Bank of Albania

FINANCIAL STABILITY REPORT

2020/HI

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INTRODUCTION

This is the twenty fourth issue of Bank of Albania's Financial Stability Report, which is published half-yearly. The Financial Stability Statement, whose half-yearly release is a legal requirement, prefaces the Report. The purpose of this Report is to identify and assess the overall risks to the financial system of the Republic of Albania and its infrastructure, and it assesses the ability of the financial system to absorb these risks. This Report provides to the public authorities the possibility to timely identify the relevant measures for corrections, as necessary.

In producing this Report, we have used data available at the Bank of Albania, and information from other authorities supervising the financial market. We have also used information and analyses by public and private, national and international financial institutions. The data and analyses cover mainly the developments over the first half of 2020 (hereinafter "the period"). Unless otherwise stated, the expectations for the economic and financial outlook extend through a period of up to 12 months.

The financial system stability has been assessed based on the performance and risks arising from its interaction with the overall internal and external economic environment, as well as from its activity. In order to assess the risks arising from its interaction with the surrounding environment, this Report analyses the latest highlights in international financial markets, and in advanced and regional economies. We have also assessed their impact on the financial system and the banking sector in Albania. Concerning the domestic indicators, this Report assesses the overall developments and expectations for economic growth, balance of trade, overall price level, exchange rate and fiscal indicators. Also, by analysing the performance of employment, income, and specific surveys, it evaluates enterprises and households' financial situation, and the impact on the solvency of the banking sector borrowers.

The Report presents, also, the results of the stress testing exercise, which assesses the banking sector's resilience against macroeconomic and financial shocks, expressed in terms of capital adequacy.

The Financial Stability Report is prepared by Financial Stability Department and is approved by the Supervisory Council of the Bank of Albania.

NOTES

As at end-June 2020, the classification of banks in the Albanian[1] banking sector, is as follows:

I. By marginal contribution of each institution in the systemic risk in Albania, banks are grouped into:

- "Systemically important banks" (SIB): National Commercial Bank sh.a., Raiffeisen Bank sh.a., Credins Bank sh.a., Intesa Sanpaolo Bank Albania sh.a. And OTP Bank Albania sh.a.

- and "Other banks": Alpha Bank Albania sh.a., Procredit Bank sh.a., First Investment Bank Albania sh.a., United Bank of Albania sh.a., Union Bank sh.a., American Bank of Investments sh.a. and Tirana Bank sh.a.

II. By capital origin, the banks operating in Albania are divided into:

- Banks with foreign capital[2]: Raiffeisen Bank sh.a. (Austria); Intesa Sanpaolo Bank - Albania sh.a., (Italy); Alpha Bank Albania sh.a (Greece); National Commercial Bank sh.a. (Turkey); OTP Bank, Albania sh.a. (Hungary); "Procredit Bank sh.a." (Germany); First Investment Bank, Albania sh.a. (Bulgaria); United Bank of Albania sh.a. (Saudi Arabia). These banks share around 70% in total assets of the banking sector.

- Banks with Albanian capital: Credins Bank sh.a., Union Bank sh.a, American Bank of Investments sh.a., and Tirana Bank sh.a. These banks share around 30% in total assets of the banking sector.

III. Banks operating abroad:

Banks showing an expansion of their network abroad are: the National Commercial Bank sh.a with its affiliate in Kosovo, and Credins bank with its subsidiary in Kosovo.

Regarding the analysis used in the Report, there should be taken into account that:

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[1] *The individual marginal contribution is measured by "Financial Strengthening Index". For more information on this index and of the determination of SIB, please refer to the document: https://www.bankofalbania.org/Finanacial Stability/Macroprudential policy/ Macroprudential policy instruments/ Approved acts/*

[2] *A bank is classified with foreign capital, whenever the foreign capital amounts more than 50% of the bank's paid in capital.*

(1) The terms "loan" and "credit" are used interchangeably in this Report; "enterprises" and "businesses" are also used interchangeably.

(2) In this Report, "outstanding credit" refers to the balance of the account "relations with clients", as reported by banks in the balance sheets of the period under review. It includes outstanding credit granted by the banking sector to non-financial private and public, resident and non-resident entities. The outstanding credit is affected by the non-performing loans (NPL) write off from the banks' balance sheet in the period under review. Hence, outstanding credit that is analysed in the Financial Stability Report is a different concept from that of credit to the economy that is addressed in the monetary policy reports. The latter, in addition to credit by banks, includes the credit by non-bank financial institutions. Also, the value of this credit includes only credit to the resident private sector and its value is not affected by the NPL's write off from banks' balance sheets, as these loans are already obtained by the economic entities and have affected their economic value; their later write off does not change this fact. The differentiation in these concepts on credit should be considered when interpreting the relevant analysis of credit indicators (growth rate, quality ratio, allocation by sector, by currency, etc.) in various reports of the Bank of Albania.

FINANCIAL STABILITY STATEMENT FOR 2020 H1

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 promote awareness among financial institutions and the public at large of the situation in the Albanian financial system and potential risks to 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 assessed through the stress testing exercise and placed vis-à-vis the financial situation of the banking sector to assess its resilience.

The Bank of Albania deems that in 2020 H1 (hereinafter 'the period'), banking sector showed a stable activity, notwithstanding the challenges posed by pandemic situation in Albania. The operational measures taken by banks to ensure the continuation of both critical functions and relationships with customers, and the measures taken by public authorities to mitigate the pandemic shock on the economic and financial activity of Albania, provided for the adequate continuation of the intermediation activity and the financial sector indicators remain at good levels. The uncertainty about economic prospects given the pandemic presence is considerable; like the challenges to banking and financial activities. Nevertheless, the assessments by banking industry and the stress tests suggest that currently the banking sector's ability to withstand these challenges is sufficient. The Bank of Albania remains willing to undertake all the necessary operations in accordance with the Law to support the banking activity and contribute to the stability of the financial system.

This Report, as a rule, analyses the developments in the financial system as at end of 2020 H1. Overall, these developments showed:

- The impact of pandemic shock on macroeconomic indicators. Data for 2020 Q1 showed the contraction of economy by 2.5%, mainly affected by the drop in investments and consumption. The unemployment rate showed a slight increase after some continuous improving periods. The Government, with the purpose to mitigate the pandemic hit on economy of Albania and notwithstanding the fall in budget income, aimed at safeguarding the level of public expenditure by acting swiftly to finance the increase of both budget deficit and public debt. The comparison with other countries and expectations for a deepening of pandemic shock in the second quarter of the year, show that this action was necessary and unavoidable. The contribution of fiscal policy to tackle the pandemic effects remains crucial, throughout the lifetime of the uncertainty arising from the current pandemic. The maintaining of an adequate flexibility level in the short run, should consider the longer-term objective of fiscal consolidation. Globally but also in the region, many countries experienced an economic contraction. Forecasts about future prospects are pessimistic for 2020 and show that global economy will gradually return to the positive growth rates in 2021.

- Smooth performance of financial markets in Albania. In these markets, notwithstanding the increase in the volume of borrowing from the Government in both lek and foreign currency, the average interest rate on debt securities did not show changes during the period under review. Volume of transactions in the secondary market remained low and concentrated in short-term issues, by reflecting the preference of investors to hold debt securities to maturity. In interbank market, trade volumes increased but the interest rates remained close to the level of the policy interest rate determined by the Bank of Albania. Lek depreciated against main foreign currencies at the end of 2020 Q1, but it recovered the major part of the value in the second part of the period. In real estate market, the indicators obtained from surveys show an increase of price but expectations on developments in this market, in the short run, are more pessimistic. During the period, the payment systems functioned optimally.

- The impact of pandemic on the activity of households and businesses. During the period, according to data from banks, the traditional financial position of households as net creditors, and of businesses as net debtors, to the financial system, expanded. The growth of deposits and loans was positive in both sectors, but deposits growth was higher for households, while loan growth was concentrated to businesses. Survey results about the financial situation and debt burden of households showed that the use of debt from them remains limited. The borrowing households showed a fall of their ability to pay. In the near future, it looks like loan demand will be higher from those households that do not have any debt before. In terms of enterprises, the responses in the relevant survey report a considerable impact of pandemic, which has posed the main challenge to them, during this period. Although the major part of enterprises has generated a positive financial result, the level of sales and that of the financial result have shown an extraordinary fall for all groups of enterprises, mostly for small and medium-sized enterprises. The fall in the level of sales is accompanied with the increase of the support from external funding sources (loans), which is mainly used to afford current expenses and less for investments. External funding increased to small and large enterprises. By currency, funding in lek is dominant, particularly to small and medium-sized enterprises. About ¾ of enterprises, by groups, considers the funding level adequate. For about 80% of enterprises, the debt value is half of the capital value. Expectations regarding the growth of funding, increase of investments and improvement of financial performance show more optimistic.

- The stable performance of financial system. The activity of the financial system expanded by around 4.4 percentage points during the period, up to 111.6% of Gross Domestic Product. The contribution of banking system accounts for 3.9 percentage points in this growth. The performance indicators of the financial system, including capitalisation, profitability, liquidity and assets quality, remain at good levels. The interconnection degree among financial institutions remains stable and reflects the importance of banking sector's stability to the whole financial system. The activity of the banking sector expanded by 4%, during the period, or by 7% from the previous year. The expansion of both investments in securities and lending activity provided the main contribution to the growth of assets. On liabilities side, deposits grew and in addition to own funds remain the main funding source to the activity of the banking sector. The statistical effect of the foreign exchange rate provided an upward net effect on the activity of the banking sector in foreign currency. Banking sector closed the first half of year with a profit, but 32% lower compared with a year earlier. "Net interest income" and "Income from other activities" were comparable to those of 2019, but the increase of expenses in provisions for loans and in other financial instruments, concentrated in 2020 Q1, provided a negative impact on the financial result of banks. Banking sector appears well-capitalised and none of the banks results with an adequacy ratio below the regulatory minimum of 12%. As at end 2020 H1, the capital adequacy ratio fell by 0.4 percentage point, to 18.1%, mainly affected by the growth of risk-weighted assets. Banks with foreign capital and systemically important banks show the highest level of Capital Adequacy Ratio.

- Controlled exposure of banking sector to risks. Banks perceived increase of both economic and financial risks during the period but banks' confidence in the financial system stability remained unchanged driven by the good financial indicators and the measures undertaken to maintain them. At the end of the period, non-performing loans stock was around ALL 48 billion, almost unchanged throughout the period. The main impact on this stability of the non-performing loans ratio was provided by the definitions in the moratorium on loans payment, which enabled banks to temporarily suspend changes in non-performing loans and within them. Non-performing loans ratio is around 24% lower than the level in the previous year. This fall of non-performing loans during the last 12 months, concentrated in the second half of 2019, was driven by the write offs, restructuring and repayment of loans. Given the growth of credit, non-performing loans ratio dropped to 8.1%. Liquidity situation of the banking sector appears rather good, notwithstanding the slight fall of liquidity ratios during the period. In terms of market risks, banking sector remains sensitive to foreign exchange rate risk through the segment of unhedged loans in foreign currency. Exposure to interest rate risk remains present and edged upwards

during the period, but it is assessed as limited.
Risks to banking activity reflect and are intertwined with developments of structural nature. Such a development is the existence for a long time of a low interest rates environment, which keeps pressure on the financial result of banks, prompts the change of its financing structure towards short-term needs and the need for high liquid assets, and maintains the growth potential for the increase of activity stress in case of a strong and unexpected correction. The high use of foreign currency in the banking sector is accompanied with the liquidity risk management in foreign currency. Overall, assessment indices of systemic risks increased during the period.

The Bank of Albania, via regulatory micro-prudential actions and macroprudential policy instruments, has addressed these risks. The new implemented regulatory acts including liquidity coverage ratio, de-euroisation package of measures, and the regulation on the implementation of macro-prudential capital buffers, aim at mitigating risks and strengthening the banking sector's resilience to these risks.

In March - June 2020, given the slowdown of the economic activity due to pandemic and the expected difficulties of borrowers to face credit payments, the Bank of Albania undertook some prudential measures and regulatory amendments, which aimed at easing the borrowers' burden, affected by pandemic, increase banks' financial resilience and support the continuation of lending activity of the banking sector. These measures consisted in:

- prompting a moratorium, which enables the temporary suspension of credit payments to borrowers affected by pandemic, initially until June 2020 and then extended until August 2020;
- approval of regulatory amendments which enable banks to maintain the classification of loans and the levels provisioning for non-performing loans during this situation. The purpose of these amendments is that, till the end of this year, banks and their borrowing;
- customers find restructuring forms of certain loans which quickly re-establish the creditworthiness of borrowers affected by the pandemic;
- the suspension of banks' profit allocation till the end of year, with the aim that in any event of financial losses materialisation, capital size be adequate not only to absorb this loss but also to support the new lending.

Given that these measures are temporary and the pandemic development (intensity and duration) remains uncertain, it is not excluded the possibility that the challenges the banking sector may face become deeper. Stress testing exercises conducted by the Bank of Albania suggest that in case of extreme shocks in macroeconomic framework, it would be necessary that certain banks strengthen their capital position, despite the overall banking sector appearing well-capitalised.

Hence, it is necessary banks use this period to adequately and in transparent manner manage the risks to the activity, being focused on credit risk. Although the preliminary data gathered from banks show that they are actively engaged in these processes, it is considered necessary that banks maintain their focus to:

- guarantee the well- functioning of the institutional activity from operational viewpoint, by providing safe work conditioned to the staff and ensuring the continuation of the critical functions of the activity;
- act with no delay with regard to: assessment of credit risk to their customers; use of the possibilities for credit restructuring pursuant to approaches provided by national and international standards; assessment of added provisions that may be required; the analysis of these costs on capital position and on the ways they will cope with such costs if needed. It is important to consider that capital position should be sufficient not only to absorb the possible losses but also to boost the new lending that the economy needs;
- use all the ways, including stress tests with extreme but plausible scenarios, in order to regularly and pro-actively assess their resilience degree against unfavourable developments;
- maintain constant and close communication with the Bank of Albania, in order to share in real time their assessment on the economic and financial developments and their impact on the banking activity.

The Bank of Albania, in the framework of its legal functions and in coordination with other public authorities, will be attentive to undertake all the necessary actions in order for the banking sector and financial markets to operate in this period in adequate conditions and stable manner.

The next chapters present in greater detail the report on financial stability for the first half of 2020.

1. OVERVIEW OF MAIN RISKS TO FINANCIAL STABILITY

1.1 FINANCIAL STABILITY MAP[3]

Based on the developments over 2020 H1, the Financial Stability Map shows, overall, an increased level of risks to the overall macroeconomic environment and to real economy agents, while risks to banking sector activity remain contained, by reflecting the structural changes that banking sector experienced in the recent years. In more concrete terms:

The recent developments show increased level of risks to the overall macroeconomic environment and real economy agents.

Risks to banking activity do not show fundamental changes, by reflecting the structural changes taking place in recent years, which have strengthened soundness parameters and have enhanced resilience to shocks.

A. In the overall economic environment:

I. Risk from the "domestic economy"[4] is rated as "average" and deteriorated over a one-year period, mainly driven by the narrowing of output gap and the performance of inflation rate.
II. Risk from "external environment" remains at "average" rate, but upward during the year, by reflecting the recession in the main trading partners economies and the drop in the composite leading indicator (CLI) of OECD[5], affected by SARS-CoV-2 pandemic. The fall of oil price in international markets provided a lower contribution in mitigating this risk.

B. In main real economy agents:

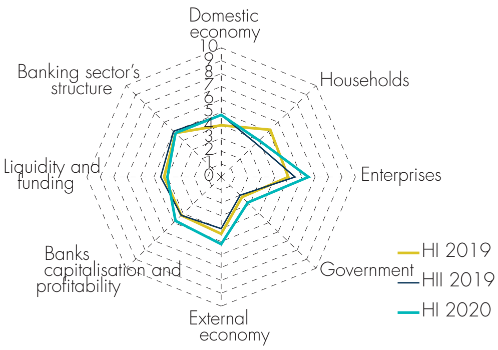
I. Risk from "enterprises" is assessed as "moderate", recording a gradual increase from the previous year. Notwithstanding the positive changes in the credit portfolio quality to enterprises, the considerable worsening in both "financial position index" and "private sector's expectations" has affected the increase of risk rate to this category.
II. Risk from "households" continues to be assessed as "average" and unchanged from the previous year. The risk rate from this category was maintained by credit portfolio quality, their borrowing share and the developments in housing market, by offsetting the effect of households' deteriorated expectations and the contraction in remittances.
III. Risk from "Government" continues to be assessed as "low", but the rate

[3] *The Financial Stability Map shows the allocation of risk among factors that determine the stability of the financial system, which include the surrounding external and internal economic environment, the banking sector, and the real economy agents: government, enterprises and households.*
[4] *Assessments have been conducted based on the latest published official data, 2020 Q1.*
[5] *The composite leading indicator (CLI) of OECD is designed to provide early signals of turning points in business cycles at global level. The fall in its values signals fluctuation of the economic activity around its long term potential level.*

to this category was upward during the period. The expansion of public debt and the worsening of tax income provided the main impact in this regard.

C. The banking sector activity at the end of the period:

Chart 1 Financial Stability Map



*Risk is assessed as: low for scores 0-3 in the map, average for scores 4-5, moderate for scores 6-8 and high for scores 9-10. The closer to the center, the lower the riks.

Source: Bank of Albania.

I. Risk from "capitalisation and profitability" maintained the "average" level, albeit it showed an upward trend over the last year, mainly driven by the fall in the interest income of the banking activity.

II. Risk from "funding and liquidity" remains at "average" level, reflecting the growth in households' deposits and a low support on the external funding sources.

III. The risk associated with the "banking sector structure" is assessed as "average" and unchanged from a year earlier. In this category, the increase of risk level, due to the increase of concentration in banking sector in terms of credit to enterprises and funding sources, was offset by the fall of risk related to CAR deviation indicator in the banking sector.

1.2 SYSTEMIC RISK[6]

1.2.1 DEVELOPMENTS IN SYSTEMIC RISK INDICATORS

Against the fall in financial stress level, the performance of materialisation and accumulation of systemic risk reflects an upward trend during the period, by dictating an enhanced attention.

Exposure of banking system to systemic risk is assessed based on the indicators related to the materialisation and accumulation of systemic risk and of financial stress. Also, the perception of the banking sector regarding these risks is included in this assessment[7].

The materialisation and accumulation of systemic risk indices reflect unfavourable developments during the period[8]. The accumulation index, notwithstanding the fall in the share of loans with variable interest rate, was affected by the expansion of both public debt and external debt and the increase in deposits stock in foreign currency, reflecting the fluctuation of the exchange rate. Materialisation

[6] *Systemic risk is defined as "the possibility for the materialization of shocks that impair the functioning of a financial system to the point where economic growth and welfare suffer materially".*

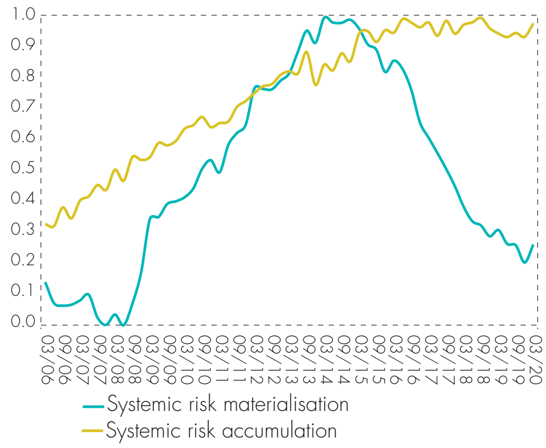
[7] *Banking sector perception related to main systemic risks in Albania is attained through an ad hoc survey.*

[8] *The analysis on accumulation and materialisation indices is based on the latest available data: 2020 Q1.*

index also was upward, affected by the performance of the exchange rate, while the improvement of credit quality to firms, affected on the downside.

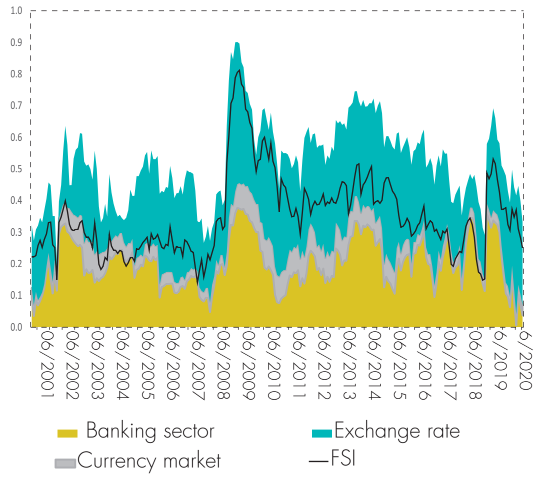
On the other hand, financial stress index was down at the end of the period, notwithstanding the increase in the first quarter of year. The performance of this index mainly reflects the expansion of deposits base and the narrowing of outstanding credit gap against its long-term trend. The effect of money market remains unchanged, while the performance of the exchange rate shows a downward stress during the second quarter of year.

Chart 2 Indices of accumulation and materialisation of systemic risk



Source: Bank of Albania.

Chart 3 Financial Stress Index



Source: Bank of Albania.

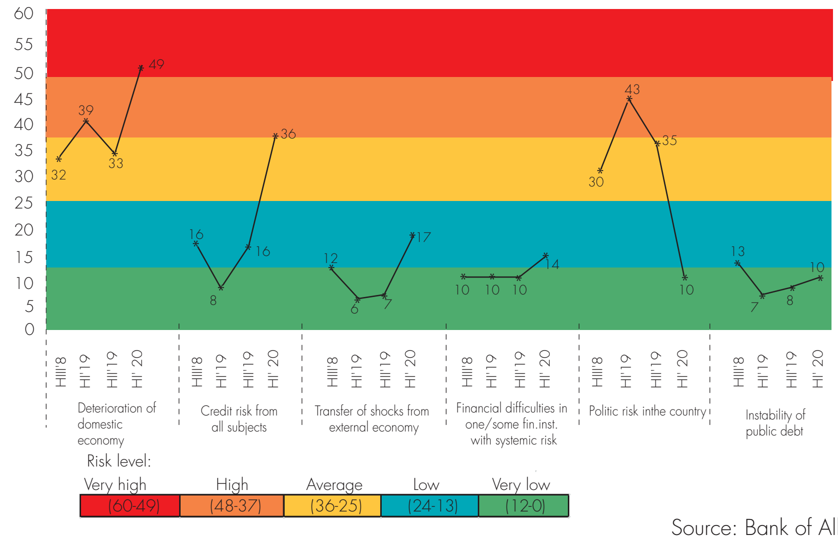
1.2.2 THE PERCEPTION OF THE BANKING SECTOR ON THE SYSTEMIC RISK

Pandemic and its effects on economy, have affected the increase of risks perception from banking system. Confidence in banking system's resilience remains solid due to the good financial indicators, and the measures taken by banks and public authorities.

Banking sector has identified "the deterioration of domestic economy" as the main risk related to the perception about the systemic risks. This assessment is directly affected by the effects of pandemic and the uncertainty it has arisen. In parallel, "credit risk from all entities" has been increased considerably due to the worsening of financial situation of firms and households.

Global pandemic spread and the restrictive measures taken by countries to contain it have increased the perception of banks on "the external shocks risk". Many businesses related to international transport, trade, tourism, etc., have experienced pronounced financial difficulties due to these measures, by reducing their ability to pay and increasing their credit risk. Last, banks identify increase of certain new risks related to pandemic period, such are: "operational risk", and "cybernetic risk"; due to the increased support on the use of technology to carry out their activities.

Chart 4 Bank's assessment on the main systemic risks in Albania



Source: Bank of Albania.

Notwithstanding the upward perception of banks on systemic economic and financial risks, their confidence on the financial system stability has remained solid. Banks base this confidence on the good financial indicators of the activity and on the measures taken by them and public authorities to mitigate the impact of pandemic.

Due to the expectations that pandemic impact would negatively affect the borrowers' solvency and their credit quality, the Bank of Albania undertook some regulatory measures that enable banks and their borrowing clients who are affected by pandemic, to restructure the respective credit exposures in order to mitigate the expected fall in credit quality. In parallel, these measures have aimed at strengthening banks' financial capacities to withstand possible financial losses. Overall, the undertaken measures are temporary. Thus, it is important banks use the implementation period for these measures to carry out in a transparent manner and effectively the restructuring processes of the identified loans. Meanwhile, the Bank of Albania has intensified the communication with banks to assess the performance of this process. Overall, the reported information shows that:

a) Banks have shown active in accepting applications for credit restructuring affected by pandemic. The ratio of accepted applications averages more than 90%;
b) Loans with status "performing" prior to pandemic, considerably dominate the restructured loans. This is a right focus, to address/help those borrowers who are affected by pandemic;
c) overall, the extension of credit payment for one or some periods, and in parallel, the extension of credit maturity term, dominate the restructuring forms;
d) In terms of value, firms dominate the restructuring, while households dominate in terms of number;
e) Restructuring have included credit to firms who have operated in various

sectors of economy, where manufacturing industry, trade and tourism have a higher share, while transport and agriculture have a lower share;

f) Despite the conducted restructuring, given the uncertainty surrounding the pandemic, banks expect to face a fall in the credit quality and an increase of credit risk provisioning. Notwithstanding, pro-actively knowing these provisions, their increase effect on the financial result of banks is expected to extend throughout 2021 as well.

2. MACROECONOMIC AND SECTORIAL DEVELOPMENTS

2.1 EXTERNAL ENVIRONMENT

GLOBAL ECONOMY

The global economy suffered an unprecedented shock at the beginning of 2020, due to the health emergency caused by SRAS-CoV-2 leading to its deep recension. The global economic prospect remains surrounded by a heightened uncertainty. Main risks are related to the evolution of pandemic and the materialisation of its impact on economy, and to the success of measures packages to support economy.

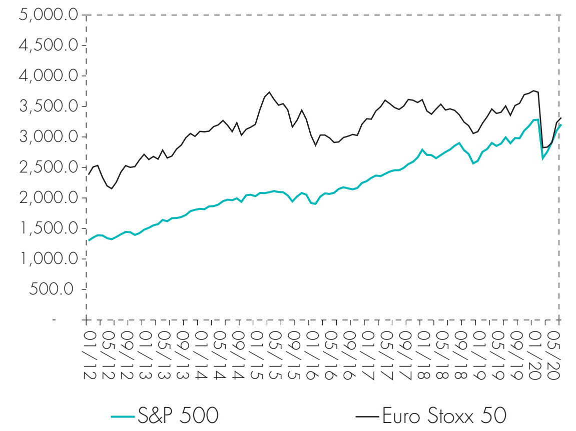
Global economy suffered an unprecedented shock in the first months of 2020 due to the emergency health caused by SARS-CoV-2 pandemic. The strong measures taken to safeguard public health, mainly to restrict movement and respect physical distancing, were accompanied by a disorder in production and trade chain, and an overall drop in consumption. Given the considerable fall of the economic activity, the inflationary pressures remained weak, notwithstanding the stable demand for everyday goods.

The negative developments in real sector, initially, drove to a considerable increase of uncertainty in financial markets. This was reflected in the tightened financial conditions; fall in the value of assets and expansion of spreads, increase of volatility indicators and overall confidence drop. This phenomenon was notable in both advanced and emerging regions. By considering the ability of emerging countries as lower to face the expansion of pandemic, the investors supported the shift of capital flows towards financial instruments of advanced countries.

Worldwide, governments in response to the created situation and to mitigate the effects of crisis built up and activated fiscal and financial package of measures to support households and business affected by pandemic. Central banks and other monetary authorities were broadly engaged in supporting financial systems and economies with liquidity through the further release of monetary policies, activation of quantitative easing programmes or easing macroprudential requirements to banks, aimed at absorbing potential financial losses and mitigating the financing bottlenecks.

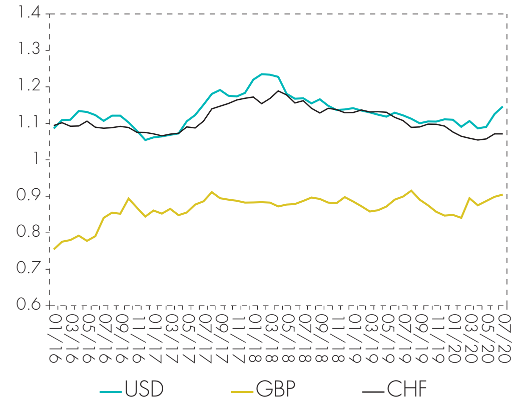
In foreign exchange and commodities markets, euro, overall, appreciated against the main currencies, like Japanese yen and Swiss franc, and against the currencies of a part of emerging regions. In the last months, expectations for a deeper contraction of US economy, during the second quarter of year, affected the appreciation of Euro against US dollar as well. The sharp drop of global demand drove to a swift fall in oil price, at around $20 per barrel per barrel, at the beginning of April 2020. In recent months, oil price in markets has recovered at around $38 per barrel (Brent index, June 2020), affected by the easing of containment measures, the economic recovery of China, and the reduction of production quotes on the supply side.

Chart 5 Main indices in stock markets



Source: European Central Bank.

Chart 6 Euro exchange rate against major currencies



Source: European Central Bank.

Global economy, with the easing of strong containment measures by the major part of countries and the restart of economic activity in the main sectors, is expected to enter the recovery path in second half of 2020 and during 2021[9], driven by the continuation of support programmes and the stabilisation of financial markets. The speed of economic recovery is subject to high uncertainties[10], first related to pandemic evolution and further to the way how pandemic will affect the behaviour of markets, investors and consumers. In addition, the complicated situation of global trade and trading protectionism, which were present before pandemic, have been further complicated.

EURO AREA

The euro area economy also contracted considerably during the first half of 2020. In 2020 Q1, GDP in euro area contracted by 3.1% in annual terms (3.6% in quarterly terms) and preliminary data suggest a stronger contraction in the second quarter. This performance particularly reflects the considerable shrunk in consumption and investments since the middle of March 2020, where France, Italy and Spain were the most affected countries. Also, labour market in euro area was strongly hit due to the lockdown measures. Unemployment rate at regional level climbed at 7.8% in June (from 7.2% three months earlier). Inflationary pressures remain subdued and downwards, mainly impacted by the drop in oil price.

In response to the situation, euro area governments undertook a set of fiscal and financial measures to mitigate the negative impacts of pandemic. These

9 *IMF forecasts global economy growth will be -4.9% in 2020, and +5.4% in 2021. (World Economic Outlook update, June 2020).*

10 *The expansion of pandemic has reduced voices expecting for a V-shaped economic recovery", against the increase in voices expecting for an either "U" or "L" -shaped recovery.*

measures aimed at controlling the increase of unemployment and supporting consumption, and financing with liquidity the businesses in order to face the fall in income. In parallel, the European Central Bank continued to be committed on easing the monetary policy stance through quantitative easing programmes to support the financial sector with the needed liquidity. European Commission projections this summer were more pessimistic than those of spring. According to the projections, the EU economy will contract by 8.7% in 2020 (-7.7% in Spring economic 2020 forecast) and grow by 6.1% in 2021. Italy, Spain and France, are expected to be mostly hit, and economy is expected to contract by 10%. The EU economy is forecast to contract by 8.3% in 2020 (-7.4% from Spring forecast) and grow by 5.8% in 2021. In the euro area, pressures on unemployment rate will remain high, given that employment supporting schemes during pandemic, begin to end in autumn of this year. Nevertheless, projections are critically conditioned by the further evolution of pandemic, progress towards the development of a safe and effective vaccine, and the possibility the authorities undertake other actions in supporting the economy (the follow-up of the European recovery plan of €750 billion).

In banking sector, lending dynamics has reflected the effects of pandemic on private non-financial sector. Lending to firms has continued to grow as a result of the increased demand for financing given the fall in income and the inability to cover spending. Opposite trends have characterised lending to households, driven by the fall in their income and the increase of uncertainty about the future.

Table 1 Selected macroeconomic indicators for the U.S. and euro area

	GDP change (annual %)			Inflation (annual %)		Unemployment (annual %)		Gross government debt (% of GDP)	
	2020 Q1	2020 Q2	2020f.	March '20	June '20	March '20	June '20	2019 Q4	2020 Q1
U.S.	-5.0	-32.9	-8.0	1.5	0.6	4.4	11.1	106.8	107.7
Euro area	-3.1	-15.0	-10.2	1.3	0.3	7.2	7.8	84.1	86.3
Germany	-2.2	-11.7	-7.8	0.8	0.8	3.8	4.2	59.8	61.3
France	-5.7	-19.0	-12.5	0.1	0.2	7.6	7.7	98.1	101.2
Italy	-5.5	-17.3	-12.8	0.2	-0.4	8.4	8.8	134.8	137.6
Greece	-0.9	:	-10.0	0.2	-1.9	14.5	15.5	176.6	176.7

Source: European Central Bank, Eurostat.

European Central Bank, Eurostat , International Monetary Fund (f- IMF estimates, June 2020), BEA –Bureau of Economic Analysis). U.S. Bureau of Labour Statistics. "- ": no available data.

WESTERN BALKANS

After a stable economic growth during 2018-2019, Balkans region was hit by global pandemic crisis. Its negative effects were materialised since 2020 Q1. Their economic growth slowed considerably, down at an aggregate level 2.5%, from 4.3% in 2019 Q4. Private consumption remains the main contributor, while investments have been volatile, falling in a part of countries. Economic slowdown is also reflected in the deterioration of labour market conditions and fall of employment. Pressures on the balance of payments lifted considerably up across all countries in Balkans region (expect of Serbia) and were followed by the financial support from the IMF and EU. In response to the situation and to mitigate its consequences on firms and households, governments of regional countries activated various fiscal and monetary packages. The expansion of fiscal stimuli, accompanied with the overall fall in fiscal income, lead to the expansion of budget deficit and increase of public debt, during the period, in the major part of this regional countries. Inflationary pressures remain weak. In these circumstances, the monetary policies continued to remain accommodative and in some countries, the central banks further cut the key interest rate.

Table 2 Key macroeconomic and financial indicators for the Western Balkan countries.

	GDP (real, annual %)				Unemployment (in %)		Credit growth (% annual)		Non-performing loans ratio (in %)	
	2019 Q4	2020 Q1	2020f.	2021f	2019 Q4	2020 Q1	2020 Q1	2020 Q2*	2020 Q1	2020 Q2*
Bosnia & Herzegovina	3.8	2.0	:	:	:	:	3.4	0.9	6.6	:
North Macedonia	3.4	0.2	-3.9	4.0	16.6	16.2	6.5	5.9	4.8	:
Montenegro	3.1	2.7	-5.9	4.4	16.1	16.3	4.3	4.6	5.1	5.3
Kosovo	3.9	1.3	:	:	25.9	:	10.0	6.4	2.3	2.4
Serbia	6.2	5.0	-4.1	6.1	9.7	9.7	11.1	12.0	4.0	:
Albania	-0.1	-2.5	-4.8	4.2	11.6	11.9	7.4	6.7	8.2	8.1

Source: European Commission, respective central banks.
'f'- forecast for June 2020,:' no information; "": data reefer to May 2020 (excluding Albania where data are reported for June 2020).*

Bank lending has continued to be positive, but the growth pace slowed down in some countries. The balance sheet of regional banks improved during the period, due to the measures taken for the deferral on loan repayments and the maintaining of non-performing loans situation.

2.2 MACROECONOMIC ENVIRONMENT IN ALBANIA

After the earthquake of November 2019, the spread of COVID-19 pandemic deepened the shock on the Albanian economy. Public authorities undertook fiscal, monetary and prudential measures to mitigate the impact of this shock. These measures have changed both fiscal and financial parameters, but they have safeguarded the equilibrium in the macroeconomic framework of the country.

The impact of COVID-19 pandemic was reflected in the contraction of the economic activity in Albania. For the second consecutive quarter, GDP fell annually, recording a contraction of 2.52% at the end of 2020 Q1[11]. This performance was driven by the reduction in both private investments and in trade exchanges of goods and services, in addition to the considerable narrowing of the final consumption of both population and government. The analysis by sectors of economy showed that the negative performance in the main branches of economy: "construction", "trade, transport, entertainment and leisure", "industry, energy and water" and "financial and insurance activities" was not mitigated by the positive contribution of the branches of "agriculture, forest and fishing" and "real estates".

External sector of economy[12] continued to provide a positive contribution due to the further narrowing of the current account deficit in the balance of payments.

[11] *The real annual growth of economic activity in Albania during 2019 Q1 and 2019 Q3 was 2.4% and 4.2%, respectively, while in 2019 Q4 was -0.10%.*
[12] *According to the data till 2020 Q1.*

Current account deficit narrowed by around 9% in annual terms, sating at EUR 226 million, by reflecting the net effect of the positive impact from the narrowing of trade deficit in goods[13] and the expansion in the surplus of secondary income, notwithstanding the unfavourable developments in the services account[14] and in net income from investments[15]. Remittances were around EUR 152 million, slightly up from the previous year (1%), but considerably down from the previous period (16%). In relative terms, current account deficit accounts for around 7% of GDP, without considerable changes from the previous year. Net inflows in the financial account, amounting to EUR 211 million, and net inflows in capital account, amounting to EUR 25 million, financed the current account deficit. At the end of period, foreign reserve assets cover 6.5 months of average imports in goods and services.

The earthquake of November 2019, in addition to the measures undertaken to save public health due to pandemic, appear to have provided an negative effect on both economic developments and labour market. This effect is reflected in the fall of confidence indicator of non-financial private sector, at lower levels than those in the financial crisis of 2009. Nevertheless, the increases of unemployment rate at 11.4%, remains close the average value of the last 12-month period.[16]

Following the consequences of November 2019 earthquake, the pandemic shock on the Albanian economy would have been even stronger, in the public authorities would not have taken fiscal, monetary and prudential measures.

Hence, the Albanian Government approved two package of financial aid and guarantee, which aimed at mitigating the shock on the incomes of private sector's employees and self-employed persons, and supporting with working capital the enterprisers affected by pandemic. The need to maintain the level of public spending and the forecasts for a fall of fiscal revenue during this year, lead to the review of public debt with the purpose to forecast higher levels of fiscal deficit and public debt, and to determine the necessary financing forms. At the end of the period, due to the growth of public spending by 2% and fall in fiscal revenue by 14%, public deficit is estimated upwards at around ALL 38.5 billion (or around 2.5% of GDP), considerably above the levels recorded in the two previous 6-month periods[17]. Budget deficit was entirely financed by external funds. Additional funding

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13 *The trade deficit narrowed by around 6% in annual terms, mainly driven by the fall in the imports of electricity and in "machinery and equipment" item".*

14 *Trade surplus in services fell by around EUR 18 million, due to the contraction of positive balances in "services for the processing of physical inputs owned by others" and in "other business services". Meanwhile, travel services closed with a positive balance sheet of EUR 93 million, at an annual growth around 23%.*

15 *Investment income recorded again a negative balance sheet, around EUR 94 million, expanding in annual terms (15%), mainly in the form of payments to dividends and reinvested profit and interest payments.*

16 *The unemployment rate was 11.2% in 2019 Q4 and 12.1% in 2019 Q1. The average unemployment rate for the period 2019 Q1 - 2020 Q1 is estimated at around 11.5%.*

17 *A year earlier (June 2019), budget deficit stood at around ALL 3.45 billion; while in December 2019 stood at ALL 31.54 billion).*

sources were provided through borrowing from international financial institutions and external markets.

The expectation for a strong impact of pandemic on the economic and financial indicators of Albania drove the Bank of Albania that in parallel to undertake a package of measures to address the situation. These measures included the further easing of the monetary policy through the cut of key interest rate[18]; approval of a memorandum for the suspension of loan payments if required from borrowers being affected by the pandemic, at the beginning up to 31 May 2020, and following up to 31 August 2020; easing of operational cost for the use of electronic payment systems in national currency; and the removal of limits on the liquidity being injected into the interbank market. The Albanian Financial Supervisory Authority has undertaken special actions, regarding non-bank financial institutions, to strengthen their financial resilience. Overall, these measures provided the conditions for safeguarding the stability of actions and interest rates in the financial market and mitigate the effects of pandemic shock on borrowers, banks and investors.

The above stated measures by public authorities represent an extraordinary response to an unprecedented hit on the public health and on the economy of Albania. The implemented measures are similar and proportional with those implemented across other countries. They reflect the short-term objective to ease the shock on the Albanian economy, in addition to the long-term one for maintaining the necessary equilibriums in the macroeconomic framework of Albania.

2.3 DEVELOPMENTS BY SECTORS OF THE ECONOMY

2.3.1 FINANCIAL POSITION OF HOUSEHOLDS AND ENTERPRISES[19]

During the period, according to data from banks, the traditional financial position of households, as net creditors, and of enterprises as net debtors, to the financial system expanded. The growth of deposits and loans was positive in both sectors. Deposits grew higher to households, while loan growth was concentrated to enterprises.

The expansion of net financial position, by sectors, is attributable to the growth of deposits in the national currency to households, and of credit in foreign currency to firms.

Banks report an expansion of deposits (mainly in lek), in the households' sector, and of credit stock (mainly in foreign currency), by around ALL 26.1 billion and ALL 3.7 billion, respectively. For enterprises, the growth of credit by around ALL 20.4 billion (mainly in foreign currency) was accompanied by the ALL 5.3 billion growth of deposits (entirely in lek).

As a result, at the end of June 2020, creditor position of households was up at around ALL 829 billion, and debtor position of enterprises expanded at around ALL 177 billion.

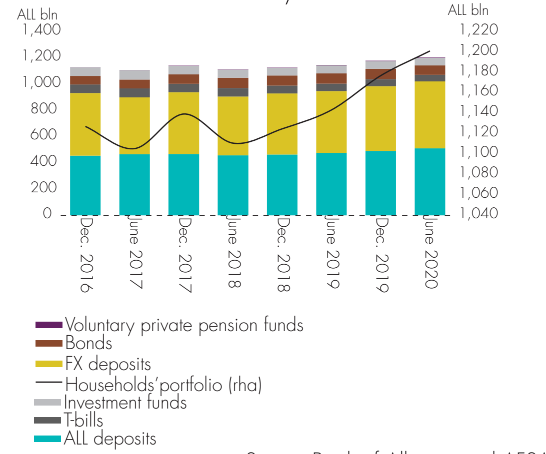
[18] *The cut of the policy rate from 1.0% to 0.5%, in 25 March 2020.*

[19] *The analysis refers to the main developments in the financial position of households and businesses. For more information, please see the respective chapter.*

Chart 7 Sectoral financial position (ALL billion)

Source: Bank of Albania.

Chart 8 Resident households'assets in the financial system



Source Bank of Albania and AFSA.

Note: Values for investment and private pension funds belong to Q1-2020 (the latetst avaiable report).

2.3.2 RESIDENT HOUSEHOLDS

The structure of Albanian households' savings remain concentrated in instruments supplied by the banking system, and less in alternative investment forms supplied by the other operators of the market.

Resident households grew their savings, over the period, at around ALL 24 billion. Growth of deposits, both in lek and foreign currency, continues to provide the main contribution in this regard, notwithstanding the reduction of investments in log-term securities of government and in investment funds. Also, annual developments show that investments in deposits (in all currencies) remain the preferred form of households' savings.

Nevertheless, the performance of net wealth of households should be estimated as a ratio to the debt burden they have. In this regard, the respective regular survey was conducted on a sample of 1210 interviewed households, methodologically selected by the Institute of Statistics. Around 89% of the sample households (1079 households) participated in interviewing process, by fully or partially responding to the questions of the survey. The share of responders to the total sample has remained unchanged compared to the previous survey.

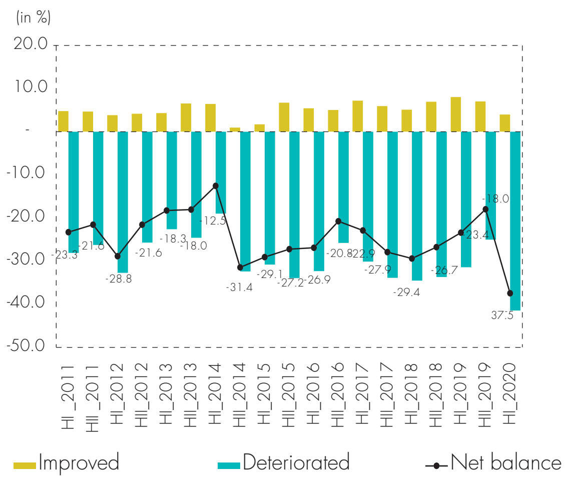
Use of debt from Albanian households remains limited. The borrowing households have decreased their solvency during the period. In the near future, it appears that the demand for loan would be higher from households who have not had a debt previously.

Around 23% of respondent households declare that they have at least one loan to settle, secured through various sources. This share decreased by 1 percentage point compared with the previous period and with the previous year, remaining below the historical average of the survey. Total reported outstanding loans increased compared with two previous surveys.

Regarding the debt burden, around 80% of responding borrowing households declared that the loan instalment has not changed during the period under review. Net balance of responses of the rest of borrowing households (20% of borrowing households) results 1 percentage point, signalling an increase in the value of loan instalment. Around 55% of borrowing households have declared that their solvency "has not changed" during 2020 H1. This share was down by 13 percentage points compared with the previous 6-month period. The rest estimates, in aggregate, a worsening of their solvency, by reflecting an overall deterioration of the economic parameters in Albania due to Covid-19 pandemic.

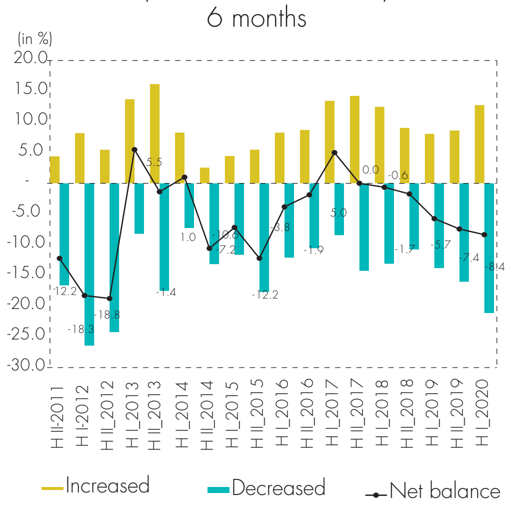
This is also reflected in the pessimistic expectations of households regarding their solvency in the future. Hence, 66% of borrowing households do not expect a change in their solvency (downwards by 9 percentage points compared with the previous survey) in the second half of 2020. The net balance of the rest of responses was – 8.4 percentage points, showing that overall, households expect a worsening of their solvency in the next six months.

Chart 9 Solvency in the previous six months



Source: Bank of Albania.

Chart 10 Expectations on solvency in the next 6 months

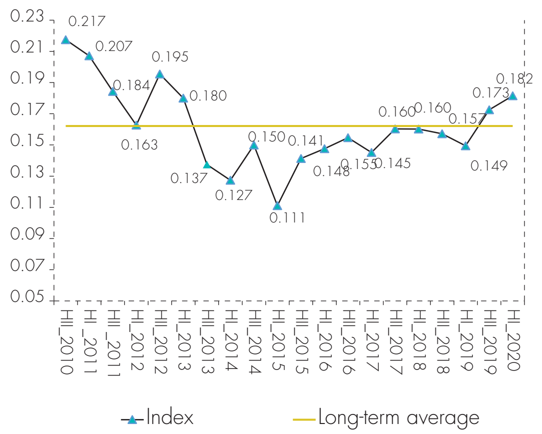


Source: Bank of Albania.

Households' demand for borrowing may be higher, in 2020 H2. Around 58% of households have declared that "they do not expect to take a loan in 2020 H2", but 42% of households declare to consider at different security levels[20] the possibility "to receive/re-take a loan". This share has increased compared with the two previous surveys (by 2 percentage points and 9 percentage points, respectively). As a result, the possibility index to take/retake a loan has resulted 0.182, upward compared with the two previous surveys and exceeds its long-term average.

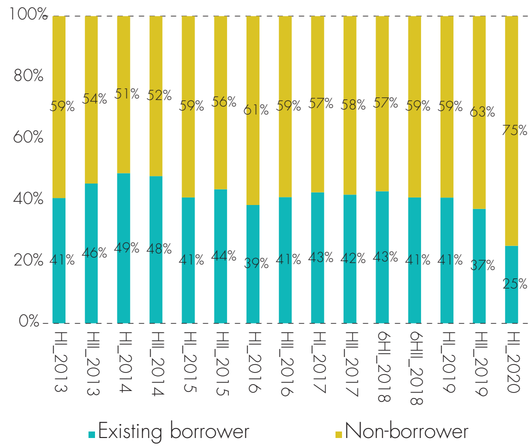
[20] *The alternatives provided are: "little possibility", "a lot of possibilities" and "certain".*

Chart 11 New borrowing planning/rollover index



Source: Bank of Albania.

Chart 12 Households planning to take a loan in the next six months



Source: Bank of Albania.

In the group of households planning to take a new loan, 75% of them are "new borrowers", that is, they do not have a debt to pay at the investment moment. This share increased by 12 percentage points in half-yearly terms and by 16 percentage points in annual terms.

2.3.3 BUSINESSES/ENTERPRISES

Enterprises' debt burden is estimated upward in terms of capital and income.

The rather optimistic expectations for a new short-term borrowing represent a positive development.

The regular survey conducted with the help of the Institute of Statistics is used to estimate the financial situation, the debt use and burden to enterprises. This survey was conducted on a sample of around 1374 enterprises of various sizes, geographically located in various regions of the country and operating in the main sectors of the economy. Around 82% of total enterprises participated in the survey by fully or partially responding to the questions of the survey.

The surveyed enterprises report that their financial situation was strongly affected by pandemic, throughout the period. As a result, sales and financial result show a considerable drop in 2020 H1 across all sizes of enterprises, more notably for small and medium-sized enterprises. All three groups of enterprises indicate a contraction of their activity, without being able to increase investments to expand it. Despite the deteriorated performance of these indicators, the expectations of all enterprises are positive in terms of sales and financial result for 2020 H2, even more optimistic than in the previous survey. Regarding the expansion of their activity, enterprises also express positive expectations, but medium-sized and large enterprises are less optimistic compared to the previous six-months.

During the period, around 40% of total responding enterprises declare that they have financed their activity through sales. The major part of responding enterprises, in this survey, have reported declined sales; hence the reliance on this source alone has fallen considerably for all three groups of enterprises.

Meanwhile, the propensity to combine several sources of funding has a considerable and expanded share during the period for all the three groups of enterprises. For more than half of enterprises of all sizes, financing is realised through the combination of sales and held reserves.

Survey responses show that the enterprises' debt burden is assessed upward during the period, more pronounced for small and medium-sized enterprises. The total value of loan is about half the value of the enterprise's capital for 80% of borrowing enterprises and equal of higher than the value of capital for 20% of them. The loan/equity ratio resulted higher for large enterprises, with 22% of them declaring that this ratio is equal or exceeds the value of equity, implying a higher debt burden. By sectors, debt burden is more pronounced in enterprises of the services and trade sectors.

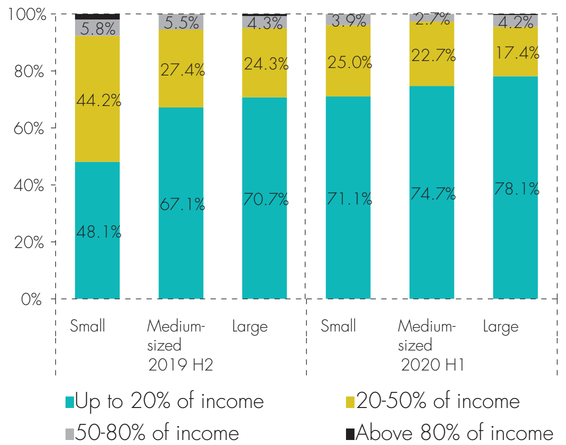
Table 3 Share of enterprises whose debt value is equal or higher than equity, by sector

	Industry	Services	Construction	Trade
2018 H2	20.7%	14.9%	15.0%	29.6%
2019 H1).	26.8%	18.5%	18.3%	28.8%
2019 H2	20.4%	28.0%	13.4%	26.5%
2020 H1	16.4%	22.9%	19.7%	22.2%

Source: Bank of Albania,

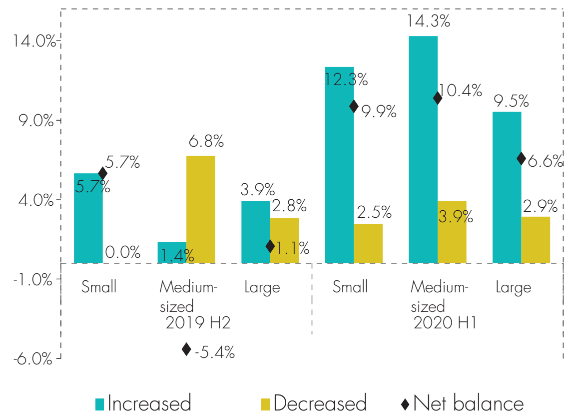
Most of the borrowing enterprises (76%) state that the loan payment amounts goes up to 20% of the enterprise's income. This share has increased by 9 percentage points compared with the previous survey. The burden of loan payments is heavier for small enterprises. Among them, the number of enterprises reporting that this payment exceeds 20% of revenues accounts for 29% of the total of the group[21]. For medium-sized and large enterprises, this share is 25% and 22%, respectively. Asked if the debt repayment has changed during the period, most enterprises (around 85% of small enterprises, 82% of medium-sized enterprises and 93% of large ones) state that this repayment has not changed.

Chart 13 Enterprises by size and debt instalment/income ratio



Source: Bank of Albania.

Chart 14 Enterprises that declare a change in the debt instalment during the period



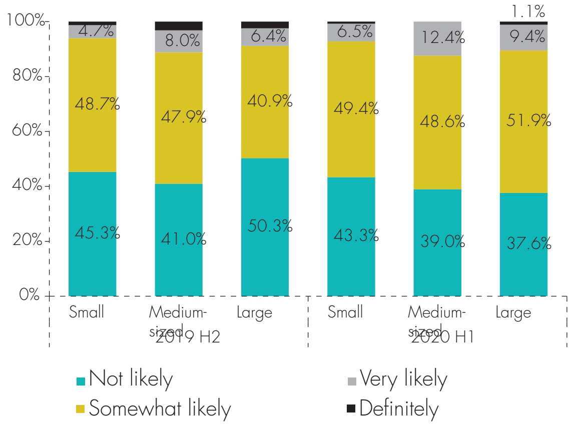
Source: Bank of Albania.

[21] *Calculated as the sum of weight for responses: "20-50% of total income","50-80% of total income" and "higher than 80% of total income:*

The responses of the rest resulted in net positive balances for all sizes of enterprises, showing an increase of this expenditure as a ratio to income.

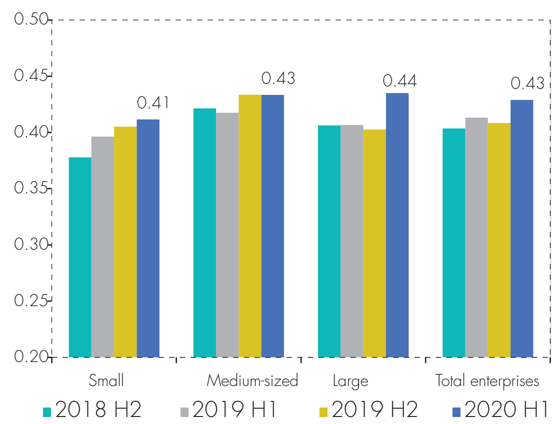
With regard to the borrowing planning for the next six months, based on the responses of enterprises, credit demand gives good signals of recovery. Around 39% of responding enterprises declare that there is no possibility to demand a loan during the next period, but compared to the previous period, this share has declined for all sizes of enterprises. This contraction has been more significant for large enterprises. Furthermore, it is observed an increase of the share of enterprises that claim that there is "little possibility" to take a loan in 2020 H2, as well as the share of enterprises that declare that there is a high possibility for this to happen in the next period. On the other hand, all groups of enterprises registered a decline of the alternative "it is certain", expressing the uncertainty of the situation in planning a loan.

Chart 15 Enterprises planning to borrow in the next six months



Source: Bank of Albania.

Chart16 Bank borrowing planning index in the next six months



Source: Bank of Albania.

Overall, the borrowing planning index for the short-term future, increased for all enterprises, with large enterprises providing the highest contribution in this regard, followed by small enterprises.

3. MARKETS AND PAYMENT SYSTEMS

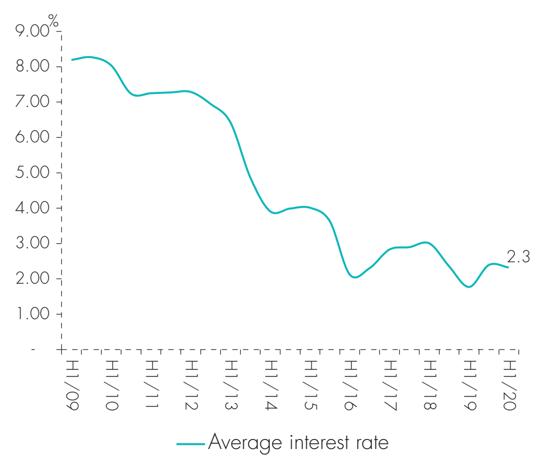
3.1 MARKETS

PRIMARY MARKET OF SECURITIES

In the primary market of securities, the securities of the Albanian government debt are dominant. In this market, the issue of these securities to residents grew by ALL 75 billion, standing at ALL 206 billion, during the period. Out of which, around ALL 12.6 billion were issued in euro, while the rest in lek. During the period, the average yield on the domestic debt remained almost unchanged, at 2.3%. Nevertheless, this yield was 0.6 percentage point higher compared with the same period in the previous year[22]. The issue of government debt securities in lek was up to ALL 193 billion, 48% higher compared with the previous half of year. Compared with the issue in the previous year, the growth was around ALL 20 billion or 12% higher. The share of short-term debt to total domestic debt in lek - downwards during the last two years - increased to 71% during the first half of year.

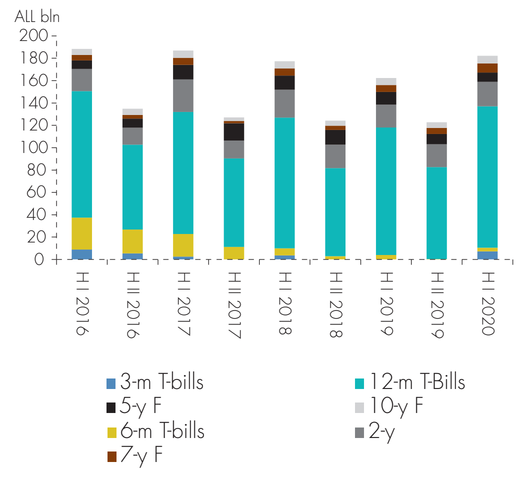
The issue of government debt securities increased considerably during the period, but the yield remained almost unchanged. The increase in the issues of debt in lek is accompanied with the growth in the share of short-term securities.

Chart 17 Average yield on debt securities, in %



Source: Bank of Albania.

Chart 18 Composition of issued debt during 2016-2020 H1



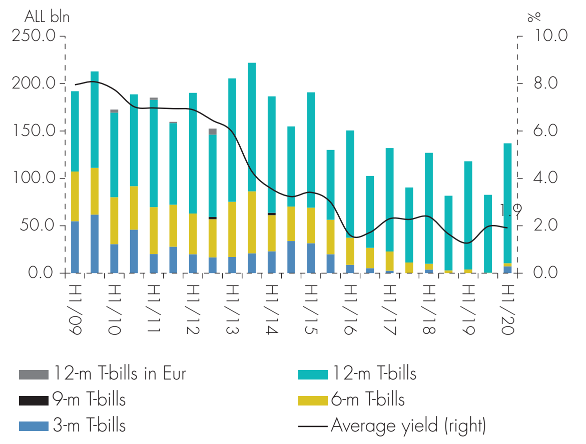
Source: Bank of Albania.

The issuance of government debt securities in lek, in the form of Treasury bills amounted to ALL 137 billion. Long-term debt securities amounted to ALL 56 billion.

[22] *In 2019 H1, the yield dropped to the historical minimum average level, of 1.8%.*

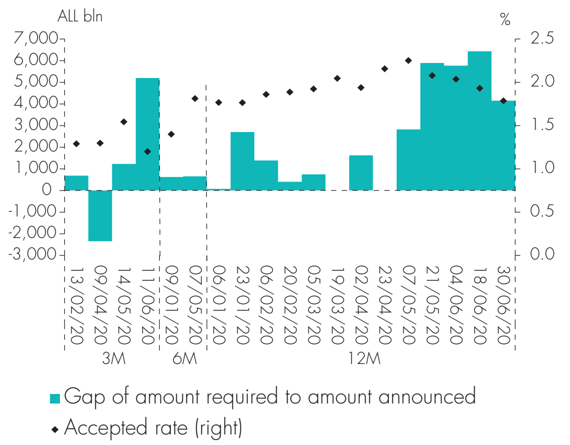
During the period, the issuance of Treasury bills was 66% higher than in 2019 H2 and 12% higher compared with the same period in the previous year. Around 92% of these issuances of T-bills were 12-m maturity, and 5% of 3-month maturity (this maturity was missing in the market for about two years). The average yield on 3-; 6-; 12- month T-bills were 1.4%, 1.6% and 1.95%, respectively. The average yield on short-term issuances was around 1.92%, down by 0.05 percentage point from the previous period. In annual terms, the average yield on short-term securities increased by 0.6 percentage point. Overall, the bid for investment in short-term securities has been equal or higher than the government's demand for borrowing.

Chart19 Volume and weighted average yield on bonds in the primary market



Source: Bank of Albania.

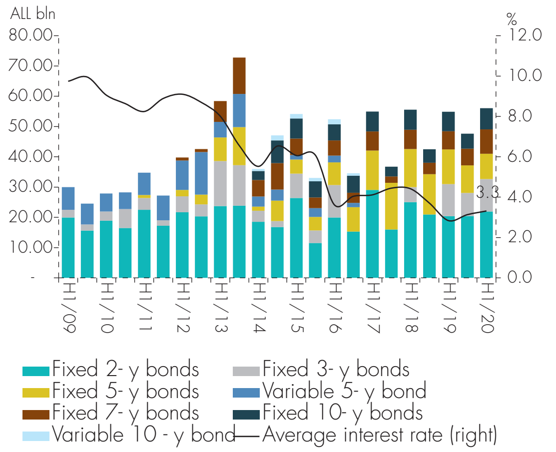
Chart 20 Surplus on the amount announced for investment and treasury bills yields, for 2020 H1



Source: Bank of Albania.

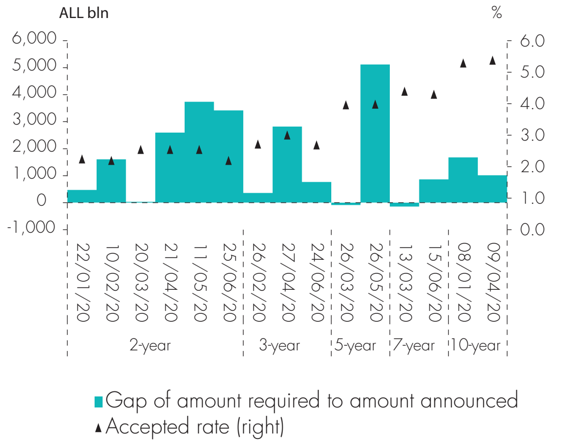
During the period, the issuances in long-term securities were 18% higher compared with 2019 H2, and 2% higher compared with the same period in the previous year. Around 60% of these issuances is composed by 2 to 3-year maturity term, and were upwards during the period, while issuances of 5-year maturity were lower. During the period, the average yield on long-term securities increased to 3.3%, from 3.1% in 2019 H2, and 2.8% in the previous year. The yields on 2-, 7- and 10-year bonds slightly fell, from 0.02 to 0.07 percentage point. The average yields on 3- and 5-year securities increased by 0.2 percentage point and 0.6 percentage point, respectively, from 2019 H2. Overall, the bid for investment in long-term securities has almost been always higher than the government's demand for borrowing. This was more pronounced for 2-year bonds.

Chart 21 Volume and weighted average yield on bonds in the primary market



Source: Bank of Albania.

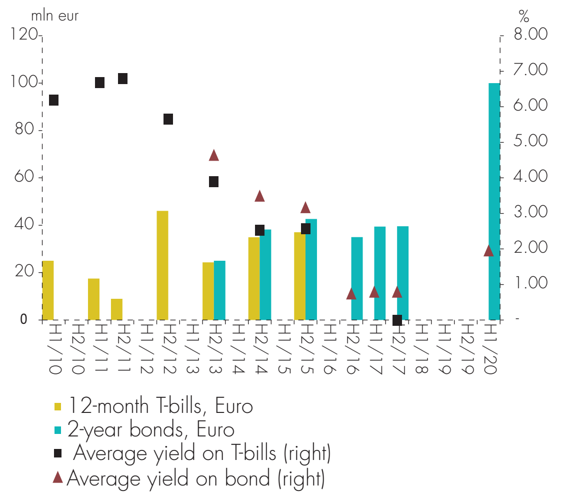
Chart 22 Investment announced amount surplus and bonds interest rates, for 2020 H1



Source: Bank of Albania.

At the beginning of the year, the government reissued in the domestic market the medium-term debt in euro in the form of 2-year bonds. The debt in euro, issued in April 2020, amounted EUR 100 million and the average yield was around 1.96%. This was the only issue in euro for more than 2 years and represents around 6% of the domestic debt issued during the period. Notwithstanding the high demand of Government for borrowing in euro, the investment bid in this security exceeded the announced amount by around 37%.

Chart 23 Domestic borrowing in euro



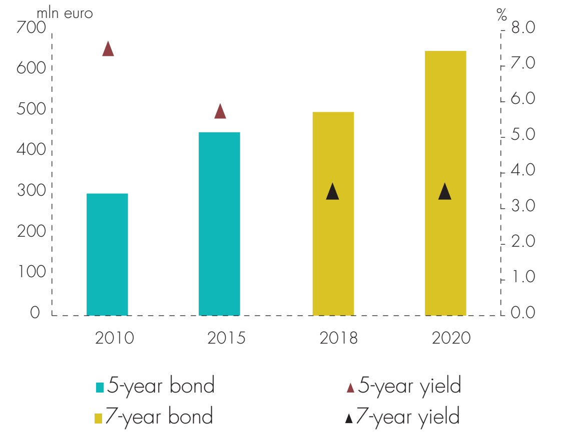
Source: Bank of Albania.

BORROWING IN INTERNATIONAL CAPITAL MARKET

International capital markets function at global level, beyond the geographical borders. Access to these markets, improves (diversifies) debt structure regarding the characteristics of its holders and currency, and may drive to the reduction of its average cost. On the other hand, the issuance in international markets increases transparency in debt price and serves as a disciplinary mechanism to debt issuers, both public and private ones.

In June 2020, the Albanian Government was introduced in the international capital market through the issuance of a new 7-year bond, amounting EUR 650 million and coupon rate 3.5%. Notwithstanding the challenging conditions of market to emerging economies during the first half of year, investors' bid was

Chart 24 Issuances of the Albanian government in the international capital market, by year



Source: Ministry of Finance and Economy.

sometimes higher than the Albanian Government's demand. The main purpose of this issuance is to cover the budget need for financing, including the recovery of economy after the earthquake of November 2019 and SARS-CoV-2 pandemic. This is not the only case of introduction to international capital markets. The previous issuances in this market have been realised in 2010, 2015 and 2018. Despite the issuance of this year has a higher amount compared with the previous issuances, its interest rate is equal with that of the issuance of year 2018 ant at the lowest level recorded so far.

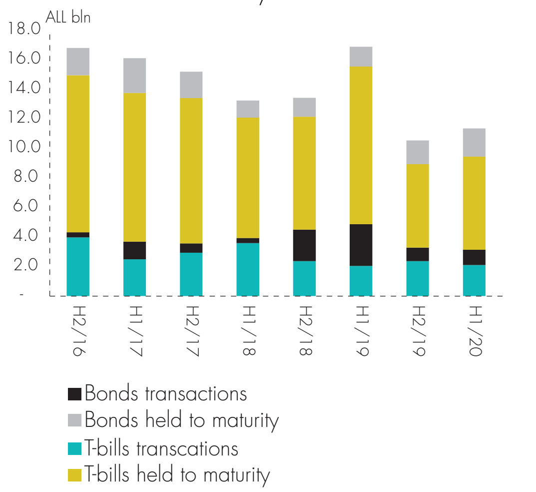
SECONDARY MARKET FOR DEBT SECURITIES

The activity in the secondary market of government's debt securities registered decline both in value and number of transactions.

The yield curve in the market has a normal slope, but investors continue to show a preference for keeping securities until maturity.

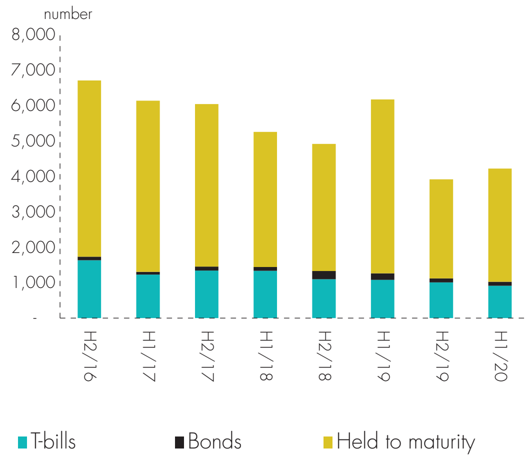
During the period, the activity in the secondary market of government's debt securities registered decline both in value and number of transactions. The volume of both short-term and long-term securities transactions carried out in the retail secondary market was around ALL 3.1 billion, or 4% less than in the previous six-months and 36% les compared with the previous year. The number of transactions was 1.027 or 8% lower compared to the previous six-months. The main impact to this trend came from the decline in volume and numbers of short-term securities by 11% and 9%, respectively. Long-term securities traded during the period registered an increase of 13% in the traded volume, but the number of transactions decreased by 3%.

Chart 25 Volume of securities transactions in secondary market



Source: Albanian Financial Supervisory Authority.

Chart 26 Number of securities transactions in secondary market



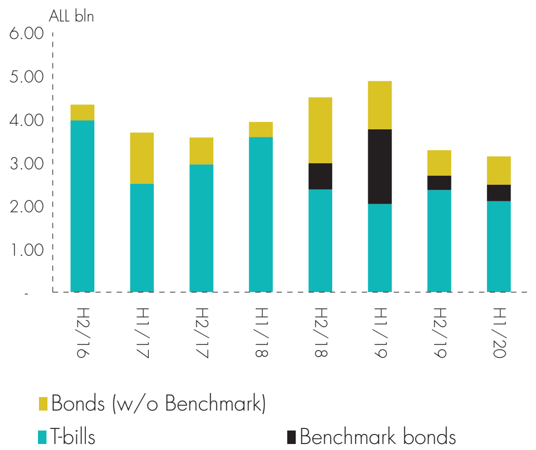
Source: Albanian Financial Supervisory Authority.

T-bills transactions, accounting for around 89% of the traded volume, are dominant in the retail securities market. Compared with the same period in the previous year, the number and volume of transactions of traded securities decline by 19% and 36%, respectively. Investors in the retail secondary market continue to show a preference to keep securities until maturity (only around 26% of them are traded).

Market makers have continued the daily quotations of benchmark securities (reference bonds with 3 and 5-years maturity). Although the number of their transactions declined by 11% compared with the previous six-months, the traded volume increased by 15%.

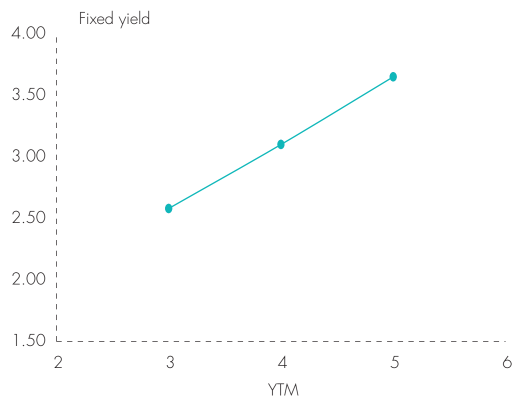
The daily quotation of benchmark securities allows the calculation of the yield curve, which serves as a reference of other debt securities in the market and increased the transparency by giving information in real time on the price of securities. Compared with the previous periods, the yield curve however maintains a normal slope, where interest rates have increased for all longer maturities and periods of investments.

Chart 27 Volume of transactions in the secondary market by trading securities



Source: Albanian Financial Supervisory Authority.

Chart 28 Yield to Maturity (YTM) on 30.06.2020



Source: Bank of Albania.

INTERBANK MARKET

Activity in the interbank market increased and interest rates fluctuated close to the policy rate.

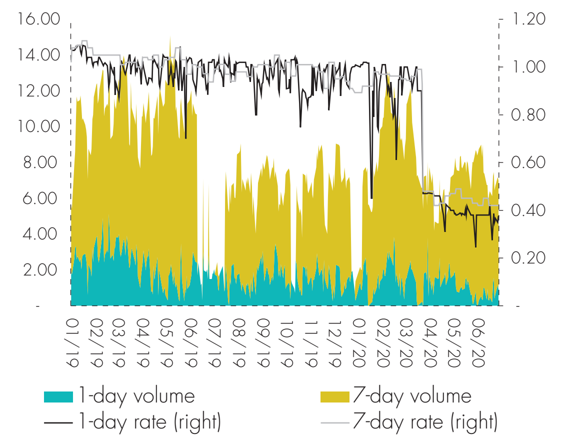
During the period, the volume of transactions in the interbank market increased, while interest rates fluctuated around the Bank of Albania's policy rate. The interbank market continues to be dominated by 7-days transactions (83% of the volume of interbank borrowing) followed by 1-day transactions (16%). Compared with the previous six-months, the volume of transactions increased by around 40% in the 7-days transactions. On the other hand, 1-day and 1-month transactions declined compared with the previous period. Banks continued to conduct transactions with 2-days or 3-days maturity, but with smaller volumes compared with the other types. Interest rates remained close to the level of the policy rate following its decrease from 1% to 0.5% in March 2020.

In the foreign exchange market, lek felt the shock of the pandemic by depreciating against main currencies. However, the high volatility turned out to be short-term.

FOREIGN EXCHANGE MARKET

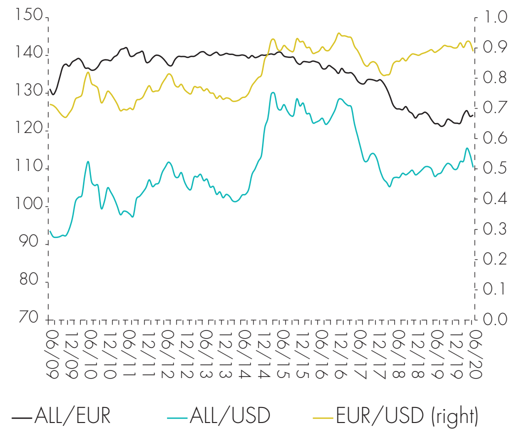
At the end of 2020 H1, the euro and the US dollar appreciated against lek compared with six-months and a year ago. Specifically, the euro by 1.7% and 1.8%, respectively, and the US dollar by 0.4% and 2.2%.

Chart 29 Interest rates in interbank market



Source: Bank of Albania.

Chart 30 Exchange rate in the domestic foreign exchange market



Source: Bank of Albania.

At the beginning of 2020, the value of lek was stable against foreign currencies. After the spread of the SARS-CoV-2 pandemic and the restrictive measures to mitigate it, in March the euro and the US dollar appreciated significantly where the euro exchanged for ALL 125.4 and the US dollar for ALL 115.4, respectively on average. However, the intervention of the Bank of Albania and the adjustment of market operators drove that volatility to be short-term and the exchange rate stability restored. At the end of the period the euro was exchanged on average for ALL 124.2 and the US dollar for ALL 110.4.

Housing price index increased slightly and the indicators for bank lending for construction and real estate support this. Despite that, qualitative indicators - from the real estate survey and the bank lending survey - report tightened lending standards, weaker demand for this type of credit and, overall, a pessimist point of view of the agents for the period and short-term future.

REAL ESTATE MARKET

The indicators used to monitor the performance of the real estate market give mixed signal regarding supply and demand in this market during the period. On the demand side, qualitative indicators reflect the tightened conditions of banks on loans for real estate and declining conditions from households for financing housing purchases. On the other hand, outstanding credit for real estate registered an increase and real estate trading agents report a decline in the number of unsold proprieties and an increase of selling prices. Regarding supply in this market, lending for construction registered an increase compared with the end of 2019 and the previous year.

Banking sector data indicate an upward trend of outstanding credit for real estate and an improvement of its quality during the period and compared with the previous year, Lending stock for real estate purchase by households registered around ALL 112 billion for 2020 H1 and was around 3% higher compared with the end of 2019. The performance of this credit is also favoured by low and stable interest rates for this category. The non-performing loans ratio for this type of credit dropped at 4.4%, from around 5% the previous year. The outstanding credit for construction registered an increase compared with the end of 2019 and the previous year. The share of credit for construction is 14% of outstanding credit to enterprises, remaining almost at the same level as in the last two years.

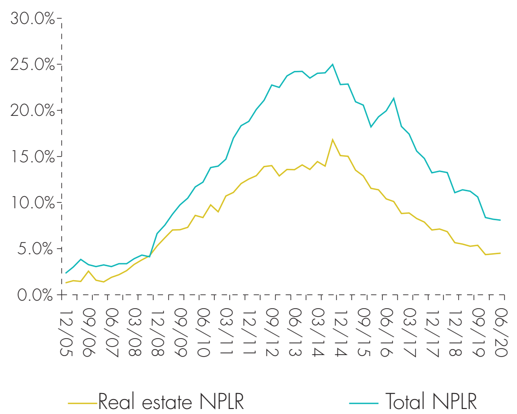
At the end of the period, the stock of loans collateralized with real estate registered an increase supported at the same level by loans collateralized in domestic and foreign currencies. Within this share, 62% of the stock is held by the households sector and the rest by the enterprises sector.

The results of the survey on the performance of the real estate market show that for the period, real estate trading agents have reported higher selling prices compared with the previous six-months. House prices, calculated according to the Fischer House Price Index for the performed sales during the period, were up by 4.9% compared to the previous six-months and by 40% compared with the base period (2013). The Fischer House Price Index for Tirana, which includes the centre, suburbs and extra urban areas, increased by 6.5% compared to the previous period and 43.4% compared to the base period.

Chart 31 Fischer Index - National level, and Tirana

Source: Bank of Albania.

Chart 32 Credit quality for real estate purchase



Source: Bank of Albania.

As expected in this period, the agents were relatively pessimistic about the developments in the real estate market, assessing the situation in this market as deteriorating. Agents remain pessimistic for the next period as well, but are significantly more optimistic about the future of this market in longer terms.

BOX 1 SUMMARY OF RESULTS FROM "REAL ESTATE MARKET" SURVEY AND THE PERFORMANCE HOUSE PRICE INDEX FOR 2020 H1

The data on the performance of prices and the assessment of the situation by real estate market agents is collected through the field survey of a sample composed by 230 entities whose main activity is the trading of real estate. The selected entities are real estate agents and construction companies whose sales represent 75%- 80% of the turnover of the entire population. The Institute of Statistics conducts the interviewing on-site, the main processes of and the physical check of the completed questionnaires.

General assessment. The assessment of agents on the overall market situation was reported to have deteriorated significantly compared to the previous period, reflecting the uncertainty of the market given the situation created by the SARS-CoV-2 pandemic. In response to the question - "How do you assess the market situation compared with the previous period (six-months)?" - the net balance of responses resulted negative [-54]%, and only 6% of agents responded positively (better), whereas around 1/3 of responses were neutral - "no change". This value of the balances registers a break with the trend of the last years, continuously narrowing, and the long-term average of around [-19.6]%. The same indicator assessed only for entities that have reported sales during the period, resulted slightly less negative, at [-44]%, also with a contrary (more pessimist) trend from the last years.

Performance of prices and sales. At the end of period, Fischer House Prices Index, on a national level, was up by 40% compared to the base period (year 2013), and by 4.9% compared with the previous six-months. Sales volumes have declined slightly on a national level, but they have increased in central and outside areas of Tirana. The Price Index for Tirana increased by 43.4% from the base period, and 6.5% from the previous period. Average prices in Tirana are reported to have increased significantly in the areas outside the city (with over 50%), but with a slight decline in central and suburbs areas. Coastal areas reported average prices by around 15% lower, while other areas show almost negligible changes.*

Number of listed properties. Agents report a lower number of new properties registered in their books. The net balance of those reporting increase in the number of listed properties and those reporting decline in their number was around [-9.3]%, down from the previous period. The number of unsold properties, both for residential and commercial buildings continued to be down for several consecutive six-month periods.

Average sale period. The average time of sale for properties, at the national level, is reported average 10.3 months, and registered a slight increase compared to the previous six-months. For Tirana, the interviewed entities reported an average sale period of 10.4 months, or 1.2 months longer compared with the previous six-months. For the coastal and other areas, the reported sale periods were 10.7 and 11.4 months, respectively, slightly increasing compared with the previous period.

Financing through bank credit. According to agents, around 60%, of both residential and commercial properties sold by them were purchased with a bank loan. This figure is down compared with 65% in the previous period.

Expectations for the future. Unlike the other periods, agents have negative expectations about the market performance in the territory they operate for the short-term future, but they are optimistic for a longer-term period (up to two years). The expected new listing for sale in the forthcoming period are assessed as downward (net balance stood at [-9.2] %). Agents do not expect significant changes in the prices of real estate for residential buildings, whereas the net balance for commercial buildings was positive (15.8%), reflecting their optimism.

Rent price. The interviewed entities report increased rental prices for the period. It should be emphasised that these responses are concentrated in Tirana.

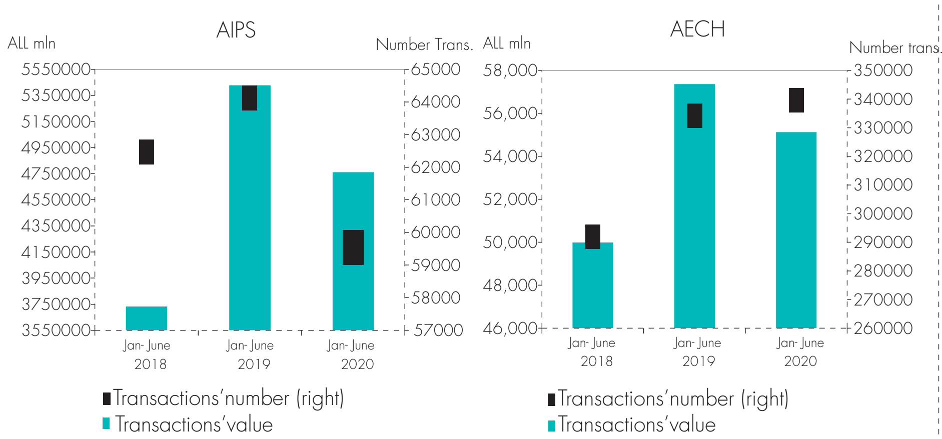
* *"Other areas" include all the areas, except for Tirana and the coastal area.*

3.2 PAYMENT SYSTEMS

During the period, the core infrastructure for the clearing and settlement of payments in the domestic currency continued to operate effectively and securely, thus supporting the financial stability and the implementation of monetary policy. In terms of processing activity, in AIPS, 59.543 payments accounting for ALL 4.762 billion were processed during the period. The number and value of transactions declined by 7.1% and 12.2%, respectively, compared with the same period in the previous year. In parallel, in the small-value payment system, AECH, during the 339.580 payments were cleared, with an average value per transaction of around ALL 162.000. Compared with 2019 H1, the activity of the AECH increased in number by 1.59%, but declined in value by 3.9%.

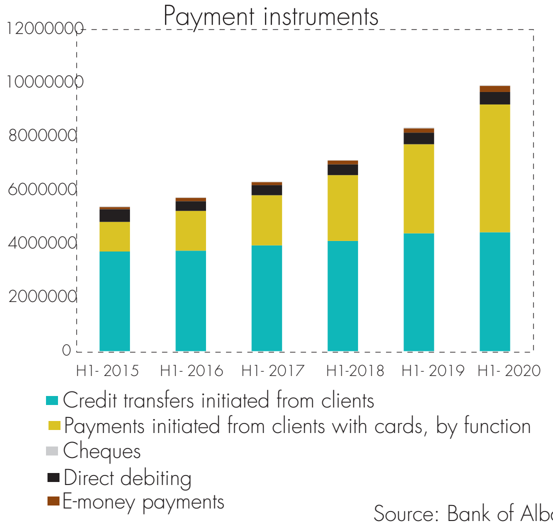
The core infrastructure for the clearing and settlement of payments in the domestic currency continued to operate effectively and securely.

Chart 33 Performance of AIPS and AECH in 2018 H1 - 2020 H1



Source: Bank of Albania.

Chart 34 Performance of payment instruments in number (2015 H1 - 2020 H1)



Source: Bank of Albania.

Regarding payment instruments, in 2020 H1, around 9.9 million transactions were conducted, totalling ALL 1.941 billion. The number of transactions increased by 19% while their value decreased by 9.4% compared with the previous year. In 2020 H1, payments with cards, for the first time, have the main share as number of transactions (48.1%), while credit transfer continue to dominate payment instruments as value of transactions (by 94.7%). The share of credit transfers as payment instruments declined driven by the decrease in number and value of these instruments in paper form. On the other hand, there is an increase of number and value of in non-paper credit transfers (internet banking, mobile banking), as well as a significant increase of the number and value of card transactions (by 43.7% in number and 63.2% in value, respectively) compared with the same period in the previous year.

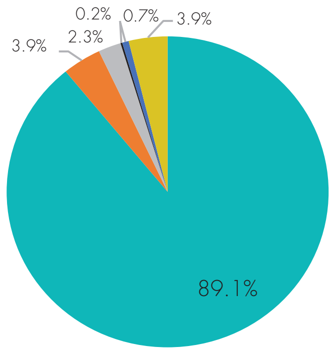
4. FINANCIAL SYSTEM

The share of total assets of the financial system[23] to Gross Domestic Product (GDP) increased at 111.6%, from 107.2% at end of the year, and 104.4% in the previous year. The activity of the banking sector, non-bank financial institutions and insurance companies supported the increase of financial system's assets, while the fund industry did not registered significant changes.

The share of assets of the financial system to GDP has increased. The main contributor to this performance was the banking sector, NBFI-s and insurance companies. The performance indicators of the financial system in terms of capitalisation, profitability, liquidity and assets quality, remain at good levels.

At the end of the period, the share of the banking sector increased at 99.4% from 95.5%, while the share of non-banking sector increased at 12.2% of GDP from 11.7% in December 2019. The performance indicators of the financial system, including capitalisation, profitability, liquidity and assets quality, remain at good levels.

Chart 35 Share of financial system segments to total assets of the financial system, June 2020



Source: Bank of Albania, Albanian Financial Supervisory Authority.

Table 4 Share of the financial system segments to GDP over the years (in %)

Licencing and Supervising Authority	Financial system	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Bank of Albania	Banking sector	88.1	92.1	94.8	97.6	97.3	100.5	99.4	96.0	95.5	99.4
	NBFIs	2.7	2.7	2.7	3.0	2.9	3.0	3.1	3.5	4.2	4.4
	SLAs and their unions	0.8	0.8	0.7	0.8	0.8	0.6	0.6	0.6	0.7	0.7
Financial Supervisory Authority	Insurance companies	1.5	1.6	1.7	1.9	2.1	2.1	2.1	2.1	2.2	2.6
	Pension Funds	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.2	0.2	0.2
	Investment Funds		1.2	3.9	4.8	5.0	4.7	5.0	4.5	4.3	4.4
Financial Intermediation		93.1	98.6	103.8	108.2	108.0	111.0	110.3	106.9	107.2	111.6

Source: Bank of Albania, Albanian Financial Supervisory Authority.

[23] *The financial system is composed by the banking sector and the non-banking sector (non-bank financial institutions, savings and loan associations, insurance companies, pension funds and investment funds). The database on the non-banking sector and the data on GDP are of 2020 Q1.*

4.1 BANKING SECTOR

4.1.1 MAIN DEVELOPMENTS IN THE BANKING SECTOR

The banking sector exercised its functions and expanded its activity, despite the impact of the pandemic. Deposits and own funds remain the main sources of financing the banking sector activity. The statistical effect of the exchange rate resulted in different directions during 2020 Q1 and Q2. The decline in placements with non-residents has reduced the value of the net credit position of the banking sector to them.

The banking sector reported an expansion of assets by around 4% during the period, and around 7% compared with the previous a year. Despite the difficult situation created by the pandemic in Albania, the sector has continued to supporting the financing to the economy.

The reported value of assets increased by around ALL 50 billion during the period, reaching around ALL 1.530 billion. The main contribution in assets' growth came from the expansion of investments in securities by around ALL 80 billion and lending activity by around ALL 12 billion. Banking sector placements with banks and other financial institutions declined. Also, the increase of provisioning funds for credit risk provided a negative contribution in the performance of assets by around ALL 3 billion during the period.

Table 5 Structure of banks' balance sheets and annual change, June 2020

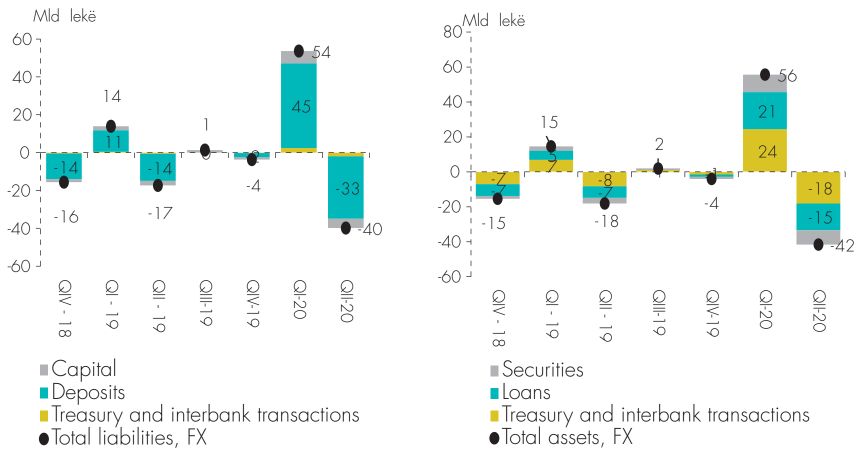
Asset	% of assets	Annual change, %	Liability	% of liability	Annual change, %
I. Treasury and interbank transactions	28.2	-8.0	I. Treasury and interbank transactions	6.3	16.3
II. Customer transactions (credit)	38.3	4.8	II. Customer transactions (deposits)	80.2	7.4
- Of which: public sector	1.5	-16.8	- Of which: public sector	2.1	22.7
- Of which: private sector	36.8	6.3	- Of which: private sector	78.1	7.0
III Securities transactions	31.7	32.3	III Securities transactions	0.2	-67.2
IV. Created Reserve funds	-2.1	-19.9	IV. Other liabilities	1.1	24.9
V. Other*	3.9	-15.4	V. Permanent sources	11.8	5.2
			Of which: Subordinated debt	0.9	-9.2
			Of which: Shareholders' equity	10.3	6.0
Total assets	100	7.4	Total liabilities	100	7.4

Source: Bank of Albania.

**"Other" in the balance sheet refers to " Other assets", "Fixed assets" and "Accrued interests"*

The statistical effect of the exchange rate on the equivalent value in lek of the key items of foreign currency balance was positive (for around ALL 56 billion) during 2020 Q1, and negative (for around ALL 42 billion) during 2020 Q2, due to the depreciation and appreciation of the domestic currency in each quarter. On the assets side, the impact of the exchange rate has been stronger on treasury, interbank and customer (credit) transactions, whereas on the liabilities side, almost the entire statistical effect of the exchange rate is reflected on the equivalent value in lek of deposits in foreign currency. At the end of the period, assets and liabilities in foreign currency of the banking sector accounted for 52% and 50% of total balance sheet, respectively, and these ratios registered a decline compared with the previous periods.

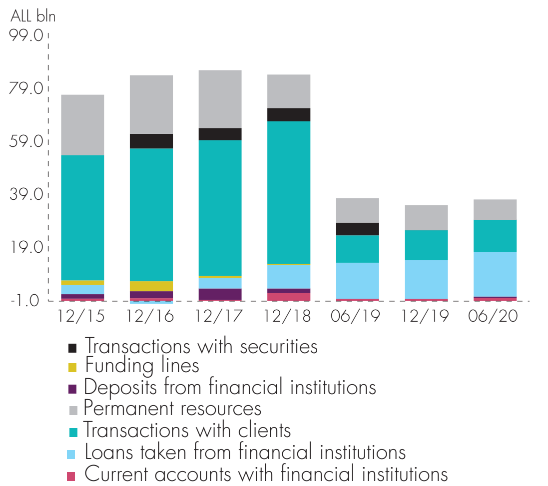
Chart 36 Exchange rate effect in lek equivalent on key items of assets (left) and liabilities (right)



Source: Bank of Albania.

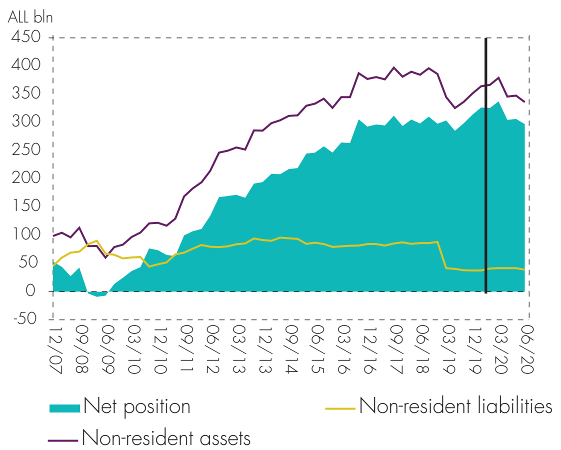
Deposits and own funds continued to be the main funding sources of the banking sector's activity, accounting for 92% of total liabilities. This structure has been stable throughout the period. Reliance on external funding sources remains at a low level. These sources are mainly in the form of loans taken by financial institutions and non-resident entities. On the other hand, assets placed with non-resident entities registered a significant decline during the period, due to the contraction of placements in the form of deposits with banks and financial and credit institutions. At the end of the period, claims to non-residents accounted for 22% of total assets, while liabilities to non-residents accounted for less than 3% of total balance sheet. Net creditor position contracted in both absolute and relative terms, reaching around 19.4% of total balance sheet, from 21.3% in the previous period.

Chart 37 Structure of non-resident liabilities



Source: Bank of Albania.

Chart 38 Net position with non-residents



Source: Bank of Albania.
*The vertical black line (right) reflects the period of transformation of the NCB branch in subsidiary.

4.1.1.1 Capitalisation of activity

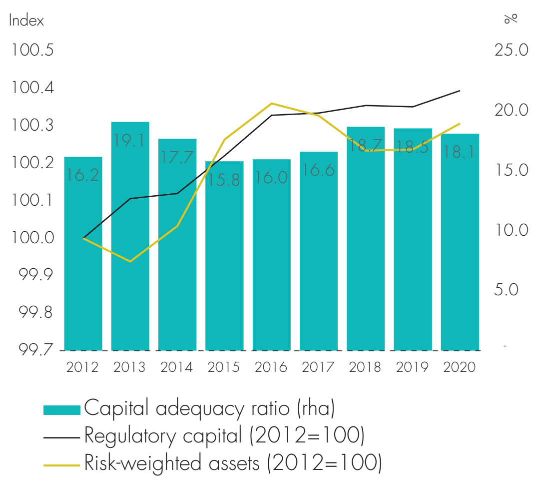
During the period, the Capital Adequacy Ratio of the banking sector decreased, affected mainly by the increase of assets weighted with risk coefficients. But all banks respected the regulatory requirements for capital levels.

Systemically important banks and those with European capital show higher indicators of activity capitalisation.

The banking sector appears well-capitalised and none bank of the sector results with an adequacy ratio below the regulatory minimum 12%. At end-2020 H1, the Capital Adequacy Ratio stood at 18.1%, from 18.5% in December 2019 and in June 2019. Banks with European capital and systemically important banks show the highest level of Capital Adequacy Ratio. Banks with Albanian capital have the lowest level of Capital Adequacy Ratio, but this ratio has increased steadily during the last years. The high level of capitalisation of the banking sector is reflected in the allocation of Capital Adequacy Ratio by relevant intervals. Currently, 10 out of 12 banks have a Capital Adequacy Ratio over 15% and no bank of the banking sector is classified in the 12-14% interval.

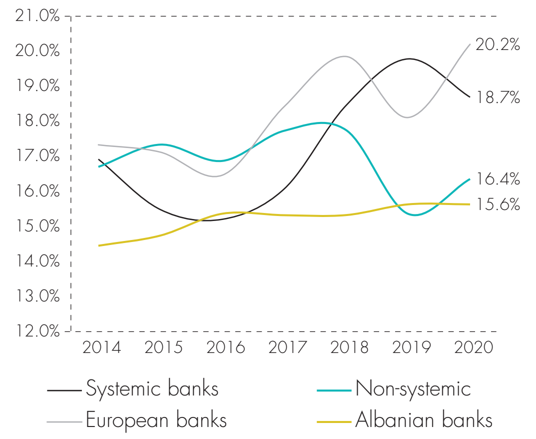
At the beginning of April, the Supervisory Council of the Bank of Albania decided[24] to suspend until the end of June 2020 the distribution of profit (in the form of dividends) by banks. As "profit", the Decision defines the profit retained from the previous periods, the profit realised in 2019 and the profit of 2020 H1. This measure adopted by of the Bank of Albania was intended to provide support for banks' capital, by strengthening their ability to absorb potential losses, and continue lending the economy during this period.

Chart 39 Capital Adequacy Ratio



Source: Bank of Albania.

Chart 40 Capital Adequacy Ratio of groups by importance and origin of capital



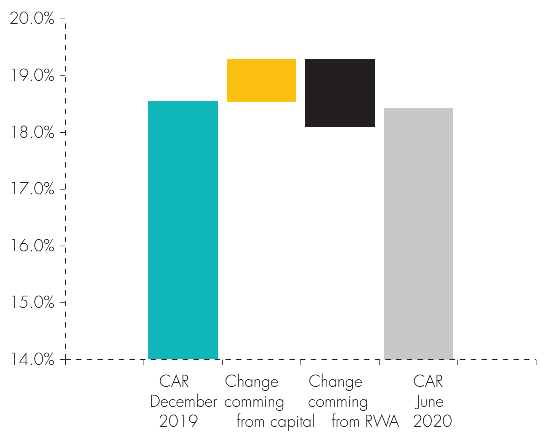
Source: Bank of Albania.

The negative impact of the increase of risk-weighted assets is higher compared with the positive impact of the increase of regulatory capital, in the performance of Capital Adequacy Ratio. During the period, the regulatory capital increased at ALL 152 billion, by providing a positive impact of 0.8 percentage point to the Capital Adequacy Ratio. Its performance was supported mainly by the increase

[24] *Circulatory Decision of the Supervisory Council No 24, dated 8.4.2020 "On the suspension of distribution of profit by banks#, Official Bulletin, Volume 22 Number 3, April 2020.*

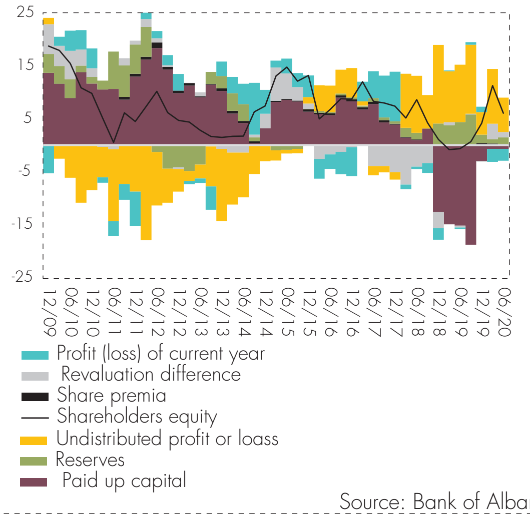
of reserves and the retained profit. On the other hand, risk-weighted assets reached around ALL 839 billion, up by ALL 54 billion from the level registered in December 2019. The increase in this indicator provided a negative impact of 1.2 percentage points to the Capital Adequacy Ratio.

Chart 41 Contribution of capital adequacy items (in p.p.)



Source: Bank of Albania.

Chart 42 Annual contribution in capital increase by component instruments (in p.p.)

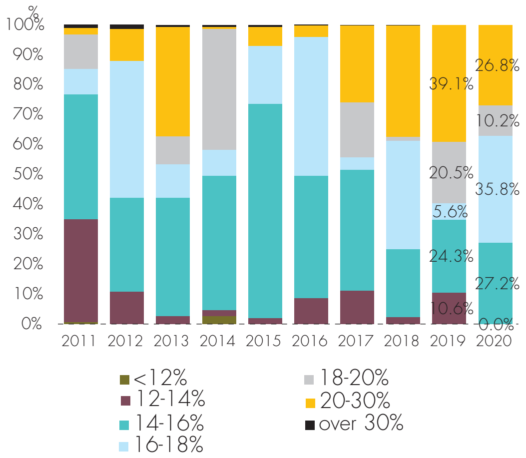


Source: Bank of Albania.

The structure of risk-weighted assets by risk has not changed and continues to be dominated by credit risk-weighted assets (87%). Assets weighted for market risk expanded by around ALL 9 billion while assets weighted for operational risk maintained the same level as in the previous year. Currently, their shares in total risk-weighted assets are calculated at 3% and 9%, respectively.

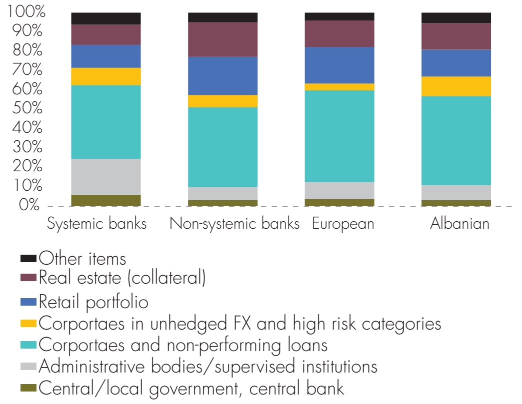
Compared to the end of the two previous six-months, no significant changes were reported in the structure of credit risk-weighted assets, both for the entire sector and for banks grouped by systemic importance and origin of capital. Systemically-important banks show a high exposure for loans to corporations, non-performing loans, and loans to other institution supervised by the Bank of Albania and the Albanian Financial Supervision Authority. Other banks (non-systemic) show exposure also to the retail portfolio, in addition to exposure to loans to corporations. Banks with European capital have a higher exposure for the class "loans to corporations and non-performing loans" and the class "retail portfolio", whereas banks with domestic capital in addition to the above-mentioned exposures are sensitive to portfolios classified with higher risk and unhedged against exchange rate fluctuations.

Chart 43 Asset allocation of banking sector by Capital Adequacy Ratio



Source: Bank of Albania.

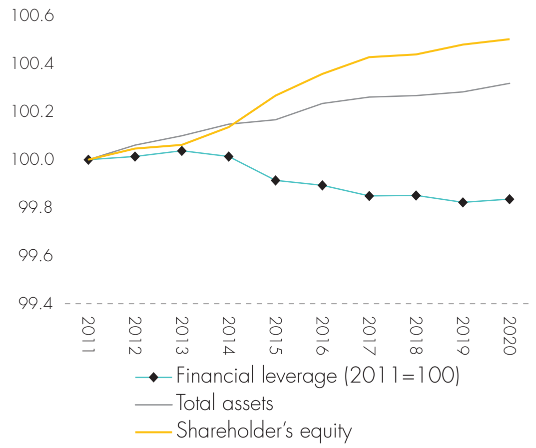
Chart 44 Credit classes' exposure of banks by systemic importance and origin of capital, June 2020



Source: Bank of Albania.

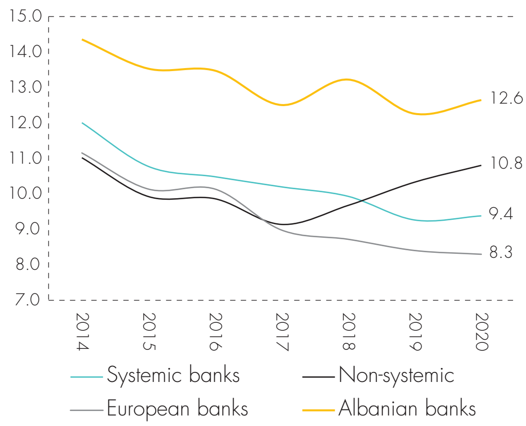
The Albanian banking sector is characterized by an adequate financial leverage ratio, thus confirming the good level of capitalisation. The financial leverage ratio[25], in June 2020, was 9.7 times, registering a slight increase from the level at the end of 2019, and close to the average of last 5 years, at 9.9 times. The downward trend in annual terms of financial leverage reflects the faster increase of equity in relation to the performance of assets. The analysis of the performance of financial leverage for different groups of banks shows that the assessed leverage for systemic banks determines the level and performance of financial leverage for the entire banking sector. Banks with Albanian capital have the highest level of financial leverage, due to the lower level of equity compared to banks with foreign capital.

Chart 45 Performance of financial leverage by components



Source: Bank of Albania.

Chart 46 Performance of financial leverage for banks by systemic importance and origin of capital, in times



Source: Bank of Albania.

25 *The financial leverage is measured as the ratio of assets to equity.*

4.1.1.2 Financial Result

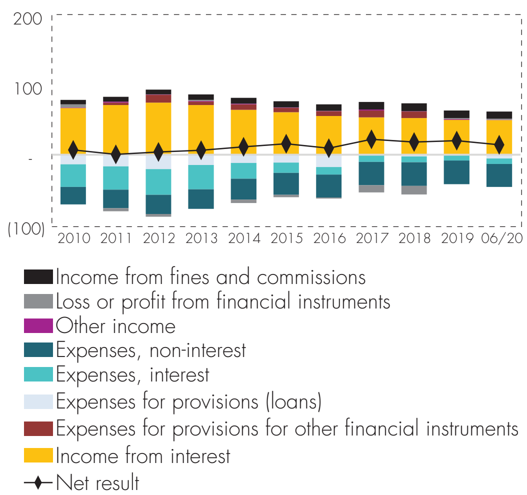
The banking sector closed 2020 H1 with a positive financial result (a profit), but around 32% lower compared with the previous year. Net interest income and other activities income were comparable to the same period in the previous year, but the increase in provisions for credit and other financial instrument had a negative impact on banks' financial result. The increase in expenditure for loans provisioning is expected to maintain this direction for the rest of the year given the slowdown in economic activity and the pressures on the solvency of borrowers. The share of banks' assets with a negative result to total assets of the banking sector remains negligible.

The activity of the banking sector was profitable during the period, but this profit was lower than in the previous year. This performance was influenced by the increase in expenses for credit risk provisions, especially in 2020 Q1.

The banking sector reported a profit of about ALL 7.2 billion, almost ALL 3.4 billion lower than the same period a year ago. Ten out of twelve banks of the sector reported a profit. The main factor for the decrease of the financial result was the increase of expenditure for provisions. The main banking activity, income from customers' interests, did not show significant changes, while the overall activity expenditures increased. The decrease in the profit of the sector is also reflected in the decrease of the average profitability indicators of the banking sector: RoA decreased at 0.9% from 1.5%, while RoE at 9.1% from 14.3% in the previous year. The performance of the banking sector improved in 2020 Q2, under the conditions created by the moratorium that "freezes" changes in non-performing loans and the related provisions.

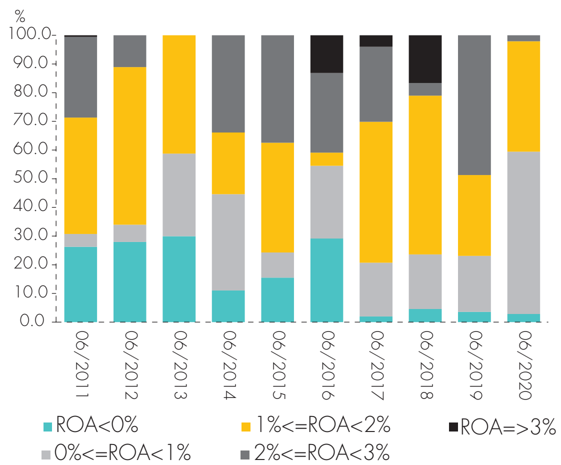
The net result from interests was ALL 20.7 billion, almost at the same level of the previous year. Both interests' income and expenditure have been at comparable levels with the previous year. Net margin from interests declined at 3.26% from 3.38% in the previous year, driven by the increase in income earning assets.

Chart 47 Financial result components



Source: Bank of Albania.

Chart 48 ROA by banks' share in sector's assets

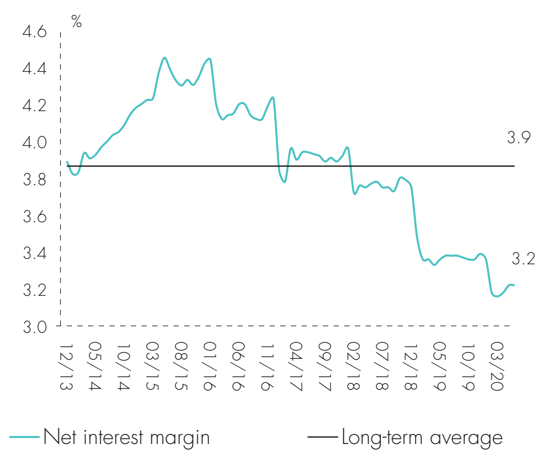


Source: Bank of Albania.

Income from other activities (not related with interest) decreased very slightly. Within them, income from financial instruments increased by ALL 0.5 billion, while those from fines, commissions, etc., decreased. Overall activity expenditures increased by ALL 0.6 billion, further decreasing the profit.

Expenditures in the form of provisions were ALL 2.7 billion, compared with the zero value in the previous year, thus negatively affecting the profit of the system. Expenditures for loans provisioning increased from ALL 0.5 to ALL 2.4 billion, while those for other financial instruments increased from -0.6 (reversal) to ALL 0.3 billion.

Chart 49 Net interest margin



Source: Bank of Albania.

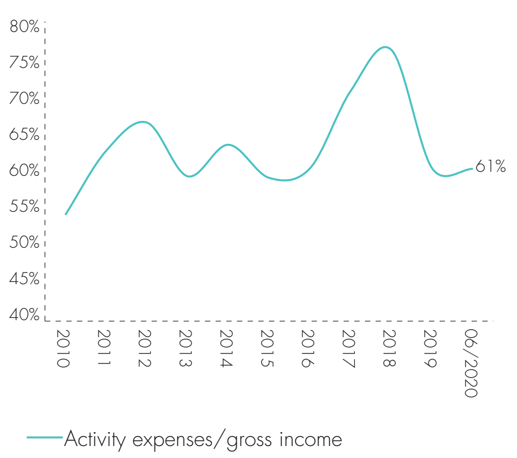
Chart 50 Profitability indicators

Source: Bank of Albania.

Activity costs were well covered by activity income.

Activity costs were well covered by activity income. Operating expenses to income ratio was 61%, trending slightly upwards, due to the increase of overall activity expenditure.

Chart 51 Activity expenditure to income



Source: Bank of Albania.

4.1.1.3 LOANS

At the end of the period, the outstanding loans registered a higher level than in the previous six-months and year, standing at ALL 590 billion[26]. The performance of new loans and the slowdown in the pace of loan repayments, classified as "standard loans" (also as a result of the moratorium on loan repayments) affected the expansion of credit stock. In particular, credit portfolio of long-term maturity, foreign currency loans and loans to enterprises, recorded a good performance. Compared to the previous year, a particularly high growth was observed in the performing classes of loans to enterprises, lek loans and those with long-term maturity.

[26] *The positive growth rate of outstanding credit was calculated excluding the statistical effect of structural breakdown in the banking sector.*

The regulatory amendments approved by the Bank of Albania - that enable financial entities to not temporarily apply, for borrowers in facing payment difficulties, the regulatory requirements for the classification and provisioning of loans by quality- have affected the expansion of the performing loans stock. On one hand, these measures aim at supporting the economic agents to cope better with the decline of income due to the slowdown of the economy as a result of the pandemic, and on the other, prevent or mitigate the negative effects of this situation in both the quality of loans portfolio and, overall in the financial activity of intermediation.

During the period, the credit stock expanded mainly as a result of the slowdown in the pace of performing loan repayments. The writing-off of lost loans from balance sheets continued, but at lower values. Excluding the impact of the exchange rate and write-offs, the annual growth of outstanding credit at the end of the period would be higher.

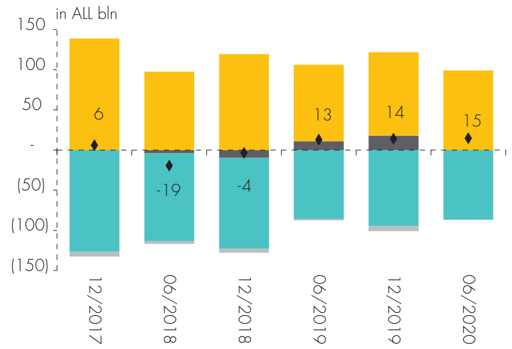
Despite the positive impact of these measures resulted in a slight decline of the non-performing loans stock, their temporary character, the dimensions of the shock and the duration of the situation suggest that the financial situation of borrowers and the quality of credit portfolio will be affected negatively to a considerable extent and for a relatively long period of time.

Table 6 Loans by maturity, sector and currency

		Value (ALL bln)	Share to total loans		Change (%)	
	Period	06/2020	06/2020	06/2020	6-months	Annual
By currency	Lek loans	287	49	47	2.2	8.8
	Foreign currency loans	304	51	53	2.9	1.8
By Entity	Public sector	23	4	5	-24	-17
	Enterprises	376	64	63	4.8	6.6
	Households	192	32	32	2.5	5.6
By maturity	Short-term	161	27	28	-1.6	0.4
	Medium-term	96	16	17	0.5	0.8
	Long-term	334	57	55	5.4	8.9
	Loans stock	591	100	100	2.6	5.1

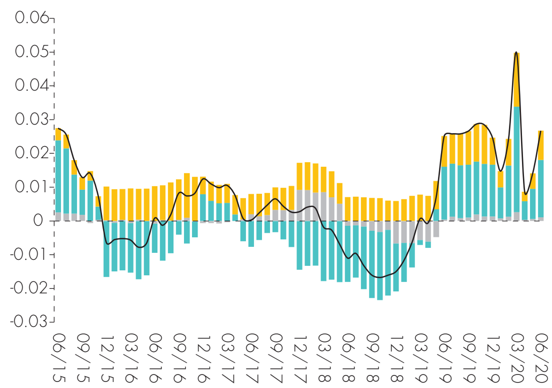
Source: Bank of Albania.

Chart 52 Six-months change in outstanding loans by composing elements



Source: Bank of Albania.

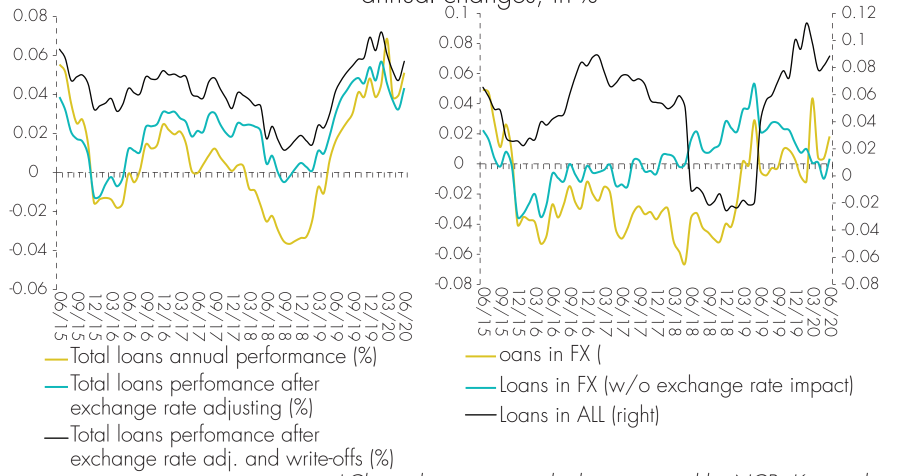
Chart 53 Loans performance, by sector, contribution in p.p., 6-month change



Source: Bank of Albania.

The appreciation of foreign currencies (euro and US dollar) against lek had a positive impact on the equivalent value in lek of foreign currency loans (around ALL 4.4 billion), over the timeframe of a year. Excluding the exchange rate effect, the annual change in outstanding loans would have been 4.3% (from 5.1%) and foreign currency outstanding loans would have been 0.3% (from 1.8%).

Performance of total loans excluding the exchange rate effect and write-offs (left); and loans in foreign currency excluding the exchange rate effect (right), annual changes, in %



*Charts do not contain the loans granted by NCB, Kosova branch.
Source: Bank of Albania.

During the period, the banks continued the written-off process of lost loans from balance sheets, but at low values. The value of written-off loans during the last 12 months was ALL 8.3 billion, and 60% of this flow was realised in the last two months of 2019. Written-off loans stock, during the last 12 months, accounted for around 17% of total outstanding non-performing loans reported by banks at the end of June 2020. If these loans had not been written-off over the year, the annual growth of loans stock would be 6.6% (from 5.1%). Excluding the effect of both the exchange rate and of write-offs, credit annual growth would register 5.8%.

LOANS TO RESIDENT ENTITIES - ENTERPRISES

The growth of credit stock for residents is supported by the growth of loans to households and enterprises, mainly in foreign currency.

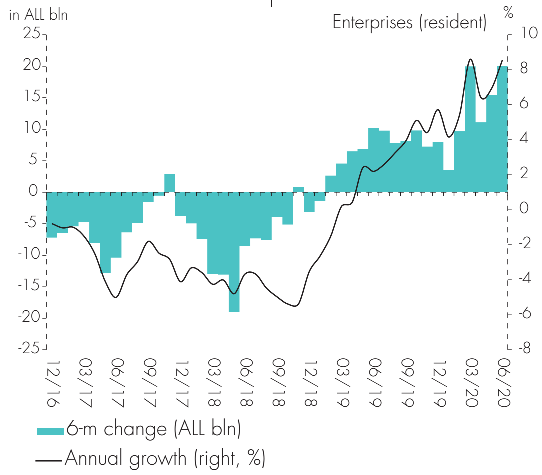
Loans to resident enterprises registered a significant growth during the period compared with the previous year.

Loans to resident entities, including enterprises, households and public sector, expanded by 3.5% during the period. These loans account for around 96% of total loans.

Over 60% of loans to resident entities are held by the business sector. Loans to this sector expanded by 5.9%, or around ALL 20 billion, and at the end of the period amounted around ALL 360 billion. The growth in this category came from the expansion of the short-term loans stock (loans for working capital and equipment purchasing) and of the loans stock for real estate purchase. Loans for investments in real estate and those for equipment purchase have the main share (around 27% of outstanding loans to enterprises, and during the period expanded by 5% and 8%, respectively.

In the last year, enterprises received 22% more new loans for working capital and 20% more new loans for investments in real estate compared with the previous year, and this growth provided the main impact on the annual change of loans stock for these categories.

Chart 55 Performance of loans to resident enterprises



Source: Bank of Albania.

The structure of loans to enterprises has changed over the last years. The categories "overdraft" and "loans for equipment purchase" registered an increase of the portfolio in domestic currency and decrease of the portfolio in foreign currency. The loans stock for investment in real estate registered an expansion of loans granted in foreign currency and a contraction of the loans stock in lek.

Chart 56 Annual performance of loans to enterprises by purpose of use and currency (in %)

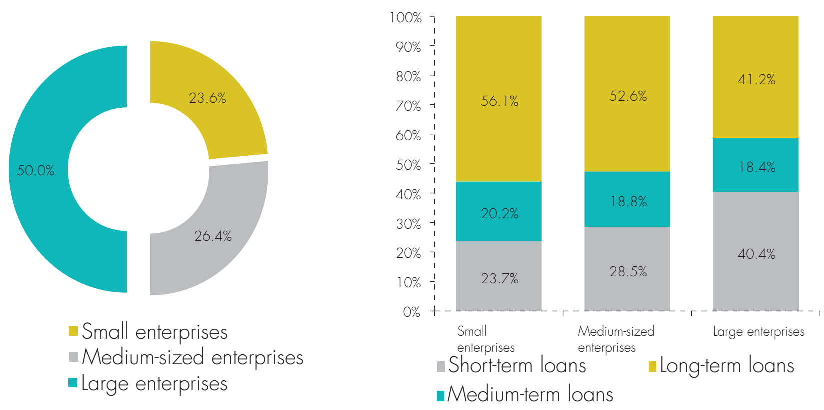
Source: Bank of Albania.

The structure of loans by size of the activity, during the period, shows an increase of the share of loans granted to medium-sized enterprises against the decline of the share of loans granted to large enterprises. Small enterprises did not register significant changes[27]. Meanwhile, the analysis by maturity indicates that all the three types of enterprises have decreased the share of short-term loans, whereas small and large enterprises have increased the share

[27] *These values marked, respectively: 51.5% (large enterprises); 25.0% (medium-sized enterprises) and 23.6% (small enterprises) in December 2019; whereas in June 2019 they were respectively: 51.9%; 23.1%; and 25.0%.*

of medium-term loans[28]. The medium-sized enterprises have increased the share of medium-term loans against the decrease in both short-term and long-term loans.

Chart 57 S Structure of loans to enterprises by size



Source: Bank of Albania.

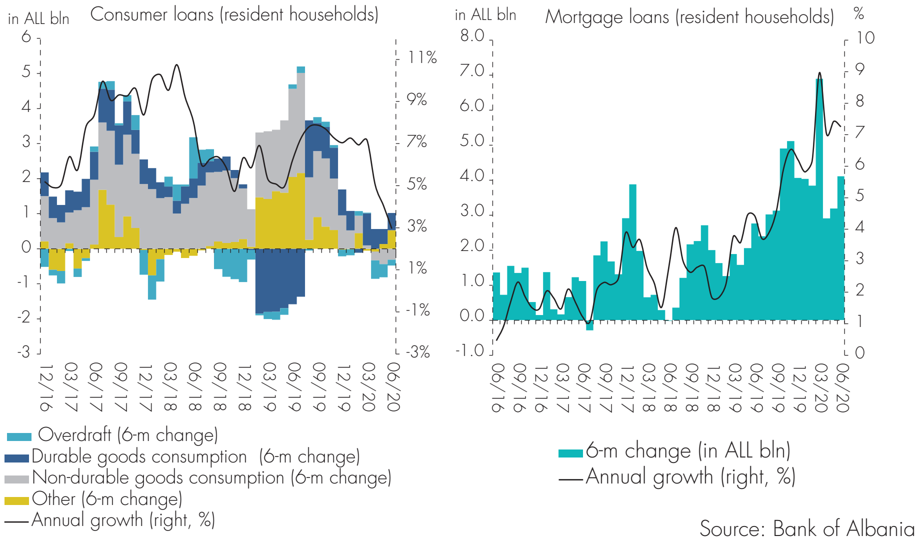
Loans to resident entities - Households and public sector

Loans to resident households expanded by 2.5% over the period. Loans for real estate recorded the faster growth, thus providing the main contribution in the performance of loans to households for the period. Outstanding loans for real estate grew by around 3.5% during the period and by 6% compared to the previous year, reaching at ALL 120 billion.

During 2015-2018, there has been a steady increase of loans to households on one hand, and a decrease of loans to enterprises on the other. This performance, despite the resumption of higher borrowing by enterprises, has led to changes in the structure of loans by sector, in favour of loans to households. In June 2020, loans to households accounted for 34% of outstanding loans, from 27% in 2015.

[28] *In annual terms, small enterprises have increased the share of long-term loans (3.3%), while medium-sized and large enterprises have increase the share of short-term loans (7.3%, respectively).*

Chart 58 Loans to resident households performance by purpose of use



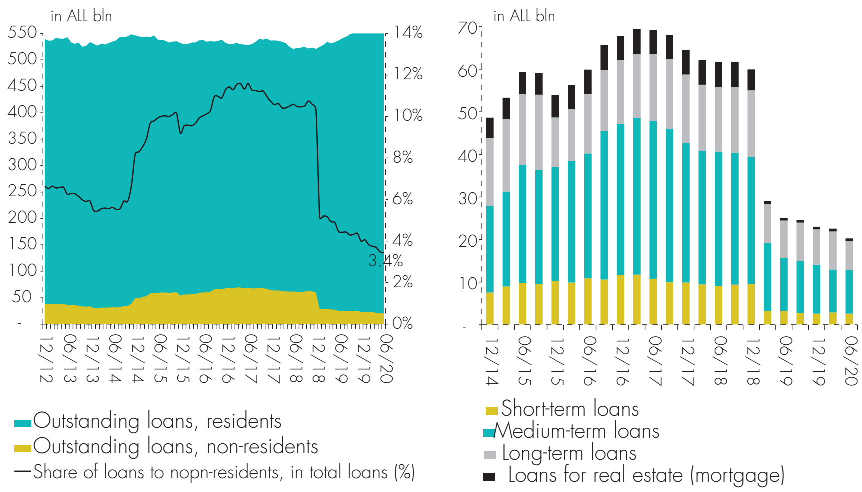
Source: Bank of Albania.

Loans to the public sector continues have a very small share in total loans (3%), meanwhile during the last year, this share decreased by around 15%.

LOANS TO NON-RESIDENT ENTITIES

Loans to non-resident entities continued to register a decline during 2020 H1 as well. At the end of June, loans to non-residents were around ALL 20 billion and accounted for 3.4% of outstanding loans of the banking sector, from 4% at the end of the previous six-month period. By sector, currency and maturity, the highest decrease was registered in loans to enterprises, in foreign currency and long-term maturity, which are the categories with the highest share in the stock of loans to non-resident entities.

Chart 59 Loans to residents and non-residents (left) and loans to non-residents by maturity (right)



Source: Bank of Albania.

UNHEDGED FOREIGN CURRENCY LOANS

The exposure of the banking sector to indirect exchange rate risk, although downwards, continues to remain high and requires continuous monitoring

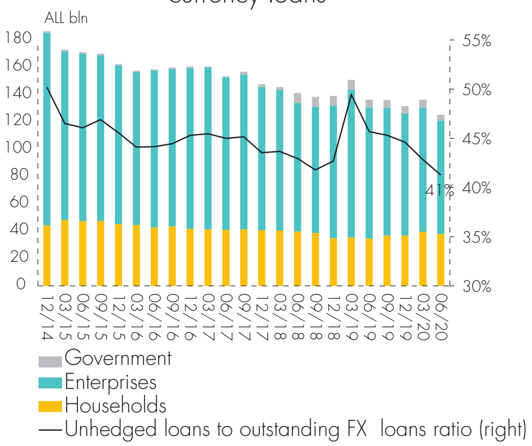
Unhedged foreign currency loans have continued to decline, contracting by 5% during the period. This fall was mainly driven by loans take by enterprises for trade purposes. Meanwhile, "households" borrowers have expanded the stock of unhedged foreign currency loans during the period. As a result, the share of unhedged loans to total outstanding loans has contracted slightly over the period (by 1.6 p.p.) at 21%, while its share to foreign currency loans portfolio decreased at 41%, from 45% in December 2019.

BOX 2 BANKING SECTOR AND UNHEDGED FOREIGN CURRENCY LOANS

During 2020 H1, unhedged foreign currency loans decreased by ALL 6 billion, at ALL 125 billion, mainly due to the contraction of unhedged loans in euro (by 4.6%). Unhedged loans in US dollar also registered a decline during the period (by 6%), but due to the low share in total unhedged loans, its contribution is low. Loans to enterprises account for 66% of outstanding foreign currency loans unhedged from the exchange rate risk, while loans to households and to government account for 30% and 4%, respectively.*

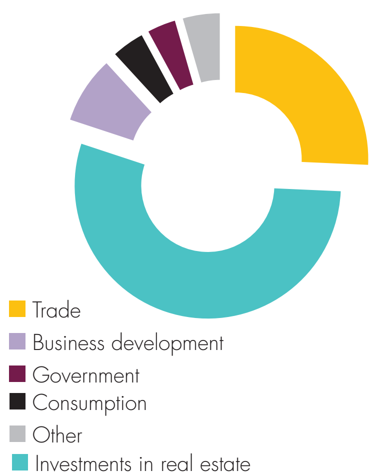
The contraction of outstanding unhedged loans is mainly related with the decline by 7% of unhedged loans to enterprises. Unhedged loans to households during the period registered an increase by around 3%, while those to the government contracted by 23%. In annual terms, unhedged foreign currency loans contracted by 8%, due to the decline of loans to enterprises and loans in euro.

Chart 60 Performance of unhedged foreign currency loans



Source: Bank of Albania.

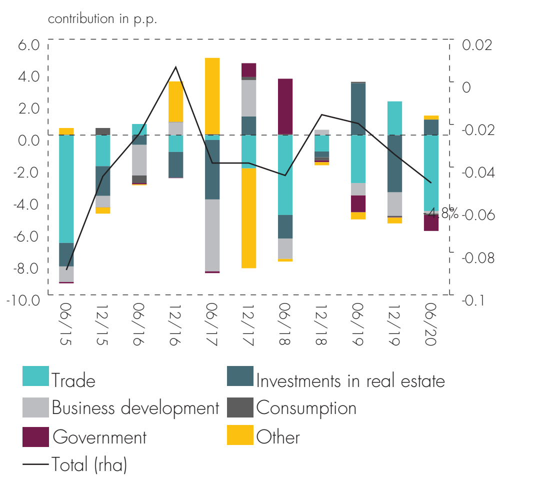
Chart 61 Unhedged foreign currency loans, by purpose of use, %



Source: Bank of Albania.

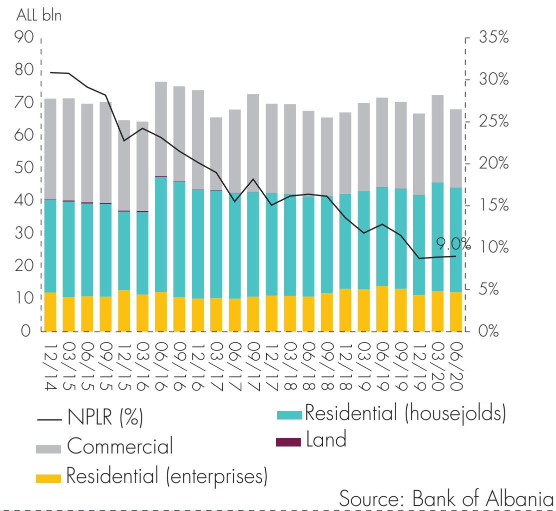
Unhedged loans granted for investments in real estate continue to account for the main share (around 54%) of total unhedged foreign currency loans, followed by loans for trade (26%). The rest of the unhedged foreign currency loans were granted mainly for business development, consumption and other purposes. The contribution to the performance of outstanding unhedged loans against the *exchange rate risk over the period came from the decline of unhedged loans for "trade" and for "government", by 16% and 23%, respectively. Unhedged foreign currency loans for "investment in real estate" were the only category of unhedged loans that registered an increase over the period (+2%).*

Chart 62 Six-month performance of unhedged foreign currency loans (contribution by sector)



Source: Bank of Albania.

Chart 63 Unhedged foreign currency loans for real estate and its quality



Source: Bank of Albania.

Unhedged loans for real estate are granted for the purchase of residential, commercial real estate and land. Unhedged loans for residential real estate granted to households have the main share (47%), expanding by 4%, during the period, and providing the main contribution in the performance of unhedged loans for real estate. Meanwhile, loans for commercial real estate (whose share in total unhedged loans for real estate registers 35%) have declined during 2020 H1. The appreciation of both euro and the US dollar's exchange rate has affected positively the reported value of unhedged foreign currency loans. Excluding the depreciation the domestic currency exchange rate, over 2020 H1 unhedged foreign currency loans would have contracted by 7% from 4.6%.

* *Outstanding euro loans, when the borrower's income is in Albanian lek, accounts for 88% of the outstanding unhedged foreign currency loans.*

NEW LOANS

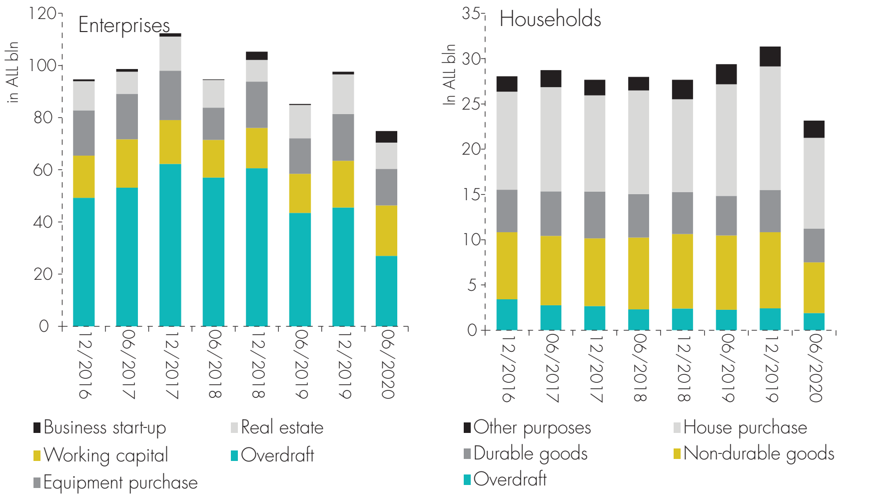
New loans granted by banks during 2020 H1 were around ALL 100 billion, downwards by 25% over the period, and almost 15% compared with the previous year. The decline was observed in lek and in the main foreign currencies. The closure of the activity of many enterprises, due to the implemented restrictions to contain the spread of the pandemic in March-May 2020, and the difficult economic situation created in Albania and globally, have driven to the lower enterprises and households' demand, for new loans, despite the fall of the average interest rate. The reported flow of new loans during these months registered lower levels than the same period in the previous year.

During the period it was observed a decline of new loans in lek and in the main foreign currencies, mainly affected by loans in the form of "overdraft" to enterprises.

The contraction of the flow of new loans during the period is mainly affected by the decline of loans to the enterprises sector (around 23%), which decreased short-term credit demand, and mainly that in the form of "overdraft". Loans grated for this purpose account for the main share in the new loans to enterprises (36%).

New loans granted to households were around 20% lower compared with the flow of the previous period. This development was affected by the contraction of loans for house purchase. New loans for house purchase have the main share in new loans granted to households (42%). Around 60% of new loans are loans in the domestic currency, whereas the decline of the flow was registered in both loans in lek and in foreign currency.

Chart 64 New loans to enterprises (left) and households (right) by purpose of use



Source: Bank of Albania.

The weighted interest rate on new loans during the period registered a decline.

The stronger decline in the average interest rates was registered for lek new loans and new loans to enterprises.

The weighted interest rate on new loans granted over the period[29] registered a decline, affected by all types of loans. The weighted average rate of new loans in June was around 0.5 percentage point lower that that registered in December 2019. The stronger decline in the average interest rates was registered in rates on new loans in lek and on new loans to enterprises. In June 2020, the weighted interest rate registered 5.0% while during period it fluctuated around 5.2%.

By currency, the interest rate of new loans in lek continued to register higher levels than the other two currencies (euro and US dollar), but this interest rate has shown a significant downward trend over the last year. In June 2020, the interest rate of new loans in lek registered 5.4% from 6.0% in the previous year. This trend is mainly driven by the accommodative policies implemented by the central bank, which in March cut the policy rate from 1.0% to 0.5%.

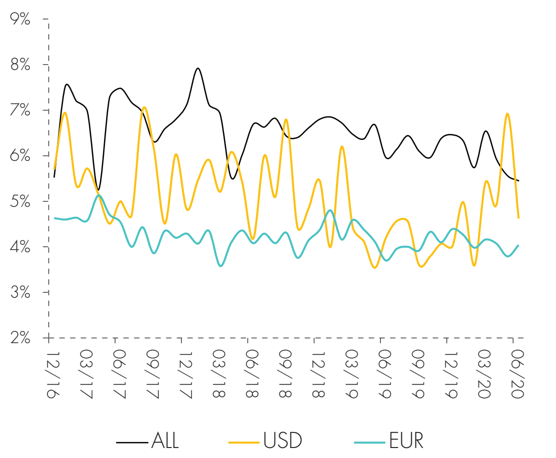
[29] *Calculated as six-month average.*

The interest rate on new loans to households continues to be higher compared with the interest rate on loans to enterprises. During the period, this rate fluctuated around 5.7% and the value registered in June remains below the value registered in December 2019. The average interest rate of new loans to enterprises fluctuated around 5% during 2020 H1[30].

Chart 65 Weighted interest rates on new loans

Source: Bank of Albania.

Chart 66 Interest rates on new loans, by currency



Source: Bank of Albania.

Chart 67 Interest rates on new loans, by entity

Source: Bank of Albania.

4.1.1.4 Deposits

Deposits held in the banking sector registered high rate of growth in 2020 H1. The growth is supported by households' deposits in the form of current accounts and demand deposits, held mainly in the domestic currency. At the end of June, the level of deposits registered around ALL 1.230 billion, up by around ALL 30 billion during the period, and ALL 70 compared with the previous year. Around half of the overall stock of deposits is composed by time deposits, which, despite some small fluctuations, have maintained the same level since the end of 2018. As a result, the share of time deposits to overall deposit stock has continued to decline, while the share of demand deposits and current accounts has increased.

The growth of deposits has been high during the period, supported mainly by households' demand deposits and in the domestic currency. The share of demand deposits and current accounts continues to expand compared with the share of time deposits.

[30] *The weighted average interest rate for loans to enterprises in 2019 H2 registered 5.2%.*

Table 7 Data on the performance of deposits by maturity, sector and currency

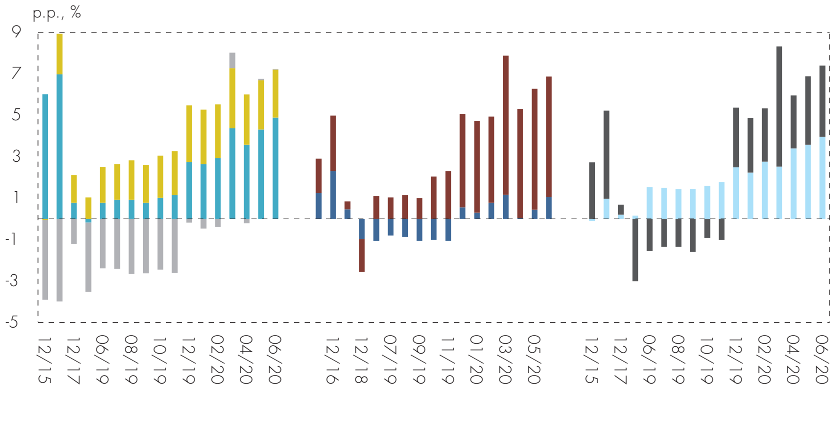
Period	June'20		June' 20/ December'19		January- June'20/ January- June'19	
Type of deposit	ALL, bln	Share to total (%)	Change (%)	Contribution (p.p.)	Change (%)	Contribution (p.p.)
Current account	443	36	7	3	11	4
Demand deposits	156	13	5	1	21	2
Time deposits	614	50	-	-	-	-
Public sector	32	3	18	0	19	0
Enterprises	167	14	3	0	5	1
Households	1,031	84	3	2	6	5
Lek deposits	607	49	5	2	6	3
FX deposits	623	51	1	1	7	3
Deposits, Stock	1,230	100	3	3	6	6

Source: Bank of Albania.

The average annual growth rate of stock of deposits during the period was around 6%, meanwhile for 2018 and 2019 this rate did not exceeded +0.5%. Deposits in the domestic currency maintained the positive growth rates observed in the first months of 2019 and their expansion was particularly rapid during 2020 Q2. At the end of 2020 H1 foreign currency deposits registered a level comparable to that of the end of the previous year, and provided a modest contribution in deposits growth during the period. Strong fluctuations in the exchange rate of lek against US dollar and euro during March and April resulted in significant effects, but with opposite directions in the counter value in lek of the foreign currency deposits. The statistical effect of the exchange rate during this period was positive and with significantly higher values compared with the two previous six-months.

The increase of current accounts and demand deposits has continued during 2020 H1 as well. During this period, current accounts and demand deposits expanded on average by 11% and 21%, respectively, compared with the previous year, whereas these deposits were 7% and 5% higher, respectively, compared with the end of 2019. After several years of continuous decline, time deposits have stabilised close to ALL 610-615 billion, remaining almost unchanged since the end of 2018. Interest rates on time deposits in lek and foreign currency continue to remain at low levels and their average has remained almost unchanged during 2020 H1. Households' deposits account for around 85% of total deposits and have continued to provide the main contribution in deposits growth during the period.

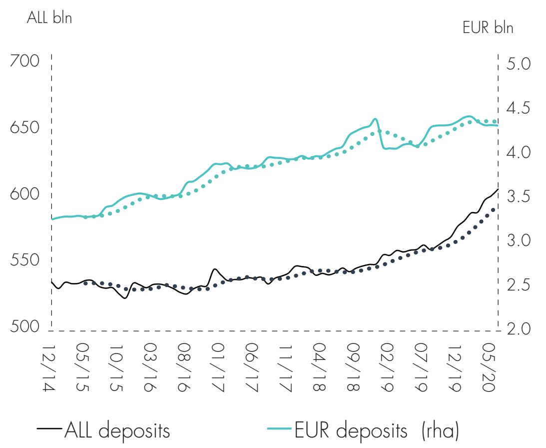
Chart 68 Deposits performance by maturity, sector and foreign currency, (contribution to annual change)



Source: Bank of Albania.

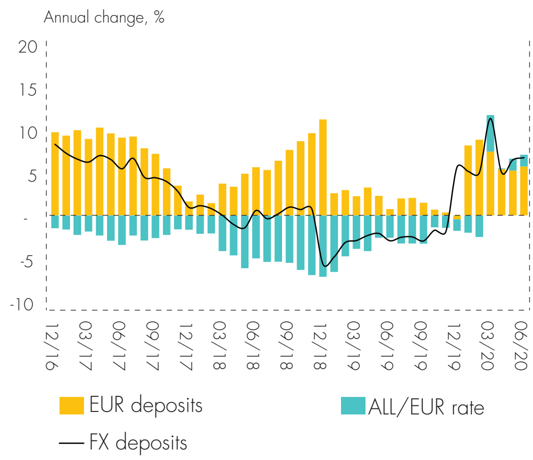
Deposits in lek and foreign currency contributed almost at the same level to the annual growth rate of deposits during 2020 H1. Over the last 5 years, both deposits in lek and in euro, which account for over 90% of foreign currency deposits, have maintained positive and comparable growth trends, but the increase of lek deposits have been somewhat more rapid during the last 12 months. The annual growth of euro deposits has been continuously positive, but the annual growth rate of foreign currency deposits is affected negatively by structural changes and the statistical effect of the exchange rate. The latter, due to the strong appreciation of the domestic currency against the two main foreign currencies drove the foreign currency deposits stock converted in lek to record negative growth rates during most of 2018-2019. In 2020 H1, the statistical effect of the exchange rate on the reported value of deposits has been positive, due to the temporary depreciation of the domestic currency, particularly during 2020 Q2.

Chart 69 Deposits in lek and in euro (in bln unit)



Source: Bank of Albania.

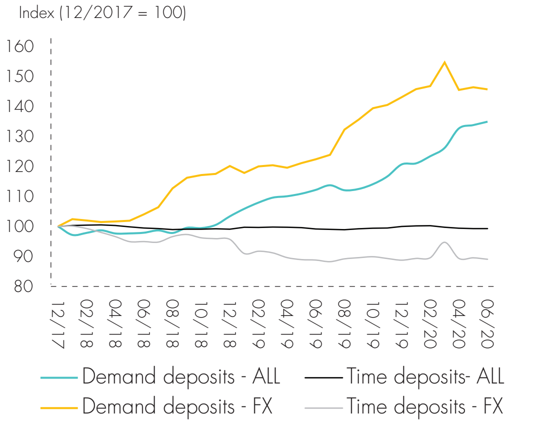
Chart 70 Exchange rate effect on foreign currency deposits



Source: Bank of Albania.

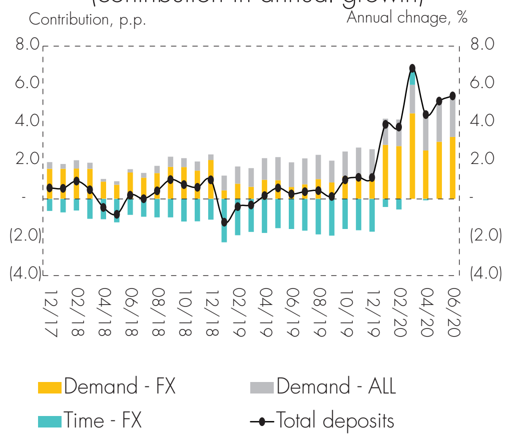
Detailed data on households' deposits, by currency and term, show that time deposits in lek have remained almost unchanged, while those in foreign currency show a significant downward trend. The strongest growth on demand deposits[31] continues to be observed in the foreign currency deposits stock. Since the end of 2017, the households' demand deposits stock in foreign currency expanded by around 40%, while that in lek by around 30%. The decline in the time deposits stock both in lek and in foreign currency does not exceed 10%.

Chart 71 Performance of households' deposits by maturity and currency (index)



Source: Bank of Albania.

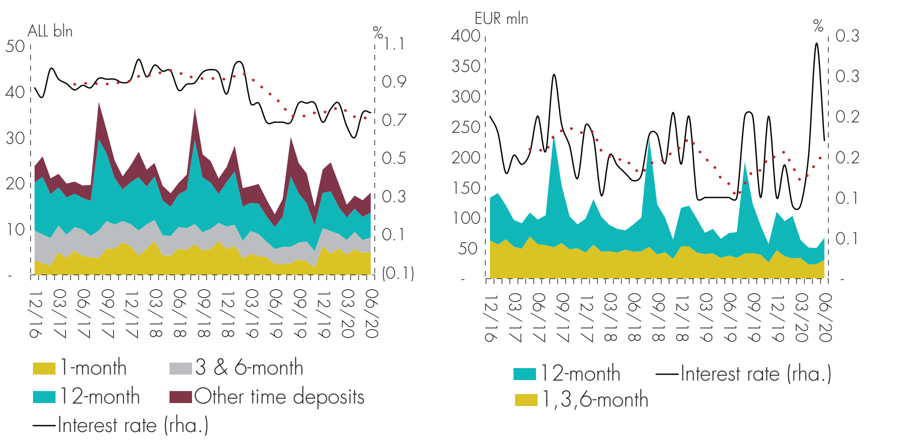
Chart 72 Performance of households' deposits by maturity and currency (contribution in annual growth)



Source: Bank of Albania.

Interest rates on time deposits in lek fluctuated around 0.7% in 2020 H1, registering a slight decline compared with the average value of the previous year. For time deposits in euro, the amplitude of the average interest rate of time deposits has been higher compared with the previous periods, but the downward trend of has continued in 2020 H1 as well.

Chart 73 Flows and average interest rate for new time deposits in lek and euro



Source: Bank of Albania.

[31] *To facilitate interpretation here current accounts included as well.*

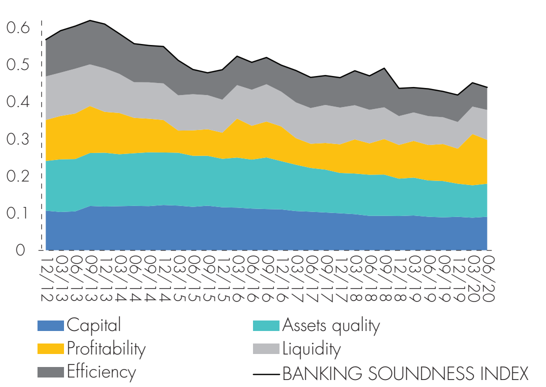
BOX 3 BANKING SOUNDNESS INDEX

The banking soundness index represents an overall assessment of the core conditions and significant factors of risk that affect the stability of the banking sector and of individual banks. The index is composed of five indicators, which represent five dimensions of the banking sector: capital, assets quality, profitability, liquidity and efficiency. (MISHRA et.al (RBI); 2013):

The aggregate index of key indicators used to track the performance and the banking stability situation has slightly deteriorated during the period and compared to the previous year. Its value increased to 0.44 from 0.42 in December 2019 and 0.43 at the end of June 2019. The components of the index, which registered a weaker performance in the last year, are: liquidity and profitability. The latter provided the main contribution to the expansion of the value of banking soundness index, reaching 0.59 from 0.48 in June 2019. The deterioration of the profitability index over one-year period is affected by the decline in the profit of banks. At the same time, net margin from interests has declined as well.*

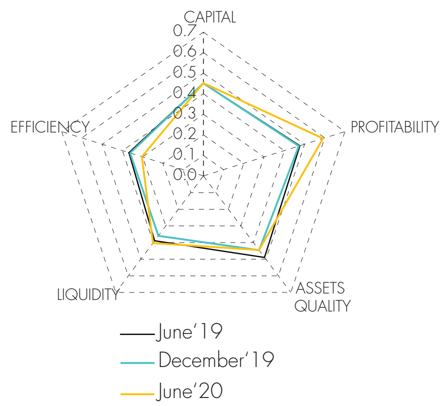
The indicator of profitability is the main contributor to risk, which during the last two years reports a continuous deterioration and consequently an increase in risk contribution. The liquidity indicator also had a weak performance in the last year, affected by the decline of the liquid assets to total assets ratio. Assets quality has improved and the contribution of this indicator to risk has decreased. Since the beginning of 2015, the contribution of this indicator to risk has significantly and continuously decreased, downwards from 0.71 in March 2015 to 0.44 in June 2020. The "efficiency" indicator has the more significant improvement in the timeframe of a year, which reflects a more efficient management of expenses expressed in declining activity expenditure and mainly of personnel expenses, contributing in the improvement of banking soundness. The "capital" indicator reports the same soundness as in the previous year, and its value has not changed compared with the previous period and the previous year. Within the sub-indicators of capital we evidence an expansion of financial leverage, expansion of the core capital to regulatory capital ratio, and a slight decline of the Capital Adequacy Ratio. During the last five years (2013-2019) the aggregate banking soundness index registered a downward tendency, which means better soundness and higher stability for banks. In 2020 H1, the aggregate banking soundness shows a weaker performance, which should be monitored continuously to prevent potential risks that may jeopardise the banking sector.

Chart 74 Banking soundness index*



The increase in the value of index shows lower stability. The breadth of each dimension shows its contribution to risk.
Source: Bank of Albania.

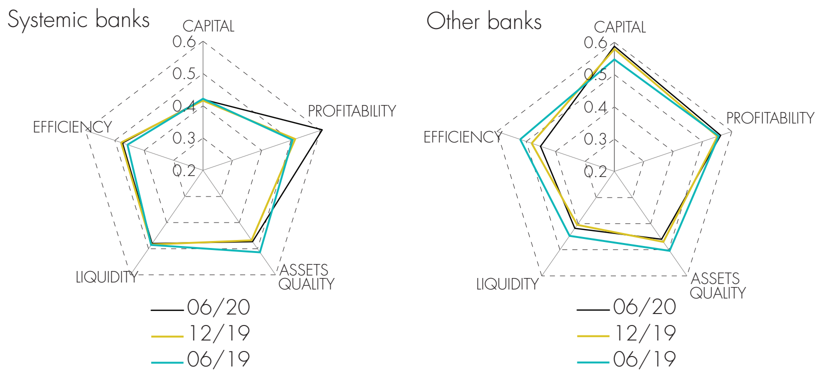
Chart 75 Banking soundness map*



* The closer to the center, the lower the risk, in an interval from 0 to1
Source: Bank of Albania.

The soundness index for systemic banks has deteriorated compared with the previous year. For this group of banks, there is deterioration in the indicators of "profitability" and "efficiency"; whereas "assets quality" and "liquidity" have improved. Other (non-systemic) banks report an improvement in the index over a one-year period, which reflects the improvement of liquidity, asset quality and efficiency. Meanwhile, the capitalization and profitability indicators represent weaker soundness for this group of banks in the one-year timeframe. Systemic banks have the lowest value of the index, which indicates better soundness and higher stability compared to the other group of banks.

Chart 76 Banking soundness map, in groups, by systemic importance



The closer to the center, the lower the risk, in an interval from 0 to1
Source: Bank of Albania.

* *The decrease of the value of the index implies the improvement of banking soundness and vice versa.*

4.1.2 ACTIVITY RISKS TO THE BANKING SECTOR

4.1.2.1 Credit risk

In 2020 H1, credit quality continued to improve, although at a slower pace. However, this indicator requires continuous monitoring, since the negative impacts causes by the pandemic are expected to be relevant in the following period.

At the end of the period, non-performing loans stock was around ALL 48 billion, almost unchanged throughout the period. The main impact on this stability of the non-performing loans ratio was provided by the definitions in the moratorium on loans repayment, which enabled banks to temporary suspend the evidence of non-performing loans and the changes within them. Thus, non-performing loans ratio is around 24% lower than the level in the previous year. This decline of non-performing loans during the last 12 months, concentrated in the second half of 2019, was driven by write-offs[32], restructuring and repayment of loans.

[32] *Write-offs of lost loans from banks' balance sheets intensified in the last months of the previous year, affected mainly by regulatory changes that decreased to a maximum of 2 years the time of keeping in the balance sheet loans classified as "lost". During the last 12 months, around ALL 8.3 billion of lost loans were written off, mainly represented by loans to enterprises in foreign currency. Overall, since the start of the write-off process (January 2015), ALL 65 billion of lost loans have been written off (which is as much as 140% of the present value of non-performing loans).*

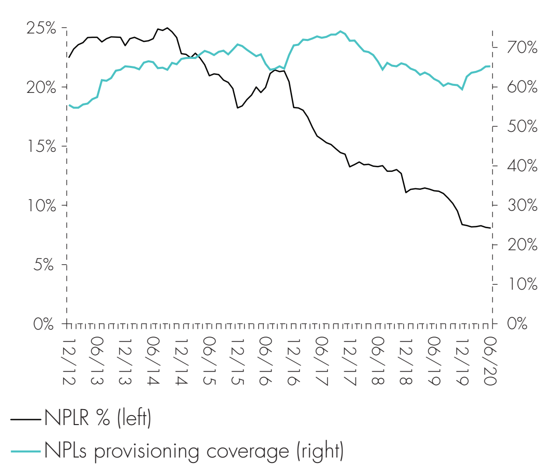
In March 2020, given the slowdown of the economic activity due to pandemic and the expected difficulties of borrowers to face credit payments, the Bank of Albania undertook some measures and regulatory amendments, which aim: to ease the borrowers' burden affected by pandemic; increase the banks' financial resilience; and the continuation of lending of the banking sector. These measures consist in:

- Issuance of a moratorium, which enables the deferral of loan repayments to borrowers affected by pandemic, initially till the end of May 2020, and then extended till the end of August 2020.
- Approval of regulatory amendments which enable banks to maintain the classification of loans and the levels of non-performing loans provisioning during this period. The purpose of these amendments is that, till the end of this year, banks and their borrowing customers find restructuring forms of certain loans which quickly recover the borrower's creditworthiness who are affected by pandemic.
- The suspension of banks' profit allocation till the end of year, with the aim that in any event of financial losses materialisation, capital size is adequate not only to absorb this loss, also to support new lending.

The above measures are similar to those recommended by international institutions as well as those taken in different countries of the world. Since these measures are temporary and the trend of the pandemic is surrounded by high uncertainty, it is necessary for this period to be used by banks to manage credit risk appropriately and transparently, provisioning carefully while showing actively.

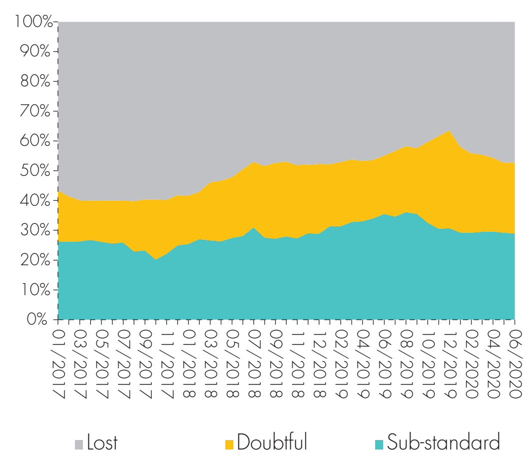
Due to the 'freezing' of non-performing loans and the continuation of lending, the non-performing loans ratio (NPLR) dropped to 8.1% at the end of the period, from 8.4% at the end of the previous year. In conditions when some of the banks continued to make provisions, especially in 2020 Q1, the coverage ratio of non-performing loans provisioning rose to 65%, from 59% in December 2019. Non-performing loans write-offs during the period have been negligible.

Chart 77 Non-performing loans ratio and provisioning



Source: Bank of Albania.

Chart 78 Non-performing loans structure



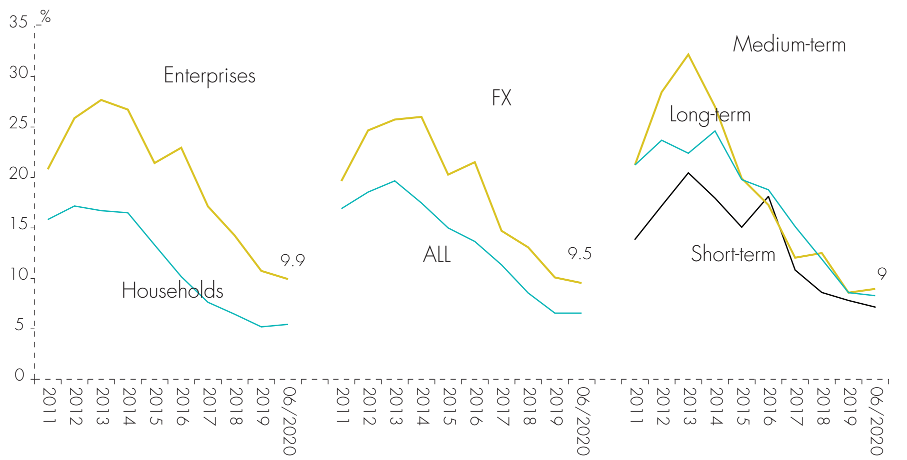
Source: Bank of Albania.

The improvement in credit quality was observed mainly in the portfolio of loans to enterprises, foreign currency loans and short-term loans.

Compared to the previous year, the non-performing loans ratio fell by 3.1 percentage points and the decline mainly reflects the contraction in the stock of non-performing loans. In the last year, there has been a shift of the share between non-performing loans classes, from the "sub-standard" to those with higher risk. The share of "lost" and "doubtful" loans in the stock of non-performing loans increased at 47.3% and 24%, respectively, from 45% and 20% in the previous year.

For all categories by maturity, entity and currency, it was observed a significant improvement in the quality of this asset during the timeframe of a year. Loans quality is weaker for loans to enterprises, foreign currency loans and medium-term loans. However, the first two classes are also those with the strongest decline in the stock of non-performing loans.

Chart 79 NPLs ratio by sector, currency and term



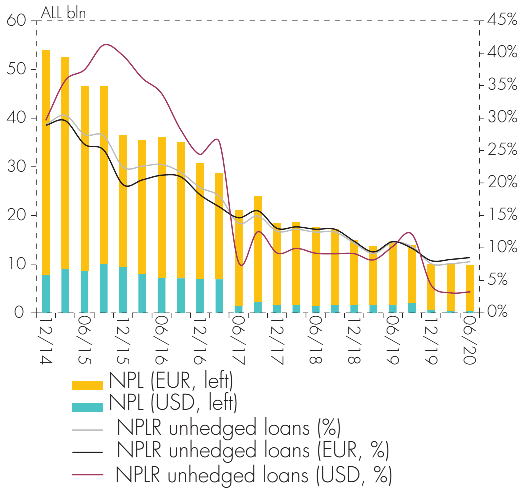
Source: Bank of Albania.

For foreign currency loans unhedged against exchange rate fluctuations, the quality has improved significantly compared with the previous year, and has slightly increased during the period, mainly driven by the contraction of non-performing loans stock. NPLs ratio for this type of loans registered 7.9% at the end of the period (from 10.9% in June 2019), driven mainly by the performance of unhedged loans in euro for real estate purchases.

By purpose of use, unhedged non-performing loans for investments in real estate have the main share in the unhedged non-performing loans (62%), and at the same time maintains the highest level of NPLR (9%). However, credit quality for this class has improved significantly, by 3.8 percentage points, throughout a year. The positive trend of credit quality is also registered for the other classes of unhedged loans, where in the timeframe of a year, NPLs ratio decreased at:

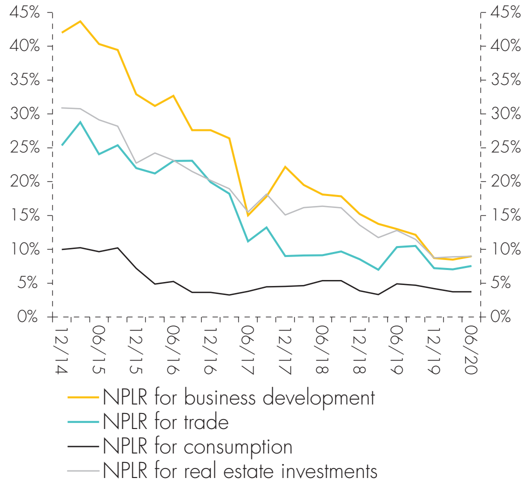
- 9% (from 13%) for unhedged loans for business development,
- 7.5% (from 10.3%) for unhedged loans for trade,
- 3.7% (from 4.9%) for unhedged consumer loans.

Chart 80 NPLR for unhedged loan against exchange rate fluctuation, by currency



Source: Bank of Albania.

Chart 81 NPLR for unhedged loans against exchange rate fluctuations, by purpose of use

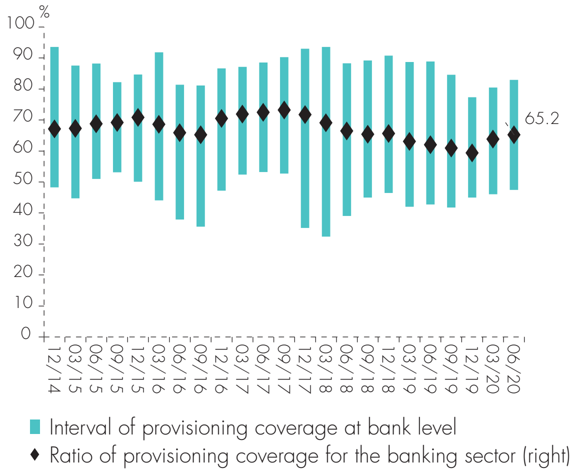


Source: Bank of Albania.

For the loan portfolio to non-residents, the credit quality remains at manageable levels and the stock of non-performing loans has declined in the last year. During the period, credit quality for non-residents remained unchanged and NPLs ratio registered 3%. The stock of non-performing loans of this category is entirely classified as lost loans. Almost the entire stock of non-performing loans to non-resident entities is held by enterprises and these loans have been granted in euro.

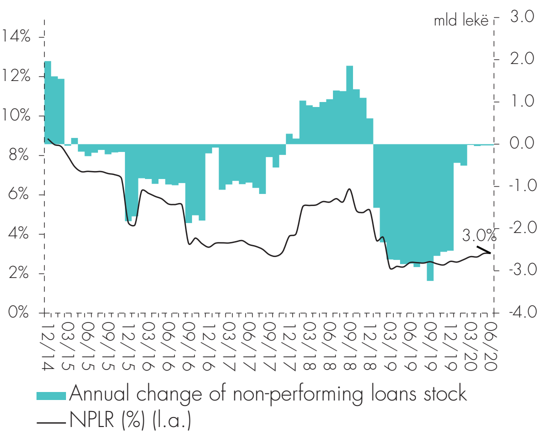
During the period, the coverage of non-performing loans with reserve funds expanded by 5.8 percentage points, reflecting the expansion by 9% of the

Chart 82 Provisioning ratio over years



Source: Bank of Albania.

Chart 83 Annual change in of non-performing loans stock and NPLR to non-resident entities



Source: Bank of Albania.

stock of reserve funds. The provisioning ratio for individual banks fluctuates between 50% and 85%.

Capital coverage of net non-performing loans[33] expanded to 9.1 times from 7.4 times at the end of 2019 H2. This expansion reflected the rapid decline in the net non-performing loans[34]. In June 2020, the net non-performing loans ratio to outstanding loans registered 2.8% or 0.6 percentage point lower than December 2019.

Loan collateralisation, which represents a critical element in the banking sector hedging instruments against the risk of non-repayment of loans, has continued to expand over the last twelve months, recording the highest level since 2012 (about 80%). Compared to a year ago, loan collateralisation ratio[35] increased by about 2.6 percentage points. Loans with collateral in the form of real estate have the main share by around 66% of collateralised loans, and 53% of outstanding loans. This loans' stock expanded by around 5.3% compared with the previous year. Meanwhile, outstanding un-collaterised loans contracted by 7% compared with June 2019.

Quality of collateralised loans continued to improve compared with the previous year. NPLs ratio for collaterised loans was 7.2% at the end of the year, from 10.7% in the previous year. The decline in non-performing loans stock for collateralised loans has started since 2016. Compared to the previous year, the non-performing loan ratio for loans collateralised with real estate "land" marked the most rapid fall by 6.6 percentage points, at 11.7%. This is the lowest level reported in the last ten years.

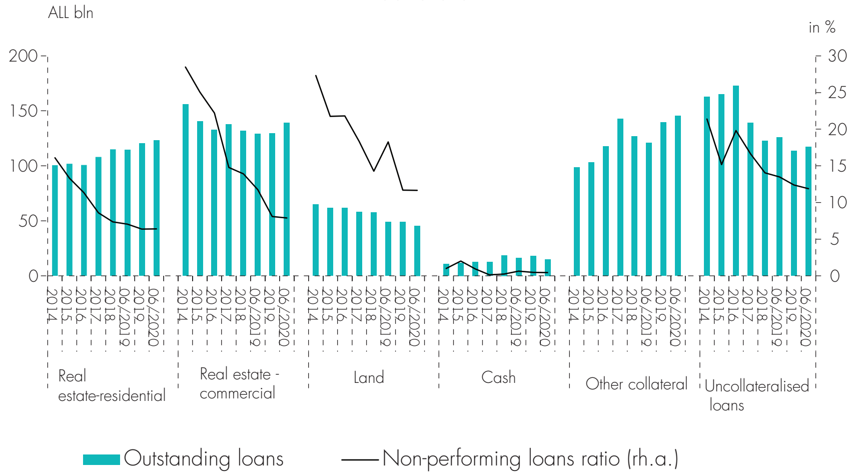
The quality of credit is constantly improving for other loans collateralized with real estate as well, recording the lowest levels of non-performing loans in the last decade. Loans collateralised with cash, continue to maintain the lowest level of un-performing loan ratio (0.5%) and at the same time the lowest level of collateralised loans. The quality of un-collateralised loans also improved compared with the end of the previous period and with the previous year. However, this type of credit has the highest level of non-performing loans ratio (11.9%).

[33] *Non-performing loans after the deduction of provisions.*

[34] *As a result of the contraction in outstanding net non-performing loans by nearly 15% and the expansion of regulatory capital by around 4%, the "net non-performing loans/regulatory capital" ratio decreased to 11%, from 13% in the end of 2019.*

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

Chart 84 Outstanding loans and non-performing laons ratio, by type of collateral



Source: Bank of Albania.

BOX 4 EFFECTS OF MEASURES FOR LOAN CLASSIFICATION, PROVISIONING AND ACCOUNTING - INTERNATIONAL EXPERIENCE

The majority of countries that have implemented accommodative measures / instruments for borrowers and the appropriate prudential treatment have generally done so in accordance with the instructions of the Basel Committee, the International Accounting Standards Board (IASB), and the regional / national authorities in charge.

For the classification of loans as 'non-performing', especially for the element related to 90 days in arrears, the instructions suggest that this ought to be related to the 'modified payment schedule', i.e. considering the changed debt obligations after the application of the mitigation measure. This way, as long as the moratorium is in force and the loan repayments are suspended, counting the 'days in arrears' for the loan is stopped. Likewise, the other element of the loan classification related to the borrower 'insolvency' (despite not being 90 days late in payment), should be based on the bank's assessment on whether the borrower is insolvent according to the modified payment schedule of loan. As long as the bank deems that the borrower's payment difficulties are temporary and are sufficiently addressed by rescheduling payments, loans may remain in the same classification category, with unchanged provisioning requirements.

Regarding accounting, the IFRS 9 standard is used in many countries of the world, including countries that are member states of the European Union. This standard entered into force on 1 January 2018 and is being completed through a transitional phase. In the US, the Financial Accounting Standards Board (FASB) has adopted its Expected Credit Losses framework, known as Current Expected Credit Losses (CECL). For large US banks (listed on stock exchanges) the framework came into force on 1st January 2020, while for others it enters into force on 1st January 2022, always through a transitional phase.

IFRS 9 groups loans into three categories: performing / standard (Class 1), substandard (Class 2) and non-performing / impaired (Class 3). Unlike the previous methodology (IFRS 39) which required the creation of credit risk provisions on the basis of 'incurred losses' on the reporting day (incurred losses - IL), IFRS 9 requires banks to create provisions on the basis of Expected Credit Losses (ECL) for the first 12 months of credit term in Class 1, and for the entire loan term in Classes 2 and 3. For this reason, the criteria that cause the transfer of loans from Class 1 to Class 2 and 3 are important.*

In order for a loan to move from Class 1 to Class 2, the following must have occurred: a) a Significant Increase in Credit Risk (SICR), from the moment the credit is registered (recognition) when it offered or bought; b) there is an over 30 days delay from repaying the loan (but this is a determinant deadline; or c) the bank has modified the loan terms (forbearance). A loan is classified in Class 3 if the delay in loan repayment exceeds 90 days or even earlier if an event is verified that is estimated to cause insolvency to the borrower (default).

Table 8 IFRS 9 - classification, provisioning and accumulation of interests

	Class 1 - Performing loans	Class 2 - Sub-standard	Class 3 - Non-performing loans Each of the following events serves as evidence / proof of credit failure
Classification (credit quality)	-Performing loan & does not have a SICR from the moment of loan origination.	- A SICR has occurred since the loan origination. - SICR is not defined but there are various qualitative factors which provide important information for the evaluation of the SICR; - Loans overdue by more than 30 days are considered to represent a SICR.	-Significant financial difficulties of the borrower; -Breach of the contract as a failure or delay (considering that delays in payment beyond 90 days, represent a failure); - The bank has provided the borrower with some facilities, due to its difficulties (forbearance); - It is possible for the borrower to apply for bankruptcy; - The disappearance of an active market for the financial instrument, due to difficulties; - The value or origin of a financial asset with a very high discount that reflects the credit losses.
Provisioning	ECL for 12 months	ECL for the whole term of the loan	ECL for the whole term of the loan.
Accumulation of interest income	Based on the gross value of the loan		Based on the net value of the loan (gross value minus applicable provisions)

Source: "Payment holiday in the age of Covid: implications for loan valuations market trust and financial stability", BIS, May 2020

Another difference between the IFRS 9 and CECL is the way in which interest income is recognized from non-performing loans. According to the IFRS 9, *interest income is accrued on a gross basis for Class 1 and 2 loans, and on a net basis (deducting provisions) for Class 3 loans. Under the current standard in the USA (which supports the IL and CECL methodology), the treatment of interest income is not specified. In the absence of an accounting standard, banks in the US follow the regulatory guidelines of US banking agencies (FED, OCC, FDIC, NCUA) that prohibit the continued accumulation of interest income (and require the deduction of one that is known but not yet collected) for problematic credit exposures (arrears of more than 90 days)**. On the other hand, even in the case of deferred payments due to the moratorium, IFRS 9 allows banks to accumulate interest on lost payments. This increases the risk of future (prospective) developments if borrowers are insolvent.*

It is estimated that unlike the IL accounting model, the ECL model is much less procyclical, as banks are required to make provisions before the loan fails. Under such conditions, the effect on banks' financial performance and capital will be less volatile and as a result their ability to support lending will be more stable throughout the financial cycle.

But this effect is not obtained in the current situation as the shock that Covid-19 caused was too strong. In fact, according to IFRS 9, in the face of very uncertain economic developments as a result of the pandemic, banks would have to reclassify a significant part of their loans from 'standard' to 'substandard' and even to 'non-performing', due to the more negative expectations for credit risk throughout its duration. For restructured loans where there is a decrease in the Net Present Value of the exposure after restructuring, the bank should add provisions for the value of the change. Also, they would also need to recalibrate their parameters for the assessment of the ECL. Together these would cause a significant increase in provisions for loan risk, which could cause financial losses for banks and a reduction (until absence) of capital.

In these circumstances, pragmatism is needed to reduce procyclicality and find the right equilibrium between a financial situation which is accompanied with lack of lending and potentially problems in the financial system in one side, and the need to maintain the significant accounting standard and credit risk provisioning with a forward-looking approach, on the other side.

Overall, in jurisdictions that implement IFRS, the authorities have issues special guidelines, aiming at evidencing the flexibility available in IFRS 9. Thus, in Canada, European Union and United Kingdom, the Basel Committee and IASB have clarified that the use of programs to defer the repayment of loans should not automatically be considered to have suffered a "Significant Increase in Credit Risk" (SICR) and does not necessary raise a loan sift from Class 1 towards those 2 and 3. Also, it is evidenced, that the estimation of ECL, in general, and of SICR, in particular should be conducted by taking into account reasonable and supportable information that is available about past events, current conditions and forecasts of future economic conditions. Overall, the measures taken by authorities in jurisdictions that implement IFRS 9, have aimed at avoiding the extremely pessimistic expectations on the forthcoming economic developments and the estimations of ECLs. For example, in Canada and the United Kingdom, the authorities have requested banks to consider in addition to Covid-19 effects, also the supporting measures taken by the governments while determining their forecasts. Also, EBA has reiterated the European banks on the importance that the crises is perceived as temporary and the data for a current information/ assessment, currently are not available.

Table 9 IFRS jurisdictions – impact of measures on provisions, earnings and CET 1

	Impact on provisioning	Impact on net income	Impact on CET1
Banks can accrue interest on payments that have been deferred.*		Increase	Increase
Use of payment deferral programme should not automatically lead to a migration of loans to stage 2	Decrease	Increase	Increase
In use of forward-looking information in determining ECL provisions, consider exceptional circumstances and government support.	Decrease	Increase	Increase
For risk-based capital requirements on loans subject to a government guarantee, the credit risk of the sovereign should be used. (BCBS).			Increase
Payment deferral programmes related to Covid-19 do not need to be treated as past due for risk-based capital requirements. (BCBS).			Increase
Transitional rules on impact of ECL provisions on CET 1 capital. (BCBS).			Increase

Source: "Expected loss provisioning under a global pandemic", BIS, April 2020

* IFRS 9 allows banks to accrue interest on stage 1 and 2 loans on a gross basis and stage 3 loans on a net basis.

In USA, the authorities have undertaken legal actions (Coronavirus Aid, Relief and Economic Security - CARES Act, March 2020) which allow banks to delay CEC implementation until the end of 2020. Following, the banking agencies issued an interim final rule that allows banks that elect to adopt CECL in 2020 to mitigate the effects of implementing CECL in their regulatory capital for up to two years. In other words, even if large listed banks adopt CECL in 2020 for the purposes of recognition in earnings and their published financial statements, any increase in provisions that is due to the application of CECL versus the IL methodology will not be reflected in regulatory capital during this two-year period.

Table 10 United States – impact of measures on provisions, earnings and CET 1

	Impact on provisioning	Impact on net income	Impact on CET 1
Option to defer application of CECL until 4Q 2020 for large, listed banks.	Decrease	Increase	Increase
Short-term modifications to borrowers affected by Covid-19 and who were paying as agreed prior to the debt modification and would not be considered a "troubled debt restructuring"	Decrease	Increase	Increase
For risk-based capital requirements on loans subject to a government guarantee, the credit risk of the sovereign should be used. (BCBS)			Increase
Payment deferral programmes related to Covid-19 do not need to be treated as past due for risk-based capital requirements. (BCBS).			Increase
Transitional rules on impact of ECL provisions on CET 1 capital. (BCBS).			Increase

Source: "Expected loss provisioning under a global pandemic", BIS, April 2020

At the international level, the Basel Committee has clarified the regulatory treatment of different payment moratoriums and government guarantees in the context of risk-based capital requirements. The Committee also has agreed on certain amendments to the existing transitional arrangements in regard to the recognition of ECL provisions in regulatory capital, allowing the option *to add back into regulatory capital up to 100% of the provisions attributable to the application of ECL provisioning methodologies in 2020 and 2021. If this option is exercised by all BCBS members, it means that only accounting provisions related to incur losses will be reflected in the calculation of banks' CET 1 measures in 2020 and 2021.*

Overall, all measures taken by various countries aim at easing the pressure on banks' ECL provisioning practices and their reported earnings, while allowing member jurisdictions the option to fully neutralise the impact of ECL provisions in the calculation of CET 1 capital for 2020 and 2021.

* Unlike IFRS 9, CECL in the US requires banks to raise credit risk provisions, for the entire duration of the loan, from the first day of its registration.
** The supervisory regulatory framework of the Bank of Albania follows a similar approach.

3.1.2.2 Liquidity risk

The banking sector's liquidity position is assessed as at satisfactory levels. The liquidity indicators, both in lek and foreign currency, stand above the minimum regulatory ratios. Deposits remain the main source for funding bank credit, which cover twice the volume of bank loans. At the end of June 2020, the loans/deposits ratio registered 48%, slightly down compared with the previous period and the previous year. By currency, this ratio stands at 47.2% for the domestic currency and 48.7% for foreign currency.

The banking sector's liquidity position remains at good levels, and the respective indicators stand considerably above the minimum regulatory ratios.

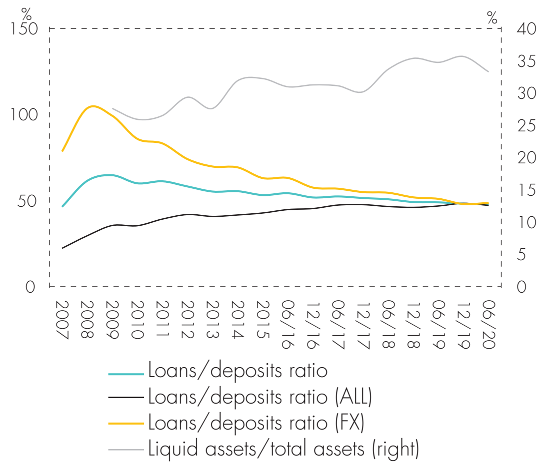
The abundant presence of liquid assets mitigates the potential risk signals coming from negative values in the maturity gap between assets and liabilities in the short run.

The loans/deposits ratio in lek is considerably lower than the values in the previous period (48.5%), as deposits grew faster than loans. Changes in this ratio appear to be low, compared with the previous year, as both loans and deposits base in lek have shown similar performance. This ratio in foreign currency was slightly up for the period, and fell by 2.3 percentage points compared with the previous year, by reflecting the higher pace of deposits growth in foreign currency compared with the growth pace of loans denominated in foreign currency.

Liquid assets in banks' balance sheets remain high, reflecting the slow performance of lending. At the end of June 2020, the ratio of liquid assets to total assets of the banking sector was 33.3% or around 2.4 percentage points lower than in the previous period. This performance reflects the fall of liquid assets in banks' balance sheets in addition to the expansion of total assets. The fall of liquid assets drove to the decline of liquid assets to total short-term liabilities ratio by 3.3 percentage points, standing at 46.1%.

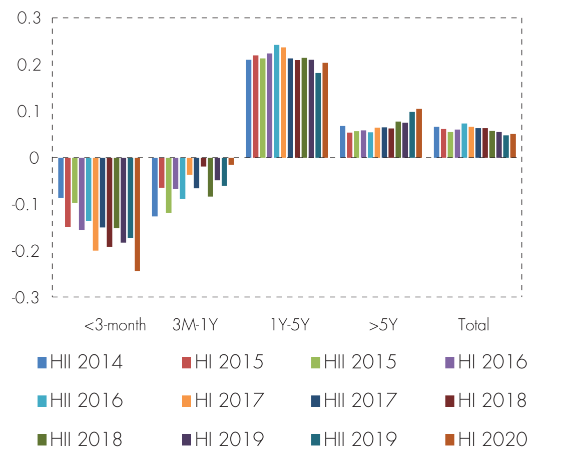
Although banks are operating under ample liquidity conditions, the negative gap between assets and liabilities by residual contractual maturity segments, as a ratio to total short-term assets, remains at high levels. The negative gap between short-term assets and liabilities by residual contractual maturity segments[36] for the period up to 3 months, increased to 26% of assets, from 17%. On the other hand, the gap between assets and liabilities for the period of 3 months - 1 year, during the period, decreased to 2% of total assets. The overall gap continues to be positive, supported by the high positive values for longer-term maturities, and amounts to 5% of banking sector's assets.

Chart 85 Liquidity indicators



Source: Bank of Albania.

Chart 86 Maturity mismatch between assets and liabilities



Source: Bank of Albania.

The average maturity mismatch between assets and liabilities has increased during the period, due to the expansion of the average maturity of assets. At the end of June 2020, this mismatch was around 23.1 months, from 21.4 months at the end of the previous period. Deposits' residual maturity, which represent the most significant category of liabilities, narrowed to 7.7 (from 8.3) months over the period. The residual credit maturity also decreased to 45.7 months (from 46.5).

The opposite performance of loans and assets' average maturity is explained in the view of the increased share of securities in the banking sector's assets. The maturity terms of the latter have increased, while the maturity terms of loans are shorter. On the other hand, the lowering in maturities of loans may show the hesitation of the banking sector to lend in longer terms, as the solvency, due to the latest developments, may fall in the future. Similar to the previous period, the banking sector did not report the use of funding lines by the parent groups.

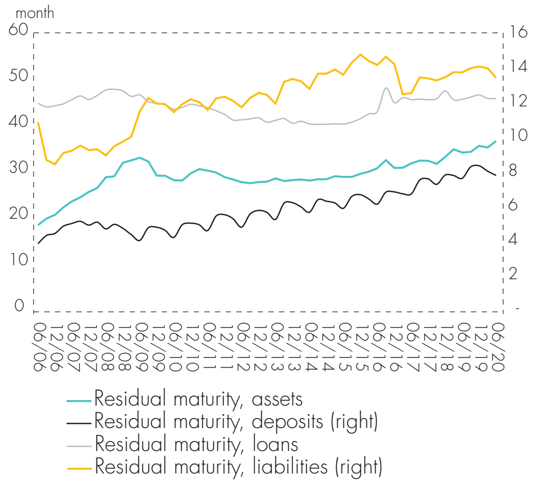
[36] *Calculated as the ratio of 'difference between assets and liabilities' to 'total assets' for each basket of residual maturity. Off-balance sheet items are included in the value of assets and liabilities.*

4.1.2.3 Market risks

EXCHANGE RATE RISK

Net open foreign currency position levels point to a declining and limited exposure to the direct impact of exchange rate fluctuations on banks' balance sheets. The aggregate indicator for all banks, as well as the indicator for the group of banks by size, showed very low values compared with the 30% upper limit of regulatory capital defined by the respective regulation.

Chart 87 Average residual maturity



Source: Bank of Albania.

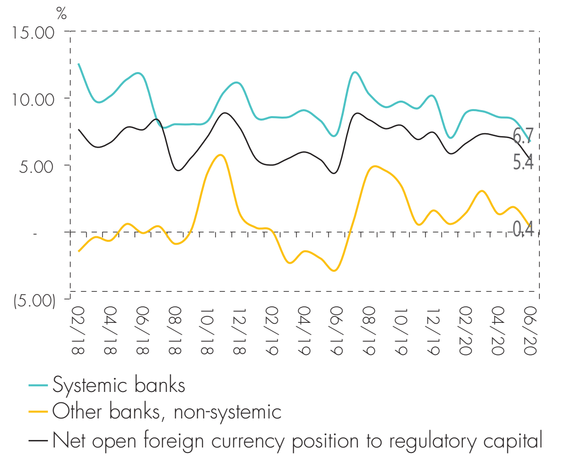
During the first half of the year, the open foreign currency position decreased by about 2 percentage points, down at 5.4% of regulatory capital. This indicator was around 0.9 percentage point higher compared with the previous year. The performance of the indicator is dictated by the group of systemic banks, which have maintained a long open position. This position was at 6.7% of regulatory capital or 3.3 percentage points lower from 10% at the end of 2019, and 0.3 percentage point lower than 7% in the previous year. The group of other banks (non-systemic) shows a lower exposure to the exchange rate, with a net open foreign currency long position accounting for 0.4% of regulatory capital. During the first half of the year, non-systemic banks recorded a net long position accounting for 1.6% of their regulatory capital.

Net open foreign currency position of the banking sector, has been downward, remaining at limited levels and significantlybelow the regulatory limit.

The banking sector's exposure to indirect exchange rate risk increased, driven by the upward exposure indicators from the group of systemically important banks.

The exposure of the banking sector to the indirect exchange rate risk increased by 0.4 percentage point compared with the previous period, while it was 0.3 lower percentage point compared with the previous year. At the end of the period, the foreign currency mismatch[37] for all currencies resulted at 16.5% of total assets from 16.1% and 16.8% in the previous period and in 2019, respectively. Foreign currency assets and liabilities recorded the same growth rate (around 2%), but the main impact on the increased of the indicator was given by the growth of loans in foreign currency to residents (around 4%), which increases the indirect risks coming from fluctuations of the exchange rate. The European currency has a much higher contribution and correlation with the overall index. Euro has a considerable share in the balance

Chart 88 Open foreign currency position to regulatory capital for the sector and groups

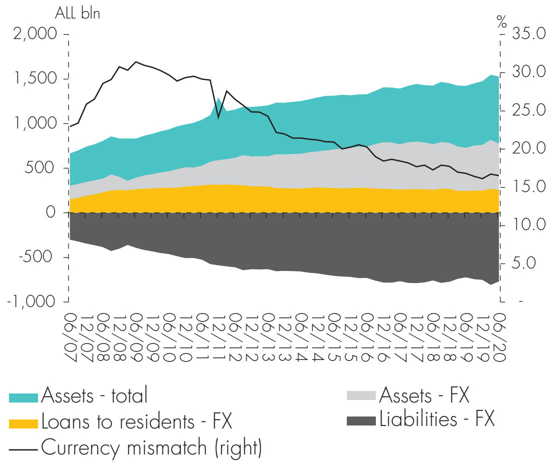


Source: Bank of Albania.

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

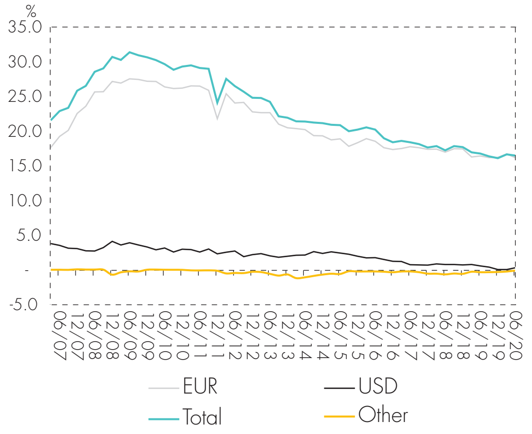
sheet and activity of banks, compared to other currencies. Notwithstanding, the index for the Euro slightly fell by 0.1 percentage point, to 16.2%, during the period. The increase of the index for US dollar at 0.4%, from 0.1% in the previous period, provided the main contribution in the increase of the value of the overall index, in 2020 H1. At the same period in the previous year, the index values for the Euro and US dollar were 16.5% and 0.6%, respectively. The foreign currency mismatch index for the other foreign currencies was stable in time and at very low levels, by reflecting an insignificant exposure risk to these currencies.

Chart 89 Indexes components for the banking sector



Source: Bank of Albania.

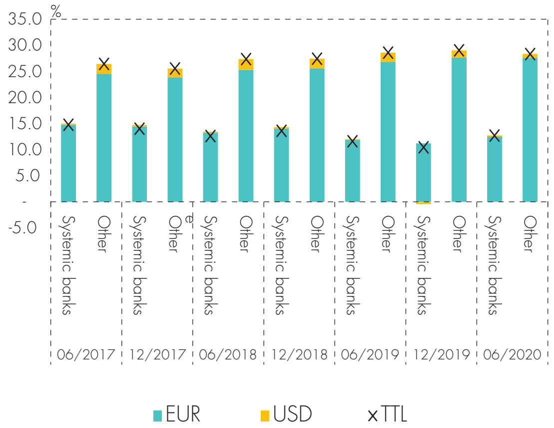
Chart 90 Currency mismatch by currency



Source: Bank of Albania.

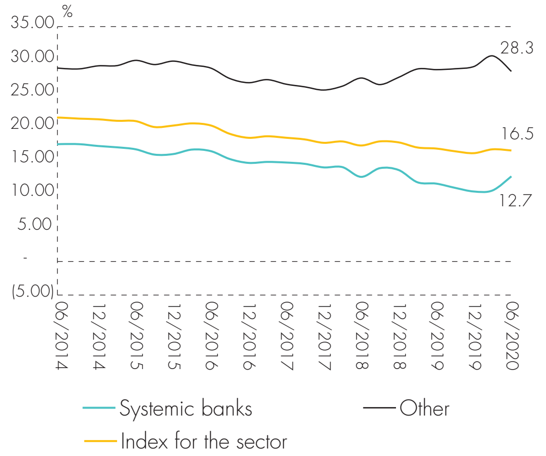
The group of systemic banks continues to provide the main contribution in the performance of the foreign currency mismatch index. This group shows a lower indirect exchange rate risk, as it records lower values of index compared with non-systemic banks. At the end of the period, the total index for systemic banks accounted for 12.7% of the group's assets, from 10.4% in the previous period, and 11.6% a year earlier. By currency, the increase of the index for euro by 1.3 percentage points, accounting for 12.5% of assets, provided the main contribution in this group. The index for US dollar was up by 0.7 percentage point. At the end of 2020 H1, the index for non-systemic banks accounted for 28.3% of assets. This index was down by 0.7 percentage point and 0.3 percentage point compared with the previous period and the previous year, respectively.

Chart 91 Foreign currency mismatch by groups and currency



Source: Bank of Albania.

Chart 92 Performance of foreign currency mismatch indicator for bank groups



Source: Bank of Albania.

INTEREST RATE RISK

The banking sector exposure to the interest rate risk increased considerably during the period, but remains at limited levels. The weighted total net position in banks' balance sheet against regulatory capital stood at 5.9%, higher 3 percentage points from the level at the end of previous year. The weighted spread of assets with fixed interest rate liabilities (FIR)[38] provided the main contribution in the increase of this indicator. On the other hand, the net position with variable interest rate (VIR) increased in semi-annual and annual terms, although at a lower level compared with FIR, by maintaining the positive direction of the last two years.

The banking sector exposure to the interest rate risk increased during the period, but remains at limited and at low levels against the regulatory capital, considerably below the regulatory limit.

Banking sector shows an increased sensitivity to possible interest rate fluctuations for net position at fixed interest rate, for both long and medium-term maturities and in the European currency.

When the total net position is positive, i.e. the volume of claims that collect interest is greater than the liabilities for which interest is paid, the banking sector would be exposed to an immediate decline in interest rates. However, under the conditions where the regulatory capital hedging of these positions remains high and having limited room for further decrease of interest rates, the cost that may come to the banking sector due to the further decrease of interest rates can be easily absorbed.

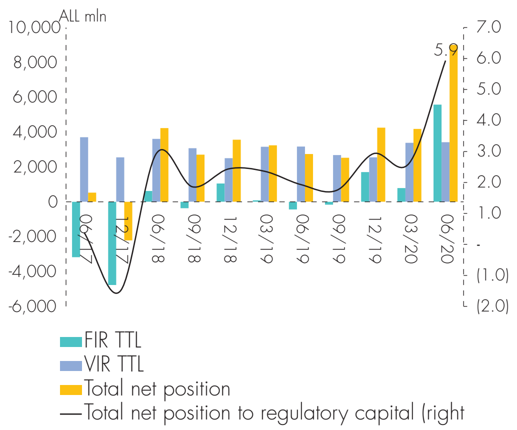
During 2020 Q2, banking sector was characterised by a notable increase of exposure to the interest rate risk. The exposure indicator reached to the highest level in the last years, standing at 5.9% of the banking sector's regulatory capital. During 2020 H1, systemic banks and other banks showed an upward exposure compared with the previous period and a year earlier. The group of other banks (non-systemic) shows a higher exposure compared with systemic banks, at 6.7% of their regulatory capital. The other banks expanded their exposure increasing by 2.2 percentage points and 3.5 percentage points,

[38] *Positions sensitive to interest rate are classified in positions with fixed interest rate (FIR) and positions with variable interest rate (VIR), by maturity and currency.*

respectively, compared with the previous period and the previous year. The performance of the banking sector indicator is driven mainly by the group of systemic banks. This group expanded considerably its exposure at 5.7% of regulatory capital, up by 3.3 percentage points from the previous period, and by 4.3 percentage points from the previous year.

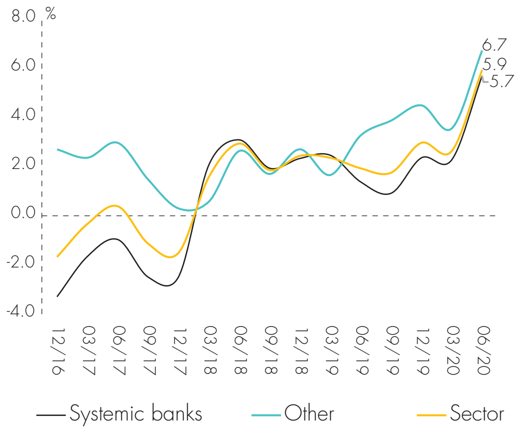
Both groups of banks showed higher exposure in the spread between assets and liabilities with Fixed Interest Rate (FIR), and this position was 3% of regulatory capital for systemic banks, and 6% of the regulatory capital for the other banks. At the end of 2020 H1, the exposure to assets and liabilities with Variable Interest Rate (VIR), was lower than the exposure to the fluctuations of fixed rate, and resulted 2.7% for systemic banks and 0.7% of regulatory capital for the other banks.

Chart 93 Weighted total net position in bank's balance sheets against regulatory capital, in %



Source: Bank of Albania.

Chart 94 Performance by groups of weighted net position against regulatory capital, in %



Source: Bank of Albania.

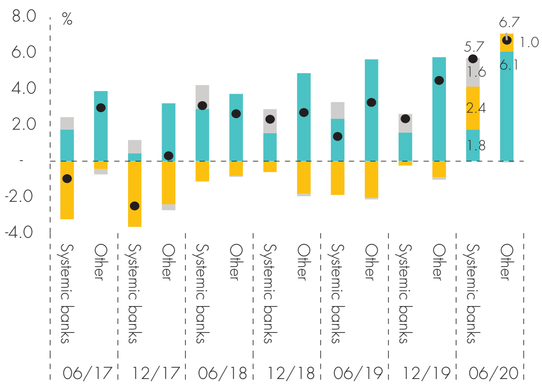
By currency, the total net position to regulatory capital was affected by the net position in the European currency, which for the first time in these five years, recorded positive values[39]. This position expanded by 2.5 percentage points, accounting for 2.1% of the banking sector's regulatory capital, compared with the end of 2019. Net position in Euro has positive values for systemic banks, whose position in this currency is the highest one among the positions by currency, and accounts for 2.4% of their regulatory capital. For the group on non-systemic banks, this indicator was 1% of the regulatory capital. Exposure indicator against interest rate fluctuations in the domestic currency stood at the same level with that of the end of previous period, accounting for 2.8% of regulatory capital. Nevertheless, it continues to be the main exposure for the banking system, due to the large position in this currency of the non-systemic banks group. During the period, the position in lek for these banks, expanded by 0.3 percentage point, standing at 6.1% of the regulatory capital.

[39] *Assets and off-balance sheet items sensitive to the interest rate are larger than liabilities and off balance sheet items in Euro.*

Meanwhile, systemic banks increased by 0.2 percentage point their exposure in lek, to 1.8% of the regulatory capital. The position of banking sector in US dollar increased by 0.5 percentage point to 1.2% of regulatory capital, driven mainly by systemic banks, which increased their exposure by 2.6 percentage points, to 2.4% of the regulatory capital. On the other hand, non-systemic banks maintained a stable exposure in time and at very low negative values (-0.1% of regulatory capital).

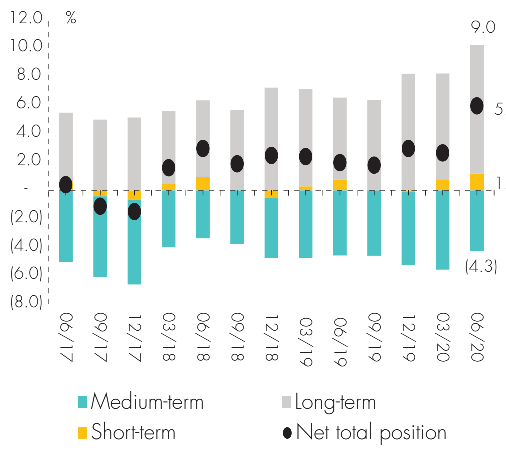
By maturity term, long-term maturity basket shows higher exposure to interest rates fluctuation, recording 9% of regulatory capital, up by 0.8 percentage point from the previous period. Nevertheless, the weighted net position to regulatory capital was mainly affected by short-term maturity position, which increased by 1.3 percentage points, at 1.2% of regulatory capital, from the low negative position in the previous period (-0.1%). For medium-term maturity the negative position between assets and liabilities, sensitive to interest rate, was -4.3% of regulatory capital. This indicator decreased by 0.9 percentage point and 0.3 percentage point, respectively, from the position in the previous period and in the previous year. The narrowing by ALL 1.7 billion of the weighted net position for fixed interest rates (FIR) in Euro provided the main contribution in this maturity.

Chart 95 Gap by group and currency against regulatory capital, in %



Source: Bank of Albania.

Chart 96 Weighted net position by m,aturity to regulatory capital, in %



Source: Bank of Albania.

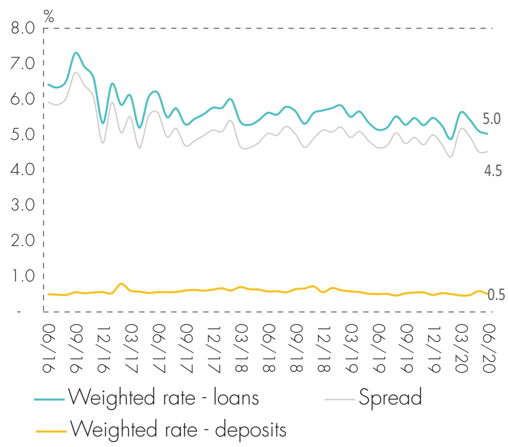
The indirect risk to interest rate spread[40] decreased during the period. The weighted credit interest rate fell by 0.5 percentage point compared to six months ago, standing at 5%, while the weighted deposits rate stood at the same level of 0.5%. As a result, the overall spread fell by the same level of

[40] This risk refers to the impact that the change in the interest rate has on banks' clients. For example, despite the fact that the increase of the interest rate may have a positive impact on bank's balance sheet (due to positive value of the net position between assets and liabilities sensitive to the interest rate), this increase will have a negative impact on the solvency of bank's borrowers when the loans is granted with variable interest rates (indirect risk).

0.5 percentage point from the six months ago, to 4.5%. The fall is only 0.1 percentage point, from the previous year spread of 4.6%.

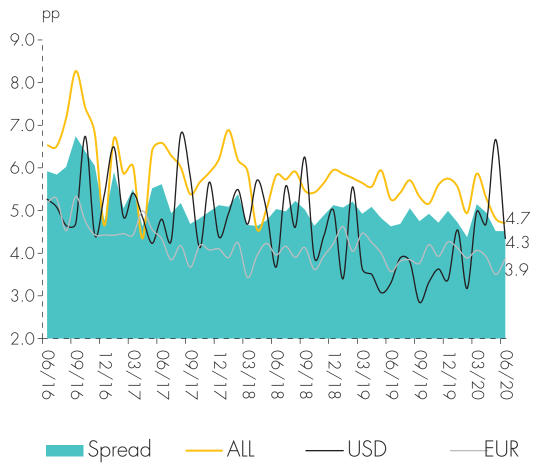
By currency, the 1.1 percentage point and 0.4 percentage point fall in the spread of both domestic and European currencies, to 4.7% and 3.9%, respectively, provided the main contribution in the redaction of spread. Unlike the two-above currencies, US dollar spread increased by 1 percentage point, to 4.3%, driven by the increase in the weighted interest rate on loans in US dollar during the first half of year. The highest level of spread for US dollar is noted in May, due to the increase in both the interest rate applied on loans and the number of banks which granted loans in this currency.

Chart 97 Spread of weighted interest rates of loans and time deposits by currency, in %



Source: Bank of Albania.

Chart 98 Spread of weighted interest rates of loans and time deposits by currency, in p.p.



Source: Bank of Albania.

BOX 5 MEASURING BANKING SECTOR'S RISK THROUGH Z -SCORE

Z-score is one of the most employed indicators to measure the risk level to financial institutions and their distance from the likelihood of bankruptcy. Various researches have proposed different approaches to measuring this indicator. The major part of approaches is based on the performance of profitability and on the capitalisation ratio of institutions or particular segments of the financial system. The classic formula used to calculate the Z-score (formula 1) shows the number of standard deviations by which the capitalisation level of a bank should be reduced so far it cannot be in the position to pay the liabilities. Built in this way, the Z-score shows in quantitative terms, (in index units) a bank's distance from bankruptcy. The higher Z-score is, the financial situation of the bank will be more stable, risk that bank heads to bankruptcy, or the insolvency probability -∏ will be lower (formula 2) .

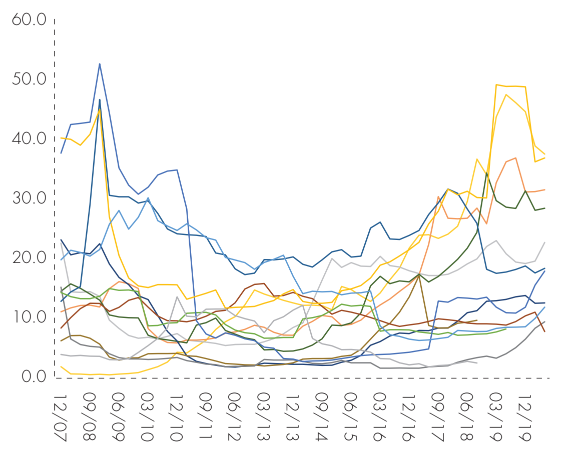
(Formula 1) $$Z = \frac{RoA = K/A}{\sigma RoA}$$

(Formula 2) $$\pi = \frac{1}{2*Z^2}$$

Where: RoA is the Return on Assets, C/A is the shareholder's equity to average assets and σRoA is the standard deviation of RoA indicator. Here it is analysed the decomposition of Z-score by two basic components: profitability (RoA/σRoA) and capitalisation ((C/A)/σRoA).

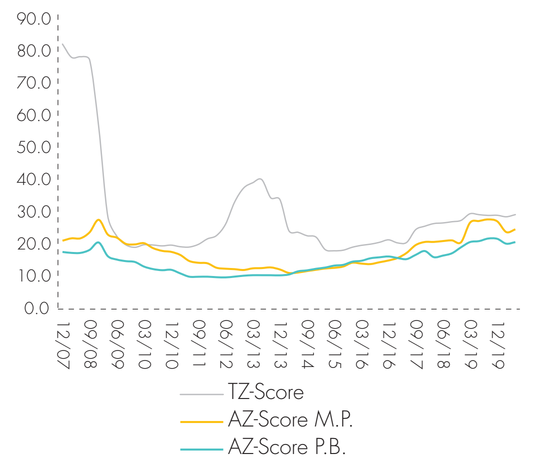
To calculate Z-score for the banking sector, and individual banks that conduct their activity in Albania, the Bank of Albania is based on contemporary methodologies that consider the timely change in the risk profile of financial institutions. In technical terms, this calculation is performed by replacing the current values of profitability by the moving average of some periods (months, quarters or years, which cover a 3-y period of time). In case of Albania, because of the length of series and the frequency of data, the time period being selected to build the moving average and the standard deviation of RoA is 16 quarters or 4 years. In the first step of the research, Z-score is calculated for each bank of the Albanian banking system for the period Q1:2004 - Q2:2020. In the second step, there are performed various estimations for the aggregate Z-score to the banking sector, and there are built the aggregated indicators to groups of banks, as: systemically important banks; non-systemic banks, banks with foreign capital, etc. In the third step, it is analysed the contribution of individual banks to the overall risk to the banking system by the method "excluding one bank". The contribution of systemic banks in the overall risk level of the banking sector is analysed in the same context.

Chart 99 Z indicator for individual banks during Q4:2017 – Q2:2020



Source: Bank of Albania.

Chart 100 Aggregated Z indicator during Q4:2017 – Q2:2020



Source: Bank of Albania.

Results for individual banks show that for the major part of banks, Z-score dropped during 2010-2011, standing at low levels during 2013-2017, and is upward from the beginning of 2015 and onward. The minimum, maximum and average values of Z-score to individual banks are: 0.6, 58, and 14.6, respectively, while, for the whole period 11 banks have had the value of Z-score above 10 and 8 banks above 15. Notwithstanding the fluctuation level of RoA plays an important role on the performance of Z-score, it is noted that capitalisation component has the major share and provides the main contribution in the overall risk level to each bank. Overall, in all cases when it is evidenced an improvement of banks' soundness, equivalent to the risk fall for bankruptcy, the improvement is explained in the view of the increase of capitalisation ratio from the bank. On the other hand, the deterioration of the Z-score is directly *related to the drop in profitability, increase of profit fluctuation or both events. Regarding the default probability, ∏ indicator reached at the highest values during 2011-2014, and was considerably down in 2019-2020.*

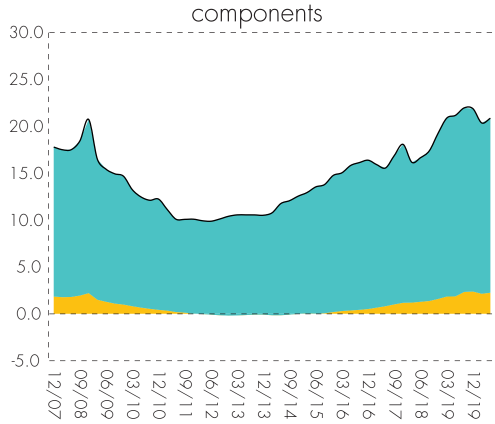
Table 11 Average values of aggregated Z-score and default probability

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	HI-2020
Z (index unit)	19	15	13	10	10	11	12	14	16	17	17	21	21
∏ (index unit)	0.1	0.2	0.3	0.5	0.5	0.5	0.4	0.3	0.2	0.2	0.2	0.1	0.1

Source: Bank of Albania

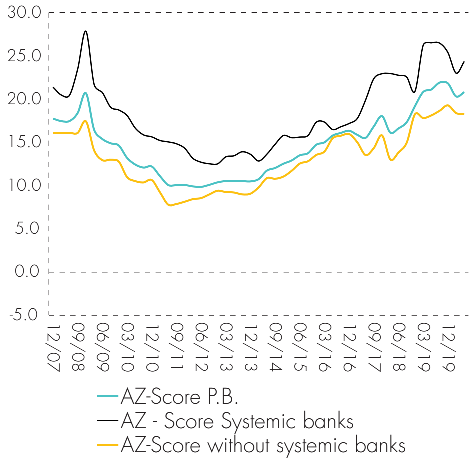
The calculation of the aggregate Z score for the whole banking sector is realised through three ways. TZ-score is calculated at the same way as Z-score for individual banks, by employing the RoA and C/A indices for the whole banking sector. AZ-score W.A. is calculated as the weighted average of Z indices of individual banks, where assets weights of banks to total assets of the sectors are use as weighting coefficients. AZ - Score P.B. Is calculated as simple average of Z scores of individual banks. The detailed analysis of decomposition and correlation of each of aggregated indices with Z-score of individual banks, it results that AZ score - P.B is the most adequate indicator to assess the risk level of the banking sector. Also, the aggregate indicator by employing equal shares, suggests that banking sector's soundness have been improving since the end of 2014-beginning of 2015. In 2020 H1, the average value of Z-score is 21 index units, which in addition to the average of 2019, is the highest value since the end of 2017. The improvement of soundness and the fall of risk to banking sector, alike for individual banks, are affected by the improvement of capitalisation level of the banking sector.

Chart 101 Decpmpositioon of aggreagted Z indicator by profitability and capitalisation components



Source: Bank of Albania.

Chart 102 Contribution of systemic banks in the overall risk level by Z indicator



Source: Bank of Albania.

A value added to the analysis of banking sector risk through Z-score is the assessment of individual banks' contribution of groups of banks with special characteristics in the overall risks of banking sector. The aggregate Z-score constructed for systemic banks suggests the overall risk level to this group of banks has continuously been lower compared with the risk to the rest of banking sector, because during the period under review, the values of Z-score* *to systemic banks are above the values of aggregate Z-score of the banking sector. In a symmetric way, Z-score calculated by excluding systemic banks, has low values or shows higher risk than the indicator being assessed for all banks. The conclusion that systemic banks, overall, have contributed in strengthening the stability and mitigating the systemic risk in the banking sector, is explained in the light of not only the good and stable levels of profitability of these banks, in addition to the their averagely higher capitalisation rates compared with the rest of the baking sector, conditioned by the regulatory requirements of the Bank of Albania on systemically important banks and /or their exposure to particular risks.*

Z -score to the banking sector, individual banks and banking sector, by excluding banks or group of banks, will continue to be used as part of the package to identify and monitor systemic risks in the framework of implementing and assessing the effect of macroprudential measures. In particular, the analysis of systemic banks group will support the analysis and macroprudential framework available to systemic banks in each stage of determining the systemic banks and capital buffers for the systemic importance.

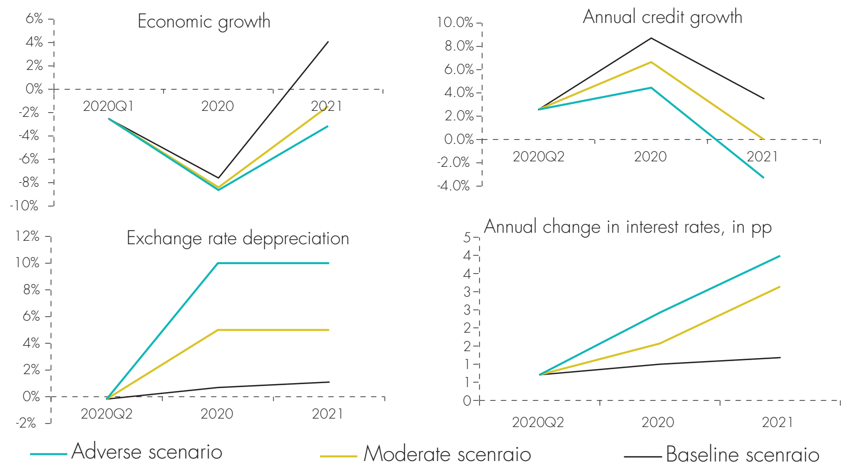
** See Governor's Decision No. 1714, dated 25.03.2020 on "On macroprudential capital buffers".*

4.1.3 BANKING SECTOR RESILIENCE

The results of stress-testing exercise show that banking sector appears resilient to the possible macroeconomic shocks, particularly during the first year of the exercise. During the second year of the exercise, under the most extreme assumption of adversed scenario, the capital adequacy ratio to the banking sector shows a considerable fall and the needs for capital in specific banks are considerable.

The stress test exercise assesses the banking sector resilience in terms of capital adequacy for the period 2020-2021. The exercise is conducted by applying three scenarios: the baseline scenario, the moderate scenario, and the adverse one. Chart 103 shows the considered assumptions in each scenario. The last two scenarios have a lower probability of occurrence and more extreme assumptions. Unlike the previous periods of conducting the stress test, the assumptions in the current exercise contain an effort to include the

Chart 103 Assumptions to construct stress testing exercise



Source: Bank of Albania.

pandemic shock, through the possible transmission channels into the Albanian economy during 2020 and 2021. The scenarios are modelled by assuming that the measures taken by the Bank of Albania regarding the suspension of non-performance loans change and their provisioning neither exist nor are completed. Hence, years 2020 and 2021, may be read as "first year" and "second year" of the exercise.

The baseline scenario assumes an economic contraction in 2020 and a positive economic growth rate in 2021. In this scenario, economic growth is accompanied with the increase of lending and improvement of credit portfolio quality based on loans repayment and write-offs. The moderate scenario assumes a negative economic growth for the two years of the exercise, while the adverse scenario assumes a deepening of the economic contraction for the two years of the exercise.

To the assumptions on the economic performance in both adverse scenarios are also attached the respective assumptions for a depreciation of the exchange rate of the domestic currency, an increase of the interest rate and a halving of the lending pace up to its contraction or stoppage. These developments are reflected in a worsening of credit portfolio quality. In more concrete terms, the ratio of non-performing loans by the end of the second year of the exercise deteriorates to 8.6 percentage points (moderate scenario) and 12.4 percentage points (adverse scenario), compared with the June 2020 H1 real data. These assumptions lead to a decline in the indicators' value of capitalisation, to banks and to the whole banking sector, mainly during 2021. In the adverse scenarios, the effects of market and operational risks are added to the effects coming from the fall of credit quality.

Stress test results in terms of capital adequacy show that:

1. Developments during the first year of exercise and the needs for additional capital [41]

- *In the baseline scenario*, the Capital Adequacy Ratio (CAR) of the banking sector appears stable and above the latest factual value of 2020 H1. In concrete terms, this rate for the banking system is assessed to reach 22.3% at the end of the first year of the exercise. For systemic banks, this average rate stands 22.8%, while for the other banks it stands at 20.8%. These developments reflect the assumptions on the improved growth of credit in the second part of year, further improvement of non-performing loan portfolio and the favourable performance of the exchange rate. These developments show stability and high levels of capitalisation for both the whole banking sector and individual banks, by considering the minimum required level and the additional capital requirements.

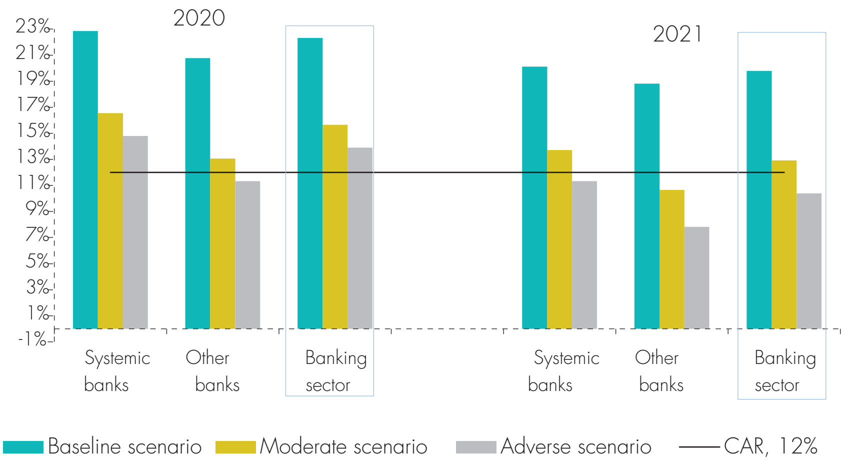
[41] *Calculations on "additional capital" refer to the CAR specific regulatory limit of for each bank.*

- *In the moderate scenario,* the banking sector's CAR registers 15.6% at end-2020. Average CAR for systemic banks is 16.5%, while for the other banks is 13.1%. These rates are maintained within the established regulatory requirements, notwithstanding the assumptions in this scenario for a contraction of the economic activity, depreciation of the domestic currency, worsening of credit portfolio quality and losses in securities portfolio. Based on the above assumptions and the results obtained, developments in individual banks show the need for capital injection, which is estimated amounting up to ALL 7 billion.
- *In the adverse scenario*, the banking sector remains capitalised, but its CAR declines at 13.9% at the end of the first year of exercise. In this scenario, the average capital adequacy ratio for systemic banks is 14.8%, while for the other banks it declines at 11.3%. The adverse macroeconomic developments included in this scenario affect the considerable worsening of credit portfolio quality. This scenario also assumes a loss in securities portfolio and an increase of exposure to operational risk. In this case, the needs for capital are doubled compared with the moderate scenario.

2. Developments during the second year of exercise and the needs for additional capital

- *In the baseline scenario*, capitalisation of banks appears stable registering 20.1% for systemic banks and 18.8% for other banks. Overall, banking sector reaches a capitalisation rate of 19.8% at end of 2021, based on the assumptions for: a positive lending growth; improved quality of credit portfolio; and stability of the exchange rate; throughout 2021.
- *In the moderate scenario,* CAR of the banking sector points to 12.9% at the end of 2021. The group of systemic banks has an average increase CAR of 13.7%, while this rate for the group of other banks is 10.7%. This rate is affected by the assumptions for: a contraction of the economic activity, lack of lending; depreciation of the domestic currency; worsening of credit portfolio quality; and loss from securities portfolio. Based on these assumptions, results show that individual banks evidence the need for capital injection up to the end of 2021, which is three times higher from the first year.
- *In adverse scenario,* CAR for the banking sector drops below 12% at the end of the second year of the exercise. The assumptions on the adverse macroeconomic developments and lending contractions, included in this scenario, affect the considerable worsening of credit portfolio quality. Also, this scenario assumes a loss in securities portfolio and an increase of exposure to operational risk. In this case, the needs for additional capital are 2.5 times higher than those in the first year of the exercise.

Chart 104 Capital Adequacy ratio, by stress-testing scenarios



Source: Bank of Albania.

In addition to the above stress test exercise, the Bank of Albania uses also another approach, through which it is, tested the sensitivity of the banking sector to particular shocks in market and financial indicators, not mechanically related between them. This exercises, is particularly important in cases the relationship between macroeconomic indicators (for example the performance of GDP, exchange rate, interest rates) and the financial indicators (for example, credit, non-performing loans ratio, capital indicators) has become unsecured. This approach is also important to assess the resilience performance of the banking sector against the same shocks, during some time periods. In the performed exercise, the shocks being tested were different, including the unfavourable movements with a certain value of: non-performing loans; the exchange rate; the interest rate; and their combination. The shocks may be calibrated in such a way to understand when the first bank that needs capital appears, when the first systemically important bank that needs capital appears. This approach serves to understand in more details against which shock individual banks are more sensitive and against which one they are more resilient.

Overall, both approaches of stress testing exercise, evidence the importance that the structure of banks' assets and their financial performance have, in the resilience they show to assumed shocks. The most important thing, the results of these exercises provide information to the decision-making of the Bank of Albania regarding the various supervisory measures taken to individual banks and to the banking sector.

4.2 NON-BANKING SECTOR

4.2.1 MAIN DEVELOPMENTS IN THE NON-BANKING SECTOR

The period[42], overall, is characterised by a good performance of the non-banking part of the financial system. The segments of non-bank financial institutions and insurance companies have recorded the highest growth; meanwhile the funds industry appears stable.

Sectors of trade, services and agriculture represent the main activities that take loans to non-banks and SLAs. The quality of loans granted from these entities till the end of the first quarter was relatively good, but downwards from the previous quarter and year. The exposure of banking sector to non-banking sector remains limited and has recorded no change during this period. The non-banking sector's exposure to the banking sector's exposure continues to remain high, as the placements of non-banks to the banking sector, in the form of deposits and capital instruments, account for around 20% of non-banks balance sheet.

INSTITUTIONS SUPERVISED BY THE BANK OF ALBANIA.

During the period, non-bank financial institutions (NBFIs) expanded their activity due to the positive performance of lending activity and investments in the form of time deposits in banks. At end- 2020 Q1, 30 NBFIs operated in the financial system, with a total assets amounting ALL 67 billion. The balance sheet of NFBIs was 3% and 22%, respectively higher, compared with the end of 2019 and the previous year. Lending NBFIs have the main share, followed by those that provide payment and transfer services. Around 70% of shareholding equity of these entities is Albanian capital.

Non-bank financial institutions (NBFIs) expanded their activity following the increase in the financial intermediation. The positive financial result continues the positive trend, being materialised into a satisfactory level of activity capitalisation.

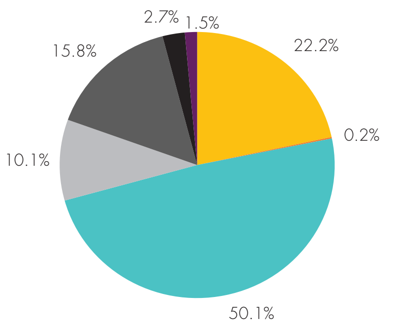
The quality of NFBIs credit portfolio needs to be monitored on ongoing bases, given that the non-performing loans ratio remains above the level of the indicator for the banking sector.

NBFIs are more active in lending to service activities (around 28%) and wholesale and retail trade (16%). NBFIs ended the period with a positive financial result (about ALL 0.7 billion), higher compared to the previous year. The activity capitalisation of these entities continued to remain at satisfactory levels.

The portfolio quality of loans declined slightly, since the ratio of non-performing loans at the end of the year, was 10.2%, from 10% and 9%, respectively in the in the previous quarter and previous year.

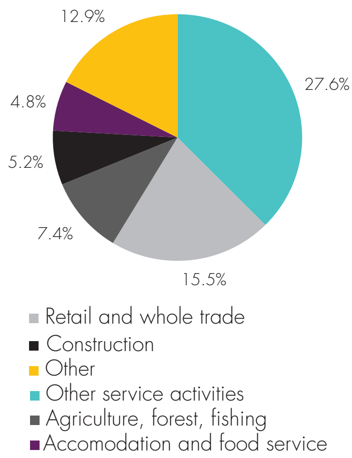
[42] *Data for the non-banking sector are for Q1-2020. This makes impossible the preliminary assessment of the unprecedented effects caused by SARS-CoV-2 pandemic on the activity of this sector.*

Chart 105 Structure of NBFIs by type of activity, March 2020



Source: Bank of Albania.

Chart 106 Structure of loans portfolio by economy sector, March 2020



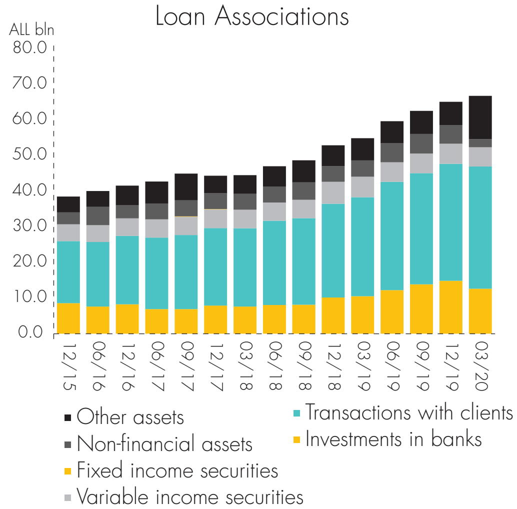
Source: Bank of Albania.

The activity of Savings and Loan Associations (SLAs) was positive in terms of lending and financial result of the period.
Due to the nature of SLAs activity, credit portfolio performs better than credit of banking sector, notwithstanding a slight increasing trend in non-performing loans ratio.

The activity of SLAs expanded both in quarterly and annual terms supported by the growth in net credit (transactions with members) and the growth of investments in the banking sector in the form of time deposits. SLAs financial result was positive and improved compared with the previous year. Net loans to members and investments in banks represent the main items of these institutions' assets. The sector with the largest funding from the activity of the members is the agricultural sector, followed by service activities. At the end of the period, there were 14 Savings and Loan Associations and 1 Union operating in the market.

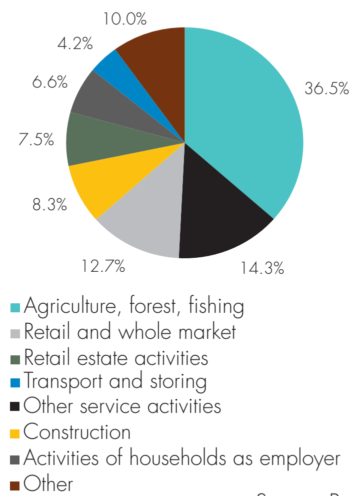
The portfolio quality of loans declined slightly, since the ratio of non-performing loans at the end 2020 Q1 was 5.4%, from 4.7% in the previous quarter, and did not show serious changes from March 2019.

Chart 107 The assets' structure of Savings and Loan Associations



Source: Bank of Albania.

Chart 108 Loan portfolio structure by economy sectors, March 2020



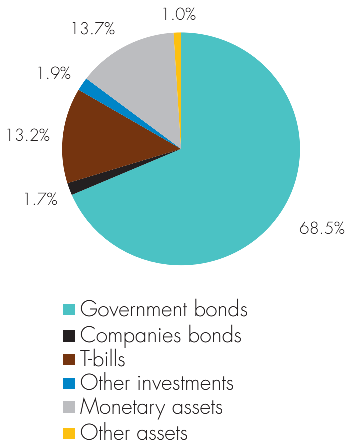
Source: Bank of Albania.

INSTITUTIONS SUPERVISED BY THE ALBANIAN FINANCIAL SUPERVISION AUTHORITY

The activity of insurance companies increased during 2020 Q1 supported by the growth in the current accounts in banks and the investments in real estate and in government bonds. There are 12 licensed insurance companies providing life (4 companies) and non-life (8 companies) insurance services. The assets of these institutions[43] recorded 19% annual growth and reached ALL 39 billion. Investments in banks held the main share (around 30%) in insurance companies' balance sheet. Gross written premiums[44], with the main contribution from non-life premiums (93%), which represent the main funding source for the insurance companies activity, narrowed by 7% in annual terms.

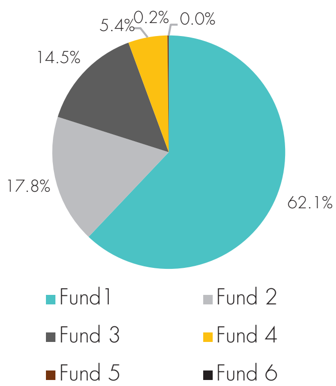
Investment funds[45] maintained the level of net assets unchanged against the end of 2019, at ALL 67 billion. Investments in government securities in the form of bonds and monetary assets recorded a positive performance. Currently, six investment funds operate in the Albanian financial system. The investment fund market is market with a relatively high concentration, where two of the investment funds have around 80% of the total net assets of funds Investment funds' assets are mainly invested in bonds issued by the Government of the Republic of Albania, with higher return, compared to alternative investments.

Chart 109 Structure of the assets of investments' funds, March 2020



Source: Bank of Albania.

Chart 110 Share of investments' fund in the market, according to assets' net value, March 2020



Source: Bank of Albania.

Supplementary Private Pension Funds[46] expanded their activity during the period. In Albania, four supplementary private pension funds operate in the financial market, as at the end of 2020 Q1, the net assets of these funds

[43] *The balance sheet of insurance companies is for 2020 Q1.*
[44] *AFSA, Statistical Bulletin, Insurance Market, January-June 2020.*
[45] *AFSA, "The Market for Collective Investment Ventures", 31 March 2020, published on 14 May 2020.*
[46] *AFSA, Statistical Report "The market of private supplementary pensions", 31 March 2020, published on 7 July 2020.*

registered around ALL 3 billion or 6% higher than the assets level at the end of 2019. The activity of pension funds is dominated by investments in government debt securities.

The Albanian Securities Exchange (ALSE) licensed by the Albanian Financial Supervision Authority in July 2017, started its activity on 22 February 2018. The activity of ALSE, during the period, consisted in transactions with government debt securities. The ALSE counts 4 members, which are banks and one Brokerage Company. According to the statistics of the ALSE Stock Exchange, during 2020 Q1[47], the value of bonds traded was around ALL 108 million, and of T-bills around ALL 119 million. Regarding the instruments traded in the stock exchange market, transactions executed for the account of customers in terms of number and value are dominant.

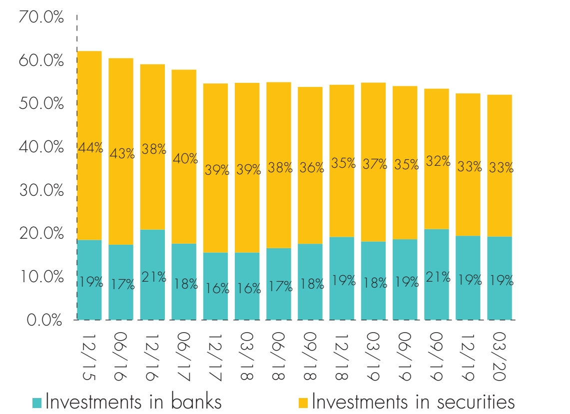
4.2.2 FINANCIAL SYSTEM INTERCONNECTION

The exposure of banking sector to non-banking sector remains limited and with no changes during the period.

The sensitivity of the non-banking sector to the activity of the banking sector remained high and upward during the period.

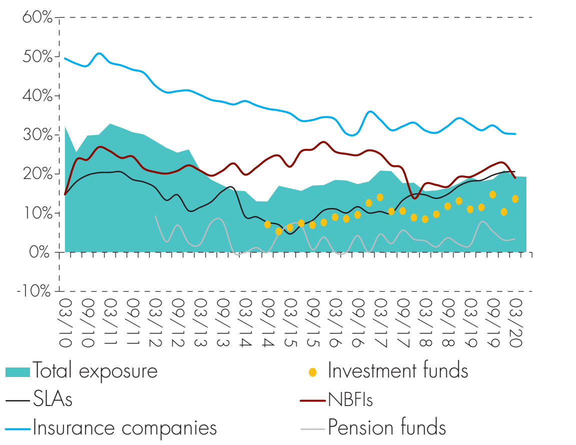
The exposure of banking sector to non-banking sector remains limited and has recorded no change during this period. This exposure on the side of banks' assets is manly represented by loans to non-bank financial institutions, which account for only 1% of total assets of the banking sector. On the side of liabilities of banks, the exposure is in the form of funds collected by them (various accounts, time and demand deposits), and accounts for around 2% of the value of balance sheet of the banking sector. This ration maintains this level for about two years and it is considered as rather low compared with the limit levels applied by the Bank of Albania to monitor the exposure and concentration risks of the activity amongst various segments of the financial system.

Chart 111 Investments of non-bank sector in banks and government securities, to total assets of the non-bank sector (share, in %)



Source: Bank of Albania, Albanian Financial Supervisory Authority.

Chart 112 Investments of non-bank financial institutions in the banking sector to their total assets (in %)



Source: Bank of Albania, Albanian Financial Supervisory Authority.

[47] AFSA, Monthly Periodicals No.132, March-April 2020.

The sensitivity of the non-banking sector to the activity of the banking sector remains high and upward during the period. The exposure of the non-banking sector accounted for 19% of the non-banking sector's assets, as at end 2020 Q1, compared with 19.5% at the end of 2019, and 18% in the previous year. Insurance companies and Savings and Loan Associations (SLAs) show the highest exposure to the banking sector, since their placements in banks in the form of deposits and capital instruments, account for 30% and 21%, respectively, of relevant assets. The NFBIs reduced the exposure and simultaneously the sensitivity to the developments in the banking sector, as these entities have decreased their current accounts in the banking sector. The Bank of Albania monitors regularly the exposure of non-banking sector to the banking sector, in the framework of the regular assessment of systemic risks and for monitoring the fulfilment of intermediate objectives of macro-prudential policy.

5. MACRO-PRUDENTIAL POLICY AND ASSESSMENT OF RISKS

5.1 ASSESSMENT OF RISKS AND MACRO-PRUDENTIAL MEASURES IN EU AND REGIONAL COUNTRIES[48]

The following analysis presents the main risks identified in the financial stability reports and the instruments of macro-prudential policies implemented in European Union (EU) and Regional countries. To this end, a set of reports on risk assessment, prepared by the European Central Bank (ECB), the European Systemic Risk Board (ESRB), the European Insurance and Occupational Pensions Authority (EIOPA), the International Organization of Securities Commissions (IOSCO), etc. The analysed reports date from 2018 till 2019 H1.

5.1.1 ASSESSMENT OF RISKS AND MACRO-PRUDENTIAL MEASURES IN THE EUROPEAN UNION

In this framework, the main identified risks by European Union countries, are the following:

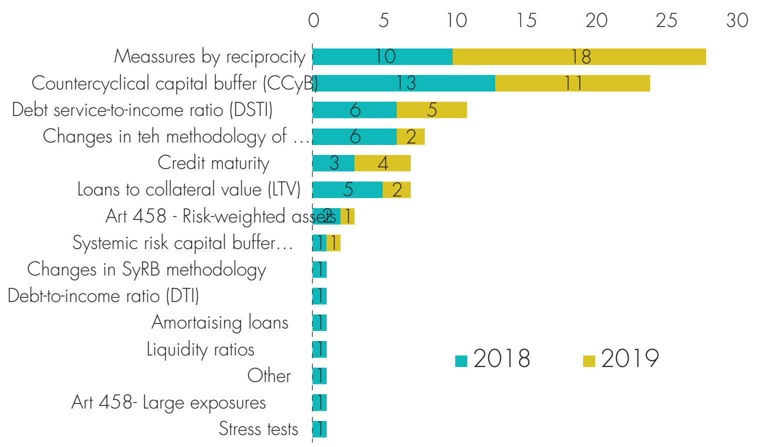
I. The probability that the prevailing low interest rate environment, be followed by pronounced deviations in the risk assessment of financial products;
II. The concern about the stability of both public and private debt levels, particularly after Covid-19 situation;
III. Reduction of banking sector' intermediation capacities due to the low profitability levels from the activity, arising and additional risk to the Euro area financial stability ;
IV. Increase of risk taking by the non-bank financial sector, accompanied by increase of risks in terms of liquidity and capital in their investment portfolio.

Regarding the macro-prudential measures undertaken by EU members, it is noted an overall easing of them during the pandemic period, although throughout 2019 the macro-prudential measures continued the increase of their requirements. In the period before "COVID-19" most measures were of a tightening nature to address cyclical risks. Nevertheless, after the outbreak of "COVID-19" crises, most European countries have lowered the macro-prudential capital requirements at the minimum levels, to enable the recovery of the financial system from this situation. The most frequent employed macro-

[48] *For the purposes of this analysis, Italy and Greece are included in Regional countries, in the framework of the exposure of the Albanian banking sector too these countries.*

prudential tools are mainly: the countercyclical capital buffers; systemic risk buffers; systemically important institutions; and instruments to address the borrower.

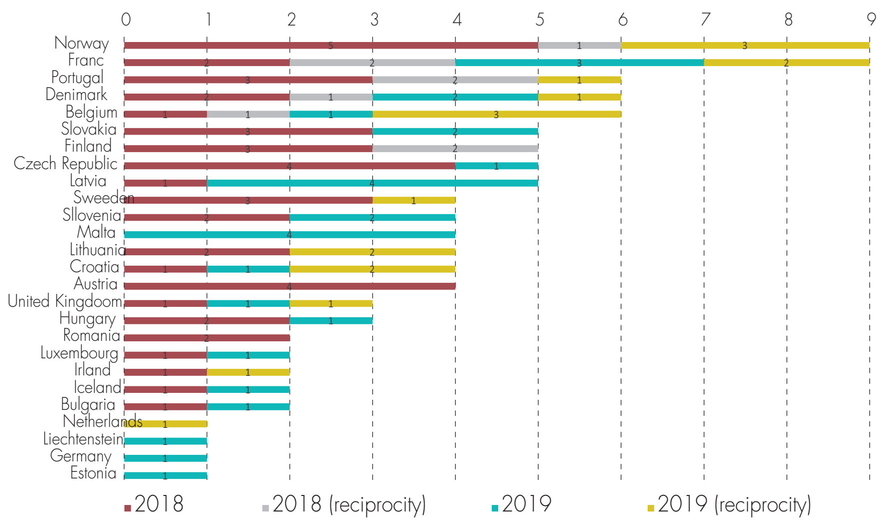
Chart 113 The main measures taken in EU countries, by type



Source: ESRB.

List of more active countries in implementing the main macro-prudential measures is headed by countries like: Norwegian, France Portugal and Denmark.

Chart 114 Number of measures taken by the EU member states



Source: ESRB.

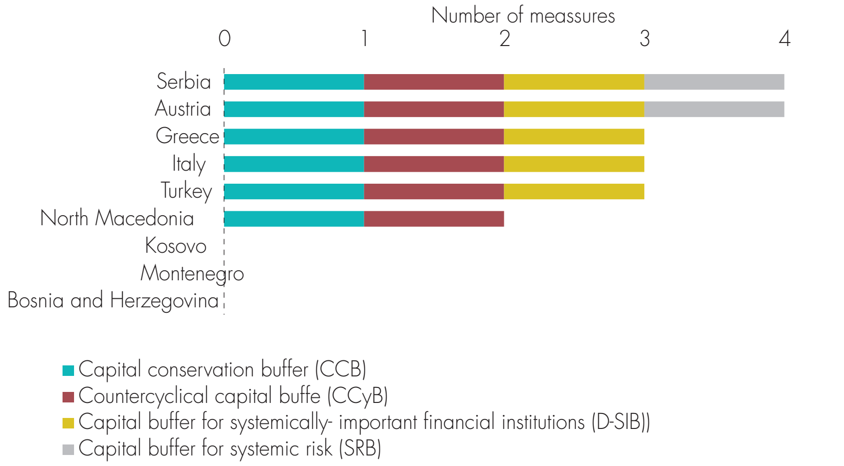
5.1.2 ASSESSMENT OF RISKS AND MACRO-PRUDENTIAL MEASURES IN REGIONAL COUNTRIES

Regarding regional countries, based on the information of the latest reports, the identified risks by them are similar to those being identified by the Bank of Albania due to the similarities of economic characteristics. Some of the main identified risks are as follows:

I. Exchange rate risk;
II. Low profit level in the financial system accompanied with a low nominal increase of portfolio and high level of non-performing loans;
III. High levels of public debt and considerable worsening due to Covid-19 pandemic;
IV. High level of exposures concentration in some sectors of economy, thus affecting the current rate of non-performing loans;

During this half of year, there has been no change in the number of macro-prudential tools being activated in the regional countries. In the regional countries, non-EU members, Serbia and North Macedonia continue to be more active in activating capital buffers requirements for macro-prudential purposes. Across these countries, the more frequently employed instruments relate to the management of systemic risks of structural nature.

Chart 115 apital-based macro-prudential instruments by countries of the region



Source: Official websites of the central banks of the reviewed countries.

5.2 ASSESSMENT OF RISKS AND MACRO-PRUDENTIAL MEASURES IN ALBANIA

5.2.1 ASSESSMENT OF RISKS IN ALBANIA

The Bank of Albania drafts and implements the macro-prudential policy, which analyses and assesses the systemic risk and implements the measures to prevent and mitigate these risks, in two aspects:

I. preventing the accumulation of risks in the financial system; and
II. strengthening the resilience of the financial system.

Regarding the prevention of risk accumulation, the central authority drafts analyses aimed at identifying financial imbalances indicators that reflect the accumulation of risks in the banking sector. The results of this analysis show that at end of 2020 H1, the banking sector continued to maintain good levels of capitalization and liquidity, sufficient to meet the short-term needs, notwithstanding the situation caused by anti-COVID-19 measures. The promotion of lending to businesses, the widening of the negative gap between assets and liabilities by residual maturity, as well as the reduction of the use of foreign currency in the domestic economy continues to be among some of the issues that require special attention.

5.2.2 MACRO-PRUDENTIAL MEASURES IN ALBANIA

In view of strengthening the banking sector's resilience against risks of cyclical and structural nature and their reduction, the Bank of Albania has approved the Regulation on "Macro-prudential capital buffers" and the package of measures to increase the use of the national currency in the financial banking activity. The regulation contains a framework for the implementation of (a) the capital conservation buffer (CCoB); (b) the countercyclical capital buffer (CCyB); (c) the capital buffer for a systemically important bank (CBSyB); and (d) the systemic risk buffer (SyRB) All macro-prudential capital buffers should be accomplished with the Common Equity Tier 1 capital requirements and expressed as a percentage of risk-weighted exposures of the bank. Their simultaneous implementation represents the combined macro-prudential capital buffer or the CMPCB.

The capital conservation buffer (CCoB) requirement is implemented to all banks and entered into force upon the approval of the above stated Regulation. The maximum value of this buffer is 2.5%. The regulation lays down that this buffer be completed at stages of 0.5 percentage point per year starting from March 2020[49]. Currently, the countercyclical capital buffer (CCyB) for Albania is equal to 0% and is announced at the end of each quarter through a decision of the Governor. The decision on determining the systemically important banks and the capital buffer for a systemically important bank (CBSyB) are announced once a year, at the end of the first quarter. Following the Decision of June 2019, the Governor took the regular Decision on 25 March 2020, which expands the number of systemically important banks from four to five and determines the capital buffer to these banks with values from 0.5% to 1.5%.

For the first time, banks report the completion of macro-prudential capital buffers for the reporting period "March 2020". The report shall take place on quarterly basis and the latest reporting is as at June 2020. The result in this report shows that all banks complete the combined macro-prudential capital buffer or the CMPCB, as the completion ratio was above 100%.

The reported results show that banks with the highest level of CMPCB completion are those banks with a high capital adequacy ratio (CAR), and which do not

[49] *During the period 29 March 2020 - 31 December 2020, banks should complete the capital conservation buffer (CCoB) up to 0.5%.*

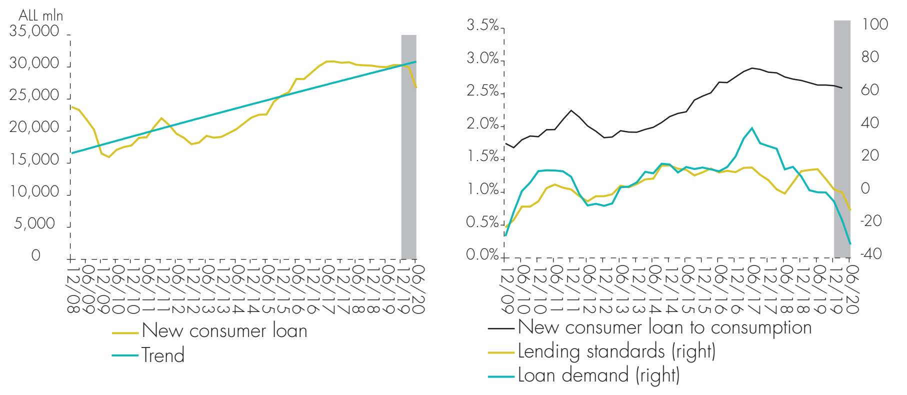
have other mandatory capital requirements (Pillar 2 of Basel) to fulfil. These conditions enable these banks to have a higher "net available capital" ratio compared with the other banks with low CAR.

ANNEX 1 DEVELOPMENTS IN CONSUMER CREDIT AND RISKS TO FINANCIAL STABILITY UNDER THE CRISIS CAUSED BY SRAS-COV-2 PANDEMIC

The hit that pandemic provided to the financial situation of families/households is expected to drive to a fall of consumption, and arises the need to find sources for supporting it. The following analysis focuses on the performance of consumer credit, as a possible source in this case.

In Albania, consumer credit considerably expanded during 2014-2018[50], by providing the main contribution in the growth of credit to households, to slowdown latter since 2019. d A sharp fall in new consumer credit flows has occurred since the first months of Covid 19 outbreak (March 2020, annual fall of 33.7%). At the end of 2020 Q2, the volume of the new consumer credit contracted further by 39.7%. In 2020 H1, the shrunk of the new consumer credit for non-durables provided the main contribution in the performance of new consumer credit. Credit for the consumption of "non-durable good" recorded an annual fall of 49.2% at the end of June. At the same time credit for the consumption of durable goods and overdrafts fell by 30.6% and 22.5%, respectively.

Chart 116 Some indicators of consumer loans



Note: 1.Left-hand chart shows the new consumer loan flows in annual terms.
2. Right-hand chart shows the indicator of consumer loan flow to consumption (left-hand axis). On the right axis of the chart, the negative value shows banks have tightened lending standards and vice versa. Also, the positive value shows increase of credit demand, while the negative balance shows its decrease.
Source: Bank of Albania, INSTAT.

The contraction of consumer credit, immediately after the pandemic shock,

[50] *More details related to the historic performance of consumer credit in Albania are discussed in the previous number of the Financial Stability Report.*

reflects its pro-cyclical nature, as it is a credit that supports consumption. This pro-cyclicality was evident for the data of Albania, if considering the new consumer credit ratio against households' consumption (the above right-hand chart). Available data till the end of 2020 Q1 on private consumption still do not fully reflect the developments related to the measures taken to prevent the pandemic spread. The negative effect of pandemic is expected to be materialised in a further fall of the indicator for 2020 Q1, in a more pronounced contraction of lending, given that the demand for consumer credit has fall sharply (according to the survey on lending activity[51] conducted by BoA), increase of uncertainty and tightening of lending standards by the banking sector.

Also, the rest of financial system (savings and loan association) has granted less consumer loans after the outbreak of pandemic. The consumer loans granted by this part of the financial system have been increasing at a double figure in recent years, nevertheless it shrunk by 12% in March 2020. Outstanding consumer credit being granted by this part of the financial system, in total, accounts for around 10% of consumer credit granted by the banking system.

Chart 117 Composition of consumer credit by purpose of use (left) and the weight ofcomponents in the growth of consumer credit to residents, by purpose of use (in percentage points)

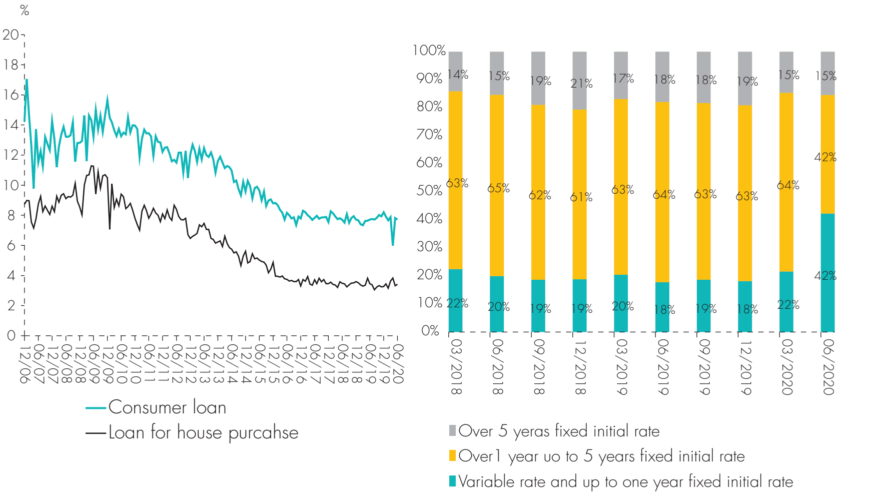
Source: Bank of Albania.

In terms of credit cost, banks have continued to operate in an environment with historically low interest rates. Average interest rate on consumer loans has been volatile during the last two quarters, recording a fall in April, to increase following at the levels similar with the previous year. During this period, the interest rates on consumer loans (mainly uncollaterised) averaged 4 percentage points higher that the interest applied on mortgage loans.

During the period, new contracts increased considerably, when the period for not changing the interest rate is limited for a definite period of time, up to one year. At the end of June 2020, they accounted for 42% of total new consumer loans, compared with the average level of 19% in the last two years.

[51] *For more details see "Bank Lending Survey", at: https://www.bankofalbania.org/Monetary_Policy/Surveys_11282/Bank_Lending_Survey/*

Chart 118 Average interest rate on new loans given to households (left) and structure of initial period of interest rate fixation for new consumer loans (right)

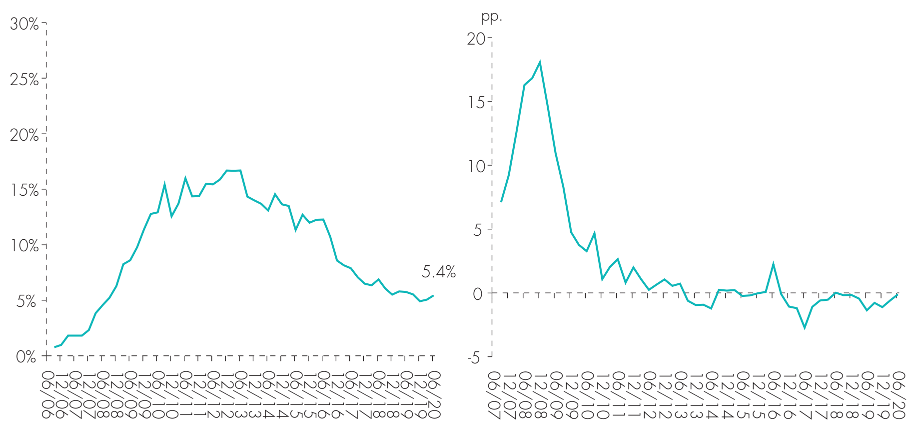


Source: Bank of Albania.

By currency, consumer loans in ALL dominate in the portfolio of banking sector. At the end of June 2020, consumer credit in foreign currency accounted for 13.6% of consumer credit, lower than the average share of around 15% during the previous year. More than half of consumer loans in foreign currency (about 58%) is classified as unhedged against exchange rate risk, however the latter account for only 8% of consumer loan stock. From the borrower's solvency point of view, the risk that comes as a result of unfavourable exchange rate fluctuations remains limited.

In terms of credit quality, consumer credit has experienced relatively lower levels of non-performing loans, despite its higher-risk nature, and has historically provided a minimum contribution in the increase of non-performing loans stock in the banking sector's total balance sheet. The ratio of non-performing consumer loans has entered a downward stage since 2013 H2, marking 5.4% at the end of June 2020.

Chart 119 Consumer NPLs ratio (left); and the contribution of consumer loans in the increase of NPLs stock in total (right, in p.p)



Source: Bank of Albania.

The above data show that consumer credit will continue to be an important instrument in supporting consumption in economy. The potential to its growth remains good, and the interest rates stand at the lowest historic levels. On the other hand, the risk factors the economy is going through in this time are specific. Uncertainty of economic operators, given the pandemic, continues to be high. For these reasons, the demand for consumer loans is rather likely to be weak for some months. In these circumstances, it is necessary to monitor credit quality and adopt its supply depending on the developments.

ANNEX 2 MAIN INDICATORS OF FINANCIAL SOUNDNESS

In %	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Capital-based indicators														
Regulatory capital to risk-weighted assets	17.1	17.2	16.2	15.4	15.6	16.2	18.0	16.8	15.7	16.0	17.0	18.7	18.5	18.1
Tier 1 capital to risk-weighted assets	16.0	16.3	15.3	14.5	14.3	14.6	14.9	13.8	13.5	14.1	15.5	17.4	17.3	17.0
Shareholders equity to total assets	7.6	8.6	9.6	9.4	8.7	8.6	8.4	8.6	9.5	9.7	10.2	10.1	10.5	10.3
Asset quality														
Net NPLs to regulatory capital	10.1	21.7	28.2	35.9	52.0	55.6	40.2	38.3	24.3	23.1	15.7	15.5	13.6	10.9
NPLs (gross) to total loans	3.4	6.6	10.5	14.0	18.8	22.5	23.5	22.8	18.2	18.3	13.2	11.1	8.4	8.1
Profitability														
ROE (annual basis)	20.7	11.4	4.6	7.6	0.8	3.8	6.4	10.5	13.2	7.2	15.7	13.0	13.5	9.1
ROA (annual basis)	1.6	0.9	0.4	0.7	0.1	0.3	0.5	0.9	1.2	0.7	1.5	1.3	1.4	0.9
FX net open position to captial														
FX net open position to regulatory capital	1.7	4.3	3.9	5.0	3.9	4.0	4.1	8.5	7.7	7.0	6.7	7.8	7.4	5.4
FX net open position to Tier 1 capital	1.8	4.5	4.1	5.3	4.3	4.4	4.9	10.4	9.0	8.0	7.3	8.4	8.0	5.7
Asset-based indicators														
Liquid assets to total assets	49.8	42.8	27.6	25.9	26.5	29.4	27.6	31.9	32.3	31.3	30.2	34.2	35.7	33.3
Liquid assets to sh.t. liabilities (up to 1 year)	74.0	64.9	32.6	30.6	33.1	36.7	34.7	40.4	41.4	40.6	40.8	46.2	49.4	46.1
Client deposits to total loans	215.5	162.6	154.3	166.4	163.2	171.6	180.8	180.2	187.8	192.8	194.0	203.2	207.2	208.4

Source: Bank of Albania