Bank of Albania

FINANCIAL STABILITY REPORT

2022/HI

**Approved by Decision No. 38, dated 7.09.2022 of the Supervisory Council of the Bank of Albania.*

Published by: Bank of Albania
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INTRODUCTION

This is the twenty-eighth issue of the Bank of Albania's Financial Stability Report (hereinafter "the 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 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 allows the public authorities to identify, in a timely manner, the relevant measures for corrections, as necessary.

In producing this Report, we have used data available to the Bank of Albania, and information from other authorities supervising the financial market. We have also used information and analyses from public and private, national and international financial institutions. The data and analyses primarily cover developments over the first half of 2022 (hereinafter "the period"). Overall, unless otherwise stated, expectations for the economic and financial outlook extend through a period of up to 12 months.

The stability of the financial system has been assessed based on its performance from its activity, and taking into account the risks arising from the system's interaction with the overall internal and external economic environment. In order to assess the risks arising from the system's interaction with the surrounding environment, this report analyses the latest developments in international financial markets, and in advanced and regional economies. We have also assessed the impact of these developments on the financial system and the banking sector in Albania. In order to assess the developments and risks related to the Albanian economy, the Report assesses the economic growth indicators, balance of payments, overall price levels, exchange rates and fiscal indicators. Also, by analysing the performance of employment and income, and by referencing specific surveys, it evaluates the financial situation of enterprises and households, and the impact on the solvency of borrowers in the banking sector. The Report also presents the results of the stress test, which assesses the banking sector's resilience against macroeconomic and financial shocks, expressed in terms of capital adequacy.

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

NOTES

As of the end of June 2022, the classification of banks in the Albanian banking sector is as follows:

I. According to the marginal contribution of each institution to systemic risk in Albania[1], banks are classified as:

- Systemically important banks: National Commercial Bank, Raiffeisen Bank, Credins Bank, and OTP Bank Albania.
- Other banks: Intesa Sanpaolo Albania, Alpha Bank Albania, Procredit Bank, First Investment Bank Albania, United Bank of Albania, Union Bank, American Bank of Investments and Tirana Bank.

II. According to capital origin, banks are classified as:

- Banks with foreign capital[2]: Raiffeisen Bank (Austria); Intesa Sanpaolo Bank Albania (Italy), Alpha Bank Albania (Greece);National Commercial Bank (Turkey); OTP Bank, Albania (Hungary); Procredit Bank (Germany); First Investment Bank, Albania (Bulgaria); United Bank of Albania (Saudi Arabia). These banks share around 68 % of the banking sector's total assets.
- Banks with Albanian capital: Credins Bank, Union Bank, American Bank of Investments and Tirana Bank. These banks share around 32% in total assets of the banking sector.

III. By geographical expansion of banking network. Banks showing an expansion of their network abroad are, the National Commercial Bank and Credins bank with one affiliate in Kosovo.

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

(1) The terms "loan" and "credit" are used interchangeably in this Report. Likewise, the terms "enterprises" and "firms," and "households" and "families" are used interchangeably.

1 *For more information on the index and determining banks with systemic risk consult the Methodology "On determining banks with systemic risk and the relevant capital buffer:https://www.bankofalbania.org/Financial_Stability/Macro-prudential_policies/Instruments_of_Macroprudential_Policy/Approved acts/*

2 *A bank is classified as having foreign capital, whenever the foreign capital amounts to more than 50% of the bank's paid-in capital.*

(2) In this Report, "outstanding credit" refers to the balance of the account "relations with clients", as reported by banks. It includes outstanding credit granted by the banking sector to non-financial private and public, resident and non-resident entities. Outstanding credit is affected by non-performing loans (NPL) which have been written off from banks' balance sheets 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 have already been 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 2022 H1

Pursuant to provisions under Article 69 of Law No. 8269, dated 23 December 1997 "On the Bank of Albania", as amended; and Article 8 of Law No. 9962, dated 18 December 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 (BoA) 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 by means of 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 2022 H1 (hereinafter, the "period"), operations of the banking sector were stable. Deposits and loans grew at a slower pace compared to previous periods, credit quality continued to improve and the other indicators of the financial system stability remained at adequate levels. Overall, the exposure of the banking sector to risks appeared contained. Economic developments throughout the period were positive, although economic growth and high energy and food prices in the international market maintained pronounced inflationary pressures.

Against this backdrop, the normalisation of the monetary policy has begun aiming to reduce the inflation rate in the medium term, and fiscal and administrative measures are being taken to ensure the necessary energy for the economy. Due to the extraordinary energy prices in the international market and the position of our country as a "net importer" of energy, the growth of economy in the upcoming months is challenging enough. If the economy slows down, the solvency of enterprises and households may decrease, and be transmitted to the banking sector through the decrease in the quality of assets, the reduction in activity-profit levels or the creation of financial losses. In order to manage this scenario, it is necessary for banks to identify their most sensitive exposures and take timely actions necessary to cover the risks, including the creation of financial reserves and the strengthening of capital positions. The

Bank of Albania will continue to carefully monitor developments in the banking sector and macroeconomic and financial indicators. This process ensures that the decisions on the policies implemented by the Bank of Albania respond to current developments and the expectations that are built on them, always aiming to safeguard the macroeconomic and financial stability.

More specifically, developments in this period revealed the following:

World economic activity expanded but at a slower pace, driven by the higher inflationary pressures, tightened financing conditions and the high uncertainty casted by the Russia - Ukraine war. After the increase in the first part of the period, energy and food prices stabilized at high levels. In the conditions of unstable supply and drought this year, the demand for energy resources, especially for gas, remains high in Europe. Central banks have embarked on the monetary policy normalisation in a challenging situation, trying to assess the interaction with other factors that can affect economic growth and expectations for inflation. In general, governments have used the improved fiscal revenue situation to protect the most vulnerable categories of households and enterprises. But, the rise in the cost of sovereign debt limits the size and duration of fiscal policy's contribution to withstand the shock. Volatility in financial markets has been significant. Although financing conditions have tightened, lending volumes and credit quality have been resilient. Overall, current expectations show a further slowdown in the world economic growth in the short term, where for specific countries or regions the performance will be determined by the availability and cost of energy resources. Financial systems will feel the stress that rising interest rates put on both the value and quality of assets.

In Albania, the economy expanded at a good rate during the period. In annual terms, economic growth for 2022 Q1 was 6%. Consumption, investments and net exports contributed positively to this performance. Employment levels improved further and wages increased with the main contribution from the private sector. The impact of Russia – Ukraine war and the strengthened domestic demand have been accompanied by significant inflationary pressures in the country. The increase in consumer prices remained beyond the target of the Bank of Albania at the end of the period. Against this backdrop, the Bank of Albania has started the normalization of monetary policy in order to create suitable conditions for controlling inflation in the medium term. Thanks to strong revenue growth, fiscal policy has increased the financial capacity to cushion the shock to the energy sector and the impact of inflation. However, capacities remain limited and the effectiveness of eventual measures depends on highly uncertain factors, including the progress of the water situation for energy production in the country in the coming autumn and winter seasons.

In financial markets, transaction volumes and prices have generally increased. The primary market of debt securities is dominated by the debt securities of the Albanian Government. The volume of debt securities in lek issued by the government during the first half of the year was higher compared to that of the previous six months but comparable to that of the previous year. The volume of debt securities issued in euro was lower than the value that matured. T-bills with 1-year maturity continue to prevail in short-term bond issuances, while T-bills with 2-year maturity account for the main share in long-term bondsissuances. The weighted average interest rate of securities in lek increased and reached 2.5%, at the end of the period. During the period, the increase in the average interest rate for short-term debt securities was 0.3 percentage point, and at the end of the first six months, the rate reached the level of 1.9%. For long-term debt securities, this increase was 0.2 percentage point at 3.5%, while for the 2-year issue in euro, the interest rate increased by 0.2 percentage point, at 2.2%. In general, in the conducted auctions, the investors' bid was equal to or greater than the government's demand for borrowing.

Although there were no changes in numbers, the value of transactions in debt securities in the secondary market increased during the period. This performance was caused by transactions in long-term securities, which increased in number and value. During the period, the volume of funding transactions in the interbank market decreased compared to the volume recorded in the previous two six-month periods. This performance was determined by the decrease in the volume of one-week transactions, which dominate the total financing transactions in the interbank market. The interest rate in interbank transactions has remained close to the key interest rate, reflecting its changes and the form of liquidity injection auctions by the Bank of Albania. During the period, the lek exchange rate was stable. The Albanian lek appreciated against the euro and depreciated against the US dollar. Developments in the international markets significantly impacted this performance.

Based on the survey data on the situation of the real estate market and house price performance, data reported by banks and other administrative data, it is estimated that during the period, demand, supply and construction costs in the real estate market have edged considerably up. The increase in the demand is evidenced by the rise in the volume of sales, the decrease in the number of unsold properties and the growth in loans for house purchase. The growth in supply is related to the steady increase in the number of building permits, accompanied this time by the apparent surge in construction costs. The performance of the latter has reflected the strong growth in spending on energy, construction materials and machinery. In parallel, this has been accompanied by an increase in the surplus of construction loans from the banking sector. These developments have resulted in a significant increase in the Fischer house price index in Albania, both in semi-annual and annual terms, by 28.4% and 39%, respectively. This performance of the index is determined by the increase in the average house price in Tirana, although prices have also increased in other areas of the country. Despite a more neutral stance on the performance of the housing market in the short term, market agents remain optimistic about its performance in the longer term.

The basic infrastructure for payment clearing and settlement has continued to operate in an effective and secured manner. The AIPS and AECH systems have experienced an increase in the number and value of transactions in lek that have been processed through them. Also, the indicators that monitor the number and value of bank customer payments increased compared to the same period of the previous year. This growth was significant in card payments and non-paper loans (where special banking applications and the Internet are used). In particular, the operation of the AIPS-EURO system began during the period; a system which processes only payments for customers within Albania in Euro and aims to reduce the time and costs of processing these payments for the customers.

The financial situation of households and enterprises was stable. During the period, households and enterprises deepened their financial positions, respectively as "net creditor" and "net debtor". The position growth for households and enterprises was around 2%, while the position expansion for enterprises was around 4%. In annual terms, this performance, was similar for households, while for enterprises, the financial position as ''net debtor'' decreased during the last year. For both, households and enterprises, the changes in the respective positions occurred in the conditions of the simultaneous growth of deposits and loans. Households save mainly in foreign currency and are financed mainly in lek. Enterprises prefer more the foreign currency for savings and financing.

The share of households that have a loan to pay decreased during the period. Despite a slight improvement during the period, the solvency of households remains below the historical average value of the indicator. Households' demand for loans may slow down somewhat during 2022 H2, affected by the international developments and the increase in financing costs. Enterprises reported an increase in investments and expansion of activity during the period. For the majority of them, the performance of sales and financial results continued to improve. There are issues related to "competition", "market acquisition", "production costs" and "availability of qualified staff". The share of borrowing enterprises has slightly changed during the year. The debt burden has decreased in relation to capital, but it seems somewhat higher in relation to income from enterprises. Expectations for borrowing from enterprises in the next period seem somewhat higher. Based on the survey for loan applications, there is an increase in the total number of applications, but also in the rejection rate from banks.

Despite the expansion in the activity of the financial system, its share to the Gross Domestic Product has decreased. At the end of the period, it is estimated that the financial system accounted for 102.6% of GDP, and the decline of the period is estimated at 2.5 percentage points. This performance reflects the fact that the annual GDP growth rate was higher compared to the growth rate of the balance of the financial system. In this decline, the banking sector contributed by around 2 percentage points, while the non-banking financial sector contributed by around 0.5 percentage point. The banking sector continues to dominate by around 90% of total assets, in the financial system. The exposure of the banking sector to the non-banking sector remains low and steady, while the sensitivity of the non-banking sector to the activity of the banking sector remains high, but has not changed during the period. The Bank of Albania regularly monitors the correlation indicators within the periodic assessments of systemic risks.

The activity of the banking sector developed steadily and expanded during the period. The total assets of the banking sector expanded during the period by ALL 31.8 billion or 1.8%, to reach ALL 1,805.6 billion. The increase in loans and investments in securities contributed positively to this trend, in contrary, the decline in treasury and interbank investments, as well as the increase in provisions for assets, provided a negative impact. In terms of liabilities, the expansion of activity was supported by the growth in public deposits and shareholders' equity, which together constitute the main sources of financing the activity of the banking sector, accounting for 92% of total liabilities. By currency, the share of foreign currency assets and liabilities to the total balance ranges between 52% and 54%, and this structure was stable during the period. In terms of assets, the use of foreign currency is higher in the interbank investments and loan. In terms of liabilities, the use of foreign currency is higher in deposits. The statistical effect of the exchange rate, related to the appreciation of the lek against the euro, has influenced the reduction of the reported size of the balance items in foreign currency. In terms of non-residents, the net loan position of the banking sector towards them, in relation to total assets, did not change. In annual terms, the assets of the banking sector grew 9.8%.

The stock of the bank loans expanded during the period by 4.5%, rising to about ALL 700 billion, as a result of the combination between the performance of new loans and the change in the repayment structure. The main contribution of the growth of the loan stock was given by the expansion of the loan to resident entities (enterprises, households, public sector), which prevails in the total loans. The largest increase was recorded in loans to households, loans in lek and long-term loans. Increase of loans to enterprises is related to the expansion of short-terms loans, while the expansion of loans to households is related to loans for purchase of real estate. The process of loan restructuring has continued during the period, as well as the write-off of lost loans from the banks' balance sheets. These are focused on loan to enterprises and the rates were similar to those of the previous year. Outstanding loans expanded by 12.1% in annual terms. Not including the statistical reducing effect of the exchange rate and the loan write-offs, the annual growth rate of outstanding loans would be 14.2%.

Unhedged outstanding loans in foreign currency decreased by 3.8%, and in annual terms by 4.6% during the period, driven by the fall in unhedged credit in foreign currency to enterprises, mainly in the trade sector and in euro. Meanwhile, unhedged loans in foreign currency to households, mainly oriented towards real estate purchase, increased. As a result, the share of unhedged credit in foreign currency to credit in foreign currency and to total loans, decreased at 17.4% and 34.3%, respectively. Loans to enterprises in euro and for investments in real estate, account for the main share in unhedged credit.

The new loans granted during the period was about ALL 140 billion, almost 24% higher than in the previous year, but 12% lower than that of the previous six months. The main contribution to this annual increase was given by the new loans to enterprises, which increased by 27%, but also by loans to households, which increased by 18%. The new loans to enterprises was mainly used for short-term purposes and in foreign currency. The new loan to households was mainly used for the purchase of housing and consumption of non-durable goods, and was given mainly in lek. The weighted average interest rate for new loans granted during the period increased. This increase was observed mainly in the average interest rates of loans to households and loans in lek. In the outstanding loans, the average interest rates for the loans for the purchase of real estate have shown the lowest levels, regardless of the currency.

Deposits in banks expanded by nearly ALL 30 billion or 2% during the period, reaching at ALL 1,460 billion. The growth pace was slower compared to the previous six months. The increase in deposits was a result of mainly the increase in the deposits of households, in foreign currency and current accounts. Deposits in lek slightly decreased. Interest rates for all types of new deposits by term, sector and currency remain at low levels, but they have shown a slight upward trend during 2022 H1.

The financial result and capitalization of the banking sector activity are at good levels. The banking sector closed the period with a profit of ALL 6.5 billion, lower compared to the same period in the previous year. As a result, the profitability indicators also decreased. The main contribution to this performance was given by the decrease in the total income and the increase in the operating expenses. The decrease in non-interest income contributed negatively to the total income. This decrease was influenced by losses in investments in financial instruments, while income from commissions increased. Interest income were higher than in the previous year, driving up both net interest income and net interest margin. Expenses for provisions decreased. In this group, expenses for credit risk were stable, while those for other financial instruments decreased.

At the end of the period, the capital adequacy ratio for the banking sector rose to 19%, up by around 1 percentage point during the period. The main contribution to this performance was given by the increase in regulatory capital, although risk-weighted assets also increased. Due to the increase in the shareholder's equity, the indicator of financial leverage slightly decreased during the period. The banking sector, as a whole, meets the capital requirements set forth by the Bank of Albania, and has tried to maintain the necessary position through the increase of retained earnings and the issue of subordinated debt.

Overall, risks to the Albanian economy were contained during the period, but the perspective is challenging. The financial stability map, for 2022 H1, shows an increase of risks related to developments in the external political and economic environment, effected by the Russia's war against Ukraine. These risks were reflected in the domestic economic developments, but the effects were until now, bearable. The relatively limited exposure toward countries involved in war, macroeconomic stability, adaptation of economic and financial policies in the public and private sectors, as well as the good balance sheets of the real and financial sectors, have alleviated the impact on economic developments in the country. However, international geopolitical developments, especially through the impact they have had on energy prices and inflation, cast a high level of uncertainty about the economic impacts anywhere across Europe. In parallel, other indicators that try to understand perceptions and assessments on systemic risks, including banking industry assessments, offer a clouded outlook. Although, banks estimate an increase of risks related to macroeconomic framework, and there is a rise in the index that follows the accumulation of risks during the period. The latter also reflects the increase in housing prices in the real estate market, which has been going on for several years.

In terms of more specific risks for the activity of the banking sector, it is estimated that:

Despite the improvement during the period, credit risk may increase in the short run. Credit quality continued improving over the period. The surplus of non-performing loans decreased by ALL 0.7 billion during the period, to ALL 37 billion, and this value was almost ALL 7.3 billion lower than in the previous year. The NPLR decreased at 5.3%. All types of loans, by maturity, sector and currency were improved. Also, other complementary indicators, affirm the improved credit quality. The reduction in the stock of non-performing loans is related to the reclassification of non-performing loans to better classes, write-offs of lost loans, and the repayment of a number of non-performing loans. The creation of provisions for credit risk was lower than the decline of non-performing loans. As a result, the coverage ratio of non-performing loans fell by 5 percentage points during the period, to 63%.

Within the period, the improvement in credit quality was concentrated in 2022 Q1, while in the second quarter of the year credit quality slightly declined. This process can be related to the developments that followed the start of Russia's war in Ukraine. As a matter of fact, international developments and the performance of the energy situation may put the economy through a challenging situation. The possibility that due to high energy costs, the economy will slow down and the incomes from enterprises and households will decrease, seems real. This may negatively impact the quality of banks' loan portfolio.

Liquidity risk of the banking sector remains contained. The liquidity position of the banking sector remains at good levels and liquidity indicators continue to remain notably above the regulatory rates.

Banks' liquid assets decreased, while short-term liabilities increased slightly during the period. Deposits continue to cover more than twice the value of loans, even by separate currencies. The gap between assets and liabilities for the basket of maturities up to 3 months widened slightly, but the overall gap remains positive and unchanged compared to previous periods. The average maturity mismatch between assets and liabilities narrowed slightly. The banking sector does not use funding lines from the parent banking groups.

The exposure of the banking sector to market risks decreased during the period, but requires careful monitoring in the upcoming months. The exposure of the banking sector to direct exchange rate risk has mitigated during the period and remains significantly below the regulatory limit. Banks' exposure to the indirect exchange rate risk edged up during the period, given the increased loans in foreign currency to residents. However, the contraction of the unhedged foreign currency loans against the exchange rate during the period, mitigates the materialization effect of this risk.

The exposure of the banking sector to direct interest rate risk decreased during the period, and continues to remain significantly below the upper limit defined by the regulatory framework. Regarding the existing exposure, the banking sector is more exposed to interest rate risk for positions in lek, those with variable interest rates and for long-term maturity. The normalisation of monetary policy in response to inflationary developments should draw the attention of the banking sector to the importance of carefully monitoring the structure of assets and liabilities according to the type of interest rate and maturity, and the impact on the value of financial assets. Also, the possible increase in the interest rate for the group of loans with variable interest rate, may be associated with the transformation of interest-rate risk into credit risk, due to the impact on the borrowers' solvency.

The results of the stress-testing exercises support the assessments on the good financial position of the banking sector, but they highlight the increased sensitivity to the assumed stress scenarios. The Bank of Albania conducts stress-testing exercises on a regular basis, in order to assess the banking sector's resilience against shocks from the real economy or financial markets in the medium-term horizon. The stress tests on capital adequacy or borrowers' solvency shows the degree of resilience of individual banks in terms of capital and aims to identify their ability to withstand assumed shocks on economic growth, credit, exchange rate, and interest rates.

Overall, the tests carried out for 2022 H1 and extended across the 2022-2024 period, show that the banking sector is resilient to the assumed macroeconomic shocks. The results also show that specific banks are more vulnerable against assumed shocks and need to strengthen their liquidity and capital positions. This vulnerability has been expanded compared to the previous period. In conclusion, it is estimated that the financial system and the banking sector have continued to perform stably during 2022 H1.

But the following months may be challenging for the Albanian economy and the banking sector, mainly due to the impact that the current unfavourable energy situation may have, if it lasts. In this case, banks may face a further decrease in profit, and possibly even financial losses. As a result, it is necessary for banks to maintain and strengthen the capitalization levels of the activity, in order to cope with eventual financial losses. Carrying out special stress testing exercises can serve to assess the size of the shock and its impact on the financial indicators of the activity. In parallel, it may be necessary to take measures to ensure that critical activities, relationship with correspondents and relationship with customers, maintain maximum functionality in cases of eventual limitation of electricity.

It should be taken into consideration that this situation can happen simultaneously in other countries as well. In addition to monitoring and evaluating the direct impact of market risks, attention should also be paid to indirect risks related to the decline in the solvency of borrowers and the possibility of a decline in credit quality. It is necessary for banks to maintain close contacts with borrowers, to mitigate issues when possible or for the quick identification and provisioning of new non-performing loans.

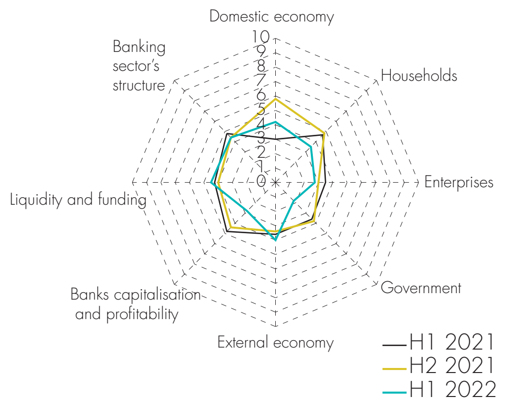
To this end, the Bank of Albania will carefully monitor developments in the banking sector and macroeconomic and financial indicators. This process ensures that the policy decisions of the institution respond to current developments and the expectations that are built on them, always aiming to maintain macroeconomic and financial stability.

1. OVERVIEW OF THE MAIN RISKS TO FINANCIAL STABILITY

1.1 FINANCIAL STABILITY MAP

Based on the developments of 2022 H1, the financial stability map shows an increase in risk levels in the external economic and political environment, following the general impact from Russia's war in Ukraine. These risks have been reflected in the domestic economic developments, but the impacts have been manageable. Relatively limited exposure to countries involved in war, macroeconomic stability, adaptation of economic and financial policies, as well as the good situation of balances of the real and financial sectors, have mitigated the impact on economic developments. International developments trigger a high level of uncertainty about the military, political and economic impacts on Europe. In the economic aspect, actions for the harmonization and flexibility of economic and financial policies, aimed at strengthening the economy's resilience to possible shocks and maintaining financial stability, take primary importance.

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 risk.

Source: Bank of Albania.

The financial stability map, for 2022 H1, shows an increase of risks related to developments in the external political and economic environment, effected by the war of Russia against Ukraine.
Currently, the ability of the Albanian economy to withstand these risks is considered good, in terms of macroeconomic and financial stability.
However, international developments maintain a high degree of uncertainty and emphasize the importance of maintaining financial stability.

In more concrete terms:

A. In the overall economic environment:

I. The risk from the domestic economy was rated as "average" and increasing throughout the period. Inflation trends, external financing needs and exchange rate volatility have signalled higher levels of risk. However, this effect was balanced by the good economic growth that has supported the indicators of the output gap and the size of the external debt.

II. The overall risk from the external environment is rated as "average" and increasing compared to the previous year, dictated by the negative performance of the OECD-CLI[3] warning index and the increase in short-term interest rates in international markets. On the other hand, the level of this risk is balanced by the decline of unemployment, at places where the majority of Albanian immigrants work and live.

[3] *The OECD-CLI index (Composite Leading Indicator) gives early warning signals on the turning points of the business cycle at a global level. The fall in its values signals fluctuation of the economic activity around its long-term potential level.*

B. In main real economy agents:

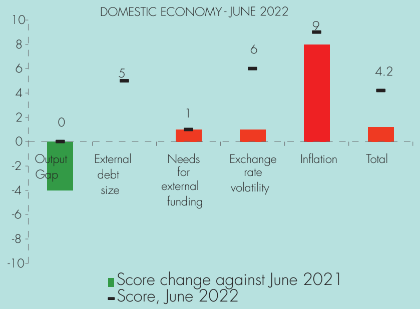
I. Risk from "enterprises" is assessed as "low," and has decreased from the previous year. In this category, the index of the financial condition for the private sector and the preservation of good levels of business borrowing quality have had an impact.
II. Risk from households continued to be assessed as "average" and decreasing compared to the previous year. The decrease in the risk score of this category has been influenced by the housing market and the better quality of the credit portfolio for households, while the share of households borrowing, the unemployment rate and the households' expectations remained stable, maintaining an unchanged level of risk.
III. Risk from the government's fiscal activity is assessed as "low" and downward compared to the previous year. This performance was influenced by the significant improvement in the level of tax revenues and the recording of a positive surplus in the budget balance.

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

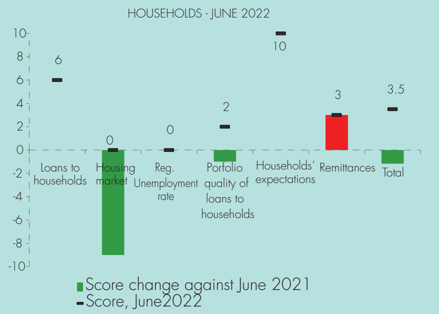
I. Risk from capitalization and profitability is assessed as "average" and downward compared to the previous year. The increase in income from interest for banking activity in relation to assets, the preservation of relatively low levels of non-performing loans and the increase in the capitalization of banks, have contributed to keeping this risk at low levels.
II. Risk from liquidity and financing has remained at the "average" level and with a slight upward trend during the year, dictated by the increased risk from the expansion of financing by non-residents (the historical average of this indicator, however, remains at very low levels), meanwhile the other indicators remained almost unchanged.
III. The risk related to the structure of the banking sector was assessed as "average" with a slight downward trend compared to the previous year. This performance was dictated by the improvement of the indicators of the concentration of bank loans to enterprises and funding sources of the banking sector.

BOX 1 FINANCIAL STABILITY MAP COMPONENTS

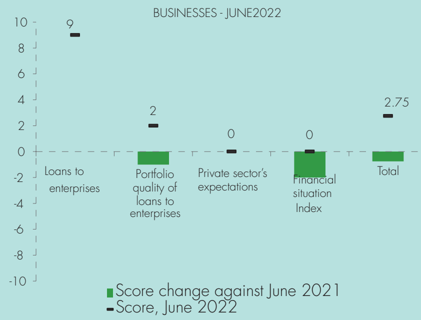
Risk from the "domestic economy" is assessed as "average" and upward for the period. The performance of inflation, the expansion of the need for external funding and the volatility of the exchange rate have shown a higher level of risk compared to the previous year. But these risks have been balanced by the good economic growth, which has supported the indicators of the output gap, and of the external debt stock.



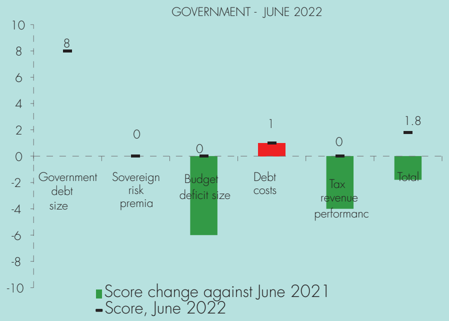
Risk from "households" is assessed as "average" and has decreased compared to the previous year. This category was impacted by the housing market and the improvement of the quality of the households' credit portfolio, while the share of borrowing by households against GDP, the registered unemployment rate and the expectations of households preserved an unchanged level of risk.



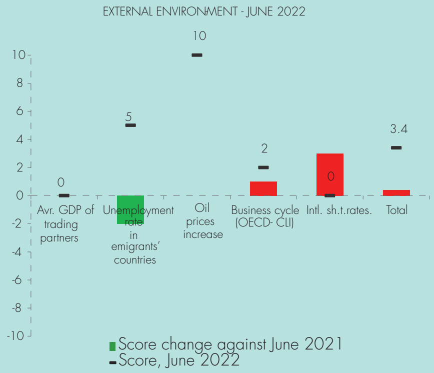
Risk from "enterprises" is assessed as "low", and has decreased during the period. The main impact on the decrease of risk is related to the improvement of the financial condition index of the private sector, as well as to the better quality of the enterprises' loan portfolio loans compared to the previous year.



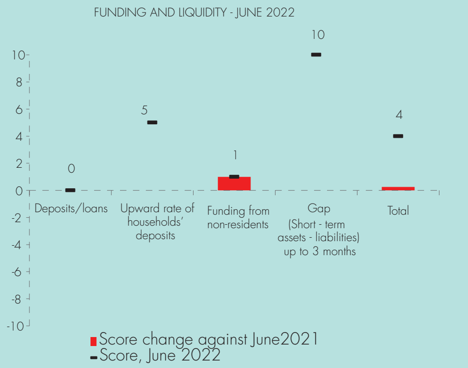
Risk from the "government" is assessed as "low" and decreasing over the one-year period. This level of risk is attributed to the positive budget balance and the significant improvement in tax revenues during the period. Meanwhile, the size of public debt and the risk premium for sovereign debt maintain an unchanged level of risk.



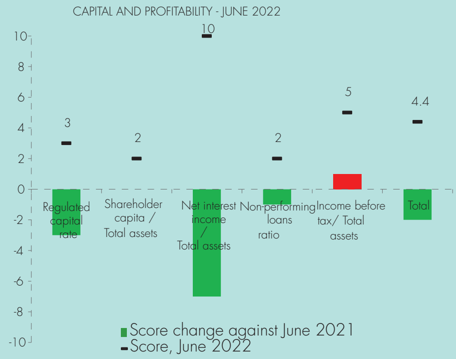
The risk from the "external environment" is "average" and has increased during 2022 H1. This performance has been influenced, firstly, by the drop in the OECD-CLI index, which warns of a negative turn in the business cycle at global level, and secondly by the increase in short-term funding rates . Developments in these indicators have reflected the consequences of Russia's war in Ukraine in curbing world economic activity, maintaining problems in production and distribution chains, and actions towards the normalization of ECB and FED monetary policy to address rapid price growth.



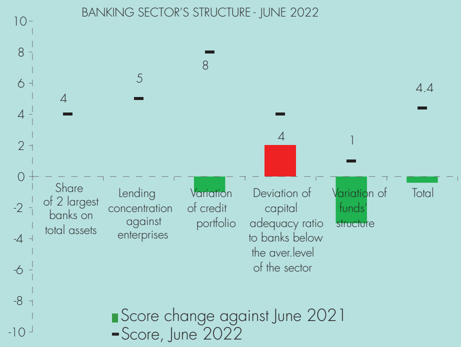
Risk from "liquidity and funding" remains "average", slightly upward compared to the previous year. This performance is determined by an increase in the risk related to the expansion of funding from non-resident depositors, whilst the level of risk from other indicators included in this category, remained unchanged during the period.



Risk from capitalization and profitability is assessed as "average" and downward compared to the previous year. This performance is determined mainly by the increase in the income from banking activity interests as a ratio to the sector' assets, the maintenance of relatively low level of non-performing loans, and the improvement of regulatory capital indicator.



Risk related to the structure of the banking sector remained as average and downward for the period, affected by the improvement of concentration indicators of credit portfolio and the structure of funds, regardless the expansion of distribution in the values of the capital adequacy indicator from the sector's average.



*Libor dhe Euribor.

1.2 SYSTEMIC RISK

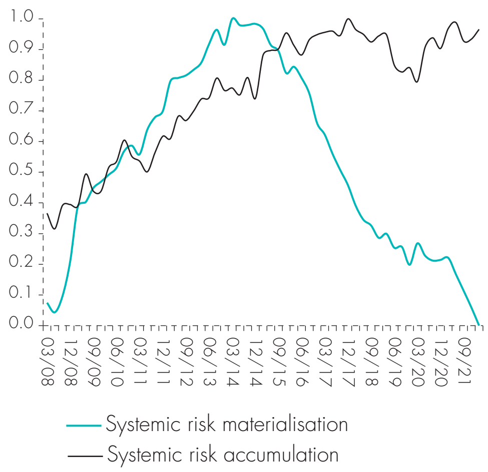
The aggregate indicators of the materialisation of systemic risks and financial stress declined during the period, while the risk accumulation index increased.
Following the military aggression of Russia against Ukraine, banks perceive increased risks from the macroeconomic framework and for their activity. However, they are still confident in the stability of the financial system.

In order to assess and monitor the exposure of the banking sector to systemic risk, the Bank of Albania considers three aggregate indicators that reflect the accumulation and materialisation of systemic risk and the scale of financial stress, as well as a survey on banking sector perceptions regarding such risks[4]. The indicators suggest that financial stress, as well as the systemic risk facing the financial system decreased during the period, while the accumulated systemic risk recorded higher levels during 2022 H1, compared with the previous period. The improvement of credit quality and a fall in the unemployment rate affected the mitigation of materialised risk, while the increase of real estate prices as well as the expansion of credit portfolio with variable interest rates, affected the increase of accumulated systemic risk.

1.2.1 DEVELOPMENTS IN SYSTEMIC RISK INDICATORS

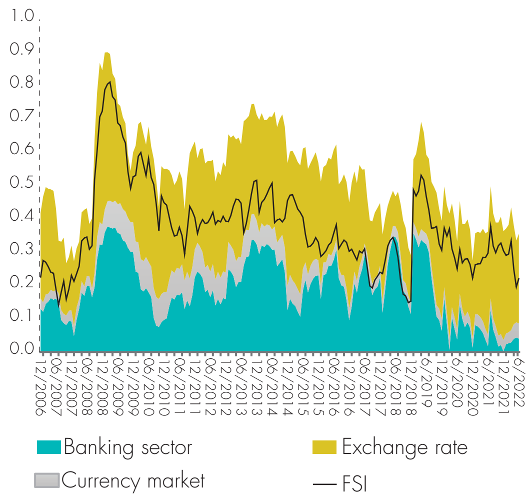
During 2022 H1, the accumulation index and the materialisation index of systemic risk performed differently from each other. The systemic risk accumulation index increased mainly due to the rise in the price of real estate, as well as the expansion of the loan portfolio with variable interest rates. In the performance of the materialization index, the drop in unemployment and non-performing loans have mitigated the effect of the increase in inflation and exchange rate fluctuations, decreasing the index. Due to the build-up of and the phenomena dealt by each indicator, it is expected that in the future the materialization index will reflect the growth observed in the systemic risk accumulation index.

Chart 2 Indices of accumulation and materialisation of systemic risk



Source: Bank of Albania.

Chart 3 Financial Stress Index



Source: Bank of Albania.

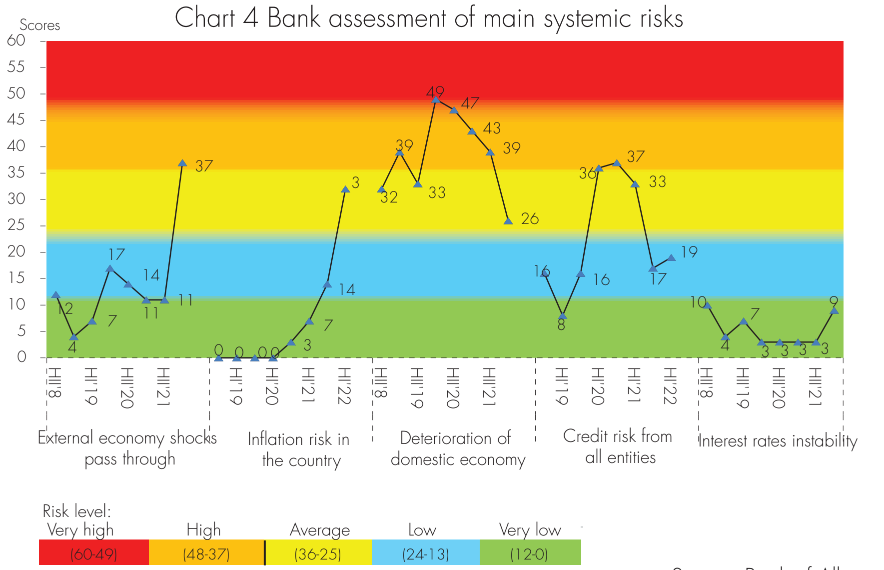
4 *Banking sector perception related to main systemic risks in Albania is attained through an ad hoc survey.*

The financial stress index decreased during the period. The good growth rate of outstanding loans and deposits above their long-term trend have influenced the maintenance of a stable level of financial stress due to developments in the banking activity. The money market has contributed to a slight increase of the index, due to the expansion of the spread of interest rate of the Albanian governments T-Bills against German ones. The exchange rate direction influenced the decrease in the value of the financial stress index during the period.

1.2.2 THE PERCEPTION OF THE BANKING SECTOR ON THE SYSTEMIC RISK

The results of the survey on the perception of systemic risks in the country by the banking industry, suggested a new outlook of the main system risks during the period, dictated by the war of Russia in Ukraine, the consequences of which have also been felt in our economy. Banks have estimated that the external shocks risk and the inflation risk represent the two main systemic risks of the period, and their assessment marked a significant jump. Deterioration of the domestic economy risk, despite not being one of the top main risks, is considered closely related to the level of materialization of the risks of inflation and external shocks. Credit risk was assessed as increasing. Although, no significant consequences of the situation in the country's financial system has been yet noticed, banks estimate that the new conditions may be accompanied by the weakening of the solvency of enterprises and households, leading to an increase of the credit risk. Finally, in the list of the main systemic risks, after a long period of time, the risk of the increase in interest rates was mentioned, which until now has been at minimal levels, thus reflecting the banks' concern regarding the normalization pace of the monetary policy inside and outside the country, as a response to high inflationary pressures.

Chart 4 Bank assessment of main systemic risks



Source: Bank of Albania.

Asked about the level of confidence in the stability of the financial system in the country, the aggregated answers of banks suggest its decline during the period. This assessment remains the same in regard to the short-term horizon (up to one-year), influenced by negative developments in the international arena and the uncertainty regarding the extent of the impact on the economy of Albania. On the other hand, banks are more optimistic when discussing about the medium-term horizon (one to three years), and the confidence level appears up, reflecting the confidence in the resilience and strong foundations of the financial system.

Russia's war in Ukraine and the consequences it has brought to our economy, have increased the banks' concern about the increased risks in their activity and in the financial system. However, banks confirm that the financial system in the country has successfully faced the challenges that have characterized the internal and external environment over the past two years. Overall, they assess the system as stable and liquid, able to absorb any potential shock.

1.3 ASSESSMENT FOR NON-CONVENTIONAL RISKS

In general, the financial stability map and systemic risk indices indicate a balanced financial stability situation.

However, the latest international developments on a global scale present special challenges. More specifically, the war in Ukraine continues, it is possible that it will escalate even more, and the uncertainty about how it will affect the European continent remains high. Following international sanctions on Russia and measures taken by the European Union to diversify resources and to save energy, the dependence that member countries have on the gas that comes from Russia is decreasing, but it still remains critical for several of them. In the conditions of the significant use of gas for the production of electricity or for heating in some member countries, the concerns remain high regarding the provisioning with the necessary energy for households and enterprises, especially for the short-term horizon. This means that most likely, providing the necessary energy in the adequate quantity and cost will represent the most fragile link of the economic development of the European Union in the upcoming months. As a result of this year's exceptional drought, the demand for energy sources of all forms will remain high and the price of energy in international markets will remain high as well. For this reason, the consequences of this unprecedented situation regarding the demand and supply of energy resources, will be felt also in other European countries that, although they do not have a significant dependence on the use of gas, do not meet the demand for energy from internal sources and must import some of it from international markets. These countries, including Albania, will be forced to participate in an unequal competition where the price and quantity of energy available in the market is set by countries with the greatest demand and financial sources.

In this case, it is possible that at a certain level, the price of energy becomes unaffordable or that the necessary amount of energy is not available on the market at the right time.

Full resilience on hydro resources in order for our country to meet most of the energy needs, puts us at a particular situation. On the one hand, if the rainfall in the autumn-winter period will be abundant and distributed in time, the country's capacities to provide the necessary energy would improve significantly, mitigating the shock and thus positively influencing the economic performance in the upcoming year. On the contrary, in case of insufficient rainfall, the economy will face an extraordinary challenge which will be felt in several ways by all economic and social entities. In this scenario, in the short term, what is of importance are the measures to mitigate the impact on the most in-need strata of society and critical services, to create financial sources/reserves for the purchase of the necessary energy during the coming autumn-winter period, to use the existing energy in an efficient way and to find temporary additional sources of energy. At the same time, the focus should be on the implementation of projects which aim at expanding and diversifying internal sources of energy production. In the longer term horizon, and keeping the impact of the climate change in mind, completion of the legal basis and procedures for the further development of alternative sources of renewable energy (besides hydro) and the implementation of incentives for the use of this energy by enterprises throughout a transitional period, would make a fundamental contribution to meeting the needs of the country's economy for energy, with a higher degree of independence and in a sustainable manner. Because we may be faced with an extraordinary energy challenge, it is necessary to factor in risk management in the baking activity. The economic slowdown, which was engendered by an increase of price (or an obstruction in the energy supply) that caused the decrease of business income, the increase of unemployment and the decrease of households' income, may increase the probability of failure of certain borrowers' group, potentially damaging the financial result of banks and emphasizing the need for appropriate levels of activity capitalization.

2. MACROECONOMIC AND SECTORAL DEVELOPMENTS

2.1 EXTERNAL MACROECONOMIC ENVIRONMENT

In 2022 H1, world macroeconomic activity slowed down, impacted by inflation increase at global level, issues in the output supply chains and tightening of financing conditions.

After the positive developments during the previous year, the global economic growth was negatively affected by the war of Russia in Ukraine and the return of anti-Covid measures in China during the first quarter. These developments exacerbated inflationary pressures, increased production costs and intensified bottlenecks in supply chains, hitting consumption and trade globally.

Central banks around the world, took action for monetary policy normalisation in order to curb inflation.
Funding conditions in markets tightened, impacted by the drop in confidence and expectations for a rapid increase of interest rates.
The economy of the euro area and of the Western Balkans expanded, supported by the recovery of domestic demand after the lifting the Covid-19 containment measures, and the strengthening of labour market. The growth rates of these economies moderated during the period. Lending volumes were high and credit quality remained at good levels, but these indications are expected to decline in the short-term horizon.

Central banks around the world, took action for monetary policy normalisation in order to curb inflation. As a result, financing conditions tightened in both developed and developing markets, leading to a decline in capital market values and a widening of interest rate spreads. Among the markets of advanced countries, the tightening of funding conditions was more pronounced in the US compared to other countries, reflecting the expectations for a more rapid normalisation of monetary policy by the Federal Reserve. In the European Union, the economic situation is more complicated and markets have reflected this element through the high volatility and tighter financing conditions. The consequences of the war in Ukraine and the sanctions imposed on Russia have a stronger effect on economic developments in our continent. Inflationary pressures from the supply side may be stronger, but a significant slowdown of the economy in the short-term horizon is also possible. The continuation of the war in Ukraine, as well as other political and social factors in Europe, cause high uncertainty regarding future developments. Thus, the European Central Bank is faced with an unprecedented challenge as it assesses the possible effects of monetary policy normalization in the euro area and adapts its decisions. The markets in the developing countries are also characterized by unfavourable financing conditions and increased capital outflows with increased pressure on the exchange rate and inflation rate.

The higher uncertainty regarding economic developments in Europe, and the possibility that the pace of normalization of monetary policy will be more restrained, has been followed by a depreciating performance of the Euro in the international markets, especially against the US dollar. The performance of Euro against the Japanese Yen, the British Pound, and the Chinese Yuan has been more balanced, reflecting the expectations on the dynamics of economic recovery in the regions.

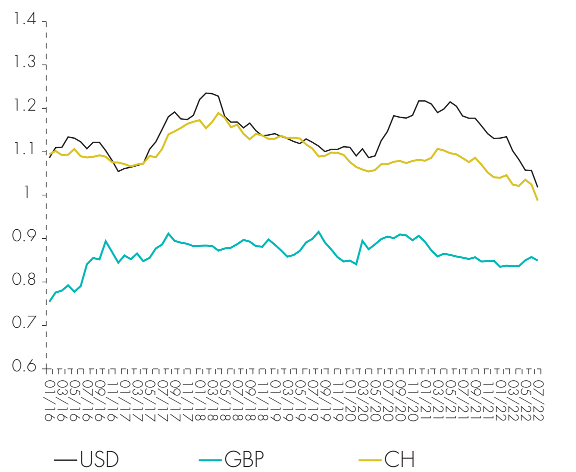
In markets of raw materials and food, prices have been high as a result of supply-side issues, mainly related with the consequences of Russia-Ukraine war. In the energy market, the price of oil has stabilized after the use of strategic reserves by the USA and the diplomatic efforts to increase production by the OPEC countries. Gas price has shown a greater volatility, at a time when European countries are trying to reduce the import from Russia and increase gas reserves by looking for alternative sources to face the winter season. The risk of suspension of gas supply from Russia remains high. Food prices have increased at a broad-base over the period, there is a state of stabilization of grain prices after the agreement on the resumption of seaborne grain exports from the Ukraine. On the other hand, metal prices decreased, reflecting a weakening of demand from China.

The short- and medium-term forecasts from experts suggest a slowdown in the economic activity in the remainder of the year[5], influenced by tightened financing conditions and a decline in purchasing power due to soaring prices, which together are expected to curb consumption and investment. Inflationary pressures are expected to remain high during the year and the IMF foresees that inflation will average at 6.6% in developed regions and 9.5% in developing ones. The short-term economic outlook remains highly uncertain, under the pressure of risks related to the war in Ukraine and the extent of its consequences, future price dynamics and the economic costs for the monetary policy normalisation. The short-term risks against global financial stability are also considered as edging up, mainly in terms of the impact of the high inflation rate and the increase in interest rates on the balance sheet of economic agents.

Chart 5 Main indices in stock markets

Source: European Central Bank.

Chart 6 Euro exchange rate against major currencies



Source: European Central Bank.

THE EURO AREA

The economy of the euro area expanded by 0.5% in 2022 Q1, (+5.4% in annual terms), supported by the positive contribution of net trade and inventories, and by 0.7% in 2022 Q2, (+4% in annual terms), driven by the

5 *The IMF forecasts that the global economy will expand by 3.2% in 2022 and will slow down by 2.9% in 2023 (World Economic Outlook, update).*

increase of consumption in the services sector after the economic reopening of European countries and the removal of restrictive measures of the pandemic. At the same time, the economic recovery of the euro area was hampered by disruption in supply channels as a result of the war in Ukraine and the return of restrictive measures in China, which caused a further increase in the price of raw materials and tightening of financing conditions in markets. Despite these events, the developments in the labour market remained positive, although to a lesser extent, also underpinned by public support schemes for the preservation of job places. The euro area unemployment rate was 6.6% in May, registering the lowest rate since the creation of the euro area.

The inflation rate reached 8.6% in June 2022 from 2.2% in the previous year. The inflation hike is dictated by the upsurge in energy and food prices, a direct consequence of Russia's war in Ukraine, the recovery of domestic demand in the service sector and the depreciation of the Euro. In these conditions, after a long period of time with unchanged interest rates, the ECB increased the refinancing rate by 50 basis points to 0.5%, and has suggested a further increase in the interest rate in September 2022. Also, the ECB has significantly reduced quantitative easing programs and other liquidity injection instruments, but has activated the transmission protection instrument, with the aim of mitigating market distortions and increasing the effectiveness of monetary policy in the euro area.

In the financial markets, volatility has been significant. Interest rates on sovereign debt securities rose and spreads across countries deepened, reflecting the economic uncertainty and potential political fallout. In the banking sector, loans to the private sector continued to steadily increase, but lending conditions tightened in the second quarter of the year and interest rates have been upward. These developments reflected the expectations for the further normalisation of the ECB's monetary policy, and assessments of increased risk in lending activities.

Referring to the latest forecasts published by the ECB, despite the high uncertainty, the Euro area's economic activity is expected to grow at a positive rate during the second half of the year, supported by the recovery of the services sector, stable conditions in the labour market and the continuation of supportive fiscal policies that will cushion the effect of inflation on income and consumption. In the short-term, the region's economic outlook remains conditioned by the risk of disruption of Europe's supply of energy and fuel, which would drive price further up and production disruptions. In the long term, the decrease in confidence, the increase in production costs and the tightening of funding conditions, are expected to affect investment's growth in Europe. In response to the situation, the ECB and other European institutions are fully committed to undertake adequate policies to preserve the economic and financial stability of the region.

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

	GDP change (annual %)			Annual inflation (annual %)		Unemployment (annual %)		Gross government debt (% of GDP)	
	2022*	2022 Q1	22 Q2	March '22	June '22	March '22	June '22	2021 Q4	2022 Q1
U.S.	2.5	3.5	1.6 (-0.9):	8.5	9.1	3.6	3.6	123.4	124.6
Euro area	2.3	5.4	4.0 (0.7):	7.4	8.6	6.8	6.6	95.7	95.6
Germany	1.2	3.6	1.5 (0.0):	7.6	8.2	2.9	2.8	69.3	68.2
France	2.3	4.8	4.2 (0.5):	5.1	6.5	7.3	7.2	112.5	114.4
Italy	3.0	6.2	4.6 (1.0):	6.8	8.5	8.3	8.1	150.8	152.6
Greece	:	7.0	:	8.0	11.6	12.2	:	193.3	189.3

Source: ECB, Eurostat,
**-IMF Assessment (July 2022), Economic Analysis Office; Bureau of Economic Analysis (US Bureau of Labour Statistics.);'': "- ": no available data.*
*** In brackets are the quarterly GPD growth. *

THE WESTERN BALKANS

The Western Balkan economies continued to recover in 2022 Q1, but the growth pace is moderated compared with the previous quarters. GDP expanded by 4.7% compared to 6.3% in the last quarter of 2021, dictated mainly by the economic slowdown of Serbia and Bosnia Herzegovina. In addition to the comparative base effect, which was waning at the end of the year, growth is broadly underpinned by the strengthening of domestic and external demand, after the alleviation of restrictive measures and a restart of the activity in the services sectors. In the same vein as slowdown of economic performance, developments in the labour market were moderate and levels of unemployment remained at two digit figures.

The increase of prices led to a significant growth in budget revenues from taxes and a decrease of the fiscal deficit across all countries of the region, creating thus space for reallocation of expenses and/or reduction of public debt. Developments in the external sector, in the first quarter, were supported by a rebound in the exports of goods and services (mainly from tourism) and by an increase in remittances. Imports of goods were significantly up during the period, increasing the trade deficits in most countries of the region. Inflationary pressures were more pronounced during the period influenced by the strengthening of domestic demand due to the global increase in prices of energy, food and transport. As a result, inflation rates in all countries of the region have significantly exceeded the levels targeted by the central banks, driving the latter to take actions toward the normalisation of monetary policy, through the increase of the policy rate. Governments have also taken temporary measures to contain the increase in the prices of oil and food by reducing the tariffs or limiting profit margins, while they have also activated financial packages to support the most vulnerable categories of households and enterprises.

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 %)	
	2021 Q4	2022 Q1	2021	2022p	2021 Q4	2022 Q1	2022 Q1	2022 Q2	2022 Q1	2022 Q2
Bosnia & Herzegovina	7.2	5.5	6.9	:	:	:	3.7	4.5	5.4	6.1
North Macedonia	2.3	2.4	4.2	3.0	15.3	14.9	9.0	9.8	3.1	3.0
Montenegro	8.2	7.2	12.4	3.8	15.7	17.0	6.0	7.2	6.2	6.2
Kosovo	6.4	4.9	10.5	:	:	:	17.0	17.6	2.0	2.1
Serbia	7.0	4.4	7.4	3.4	9.8	10.6	10.6	13.1	3.6	3.4
Albania**	5.5	6.0	8.5	2.7	11.9	11.7	12.8	12.1	5.2	5.3

Source: European Commission, respective central banks. Explanations f- Forecast of ECFIN for July, 2021; ':' no available information; "": data refer to May 2022; "**": data refer to June 2022.*

Loans continued to grow in annual terms in most of the countries of the region, supported by the recovery of economic activity and the continuation of some easing regulatory measures. In most countries, loans to private sector continued to grow at a more rapid speed compared to loans to enterprises. The ratio of non-performing loans further declined in Albania, Serbia, and Bosnia-Herzegovina, and remained unchanged in the rest of the region. This indicator was influenced by the regulatory easing undertaken by the central banks during the past year, while the high inflationary pressures, the tightening of financial conditions and the slowdown of economic growth, may be transmitted to the balance sheets of economic agents and contribute to increase the amount of non-performing loans over the short-term horizon.

Economy expanded at good rates during the period. Consumption, investments and net exports contributed positively to this trend. Employment further improved and wages increased. The impact of Russia's war in Ukraine and the strength of domestic demand, were accompanied by significant inflationary pressures in the country. Increase of consumer prices remained beyond the objective of the Bank of Albania at the end of the period. Under these conditions, the Bank of Albania started the normalization of the monetary policy in order to create adequate conditions for controlling inflation over the medium-term horizon. Given the steep growth in income, fiscal policy increased the financial capacities to mitigate the shock in the energy sector and the impact of inflation. However, capacities remain limited and the effectiveness of eventual measures depend on factors with high uncertainty.

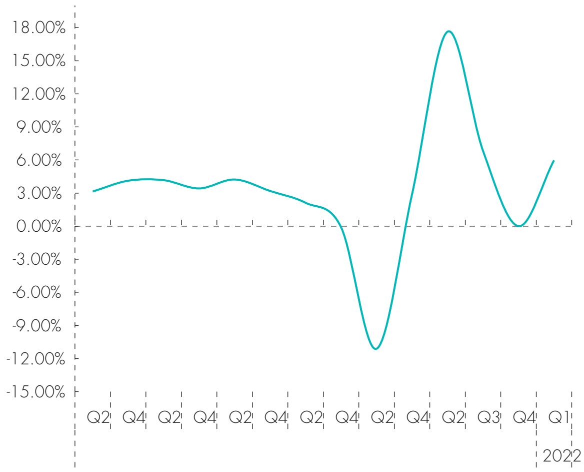
2.2 MACROECONOMIC ENVIRONMENT IN ALBANIA

The economic growth rate was satisfactory during the period, despite the negative impact of economic developments in the international arena. Consumption, investments and net exports contributed positively to this performance. Following the increase in import prices and the strength of domestic demand, the inflation rate increased significantly. As a result, the Bank of Albania started the normalisation of the monetary policy. Despite the broad-based recovery of economic activity in the country, uncertainties regarding international developments and the energy situation may drive to a deceleration of the economic growth. Inflationary pressures will remain present, if issues related to supply for energy products, food and sub-products related to them, continue. However, these pressures may be weaker, due to the comparative base effect and the slowdown of domestic demand. The monetary policy of the Bank of Albania will be adjusted to return the inflation rate to target in the medium term, based on the data coming from the economy in real time. The approach of the fiscal policy to carefully use the surplus of budget revenues increases its capacities for amortization of the risks around the energy situation, for mitigating the impact of inflation on the most vulnerable groups of society and for coping with the increase in the public debt cost.

REAL SECTOR

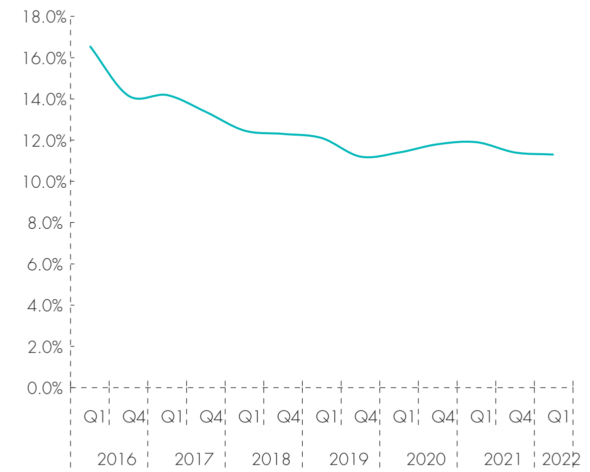
Albanian economy grew by 6% during 2022 Q1, maintaining the satisfactory growth rate of the previous year (+5.5%). Economic growth was mainly supported by the expansion of final consumption, the increase in private sector investments and the increase in exports of goods and services. Whereas, the contraction of public investments and the expansion of imports of goods and services had the opposite effect. Production data by sector shows that growth was registered in the main sectors, such as: construction (26%), trade, transportation and accommodation (11%). The services sector also expanded its activities during the year, particularly real estate (15%), and financial and insurance services (12%). The economic sentiment indicator, improved during the period, driven by the improved business confidence in the industry, construction and services sectors, and the reduced confidence in the trade sector. Economic developments in the second quarter of the year are expected to reflect the impact of Russia's war in Ukraine and the consequences on the global markets of energy and food.

Chart 7 Annual GDP growth



Source: INSTAT.

Chart 8 Unemployment rate



Source: INSTAT.

LABOUR MARKET

The labour market showed positive developments during 2022 Q1, after a slight deterioration in the previous quarter. Employment increased by 3.4% in annual terms, causing the unemployment rate to drop to 11.3% from 11.9% in the previous year. Unemployment of youth (aged 15-29 years old) fell to 20.7%, or by 2.6 p.p., compared to 2021 Q1, standing below the average of the last four years. During the period, the employment growth in the industrial sector (8%), in the agricultural sector (3%) and in the services sector (2%), supported the recovery of the labour market.

During the first quarter, wage growth[6] continued to accelerate to 5.8% in annual terms, with the entire contribution from the private sector (11%). Within the private sector wages increased for almost all sectors, but the highest growth was reported by the enterprises of the services sector.

THE EXTERNAL SECTOR

The external sector contribution to the economy was positive during the period, due to the decline by 22% of the current account deficit compared to the previous year, and decreased at about 7% of GDP [7]. Its improvement in annual terms was dictated by the expansion of the trade surplus in services, which overcame the negative effects of the deepening of trade deficit in goods and the slight expansion of the negative balance of primary income.

The positive surplus in services expanded by around 50%, reaching EUR 400 million at the end of the first quarter of the year. The recovery of services was mainly supported by those of transport, processing of physical inputs and telecommunications. Travel revenues grew significantly, in annual terms, by around 70%, whereas travel expenditures doubled. This led travel account to register a positive balance of around EUR 90 million, almost 15% lower compared to the previous year. These developments reflect the gradual improvement of the situation in the transport sector, but also the increase of services' price in international level.

Despite the faster growth of exports, the trade deficit in goods deepened by around 8% in annual terms, at EUR 820 million. This development was dictated by the increase in commodity prices in international markets, mainly for food groups, oil, electricity and basic metals. Imports of goods were at EUR 1.300 million, expanding by 28% in annual terms, while exports reached EUR 480 million, increasing by around 83% in annual terms.

Foreign exchange flows in the form of remittances are estimated at around EUR 180 million, with an annual increase of 9% while the flow of foreign direct investments is estimated at EUR 270 million, increasing annually by 16%. At the end of the period, the reserve assets are estimated to be sufficient to cover by about 8.2 times the needs for monthly imports of goods and services.

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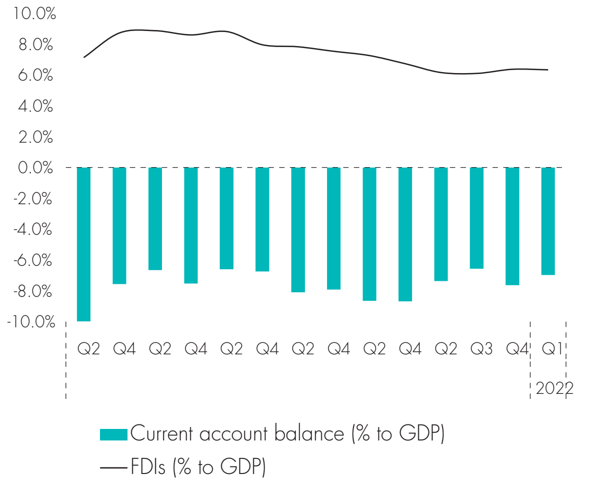
6 *It refers to the average gross wage*

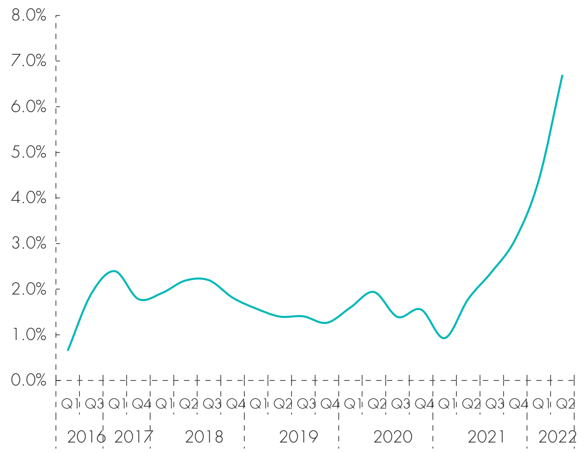
7 *This indicator is estimated as a ratio between the cumulative balance of current account for the last four quarters and the cumulative GDP for the same period.*

Chart 9 Current account and foreign direct investments



Source: Bank of Albania and INSTAT.

Chart 10 Annual change in Consumer Price Index



Source: INSTAT.

MONETARY DEVELOPMENTS

During the period, inflationary pressures were strong, driving up the consumer price index by 7.4% at the end of June. This performance of prices reflected the shocks from the supply side of goods and services in international markets, but also the sustainability of domestic demand following the improvement of employment and wages. The abundant net foreign exchange flows influenced the stability of the exchange rate of lek, especially against the euro, thus mitigating the severity of inflationary pressures. Due to these developments, the Bank of Albania deemed it as necessary to start the normalization of monetary policy, increasing the policy interest rate by 0.5 percentage point up to 1.0%[8]. According to the Supervisory Council of the Bank of Albania, the normalization of monetary policy will create more suitable conditions for maintaining price stability and returning inflation to target within the medium-term horizon. At the same time, monetary policy will aim to remain accommodative throughout the normalization process without compromising the premises of economic growth.

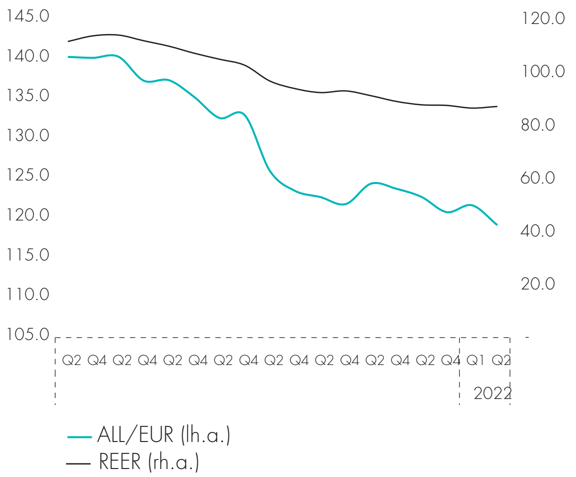
FISCAL DEVELOPMENTS

During the period, the fiscal policy was in general, consolidating. At the end of June 2022, the budged balance recorded a surplus of about ALL 15.2 billion, against a deficit of ALL 29.1 billion in the previous year. This performance reflects the sharp increase of annual revenues by about 20%. The increase in income was more significant in the item “income from taxes and customs” and reflects the price dynamics in international markets. Expenditures remain at comparable levels to a year ago, registering a minimal increase of about ALL 0.8 billion or about 0.3%. Expenditures were mainly for current expenses such as: health and social insurance and interest payments.

[8] *Normalization has continued, and at the end of August 2022, the policy interest rate of the monetary policy is 1.75%.*

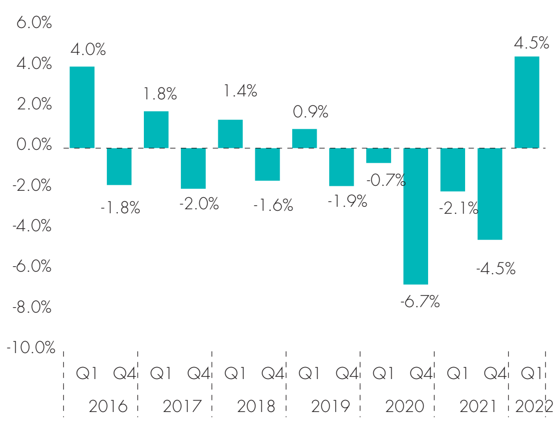
The above approach seems prudent and appropriate given the great uncertainties that accompany international developments and their impact on the global and domestic energy situation. It increases the financial capacities of the government to support, with appropriate instruments, the provision of energy or the temporary subsidization of its price for the most vulnerable strata of society. This way, it also contributes in mitigating the overall inflationary pressures that accompany their cost. Fiscal measures are however temporary and fiscal financial capacities remain limited. Their effectiveness in the short term will depend on the flexibility of their implementation, the duration of energy issues in international market, as well as the hydrological developments in the country.

Chart 11 Exchange Rate



Source: Bank of Albania.

Chart 12 Budget deficit to GDP



Source: Ministry of Finance and Economy, INSTAT, and Bank of Albania staff's calculations.

2.3 FINANCIAL POSITION OF HOUSEHOLDS AND ENTERPRISES

During the period households and enterprises deepened their financial positions, as net creditor and net debtor, respectively. The increase of the credit position for households was around 2%, while the expansion of the net debtor position for enterprises was around 4%. For both, households and enterprises, the changes in the respective positions occurred in the conditions of the simultaneous growth of deposits and loans. Households save mainly in foreign currency and are financed mainly in lek. Enterprises prefer more the foreign currency for savings and financing.

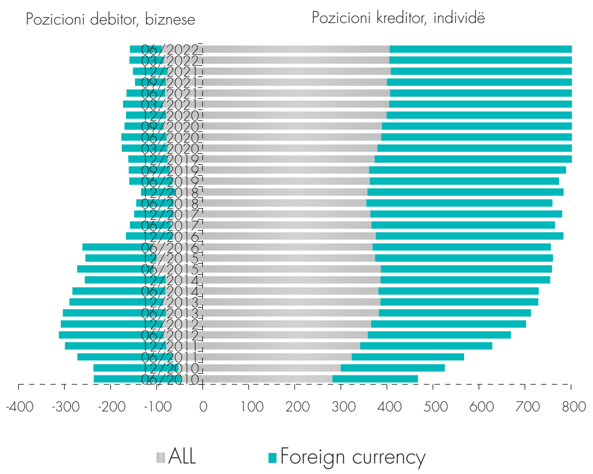
During the period, households and enterprises, deepened their financial positions, as net creditor and net debtor, at ALL 926 billion and ALL 158 billion, respectively. The increase of the credit position for households was around 2%, while the expansion of the net debtor position for enterprises was around 4%.

In annual terms, the performance was similar for households where the expansion of net credit position was around 6%. For households, the financial position as net debtor decreased during the last year by about 5%.

For both, households and enterprises, the changes in the respective positions occurred in the conditions of the simultaneous growth of deposits and loans. Households save mainly in foreign currency and are financed mainly in lek. Enterprises prefer more the foreign currency for savings and financing.

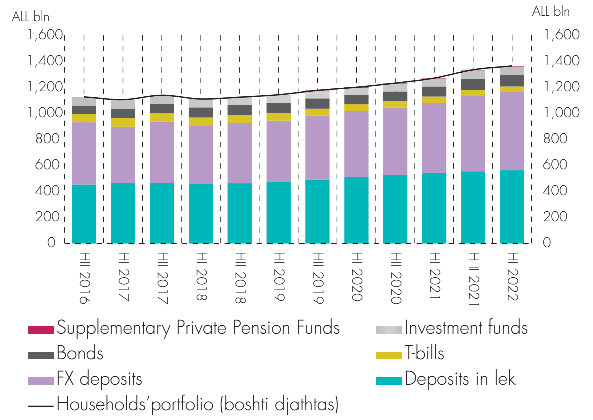
Deposits in banks account for the largest share of households' savings and their increase during the period, by around ALL 30 billion, has given the main contribution to the expansion of the financial position. Investments in Government Bonds also increased during the period. Whilst investments in T-bills and investment funds, decreased.

Chart 13 Sectoral financial position (ALL billion)



Source: Bank of Albania.

Chart 14 The Portfolio performance of households' investments



Source: Bank of Albania, Albanian Financial Supervisory Authority. According to the latest reports, the values for investment funds and private pensions are from 2021 Q1.

2.3.1 FINANCIAL POSITION, BORROWING AND HOUSEHOLDS' SOLVENCY

The share of households that have a loan to pay decreased during the period. Despite a slight improvement during the period, households' solvency remains below the historical average.

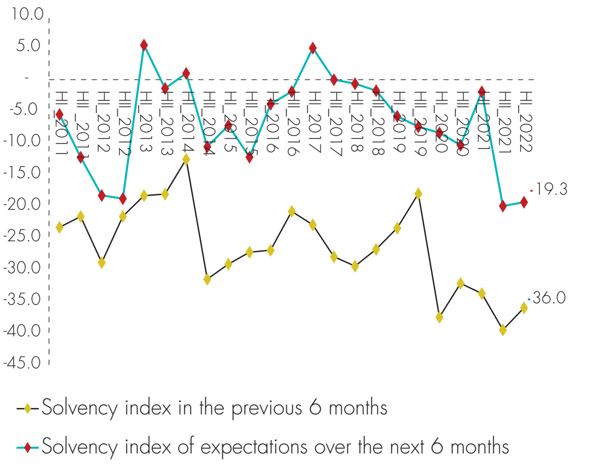
Households demand for loan may have slowed down somewhat during 2022 H2, influenced by the international developments and the increase of financial costs.

A periodic survey is carried out to assess the financial situation, use and the debt burden of households[9]. Around 22% of households that responded to the questionnaire stated that they had at least one loan to pay at the time of the interview. This share has decreased by 1 percentage point compared with the previous half-year and by 2 percentage points compared with the previous year, remaining below the historic average.

Around 51% of borrowing households declared that their solvency "has not changed" during the period, while the rest report a slight improvement in their solvency compared to the previous period, but yet remaining below the values of the previous years. A similar picture shows the solvency expectation index, for the next six months. Around 71% of households state that the loan settlement is less than 30% of the monthly income and this indicator decreased by 5 percentage points compared to a year earlier.

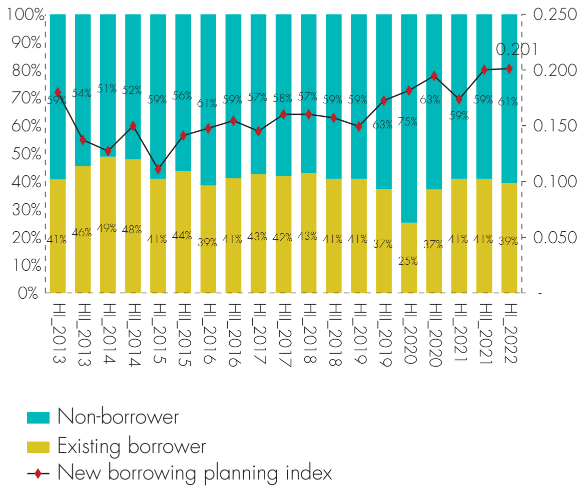
[9] *The survey analysis is published on the website of the Bank of Albania. (www.bankofalbania.org).*

Chart 15 Solvency in the previous six months and solvency expectation for the next six months



Source: Bank of Albania.

Chart 16 Borrowing planning index/ turnover of households planning a new loan



Source: Bank of Albania.

Enterprises report an increase in investments and expansion of activity during the period. For the majority of them, the performance of sales and financial results continued to improve. There are issues related to 'competition', 'market acquisition', 'production costs' and 'availability of qualified staff'. The share of borrowing enterprises has changed little during the year. The debt burden has decreased in relation to capital, but it seems somewhat higher in relation to income from enterprises.

Expectations for business borrowing in the next period seem somewhat higher.

Based on the survey for loan applications, there is an increase in the total number of applications, but also of the rejection rate by banks.

Around 53% of respondents stated that they "do not expect to get a new loan in the next six months", while about 47% of them stated that they consider, at various levels of certainty the possibility to take a new loan. This share has increased by 2 percentage points compared with the previous half-year and by 6 percentage points compared with the previous year. Analysing only the group of households planning to take a new loan, it results that around 59% of them are "new borrowers", that is, they do not have unpaid loans at the time of the interview, and this share has remained unchanged compared with the previous six months, but decreased by 4 percentage points compared to the previous year. The possibility index to take a new loan was 0.201, remaining almost the same level as the previous period, which may signal a moderation of demand from households for loans in 2022 H2. However the future developments of households' demand for loans, is expected to be influenced by developments in the international arena and the performance of interest rates.

2.3.2 FINANCIAL POSITION, BORROWING AND ENTERPRISES' SOLVENCY

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. Around 82% of total enterprises participated in the survey by fully or partially responding to the questions of the survey. During the period, the surveyed enterprises assessed the elements of "competition" and "market acquisition" as the main issues in the exercise of their activity, "Competition" for small and medium-sized enterprises increased compared to the previous period, similar to the element "market acquisition". The elements that were identified as challenge to all sized enterprises were "cost of production and labour" and "availability of qualified staff".

Over 90% of enterprises in each size group reported profits during the period. Sales performance and financial result for medium-sized and large enterprises, continued to improve in 2021 H2. During the period, around 59% of responding enterprises declare that they have financed their activity through sales. In regard to the expansion of activity or investment growth, the expectations of all sized enterprises are positive for the upcoming period.

Around 40% of the total responding enterprises declare that they currently have loans to pay. This share decreased by 2.9 percentage points compared to the previous six months, and 0.8 percentage point to the previous year. About 82% of small enterprises, 81% of medium-sized enterprises and 82% of large enterprises consider their level of borrowing for financing their activity as adequate. Borrowing is denominated in the domestic currency for 64% of small borrowing enterprises, 51% of medium-sized enterprises and 45% of large enterprises; while the rest is in foreign currency and/or combined. The share of enterprises borrowing in foreign currency has increased for all sized-enterprises. This element is influenced by the currency in which these enterprises carry out their activity, however it requires a careful evaluation in the future in regard to exposure against exchange rate, given the fact that the share of enterprises borrowing in foreign currency is higher than the share of enterprises that carry out their activity in foreign currency.

The total value of the loan is approximately half the value of the enterprise's equity for around 78% of total borrowing enterprises and almost at the same level of the value of equity for around 11% of them, whilst the other 11% state that the value of loan is higher that the value of equity. The loan/equity ratio resulted higher for medium-sized and large enterprises, with 25% and 23% of them declaring that this ratio is equal to or exceeds the value of equity. This period, the ratio decreased for medium-sized and large enterprises. At sectoral level, debt burden decreased for some of the sectors under review.

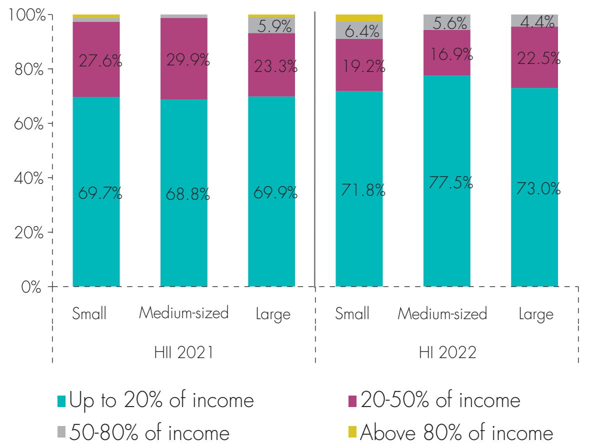
Table 3 Share of enterprises with an equal/higher value of debt to equity, by sectors

	Share of enterprises with an equal/higher value of debt to equity, by sectors			
	Industry	Services	Construction	Trade
2020 H2	19.7%	25.0%	17.6%	21.9%
2021 H1	22.3%	26.5%	29.9%	27.0%
2021 H2	22.7%	24.7%	24.4%	22.1%
2022 H1	20.7%	21.2%	25.3%	22.5%

Source: Bank of Albania

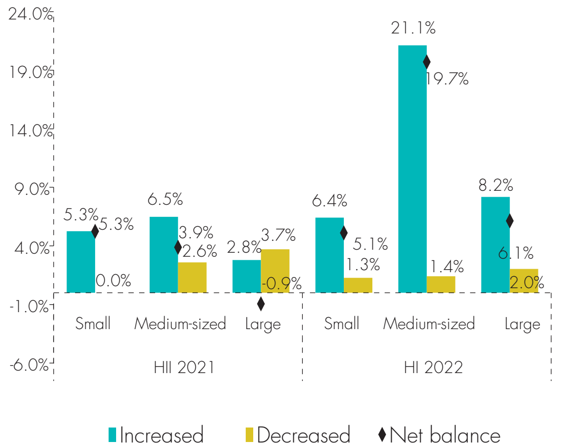
Most of the borrowing enterprises (74%) state that the loan payment amounts goes up to 20% of the enterprise's revenue. This share has increased by 3.8 percentage points compared with the previous survey. Questioned whether the service cost of the loan has changed over the period, the majority of enterprises claim that this expenditure has remained unchanged. The reponses of the rest resulted in net positive balances for all sizes of enterprises, showing an increase of this expenditure as a ratio to income.

Chart 17 Enterprises by size and debt instalment/income ratio



Source: Bank of Albania.

Chart 18 Enterprises that declare a change in the loan instalment during the period



Source: Bank of Albania.

Regarding planning for a loan in the future, around 47% of responding enterprises reported "no possibility" of bank borrowing in the next period. This share decreased for all sized enterprises compared to the previous period. Furthermore, it is observed an increase of the share of enterprises that claim that there is ''little possibility'' to take a loan in 2022 H2, as well as the share of enterprises that declare that there is a ''high possibility'' for this to happen in the next period. The share of enterprises that responded with ''it is certain'' decreased for medium-sized enterprises and slightly for large enterprises, even though at a lesser extent. The borrowing planning rating index for the next six months increased for all enterprises, but this increase is more significant for medium-sized and large enterprises.

BOX 2 PERFORMANCE OF THE NUMBER OF LOAN APPLICATIONS AND THE REJECTION RATE BY BANKS IN THE COUNTRY, 2022 H1

During 2022 H1, banks reported that they considered a total of 66,025 loan applications, of which 9% (or 5,776) belonged to the enterprise' sector (3,324 applications from 'small and medium-sized enterprises' and 2,452 applications from' other enterprises '), and 91% belonged to the 'households sector" (60,249 applications). This structure marked a shift in favour of 'enterprises', in semi-annual and annual terms.

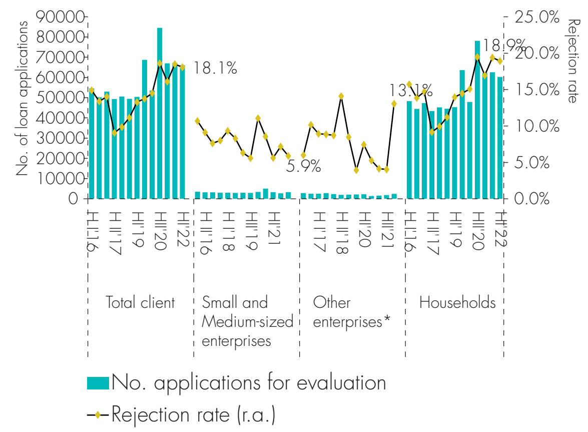
The total number of loan applications reviewed by banks showed a decrease by 1.6% and 1.4%, respectively, compared to the previous six months and the previous year. The decline came from the segment of 'households' (4% in semi-annual terms and 3% in annual terms), while the number of applications reviewed by the category 'small and medium-sized enterprises' and 'other enterprises' (large enterprises predominate) increased in both periods.

In the total of considered applications during the period, around 18.1% of them are rejected from banks. This rate slightly decreased compared to the previous six months (by 0.4 percentage point), but remained higher, by around 2 percentage points, compared to the previous year. This performance seems to have been influenced by the rate of rejection to households and small and medium-sized enterprises, meanwhile the rate of rejection to large enterprise ('other enterprises'), increased at 13.1% from the average of around 4% reported in the two previous six-months.

Analysing the rejection rate by groups of banks, it results that the total rejection rate of loan applications from banks with domestic capital, increased to 6.3% (from 6.2% in the previous six-months), while for banks with foreign capital this rate dropped to 24% (from 27% in the previous six months). Despite this, both banking groups showed similar attitudes towards segments of "customers". Thus, although foreign banks remain more inclined to lend to the enterprise segment, specially to large enterprises or 'other enterprises'), while domestic banks continue to focus on the private sector and small enterprises (small and medium sized enterprises) the rejection rate of lending to large enterprises has been increasing for both groups, but it has decreased for other segments of "customers''.

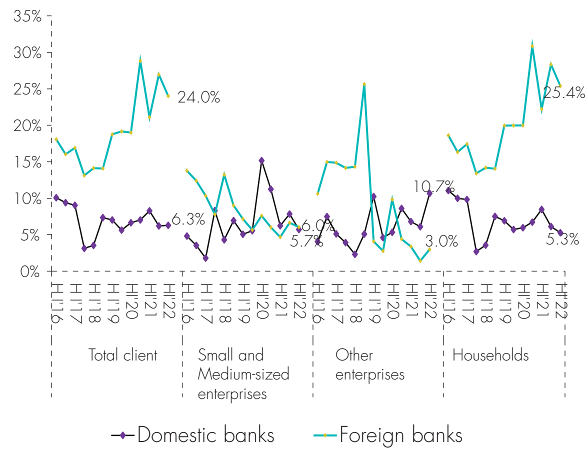
Overall, from the above analysis, it can be concluded that the progress of applications reviewed by banks during 2022 H1, indicates a moderation in the demand for loans by households, both in semi-annual and annual terms while this demand has increased for the enterprise sector more pronounced from large enterprises. On the other hand, given the high uncertainty in the international

Chart 19 Number of evaluated applications and rejection rate analysis



Source: Bank of Albania.

Chart 20 Rejection rate of loans, by domestic and foreign banks



Source: Bank of Albania.

arena and the problems it has brought to the production and trading chains, the banking sector in the country has been reluctant to finance large businesses that may be more exposed to the external shocks, looking for other financing alternatives in the sectors of households and small enterprises.

3. MARKETS AND PAYMENT SYSTEMS

The volume of debt securities in lek issued by the government during the first half of the year was higher than in the previous six months, but comparable to that of the previous year. The volume of debt securities in euro was lower than the maturity value.

12-month T-bills continue to dominate the issuance of short-term securities, while 2-year bonds have the main share in the issuance of long-terms securities.

The weighted average yield on securities in lek increased, reaching 2.5% at the end of the period. The average yield, over the period, on short-term debt securities rose by 0.3 pp, at 1.9%. While, for long-term securities the average yield was up by 0.2 pp, reaching 3.5%. The yield on the 2-year issuance in euro increased by 0.2 pp, at 2.2%.

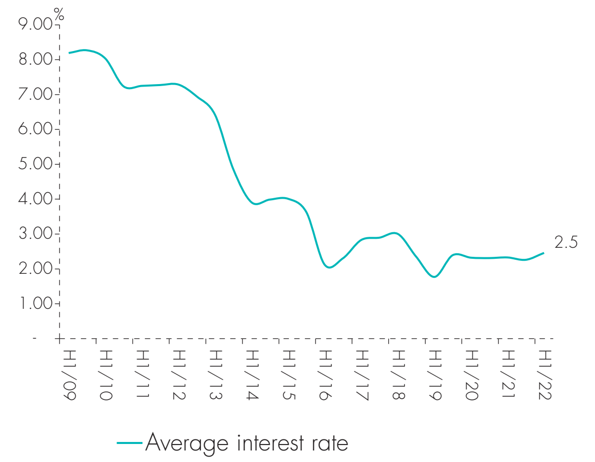
Overall, investors' bidding was congruent with the demand of government for borrowing.

3.1 CAPITAL AND FOREIGN EXCHANGE MARKETS

PRIMARY MARKET OF SECURITIES

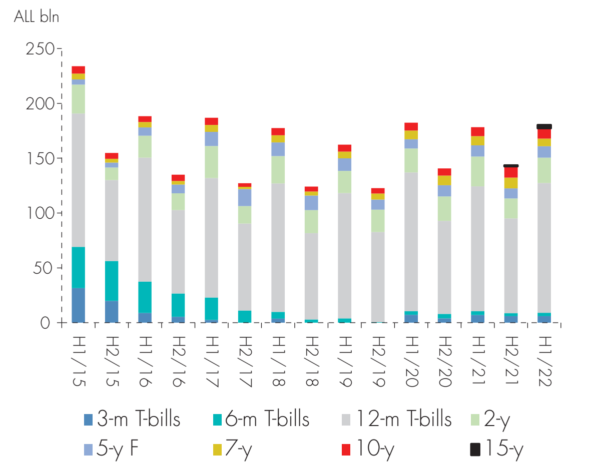
The primary debt securities market is dominated by debt securities of the Albanian Government. The volume of Government debt securities issued in lek, in the first half of the year, was around 25% higher compared to the volume issued in the previous six months, but almost equal to the volume issued in the same period of the previous year. In the first six months of the year, there were around ALL 200 billion securities issued. Around 96% of this value consists of securities issued in the domestic currency, while ALL 8 billion or 4% of the total issuance was in euro. The weighted average yield on all securities maturities increased by 0.2 percentage point, reaching 2.5% at the end of the period. The issue of short-term securities continues to represent the largest share in the volume of issued securities.

Chart 21 Weighted average interest rate on debt securities (in %)



Source: Bank of Albania.

Chart 22 Composition of domestic debt in lek issued during 2015-2022 H1

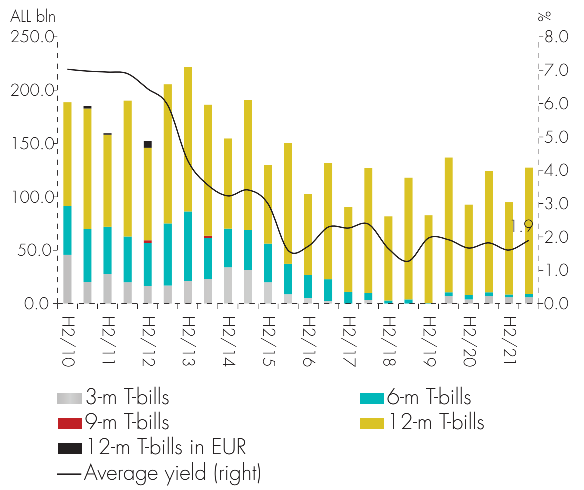


Source: Bank of Albania.

The issued short-term securities account for 63% of the domestic debt. Over the period, there were ALL 130 billion short-term securities issued, up by 34% and 2%, respectively, compared to the volume of the first and second half of the previous year. 12-month T-bills accounted for around 93% of short-term debt. The issuance of 12-month bonds amounted ALL 120 billion, or up by 37% and 4%, respectively, compared to the issuance in the previous period and in the previous year. The issuance of 6-month T-bills was also higher compared to the volume issued in the previous six months, but it decreased slightly compared to the volume issued during the same period of the previous year. The volume of 3-month T-bills was around ALL 6 billion, or twice as high than the volume of 6-month T-bills. Also, the volume of 3-month bonds issued was somewhat smaller compared to the previous year.

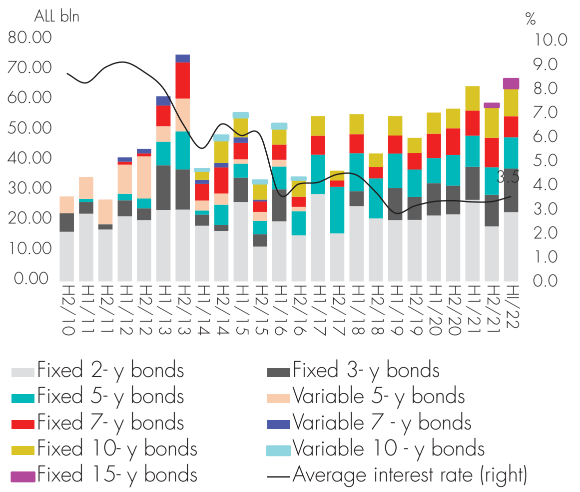
At the end of the period, the weighted average yield on short-term securities reached 1.9%, up by 0.3 percentage point compared to the level recorded at the end of 2021. Overall, the bid for investment in 12-month securities has been equal or higher than the government demand for borrowing. In cases when the government demand for financing through 3-and-6-month issues was not met, there were strengthened pressures for increasing the interest rates on these maturities. In the most recent issuances of the period, these yield reached 1.7% and 1.9%, respectively. These values were the highest rates recorded during the first half of the year.

Chart 23 Volume and weighted average yield on T-bills in the primary market



Source: Bank of Albania.

Chart 24 Volume and weighted average yield on bonds in the primary market



Source: Bank of Albania.

The volume of long-term securities issued during the first half of the year, in lek and Euro, was ALL 70 billion and EUR 70 million, respectively. The volume of long-term debt securities issued during the period was around 15% higher compared to the previous half year, and comparable to the one of the same period in the previous year. The 2-year bonds in lek continue to account for main share in the volume of long-term securities. In the first half of the year, there were around ALL 23 billion of 2-year bonds issued. This volume was somewhat higher than the previous six months, albeit below the level of the first half of 2021. There was an increase in the volume of bonds issued with a maturity of 3, 5 and 15 years, whereas the issuance of 7-and-10-year securities fell since government demand did not match investors' bidding. Euro bonds account for around 12% of the long-term debt, and the issuance conducted over the period carried a 2-year maturity. Compared to the latest issuance of this security, which was conducted in 2020 H1, the current volume issued was lower (by

ALL 30 million), and the interest rate was up by 0.2 percentage point, standing at 2.2%.

The weighted average yield on long-term securities rose by 0.2 percentage point during the period, to 3.5%. The yields on securities with maturity of 2, 5 and 15 years were up by the same degree, reaching 2.3%, 3.6%, and 6.1%, respectively. The yield on 3-and-10-year maturities rose by 0.4 percentage point, recording 3% and 5.5%, respectively. The sharpest increase was recorded in the yield on bonds with a maturity of 7 years, up by 0.6 pp, at 4.6%.

SECONDARY MARKET FOR DEBT SECURITIES

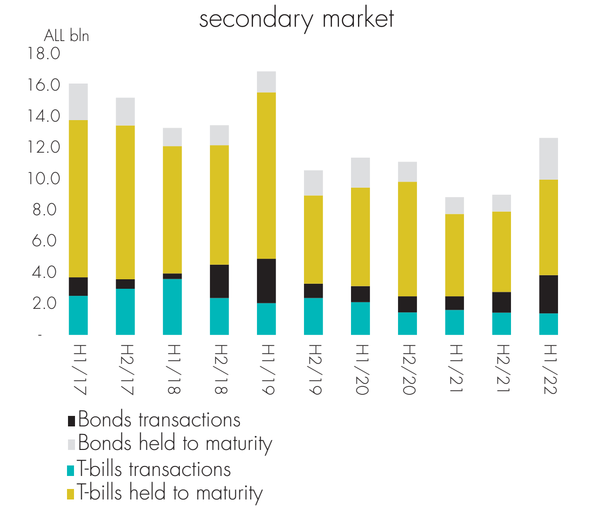
The overall volume of transactions performed in the secondary market during the period was upward. It amounted around ALL 4 billion, or around ALL 1.1 billion higher than the value recorded in the previous quarter, and ALL 1.4 billion more than the previous year. The value of transactions carried out was dominated by long-term securities, which reached ALL 2.5 billion during the period, or up by 1.4 billion than the previous six months. The value of transactions in short-term securities was ALL 1.4 billion, or down by 4% compared to the previous six months, and by 14% lower than in the previous year. The total number of transactions performed in the secondary market (800 transactions) was comparable to the previous six months, but 8% lower than the same period of the previous year. Around 72% of the performed transactions were in short-term securities. The number of transactions in long-term securities (220) increased by 16% compared to the previous six months, while the 570 transactions in short-term securities was comparable to the number recorded in the previous half year. Investors in the secondary retail market continued to show a preference for holding securities until maturity as only about 28% of them are traded.

Although the numbers remained unchanged, the value of transactions in the secondary market increased during the period. This performance was due to transactions of long-term securities, which recorded an increase in number and value.

Market makers helped increase the volume and value of the reference securities traded.

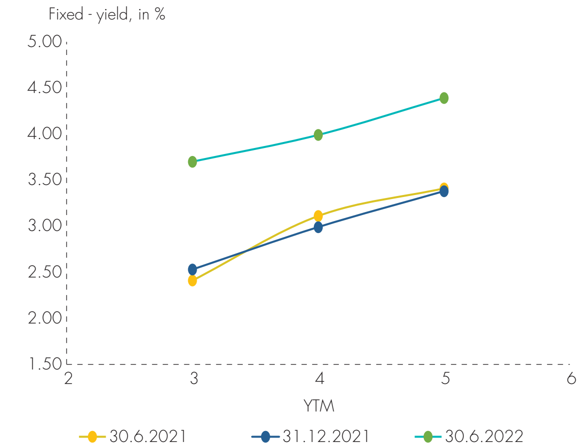
Investors continued to have a preference for holding securities until maturity. The yields curve in the market showed a normal slope, but tilted upwards as a result of the increase of the policy rate and the investors' demand for return on investment.

Chart 25 Volume of securities transactions in the secondary market



Source: Financial Supervision Authority.

Chart 26 Yield to maturity (YTM) on 30.06.2021



Source: Bank of Albania.

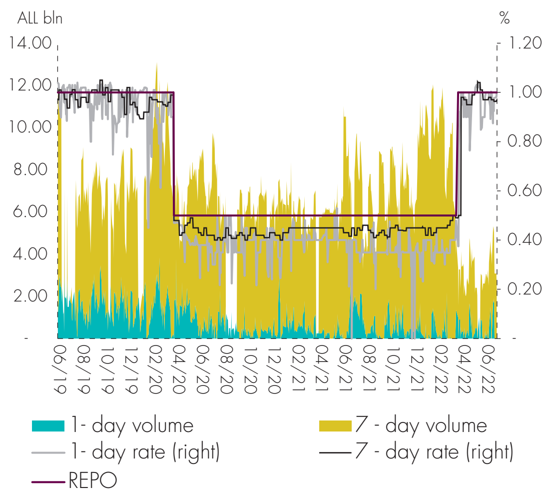
Market makers have continue the daily quotations of benchmarks (reference bonds with 3 and 5-year maturity). Daily quotation of benchmark securities provides for the calculation of the yield curve, which serves as a benchmark for other debt securities in the market, and enables the calculation of price. During the period, around ALL 1.2 billion in benchmark bonds were traded (approx. 50% of the value of transactions in long-term securities), with a significant rise, in both value and number, compared to both periods of the previous year. At the end of the period, the yield curve in the market showed a normal slope, with higher interest rates on issuances with longer maturities. Compared to the previous periods, the yield curve appears tilted upwards, reflecting the higher interest rates on each maturity. This performance reflects the higher policy rate, and investors' demand for the rate of return on securities investment.

During the period, the volume of transactions in the interbank market has decreased compared to the volume recorded in the previous two six months. This performance was driven by the fall in the volume of the weekly transactions, which dominate the total of financing transactions in interbank market. The interest rates of interbank transactions remained close to the policy rate, reflecting changes in the latter and in the form of auctions for liquidity injection, from the Bank of Albania.

THE INTERBANK MARKET OF FINANCING

During the period, the volume of transactions in the interbank market shrank by 27%. The interest rates in the interbank market fluctuated close to the level of the key interest rate set by the Bank of Albania. They immediately reflected the higher policy rate at the end of March. The interbank market continued to be dominated by 7-day transactions, which accounted for about 90% of the volume of interbank borrowing. During the period, the volume of 7-day transactions decreased compared to the previous six months and the same period of the previous year by 24% and 5%, respectively. The overnight transactions accounted for about 7% of the total volume and compared to the previous two six-months, they decreased by about 36% and 22%, respectively. During the first half of the year, the 3-month transactions that were registered in the interbank market, dropped by 19%, and they account for a smaller volume compared to overnight and 7-day transactions. During the period, the Bank of Albania injected liquidity through a one-week and three-month reverse repurchase agreement In the beginning of the period, the auction regained its usual form with a "limited amount"[10].

Chart 27 Interest rates in interbank market



Source: Bank of Albania.

[10] *Starting from November 2020, injecting operations were "at the same price," which allowed banks to borrow in unlimited amounts, at the key interest rate level.*

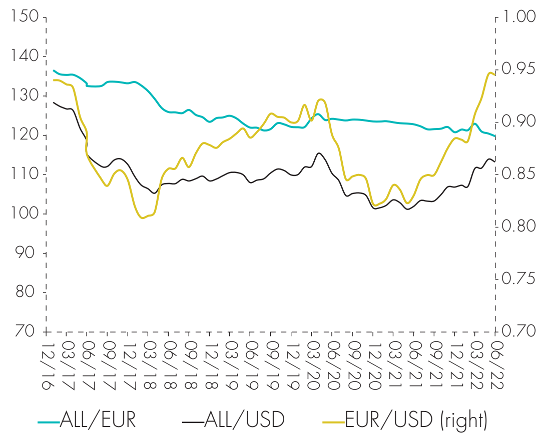
FOREIGN EXCHANGE MARKET

At the end of the first six months of the year, the average exchange rate of one euro was 119.8 lek, reflecting the appreciation of lek by 1% and 2%, respectively, compared to the values registered at the end of the previous two six months. Overall, the foreign exchange market appears stable and was characterised by normal trading parameters, except the short-term fluctuation in the wake of of the Russian's war against Ukraine.

During the period, the exchange rate of lek was stable. The domestic currency appreciated against the euro and depreciated slightly against the US dollar. Developments in international markets affected considerably this performance.

At the end of the first week of March, in order to avoid distortions in the foreign exchange market engendered by the war in Ukraine, the Bank of Albania enacted a short-term intervention by selling foreign currency and, simultaneously, decided to cancel three foreign exchange purchase auctions that were scheduled in March and April 2022. As a result, the lek/euro exchange rate stabilised until the end of the period. The performance of the US dollar against the domestic currency exchange rate reflected the appreciation of the US dollar in international markets. At the end of June 2022, the exchange rate of one US dollar averaged 113.3 lek, showing the deppreciation of the lek by 6% and 11%, respectively, compared to the values of the previous six months and the previous year.

Chart 28 Exchange rate in the domestic foreign exchange market



Source: Bank of Albania.

3.2 THE REAL ESTATE MARKET

Indicators used to monitor the performance of the real estate market suggest that, in 2022 H1, the average house price has risen significantly, as demand, construction costs, and supply, have gone up.

Based on the data on the real estate market survey and the developments of the house prices, the data reported by banks, and other administrative data, it is assessed that demand and supply and the construction costs in the real estate market, have increased significantly.

The increase of demand is evidenced by the higher volume of sales, the fall of unsold properties, and the growth of credit for house purchases. The higher supply is related to the stable increase of construction permits, accompanied this time around by the notable increase of construction costs as well. The performance of the latter has reflected the steep rise in expenditure for energy, construction materials, and machinery. In parallel, this was accompanied by an increase in outstanding loans for construction, granted from the banking sector.

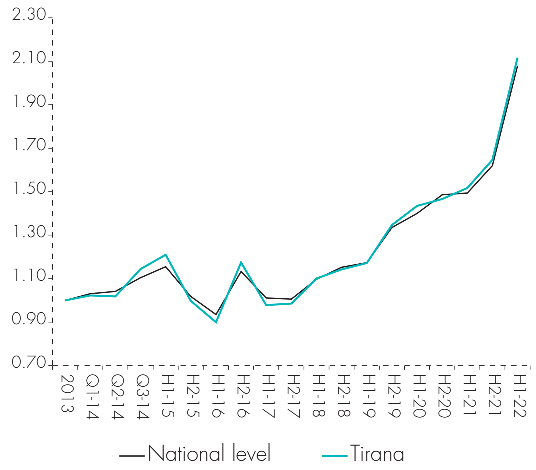
<u>In terms of demand,</u> real estate trading agents report that the volume of sales was stable and the number of unsold properties decreased, due to the higher households' demand. Also, banks eased lending standards and conditions for house purchase loans given the increase of the demand, the preservation of credit quality, and the use of collateral. Thus, the loans stock for the purchase of real estate by the household sector, at the end of the period, amounted to ALL 140 billion, increasing by 8% and 16% compared to the level recorded in the previous six months and the previous year. The performance of this loan continues to be favoured by an environment with relatively low and stable interest rates. The non-performing loans ratio for this type of credit dropped to 2.7%, from about 3.0% in the previous six months, and 4% in the previous year. At the end of the period, the stock of loans collateralized with real estate was around ALL 8 billion higher compared to the previous six months; the growth in this stock was driven by the equal increase recorded in the stock of loans in both lek and foreign currency. Around 65% of loans collateralized with real estate is held by the households' sector.

These developments drove the Fischer House Prices Index, for Albania, significantly upward, in both semi-annual and annual terms, by 28.4% and 39%, respectively. This index performance was determined by the rising average house prices in Tirana, although prices were up in other areas of the country as well.

Despite a more neutral stance on the real estate market performance over the short-term, for the long-term, market agents remain optimistic.

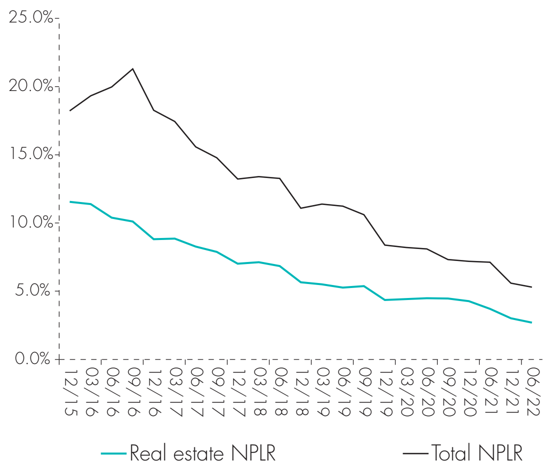
In terms of supply, the number of construction permits during 2021 H1, were up by around 60% compared to the same period in the previous year. For the first time, after a long period of small changes, the construction costs, calculated according to the Construction Cost Index, increased significantly during the first six months of the year. The annual difference in the overall index was 5%, while the expenditure items with the highest increase recorded were energy (+12%), construction materials (+6%), and machinery (+4%). Wage expenditures of the construction sector rose by around 3%. These factors seem to have also influenced the performance of the outstanding loans to construction, which increased compared to the end of December 2021 and the end of the previous year, by 12% and 29%, respectively. The share of loans for construction accounts for 17% of outstanding loans to enterprises. This share has increased significantly compared to the previous period.

Chart 29 Fischer House Price Index - National level and Tirana



Source: Bank of Albania.

Chart 30 Credit quality for real estate purchase



Source: Bank of Albania.

Due to the higher construction costs, real estate agents have reported higher selling prices compared to the previous six months. The average house prices calculated according to the Fischer Index[11], for sales made during the period, increased by 28.4%, compared to the previous six months, and by 39% compared to the previous year. This performance was driven particularly by the volume of sales in the Tirana area, which includes the centre, the suburbs and areas outside the city. The index of sales prices in the capital city rose by around 28.5% compared to the previous period, and around 40% compared to the previous year.

The assessments of the entities interviewed for the survey on the real estate market and house prices, are balanced in the short-term, being neutral for the situation in the Tirana area, and less pessimistic in the other areas. This assessment might have been influenced from external developments and the uncertainty about inflation and construction costs. In the longer term, the expectations of these entities for the situation and performance of the house market, remain optimistic.

[11] *This index is constructed based on a specific survey. This survey is published in full on the website of the Bank of Albania (www.bankofalbania.org).*

BOX 3 SUMMARY OF THE RESULTS FROM THE "REAL ESTATE MARKET" SURVEY AND THE DEVELOPMENTS OF THE HOUSE PRICES INDEX FOR 2022 H1

Data on the developments of prices and the assessment of the situation by real estate market agents was collected through a field survey of a sample of 230 entities whose main business was the trading of real estate. The selected entities are real estate agents and construction companies whose sales represent around 75%-80% of the turnover of the entire population. The Bank of Albania conducts the drafting of the questionnaire as well as data entry and processing of the results, while the Institute of Statistics conducts the field interviews, the main processes of sampling and the physical check of the completed questionnaires. In addition to the data on the increase of the Fischer House Prices Index, for Albania, aforementioned in this report, the data from the survey shows that:

The general assessment of the agents for the overall situation of the market has slightly deteriorated compared to the previous period. Responding to the question "How do you assess the market situation compared with the previous period (six-months)?" the net balance of responses was [-11%], but around 2/3 of respondents gave a neutral report – "no change." There were pessimistic answers concentrated in the "Other areas", while in the capital city agents gave a neutral report. The balance of this question is, nonetheless, lower than the long-term average for this indicator of around [-20] %. The same indicator assessed only for entities that have reported sales during the period had a neutral net balance.

Number of listed properties: Agents report a lower number of properties listed in their books compared to the previous period. The net balance of those reporting an increase in the number of registered houses and those reporting a decline in their number was around [-6%], and this value showed a decrease in the indicator compared to the previous period. The number of unsold properties, both for residential and commercial buildings, continued to be down for several six-month periods running.

Average sale period: The average time of sale for property, at national level, has decreased slightly to 10.8 months. In Tirana, the respondents reported an average sale time of 9.7 months, and this value recorded a slight increase from the previous six months. For the coastal area, the sale time has shortened significantly, from 11 to 6 months. The sales time for other areas has remained almost unchanged at 13.1 months.

Financing through bank credit has continued to dominate a good part of properties being sold. According to agents, similar to the previous period, around 50% of residential and commercial properties sold by them are purchased with a bank loan. For most of these cases, the loan accounts for up to 60% of the value.

Expectations for the future appear positive despite the uncertainties related to the situation. Agents were positive about the short-term future performance of the market in the territory where they operate, and for the longer term period (up to 2 years). The number of properties expected to be registered for sale during the current period, is not expected to have essential fluctuations, as responses were in equilibrium. Also, agents foresee a rise of real estate prices for residential and commercial properties; the net balances for these two questions were positive at [+ 24%] and [+ 22%], respectively, reflecting optimism from the agents.

The rental prices according to the agents increased during the period. The overall demand for rental properties has increased compared to the previous six months. The data on the demand and prices for rental properties were mostly collected from agents operating in the capital city area.

3.3 PAYMENT SYSTEMS

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

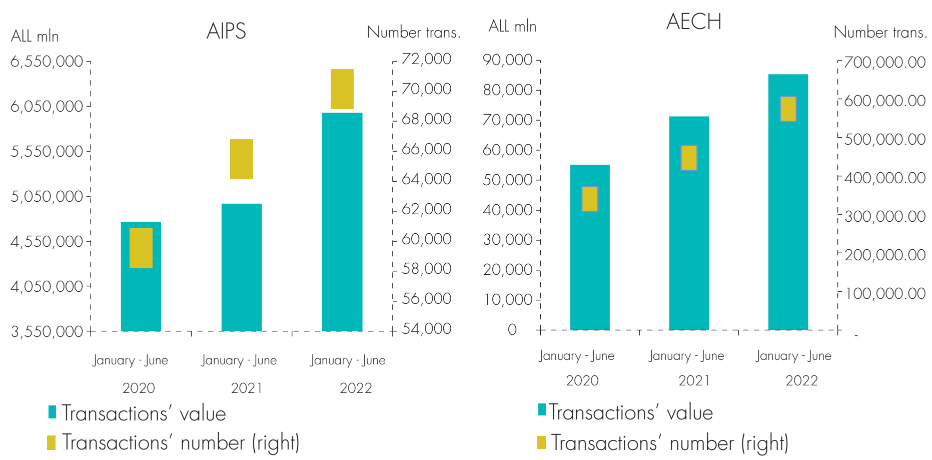
AIPS and AECH systems recorded an increase of the value of lek transactions settled through them. Also, the indicators that monitor the number and the value of payments of banks' clients, recorded an increase compared with the same period of the previous year. This increase was more significant in card and non-paper credit payments (which use specific bank applications and the internet).

Not least, during this period the AIPS-EURO system was put into operation, which processes euro-denominated payments only for clients within Albania and aims to reduce the processing time and cost of these payments for the public.

Over the period, AIPS and AECH systems have operated effectively and safely, and the transactions settled through them have increased considerably in number and value.

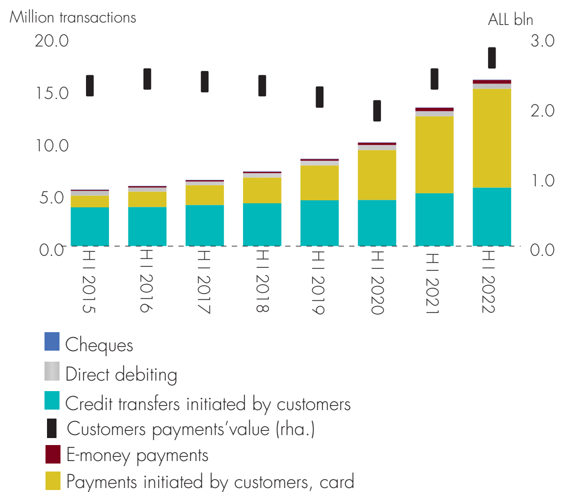
Thus, the AIPS system cleared 70 thousand transactions valued at ALL 6 trillion, up by 7% and 20%, respectively, compared to the numbers recorded during the same period last year. At the same time, the small value payment system, AECH, cleared 570,000 transactions, with an average value per transaction of around ALL 150,000. Compared with the first half of 2021, the activity of the AECH registered a significant increase both in volume and value, by 28% and 20%, respectively.

Chart 31 AIPS and AECH activity in 2020 H1 and 2022 H1



Source: Bank of Albania.

Chart 32 Performance of payment instruments in number and value (2018 H1 - 2022 H1)



Source: Bank of Albania.

On January 24 2022, the AIPS-EURO system was put into operation, which processes euro-denominated payments only for clients within Albania. Until the end of June 2022, this system cleared around 59,000 payments at a value equal to EUR 1.4 billion. The goal of the AIPS-EURO system is to reduce the time and cost of processing domestic euro-denominated-payments, as well as contribute in reducing the volume of euro-denominated cash management from local banks.

During the period, 15.9 million payments were made for banks' clients (households and enterprises), accounting for ALL 2.7 trillion. The number of transactions were up by 19%, while the value of transactions was 12% higher compared to the first half of the year.

In accordance with the instrument used, paper credit transfers continue to represent the main share of the payment value, by around 69%. The non-paper credit transfers (including internet and mobile banking), account for 25% of the value of payments, but banks have reported an annual increase in their number and value during the period, by 17% and 18%, respectively. Card payments represented the main share in terms of the number of transaction made by clients, by around 60%. Over the period, the number and value of card payments increased by 30% and 40%, respectively, compared to the levels recorded during the first half of the previous year.

4. FINANCIAL SYSTEM

In 2022 H1, the share of financial system assets[12] to Gross Domestic Product (GDP) decreased by 2.5 percentage points, to 102.6%. This performance reflects the annual growth rate of GDP was higher compared to the growth of the financial system balance. This decline was driven by both the banking sector and the non-bank financial sector, which contributed around 2 pp and 0.5 pp, respectively. Within the financial system, the banking sector continued to dominate the total assets by almost 90%.

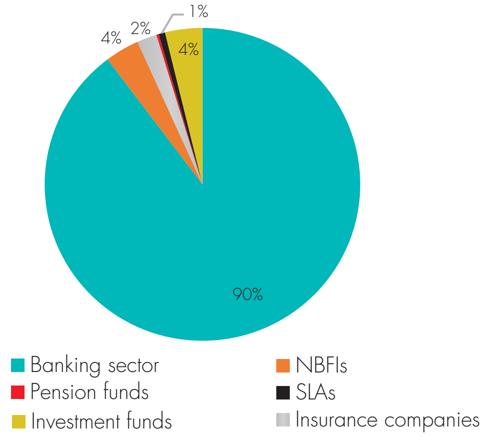
Table 4 Share of financial system segments to GDP over the years (in %)*

Licensiong and Supervision Authority	Bank of Albania			Albanian Financial Supervisory authority			Finanacial Intermediation
Financial system	Banking sector	NFBIs	SLAs and Union	Insurance comp.	Pension funds	Investment funds	
2011	86.1	2.6	0.8	1.5	0.0		91.0
2012	89.1	2.7	0.8	1.6	0.0	1.2	95.4
2013	91.4	2.6	0.7	1.6	0.0	3.7	100.2
2014	92.7	2.8	0.8	1.8	0.0	4.6	102.7
2015	91.9	2.7	0.7	2.0	0.1	4.7	102.0
2016	95.5	2.8	0.6	2.0	0.1	4.5	105.5
2017	93.2	2.9	0.5	2.0	0.1	4.7	103.4
2018	88.8	3.2	0.6	1.9	0.1	4.2	98.8
2019	87.2	3.9	0.6	2.0	0.2	4.0	97.9
2020	97.8	4.2	0.7	2.4	0.2	4.2	109.5
2021	93.8	4.0	0.7	2.2	0.2	4.1	105.1
2022	92.0	3.6	0.7	2.1	0.2	3.9	102.6

Source: Source: Bank of Albania, Albanian Financial Supervisory Authority.

* *The values in the table have been calculated using nominal GDP at current prices, according to INSTAT.*

Chart 33 Share of financial system segments/ total assets of the Financial system, June 2022



Source: Source: Bank of Albania, Albanian Financial Supervisory Authority.

The exposure of the banking sector to the non-banking sector remains low and stable, whereas the sensitivity of the non-banking sector to the activity of the banking sector remains high, but unchanged during the period. The Bank of Albania monitors the interconnectedness indicators on a regular bases, in the framework of the periodical systemic risk assessment.

[12] *The financial system consists of the banking sector and non-banking sector (non-bank financial institutions, credit savings associations, pension funds and investments funds). The non-banking sector database and the GDP data are from 2022 Q1.*

4.1 BANKING SECTOR

4.1.1 MAIN DEVELOPMENTS IN THE BANKING SECTOR

Banking sector expanded the activity during the period, mainly driven by a surge in loans and investments in securities and loans to the economy. The fall of treasury and interbank investments, as well as the higher assets provisioning, contributed on the opposite direction.

Banking sector's assets expanded by about 2%, during the period, and by 10% compared to the previous year. The banking sector has smoothly carried out the main functions of the activity and has supported the economy with financing. The reported value of assets increased by around ALL 32 billion during the period, reaching around ALL 1.800 billion at the end of the period. The expansion in both lending activity by around ALL 30 billion, and in investments in securities by around ALL 15 billion, provided the main contribution to the growth of assets.

Treasury and interbank investments contracted compared to the first six months, by around ALL 6 billion (or 1%), driven by the reduced level of current accounts in banks and other financial institutions, mainly non-resident ones, as well as in the "central bank relationship" item. The expansion of the provisioning funds of the banking sector reduced the level of assets by around ALL 7 billion during the period.

Table 5 Structure of banks' balance sheet and annual change, June 2022

Assets	% of assets	Annual change,%	Liability	% of liability	Annual change,%
I. Treasury and interbank transactions	27	3	I. Treasury and interbank transactions	6	19
II. Customer transactions (credit)	39	12	II. Customer transactions (deposits)	81	9
Of which: public sector	1	74	Of which: public sector	1	15
Of which: private sector	38	12	Of which: private sector	80	9
III. Securities transactions	33	14	III. Securities transactions	0	-2
IV. Created Reserve funds	-2	15	IV. Other liabilities	1	-2
V. Other*	3	-1	V. Permanent sources	11	10
			Of which: Subordinated debt	1	21
			Of which: Share capital	10	10
Total assets	100	10	Total liabilities	100	10

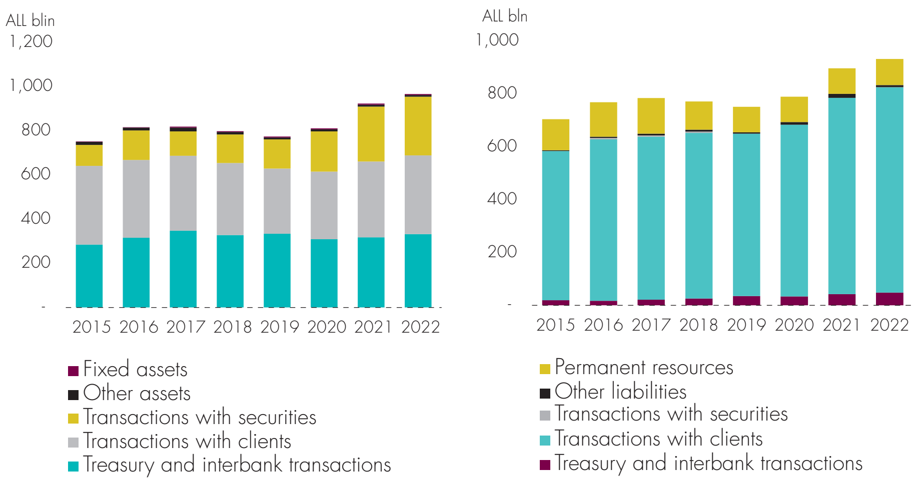
Source: Bank of Albania.

* *The item "Others" in the balance sheet refers to "Other assets", "Fixed assets" and "Accrued interests".*

The assets and liabilities of the banking sector in foreign currency accounted for 52% and 54% of the total balance sheet, respectively, and these ratios were stable during the period. On the assets side, the use of foreign currency was higher in the lending activity and interbank investments. On the side of liabilities, the use of foreign currency was higher in deposits. The statistical effect of the exchange rate, related to the appreciation of lek against euro, reduced the size of foreign currency items reported in the balance sheet. Despite the increase of assets and liabilities to non-residents during the period, the net lending position of the banking sector to them, in relation to total assets, did not change.

At the end of the period, the assets and liabilities of the banking sector in foreign currency accounted for 54% and 52% of the total balance sheet, respectively, and these ratios were maintained during the period. In absolute terms, banks reported similar levels of foreign currency assets and liabilities (ALL 960 billion and ALL 930 billion), showing thus a balanced and compatible exposure to foreign currency activity by the banking sector. On the foreign exchange assets side, lending activity and interbank investments remained the most important items, while during the last two years there has been an increase in the share of investments in securities. In terms of foreign currency liabilities, the structure has been more stable over the years, and was dominated by deposits in foreign currency. These components have largely determined the sensitivity of the banking sector to foreign currency exposure.

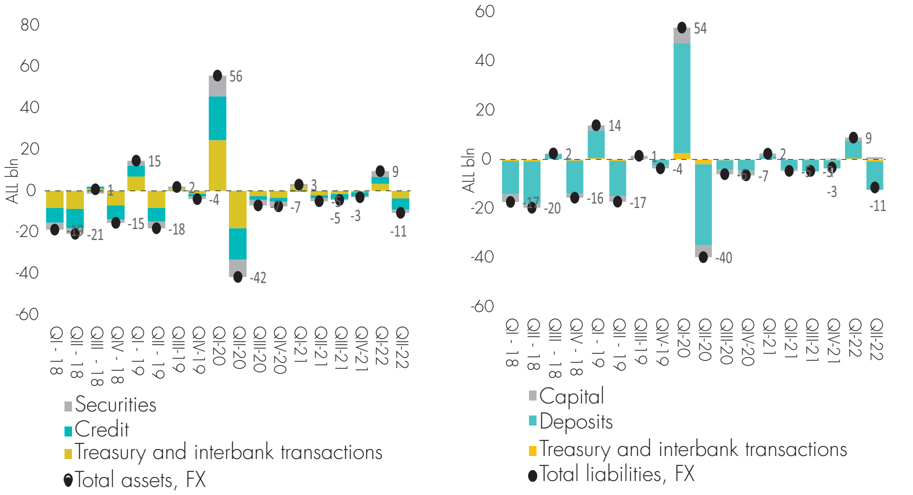
Chart 34 Foreign currency assets (left) and foreign currency liabilities (right)



Source: Bank of Albania.

The statistical effect of the exchange rate on the lek equivalent of the main items in the foreign currency balance sheet was negative in the first half of the year, due to the appreciation of the domestic currency, and this effect has deepened compared to the end of 2021. Thus, the appreciation of lek in 2022 Q2, has rendered the statistical effect of the exchange rate on the foreign currency balance reported by the banking sector, negative (ALL -11 billion). On the assets side, the appreciation of domestic currency had a strong impact on the main items of the balance sheet such as treasury and interbank transactions (ALL -4 billion) and customer transactions (ALL -5 billion); whereas on the side of liabilities, almost the entire statistical effect of the exchange rate was reflected on the lek equivalent of foreign currency deposits (ALL -12 billion).

Chart 35 The exchange rate effect on the performance in the lek equivalent of the main items of assets (right) and liabilities (left)

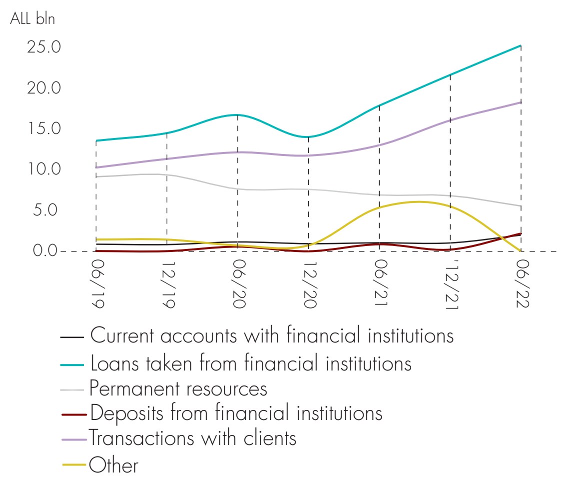


Source: Bank of Albania.

Deposits and own funds continue to be the main sources of financing in the banking sector, accounting for 92% of total liabilities, and this structure was stable during the period. Reliance on external funding sources at the end of the period was somewhat higher compared to the previous year, as a result of increased liabilities to non-residents. The higher liabilities were driven by the expansion of the credit stock granted by banks and non-resident financial institutions, as well as the growth in the deposits of non-residential customers. These two items account for the main share in the structure of liabilities to non-residents by about 48% and 35%, respectively. On the other hand, permanent sources which represent own funds to non-residents have been downwards over the three year period, due to the contraction of the subordinated debt and the structural changes in the capital of banks. During the period, "other liabilities" decreased because the "dividend payable (to non-residents)" was paid off over February 2022.

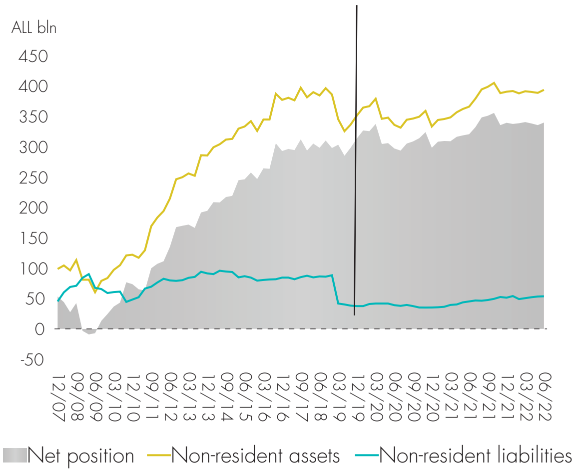
Assets of non-residential entities increased during the period due to the expansion of investments in securities and placements in the form of loans with banks and financial institutions. At the end of the period, claims on non-residents accounted for 22% of total assets, while liabilities to non-residents accounted for only 3% of total balance sheet. The net creditor position remained unchanged in both relative and absolute terms compared to the previous six months and the previous year, at 19% of total assets of the banking sector.

Chart 36 Liabilities to non-residents



Source: Bank of Albania.

Chart 37 Net position with non-residents*



Source: Bank of Albania.

*The vertical black line (chart on the right) represents the period of transformation of the NCB branch in Kosovo, in a subsidiary.

The banking soundness index shows an increase of risks during the period.

This performance was mainly affected by a deterioration of efficiency indicators (related to higher operating expenses) and profitability.

In the longer term, the performance of the banking soundness confirmed the improvement of the banking sector's activity, in terms of asset quality, capitalisation and liquidity.

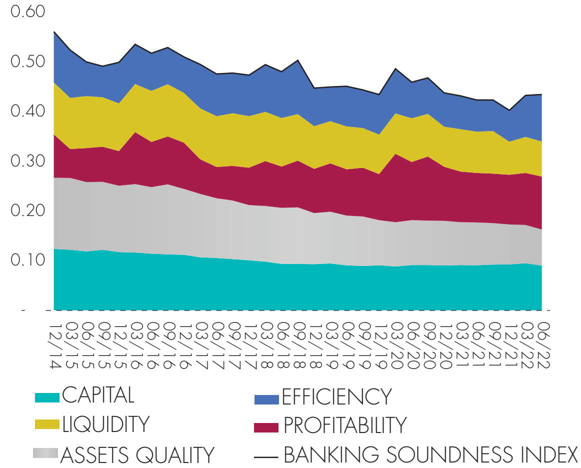
4.1.1.1 Banking soundness index

The banking soundness index shows that there is an increase in the risks to the banking soundness during 2022 H1, and compared with the previous year. This development was driven by the deterioration of the efficiency and profitability indicators. The higher profitability risk[13] reflected the decrease of the net financial result of the banking sector. The contribution of the "Efficiency" indicator to the level of risk increased significantly over the past 12 months, due to the higher expenses in relation to income. Risk related to liquidity and asset quality has decreased over the last 12 months, but the impact of these two indicators on the performance of the aggregate banking soundness index, was more limited compared to the other indicators. Liquidity indicator has slightly improved due to an expansion in liquid assets ratio to total assets, and the contribution of this component to the aggregate level of risk over time, has generally decreased, especially in the last year[14].

[13] *The value of the profitability indicator jumped to 0.53, from 0.50 recorded during December 2021, showing an increase of risk. During 2020, this indicator recorded the highest values since 2013.*

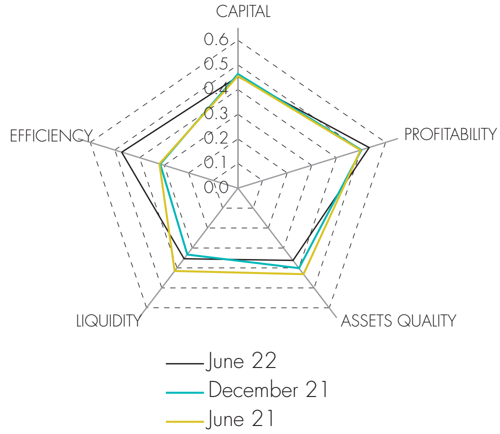
[14] *The value of the liquidity indicator dropped from 0.42 to 0.35 during June 2021 - June 2022.*

Chart 38 Banking soundness Index*



Source: Bank of Albania.
*The higher the value, the higher the risk. The breadth of each dimension means its contribution to risk.

Chart 39 Banking soundness map*



Source: Bank of Albania.
*Away from the centre means increased risk, in a 0 to 1 range.

The quality of assets has improved compared to the previous year, and the contribution of this sub-indicator to overall risk has been declining in recent years. The value of this indicator fell from 0.73 in September 2014 to 0.36 in June 2022, and the main role in this performance was played by a significant decline in the ratio of non-performing loans.

The soundness index has deteriorated for half of banks of the system. For systemic banks, the soundness index has slightly improved compared with the previous year. For this group of banks there was an improvement in three of the five indicators, but in particular improvement was recorded in the asset quality indicator. The profitability and efficiency indicators for systemic banks marked a decline over the past 12 months, as profits declined and expenses increased in relation to the income of this group of banks. Overall, during 2014-2021, the aggregate banking soundness index trended downwards, showing an improvement of soundness and increased stability of the banking sector. This performance was mainly affected by improvement in the quality of assets, liquidity position and capital. At the same time, since 2020 Q1, the profitability-related risk has become more prominent to the overall banking soundness.

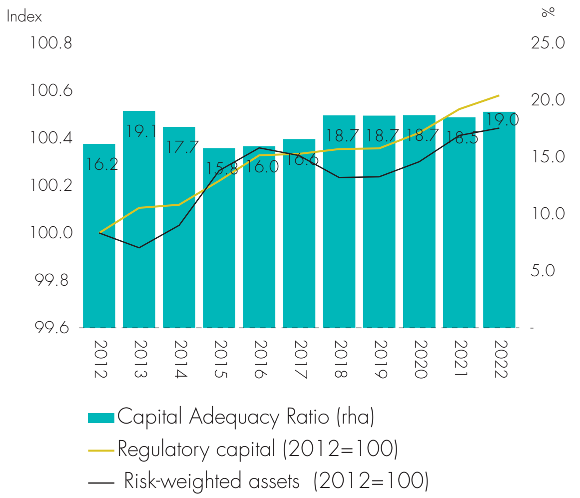
4.1.1.2 Capitalisation of activity

CAPITAL ADEQUACY RATIO

The Capital Adequacy Ratio (CAR) was up to 19% at the end of June 2022, mainly as a result from the growth of the regulatory capital. This indicator was above the 12% regulatory minimum across all banks. During the period, this ratio rose by 1 percentage point. Banks with European capital and systemic banks report the highest level of capital adequacy ratio. Banks with Albanian capital report the lowest level of capital adequacy ratio compared with the other group of banks.

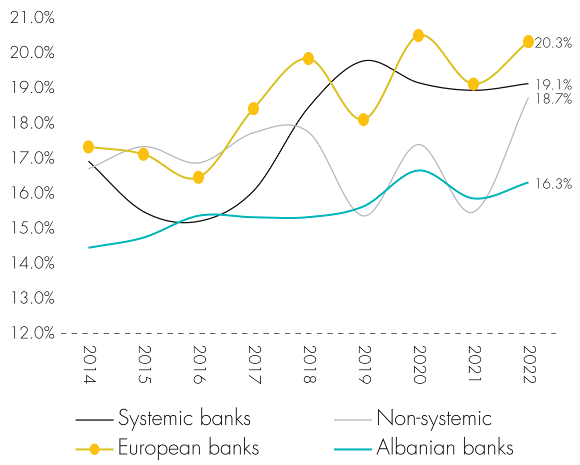
At the end of the period, the capital adequacy ratio jumped to 19%, up by around 1 pp during the period. The increase of the regulatory capital was the main contributor to this performance, although risk-weighted assets grew as well. The financial leverage ratio recorded a slight decrease during the period, due to the increased shareholders' equity.

Chart 40 Capital Adequacy Ratio



Source: Bank of Albania.

Chart 41 Capital Adequacy Ratio of groups by importance and origin of capital



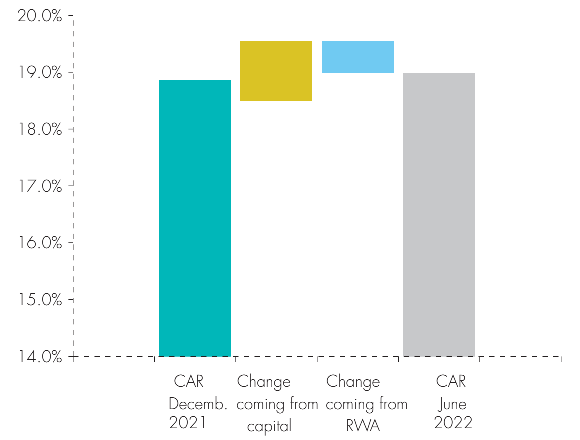
Source: Bank of Albania.

The increase of the capital adequacy ratio over the period, was affected on the positive side (by 1.1 percentage points) from the increase of the capital adequacy ratio of banks, and on the negative side (by 0.6 percentage point) from the expansion of risk-weighted assets. At the end of the period, the regulatory capital of banks recorded ALL 180 billion, up by around ALL 10 billion compared to the end of 2021. The growth in regulatory capital was mainly influenced by an increase in retained profits. Retained profit from previous periods has been the main element affecting the increase of shareholders' equity and regulatory capital. The Decisions of the Bank of Albania in January 2021 on suspending the distribution of profit from banks[15] have affected the preservation of retained profit from previous periods. In annual terms, the growth pace of regulatory capital was lower due to the decrease in the other items of Common Equity Tier 1 (CET1) and Tier 2 (CET2).

On the other hand, risk-weighted assets increased compared to the previous six months, as well as to the previous year, reaching ALL 960 billion. The rise in risk-weighted assets is mainly related to the increased exposures in corporations, retail portfolio, and in non-performing loans. However, in relation to total assets, the share of risk-weighted assets has not changed, standing at 53%.

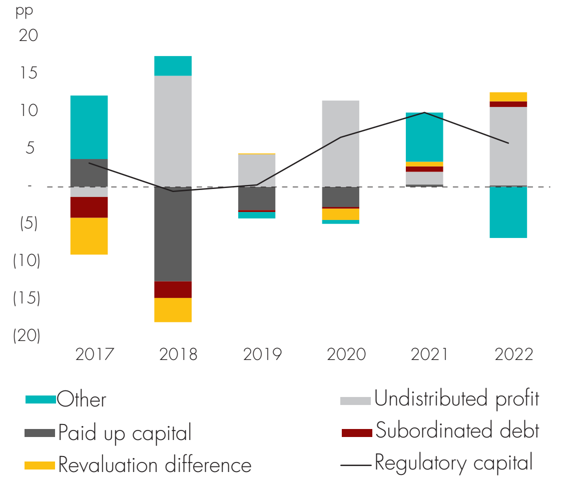
[15] *Decision no. 6, dated 02.02.2022 "On the suspension of profit distribution of banks" with effect until 31 December 2022.*

Chart 42 Contribution of capital adequacy items (in p.p.)



Source: Bank of Albania.

Chart 43 Change in regulatory capital by component instruments (in p.p.)

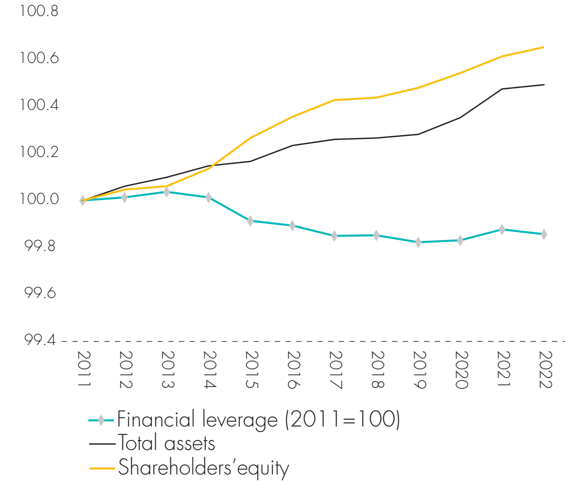


Source: Bank of Albania.

Assets related with credit risk continue to dominate the structure of risk-weighted assets by risks (87%), while assets related with market risk and operational risk account for 3% and 10% of the total, respectively.

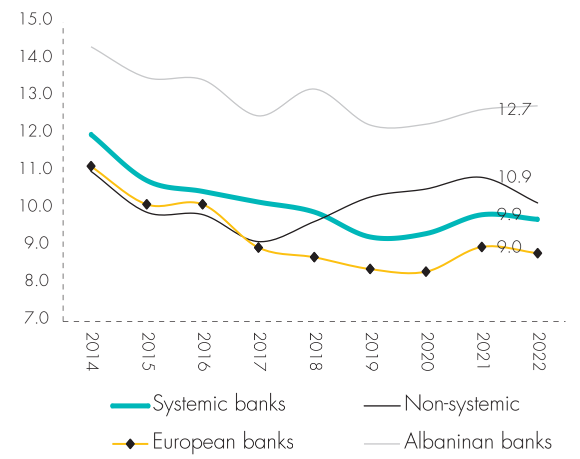
The financial leverage ratio[16] in June 2022 was slightly lower (9.89 times) compared to the end of 2021 (10 times), due to the improved indicators of shareholders' equity. Analysis of the performance of financial leverage for certain groups of banks shows that its level is determined by systemically important banks. Banks with Albanian capital have the highest level of financial leverage, showing that these banks should use more capital to finance their activity.

Chart 44 Financial leverage performance by components



Source: Bank of Albania.

Chart 45 Financial leverage of banks according to systemic risk and the origin of capital, in times



Source: Bank of Albania.

16 *The financial leverage ratio is measured as the ratio of assets to shareholders'equity.*

The Bank of Albania requires banks to fulfil some levels of capital, including also the requirements for macro-prudential capital buffers. At the end of the period, the banking sector fulfilled these requirements and registered a capital surplus. This surplus has somewhat decreased over the last 12 months, as banking sector's profit have fallen and the level of capital required from banks has increased. In order to strengthen the capital positions during the period, banks have increased retained profits and the use of subordinated debt.

CAPITAL SURPLUS AND FULFILMENT OF REGULATORY REQUIREMENTS ON MACRO PRUDENTIAL CAPITAL BUFFERS

In accordance with the regulation "On macro-prudential capital buffers"[17], banks are subject to the capital conservation buffer (CCoB), the countercyclical capital buffer (CCyB); systemically important banks buffer (O-SLLs) and the systemic risk buffer (SyRB). The capital conservation buffer for 2022 is 1.5% for all banks of the sector, while the effective buffer for systemic banks varies from 0.5%, 1% and 1.5% depending on the systemic importance of the bank. The countercyclical capital buffer is 0% and currently the Bank of Albania has not announced buffers for systemic risk.

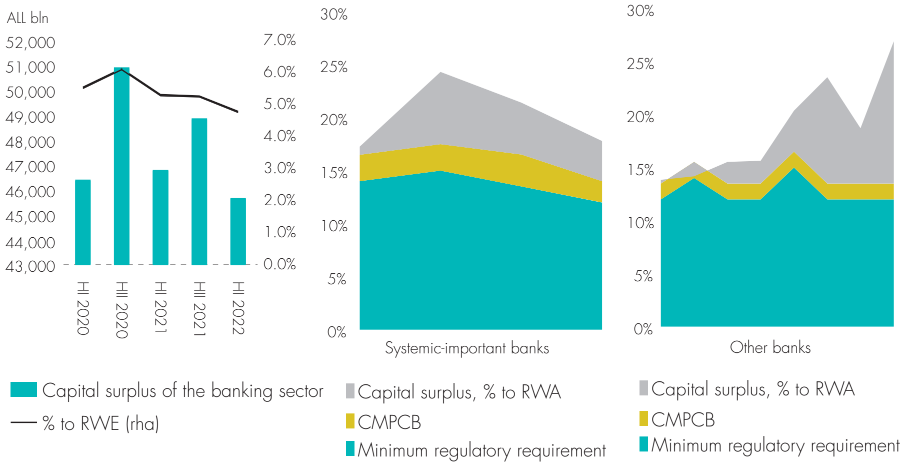
Taking into account the above buffers as well as the specific buffer that some banks of the banking sector have, the required capital adequacy ratio limit varies between 14% and 18% for systemically important banks and 14% and 17% for other banks. According to the reports at the end of the period, capital adequacy ratios for systemically important banks and other banks are currently higher than the aforementioned regulatory levels.

The purpose of macro-prudential capital buffers is to improve banks' resilience against systemic risks of a cyclical and structural nature. To this end, banks build capital reserves to absorb potential losses and create the possibility of supporting the real economy with financing in difficult times. The calculations of all capital requirements according to the data reported at the end of 2022 H1, shows that the banking sector has capital surplus. The performance of capital surplus is dictated by the performance of banks' profits, the behaviour of instruments of Common Equity Tier 1, as well as the requirements for macro prudential capital buffers. At the end of the period, capital surplus or own funds reached the level of ALL 46 billion, or down ALL 3 billion compared to the end of 2021. The decrease of own funds was driven by the higher requirements on macro-prudential capital buffers,[18] as well as the decrease of banks' financial results compared to the previous six months and the previous year. Against this backdrop, in order to strengthen capital positions during the period, banks have increased the level of retained profits and the use of subordinated debt. Both these elements have improved the capital indicators.

[17] *Regulation No.41, dated 5.6.2019 "On macro-prudential capital buffers".*

[18] *The capital conservation buffer (CCoB) increased from 1% to 1.5% in 2022, whereas O-SLLs increased for one systemic bank from 1% to 1.5%, and did not change for the other systemic banks.*

Chart 46 Capital surplus for the banking sector and macro-prudential capital buffers by groups of banks (June 2022)



Source: Bank of Albania.

Systemically important banks determine the performance of the capital surplus of the banking sector, as these banks own more capital compared to other banks. At the end of the period, the capital surplus for these banks reached ALL 26 billion, or ALL 15 billion less than the surplus of the previous six months, and it accounted for 4% of risk-weighted assets. The contraction of own funds for systemic banks came as a result of changes in the classification of systemic banks[19] and due to the fact that they should comply with a higher level of macro-prudential capital buffers than other banks. Although the level of own funds decreased, these banks report satisfactory profits and, consequently, high capital adequacy ratios that enable them to meet the regulatory requirements in force. Other banks reported lower levels of core equity tier one, and consequently the capital surplus remaining after meeting regulatory requirements was lower than that of systemically important banks. At the end of the first six months, this surplus was ALL 20 billion, from ALL 8 billion which was the level reported at the end of 2021. The expansion of the own funds stock for this banks was as a result of the structural changes in the banking sector, as these banks, contrary to systemic banks, should fulfil the capital conservation buffer of 1.5%.

[19] *There are currently four systemically important banks: National Commercial Bank sh.a, Credins Bank sh.a, Raiffeisen Bank sh.a., and OTP Bank sh.a.*

4.1.1.3 Financial result

The banking sector ended the period with a positive net financial result of ALL 6.5 billion, but lower compared to the same period in the previous year. As a result, profitability indicators have also declined.

The main contribution to this performance came from the decrease of total income and the increase of operating expenses.

The negative contribution to total income was brought about by the decrease of non-interest income. This latter development was driven by the loss from financial instrument investments, whereas income from commissions increased. Income from interest was higher than the previous year, driving upwards both the net interest income and the net interest margin. Expenses for provisions recorded a decline. In this group, provision expenses on the credit risk were stable, whereas those on other financial instruments were downwards.

At the end of the period, the net financial result of the banking sector was ALL 6.5 billion, or about 38% lower compared to the previous year. The decrease of the net financial result was experienced by the majority of banks. The shrinking of the banking sector's profit was also reflected in a decrease in the average profitability indicators of the banking sector: RoA dropped to 0.7% and RoE dropped to 7.2% from 1.3% and 12.9%, respectively, in the previous year. The biggest impact on the deterioration of the banking sector's profit was provided by a decrease of total income and, at a smaller degree, an increase of total operating expenses. In comparison to the same period in the previous year, the banking sector registered an increase of income from interest, a decrease of non-interest income (due to financial instrument losses, although income from commissions were up), a slight increase of expenses for interest, a decline of provision expenses, and higher operating expenses. Net interest income continued to represent the main item of revenue and non-interest expenses remained the main item of expenditure. Income from commissions continued to remain stable and have become an important source of income for the banking sector over the past years.

The intermediary financial activity as reflected in the performance of net interest income, edged up. The higher net result from interests was driven by the increase, at the same degree, of the activity in both lek and foreign currency. This development was steered mainly by the increase of income from interests, since expenses for interest, until the end of the period, were somewhat higher compared to expenses reported in the previous year. The net result from interests was ALL 24.7 billion, or 11% higher than the previous year. Interest income collected from customers was about 8.6% more than in the previous year and amounted to ALL 16.7 billion, whereas interest received from investments in securities amounted to ALL 11.6 billion, being about 17% higher compared to the revenues reported in the previous year. The increase in net interest income was as a result of a larger increase in the interest rates of credit stock compared to those of deposit stock. At the same time, the increase in the credit stock, particularly for the domestic currency, was somewhat higher compared to the increase in the deposit stock. The increase in interest income was also reflected in the increase of net interest margin, which reached 3.9%, from 3.4% in the previous year.

Table 6 Income and expenditure of the banking sector 2021-2022 (ALL bln)

	June 2022			June 2021
	In ALL	In FX	Total	Total
Income from interest	17.7	11.1	28.8	25.9
Expenses for interest	2.8	1.2	4	3.6
Net interest income	14.8	10	24.7	22.4
Non-interest income	4.1	-2.3	1.9	8
- Fines and commissions	4	3.2	7.3	6.2
- Loss or profit from financial instruments	-0.3	-6	-6.3	1.1
Non-interest expenses	15	4.2	19.2	17.4
Provisions (net)	0.2	0	0.2	2
- For loans	1.5	-0.25	1.25	1.2
- For other financial means	-1.3	0.23	-1	0.7
Uncommon items	-0.5	-0.1	-0.6	-1
Income taxes	1.3	-	1.3	1.5
Net result	3	3.5	6.5	10.5

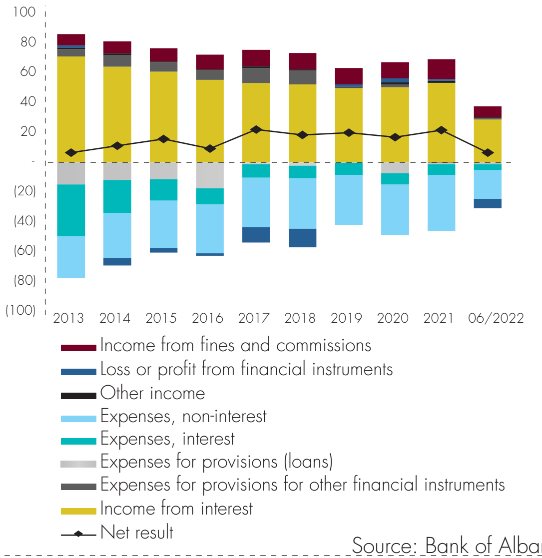
Source: Bank of Albania.

Non-interest income collected by banks during the period, fell from ALL 8 billion to ALL 2 billion, because the banking sector reported a loss of ALL 6.3 billion from financial instruments in foreign currency. On the other hand, during these six months, banks recorded around 20% more income from commissions compared to the previous year.

At the same time, operating expenses increased by over 10%, to around ALL 19 billion. Although operating costs continued to be adequately covered by banks' revenues, the ratio of operating expenses to income increased significantly during the period, reaching 72% from 57% in the previous year, as a result of an increase in operating expenses and a decrease in income.

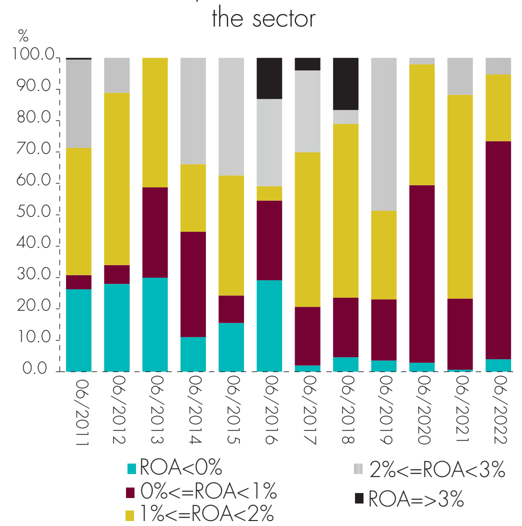
In 2022 H1, the provision expenses for loans remained unchanged compared to the previous year, recording ALL 1.3 billion. Simultaneously, the banking sector reported a reversal of expenses for the provisioning of other financial assets, amounting ALL 1 billion, which had a positive impact on banks' profits.

Chart 47 Financial result components



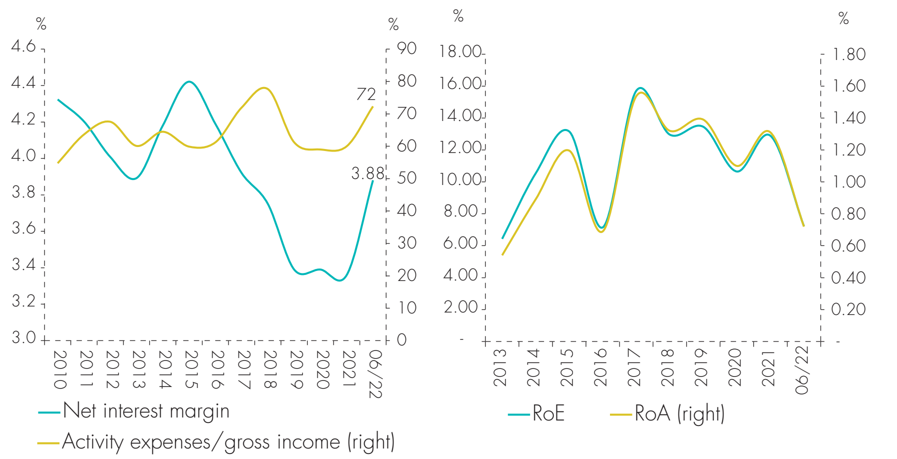
Source: Bank of Albania.

Chart 48 ROA by banks' share in the assets of the sector



Source: Bank of Albania.

Chart 49 Profitability and expense indicators of the banking sector



Source: Bank of Albania.

The stock of banking loan expanded during the period by 4.5%, due to the good performance of new loans. The main contribution was from the expansion of loans to residential entities (enterprises, households, public sector), which dominates the total loans. Loans to households, loans in lek, and long-term loans recorded the highest growth.

The increase of loans to enterprises is related to the expansion of short-term credit. Meanwhile, the expansion of loans to households is related to credit for real estate purchases (the latter is concentrated in the areas of Tirana and Durrës).

During the period, the process of loan restructuring and witting off lost loans from banks' balance sheets, has continued. These were more prominent in loans to enterprises. The rates were similar to the previous year.

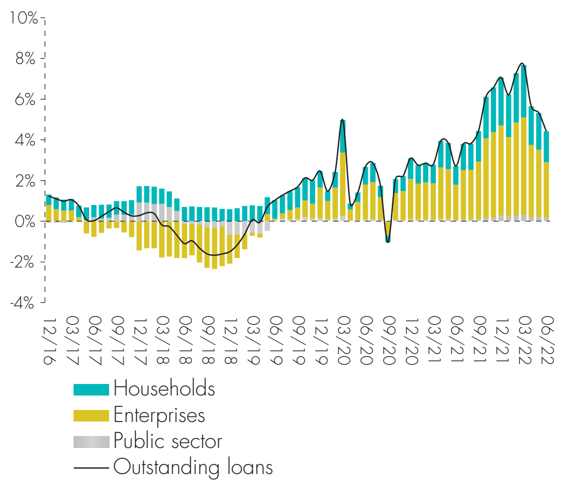
In annual terms, outstanding loans expanded by 12.1%. Excluding the diminishing statistical effect of the exchange rate and that of written-off loans, the outstanding loans rose by 14.2% in annual terms.

4.1.1.4 Loans

Outstanding loans expanded during the period, and reached ALL 700 billion at the end of it. In relative terms, its growth was 4.5% and 12.1%, respectively, compared to the previous six months and the previous year. The increase of outstanding loans during the period was affected by the performance of new loans, which was granted mainly to the business sector and for short-term purposes. The highest increase in outstanding loans was recorded in the portfolio of loans in lek (4.9%), loans to households (7.8%), and long-term loans (5.8%).

In annual terms, the credit portfolios with the largest increase were household loans, long-term loans, and loans in foreign currency. Loans in foreign currency expanded at a particularly high rate during the last quarters, and the annual change in June reached 14.6%, whereas loans in lek expanded by 10%. Excluding the statistical effect of the exchange rate, which was negative by ALL 7 billion, the annual change of loans in foreign currency would be calculated at 16.7%.

Chart 50 Loans by sector, contribution in percentage points, 6-month changes



Source: Bank of Albania.

Table 7 Loans by maturity, sector and currency

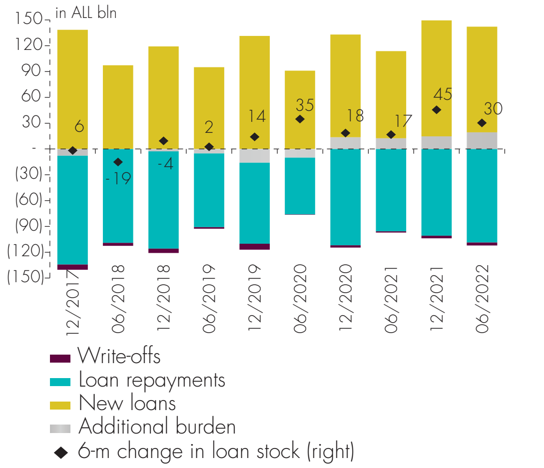
	ALL billion	Weight (%)		Change (%)	
	06/22	06/22	06/21	6-month	Annual
Lek	344	49	50	5	10
Foreign currency	357	51	50	4	15
Public sector	26	4	2	3	74
Enterprises	434	63	64	3	9
Households	241	33	34	8	14
Short-term	177	25	24	4	20
Medium-term	98	14	15	0	2
Long-term	426	61	61	6	12
Loans	701	100	100	5	12

Source: Bank of Albania.

The value of restructured credit over the last twelve months was around ALL 6.3 billion, or 5% of the annual new credit flow, of which around 30% was realised during 2022 H1. Credit restructuring had the biggest impact on the portfolio of loans to enterprises, loans to the industry sector, and loans in foreign currency.

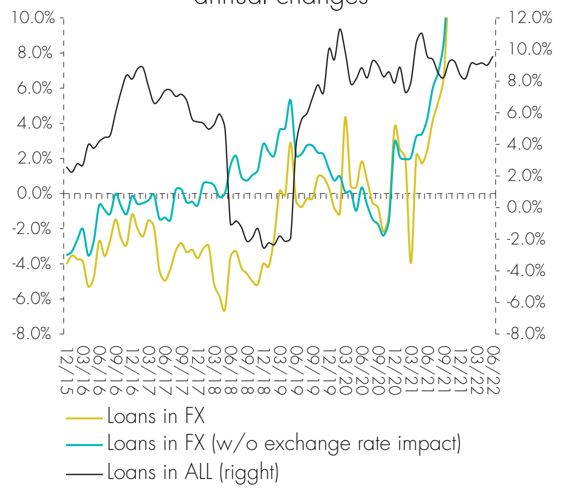
During the first half of 2022, banks have continued to write off lost loans from their balance sheets. The value of written-off loans from banks' balance sheets during the period, was around ALL 3.3 billion. During the last twelve months, around ALL 6.4 billion of lost loans were written off, and 80% of this volume consisted of loans granted to local businesses in foreign currency. The value of written-off loans in the last year accounted for 17% of the overall outstanding non-performing loans in the banks' portfolio at the end of June 2022, from 10% in 2021. If outstanding loans, in addition to the statistical effect of the exchange rate, included the stock of written-off loans during the last twelve months, the annual credit growth would be 14.2%, (from 12.1%).

Chart 51 Six-month change in outstanding loans by composing elements



Source: Bank of Albania.

Chart 52 Loans in lek and loans in foreign currency including and excluding the exchange rate effect, annual changes



Source: Bank of Albania.

LOANS TO RESIDENT ENTITIES - ENTERPRISES

Loans to resident entities account for 96% of the outstanding loans of the banking sector. It reached ALL 410 billion at the end of June, up by around ALL 14 billion or 3.6%, during the period. The expanded stock of loans for short-term purposes (overdrafts), loans for investments in real estate, and loans for equipment purchase provided the main contribution in loans to resident enterprises. Outstanding loans to enterprises, compared to the previous year, expanded by 8.6%.

Loans for investments in real estate and loans for equipment purchase have the main share in credit to resident enterprises, accounting for 30% of the total stock. Loans obtained for these purposes were mainly in foreign currency. Over the last years, banks reported a particularly sharp rise in the portfolio of loans in the euro, which have been granted to enterprises to purchase real estate. For short-term loans[20], in the last years, enterprises have preferred the borrowing in the domestic currency.

Chart 53 Annual performance of loans to enterprises by purpose of use and currency, (2016=100)

Source: Bank of Albania.

LOANS TO RESIDENT ENTITIES - HOUSEHOLDS AND PUBLIC SECTOR

Loans to resident households recorded ALL 237 billion, and expanded by 8% during the period. Loans for the purchase of real estate (mortgages) recorded the fastest growth and in turn provided the largest contribution to the positive performance of loans to households. Also, the stock of consumer loans recorded a somewhat more moderate increase.

Loans for real estate investments expanded by 9.1% during the period, and continued to have the main share, around 66%, in the loan portfolio to households. From the end of 2016 until the end of June 2022, the stock of these loans expanded by about 53%. In recent years, the fast increase of credit

[20] *Such as loans to purchase equipment, as working capital, and overdraft*

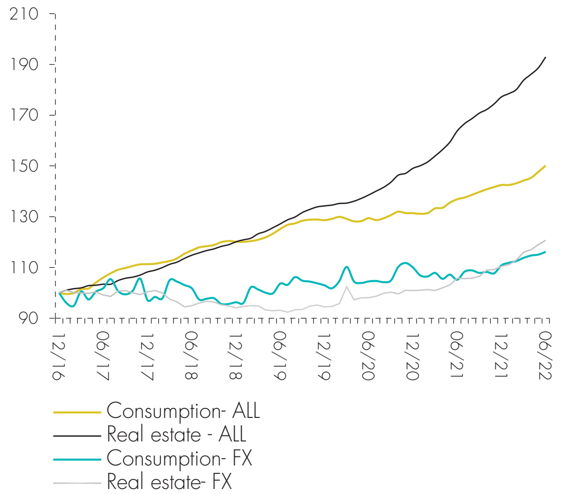
stock in lek has driven the rapid growth of credit stock to households. Credit to households in foreign currency has shown low fluctuations until the end of June 2021, while in the past 12 months, these loans grew by around 14%.

Around 65% of the entire stock of loans to households was provided for those in Tirana. Durrës is second, with 8%, while Vlora, Fieri, Elbasan and Shkodra share 4-5% of the total stock of loans to households. The share of Tirana was even higher in the stock of real estate loans or mortgage loans, as for this distribution of loans to households, Tirana shared around 71% of the total value of mortgage loans for households in Albania.

Almost all the increase in the stock of mortgage loans for households since the end of 2015 has been related to the expansion by over 70% and 50%, respectively, in the stock of this part of the loan for Tirana and Durrës. Mortgage lending to households in other districts during this period has also expanded. Nonetheless, given the low share that other counties occupy on the total loans for real estate investments, the impact on the performance of this credit was moderate. The large share and rapid growth of mortgage to households in Tirana and Durrës is related to migration from other counties to these two counties, as well as developments in the last decade in the real estate market, such as the increasing of construction volume, expansion of built-up areas, increase in both quality and the price of real estate.

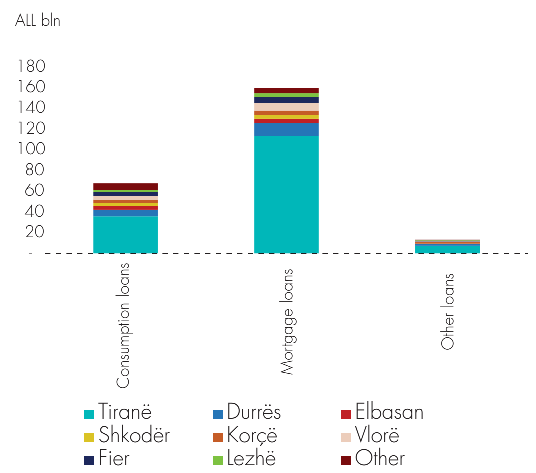
Loans to public non-financial corporations, at around ALL 28 billion, account for a small share of total loans to residents (4%). During the second half of 2022, its stock expanded by around 10%.

Chart 54 Loans to households by purpose of use and currency (index, 2016 = 100)



Source: Bank of Albania.

Chart 55 Loans to households by purpose of use and districts (June 2022)



Source: Bank of Albania.

LOANS TO NON-RESIDENT ENTITIES

At the end of June 2022, loans to non-residents were around ALL 25 billion and accounted for around 3.6% of the outstanding loans of the banking sector. The credit stock for non-resident entities contracted by about 8% during 2022 H1, while it expanded by 11% compared to the previous year. The increase in the stock of loans to enterprises, loans in foreign currency and long-term loans provide the main contribution to the expansion, in annual terms, of loans to non-residents. Also, these categories have the highest share in the credit stock for non-resident entities.

UNHEDGED FOREIGN CURRENCY LOANS

Outstanding unhedged foreign currency loans fell during the period and in annual terms.

The drop in unhedged foreign currency loans to enterprises, mainly in the sector of trade and in euro, provided the main contribution in this performance. Whereas, the unhedged foreign currency loans to households, oriented primarily toward the purchase of real estate, has trended up, during the period.

As a result, the share of unhedged foreign currency loans, against both foreign currency loans and total outstanding loans, decreased.

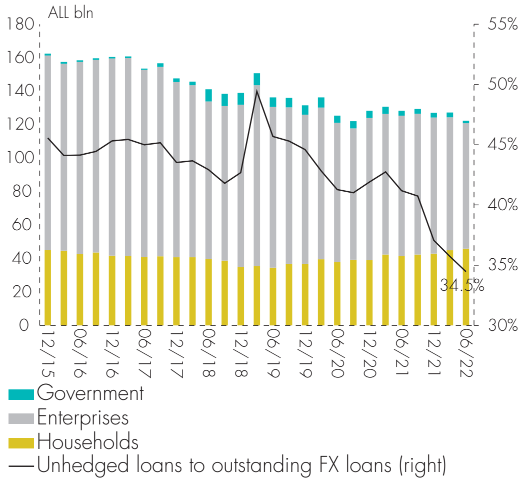
Most of unhedged loans are represented by loans to enterprises in euro and loans for investments in real estate.

During the period, the stock of unhedged foreign currency loans fell by ALL 4.8 billion, or 3.8%, to ALL 123 billion, the lowest level since 2011. The decline in unhedged foreign currency credit stock and the increase in the stock of foreign currency loans drove the share of unhedged foreign currency loans, against both outstanding foreign currency loans and total loans, to fall by 3 percentage points and 1.4 percentage points, to 34% and 17.5%, respectively. Loans to enterprises, down by 8%, have the main share in unhedged loans (61%), during the period, due to the contraction in the regular loan portfolio in euro. By sectors, "real estate" accounts for the main share of unhedged foreign currency loans by 57%, followed by loans for "trade" by 23%. In general, this performance shows a decrease in the exposure of the banking sector to the indirect exchange rate effect, by positively contributing to its stability.

The unhedged loans to households rose by 6.7% during the first half of the year, due to new loans for real estate investments. This credit increased in annual terms as well. In spite of this performance, since unhedged loans to households accounted for a relatively low share of the unhedged foreign currency loans, the impact of the growth of this portfolio on the performance of the overall unhedged loan stock did not succeeded to set off the decline of this credit for the business sector by around 7.7%. Loans in euro have the main share of the unhedged foreign currency loans (around 90%), and the stock of this portfolio decreased during the period.

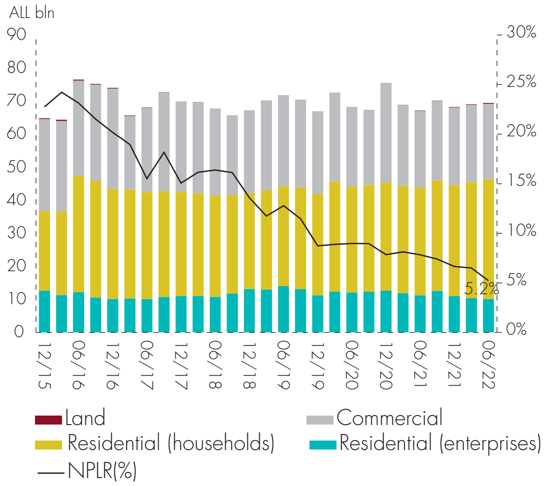
In annual terms as well, unhedged foreign currency loans contracted by 4.1%, mainly due to the decline of unhedged loans to enterprises and loans in euro.

Chart 56 Unhedged foreign currency loans



Source: Bank of Albania.

Chart 57 Unhedged foreign currency loans for real estate and its quality



Source: Bank of Albania.

Unhedged loans granted for investments in real estate continued to account for the main share (around 57%) in the total unhedged foreign currency loans, followed by loans for trade (by 23%). The rest of the unhedged foreign currency loans were granted for business development, consumption, to the Government and for other purposes. Developments in the performance of the unhedged loans stock during the period were affected by the contraction of unhedged loans for trade, loans to government, and that granted for other purposes.

Unhedged loans for real estate were granted for the purchase of residential, commercial real estate, and land and were slightly up during the period (around 2%). Unhedged loans for residential real estate granted to households have the main share (52%), up by 8% during the period. The entire growth in the stock of unhedged loans granted for real estate purchases during the period is related to the expansion of the portfolio of these loans to the households' sector.

NEW LOANS

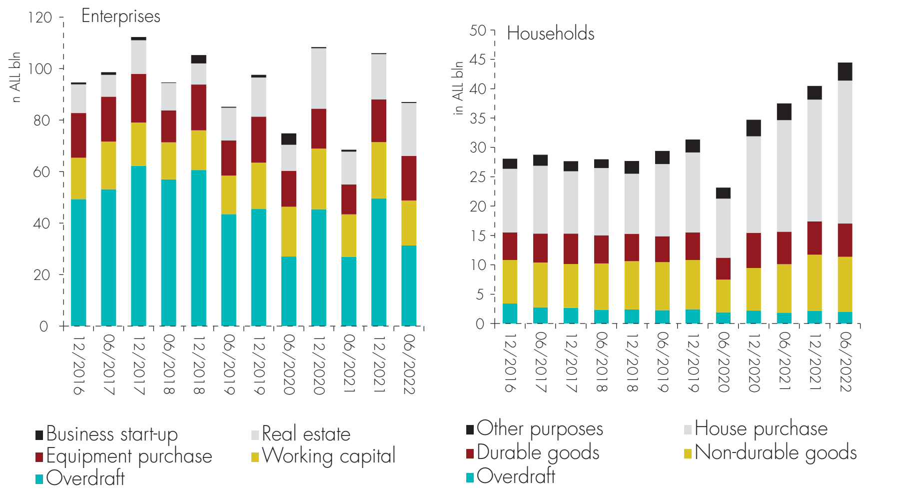
New loans granted during this period were around ALL 140 billion, up around 24% compared with the same period of the previous year, but around 12% lower than 2021 H2. Compared to 2021 H1, banks granted more new loans with long-term maturity and in euro during the period.

New loans granted during the period were around 24% higher compared to the same period in the previous year. The main contribution to this growth was enabled by both new loans to enterprises and households, which were up by 27% and 18%, respectively. New loans to enterprises were mainly granted for short-term purposes and in foreign currency. New loans to households were mainly used for house purchases and consumption of non-durable goods, and was mainly granted in lek.

In annual terms, new loans granted to enterprises grew by 27%. Around 60% of these new loans was granted for short-term purposes, as overdrafts and loans for working-capital, and more than half of it was in the euro. New loans to enterprises for real estate investment and equipment purchase purposes recorded the highest growth.

New loans to households were around 18% higher compared to the previous year, and mainly oriented for house purchases and non-durable goods consumption. New loans for house purchases accounted for 55% of new loans granted to households during the period. Despite loans in euro accounted for less than 35% of new loans to the households' sector, they provided a considerable impact on the annual performance of the flow of loans to households.

Chart 58 New loans to enterprises (left) and households (right) by purpose of use



Source: Bank of Albania.

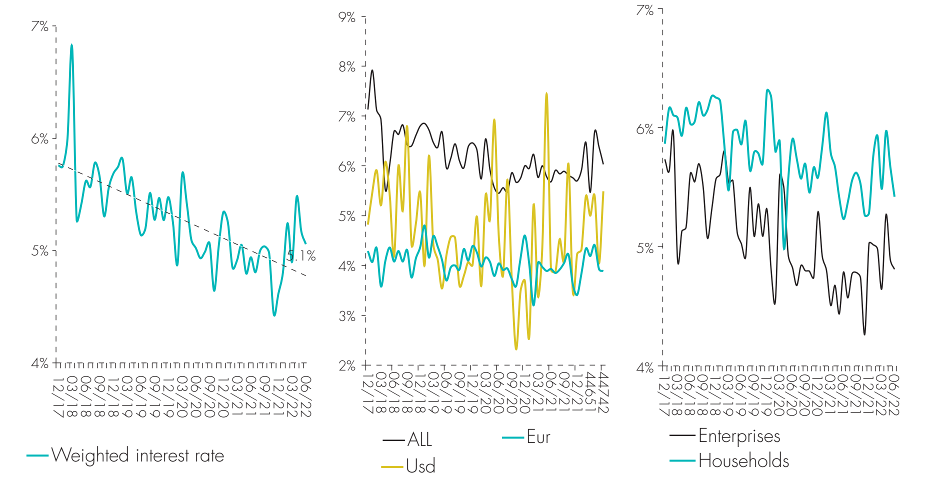
WEIGHTED INTEREST RATES ON NEW LOANS

The weighted average interest rate on new loans granted over the period has increased. This rise was mainly reflected in loans to households and in loans in lek. The average interest rates on loans for real estate purchase, in outstanding loans, have reflected lower levels, despite the currency.

The weighted interest rate edged up across all new loans during the period, standing at 5.1% in June 2022. The interest rate increased on new loans both in lek and foreign currency. The reaction of interest rates appears to be related to the recent decisions of central banks on monetary policy normalisation. The increase in interest rate on new loans is mainly noted on loans to households for consumption purposes and on loans in foreign currency. The average interest rate on new loans in lek was 5.7%, up by 0.3 percentage point during the last year, and remaining higher than the average interest rate on new loans in the euro and the US dollar.

The average interest rate on new loans to households continues to remain higher compared with the average interest rate on loans to enterprises.

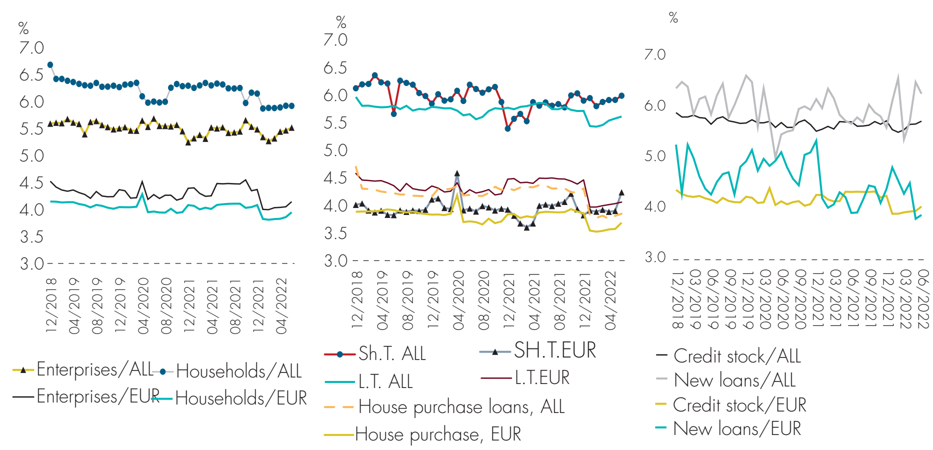
Chart 59 Weighted interest rates on new loans, in %; aggregate rate (left); rate by currency (middle); rate by entity (right)



Source: Bank of Albania.

The rise in interest rate on new loans has started to affect also the weighted interest rates on loan stock by the relevant portfolios. During the period December 2018 - June 2022, the average interest rates on the loan stock to households in lek, enterprises in lek, enterprises in euro and households in lek fluctuated at around 6.2%, 5.5%, 4.3%, 4.0%., respectively. The comparison of interest rates on the loan stock by maturity for the same period, shows that borrowers have paid the lowest interest rate on loans for real estate, despite the currency. The spread between the interest rate on loan stock in lek and euro, in the last four years, has been relatively stable, and has fluctuated around an average of 1.5 percentage points. In the last three quarters, this spread has slightly increased, mainly due to the fall in the interest rate in the euro. As at end of 2022 H1, this spread reached at 1.7 percentage points.

Chart 60 Weighted interest rate on loan stock, in %*



Source: Bank of Albania.
*Sh.T - Short-term; L.T - Long-term; house purchase loans to households with original maturity over 5 years

BOX 4 RESTRUCTURED LOANS

The value of restructured loans over the last 12 months was around ALL 6.3 billion, of which ALL 2 billion were restructured loans during 2022 H1. In most cases (76%) restructuring is realised upon a client's request. The restructured loans during last year accounted for 1% of the overall outstanding loans and 17% of the stock of non-performing loans. In the last twelve months, restructured loans mainly occurred in non-performing loans portfolio (60%). More than 80% of restructured loans are loans granted to enterprises, mainly to large enterprises. Restructured loans, during the period July 2021 - June 2022, account for around 1.2% of the outstanding loans granted to enterprises. Meanwhile, restructured loans to households accounted for 0.4% of the outstanding loans to households sector.

In terms of sectors of the economy, by type of manufacturing activity, the industry sector is the one with the highest demand for loan restructuring in the last two six-month periods. The borrowing enterprises operating in the industry sector have restructured around 4% of the overall stock of loans, and the restructured loans for this sector accounted for around 40% of the total volume of loans restructured by the banking sector in the last twelve months. Around 50% of restructuring volume from enterprises operating in industry sector has taken place in the credit portfolio classified as "lost loans". Industry sector has submitted restructuring requests also for loans classified as "standard", which accounts for 26% of restructures conducted for the industry sector in the last year.

During the last twelve month, tourism and trade, are the other two sectors of the economy, with a considerable share in the volume of restructured loans, by (17%), respectively. Both sectors have mainly applied for restructuring of non-performing loans. Trade has the highest share in the stock of non-performing loans to domestic enterprises, followed by the sectors of industry and tourism. Nevertheless, loans quality to these sectors has considerably improved, in turn providing the main contribution in the performance of loans quality to domestic enterprises during the year.
Loans denominated in foreign currency accounted for around 70% of the value of restructured loans. In 2022 H1, loans affected by restructuring were for the most part classified as standard loans, meanwhile loans classified as non-performing were restructured as well. In 2021 H2, restructures mostly were in the stock of loans classified as "lost". In the lost loans portfolio the restructured loans accounted for 12% of the overall outstanding lost loans. For the two other classes of non-performing loans - "doubtful loans" and "sub-standard loans" - restructures, in the last year, accounted for 3% and 11%, respectively, of the loan stock. The value of restructures for non-performing loans accounted for around 60% of the annual flow of restructures (around ALL 4 billion) and 10% of outstanding non-performing loans recorded in June 2022.

The main forms of restructuring used by banks were: extension of maturity term; capitalisation of interest and/or charges payable for default; changes to loan product; changes to principal; and assignment of a grace period for the principal or credit interest. In the last quarters of 2021, restructuring of loans was mainly carried out in the form of maturity term extension. While in 2022 H1, clients mainly have applied for changes to loan product. This form of restructuring accounts for around 44% of restructures flow in 2022. The rest was carried out through: changes to the principal; capitalisation of interest and/or charges payable for default; and granting an overdue period for the interest or principal.

Table 8 Data on restructured loans during 2021 and 2022

	2021 H1	2021 H2	2022 H1	Share**		2021 H1:	2021 H2	2022 H1	Share**
Share in the restructured loans					Share in the restructured loans				
Entity					Restructuring form				
Households	20	12	22	0.4	Extension of maturity term	50	43	28	
Enterprises	80	88	78	1.2	Capitalisation of interest and/ or charges payable for default	7	7	16	
Large	44	46	46		Changes to loan product	1	4	44	
Medium-sized	20	19	12		Changes to principal	8	15	3	
Small	16	23	20		Period of principal/ interest granting	27	11	4	
					Other	6	9	4	
Currency									
Lek	45	24	31	0.5					
Foreign currency	55	76	69	1.3					
Classes					Sectors of the Economy				
Standard	37	13	44	0.2	Trade, automobile repair	33	20	10	1
Special mention loans	26	25	9	6	Construction	2	1	5	0.2
Sub-standard	16	19	30	11	Industry	11	39	36	4
Doubtful	10	2	5	3	Energy, gas, water	3	0	2	0.1
Lost	11	41	12	12	Agriculture, Forestry, Fishing	1	0	4	1
Destination					Hotels and restaurants	12	21	7	3
Business loans	80	91	76		Other	18	19	15	2
Mortgage loans	13	5	10						
Consumer credit	7	4	14		Restructured loans (flow, ALL bln)	5.6	4.5	1.7	1

Source: Bank of Albania.

* *Share of restructures carried out in the last 12 months to outstanding loans reported in June 2022.*

4.1.1.5 Deposits

Deposits held in the banking sector expanded by ALL 30 billion or by 2%, during January - June 2022, reaching at ALL 1,460 billion as at- end of period. This growth was lower than in the previous two six-month periods. Deposits in foreign currency - as lek deposits were slightly down - provided the positive contribution in the growth of deposits during the period. Current accounts, deposits in foreign currency and household deposits recorded the strongest increase. Time deposits have been stable and slightly up since 2021 Q2. In annual terms, the growth rate of deposits was 9%, with positive contribution from both lek and foreign currency. This growth rate was lower than the 11% increase during 2021.

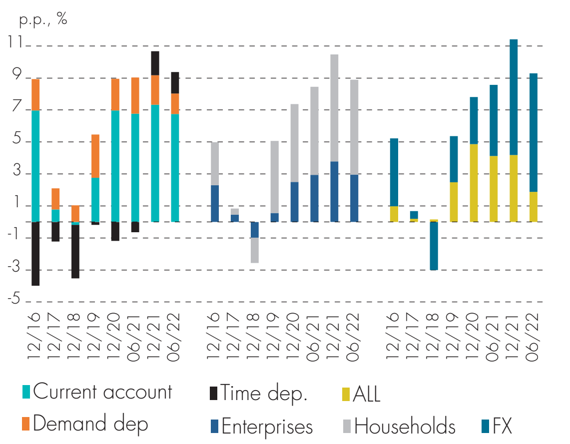
Deposits held in the banking sector reached ALL 1,460 billion, expanding by around ALL 30 billion or 2% during the period. Deposits growth showed a slower pace compared with the two previous six-month periods. The growth in deposits was mainly driven by the increase in household deposits; deposits in foreign currency; and current accounts. Deposits in lek recorded a slight fall.
The interest rates across all types of new deposits by maturity, sector and currency remain at low levels, though they trended slightly up during 2022 H1.

Table 9 Data on the performance of deposits by maturity, sector and currency

	06/22).		06/22 to 12/21		Y/Y
	ALL billion	Share	(%)	(p.p.)	(%)
Current account	616	42	4	2	17
Demand deposits	201	14	2	0	9
Time deposits	624	43	1	0	3
Public sector	39	3	(13);	(0);	15
Enterprises	243	17	1	0	19
Individuals	1.178	81	3	2	7
Lek	683	47	(1);	(1);	4
Foreign currency	777	53	4	2	15
Deposit stock	1.460	100	2	2	9

Source: Bank of Albania.

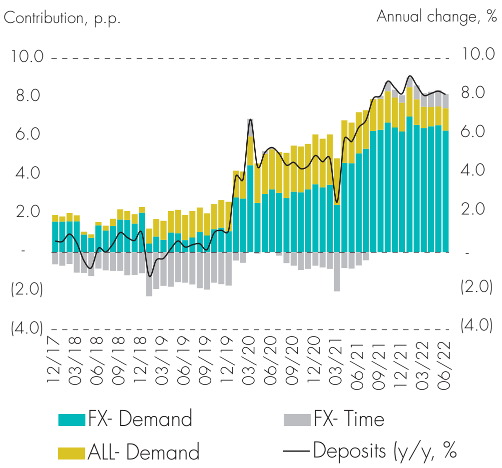
Chart 61 Performance of deposits, by maturity, sector and currency (contribution to the annual rate change)



Source: Bank of Albania.

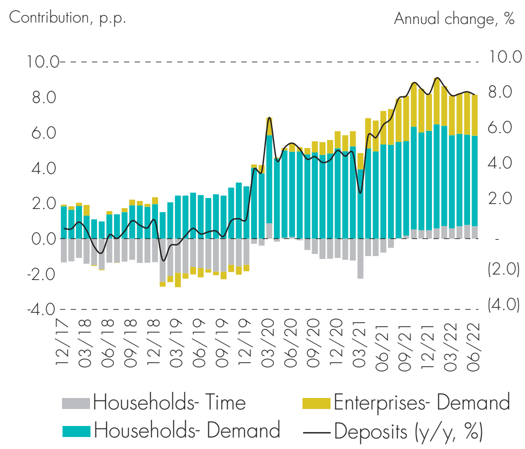
Structure of deposits by maturity and sector does not show considerable changes in the last year. Meanwhile, structure of deposits by currency has slightly changed in favour of deposits in foreign currency. As at end of June 2022, deposits in foreign currency accounted for 53% of total deposits, from 52% and 51%, respectively, in the previous period and previous year. Without the statistical effect of foreign exchange rate (lek appreciation against the euro) in the last year, the share of deposits in foreign currency would have been higher at the end of the period. Deposits in foreign currency grew by 4.1%, during the period, and by 14.6% in annual terms. Deposits denominated in euro account for around 90% of deposits in foreign currency. At the end of the period, deposits denominated in euro were EUR 5.65 billion, from EUR 5.33 billion as at end of 2021. These deposits increased by around EUR 0.9 billion during the last 12 months.

Chart 62 Deposits by maturity and currency



Source: Bank of Albania.

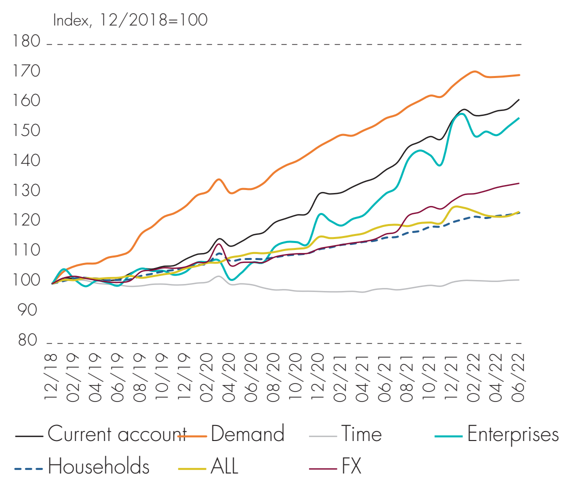
Chart 63 Deposits by maturity and sector



Source: Bank of Albania.

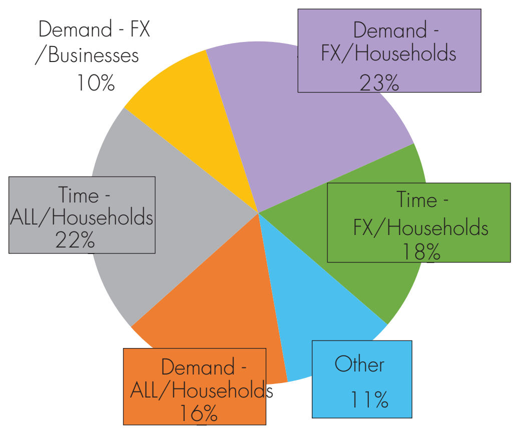
Despite time deposits account for around 40% of total deposits, the growth in overall deposits, in the last two years, was mainly attributable to the expansion in current accounts and demand deposits, mainly of households, in foreign currency. The performance of interest rates affects the preference of public to choose between time deposits and demand deposits. Meanwhile, developments in the balance of payments, in foreign exchange market and in lending activity, affects the choice of foreign currency in which are held whether savings or income in the banking system. In 2022 Q1, the net foreign currency flows, compared to the first quarter of 2021, were somewhat higher, given that the deepening of goods deficit was lower compared with the increase in the surplus of services and the increase in the remittances flow. The expansion in the stock of loans and the rise in gross average wage in the private sector, also may have affected the expansion of deposits in the banking system.

Chart 64 Deposits performance by type



Source: Bank of Albania.

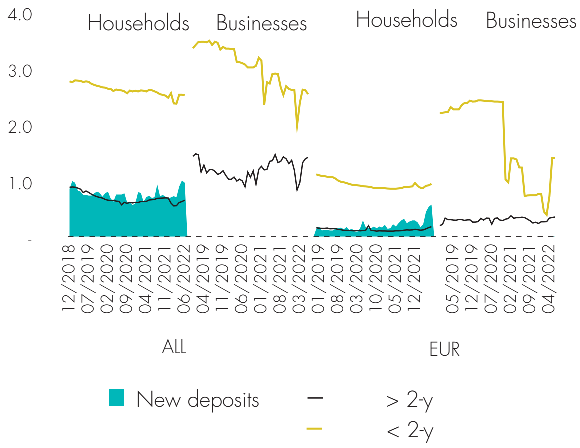
Chart 65 Structure of deposits by maturity, sector and currency



Source: Bank of Albania.

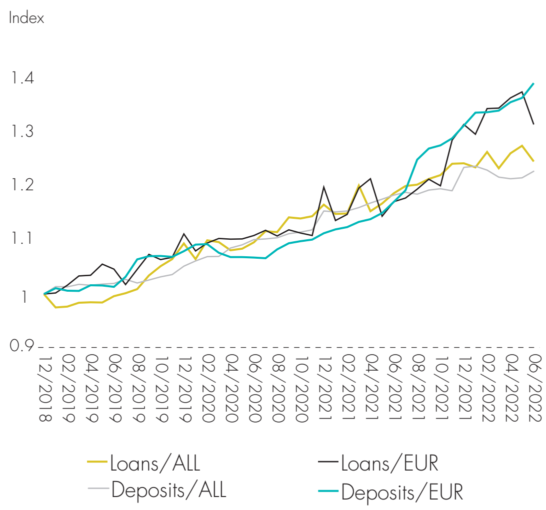
The interest rates across all types of new deposits by maturity, sector and currency remain at low levels, though they trended slightly up during 2022 H1. At the end of the period, the average interest rate on time deposits in lek to households was 0.9%, from 0.7% in the previous period. The average interest rate on time deposits in euro to households was 0.5% from 0.2% at the end of 2021. This performance has been reflected in a slight increase of the interest rate on deposit stock, particularly for deposits in lek.

Chart 66 Interest rate on new deposits and deposits stock by maturity, sector and currency (in %)



Source: Bank of Albania.

Chart 67 Time deposits and loans by currency



Source: Bank of Albania.

Credit quality improved during the period. Outstanding non-performing loans declined by ALL 0.7 billion, during the period, to ALL 37 billion, almost ALL 7.3 billion lower than in the previous year. The NPL ratio declined at 5.3%. All types of loans, by maturity, sector and currency were improved. Also, other complementary indicators, affirm the improved credit quality.

The contraction in the non-performing loans stock was driven by: the reclassification of non-performing loans to performing classes of loans; the lost loans write-offs; and the re-payment of a part of non-performing loans.

The creation of provisions for credit risk was lower than the fall in non-performing loans. Hence, the provisioning ratio for the non-performing loans dropped by 5 p.p., at 63%.

Within the period, credit quality improved mainly in the first quarter of 2022, while it fell slightly in 2022 Q2. This fall may be due to the developments in the wake of war to Ukraine from Russia. In real terms, international developments and energy situation may drive economy to tackle a challenging environment. The possibility for a slowdown in the economy, triggered by the high energy costs, coupled with lower income to enterprises and households appears real. This, in turn, may have a negative impact on the quality of credit portfolio of banks.

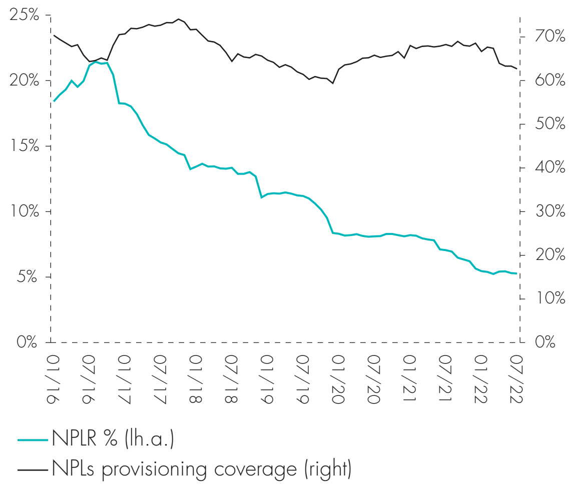
4.1.1 RISKS TO THE ACTIVITY OF THE BANKING SECTOR

4.1.2.1 Credit risk

Credit quality improved slightly during this period. The reduced credit stock in the classes of "sub-standard loans" and "lost loans" provided the main contribution in the improvement of credit quality. Also, the lost loans write-off from banks' balance sheets, the re-payment of non-performing loans coupled with the reclassification process of non-performing loans in the performing classes have driven to this improvement in credit quality. As at end-period, the non-performing loans ratio (NPLR) fell by 0.3 percentage point, at 5.3%. Within the period, NPLR was down by 0.4 p.p. in the first quarter, while climbing by 0.1pp in the second quarter. Non-performing loans stock reduced by around ALL 1 billion. It stood at ALL 37 billion as at end of June 2022, the lowest level recorded in the last thirteen years.

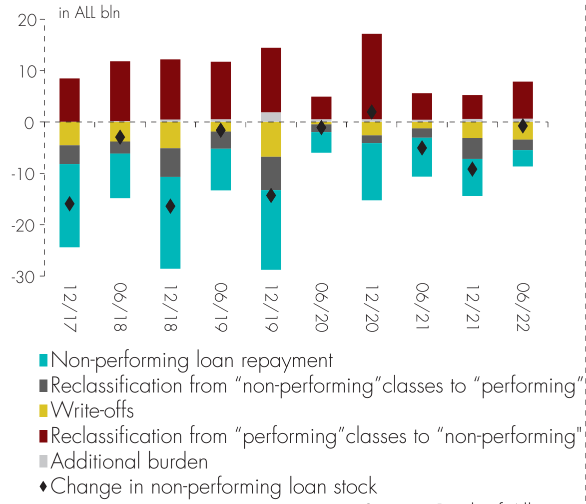
The non-performing loans stock dropped by ALL 7.3 billion, while NPLR declined by 1.8 p.p compared with the previous year. Banks have reported improved credit quality for loans to enterprises, long-term loans, and foreign-currency denominated loans, compared to the previous year. During January 2015 - June 2022, around ALL 75 billion lost loans have been written off from banks' balance sheets. In the last 12 months, the written off lost loans amounted around ALL 6 billion, mainly represented by loans to enterprises in euro. Banks have reported a fall in the outstanding loans for the last two classes of non-performing loans ("doubtful" and "lost"). "Sub-standard" loans expanded in the last year. Its share in outstanding non-performing loans increased at 35%, from 28% in the previous year. "Lost" loans continue to have the main share in the stock of non-performing loans.

Chart 68 Non-performing loans ratio and provisioning



Source: Bank of Albania.

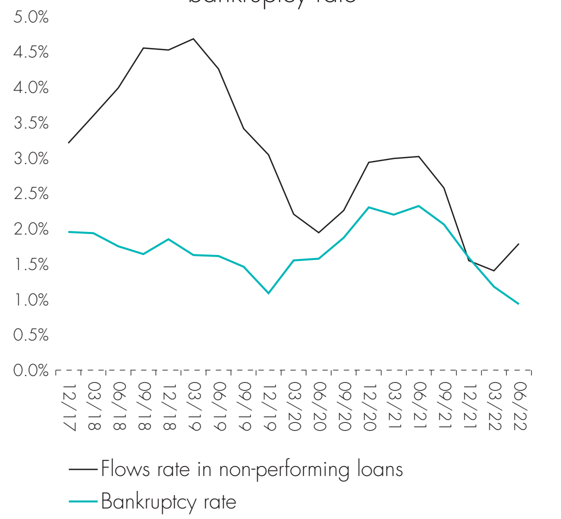
Chart 69 Contribution to the semi-annual change of the non-performing loans stock



Source: Bank of Albania.

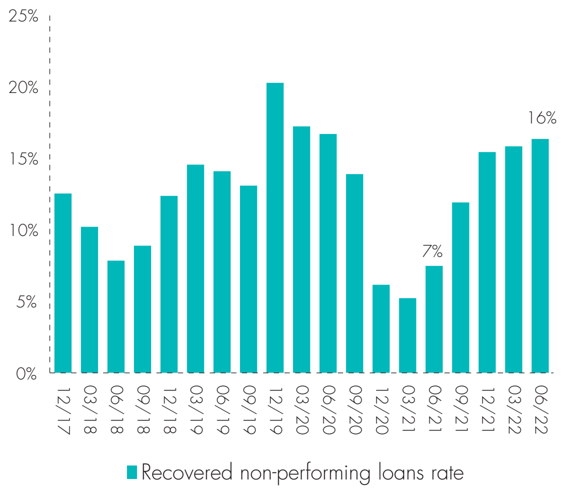
Loans to enterprises, medium-term loans, and lek-denominated loans have the highest values of non-performing loans ratio. As at end of June 2022, the non-performing loans ratios for these types of loans were 7.7%, 6.2% and 5.9%, respectively. Banks have continued to create provisions for non-performing loans, but the provisioning level has been decreasing. Given that the decrease in the stock of non-performing loans was slower compared to the reduced provision fund during the last twelve months, the coverage ratio of non-performing loans fell to 63%, from 68% recorded a year earlier.

Chart 70 Flow rate of non-performing loans and bankruptcy rate



Source: Bank of Albania.

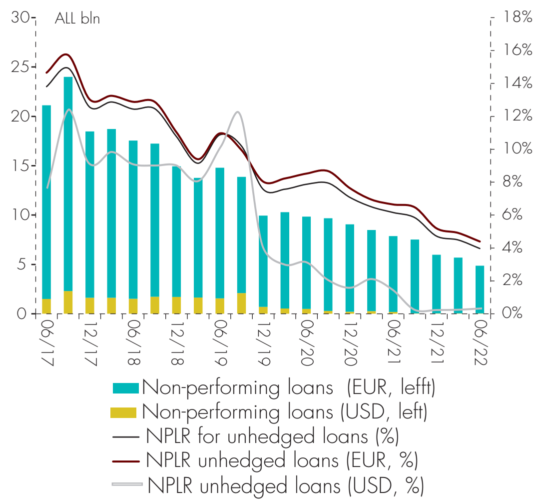
Chart 71 Recovery rate of non-performing loans



Source: Bank of Albania.

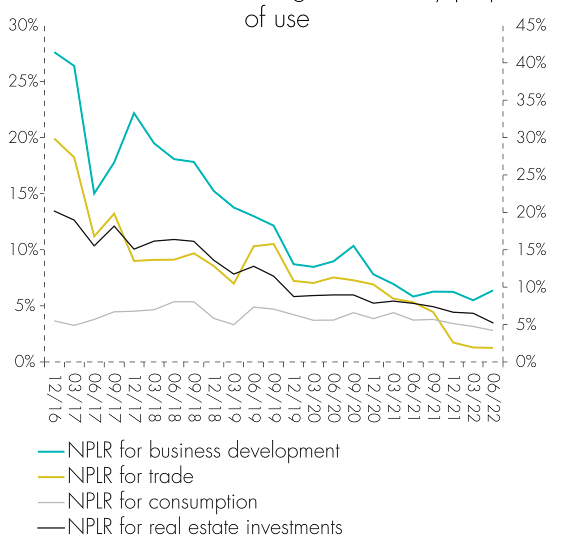
The assessment of credit quality and credit risk may be completed through the analysis of some complementary indicators of credit quality, as: the flow rate of non-performing loans[21]; bankruptcy rate[22]; and the recovery rate of non-performing loans[23]. All the three complementary indicators of credit quality suggest that in the last twelve months, the banking sector has recorded less new non-performing loans and has been more successful in improving the credit quality for the stock of existing non-performing loans. As at end of June 2022, the flow of new non-performing loans was equal to 1.8% of regular loans, slightly up from 2021 H2. Meanwhile, the flow rate of new non-performing loans has declined notably compared with the previous year. This rate has recorded the maximum of 5% in 2019, and a temporary increase at 3% in 2021 H1. On the other hand, the "bankruptcy rate" that shows the rate by which the lost loans are accumulated compared to the overall loan portfolio, dropped at 0.9% as at end of June 2022, from 1.6% as at end-2021 H2 and 2.3% in the previous year. The fall in the bankruptcy rate, in the last twelve months, signals a more manageable risk of loans portfolio. Also, "the recovery rate of non-performing loans" increased at 16%, from 7% in the previous year. This performance shows the considerable improvement in the ability of banks for recovering non-performing loans. In the last four years, the performance of recovery rate shows that banks have improved the collection of non-performing loans since the mid-2018 up to the end of 2019, and throughout 2021 and beyond, while they have encountered difficulties in this process in the first part of 2018, and throughout 2020.

Chart 72 NPLR for loans unhedged against exchange rate fluctuations, by currency



Source: Bank of Albania.

Chart 73 NPLR for unhedged loans, by purpose of use



Source: Bank of Albania.

[21] *The flow of non-performing loans during the period against the outstanding regular loans at the end of the period.*

[22] *The flow of new lost loans during the period against the overall outstanding loans at the end of the period.*

[23] *The flow of new non-performing loans that have been reclassified to performing classes against the outstanding non-performing loans at the end of the period.*

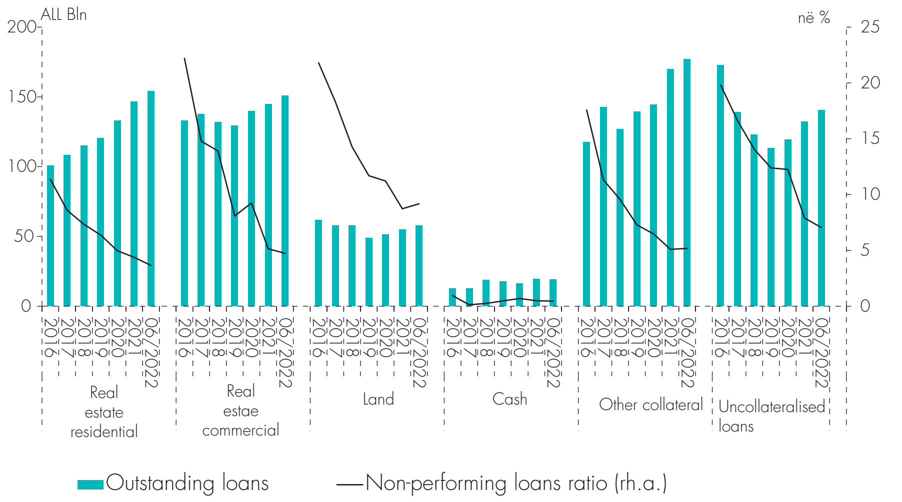
The quality of loans unhedged against exchange rate fluctuations has improved compared to both the end of 2021 H2 and the previous year. NPLR for this portfolio fell at 4.0% as at end-June 2022, compared to 4.7% and 6.2%, as at end 2021 H2 and in the previous year, respectively. This is the lowest non-non-performing loans ratio for unhedged foreign currency loans since 2009. The reduction in the stock of non-performing loans for real estate investments and loans for trade has affected the improvement in the quality of unhedged loans. The main share[24] in the outstanding loans unhedged from exchange rate fluctuations continues to be held by loans for investments in real estate and the NPLR for this category of loans fell to around 5.2% from 7.8% in the previous year. Positive performance is recorded across all types of unhedged loans, but loans for trade purposes recorded the fasted decline in NPLR. NPLR for this type of loans fell by 4.1 percentage points during the last twelve months, at the lowest historical level of 1.3%. In addition to unhedged NPLR for business development, which was slightly up in annual terms, NPLR improved across other portfolios of unhedged loans by purpose of use, in the last year. The quality of loans granted from domestic banks to non-residents, which is represented by loans to enterprises in euro, continues to be at good levels and improved during the period compared to the previous year. NPLR for these entities fell close to 0.3%, while this ratio stood at 1.6% in the previous year.

The coverage ratio of non-performing loans with provisions declined by 5.3 percentage points compared with the previous period, and by 4.6 percentage points compared with the previous year, reaching at 63% driven by the more rapid fall in provisions for non-performing loans compared with the contraction of non-performing loans stock. The provisioning ratio for individual banks fluctuates between 48% and 78% range. Capital coverage of net non-performing loans[25] declined at 13.3 times from 14 times at the end of 2021 H2. This growth was mainly driven by the fast increase in net non-performing loans[26] compared with the expansion in capital. As at end of June 2022, the net non-performing loan ratio against outstanding loans stood at 2.0%.

Loan collateralisation[27] which represents a key element in the group of hedging instruments of banking sector from the risk arising from non-returned loans, stood at levels similar to the end of 2021 and the previous year. It fluctuated around the ratio 80%. Loans collateralised with real estate have the main share, or account for around 65% of collateralized loans, and 52% of overall outstanding loans. The stock of collaterised loans expanded by around 12% compared to the previous year.

24 Around 74% of total.
25 Non-performing loans after the deduction of provisions.
26 As a result of the expansion in outstanding net non-performing loans by almost 15%, the "net non-performing loans/regulatory capital" ratio increased to 7.5%, from 7.1% as at end-December 2021
27 Collateral in the form of real estate (residential, commercial or land), cash etc.

Chart 74 Outstanding loans and non-performing loans ratio by collateral



Source: Bank of Albania.

The quality of loans for the category of loans collaterised in the form of real estate has improved over the course of one year, mainly driven by the improved quality of collatarised loans for residential real estates. Loans collaterised in the form of cash continue to maintain the lowest level of NPLR. Meanwhile, the share in non-performing loans stock for this type of loans to the total non-performing loans is rather low. Outstanding non-collateralized loans expanded as well during the period and compared to the previous year. Nevertheless, the share of non-collateralized loans against the overall outstanding loans remains manageable, around the level of 20%. The quality of loans across this category has improved considerably in the last year, and NPLR fell to 7% in June 2022, from around 8% as reported at the end of 2021 and 12% in the previous year.

Within the period, credit quality improved mainly in the first quarter of 2022, while it fell slightly in 2022 Q2. This fall may be due to the developments following the start of war to Ukraine from Russia. In real terms, international developments and energy situation may tackle the economy with a challenging environment. The possibility for the economy to slow down, triggered by the high energy costs, coupled with lower income to enterprises and households appears real. This may provide a negative impact on the quality of credit portfolio of banks. Thus, a rather careful management process in granting, monitoring and knowing this risk in lending is necessary, particularly in terms of those activities and borrowers who have i high use of energy.

4.1.2.2 Liquidity risk

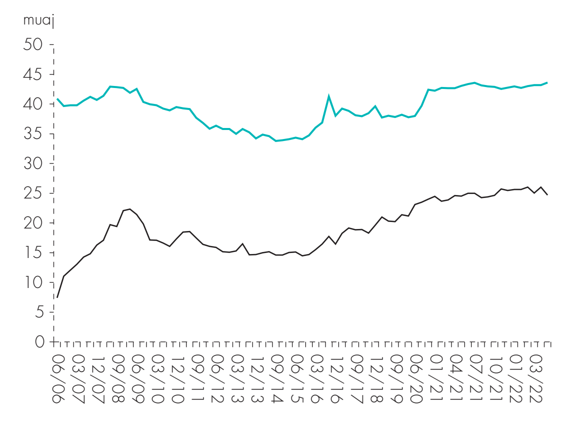
The liquidity risk in the activity of the banking sector remains contained. The main liquidity indicators, both in lek and foreign currency, continue to be notably above the minimum regulatory ratios. Total assets of the banking sector declined, during the period, while short-term liabilities recorded a slight increase. The negative gap between assets and liabilities for maturities up to three months expanded, while the negative gap in the next basket improved at almost the same degree. The overall gap between assets and liabilities, due to these developments, has remained almost unchanged, at around 5% of the overall assets of the banking sector. The average maturity mismatch between loans and deposits has increased slightly, mainly due to the increase in the average maturity of loans.

The liquidity position of the banking sector remains at good levels and the liquidity indicators continue to remain notably above the regulatory ratios.
Liquid assets in banks' balance sheets were reduced, while short-term liabilities recorded a slight increase during the period. Shifts represent actions for interest rate risk management and the support to lending.
The gap between assets and liabilities in the basket of maturities up to three months expanded slightly, but the overall gap remains positive, with no changes from the previous periods.
The average maturity mismatch between assets and liabilities has slightly narrowed. The banking sector does not use credit lines from parent banking groups.

Deposits remain the main funding source of lending activity of banks, by covering above twice the loans volume of the sector. At the end of the period, the "loans/deposits" ratio was 48%, or 1.2 percentage points higher than the level in the previous six months, as outstanding loans have grown with a higher pace than the overall deposits. This performance is evidenced in loans and deposits portfolio in lek, driving to an increase in the "loans/deposits" ratio for lek to 50.4% from 47.5% as at end of December 2021. The "Loans/ deposits" ratio in foreign currency fell slightly at 45.9% from 46.1%.

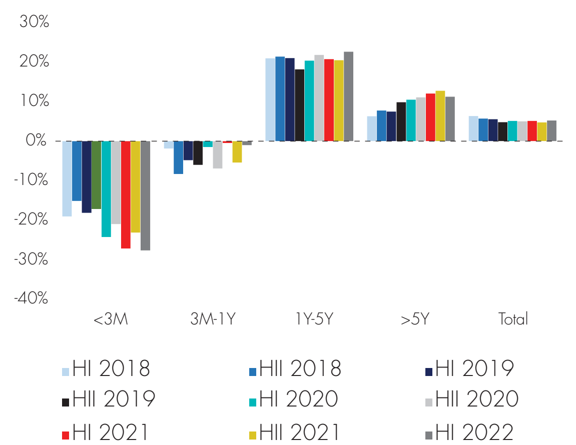
During the period, liquid assets of the banking sector fell by around ALL 70 billion, reaching at ALL 520 billion as at end of the period. Reclassifications and shifts in some items of liquid assets both in lek and foreign currency from banks, drove to this performance. Shifts mainly represent actions for the management of interest rate risk and the support to lending. Despite this performance, the ratio of liquid assets to total assets in banks' balance sheets continues to remain high. As at end of June 2022, this ratio stood at 29% from 33% at the end of 2021. At the same manner, the fall in liquid assets accompanied by the slight increase in short-term liabilities has driven to the decrease in liquid assets ratio to short-term liability at 40% from 45% in the previous six months.

Chart 75 Average residual maturity mismatch between assets-liabilities and loans-deposits



Source: Bank of Albania.

Chart 76 Maturity mismatch between assets and liabilities*



Source: Bank of Albania
*Off-balance assets and liabilities are also included.

The negative gap between assets and liabilities, by residual contractual maturity segments, as a ratio to total short-term assets, increased during the period. The gap between short-term assets and liabilities by residual contractual maturity segments for the period up to 3 months,[28] that continues to remain the largest negative gap for the whole horizon of maturities, expanded to 28%, from 23% to the total assets in the previous six months. At the same time, the negative gap for maturities 3 months up to 1 year has recorded a decrease at a similar size, while the mismatches between assets and liabilities for the other horizons of the residual maturity have remained almost unchanged.

The overall gap across all maturities continues to be positive and has recorded no notable changes compared with the previous periods, due to the stability in the positive positions for longer-term maturities. This gap since 3 years has fluctuated around 5% of assets in the banking sector. During the period, the mismatch of average maturity of assets and liabilities has narrowed, due to a slight increase of the average maturity of liabilities and the fall of average maturity of assets. At the end of the period, this mismatch was around 24.7 months, from 25.5 months at the end of 2021 H2. Deposits' residual maturity, which represent the most significant category of liabilities, decreased slightly at 7.6 months, due to the growth in the stock of current accounts. The residual credit maturity increased to 51.2 months. Similar to the previous period, the banking sector did not report the use of funding lines by the parent groups.

4.1.2.3 Market risks

EXCHANGE RATE RISK

The exposure of the banking sector to direct exchange rate risk has decreased during the period, remaining considerably below the regulatory limit.

The exposure of banks to indirect exchange rate has increased during the period, given the growth in foreign currency loans to residents. Nevertheless, the contraction of loans unhedged against the exchange rate mitigates the materialisation of this risk.

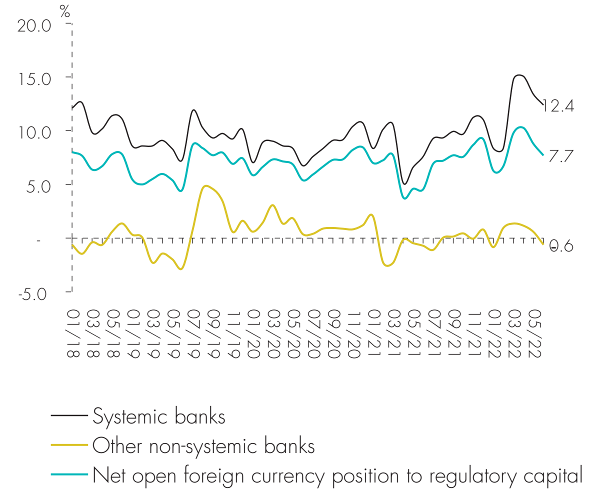
The exposure ratio of banks to direct exchange rate declined compared to the level in the end of 2021 H2, but increased compared to the previous year. At the end of 2022 H1, the ratio of the net open foreign currency position of the banking sector was long and accounted for 7.7% of the regulatory capital of the banking sector, being 1.5 percentage points lower compared to the end of 2021. During March - April 2022, this ratio increased at 10.3% of regulatory capital, though standing considerably below the regulatory limit of 30%, while in the next months it returned to the levels in the previous months. Systemic banks show a higher exposure to direct exchange rate risk and held a long net open foreign currency position. At the end of the period, the ratio of the net open foreign currency position for these banks was 12.4%, and 1.4 percentage points above the level in the previous six months.

[28] *Calculated as the ratio of 'mismatch 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.*

Non-systemic banks have a short net open foreign currency position, accounting for 0.6% of their regulatory capital. Overall, they show a low and stable exposure to exchange rate fluctuations.

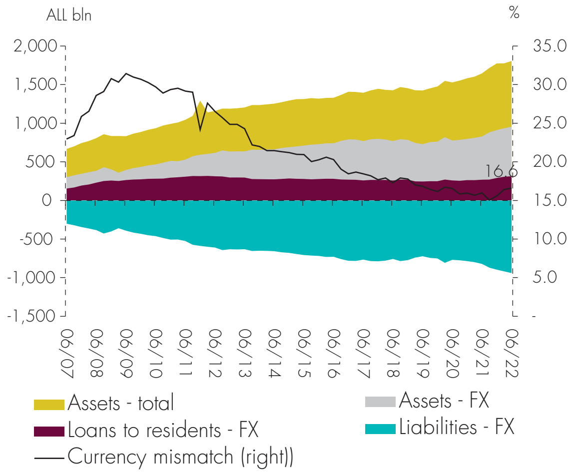
During the period, the exposure of the banking sector to indirect exchange rate risk, as measured by foreign currency mismatch indicator[29] has edged up. As at end-2022 H1, the foreign currency mismatch indicator was equal to 16.6% of banking sector's assets. Foreign currency-denominated assets and liabilities of banks grew by 4.8% and 5%, respectively, from the level in the previous six months, while credit in foreign currency to resident entities grew by 7.8%. The sub-index in the European currency, up by 1.3 percentage points to 17.1% of assets compared to the end of the previous year, continues to dominate the overall index.

Chart 77 Open foreign currency position to regulatory capital for the sector and groups



Source: Bank of Albania.

Chart 78 Performance of Indexes components for the banking sector

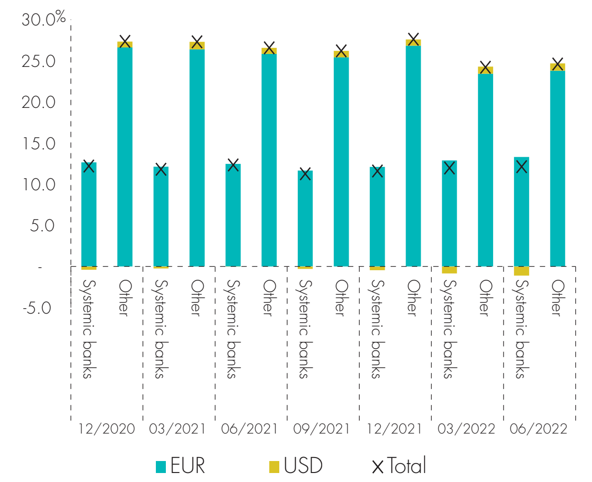


Source: Bank of Albania.

The group of systemic banks continues to provide the main contribution to the performance of the foreign currency mismatch index. In 2022 H1, the indirect exchange rate risk for systemic banks increased by 0.5 percentage point, equal to 12.1% of group assets, from 12.3% of assets a year earlier. The index of foreign currency mismatch for the group of non-systemic banks has a higher value and shows a larger exposure of these banks to indirect exchange rate risk. At the end of 2022 H1, this index was equal to 24.6% of groups' assets. This value was lower form the previous six months and previous year by 3 p.p. and 2 p.p, respectively.

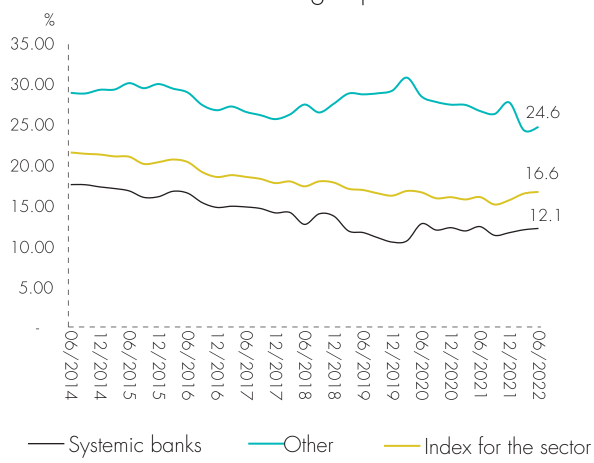
29 The foreign currency mismatch indicator measures the hedging rate of the banking sector's liabilities with assets set off by resident credit in foreign currency. A low value of this indicator's ratio to assets shows a low exposure to movements in the exchange rate. For the calculation of the exchange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

Chart 79 Currency mismatch by groups and currency



Source: Bank of Albania.

Chart 80 Foreign currency mismatch index for bank groups



Source: Bank of Albania.

Notwithstanding the increased index of foreign currency mismatch due to the growth in foreign currency loans to residents, the contraction of loans unhedged against the exchange rate risk, mitigates the materialisation of the exchange rate risk.

INTEREST RATE RISK

The banking sector's exposure to direct interest rate risk decreased during the period, and it continues to remain notably below the upper regulatory limit.

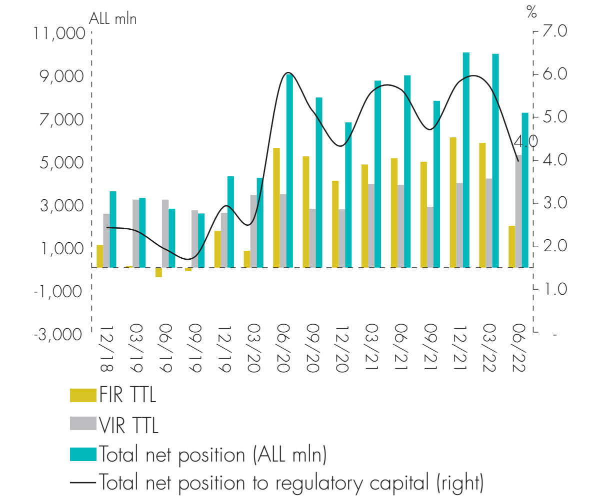
In terms of the existing exposure. The banking sector is more exposed to the interest rate risk for: the positions: in lek; with fixed variable interest rate; and for the long-term maturity.

Attention should be paid on the impact arising from the possible increase of credit interest rate on both borrower's solvency and credit quality.

In 2022 H1, the exposure of banks to interest rate risk has decreased. As at end of year, the weighted total net position in banks' balance sheet was at 4.0% of regulatory capital, or around 2 percentage points below the level recorded in the previous six months and a year earlier. The maximum regulatory limit for this indicator is 20% of regulatory capital. The weighted difference of assets to liabilities with fixed interest rate (FIR) fell by 2.5 percentage points at 1.1% of regulatory capital of the sector. Meanwhile, the weighted difference of assets to liabilities with variable interest rate (VIR) increased by 0.6 percentage point at 2.9% of regulatory capital. The indicator of the weighted net position for systemic banks was slightly up, reaching at 5.7% of regulatory capital. This performance suggests a slight increase of exposure to the interest rate fluctuations risk for this group of banks. During the period, the exposure to the fluctuation risk of interest rates for non-systemic banks has been considerably downwards during the period, at 1% from 7.5% as at end of 2021.

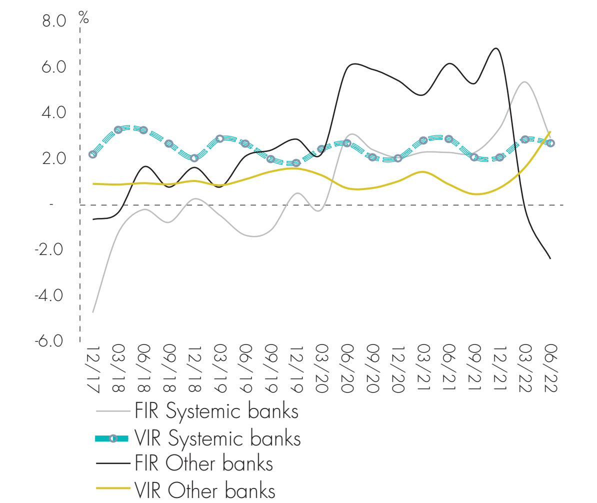
The increased exposure in assets and liabilities with variable interest rates (VIR) provided the main contribution in the rise of the overall index for the group of systemic banks. At the end of 2022 H1, this index was equal to 2.7% of regulatory capital of the group, from 2.1% in the previous six months. During the period, the exposure indicator to fixed interest rate (FIR) fluctuations fell by 0.4 percentage point, at 2.9% of regulatory capital. Non-systemic banks decreased considerably their exposure to fixed interest rate (FIR) fluctuations, shifting to negative net position[30], equal to 2.4% of regulatory capital, from the positive position of 6.7% as at end of previous year. For the same period, the exposure indicator to variable interest rate (VIR) fluctuations was up by 2.5 percentage points at 3.2% of regulatory capital of non-systemic banks.

Chart 81 Weighted total net position in bank's balance sheets against regulatory capital, in %



Source: Bank of Albania.

Chart 82 Performance by groups of net position for fixed interest (FIR) and variable interest (VIR) rates



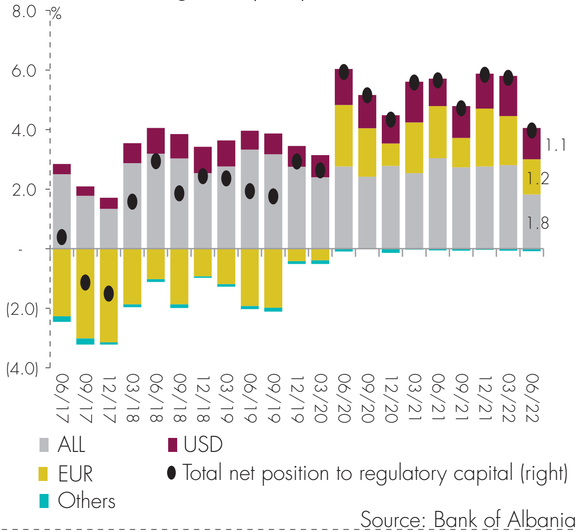
Source: Bank of Albania.

By currency, net position in the domestic currency, reaching at 1.8% of regulatory capital at the end of the period, continues to provide the main contribution in the exposure to interest rate fluctuations. This indicator was around 1 percentage point lower compared to the previous six months and a year earlier. The exposure of assets and liabilities, sensitive to the interest rate fluctuations in euro, fell by 1 percentage point at 1.2% of regulatory capital. The exposure in the US dollar was equal to 1.1% of regulatory capital, close to the level of 1.2% in the previous six months.

By maturity, the change in the total net position was mainly driven by the decrease in the positive exposure for long-term maturity basket, whose indicator was down to 8.2% of regulatory capital, from 10.3% in the previous six months, and 9% a year earlier. The position for short-term instruments was positive and up by 1 percentage point, standing at 1.5% compared to the previous six months. For instruments with medium-term maturity, the liabilities sensitive to the interest rate fluctuations are higher than assets, resulting in a negative weighted net position. As at end of the period, the negative position deepened more slightly reaching at 5.7% of the regulatory capital of banks.

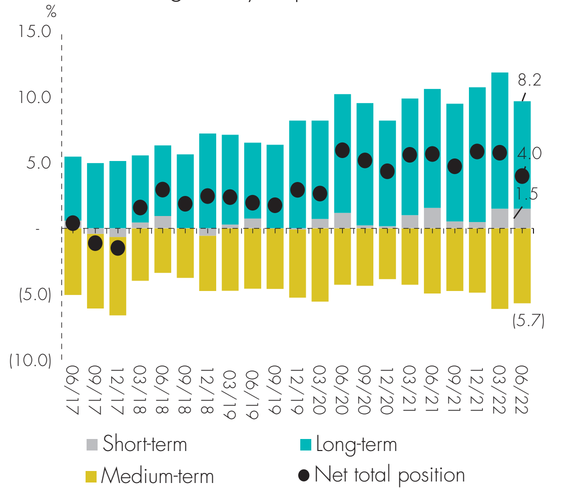
[30] *Negative position shows that fixed interest rate assets are higher than fixed interest rate liabilities in the banking book.*

Chart 83 Gap by group and currency against regulatory capital, in %



Source: Bank of Albania.

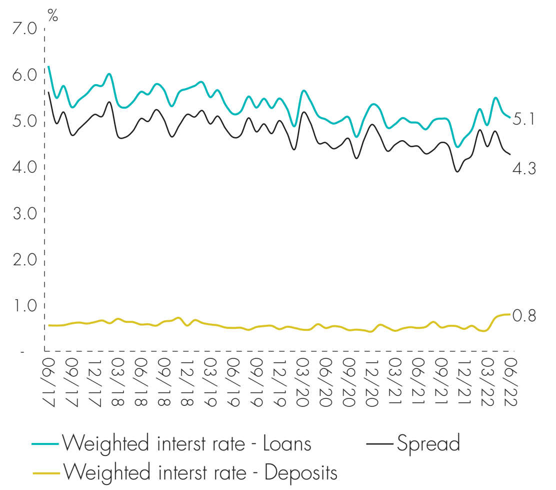
Chart 84 Weighted net position by maturity against regulatory capital, in %



Source: Bank of Albania.

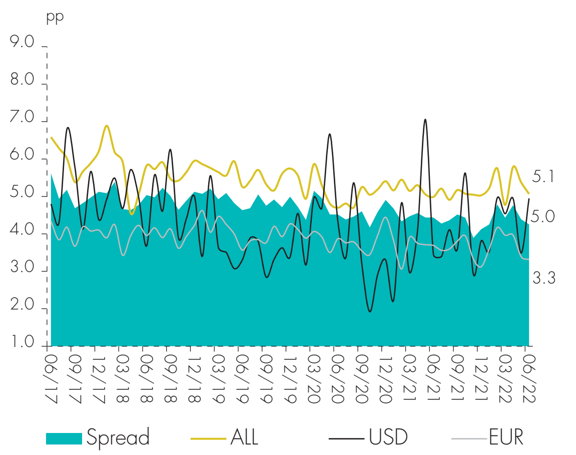
Indirect risk to interest rate change[31] has trended upwards in the first half of 2022. As at end-2022 H1, the overall spread between the weighted interest rate on loans and deposits was 4.3%, somewhat higher from 4.1% recorded in the previous six months. The increase in the spread for the euro by 0.2 percentage point, compared to the value in the previous six months, provided the main contribution in this regard. This performance is related to the high surge in the interest rate on credit compared to the interest rate on deposits in this currency.

Chart 85 Loans and time deposits weighted interest rates and interest rates spread, in %



Source: Bank of Albania.

Chart 86 Spread of weighted interest rates of loans and time deposits by currency, in p.p.



Source: Bank of Albania.

[31] *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).*

The normalisation of monetary policy stance in response to inflationary developments, should draw attention of banking system towards the importance to carefully monitor the structure of assets and liabilities by type of interest rate and terms of maturity. Also, the possible rise of policy rate for the group of loans with variable interest rate may be accompanied by the transformation of interest rate risk into credit risk, due to the impact on the borrowers' solvency.

4.1.3 STRESS TEST EXERCISE IN TERMS OF CAPITAL ADEQUACY

The stress test exercise assesses the banking sector's resilience against shocks from real economy. Stress test on capital adequacy shows the resilience level of individual banks in terms of capital and aims at identifying its adequacy to withstand assumed shocks on: economic growth; credit; exchange rate; and the interest rate levels. The exercise is conducted by applying three scenarios: the baseline scenario; the moderate scenario; and the adverse scenario, for the period up to the end of 2024.

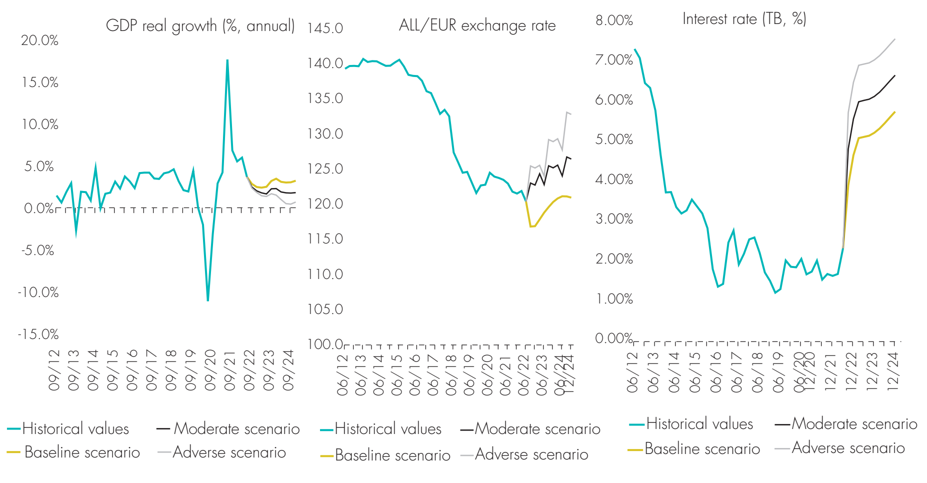
Results of stress test exercise conducted for the period 2022 -2024 show that the banking sector, in absence of new developments, is assessed to remain resilient to possible macroeconomic shocks.

Particular banks may need to strengthen their capital positions in event of extreme assumptions.

There should continuously kept in mind that the involved assumptions/scenarios in stress test exercises do not represent forecasts on the performance of the selected indicators.

The baseline scenario assumes a positive economic growth rate for the time frame of the exercise (4%). In this scenario, the economic growth is accompanied with a considerable growth rate of lending and an improvement of the quality of the credit portfolio. In the moderate scenario, the economic growth is assessed to be positive over the time frame of the exercise, but at a lower growth rate (around 2.5%). The adverse scenario assumes a positive growth rate as well, though lower than in the moderate scenario (around 1%). Also, all the three scenarios assume the suspension of dividends allocation from banks, till the end of 2022[32].

Chart 87 Projections on the key macroeconomic indicators

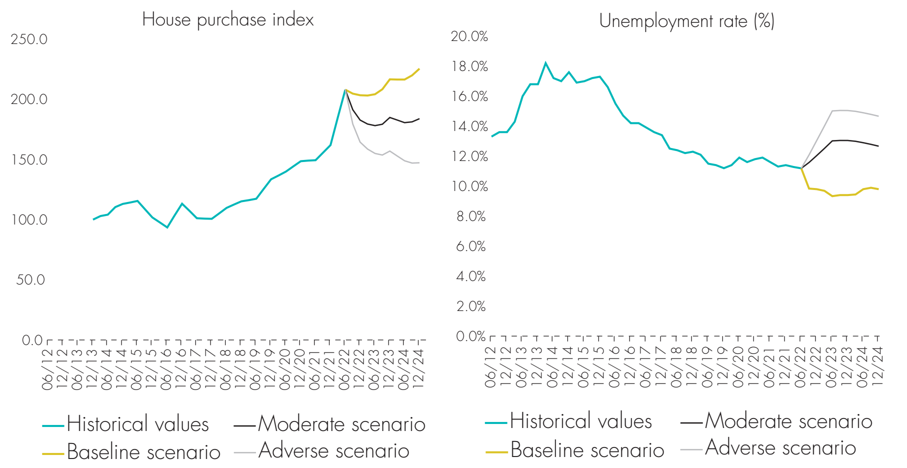


Source: Bank of Albania.

32 *Pursuant to the Decision No. 6, dated 2.2.2022 of the Supervisory Council "On the suspension of profit allocation from banks".*

Assumptions on the weaker economic performance in the moderate and adverse scenarios were coupled with relevant assumptions on depreciation of lek exchange rate, increase of interest rates and a decrease of lending pace up to zero increase of credit stock. These developments are reflected in the deterioration of the credit portfolio quality, for both enterprises and households.

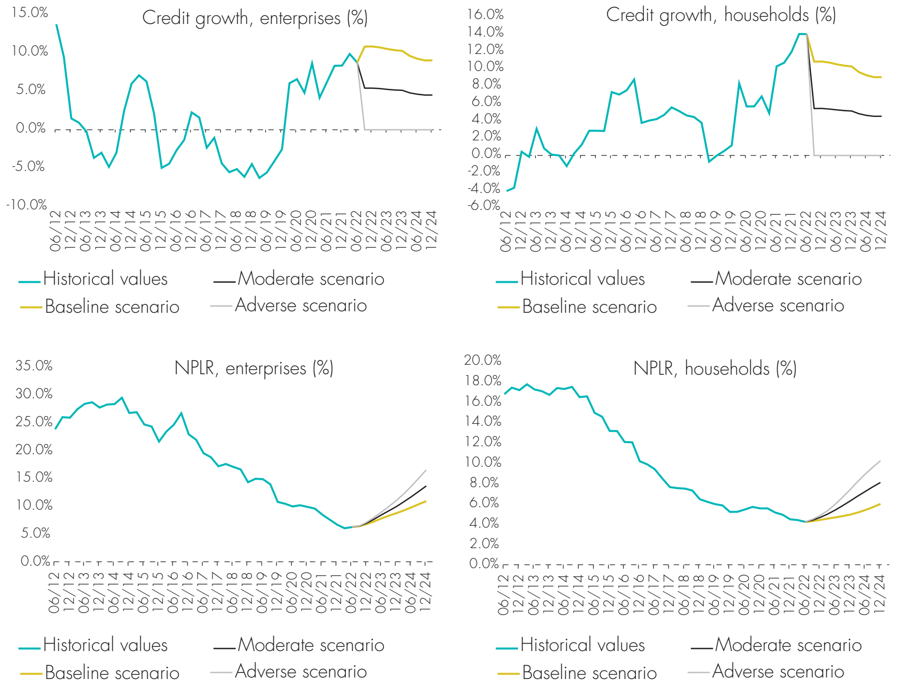
Chart 88 Projections on the new macroeconomic indicators



Source: Bank of Albania.

Also, assumptions on the new macroeconomic indicators included in the exercise, reflect a fall in housing prices over 2022 under the most unfavourable scenarios, and an increase of unemployment rate. These assumptions lead to a worsening of the capitalisation indicators for individual banks and the overall banking sector, mainly during 2024.

Chart 89 Projections on credit portfolio by relevant models to enterprises and households

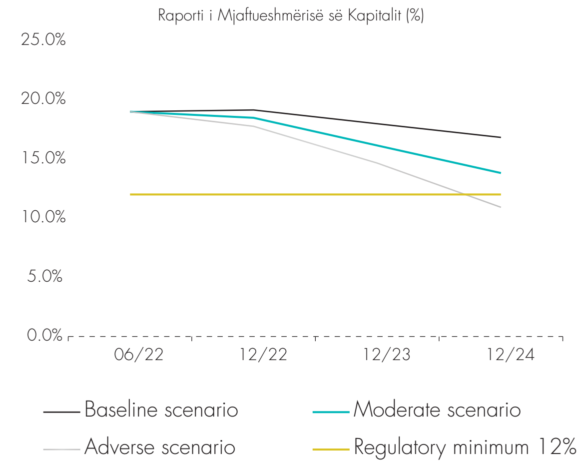


Source: Bank of Albania.

Stress test results in terms of capital adequacy show that:

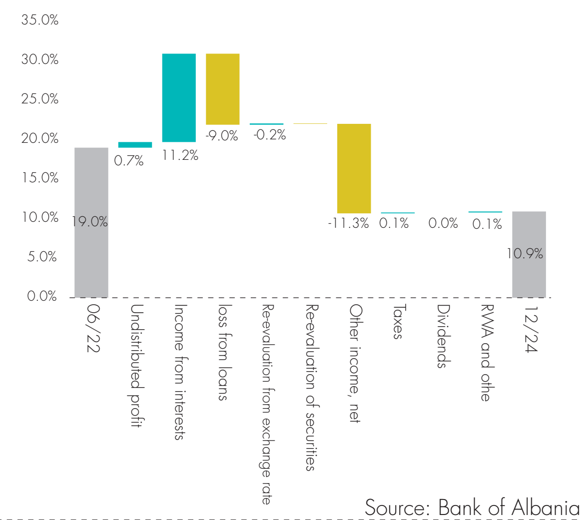
- In the baseline scenario, the Capital Adequacy Ratio (CAR) of the sector registers 19.1% at the end of 2022, while it decreased to 18% at the end of 2023, and to 16.8% at the end of 2024. Notwithstanding the banking sector appears well-capitalised, developments in particular banks evidence the need for capital injection during the period of the exercise. Seven banks appear under-capitalised by the end of 2024 in this scenario, accounting for around 40% of the sector's assets. In this case, the need for additional capital is assessed to amount up to around ALL 15 billion (or 0.8% of GDP).
- In the moderate scenario, the banking sector's CAR is slightly lower at 18.5% at end-2022, and 16.1% at end-2023, and 13.8% at end-2024, by continuing to maintain adequate capital levels throughout the three years period. Based on the results obtained, developments in particular banks evidence the need for capital injection at the end of the period of the exercise. In more concrete terms, the number of these banks increases to eight banks appearing under-capitalized by the end of 2024, in this scenario, accounting for around 55% of the sector's assets. In this case, the need for additional capital is assessed to amount up to around ALL 33 billion (or 1.7% of GDP);
- In the adverse scenario the banking sector remains capitalized in 2022 and 2023, with CAR at 17.8% and 14.7%, respectively. Meanwhile, the banking sector falls under-capitalised - in this scenario - at end-2024, with CAR of 10.9%.

Chart 90 CAR over the time frame of the exercise



Source: Bank of Albania.

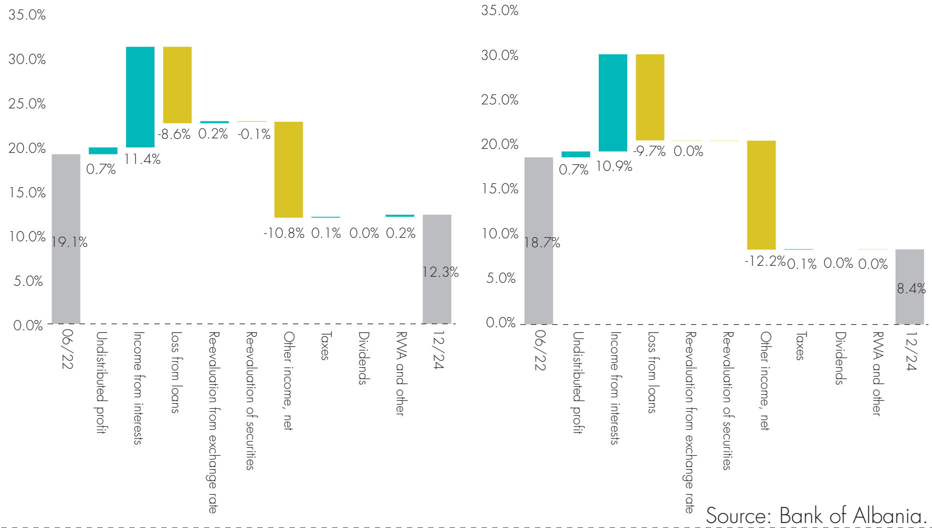
Chart 91 Contribution of the main balance sheet's items in CAR change in adverse scenario



Source: Bank of Albania.

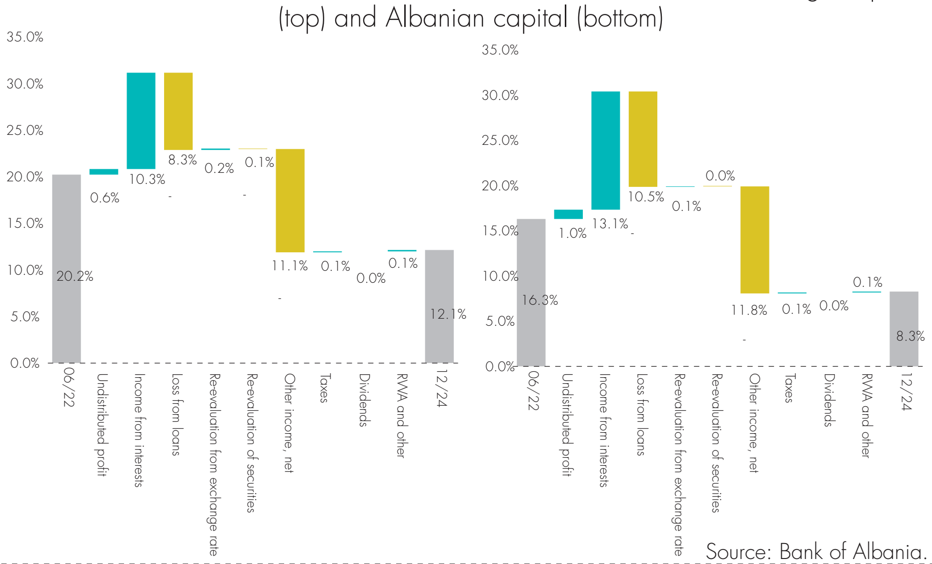
Losses from loans and from other operating income present the main contribution in the capital shortfall in this scenario. Nine banks appear under-capitalized by the end of 2024 in this scenario, accounting for around 58% of the sector's assets. In this case, the need for additional capital is assessed to amount up to around ALL 51 billion (or 2.6% of GDP).

Chart 92 Contribution in CAR in adverse scenario, for Systemically Important Banks - SIBA (top) and Other Banks (bottom)



Source: Bank of Albania.

Chart 93 Contribution in CAR in adverse scenario, for Banks with foreign capital (top) and Albanian capital (bottom)



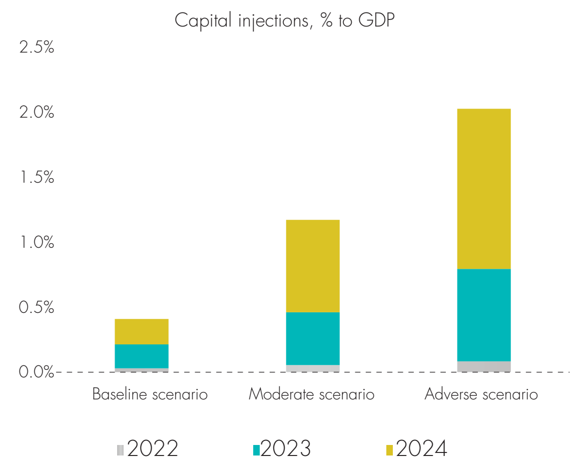
Source: Bank of Albania.

In the adverse scenario, overall, systemic banks (SIBS) show a stable capitalization ratio of 12.3% at end-2024, while the other banks appears under-capitalized, reaching at a CAR of 8.4%. The difference between these two groups originates form a lower contribution of loss from loans and loss from other net income for SIBS, and from a higher undistributed profit for this group of banks. In the adverse scenario, banks with foreign capital show a capitalisation ratio of 12.1% at end-2024, while banks with Albanian capital reach at a CAR of 8.3%. The difference between the two groups originates from a higher contribution of loss from loans and a higher drop of other net operating income for banks with domestic capital.

At the conclusion of the exercise, the analysis shows that the banking sector is resilient to macroeconomic shocks, but particular banks show high sensitivity to assumed scenarios. In the extreme scenarios, the need for capital injection reaches a maximum weight of around 2.6% of GDP at end 2024, in the adverse scenario.

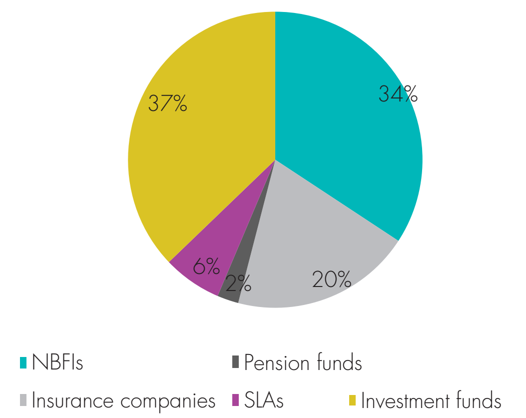
4.2 NON-BANKING SECTOR

Chart 94 Needs for additional capital to GDP*



Source: Bank of Albania.
*Macroprudential buffers are not included.

Chart 95 Non-banking sector structure



Source: Bank of Albania, AFSA.

NON-BANKING SECTOR PERFORMANCE

The Albanian non-banking sector consists of non-bank financial institutions (NBFIs), Savings and Loan Associations (SLAs), insurance companies, investment funds and pension funds. 38 NBFIs, 16 SLAs, 12 insurance companies, 12 investment funds and 5 pension funds operate in the financial market. Non-banking sector's assets account for around 10% of the total assets of the financial system and around 11% of GDP. Investment funds have the main share in the activity of non-banking sector, followed by non-bank financial institutions.

In 2022 Q1, non-bank financial institutions and investment funds slowed down their activity, meanwhile the latter expanded across other segments of the financial systems.

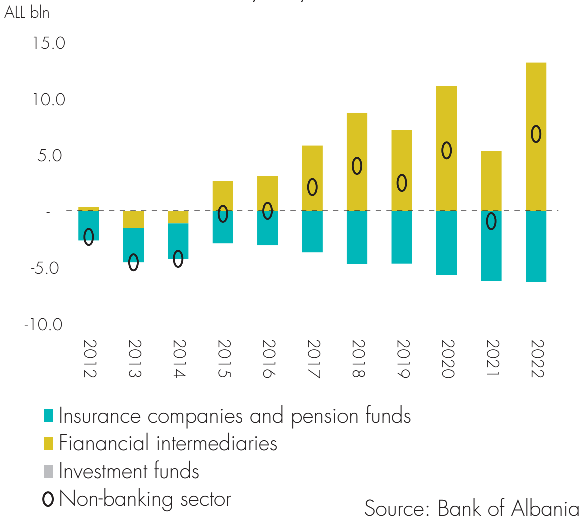
Lending NBFIs had the main share followed by those that provide payment and transfer services. NBFIs are more active in lending to the sector of wholesale and retail trade (19% of the total loan stock to enterprises, followed by other service activities (16%). Credit to households accounted for 54% of total loans while 46% was granted to enterprises. Albanian capital accounts for around 70% of shareholding equity of the non-bank financial institutions. As at-end of the period, NBFIs reported a positive financial result (around ALL1.5 billion), close to the level in the previous year. The capitalisation of activity of these entities continues to remain high, while the quality of loan portfolio fell in annual terms, and CAR increased at 14% from 13%.

The Savings and Loan Associations (SLAs) expanded their lending activity to their members and recorded a positive net profit. This segment recorded a slight improvement of credit portfolio from a year earlier. The non-performing loans ratio dropped to 5.4%, from 6.2% the previous year. Investments in loans and investments in banks in the form of time deposits have the main share in the investment portfolio of SLAs, by 69% and 21%, respectively. Agricultural sector has attracted the largest funding from the activity of the members (36%), followed by the wholesale and retail trade sector (13%).

Insurance companies and pension funds expanded their activity driven by the increase in gross written premiums and investments in government debt securities.

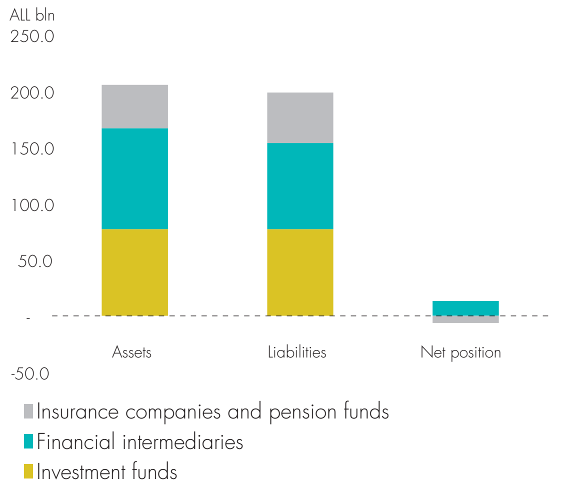
Investment funds reported a lower level of assets as a result of the contraction of investments in government's bonds.

Chart 96 Net position of non-banking sector by entity in years



Source: Bank of Albania

Chart 97 Assets, liabilities and net position by entities of non-banking sector (March 2022)



Source: Bank of Albania.

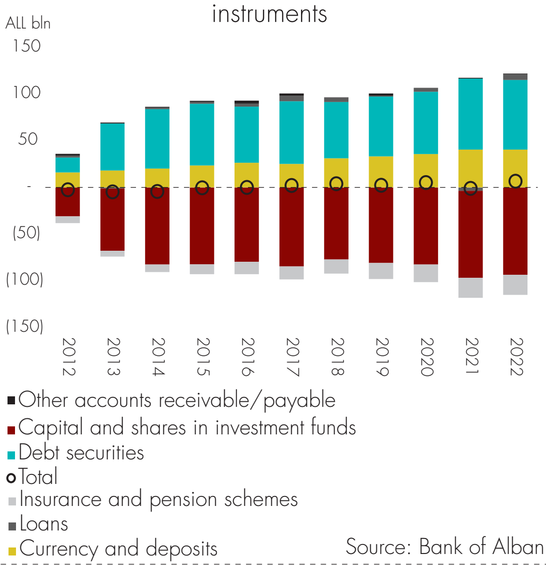
The non-banking sector has continuously recorded a balanced position of financial assets and liabilities[33]. Debt securities and loans represent the main items of SLAs' assets, while currency and deposits as well as capital and shares in investment funds represent the SLAs' liabilities. The net position of non-banking sector resulted positive after two quarters in a raw with negative values. The higher expansion of financial assets, mainly in the form of currency and deposits, and debt securities provided the main impact on the shifting of the position. Within the non-banking sector, insurance companies and pension funds have a net negative (debtor) position, while the other financial intermediaries (non-banks and SLAs) have e net positive (creditor) position. For the sub-sector of insurance companies and pension funds, debtor position amounted to 3% of total assets as at end of 2022 Q1.

Debt securities account for around 36% of the financial assets of non-banking sector, while loans and currency and deposits account for 22%, respectively. These ratios differ across entities of this sector. Debt securities in investment funds account for around 84% of their assets, while loans have the highest share in the assets of other financial intermediaries. Both insurance companies and pension funds, have the most heterogeneous distribution of assets, into: currency and deposits (34%); debt securities (26%); insurance and pension schemes (17%); and capital and shares in investment fund (10%). By instrument,

[33] *The analysis of assets and liabilities of non-banking sector is based on the data of financial accounts for the first quarter of 2022.*

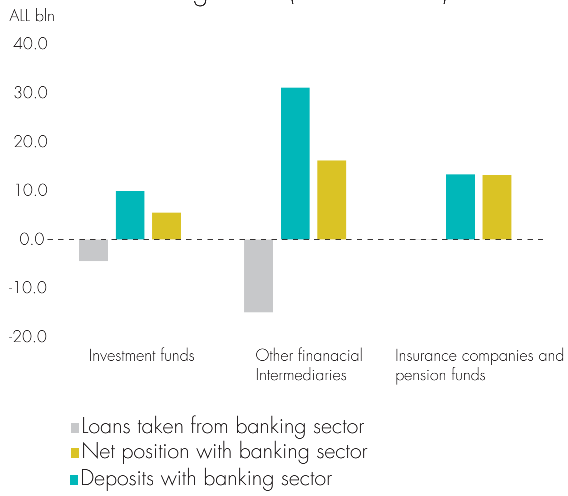
non-banking sector has a net debtor position for the capital and shares in investment funds, in insurances and pension schemes, with a net creditor position for debt securities and currency and deposits.

Chart 98 Net position of non-banking sector by instruments



Source: Bank of Albania.

Chart 99 Non-banking sector interconnection with banking sector (March 2022)



Source: Bank of Albania.

RISKS AND EXPOSURES BETWEEN BANKING AND NON-BANKING SECTORS

The banking sector's exposure to the non-banking sector in Albania remains low and stable. This exposure on the side of banks' assets is represented by loans granted to non-bank financial institutions. Financial intermediators (non-banks and SLAs) are the segment with the highest financing stock from the banking sector, at ALL 15 billion in 2022 Q1, followed by investment funds of around ALL 4 billion. Banking sector' total financing stock amounts to around ALL 19 billion, around ALL 4 billion higher than at end-2021, and accounts for only 1% of the banking sector's balance sheet.

The sensitivity of the non-banking sector to the activity of the banking sector remains high, but it has maintained the level of December 2021. Claims of non-banking sector to banks are in the form of placements (current accounts, demand and time deposits). Stock of funds placed in banks, during the period, amounted to around ALL 54 billion, or accounting for around 26% of total assets of the non-banking sector. The other financial intermediaries (non-banks, SLAs) have the largest placements in the banking sector, accounting for 57% of total placements of non-banking sector, slightly down compared to the end of 2021. As ratio to their assets, insurance companies and pension funds have the highest exposure to the banking sector, as their placements in banks account for around 34% of their assets. Investment funds have increased the sensitivity to developments in the banking sector, as the placements in the form of currency and deposits in banks have increased. The non-banking sector has narrowed its net creditor position to the banking sector, reaching at ALL 35 billion from ALL 38 billion reported at the end of 2021. The contracted net position mitigates the sensitivity of non-banking system to the activity of the banking sector. Financial intermediators have the highest net creditor position, since they have more placements in the banking sector, followed by insurance companies and pension funds. 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

5.1 ASSESSMENT OF RISKS AND MACRO-PRUDENTIAL MEASURES IN ALBANIA

The Bank of Albania, in collaboration with other authorities, contributes in safeguarding financial stability. To this end, the Bank of Albania compiles and implements the macro-prudential policy, which aims at operating in two directions:

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

In view of preventing the accumulation of risks, the Bank of Albania conducts analyses aimed at identifying financial imbalances based on close monitoring of the performance of indicators that reflect the accumulation of risks, with the main focus on the banking sector. The Bank of Albania has already identified a complete set of macro-prudential[34] indicators in full compliance with the recommendations of the European Systemic Risk Board (ESRB), which are grouped into four objectives[35]. In the first half of 2022, the indicators of the Macro-prudential Map reflect that the banking sector has continued to be well-capitalized and with sufficient liquidity to meet the needs of the activity. The following is a brief analysis of each objective:

<u>Objective I</u>: The negative credit gap for the economy to gross domestic product (GDP) has continued to remain in negative values, being somewhat contracted in the last periods, mainly driven by the high lending pace. The possible acceleration of lending, particularly in its component related to loans for real estate and the connection it establishes with the increase of house prices, should be monitored carefully to be eventually addressed through macro-prudential measures.

<u>Objective II</u>: During the period, liquid assets fell by around 5 percentage points to the total assets, reaching at 29%. Also, there was a significant negative gap between assets and liabilities across all maturity baskets. The exchange rate

[34] For each objective, there are specific indicators selected that best signal the systemic risk around which the objective is built. The monitoring of the risk signals captured by each of them is done by comparing the current value and the timely performance of the indicator towards a critical value, the exceeding of which may signal the accumulation of risk.

[35] For more details, see the Document '"The Macro-prudential Policy Strategy", No. 37, dated 2.8.2017: https://www.bankofalbania.org/Financial_Stability/Macro-prudential_policies/Macro-prudential_strategy/

spread for the euro in the interbank market has decreased during the period, particularly in its second part. The exchange rate volatility for the domestic currency has increased somewhat during the period, temporary, due to the beginning of the Russia-Ukraine war. The expansion of liquidity gap, given the change in the structure of financing sources in favour of current accounts and demand deposits, increases the need to pay attention to liquidity risks in the banking sector and in individual banks.

Objective III: The concentration rate of banking sector's activity signals a limited impact in terms of systemic risk. Exposure to large borrowers, to economy sectors, and by currency, notwithstanding the slight increase in one of them, does not signal a considerable change of risk. Banking sector's assets to non-resident as a ratio to total assets of the sector has slightly increased during the period, but standing at the historical average level. Liabilities of non-bank financial institutions to banking sector, as a ratio to their total assets, also remain close to low levels. Assets in foreign currency show a performance trending up in the last periods. In order to address the high level of foreign currency assets, the Bank of Albania signed, on April 18, 2017, the Memorandum of Cooperation with the Ministry of Finance and Economy, and the Albanian Financial Supervision Authority, to reduce the level of euroization in Albania. The Bank of Albania has implemented a package of concrete measures to promote the use of the national currency. A detailed analysis about the effect of de-euroization measures is published periodically on the official website of the Bank of Albania.[36]

Objective IV: Concentration in the banking sector structure remains at contained levels. The main indicators of concentration in terms of: relationships with non-residents; the exposure within the financial system; systemic importance of systemic banks and other banks, have remained unchanged or have slightly declined. All these indicators remain at contained levels and stand notably below the comparative threshold. The concentration of banking sector, for the entire sector and within the group of systemic banks, remains below the limits, showing a moderate or high concentration. It suggests that the concentration risk of the banking sector is limited.

5.2 MACRO-PRUDENTIAL MEASURES IN ALBANIA

During the period, there were no new measures of macro-prudential nature or change of existing measures implemented.

The banking sector has conducted its activity without the supportive measures of prudential nature that the Bank of Albania implemented in the framework of mitigating the effects of the pandemic (which ended in March 2021). Despite expectations, there were no adverse reactions to the credit quality of

[36] *https://www.bankofalbania.org/Financial_Stability/De-euroization_Package/*

the banking sector. Developments in lending took place relatively at a rapid pace, but the capitalisation levels of activity improved due to the increase in regulatory capital. Geopolitical developments and the energy situation could slow down economic growth in Albania, and this may lead to a decline in the volume and quality of the loan portfolio. In these circumstances, it is necessary for banks to maintain the best possible capital positions.

Pursuant to the Regulation 41/2019 "On macro-prudential capital buffers", the decisions of the Governor on the implementation of these buffers have continued[37] to be published.

In parallel, the Bank of Albania has continued the operationalization of capital values that hedge structural risks in the financial system, and the conception of instruments that prevent excessive growth of credit and debt, mainly from households.

[37] *See at: https://www.bankofalbania.org/Financial_Stability/Macro-prudential_policies/Instruments_of_Macroprudential_Policy/Instruments_and_Decisions/*

ANNEX INDICATORS OF FINANCIAL SOUNDNESS

Indicators of financial soundness																
In %	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
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	18.7	18.5	19.0
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	17.6	17.4	17.8
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	10.4	9.9	10.1
Assets quality																
Net non-performing loans 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	11.3	7.1	7.5
Non-performing loans (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	5.6	5.3
Profitability																
Return on Equity (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	10.7	12.9	7.2
Return on Assets (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	1.1	1.3	0.7
Net open foreign currency position to capital																
Net open foreign currency 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	8.4	9.2	7.7
Net open foreign currency 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	9.0	9.8	8.2
Assets-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	34.8	33.3	28.9
Liquid assets to short-term liabilities (up to one 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	47.4	45.4	39.9
Customers'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	211.3	213.6	208.2

Source: Bank of Albania.