Statistics (INSTAT) as at the submission date of this report for review by the Supervisory Council of the Bank of Albania. Since then, INSTAT has revised the economic growth rate of 2018 Q3 to 4.66%, and has published the economic growth rate of 2018 Q4, equal to 3.1%. Our assessment is that these values do not cause significant change in this analysis.



Survey results on the financial situation and borrowing of households show that their debt burdens remain overall at adequate levels. For almost $\frac{3}{4}$ of borrowing households, the value of debt servicing amounts up to 30% of the income level.

Loans to enterprises declined during the period, driven by loans in lek for resident enterprises. Loan quality improved considerably, over the period, also for enterprises. The NPL ratio stood at 14.3%. Survey results on the financial situation and borrowing of enterprises show that the debt burden of enterprises is assessed as affordable. For about 80% of the enterprises, the debt value is assessed at half the capital value. Most borrowing enterprises state that debt (loan) services amount to around 20% of the enterprise's income. According to survey results, the households and enterprises credit demand for the short-term future period is likely to remain moderate.

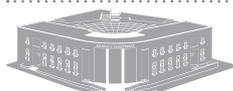
FINANCIAL SYSTEM ACTIVITY

The ratio of financial system assets to Gross Domestic Product (GDP) was 107.6%, almost unchanged from the previous six months, around 2.7 percentage points lower than at the end of 2017. The share of the banking sector assets was at about 96.8% of GDP. During the period, banking sector assets expanded by 1.9%, or ALL 27 billion, reaching ALL 1,453 billion. The increase in securities' investments was the main contributor to the change of the balance sheet. The appreciation of lek affected adversely the reporting of foreign currency values in the banking sector balance sheets, by about ALL 15 billion. The impact was concentrated in the last quarter of the year. The banking sector maintained high levels of net creditor position, in the relation with non-resident entities, with no significant changes during the period. In terms of financial soundness, the banking system was characterised by the increase of capitalisation levels, mainly driven by the fall in risk-weighted assets' value due to regulatory changes. Profitability is estimated at high levels, albeit lower than in 2017. Liquidity indicators are considered as satisfactory. The direct exposure of the banking sector to the non-banking sector is estimated as low, whereas the banking sector's performance remains a critical factor for the activity and stability of the non-banking sector.

BANKING SECTOR'S EXPOSURE TO ACTIVITY RISKS

The Bank of Albania assesses activity risks to the banking sector, as follows:

1. Non-performing loans (NPL) continue to decline at a good pace. During the period, the NPL declined by about 17%, to ALL 64 billion. As a result, the NPL ratio fell to 11.1%, nearly 2.2 percentage points lower than at the end of 2018 H1. By contribution, the decline in NPLs was



attributable to the repayments (for about ALL 17.6 billion), lost loans write-offs (about ALL 4.5 billion) and restructuring. Since the beginning of 2015, it is estimated that banks have written off nearly ALL 55.5 billion of lost loans from their balance sheets. The reduction of NPLs is accompanied by a faster decrease of provisioning, driving to the fall in their provisioning ratio by 0.8 percentage point, to 65.6%. Despite the decline in the provisioning ratio, coverage of net non-performing loans with capital improved. Collateralisation remains at high levels.

Despite the improvement, it is necessary for banks to maintain the downward trend of non-performing loans. This is especially important for those banks whose non-performing loans is above the average of the sector. The values of non-performing loans collection are at good levels, evidencing the banks' effort to collect them. The appreciation of the exchange rate the lower interest rate had an impact in the improvement of borrowers' solvency. Attention should be paid to the value of standard loans moving toward non-performing loan classes, because in the last two years these values were relatively stable. This highlights the need to maintain a prudent approach during the process of loans' underwriting and monitoring.

2. Liquidity risk in the banking activity remains low. The ratio of liquid assets, both in lek and in foreign currency, to short-term liabilities stand significantly above the minimum regulatory requirements. Deposits, accounting for almost 81% of liabilities, remain the main source of funding of the banking activity, by covering almost twice the volume of loans of the sector.

In addition to the further decline of time deposits in the deposit structure of the banking sector, further growth of foreign currency deposits (although in terms of their share, there are no significant changes) was observed during the period, by both households and enterprises. This is a development that reflects a broad foreign currency presence in the economy, which is accompanied by challenges with regard to the effectiveness of economic and financial policies, as well as with certain risks to financial stability. Hence, in line with the Interinstitutional Memorandum for strengthening the use of national currency in the economy and the financial system, it is necessary for the respective authorities to take concrete steps toward the reduction of the use of foreign currencies by real economy agents. The Bank of Albania stands ready to provide all the necessary cooperation in this process.

3. The banking sector's exposure to market risks, albeit downward over the period, remains important. The exposures to both direct and indirect foreign exchange risk did not show considerable change over the period and over the past year. Loan portfolio in foreign currency unhedged against exchange rate risk stood at 24% of total outstanding credit, in



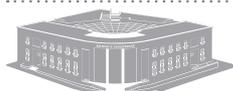
which enterprises continue to share around 2/3 of value. Regarding the impact of interest rate fluctuations, the banking sector remains exposed to them. The data show that the direct impact is moderate, given that the open balance sheet positions between interest-sensitive assets and liabilities, as a ratio to regulatory capital of the sector, is limited. Indirect impact from the interest rate risk remains important, because under the conditions when the credit portfolio is dominated by variable interest rates and when interest rates' spread is at historically low levels, the impact of a possible correction of interest rates on borrowers' solvency increases in the medium-term period.

4. As a result of a restructuring process, the share of domestic capital in banks operating in Albania has increased. This is a recent phenomenon present in other countries of the region as well. In parallel with the consolidation of the banking activity, based on the insofar experience, this development is expected to contribute to a more active role of the banking sector towards financial intermediation. At the same time, the Bank of Albania will maintain an appropriate supervisory approach to ensure that banking activity is carried out in accordance with the best standards on governance and risk management.

RISKS TO FINANCIAL STABILITY

To assess systemic risks, the performance of several indicators is analysed. Such indicators are related to the materialization and accumulation of systemic risk, the stress level in the financial system, and the perception of the banking industry regarding the exposure of its activity to systemic risk. Also, the financial stability map provides a consolidated approach for assessing risks to financial stability.

Overall, the financial stability map, the materialisation and accumulation of systemic risks indices and the financial stress index, show that risks to the financial stability are contained. Indicators related to developments in the real sector of the economy and the banking sector provided positive contribution, whereas risk indicators related to the external economic environment show a slight increase. Banks' responses in the relevant survey show that they did not have significant changes in the perception of systemic risks throughout the period, but within these risks the perception of banks for political risk increased. This response by banks was expected following the rising tensions in the political landscape in the country at the end of the period. It also evidences the importance of improving this climate to better support economic and financial developments, as well as restrain risks to the banking activity.



MACRO-PRUDENTIAL POLICY

During the period, work was carried out for finalising new indicators that signal developments in systemic risk, regarding its cyclical and structural elements. The list of indicators also includes those determining the financial cycle and systemically important banks, which will then serve to signal the possibility of implementing relevant macro-prudential instruments.

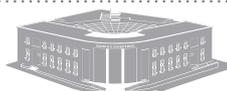
Furthermore, within the framework of measures undertaken to strengthen the use of lek in banking activity, which entered into full force during the period (July 2018), the Bank of Albania has identified and is monitoring several indicators to assess the effect of these measures and the need for reviewing/enriching them. Based on the performance of these indicators, during 2018 H2, it is noted that changes in most cases are minor, and in general, the indicators' values show significant deviation from the average values of the indicators for countries whose economy is similar to the Albanian one. Under these conditions, it is too soon to provide an assessment of the impact of these measures and the continuous monitoring of the relevant indicators is needed.

BANKING SECTOR'S ABILITY TO WITHSTAND RISKS

The banking sector's ability to withstand risks is assessed by analysing its capitalization and profitability situation, and by testing the adequacy of these indicators through stress-test scenarios. This time around, the stress-test exercise was carried out to also assess in greater detail the banking sector's liquidity situation.

At the end of the period, the banking sector's capital adequacy ratio was 18.2%, standing 1.2 percentage point higher than at the end of 2017 and notably higher than the 12% level of the minimum requirement. The fall in the value of risk-weighted assets dictated most of the improvement in the capital adequacy ratio. This fall arose from simultaneous factors related to changes in the regulatory framework. The financial result of the sector was at good levels. The profitability indicators of the sector, Return on Assets (RoA) and Return on Equity (RoE), resulted at 1.3% and 13% respectively, downward by 2.4 percentage points and 2.0 percentage points, respectively, than in the previous year. The net interest margin dropped at 3.75%, over the period, compared with 3.9% in the previous year, hence reflecting the impact of the presence of low interest rates for a prolonged period.

The adequacy of the above indicators was verified through stress tests, with scenarios that assumed adverse developments in macroeconomic and financial indicators for 2019-2020. Similar to before, extreme assumptions in the adverse scenario (with a low probability of occurrence) included the strong contraction of the economy and of credit, rapid growth of average interest rates and strong depreciation of the exchange rate.



Overall, the results of the stress tests show that in the scenario containing assumptions with a higher probability of occurrence, the banking sector remains well capitalized and shows good performance. In the more extreme scenarios, individual banks and the banking sector would need to increase capital.

With regard to the stress-test to assess the resilience of the banking sector and of individual banks against shocks to liquidity conditions, the stress-test conclusions indicate that the banking sector is resilient to these shocks. By currency, the resistance is better for the lek and the US dollar than for the euro. The strengthening of lek's resilience is related to the increase in the value of assets that can be liquidated when a need arises, while the weakening of euro's resilience reflects a decrease in the value of the ratio between inflows and outflows and a slight decrease in the volume of liquid assets available for liquidation in the case of a liquidity shock.

Based on this analysis, the Bank of Albania deems that capitalization and profitability of banks is actually adequate to withstand activity risks. As previously, banks should regularly analyse and test their capacity to withstand various risks, in compliance with the supervisory and regulatory framework.

A more detailed analysis is presented in the financial stability report for the second half of 2018 that follows this statement.

