Bank of Albania

FINANCIAL STABILITY REPORT

2021/H2

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INTRODUCTION

This is the twenty-seventh 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 equips public authorities to be able, in a timely manner, to identify 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 second half of 2021 (hereinafter "the period"). The economic and financial indicators and the accompanying analysis refer to the period prior to the armed conflict between Russia and Ukraine, and they do not reflect the economic and financial effects of this event. However, the report presents a qualitative assessment of the potential impact of this event on the economy and the activity of the banking sector. 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 trade, 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 and liquidity adequacy. This Report features for the first time an analysis on the interconnection and the risk of spread of crises between institutional sectors such as the non-financial corporation sector, households, the General Government sector, the financial corporation sector and the non-residents sector.

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 December 2021, 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, Intesa Sanpaolo Albania and OTP Bank Albania.
- Other banks: 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 70% of the banking sector's total assets.
- Banks with Albanian capital: Credins Bank, Union Bank, American Bank of Investments, Tirana Bank. These banks share around 30% in total assets of the banking sector.

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

[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/test/*

[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.*

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 2021 H2

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 2021 H2 (hereinafter 'the period'), operations of the banking sector were stable. Deposits and loans grew at a rapid pace, credit quality continues to improve and other financial stability indicators remained at appropriate levels. Overall, the exposure of the banking sector to risks appears contained. Economic developments throughout 2021 were quite positive, although economic growth, a decrease in the unemployment rate, and supply-side shocks were accompanied by higher inflationary pressures at the end of the period.

The military conflict in Ukraine and sanctions on Russia, have caused issues with production and supply chains to worsen even further, leading to an upsurge in prices of oil, gas, grains and metals. New projections suggest that inflationary pressures will be stable in the short run, which may be accompanied by an increase in the cost of production, a fall in consumption and investments, thus, a deceleration of economic growth.

Assessment of current economic and financial policies introduced to mitigate this shock shows them to be moving in the right direction, given the considerable uncertainties around geopolitical developments and the energy situation. Direct exposure of the banking sector to the effects of the conflict between Russia and Ukraine is low, and it will not affect indicators of financial stability in its activity. Indirect exposure is determined by the performance of the economy, *macroeconomic stability and borrowers' performance. These developments identify the need for economic and financial policies to maintain elements of flexibility in order to react in line with the dynamic of these developments. Related to the banking sector, the importance of regular assessment of the degree exposure to risks, and preservation of a proactive approach to measures for mitigating and tackling these risks, remain pertinent. In this regard, the Bank of Albania stands ready to take all necessary actions pursuant to the law, to support banking activity and contribute to the stability of the financial system.*

Developments in this period revealed the following:

Global economic activity continued to recover during the period, at a slower pace, and it was different from region to region. Positive developments in the Euro area and the Western Balkans region were due to an easier health situation related to the pandemic and stronger internal demand. The upsurge in energy prices and supply-side shocks engendered inflationary pressures and higher interest rates from central banks, particularly in advanced economies. Financial conditions tightened and volatility increased in financial markets. The military aggression of Russia against Ukraine and the economic sanctions imposed on Russia were accompanied by a rise in the prices of energy, food and metals, causing major economic and financial consequences. The degree of uncertainty regarding the course of this war and its implications on the economy and beyond, remain high. In the short run, its consequences are expected to further decelerate global economic growth, which includes the European Union and our region as well.

In Albania, the pace of economic growth remained high during the period, despite its deceleration. Economic growth is driven by improvement of consumption and investments, reflecting a strengthening of internal demand. It was accompanied by a fall in the unemployment rate, a rise in wages, and higher inflationary pressures, given the continuation of supply issues in international markets. The latter became more severe after the armed conflict in Ukraine and the sanctions imposed on Russia. In response to these developments and with a view to mitigating the shock on enterprises and households, fiscal and monetary policies reacted. This reaction has been assessed as appropriate given that uncertainties around geopolitical developments and the energy situation are considerable. The challenging situation facing the economy requires flexibility and coordination of economic and financial policies in the short run, whereas in the long run, it is necessary to undertake structural reforms to develop alternatives for energy and food security.

Markets carried on their activity as normal, free from large fluctuations. During the period, the level of government debt securities issued in lek was comparable to the previous year. The tendency to borrow with long-term maturity has continued. The average interest rate of securities was stable and fluctuated close to 2.3% throughout the period. Eurobond borrowing in November 2021 was successful, given the geopolitical developments in the beginning of 2022.

In the secondary market, the traded amount increased during the period, with the main contribution coming from long-term securities. Market developers helped to increase the volume and value of the reference securities traded. The yield curve in the market had a normal slide and investors continued to show a preference for keeping securities until maturity.

Over the last year, the volume of transactions increased in the interbank market due to a higher volume of weekly and daily transactions. The average interest rate of these transactions fluctuated close to the policy rate, which is designated by the Bank of Albania. This performance also reflected unlimited liquidity injection by the Bank of Albania over the period. The lek exchange rate was stable, reflecting developments in the international market as well. The national currency appreciated against the euro and depreciated against the US dollar. In the real estate market, demand and supply increased over the period. They were driven by higher loans for properties and construction. Sale prices for homes increased by 8.4% compared with the previous half year, and by 9% compared with the previous year, while construction costs increased by 3% in annual terms. Real estate agents remained relatively optimistic about the future of this market.

The basic infrastructure for the clearing and settlement of payments in lek continued to operate in an effective and secured manner. During the period, it was noted that there was an increase in the number and volume of small- and large-value transactions and the use of payment instruments. Payments conducted through cards or directly through apps and bank websites made a positive contribution.

The steep increase of savings caused households' position as net creditors to expand, while enterprises tightened their debtor position. The Albanian economy, overall, had a net creditor position to the rest of the world. The main contributors to this position were the business and general government sectors. Households had a net creditor position, while financial institutions had a balanced net position. If we focus on households and enterprises during the period, it is apparent that the stron\ger growth of deposits compared to credit, caused households' creditor position to expand and enterprises' debtor position to tighten. By currency, it is noted that households had a balanced structure of deposits and loans between lek and foreign currency. Enterprises had a preference for foreign currency. Survey results on households' financial situation indicate that the number of households with a debt to pay did not show significant changes throughout 2021.

Households' solvency moved downwards during the period. Households' demand for credit is expected to recover somehow during the first half of 2022, if the impact of geopolitical developments is shorter than current expectations. Survey results on enterprises show that the performance of sales and financial results improved compared with 2021 H1.

The assessment of enterprises for investment growth and activity expansion continue to indicate positive developments. The share of borrowing enterprises to total enterprises did not record any significant changes during the year. Debt burden decreased in relation to capital, but seemed somewhat higher in relation to enterprises' income. Expectations of future borrowing from enterprises seem to have improved, but uncertainties remain present. The survey on loan applications shows that the general number of applications is lower than in the previous year, but the refusal rate has not changed. The refusal rate has continued to fall for large enterprises according to the survey.

During the period, the share of financial system assets to Gross Domestic Product (GDP) slightly increased, reaching 111%. Banking sector activity and investments funds were the main contributors to this increase. The share of the banking sector to GDP reached 99%, while the share of the non-bank sector was 12% of GDP, remaining unchanged from the previous year. Performance indicators of the financial system, including capitalisation, profitability, liquidity and assets quality, remain at good levels. The exposure of the banking sector to the non-banking sector remains limited and has not recorded significant changes during this period. The exposure of the non-banking sector to the banking sector remains high, as the placements of non-banks to the banking sector, in the form of deposits and capital instruments account for around 1/5 of non-banks' balance sheets.

Banking sector activity expanded significantly during the period, and the strong growth of deposits was mainly underpinned by securities investments and lending. The foreign currency activity of the banking sector was almost balanced on both sides of the balance sheet. Deposits and own funds remained the main funding sources of the activity. During the period, the statistical effect of the exchange rate on the values reported in lek was low. The share of the net creditor position of the banking sector to non-residents was unchanged, whereas dependency on external funding sources remained low. Overall, the banking soundness indicator shows an improvement of the financial situation of the banking sector.

The banking sector maintained an appropriate level of capitalisation during the period, and the Capital Adequacy Ratio fluctuated at around 18%. The Capital Adequacy Ratio recorded a fall, year-on-year. This annual fall was mainly affected by a relative increase of risk-weighted assets, which exceeded the increase of regulatory capital. Banks with European capital and systemically-important banks reported the highest level of Capital Adequacy Ratio. The banking sector closed 2021 with a profit almost 30% higher than the previous year. The financial result recorded an annual growth due to the increase of net interest income and other activities income, and a decrease of expenditures for loans provisions. Overall activity expenses increased and their ratio to activity income increased slightly compared to the previous year. By currency, activity in the national currency made the primary contribution to the financial result.

At the end of 2021 H1, outstanding loans totalled around ALL 670 billion, up by 7% over the period, and 10% from the previous year. The expansion of loan stock was mainly affected by an increase of new loans flow, which was 40% higher compared to the previous period. The average interest rate on new loans granted during the period registered a decline. The highest increase was recorded on loans to enterprises, loans in foreign currency and short-term loans. The write off of non-performing loans from banks' balance sheets continued at a slower pace. The expansion of credit for enterprises was affected by the performance of short-term loans. The growth of credit to households was related to an increase of consumer loans and real estate purchases. Credit for investments in real estate and equipment purchases, at 30%, accounted for the main share of loans to enterprises. Mortgage loans accounted for the main share of credit to households, at 70%. Unhedged outstanding loans in foreign currency decreased slightly during the period. As a result, the share of unhedged credit in foreign currency to overall credit in foreign currency moved downwards. Restructured credit, during the period, accounted for around 25% of the restructured credit in 2021, and it focused on loans to households, loans in foreign currency, and credit for trade.

The expansion of deposits in the second half of the year was almost twice as high as their expansion in the first half of the year. Deposits grew by 7%, during the period, and by 11% compared to the previous year, reaching ALL 1,433 billion. The strong growth of deposits was underpinned by an increase in current accounts and foreign currency deposits. The share of time deposits to overall deposits stock continued to fall, favouring current accounts and demand deposits. Deposits of enterprises were mainly held in current accounts and demand deposits, and they were balanced according to currencies. Households' deposits continued to dominate the overall size of deposits and were mainly in the form of time deposits. By currency, the share of foreign currency has moved upwards. Average interest rates for different types of deposits did not record significant changes during the period.

Overall, risks to the Albanian economy were contained during the period. The financial stability map, built upon indicators that were yet to reflect the impact of the war in Ukraine, showed lower levels of risk in the overall macroeconomic environment and for real economic agents compared to the first half of the year. Meanwhile, risks to banking activity remained contained. In parallel, other indicators that try to capture perceptions and assessments on systemic risk, including banking industry evaluations, identified mitigation in the risks related to economic developments and credit quality. Furthermore, they reckoned that budget deficit performance, the level of public debt and, lastly, inflation required added attention. These issues gain an ever increasing importance given the economic consequences related to the conflict in Ukraine and the need to cushion them. The upsurge in real estate prices, which has continued incessantly for a number of years now, needs to be analysed from the sustainability angle. The mitigation of risks stemming from developments in this market will be brought to the attention of the macroprudential policy of the Bank of Albania.

In terms of more specific activity risks to the banking sector, the following is observed:

Credit risk fell significantly during the period. The non-performing loans ratio continued to fall, standing at 5.6%. This improvement can be seen in all types of loans according to maturity, sector and currency. The significant contraction of non-performing loans stock, which fell to ALL 40 billion, is related to fewer inflows of new NPLs, a better reclassification of non-performing loans, and writing off lost loans. The improvement of credit quality is also confirmed by other complementary indicators. The level of provisions created to cover for credit risk has been lower than in previous periods, but due to the contraction of non-performing loans stock, the provisioning coverage ratio increased to 69%.

The liquidity position of the banking sector is assessed as at good levels, but needs to be carefully monitored. The liquidity indicators, both in lek and in foreign currency, remained significantly above the minimum regulatory ratios. Deposits continued to cover twice the volume of loans, both in lek and in main foreign currencies. During the period, the average maturity mismatch between assets and liabilities increased slightly. For short-term maturities, the gaps between assets and liabilities remained at clearly negative values. These gaps were covered by ample liquid assets. However, in a hypothetical situation of liquidity stress, the quality of selected liquid assets may be challenged by the depth of the market where they may be traded or other yet untried factors. To this end, it is necessary that each bank assesses its capacity and framework to create liquidity sources that might be needed in stress conditions, and undertakes the necessary structural actions to gradually mitigate the maturity gap in the short run.

During the period, market risks increased, but they remain at contained levels. The exposure of the banking sector to direct exchange rate risk increased during the period, but it remains below the designated regulatory limit. The indicator of open foreign currency position to the regulatory capital hiked to 9.2%, remaining around three times lower than the upper regulatory limit. The exposure of the banking sector to indirect exchange rate risk decreased. During the period, the exposure of the banking sector to interest rate risk increased slightly. The weighed total net position in the banks' balance sheet against regulatory capital of the banking sector stood at 5.9% at the end of the year, up by 0.3 p.p. from the previous period. This indicator remains noticeably below the upper limit designated by the regulatory framework. Akin to other risks, the exposure of specific banks to market risks is necessary to be regularly evaluated and monitored as well. The results demonstrate that despite a diversified distribution, each case abides by the limits set out in the relevant regulation.

The geopolitical developments in Europe will increase risks to banking activity. Although direct exposure of the Albanian banking sector to the financial markets and instruments of countries involved in the war is insignificant, the impact might be indirect through a decline in the credibility of households and enterprises, the deceleration of economic growth, and the weakening of borrowers' performance in more exposed sectors. This might bring credit quality down and diminish the financial result of the banking sector. In addition to these risks, banks assess that the risk of cyber-attacks on their IT and communication infrastructure has increased, identifying the importance of strengthening infrastructure resilience where necessary.

The results of the stress-testing exercise support the assessment on the good financial condition of the banking sector. 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. The liquidity stress test shows the ability of the banking sector to withstand liquidity stress situations within the medium-term horizon.

Overall, the tests carried out for 2021 H2 and extended across the 2022-2023 period, show that the banking sector is resilient to the assumed macroeconomic shocks, and its liquidity situation is robust. The results also show that specific banks are more vulnerable against assumed shocks and need to strengthen their liquidity and capital positions.

In conclusion, the Bank of Albania assesses that the financial system and the banking sector have continued to perform in a stable manner in 2021. However the economic impact of the latest geopolitical developments and the unfavourable energy situation in Albania, represent crucial challenges for economic policies, and they may impact the activity of the financial system and banking sector in different ways. Therefore, it is pertinent for the banking sector to regularly assess the degree of exposure to risks and preserve a proactive approach regarding measures for mitigating and tackling these risks.

1. OVERVIEW OF THE MAIN RISKS TO FINANCIAL STABILITY

1.1 FINANCIAL STABILITY MAP

The Financial Stability Map, which summarizes the most important risks from the internal and external environment, prior to the military aggression of Russia against Ukraine, shows, overall, that these risks have become less severe during 2021 H2.

The map shows a lower level of risk from the overall macro-economic situation and in the activity of the real economy agents. Risks related to the activity of the banking sector remain at contained levels and moving downwards.

As of the end of 2021 H2, the Financial Stability Map showed a contained level of risk in the overall macroeconomic situation and in the activity of real economy agents. The risks related to the activity of the banking sector also remained at contained levels and mitigated. The indicators were assessed prior to the latest geopolitical and economic developments; therefore their performance will be monitored and reassessed accordingly. In more concrete terms:

A. In the overall economic environment:

I. Risk from the "domestic economy" has been rated as "moderate" and unchanged over a one-year period. The inflation rate and the need for external financing due to the expansion of current account deficit signalled higher levels of risk. Nonetheless, this effect was balanced by the stability of the output gap, the exchange rate, and the external debt stock.

II. Risk from the "external environment" has been assessed as "average" and moving downwards compared to the previous year. After the impact of the pandemic eased, the majority of our trading partners[3] recorded a regeneration of economic activity, as is confirmed by the positive performance of the warning index on the activity of the global economy, the OECD-CL[4]. The steep increase in the price of oil in international markets has not been sufficient to change the risk balance in this category.

B. The main real economy sectors show the following:

I. Risk from "enterprises" is assessed as "low," and has decreased from the previous year. In this category, the financial situation index and private sector expectations have improved significantly, and the credit portfolio to enterprises has also continued to improve.

II. Risk from "households" continues to be assessed as "average," and has maintained the level of the previous year. The rate of this category

[3] *The high figures of GDP growth have been partially driven by the effect of calculating based on a very low indicator recorded over the previous year.*

[4] *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 economic activity around its long term potential level.*

was affected by a decreasing pace of remittances and households' borrowing share, whereas the housing market, the unemployment rate, and households' expectations have maintained the same level of risk.

III. Risk from the "Government" continues to be assessed as "average," but moving somewhat downwards from the previous year. The main contributors to this development are the size of budget deficit to GDP and the improved performance of tax revenues.

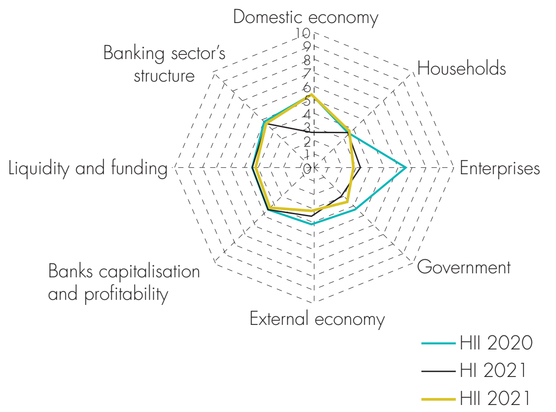
C. At the end of the period, the banking sector's activity shows the following:

I. Risk from "capitalisation and profitability" has been assessed as "average," unchanged compared to the previous year. An increase in the interest income of the banking sector and a fall in non-performing loans both contributed to maintaining low levels of risk.

II. Risk from "liquidity and funding" continued to be assessed as "average," with a slight downward trend during the year. An increase in domestic deposits balanced the risk related to the slight expansion of non-resident funding, while other indicators have remained almost unchanged.

III. The risk associated with the "banking sector structure" has been assessed as "average," moving slightly downward compared to the previous year. The increase in the level of risk, which resulted from the increase of concentration in bank credit to enterprises, was balanced by a decrease in the risk related to the indicator of concentration of the banking sector's funding sources.

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.

1.2 SYSTEMIC RISK

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[5]. In 2021 H2, indicators suggested that financial stress remained the same during the period, while the systemic risk facing the financial system and the accumulated systemic risk recorded lower levels compared to previous periods. The improvement of credit quality and a fall in the unemployment rate affected mitigation of materialised risk. Meanwhile, improvement of domestic and

The aggregate indicators of the materialisation and accumulation of systemic risks declined during the period.

Prior to the military aggression of Russia against Ukraine, based on economic performance and credit quality, risks by the banking sector were perceived to be moving downwards, despite increasing concerns of inflation risk.

As the aggression continues, banks assess that the risk on the macroeconomic framework and their activity will increase.

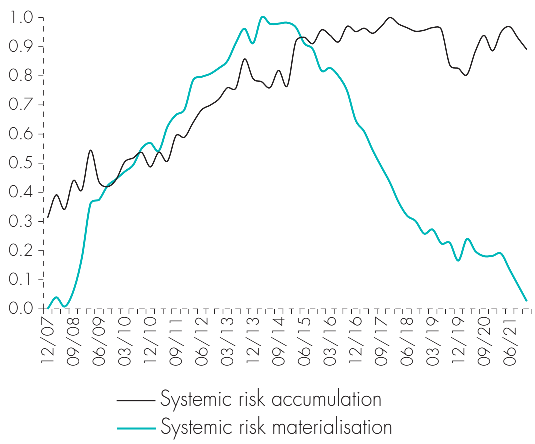
[5] *Banking sector perception related to main systemic risks in Albania is attained through an ad hoc survey.*

foreign debt and the quality of credit unhedged from the exchange rate risk, affected mitigation of accumulated systemic risk.

1.2.1 DEVELOPMENTS IN SYSTEMIC RISK INDICATORS

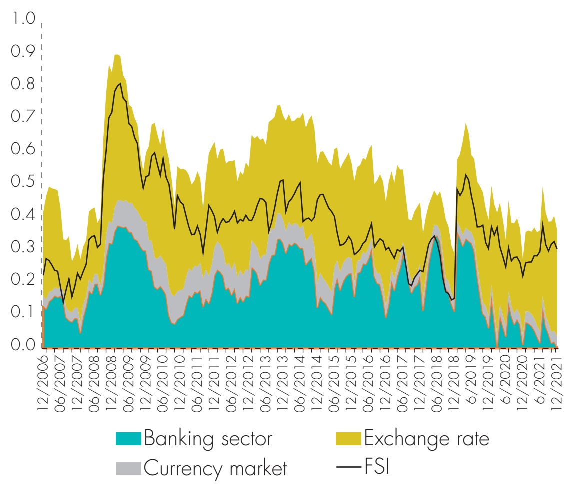
During 2021 H2, the accumulation index and the materialisation index of systemic risk fell compared to the end of the previous year. The performance of the accumulation index of systemic risk was driven by a decline in the portfolio of credit unhedged from exchange rate risk, as well as the relative improvement recorded by public debt, external debt, and current account indicators[6]. The materialisation index was affected by the improvement of credit quality, a fall in unemployment, and the exchange rate stability of the domestic currency. Given the method of construction and the phenomena that each risk indicator aims to reach, it is expected that in the future the materialization index will reflect the decline observed in the accumulation index of systemic risk. The financial stress index remained unchanged during the period. The growth of deposit and credit at a higher pace from the long-term trend, show that banking activity is free from important concerns. In the money market, a calm liquidity situation is reflected in the slight contraction of the spread of the overnight interest rate for interbank transactions. During the period, exchange rate fluctuations made a small positive contribution to an increase in the financial stress index.

Chart 2 Indices of accumulation and materialisation of systemic risk



Source: Bank of Albania.

Chart 3 Financial Stress Index



Source: Bank of Albania.

1.2.2 THE PERCEPTION OF THE BANKING SECTOR ON SYSTEMIC RISK

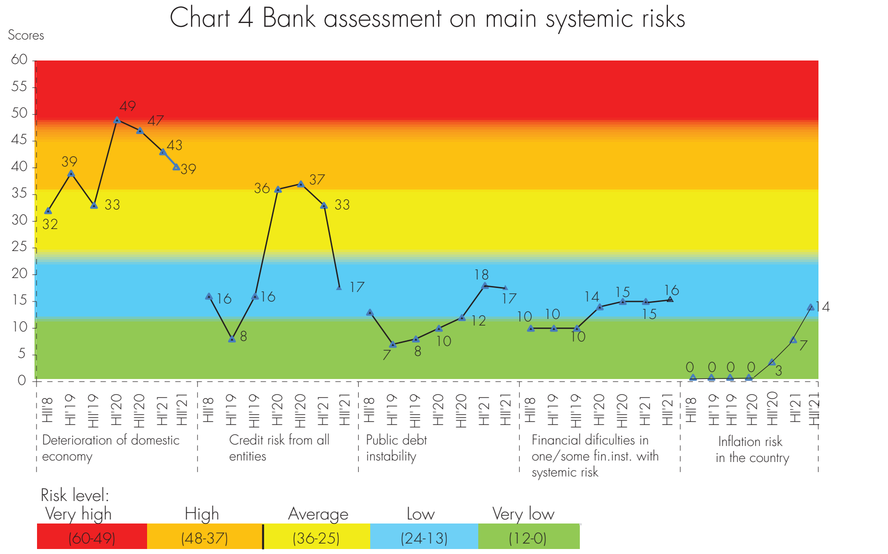
Survey results on the perception of the banking sector regarding systemic risk in Albania, carried out prior to the beginning of the military aggression of Russia

[6] *Debt and current account indicators to GDP improved, because GDP growth in relation to these indicators was higher.*

against Ukraine, suggest that the easing of the pandemic situation and the recovery of economic activity within the country and abroad have contributed to mitigating the overall perception of the banking sector towards systemic risks in 2021 H2. Although "deterioration of the domestic economy" risk and "credit risk from all categories of clients," remain classified as the two main systemic risks by banks in Albania, they are assessed as having decreased during the period. On the other hand, the expansion of the public debt to GDP ratio, affected by the cost of managing the pandemic, remains an important risk due to the potential consequences of the measures that might return it to previous levels. Banks have identified a new risk during the period, inflation risk, which was considered minimal up until now. In the latter months of 2021, supply and market chain disruptions throughout the world as a result of the pandemic, have significantly intensified upward pressures on prices, both within Albania and abroad. These developments seem to have increased banks' unease on this risk and the potential consequences of price rises on various sectors of the economy.

Banks' trust in the stability of the financial system appears stronger compared with the first half of the year and the previous year, and the trust indicator has returned to pre-pandemic levels. This trust remains satisfactory and appears to be increasing both on the short-term horizon (up to one year), as well as the medium-term future (up to three years). Despite the challenges that characterised the domestic and external environment over the past two years, the banking sector deems that the financial system in Albania continues to be well-capitalised and capable to absorb possible losses from crises. A higher level of trust during the second half of the year shows that, despite the return of infection waves with new Covid-19 variants at year-end, the negative effects of the pandemic on the economy and the financial system in Albania, were contained and have been decreasing during the period.

Chart 4 Bank assessment on main systemic risks



Source: Bank of Albania.

In March 2022, the Bank of Albania conducted a special survey[7] in the framework of gathering banks' assessments on the way the economic situation will be affected by the war in Ukraine and sanctions imposed on Russia. Results show that banks have made the assessment that the war in Ukraine and sanctions on Russia will have an impact on the Albanian economy, mainly in the form of suppressing economic growth, increasing inflation, a higher budget deficit, and a deterioration of the trade balance, for a period beyond 2022. The most negatively exposed economic sectors are energy, grains, construction, and tourism. In the banking sector, the deterioration of the quality of credit portfolio is expected to be hit the hardest and may extend beyond 2022. Banks also show high vulnerability toward the possibility of breaches in cyber security. Overall, the impact is not expected to substantially hit the liquidity and capital indicators. Banks are monitoring the performance of the situation and are expected to conduct more concrete surveys in the near future.

[7] *Refer to Annex I for more details.*

2. MACROECONOMIC AND SECTORAL DEVELOPMENTS

2.1 INTERNATIONAL ECONOMIC AND FINANCIAL DEVELOPMENTS

Global economic activity continued to recover during the period, at a slower pace, with differences between regions. Positive developments in the Euro area and the Western Balkans region were driven by a stronger internal demand.

An upsurge in energy prices and supply-side shocks engendered inflationary pressures and heightened the interest rates of central banks. Financial conditions tightened and market volatility increased.

The military aggression of Russia against Ukraine and economic sanctions on Russia were accompanied by a rise in prices and food, causing major economic and financial consequences. The degree of uncertainty regarding the course of this war and its implications on the economy and beyond, remain high. In the short run, it is expected to further decelerate economic growth worldwide, including our region.

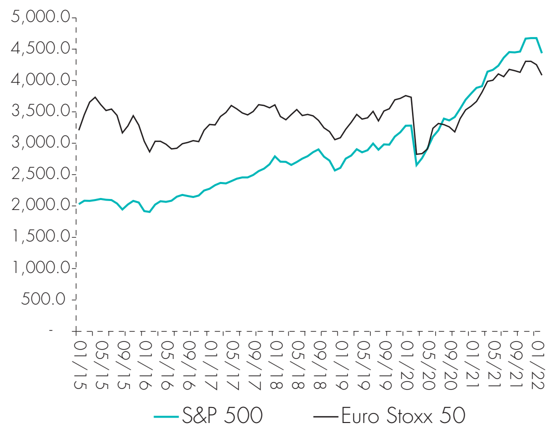
Although the Covid-19 pandemic continues, global economic activity has been normalising during 2021 H2, at a slower pace than expectations and with varying levels of performance between regions. Growth is being driven by a recovery in the services sector and consumption, after the restrictive measures of the pandemic were eased in the summer months. On the other hand, the expansion of production and trade ebbed due to a return of infections with the Omikron variant at year-end, and the intensification of supply-chain issues. Management of the pandemic and the continuation of accommodative financial and fiscal policies were the main contributors to economic recovery of the regions, also causing discrepancies between them.

Easing of restrictive measures in advanced countries helped to normalise economic activity in the third quarter of the year, but the pace slowed down somewhat in the latter months of the year due to higher infection rates. In emerging regions, the economy was negatively impacted by absences in the job market due to anti-Covid measures, financial issues in the real estate sector in China, and the contraction of funding conditions in the market. Inflationary pressures increased substantially around the world in the second half of the year, impacted by higher energy prices and supply-chain disruptions, while global demand for goods and services is up. In developed regions, the inflation rate surpassed the historical average of past years, whereas in developing regions, the dynamics were different, though there was an upward trend in prices.

Financing conditions on a global scale remain stable, overall, and conducive to economic growth. However, worsening of the pandemic situation due to higher infections with the Omicron variant, higher inflationary pressures around the world, and the notification issued by the Federal Reserve in the USA to contract monetary policy, caused higher tensions in the financial markets of emerging countries. This was mirrored by an increase in interest rate volatility and a decrease in the securities market value, both in advanced and emerging economies. In the foreign exchange markets, the Euro depreciated against the major currencies (US dollar, Japanese Yen, Swiss Franc and British pound), during the period, reflecting the trend of the market to normalise more rapidly in relation to the monetary policy of the Federal Reserve and the Bank of England.

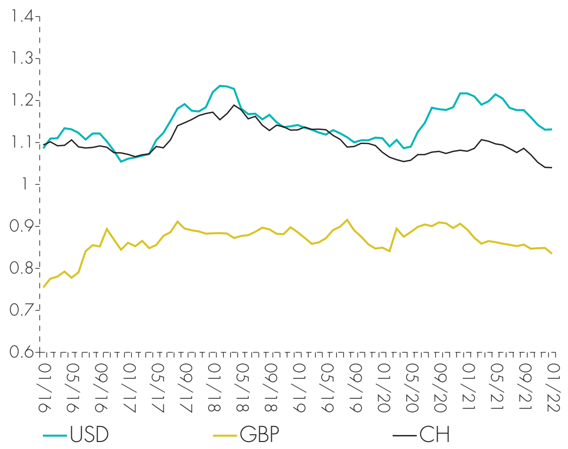
In commodities markets, the price of oil and its by-products continued to increase during the period, due to developments in demand and supply. The recovery of the global economy and the restart of international flights after removal of movement restrictions in the first half of the year significantly increased demand for oil and its by-products. On the other hand, production levels did not cover demand, causing a significant upsurge in prices. Metal and food prices followed a similar trend as they were affected by a stronger global demand and supply chain issues.

Chart 5 Main indices in stock markets



Source: ECB.

Chart 6 Euro exchange rate against major currencies



Source: ECB.

Up to January 2022, the short- and medium-term expectations of experts for the performance of global economic activity were generally positive[8]. The global economy was expected to expand at a stable pace, supported by a stronger demand for goods and services and programmes of fiscal support, particularly in advanced economies. In the first half of 2022, inflationary pressures were expected to be high, while in the second half, they were expected to normalise as the effect of temporary factors would wane. The short-term perspective remained largely affected by the dynamics of the pandemic, the resolution of obstructions to production and distribution chains, as well as the normalisation speed of the monetary policy of large central banks.

At the end of February 2022, the world was faced with the military aggression of Russia against Ukraine, the biggest armed conflict since World War II, and a serious challenge to the world order. In response, many economically developed and democratic countries have imposed heavy economic and financial sanctions on Russia, which include freezing banks' assets that are controlled by the state and a number of individuals, disconnecting some Russian banks from the international payments system Swift, and stopping the central bank of Russia from accessing a considerable part of its foreign reserve. Although both Russia and Ukraine account for less than 2% of the global economy, they have quite an important share as producers of oil and gas, grains and fertilizers, and minerals. As a result, the prices of these products have considerably increased

8 The IMF forecasts that the global economy will expand by 7.7% in 2022 and by 3.8% in 2023 (World Economic Outlook, update).

(by 20-40%) in global markets, exacerbating even further global inflationary developments. The shock is felt more acutely in markets which are dependent on Russian energy sources, such as Europe, or Russian grains, such as Africa. In addition to losses in human life and the drama of fleeing from home, this war is causing a rise in the cost of living and production, as well as a decline in consumption and investment. Most likely, these costs will remain high for at least one year, as many countries and regions have declared that they aim to reduce their dependency on Russian energy sources and to find alternative ones. The degree of uncertainty regarding the course of this war and its implications on the economy and beyond, remain high. In the short run, it is expected to further decelerate economic growth worldwide.

THE EURO AREA

In 2021 Q3, the economy of the Euro area grew by 2.3%, driven by stronger private consumption after the easing of restrictive measures in most Member States during the summer months, and the positive effect provided by accommodative financial and fiscal policies. On the other hand, higher infection rates with the Omikron variant, a rise in energy prices, and intensification of supply chain disruptions, caused slower growth rate in the region, at 0.3%, during the fourth quarter. In 2021, the GDP of the Euro area was assessed to have risen by 5.2%, after falling by 6.4% in 2020. Developments in the labour market were positive, affected also by the supportive effect of governments' schemes to safeguard jobs. The unemployment rate in the Euro area was 7% at the end of 2021. On the other hand, the return of the economy to full capacity is expected to support the rate of wages and employment. Inflationary pressures continued to rise and the inflation rate was at its record high of 5% in December. This performance reflected a rise in energy prices at a global level, as well as higher domestic demand, while supply is inadequate due to global supply chain disruptions. Against this backdrop, the European Central Bank (ECB) maintained its accommodative stance, supporting the financial sector and the economy with liquidity, through quantitative easing actions and other non-conventional instruments. In the banking sector, lending to the private sector continued to grow at a stable pace, standing at 4% at the end of the year, underpinned by favourable financing conditions and positive economic performance. Survey results on bank lending in the Euro area show that lending conditions remain overall unchanged, while credit demand from enterprises and households has increased.

According to ECB predictions for February[9], economic recovery in the Euro area is expected to remain on a stable trajectory, underpinned by further strengthening of domestic and external demand, improvement in labour market conditions, and the continuation of accommodative fiscal and monetary policies. After the eruption of the armed conflict in Ukraine, and EU involvement in providing aid and accommodation to fleeing Ukrainians, as well as strong sanctions imposed on Russia, these predictions will need to be re-evaluated. The situation is expected to decelerate economic activity as energy prices will go up, trust will fall, financial

[9] *Economic Bulletin of the European Central Bank, February 2022.*

markets will be hit hard, and trade channels will be damaged along with other impacts. But, the degree of impact is hard to assess. The ECB and other European institutions have stated their availability to adopt necessary policies in order to support economic and financial stability in the region.

Table 1 Selected macroeconomic indicators for the U.S, the euro area, and selected member countries

	GDP changes (annual %)			Inflation (annual %)		Unemployment (annual %)		Government debt (% of GDP)	
	2021*	Q3' 20**	Q4' 19**	Sept' 21	Dec' 21	Sept' 21	Dec' 21	Q2'21	Q3'21
USA	5.9	4.9(0.6)	5.6(1.7)	5.4	7.0	4.7	3.9	125.4	122.5
Euro area	5.2	4.0(2.3)	4.6(0.3)	3.4	5.0	7.4	7.0	98.3	97.7
Germany	2.7	2.9(1.7)	1.8(-0.3)	4.1	5.7	3.3	3.2	69.7	69.4
France	6.7	3.5(3.1)	5.4(0.7)	2.7	3.4	7.7	7.4	114.5	116.0
Italy	6.2	3.9(2.5)	6.2(0.6)	2.9	4.2	9.1	9.0	156.4	155.3
Greece	:	11.4(2.0)	7.7(0.4)	1.9	4.4	13.2	12.7	207.3	200.7

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

THE WESTERN BALKANS

The Western Balkan economies continued to recover in 2021 Q2 and Q3 as economic growth was recorded at 14.5% and 8.6%, respectively. In addition to the comparative base effect, which was waning at the end of the year, growth is broadly underpinned by the strengthening of internal and external demand, after the mitigation of restrictive measures and a restart in the activity of the sectors most affected by the pandemic. In the same vein as stable economic performance, developments in the labour market were positive and levels of unemployment fell in most countries of the region. In the external sector, pressures on the current account balance continued to be mitigated, supported by a rebound in the export of goods and services and a significant increase in remittances. The current account deficit fell to 3.9% of GDP at the regional level by the end of the year, recording the lowest value in the last decade. Economic recovery led to an increase of budget revenues and a contraction of fiscal deficit, and some of the countries reduced public debt to GDP. Inflationary pressures increased considerably in the latter months of the year, due to the global upsurge in energy prices and food products. The central banks of the region notified the public about the possibility of higher interest rates following economic recovery and inflationary pressures.

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 %)	
	Q2'21	Q3'21	2021p	2022p	Q2'21	Q3'21	Q3'21	Q4'21*	Q3'21	Q4'21
Bosnia and Herzegovina	12.1	8.4	:	:	18.1	16.4	2.4	3.2	5.5	:
North Macedonia	13.4	3.0	3.7	3.9	15.9	15.7	5.8	7.6	3.5	3.1
Montenegro	19.0	25.8	7.1	6.4	17.3	15.0	8.5	7.1	5.6	6.0
Kosovo	16.8	14.5	:	:	:	:	12.1	14.7	2.2	2.2
Serbia	13.7	7.7	5.3	4.3	11.1	10.5	7.9	8.9	3.6	3.6
Albania**	18.4	7.0	4.0	3.7	12.1	11.6	7.4	10.2	6.5	5.6

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

In the banking sector, lending to the private sector continued to expand in annual terms, driven by the recovery of economic activity and the continuation of some supportive regulatory measures. In most countries of the region, credit to households increased at a faster pace than credit to enterprises. Balance sheets in countries of the region have improved overall. The non-performing loans ratio fell in Albania, Montenegro, Bosnia and Herzegovina, and has remained unchanged in the rest of the region. Nonetheless, it is thought that this indicator has not yet fully reflected the financial effect of the pandemic and the regulatory facilitations undertaken by central banks during the previous year.

The region is sensitive to the war in Ukraine and sanctions against Russia. In addition to a general vulnerability to changes in the price of energy and food products, some countries are substantially more dependent on both the energy sector as well as tourism. The financial system of some of the countries rose to the occasion and acted rapidly to expel Russian investors from the banking market. Furthermore, the repercussions of the military aggression of Russia against Ukraine may engender a vulnerable security situation in some countries in the region. Overall, all the countries have acted to strengthen their security position, as well as mitigate the shocks against the economy and protect the most endangered groups in their societies. Inflationary pressures in the region will also remain high, whereas economic growth will slow down.

2.2 THE MACROECONOMIC ENVIRONMENT IN ALBANIA

The pace of economic growth remained high during the period, despite deceleration. Economic recovery was supported by a broad range of factors. Freedom from strongly restrictive measures related to the Covid-19 pandemic, an improved economic environment, increased trust of agents, accommodative monetary and fiscal policies and preservation of macroeconomic stability, allowed Albanian consumption, investments, and exports to rapidly increase. Economic growth was accompanied by a fall in the unemployment rate, an increase in wages, and higher inflationary pressures. These developments caused the consumption price index to rise, after many years, above the target of the Bank of Albania. An upsurge of prices was exacerbated by the war in Ukraine and the sanctions imposed on Russia.

The pace of economic growth remained high during the period, despite deceleration. Economic growth was driven by many factors and was broadly-based. It was accompanied by a lower unemployment rate and higher inflationary pressures, which worsened after the outbreak of military conflict in Ukraine and the sanctions imposed on Russia.

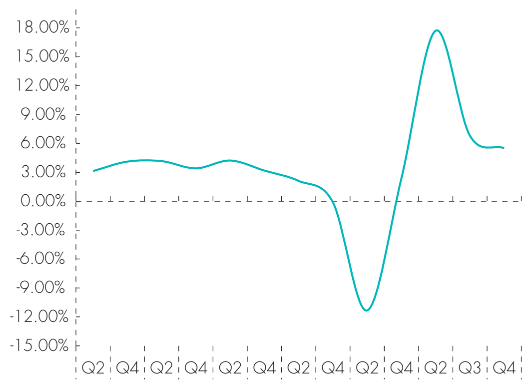
Fiscal and monetary policies reacted in response to these developments. The challenging situation facing the economy requires the coordination of economic policies in the shorter run, whereas in the long run, it is necessary to undertake structural reforms.

THE REAL SECTOR

After the 4.3% growth in the first quarter of year, the recovery of the Albanian economy accelerated significantly in the second quarter, during which the GDP grew by 17.7% in annual terms. After growing by 7% in the third quarter, the growth continued to be positive in the fourth quarter, but the annual growth pace decelerated to 5.5%. All spending categories continued to increase during the period, exceeding the low comparative base effect related to the out-of-the-ordinary developments of 2020. The increase in households' consumption and investment was higher compared to the previous quarter and the same period in the previous year. Government spending continued to rise in the fourth quarter as well, maintaining the high rates seen in the first half of the year. The high annual growth in the export of goods and services was accompanied by a recovery in imports.

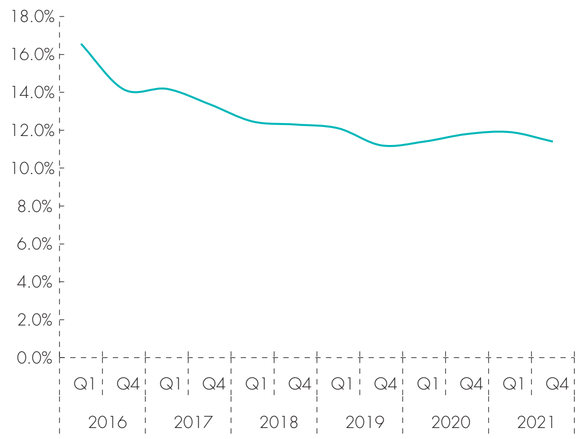
Production data by sectors show that growth was registered in the main sectors: construction (+16%), trade, transportation and accommodation (+6%). The services sector also expanded its activities during the year, particularly real estate (+12%), communication (+6%), and financial and insurance services (+2%). The economic sensitivity indicator, when assessed at the end of the year, was higher in comparison to the end of the previous quarter, but the increase slowed down against the previous quarters of the year. At the end of 2021, this indicator stood above the historical average and reflected an improvement in consumers' confidence and in the sectors of industry, services and trade. The military conflict against Ukraine and sanctions on Russia are expected to negatively affect the real economy sector through lower consumer demand, higher costs of production, and potentially lower investment.

Chart 7 Annual GDP growth



Source. INSTAT.

Chart 8 Unemployment rate



Source: INSTAT.

THE LABOUR MARKET

The labour market gave a recovery signal in the second half of 2021, after deterioration in the first quarter. Employment increased by 2.7% in annual terms, driving the unemployment rate to fall from 11.9% in the first quarter, to 11.4% in the last quarter of the year. Unemployment of youth (aged 15-29 years old) fell to 20.6%, or by 1.1 p.p., compared to 2020 Q4, recording the lowest value since 2017. The recovery of the labour market was driven by a rise in employment in the industry sector (7.5%) and in the services sector (7.2%) during the period. Wage increase[10] continued to accelerate, standing at 8.4% in annual terms, in the fourth quarter, with a joint contribution from the private sector (8.2%) and the public sector (4.1%). Within the private sector, wages

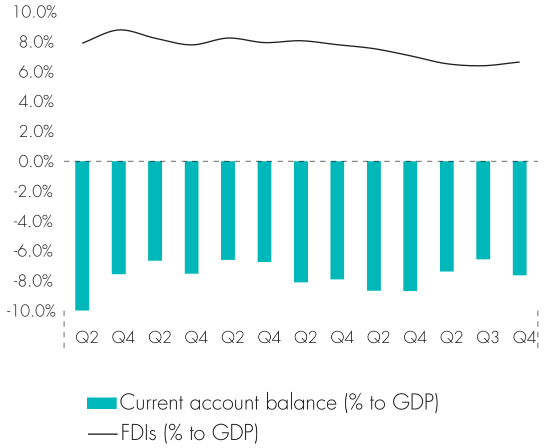
[10] *It refers to the average gross wage.*

increased across all sectors, but services recorded the highest rise. The increase of wages in the public sector was mainly due to higher wages for health workers and teachers. The improvement noticed in the labour market, is expected to decelerate depending on the scale of the real sector's vulnerability to the impact of geopolitical developments and their effects on international markets.

THE EXTERNAL SECTOR

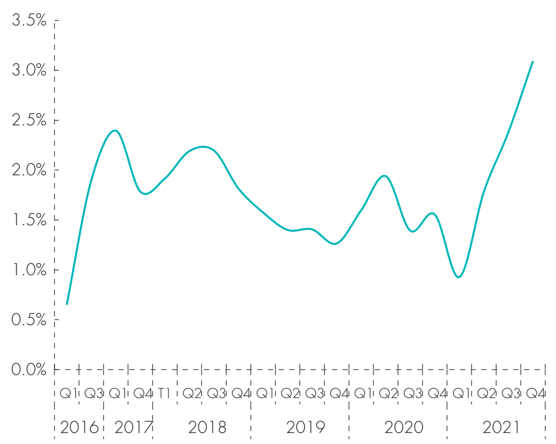
The external sector contribution to the economy was negative during the period, due to the significant expansion of the current account deficit in the balance of payments. The current account deficit reached 7.6% of GDP[11], recording EUR 546 million, or up by 56% compared to the previous year. Its deterioration in annual terms was driven by a deepening of the trade deficit in goods and a tightening of the positive balance of secondary income. Exports of services recovered, mainly as a result of travel during the summer season, putting an end to their one-year contraction and, together with the recovery of transportation transactions, these enabled mitigation of the current account deficit. The increase in exports was also underpinned by an upswing in the international prices of fuels and base metals. On the other hand, the trade deficit in goods deepened by around 39% in annual terms, reaching EUR 1,224 million. This development was driven by an increase in the import of fuels such as "energy and oil" and higher importing expenses for "machines and equipment" and "transportation equipment," driven by developments in the construction sector.

Chart 9 Current account and Foreign Direct Investments



Source: Bank of Albania and INSTAT.

Chart 10 Annual change in Consumer Price Index



Source: INSTAT.

Foreign exchange assets in the form of remittances are estimated at around EUR 222 million, with an annual growth of 9%. Meanwhile, the flow of direct foreign investment is estimated at EUR 302 million, with an annual increase of around 22%. At the end of the period, foreign reserve assets were sufficient to cover 8.8 months of imports in goods and services.

[11] *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.*

BOX 1 SOME INDICATORS FOR EVALUATING THE IMPACT OF THE MILITARY AGGRESSION IN UKRAINE AND SANCTIONS ON RUSSIA, ON THE TRADE ACTIVITY OF ALBANIA

Both direct and indirect elements shall be evaluated in order to estimate the impact on the Albanian economy of the military conflict in Ukraine. At the end of 2021, the trade activity between Albania and these two countries (import and exports of goods and service), is estimated at around 1.5% of the total value of imports and exports. The ratio of imports and exports from these two countries to total imports and exports was around 2.5%, for goods alone. For services, the ratio was 0.2%. Overall, the trade activity with Ukraine and Russia was low.*

The direct exposure of the Albanian economy to Russia and Ukraine, in the form of exports to these two countries, was almost insignificant. Albania mainly exports agricultural products, minerals and tourism services to these countries and has minimal financial exposure. Goods are usually exported to Ukraine, but the value of Albania's exposure to these two countries was insignificant. With regard to export of services, taking into account 2019 as the best year (for exporting tourism services), the values between the two countries are more balanced, but they do not go beyond 1% of the total value of exported services, or 2% of the value of exported travel services. Therefore, the potentially lost values due to the conflict are not important, and it is possible that these volumes are attracted from other markets.

The indirect effect on Albania in relation to imports from these two countries was more apparent, albeit not critical. More concretely, import of goods from Russia and Ukraine, at the end of 2021, accounted for around 3% of the total value of import of goods. The value of imports from Russia was around 4 times higher than that of imports from Ukraine, and according to importance this was concentrated on grains and plant-based products, combustible liquids (fuels), base metals and chemical industry products (fertilizers). The import of fuels and minerals, and the import of grains and plant-based products accounted for 4.1% and 41%, respectively, of the total imports in our country during 2021. The import of these goods from Ukraine was minor. Ukraine exports mostly base metals and fats and less grains and plant-based products.

When taking into account the specific shares of the main imported items from these two countries, it has been assessed that the impact in our country in terms of prices and supply, was mainly related to the international market conjecture (price movements) when considering combustible liquids (fuels). With regard to grains and plant-based products, or base metals, the effect of the military aggression in Ukraine and sanctions imposed on Russia was more direct.

** The data on the trade of services by countries are from the end of 2020, since these statistics are published later than the general statistics of balance of payments.*

MONETARY DEVELOPMENTS

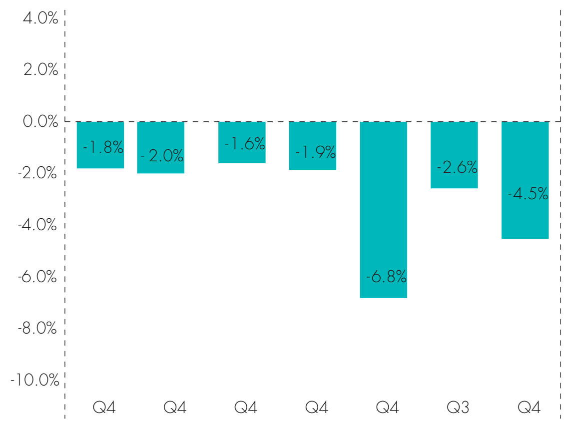
In December 2021, the Bank of Albania reconfirmed its accommodative monetary policy stance, maintaining an unchanged policy rate, at its lowest historical level of 0.5%. The inflation rate in Albania increased rapidly, reaching 3.7% in December. The expectation for rising inflation was driven by increases in demand, employment, and wages. In the last quarter of the year, inflation performance mainly reflected a steep upsurge in the prices of goods, oil, and energy in the global markets. The supply-side effects of this shock are expected to keep inflation above target during the following period. The appreciation of the national currency against the euro also continued in the fourth quarter, during which time the lek strengthened by 2.4% in annual terms and 0.6% in quarterly terms. In response to the situation created by the COVID-19 pandemic, the Bank of Albania continued to intervene in the money market through weekly unlimited injection auctions, aiming to maintain an adequate liquidity situation for commercial banks. The impact of the war in Ukraine and sanctions placed on Russia has exacerbated inflationary pressures and has demanded a review of the inflationary performance projections in Albania. According to the latest projections, the inflation rate will be above the Bank of Albania's target during 2022, requiring a somewhat tightened monetary policy. On 23 March 2022, the Bank of Albania increased the policy rate by 0.5 percentage points, to 1%. Even at the new level, monetary conditions are assessed to be overall accommodative.

FISCAL DEVELOPMENTS

The fiscal policy also remained accommodative in the second half of 2021, maintaining the same approach as in the previous year. In December 2021, the fiscal deficit reached ALL 90 billion, down by ALL 25 billion from the same period in the previous year. The deficit tightened as a result of the strong annual recovery of income (20%), mainly due to the base effect, but also thanks to a good performance across all income categories. Expenditures increased by 11% in annual terms. They were mainly expenditures for investments and reconstruction after the earthquake, but also on health and social insurance. Fiscal administration needs to pay attention to the fairer distribution of planned expenditures throughout the year, particularly those related to investment. The budget deficit is financed mostly through foreign rather than domestic borrowing.

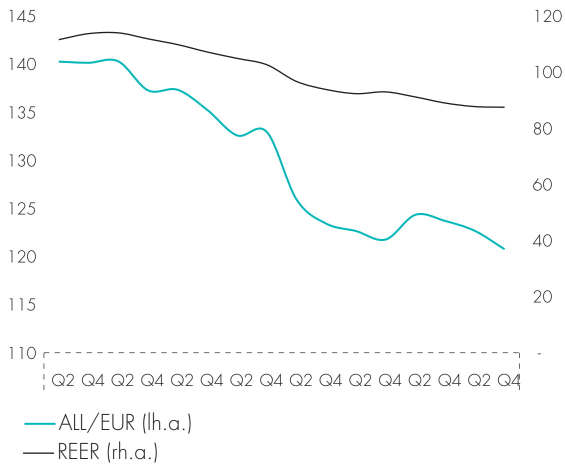
The war in Ukraine and sanctions imposed on Russia have been accompanied by higher inflationary pressures and production costs in the economy, mainly due to an increase in the cost of energy, food, and metals. These developments are expected to negatively affect consumer demand and private investments. At the same time, the situation being faced by hydro-electric power plants has caused a decrease in the production of electrical energy within the year, and an increase in the volume of imports, with exorbitant prices, following the conditions of international stock markets. Under these circumstances, the fiscal policy of the Bank of Albania has re-oriented a portion of income and expenses towards higher priority needs, including provision of assistance for the most vulnerable members of society, to face this shock. International developments and meeting energy needs will most likely remain consequential challenges to the performance of the economy in Albania throughout the year. The ability to withstand them will also identify the importance of good fiscal management and the coordination of economic and financial policies in the short run, as well as the need for deeper reforms in the field of alternative energy and food sources, in the longer run.

Chart 11 Budget deficit performance in terms of GDP



Source: Bank of Albania and INSTAT.

Chart 12 Performance of foreign exchange rate



Source: Bank of Albania.

The Albanian economy, overall, had a net borrower position (debtor) in relation to the rest of the world. The sector of enterprises and the General Government provided the main contribution to this position. The households' sector had a net creditor position, while financial institutions have a balanced net position.

During the period, the stronger growth of deposits compared to credit has caused households' creditor position to expand and enterprises' debtor position to contract.

Households have a balanced structure of deposits and loans between lek and foreign currency. The enterprise sector has a preference for foreign currency.

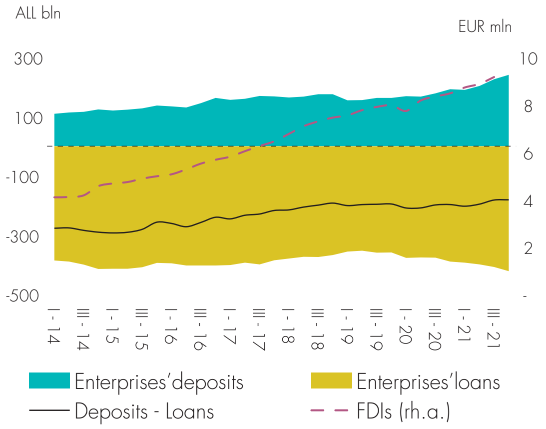
2.3 FINANCIAL POSITION OF THE ECONOMY, HOUSEHOLDS AND ENTERPRISES

The domestic economy was a net borrower compared to the rest of the world, since its financial liabilities exceeded its financial assets. The net position of the economy is determined by: a) the positive net position of households (family economies); b) the negative net position of enterprises (non-financial corporations) and that of the General Government; and c) the balanced position between the assets and liabilities of financial corporations (financial institutions).

In the Albanian economy, households are the biggest creditor sector, while enterprises are the biggest debtor sector. The financial assets of households and enterprises account for 33% and 21%, respectively, of the total assets of the economy, which recorded ALL 6, 500 billion at the end of 2020. With regard to liabilities, enterprises account for 45% of the total financial liabilities in the economy, which amounted to ALL 7,400 billion at the end of 2020, while the share of households' obligations was almost insignificant.

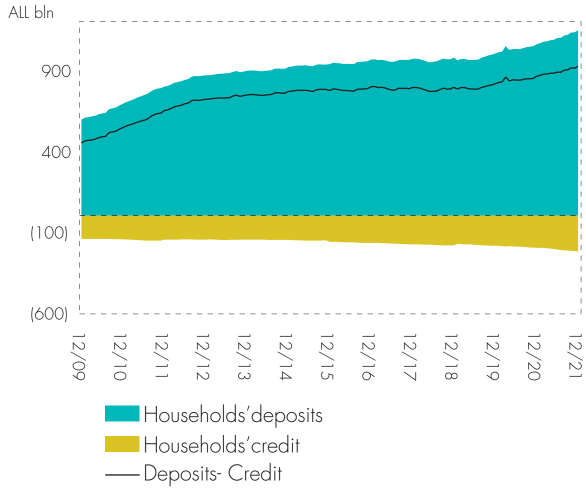
During the period, households' creditor position continued to expand, while enterprises' debtor position recorded a slight contraction. The performance of both these sectors was driven by a steep growth of deposits compared to that of credit.

Chart 13 Deposits and enterprises credit (lh.a.) and foreign direct investment stock (rh.a.)



Source: Bank of Albania.

Chart 14 Deposits and households' credit



Source: Bank of Albania.

By currency, it is noted that households had a balanced structure of deposits and loans between lek and foreign currency. Enterprises showed a clear preference for foreign currency, as they continued to attract financing from other parts of the world in the form of direct foreign investment. The growth in direct investment stock over the first 9 months of 2021 was higher compared to the growth of investment during the same period of the previous two years.

2.3.1 HOUSEHOLDS' FINANCIAL AND BORROWING SITUATION

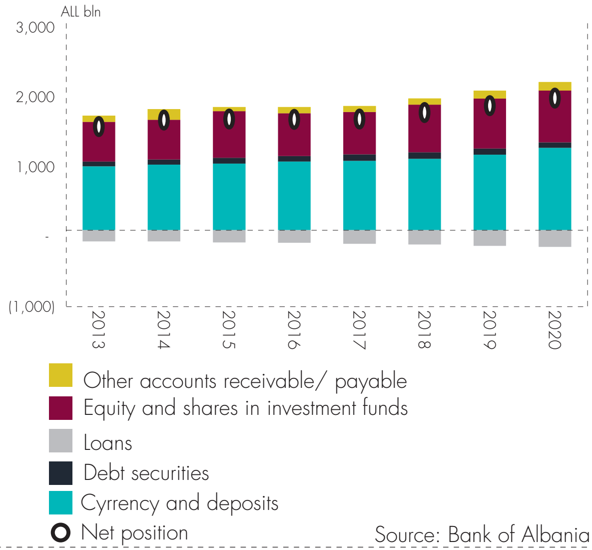
FINANCIAL POSITION OF HOUSEHOLDS

The households' sector was a net creditor sector with investments concentrated on business capital and deposits held in the domestic banking sector. On the other hand, this sector's exposure as a debtor is quite limited compared to its own financial assets; the exposure being in the form of loans by resident financial institutions. Households' financial assets, which registered ALL 2,100 billion at the end of 2020, were almost 9 times as high as their financial liabilities of ALL 250 billion. In 2017-2020, households' net position significantly expanded, driven mainly by an increase in assets (claims) in the form of deposits and business capital holdings. More than half of households' financial assets (around 55%) consisted of bank deposits, whereas 35% was held in the form of business capital and households' shares in investment funds. Investments in government debt securities and other current accounts were 4% and 6%, respectively, of households' financial assets, whereas "Loans" and "Insurance and pension schemes" accounted for an insignificant share.

Households' obligations were almost entirely represented by resident financial institutions' loans, and their growth rate was slower compared to the growth of claims.

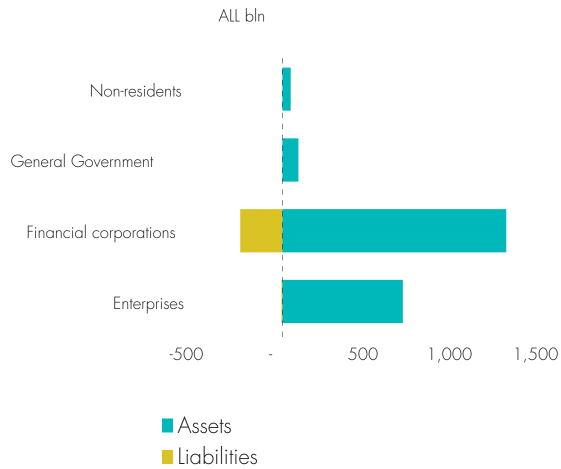
As counterparty, the sector of financial corporations has the largest liabilities to households. These liabilities were around ALL 1,300 billion at the end of 2020, and they represented 55% of financial corporations' total liabilities. They consisted of current accounts and time and demand deposits, in lek and foreign currency. Enterprises made up the second biggest sector with the largest liabilities to households. At the end of 2020, enterprises' liabilities to households were ALL 700 billion, or 20% of the total liabilities of enterprises. The general government's liabilities to households in the form of debt securities registered ALL 80 billion at the end of 2020, shrinking by ALL 20 billion in the last two years. As a ratio to total investments of the Albanian economy in debt securities[12], the sector of households owns around 7% of the total. In 2017, households held around 16% of the stock of debt securities issued by the general government; however this ratio fell to 11% by the end of 2020.

Chart 15 Households' net position by instrument



Source: Bank of Albania.

Chart 16 Households' assets and liabilities by counterparty sectors (2020)



Source: Bank of Albania.

In 2021, the households sector further expanded its net creditor position, since deposits and loans with resident banks, which represent the most of financial assets and liabilities of households, grew by ALL 90 billion and ALL 25 billion, respectively. In 2021 H2, they grew by ALL 50 billion and ALL 10 billion, respectively.

[12] *Here are included securities issued by resident and non-resident entities.*

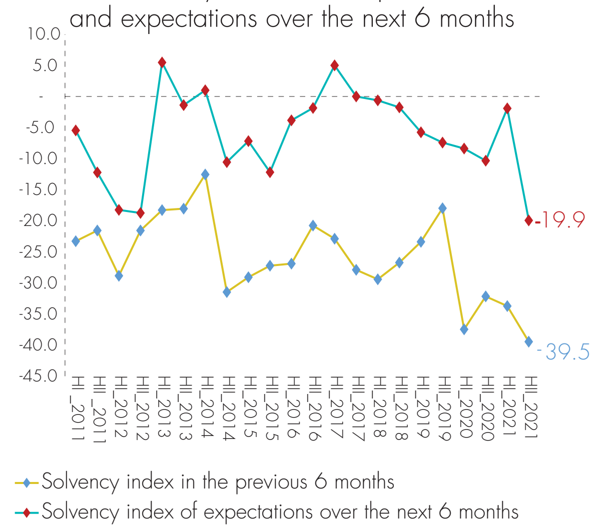
HOUSEHOLDS' BORROWING AND SOLVENCY

The share of households that have a loan to pay to the total number of surveyed households did not record significant changes compared to 2021. Households' solvency was weaker during the period.

Households' credit demand is expected to recover somewhat during the first half of 2022, while the economic situation is not largely affected by the military conflict in Ukraine and sanctions on Russia.

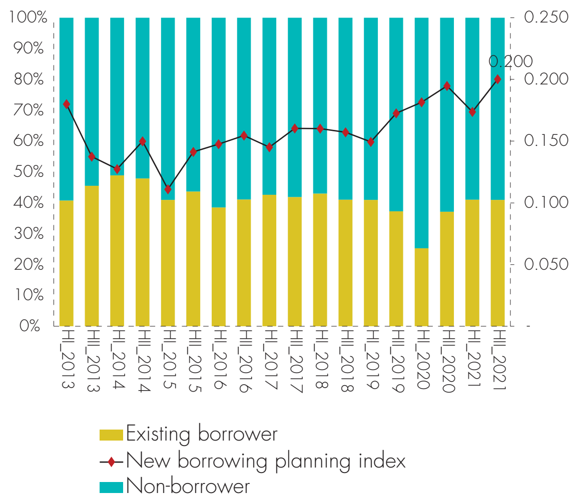
A regular survey is carried out to assess the financial situation of households, plus their debt use and debt burden[13]. Around 24% of responding households declared that they have at least one loan to pay at the time of the interview. This share increased slightly compared to the previous six months, remaining at the same level as the previous year and below the historical average of the indicator. Around 69% of households declared that loan payment accounted for less than 30% of their monthly income[14]. This index fell by 6 percentage points compared with the previous survey. Around 50% of borrowing households declared that their solvency "has not changed" during the period, while the rest reported in aggregate a decline in their solvency. This performance was also reflected in the deterioration of households' expectations regarding their solvency in the future. Around 70% of borrowing households do not expect their solvency to change in 2022 H1, while the net balance of the rest of responses was -20 percentage points, suggesting pessimistic expectations compared with the results of the previous six months and the previous year.
Around 55% of responding households declared that they "do not plan to borrow in the next six months." Meanwhile, 45% of them declared that they are considering the possibility of borrowing/re-borrowing at different safety scales[15]. This share went up compared to the previous six-months and the previous year, by 4.2 p.p. and 1.3 p.p., respectively. As a result, the borrowing

Chart 17 Solvency indices in the previous 6 months and expectations over the next 6 months



Source: Bank of Albania.

Chart 18 New borrowing planning/rollover index and households planning to borrow



Source: Bank of Albania.

13 The sample is selected and periodically reviewed by the Institute of Statistics based on the registrars used by the agency for households' questionnaires. The response scale to the survey was 88%. The survey was held prior to the economic shock related to the military conflict in Ukraine and the sanctions imposed on Russia.

14 "Up to 10% of income" for 29% of borrowing households, "10-30% of income" for 40% of households.

15 The given alternatives are: "little possibility", "a lot of possibilities" and "certain".

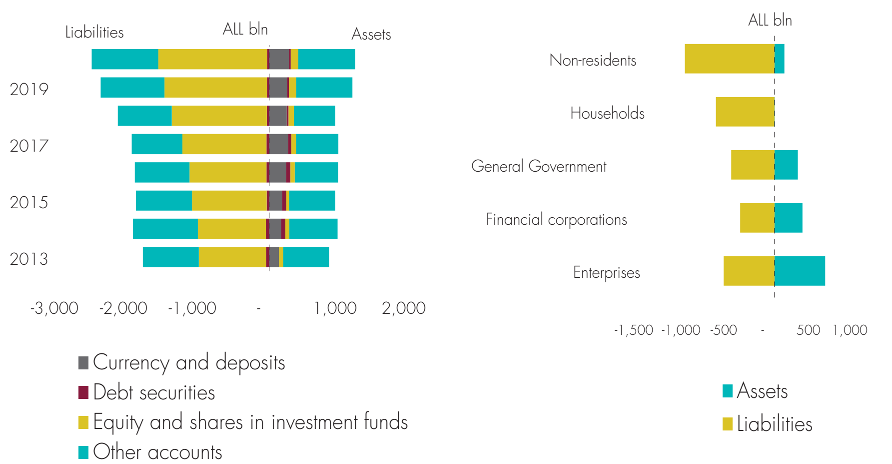
planning/rollover index"[16] stood at 0.20, moving upward from the previous surveys and the previous year. This may signal a rebound in households' loan demand during 2022 H1. In the group of households planning to take a new loan, 60% of them were "new borrowers", meaning that they did not have any debt to repay at the investment moment. This share remained unchanged compared to the previous six months.

2.3.2 ENTERPRISES' FINANCIAL AND BORROWING SITUATION

FINANCIAL POSITION OF ENTERPRISES

The sector of enterprises was the biggest net debtor in the economy. The assets and liabilities of this sector at the end of 2020 reached ALL 1,300 billion and ALL 3,300 billion, respectively. Meanwhile, in the 2014-2020 period, enterprises' debtor position expanded by around ALL 420 billion, mainly due to the increase of liabilities to the non-resident sector. In fact, around one-third of all financial liabilities of enterprises were to the non-resident sector (about ALL 1,100 billion), in the form of direct foreign investments in capital, while the second most important sector in funding enterprises was the households' sector (with around ALL 700 billion). The liabilities of enterprises to households were in the form of equity invested by households in the private sector's corporations. The exposure of enterprises to the general government was not very large in terms of size and as a ratio to total liabilities of enterprises, but it was significant as a ratio to the assets of the general government. This exposure was in the form of capital owned by the government in non-financial public corporations, as well as other accounts receivables to the government/payables to the private sector. As of end of 2020, enterprises' liabilities to the government amounted to ALL 500 billion. Enterprises' claims toward the government were mainly in the form of accounts payable to the government and receivable by enterprises.

Chart 19 Assets and liabilities of enterprises by instrument for 2013-2020 (left) and by counterparty sectors in 2020 (right)



Source: Bank of Albania.

[16] *The index is calculated as weighted average of % of responses for each alternative with relevant coefficients. To determine the coefficients, the interval 0-1 is separated in 4 option: 0 ("no possibility"), 0.33 ("little possibility"), 0.66 ("many possibilities") and 1 ("it is certain"). The index takes values from 0 to 1, where the nearest to 0 the index value results, the smaller is the chance to get a new loan, and the closest to 1, the higher the probability of getting a new loan in the next six months.*

Enterprises' exposure to financial corporations was relatively limited both in relation to assets and liabilities, but the overall position was in the negative since liabilities in the form of loans were larger than assets in the form of deposits. Liabilities were dominated by loans granted by banks and other resident financial institutions. At the end of 2020, these liabilities registered ALL 400 billion, accounting for 12% of the enterprises' overall liabilities. Enterprises' claims toward financial corporations were mainly in the form of deposits, and by the end of 2020, these claims stood at ALL 340 billion.

In terms of financial instruments, the dominant part of enterprises' assets (around 60%) was represented by account receivables or commercial loans and other claims to related sectors. Around 20% of the assets of enterprises were held in the form of bank deposits, mainly current accounts and demand deposits in foreign currency. The main liabilities of enterprises sprung from other sectors' participation in its equity, loans obtained from financial institutions, and other payable accounts. "Equity and investment funds shares" and "Loans" dominated net liabilities in this sector, as well.

On the side of financial claims or assets, the business sector concentrated its sources on funding the sector itself with commercial loans between corporations, on financial corporation sector (deposits), and on the general government sector (debt securities and other account receivables). During the first 9 months of 2021, the business sector contracted somewhat its debtor position to the financial corporation sector, since deposits of enterprises grew more than credit to this sector. At the same time, the direct foreign investment stock that was dominated by non-resident investments in the enterprises sector expanded by around EUR 40 million during the first 9 months of the year; a larger growth compared to the one registered in the first 9 months of the preceding two years.

ENTERPRISES'' BORROWING SITUATION AND SOLVENCY

For most of enterprises, the performance of sales and financial result improved compared to 2021 H1. The assessment of enterprises for investment growth and activity expansion continued to signal positive developments. The share of borrowing enterprises changed slightly during the year. The debt burden has been declining in relation to capital, but seems somewhat higher in relation to enterprises income.

Expectations for enterprises borrowing in the coming period seem somewhat higher. The survey on loan applications shows a total number lower than a year ago, but the rejection rate remained the same.

A special periodical survey conducted by the Institute of Statistics was used[17] to assess the use and debt burden of enterprises. 82% of total enterprises participated in the survey by fully or partially answering 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, but these were declining compared to the previous survey. Elements that became important for all sizes of enterprises during this period were "cost of production and labour" and "adequacy of applicable legislation", while the "availability of qualified staff" was identified as an important challenge by medium and large enterprises. The sales index reached the highest level of the last year, but did not reach the level of the pre-pandemic period. At the

[17] *The sample of 1,366 enterprises represents entities of different sizes spread geographically throughout the country and operating in the main sectors of the economy. The sample is selected, interviewed and periodically reviewed by the Institute of Statistics, based on the records used by the enterprise survey agency.*

sectorial level, the index increased for enterprises in the industry, services and trade sectors. Enterprises of all sizes reported an increase in the financial result. Small and medium-sized enterprises reported an increase in their financial result, after trending downward for three consecutive six-month periods. Large enterprises continued to declare a positive balance in their financial result, which increased significantly over the period. Expectations remain optimistic. During the period, about 60% of enterprises continued to finance their activity only through sales, and this ratio increased for all groups of enterprises by size.

About 42% of the total enterprises that responded to the questionnaire state that they currently have loans to pay. This ratio changed slightly over the year, increasing by 2 and 1 percentage points compared to six months and a year ago. About 78% of small borrowing enterprises, 83% of medium-sized enterprises and 82% of large ones, consider their level of borrowing suitable for financing activity. Borrowing was denominated in the domestic currency for 67% of small borrowing enterprises, 58% of medium-sized enterprises and 48% of large enterprises; while the rest was in foreign currency and/or combined.

The total value of loans was about half of the value of enterprise capital for about 77% of enterprises and almost the same as the value of capital for 12% of them, while 11% of them reported that the value of the loan exceeded that of capital. The "loan / capital" ratio was higher for medium-sized and large enterprises, as about 25% of them said that this ratio was equal to or exceeded the value of capital. During the period, this ratio increased only for large enterprises. The debt burden has been declining and was higher for service and construction companies.

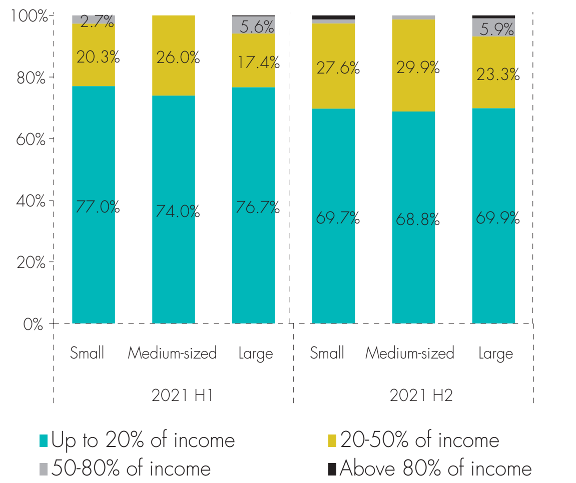
Table 3 Share of enterprises with an equal/higher value of debt to equity, by sectors

Share of enterprises with an equal/higher value of debt to equity, by sectors				
	Industry	Services	Construction	Trade
2020 H1	16.4%	22.9%	19.7%	22.2%
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%

Source: Bank of Albania.

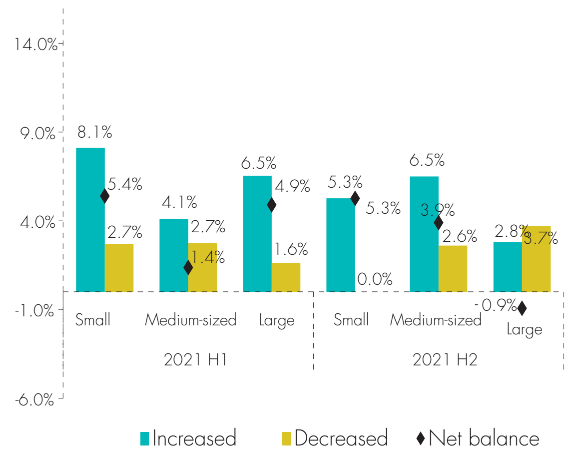
Most borrowing enterprises (70%) declared that loan repayment amounted to 20% of enterprise revenue. The share of these enterprises decreased by about 7 percentage points compared to the previous period. Asked whether the cost of debt servicing had changed over the period, over 90% of enterprises claimed that this expenditure remained unchanged.

Chart 20 Enterprises by size and debt instalment/income ratio



Source: Bank of Albania.

Chart 21 Enterprises that declared a change in the loan instalment during the period



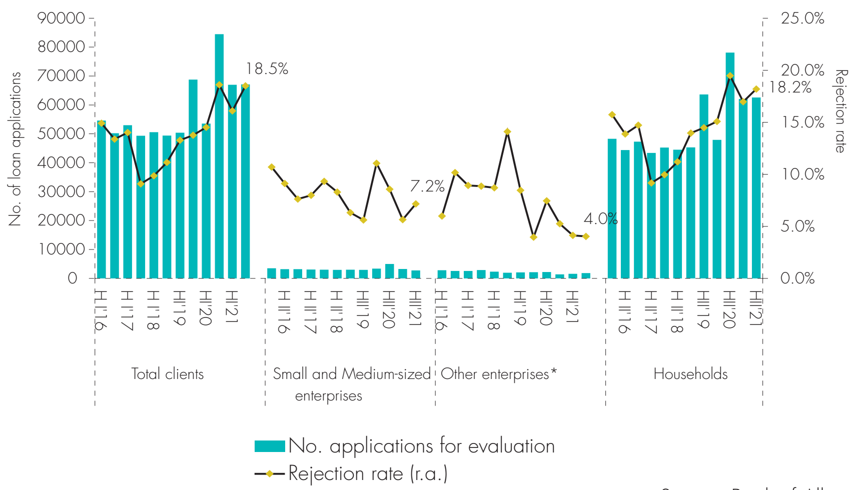
Source: Bank of Albania.

Regarding plans for borrowing in the next six-months, based on the response of enterprises, the assessment is that credit demand is expected to strengthen. Around 45% of responding enterprises declared that there is "no possibility" they will seek a loan during the next period. This weight decreased for all sizes of enterprises compared to the previous period. On the other hand, there was an increase in the weight of companies which claimed that "there is little chance" or "there are many chances" they will seek a loan in the first half of 2022. The borrowing planning rating index for the next six months increased slightly due to an increase in the index of small and large enterprises.

BOX 2 PERFORMANCE OF THE NUMBER OF LOAN APPLICATIONS AND THE REJECTION RATE BY BANKS IN THE COUNTRY, 2021 H2

During 2021 H2, banks reported that they considered a total of 67,126 loan applications, of which 7% belonged to the 'enterprise' sector (2,749 applications from 'small and medium-sized enterprises' and 1825 applications from' other enterprises '), and 93% belonged to the 'households sector (62,552 applications). This structure marked a slight shift in favour of 'households', compared to the previous year.

Chart 22 Number of evaluated applications and rejection rate analysis



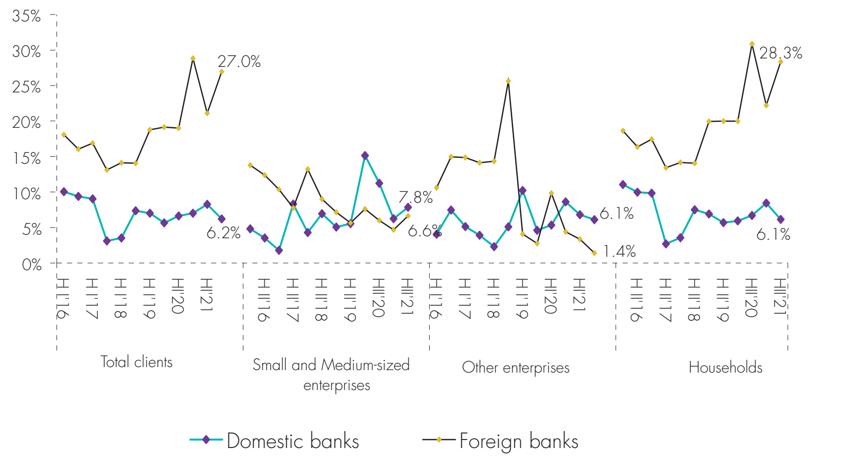
Source: Bank of Albania.

The total number of loan applications reviewed by banks showed a very slight increase compared to the previous six months, but it decreased by about 21% compared to the previous year. The decline in annual terms came from the segment of 'small and medium-sized enterprises' and 'households', while the number of applications reviewed by the category 'other enterprises' where large enterprises predominate, increased. In the total number of applications under review during the period, about 18.5% of them were rejected by banks. This rate increased compared to the previous six months (by 2.4 pp), but decreased slightly compared to the previous year and this decrease was observed in all segments of customers.

During 2021 H2, the total rate of rejection of loan applications by banks with domestic capital decreased to 6.2% (from 8.3% in the previous six-months), while for banks with foreign capital this rate increased to 27% (from 21.1% reported in the previous six- months). According to the segments of customers, foreign banks remained more inclined to lend to the enterprise segment, especially large enterprises, and the rejection rate for this group of enterprises has dropped significantly over the last two years. On the other hand, the rejection rate against the 'households' segment increased for the group of foreign banks and decreased for the group of banks with domestic capital.

In general, it can be concluded that the performance of the number of applications reviewed by banks during the second half of 2021, shows a moderate increase in demand for credit (in annual terms) from both the household sector and from the enterprises sector, but with a slight upward trend during the year. On the other hand, the easing of containment measures due to the pandemic and the *recovery of economic activity in the country after the affected sectors went back to business has continued to positively affect the lending trend of banks, especially to the group of large enterprises.*

Chart 23 Rejection rate of loans, by domestic and foreign banks



Source: Bank of Albania.

3. MARKETS AND PAYMENT SYSTEMS

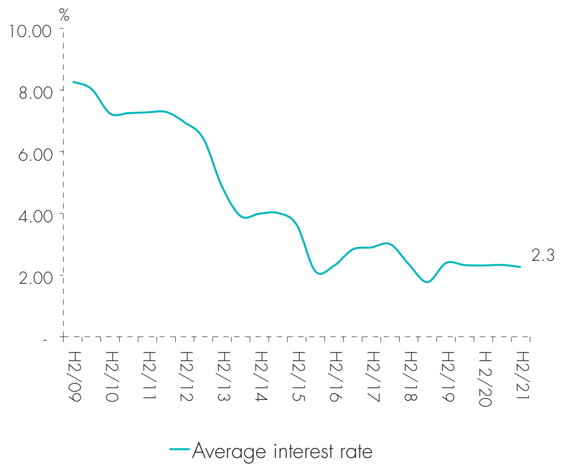
The volume of debt securities in lek issued by the government during the second half of the year was comparable to that of the previous year. The trend towards long-term borrowing continued. The average interest rate on securities was stable and fluctuated around 2.3% throughout the period. Borrowing through the Eurobond in November 2021, proved to be particularly beneficial in terms of geopolitical developments in early 2022.

3.1 EQUITY AND FOREIGN EXCHANGE MARKETS

PRIMARY MARKET OF SECURITIES

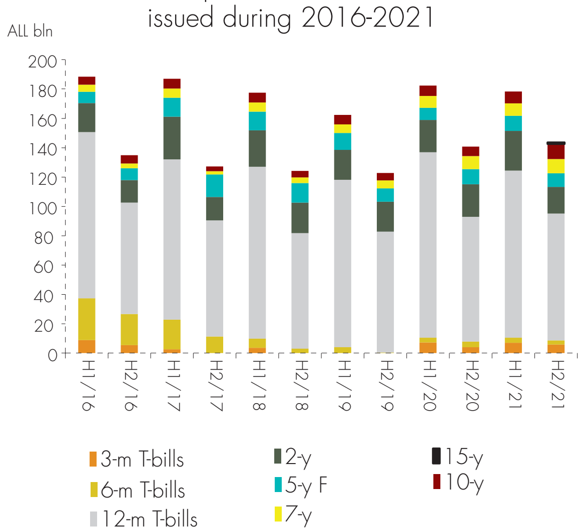
A characteristic of the primary debt securities market was that it was dominated by Albanian Government debt securities. The volume of Government debt issued in lek during the period was ALL 150 billion. Compared to the previous half of the year, the volume of securities issued was 20% or ALL 35 billion less, but this volume was comparable to that of 2020 H2. Interest rates of securities were stable and the average interest rate on all securities maturities has fluctuated around 2.3% over the last two years. Over 60% of the volume of securities issued during the second half of the year was in the form of treasury bills, while the rest were long-term securities.

Chart 24 Weighted average interest rate on debt securities (in %)



Source: Bank of Albania.

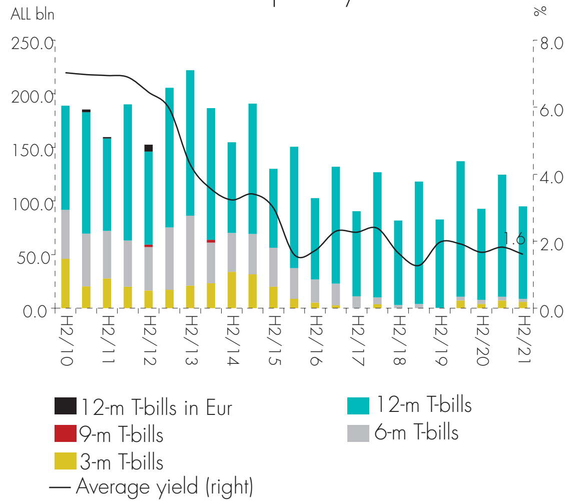
Chart 25 Composition of domestic debt in lek issued during 2016-2021



Source: Bank of Albania.

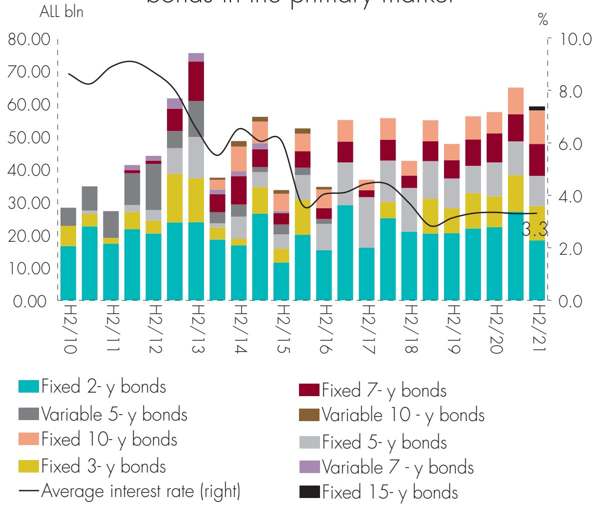
About 90% of short-term debt was accounted for by 12-month T-bills. The issuance of 12-month bonds was 24% or ALL 27 billion less than in the previous period and almost the same as the volume of 12-month bonds issued during 2020 H2. The volume of 3-month bonds issued during the period was somewhat lower than that of the first half of the year but slightly higher than the volume of the same period of the previous year, while the volume of 6-month bonds decreased compared to the previous two six-month periods. The average interest rate on short-term securities was 1.6% at the end of the period and this rate was around 0.1-0.2 percentage points below the level of six months and a year ago. With rare exceptions, the supply for investment in short-term securities stayed the same 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, the pressures for increasing interest rates for these maturities increased. The average interest rate on 12-month bonds increased from 1.4% to 1.8% during the third quarter of the year, but a continuous increase in investment bidding led to its gradual decrease during the fourth quarter down to 1.6% by the end of the year.

Chart 26 Volume and weighted average yield on T-bills in the primary market



Source: Bank of Albania.

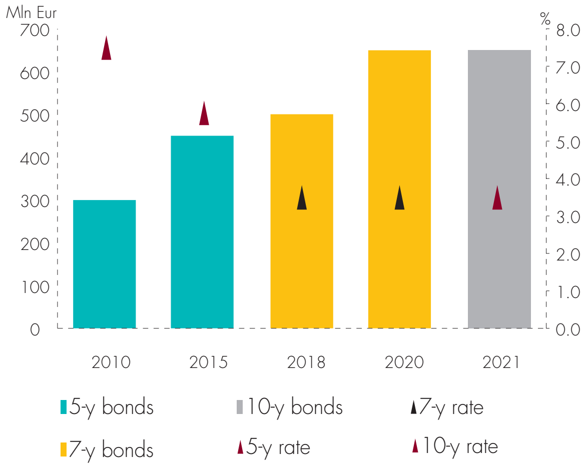
Chart 27 Volume and weighted average yield on bonds in the primary market



Source: Bank of Albania.

The volume of long-term debt securities issued during the period was 9% less compared to that of the first half of the year but increased slightly compared to the volume of the same period of the previous year. During the last two years, there has been an increase in the volume of the issuance of 7-and-10-year securities. Compared to the volumes of the first half of the year, the issuance for these maturities were 17% and 26% higher, respectively. The issuance of 2-year bonds continues to represent the largest share of the issuance in long-term securities, but the volume of this issuance during the second half of the year has been lower since the end of 2017. In November 2021, a bond with 15-year maturity was issued for the first time, and this has been the security with the longest maturity issued by the Albanian Government to date. The average interest rate on long-term securities remained at 3.3% throughout the period. The weighted average interest rate on securities with a maturity of 2, 3 and 5 years was 2.1%, 2.6% and 3.5%, respectively, while on securities with a maturity of 7, 10 and 15 years the weighted interest rates were 4.0%, 5.1% and 5.9%, respectively. The preference for investing in long-term securities has been high as the investment bidding in these securities has been in all cases higher than the government's demand for borrowing.

Chart 28 Volume and rate of borrowing in the international market



Source: Ministry of Finance and Economy.

BORROWING IN INTERNATIONAL CAPITAL MARKET

In November 2021, the Albanian Government was re-introduced to the international capital market with the issuance of a new 10-year bond, worth EUR 650 million and a 3.5% coupon. This issue has the longest term to date in the foreign market. The investment bidding was about 63% above the required amount, which showed the interest of international markets in Albanian securities and the confidence of foreign investors in the domestic economy. The Eurobond issuance was at the same level as the 7-year Eurobond issuance of 2020, and the coupon rate was comparable to that of the previous two issues. Considering the geopolitical events of the beginning of 2022 and the subsequent stress, the decision to borrow in the international market at the end of 2021 can be considered effective.

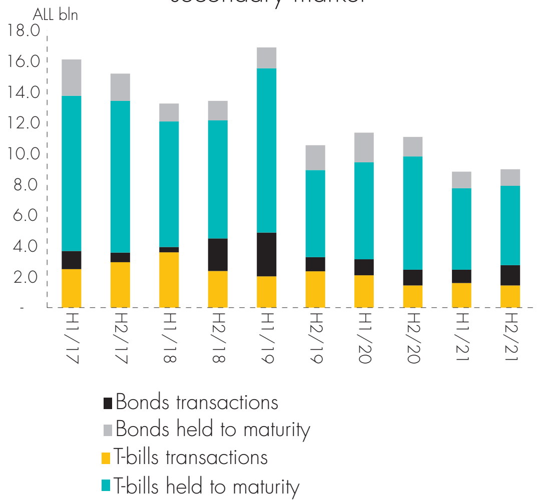
Despite a decline in the number of transactions in the secondary market of securities, the traded value increased during the period, with the main contribution coming from long-term securities. Market makers helped increase the value of securities of the traded benchmark.
The yield curve in the market showed a normal slope, and investors continued to have a preference for holding securities until maturity.

THE SECONDARY MARKET OF DEBT SECURITIES

The value of transactions performed in the secondary market during the period was about ALL 3 billion or about 10% more than the value recorded during the previous two six months. This value was evenly distributed between short-term and long-term securities. The value of transactions in long-term securities was higher and that of short-term securities was lower, compared to those of the first half of the year.

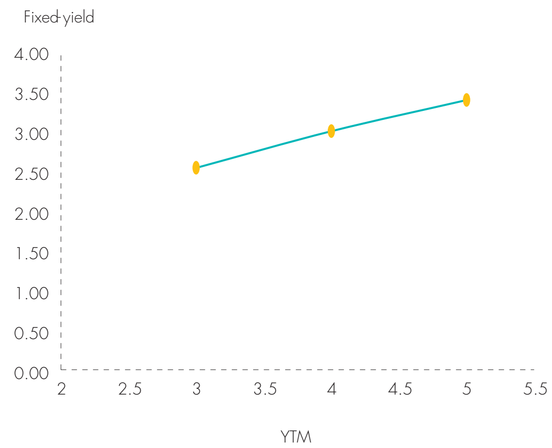
The total number of transactions performed in the secondary market (670 transactions) was smaller compared to the number of transactions carried out during the first half of the year. This decline came from the decrease by about 20% in the number of transactions in short-term securities (570 in total). The number of transactions in long-term securities (190 in total) increased by 30% during the period. Investors in the secondary retail market continued to show a preference for holding securities until maturity as only about 23% of them are traded.

Chart 29 Volume of securities transactions in the secondary market



Source: Financial Supervision Authority.

Chart 30 Yield to Maturity (YTM) on 30.06.2021



Source: Bank of Albania.

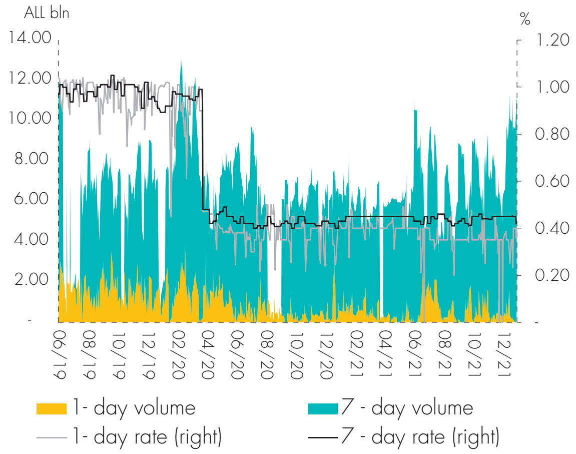
Market makers have continued the daily quotations of benchmark securities (reference bonds with 3- and 5-year maturity), which account for about 25% of transactions in long-term securities. During the period, the value of transactions carried out tripled, but remained low (at about ALL 0.3 billion). The number of transactions also showed the same performance, increasing by 16%, to a level of 43%. Daily quotation of benchmark securities enabled calculation of the yield curve, which serves as a reference for other debt securities in the market and increases transparency, providing real-time information on the price of securities. The yield curve at the end of the period represented a normal upward slope, with higher interest rates for longer-term maturities.

THE INTERBANK MARKET

During the period, the volume of transactions in the interbank market expanded by 30%, while interest rates fluctuated close to the level of the key interest rate set by the Bank of Albania. The interbank market continued to be dominated by 1-week transactions, which accounted for about 90% of the volume of interbank borrowing. During the period, the volume of 1-week transactions increased compared to the previous six months and the same period of the previous year by 25% and 34%, respectively. 1-day transactions accounted for about 10% of the total volume and compared to the previous two six-months, they increased by about 20%. During the second half of the year, 3-month transactions were registered in the interbank market, but their volume was very small compared to 1-day and 1-week transactions. During the period, the Bank of Albania injected liquidity through a one-week reverse repurchase agreement. The auction form allowed banks to borrow in unlimited amounts, at the key interest rate level.

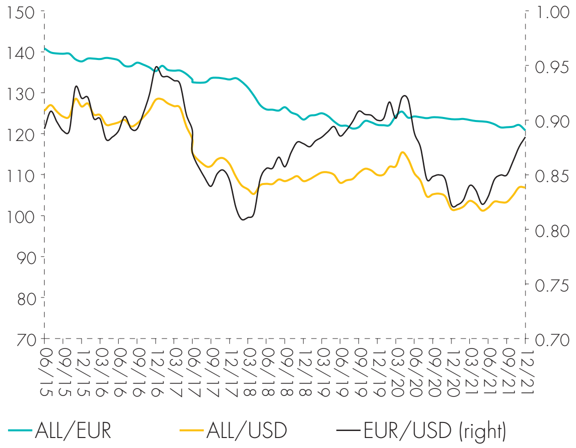
Over the last year, the volume of transactions in the interbank market has increased. The weekly and daily transactions provided the main contribution. The average interest rate fluctuated close to the key interest rate of the Bank of Albania. This performance also reflected the injection of unlimited liquidity by the Bank of Albania during the period.

Chart 31 Interest rates in interbank market



Source: Bank of Albania.

Chart 32 Exchange rate in the domestic foreign exchange market



Source: Bank of Albania.

During the period, the exchange rate of lek was stable. The domestic currency appreciated against the euro and depreciated slightly against the US dollar. This performance was also influenced by developments in international markets.

FOREIGN EXCHANGE MARKET

During the period, the foreign exchange market and the lek exchange rate showed stability. At the end of the year, the exchange rate of the euro was around 120.8 lek, showing appreciation of the lek by 1.6% and 2.2%, respectively, compared to the values of the previous six months and the previous year. The performance of the domestic currency exchange rate against the US dollar reflected international developments in the USD / Euro exchange rate. Compared to the previous six months and year, the lek depreciated by 4.8% and 5.2% against the US dollar, respectively, ending the year at All 106.9/ unit.

In the real estate market, demand and supply increased during the period. They were supported by the growth of bank loans for property and construction.

House prices sold during the period increased by 8.4% compared to the previous six months and by 9% compared to the previous year, while construction costs also increased by about 3% in annual terms.

Real estate agents remain optimistic about the future of the market.
The performance of the real estate market is important for financial stability. The Bank of Albania is working to improve data and analysis and to address the potential risks that accompany the activity of this market.

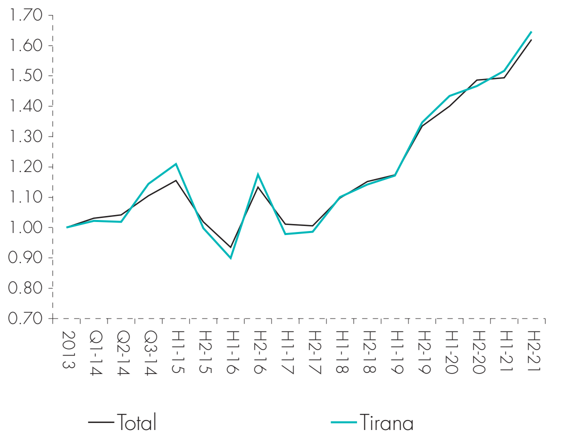
3.2 THE REAL ESTATE MARKET

Indicators used to monitor the performance of the real estate market suggest that demand and supply in this market increased during 2021 H2. Banks eased lending standards for house purchase loans. Qualitative indicators reflected the unchanged conditions of banks for real estate loans, but the demand from households for financing house purchase increased. Outstanding loans for real estate for both households and enterprises increased, while real estate agents reported higher selling prices and higher volumes of units sold during the period. In terms of supply in this market. Lending for construction increased compared to the previous half-year and compared to the previous year. The number of construction permits issued during 2021 H2 was respectively 30% and 40% higher compared to the number of permits issued during the first half of the year and during 2020 H2. Construction costs also showed a slight increase compared to the first half of the year and the previous year and the main contribution to this increase was made by an increase in expenditures for construction materials. Based on the periodic survey conducted during the period with real estate trading agencies and construction companies, agents were relatively optimistic and assessed the situation in this market as improving. At the end of the period, real estate agents reported higher selling prices than in the previous six months in the whole country. House prices calculated according to the Fischer Index for sales made during the second half of the year, increased by 8.4% compared to the previous six months and by 9% compared to the previous year. For sales in the Tirana area, which includes the centre, the suburbs and areas outside the city, the index recorded an increase of 8.5% compared to the previous period and 12.3% compared to the previous year.

Construction costs calculated according to the Construction Cost Index increased by 1.4% in average semi-annual terms and by 2.7% compared to the average level of the index during 2020 H2 Expenditure items with the highest semi-annual growth within the overall index were the sub-indicators “plumbing materials”, “construction materials”, “electrical materials” and “energy” which increased by 2.5%, 2%, 1.6% and 1.5%, respectively. The item “construction materials” was the item with the highest weight in the basket of construction expenditures with 35%, followed by expenditures for wages and machinery with 22% and 13%, respectively.

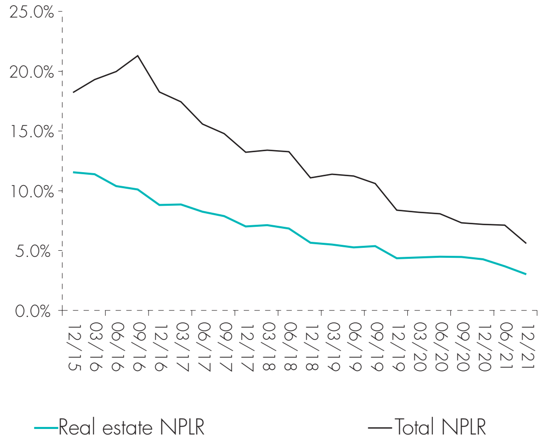
The data for the banking sector for the period showed an increase in outstanding loans to real estate and an improvement in their quality over the last year. The loans stock for the purchase of real estate by the household sector at the end of 2021 amounted to about ALL 130 billion, and increased by 7% compared to the last level of the first half of the year and by 13% compared to the level recorded at the end of 2020. The performance of this loan continues to be favoured by an environment with low and stable interest rates for this loan category. The non-performing loans ratio for this type of loan fell to 3.1%, from about 3.7% in the previous six months and 4.3% in the previous year. Outstanding loans for construction increased by 16% compared to the last level of June 2021 and by 27% compared to the previous year. The share of loans for construction accounted for 16% of outstanding loans to enterprises, and this share has been increasing in recent years. At the end of the period, the stock of loans collateralized with real estate increased due to the performance of loans collateralized in the domestic currency. Within this subdivision, 63% of the stock was held by the households’ sector and the rest by the enterprises sector.

Chart 33 Fischer Index - National level, and Tirana



Source: The Bank of Albania.

Chart 34 Credit quality for real estate purchase



Source: The Bank of Albania.

The interest of the Bank of Albania in the performance of the real estate market is not related to direct legal obligations, as the functioning of that market depends on factors not determined by the central bank (such as demographic developments or available land area for construction). However, monitoring developments in this market is important to identify situations where price performance in that market is volatile. This means that market prices do not reflect the timely changes of the underlying factors that determine the demand and supply for real estate.

If prices are developing in an unstable manner, the stress for certain groups of stakeholders increases, and there is a higher possibility that they will be amended unexpectedly, creating losses in the wealth of the economic and financial agents that are exposed to this market. The larger the exposure of the wealth of these agents, the higher the losses they might have to face and the greater the need to assess their resilience against these scenarios. This approach is important from the financial stability standpoint, in regard to the measures undertaken to mitigate eventual systemic risks. The Bank of Albania is working to improve the data and the analysis in this regard.

BOX 3 SUMMARY OF THE RESULTS FROM THE "REAL ESTATE MARKET" SURVEY AND THE DEVELOPMENTS OF THE HOUSE PRICES INDEX FOR 2021 H2

Data on the developments of prices and the assessment of the situation by real estate market agents was collected through a field survey with a sample composed of 230 entities whose main business was the trading of real estate. The selected entities were real estate agents and construction companies whose sales represent around 75%-80% of the turnover of the entire population. The Bank of Albania conducted the drafting of the questionnaire as well as the submission and processing of the results, while the Institute of Statistics conducted the field interviews, the main processes of sampling and the physical check of the completed questionnaires.

General assessment: The assessment of the agents for the overall situation of the market improved slightly compared to the previous period and this result represented a change in the direction of perception from past periods, which has been generally pessimistic. Responding to the question "How do you assess the market situation compared with the previous period (six-months)?" the net balance of responses was [+4%] while around 60% of respondents gave a neutral report – "no change". This balance shows a notable change towards the long-term average for this indicator of around [-20] %. The same indicator assessed only for subjects that have reported sales during the period was, as expected, much more positive with a value of [+28%].

*Developments of prices and sales: During the period, the Fischer House Prices Index, for Albania, was up by 8.4%, compared to the previous period, and up by 9% compared with the second half of the previous year. Sales volumes or the number of units sold in the preferred areas of the capital was twice as high compared to sales volume realized during the first half of the year, and this development, due to the higher prices in this area, also represents the main factor after the significant increase in house prices during the period. The Price Index for Tirana increased by 8.5% against the previous period and by 12.3% against the same period a year ago and this increase was determined only by the increase in sales price in the central areas of the capital. An increase was also reported for sales prices in other areas *, while sales reported in coastal cities were realized at lower average prices compared to the previous six months.*

Number of registered apartments: Agents have reported a lower number of new households registered in their books. The net balance of those who reported an increase in the number of registered households and those who estimate that their number has decreased, was about [-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 over several consecutive six-month periods.

Average sale period: The average time for selling an apartment in Albania was estimated to have increased slightly compared to the previous period, to 11 months from 10.5 months for the first half of the year. For Tirana, the interviewed entities reported an average selling time of 9.4 months, and this value remained almost unchanged from six months ago. For the coastal area and for other areas, the sales time was reported at 11 and 12.9 months respectively. It is worth noting that for coastal cities the average time increased significantly from 7.6 months in the first half of last year, approaching a long-term average of 12.1 months.

Financing through bank credit: According to agents, similar to the previous period, about 30% of residential and commercial properties were purchased via bank loans. For half of these cases, a loan covered up to 60% of the value.

Expectations for the future: As during the first half of the year, agents were positive about the short-term future performance of the market in the territory where they operate, and the expected market performance throughout the territory for the longer term (up to 2 years). The number of properties expected to be registered for sale during the current period, according to the net balance of [+ 30%], is expected to increase. Agents also expect real estate prices to rise for residential and commercial properties. The net balances for these two questions were positive at [+ 22%], reflecting optimism from the agents.

Rental price: Rental prices according to the interviewed agents increased during 2021 H2, and the demand for rental properties also increased slightly compared to the previous period. It should be noted that the answers to this section of the questionnaire were mostly completed in the capital.

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

The basic infrastructure for clearing and settlement of payments in lek has continued to operate safely and efficiently.

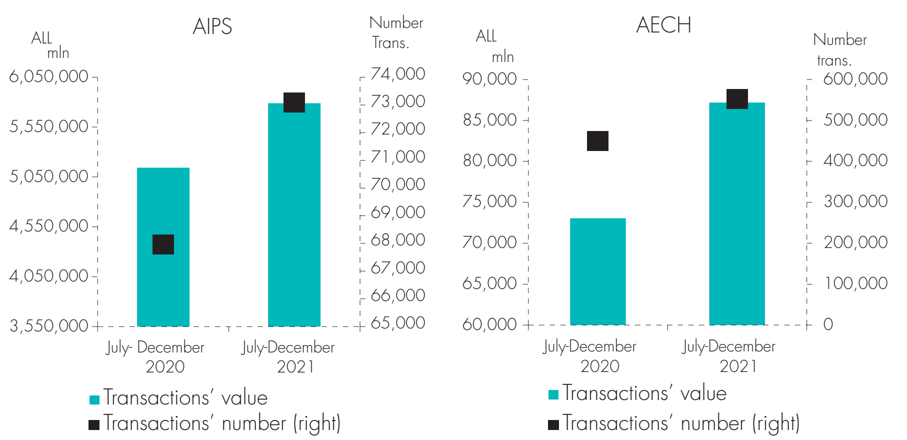
During the period a significant Increase in the volume and number of small and Large value payments was noticed.

For the second consecutive year, transfers via cards continue to take first place in terms of frequency of use.

3.3 PAYMENT SYSTEMS

During 2021 H2, the basic infrastructure for clearing and settlements of payments in domestic currency continued to function safely and efficiently, supporting financial stability and implementation of monetary policy. In terms of processing, about 73 000 payments accounting for ALL 5,800 billion, were settled through AIPS system during the period. Compared to the same period last year, the number and value of transactions increased by 8% and 13%. In the AECH, the system for small value payments, about 550 thousand payments were cleared during the period, with an average transaction value of about 160 thousand lek. Compared to 2020 H2, the activity of the AECH system registered a significant increase in both the number and the value of payments. For both of these indicators the annual growth was about 20%.

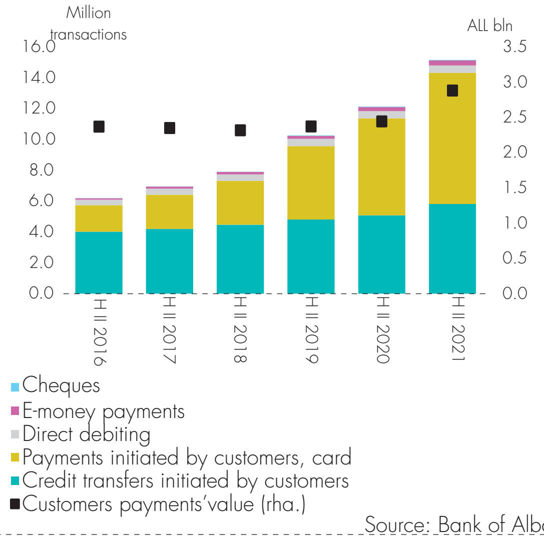
Chart 35 Performance of AIPS and AECH in the second half of 2020 and 2021



Source: Bank of Albania.

During the period, 15.2 million payments were made, accounting for ALL 2.880 billion. This performance showed a significant increase in the number and value of transactions, by 25% and 18% respectively in 2020 H2. Card payments represented the main share in payment instruments in terms of the number of transactions which was 56% of the total number of transactions for this period, thus exceeding, for the second year in a row, credit transfers in paper form, which has dominated the Albanian market for years. On the other hand, the number of non-paper credit transfers (internet banking, mobile banking) has continued to grow rapidly.

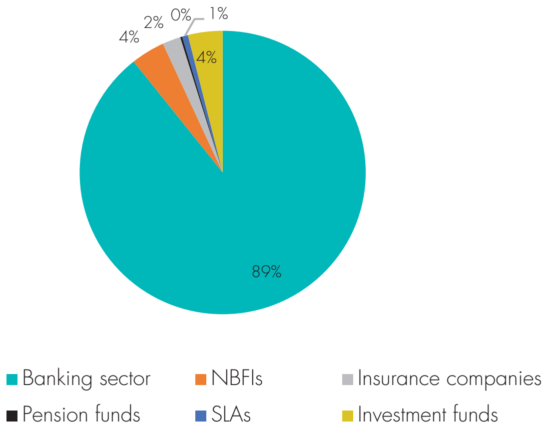
Chart 36 Payment instruments in number and value



Source: Bank of Albania.

4. FINANCIAL SYSTEM

Chart 37 Share of financial system segments/ total assets of the financial system, December 2021



Source: Bank of Albania, Albanian Financial Supervisory Authority.

During the period, the share of financial system assets[18] to Gross Domestic Product (GDP) decreased, as a result of higher GDP growth compared to assets. This share fell to 105% from 110% in the previous six months and the previous year. The share of the banking sector to GDP fell to 94% compared to 98% in the previous year, while the share of the non-banking sector was 11% to GDP, falling slightly from the previous year. The performance indicators of the financial system, including capitalisation, profitability, liquidity and assets quality, remain at good levels.

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

Liccencing and Supervising Authority	Bank of Albania			Liccencing and Supervising Authority			Financial intermediation
Financial system	Banking secctor	NBFIs	SLAs and their Unions	Insurance companies	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

Source: Bank of Albania, Albanian Financial Supervisory Authority.

* *In contrast to previous calculations when GDP was expressed at constant prices, this time the values in the table have all been recalculated, using nominal GDP at current prices, according to INSTAT. This method will be used from now on.*

Operations of the banking sector expanded during 2021. The increase in activity was supported by an increase in investments in securities and loans to the economy.

4.1 BANKING SECTOR

4.1.1 MAIN DEVELOPMENTS IN THE BANKING SECTOR

Banking sector assets expanded by about 8% during the period and by 12% compared to the previous year. The banking sector has normally developed the main functions of the activity and has supported the economy with financing.

[18] *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 reported value of assets increased by around ALL 130 billion during the period, reaching around ALL 1.770 billion. The main contribution to the growth of assets was made by the expansion of investments in securities by about ALL 60 billion and lending activity by about ALL 50 billion.

Table 5 Structure of banks' balance sheet and annual change, December 2021

Asset	% of assets	Annual change, %	Liability	% of liability	Annual change, %
I Treasury and interbank transactions	28	5	I Treasury and interbank transactions	6	30
II. Customer transactions (credit)	38	10	II. Customer transactions (deposits)	81	12
Of which for public sector	1	-34	Of which: public sector	1	60
Of which for private sector	36	8	Of which: private sector	79	11
III Securities transactions	33	21	III Securities transactions	0	-13
IV. Created Reserve funds	-2	-17	IV. Other liabilities	1	40
V. Other	3	-1	V. Permanent sources	11	7
			Of which: Subordinated debt	1	11
			Of which: Share capital	10	7
Total assets	100	12	Total liabilities	100	12

Source: Bank of Albania

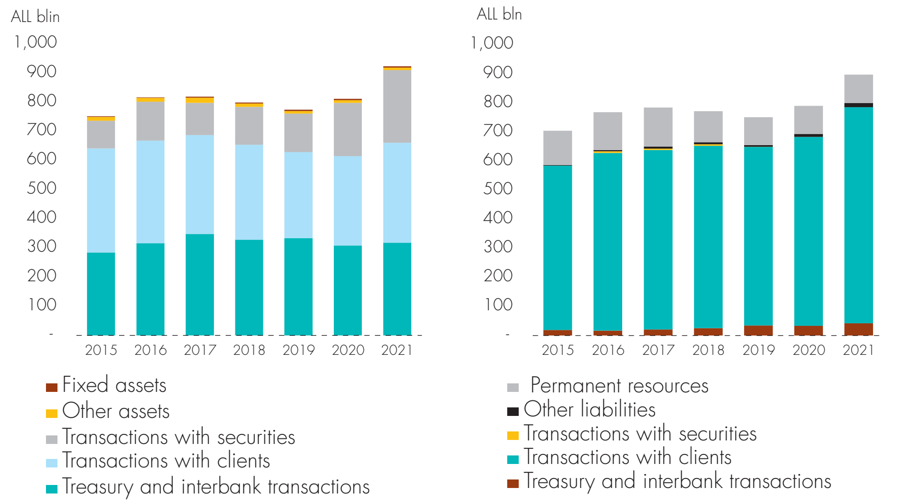
At the end of the period, the assets and liabilities of the banking sector in foreign currency accounted for 52% and 51% of the total balance sheet, respectively, and these ratios were maintained during the period. In absolute terms, banks reported similar levels of foreign currency assets and liabilities (ALL 920 billion and ALL 900 billion), thus maintaining an almost consistent exposure to foreign currency activity. 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. The statistical effect of the exchange rate on the lek equivalent of the foreign currency balance was negative, but low and without significant impact on the data reported in lek. Deposits and own funds continue to be the main sources of financing in the banking sector, with 92% of total liabilities, and this structure was stable during the period.

The activity in foreign currency of the banking sector was nearly consistent on both sides of the balance sheet. Deposits and own funds are the main sources that have financed the activity.

The statistical effect of the exchange rate on the values reported in lek during the period was low.

The share of credit position of the banking sector to non-residents did not change.

Chart 38 Foreign currency assets (left) and foreign currency liabilities (right)

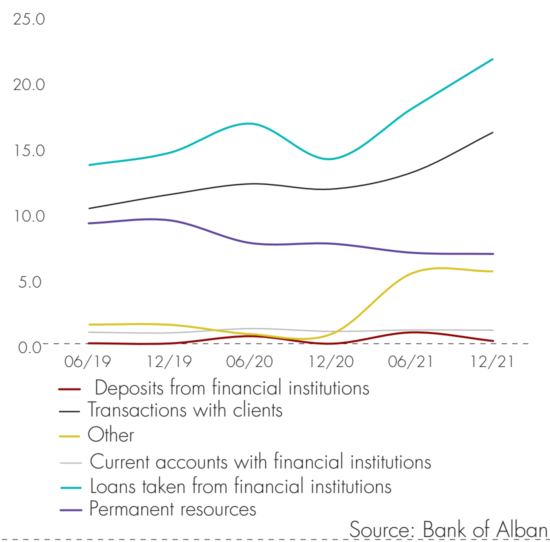


Source: Bank of Albania.

Assets of non-residential entities increased during the period due to the expansion of investments in securities and increased placements in the form of current accounts with banks and financial institutions. Reliance on external funding sources remained low, although it increased slightly during the period as a result of increased liabilities to non-residents. The main contribution came from an increase in liabilities in the form of loans and deposits, while liabilities in the form of own funds continued to decline due to the contraction of subordinated debt and structural changes in the capital of banks.

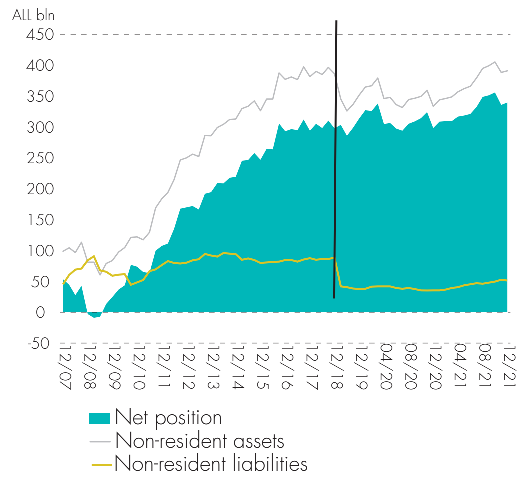
At the end of the period, claims on non-residents accounted for 22% of total assets while liabilities to non-residents accounted for only 3% of total balance sheet. The net lending position of domestic banks to non-resident sector expanded slightly in nominal terms but remained unchanged in relative terms, at 19% of assets.

Chart 39 Liabilities against non-residents (ALL bln)



Source: Bank of Albania.

Chart 40 Net position with non-residents*



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

Source: Bank of Albania.

4.1.1.1 The banking soundness index

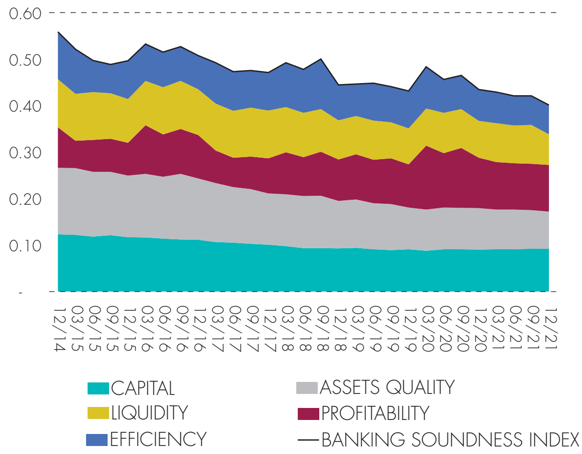
The banking soundness index improved during the period. This performance was mainly affected by improvement in the quality of assets, liquidity position and an increase of profitability. According to the index, the improvement of banking soundness has been gradual but steady in the last 5-6 years.

The banking soundness index continued to improve during the period, reaching its best level since 2005. The improvement of the index was mainly influenced by the positive performance in the indicators of asset quality and liquidity. The decline in profitability risk during the last year[19] reflected increased profitability in the banking sector. The contribution of the "Capital" indicator to the level of risk increased during the last year, mainly due to the decline of the capital adequacy ratio and the expansion of financial leverage. Liquidity-related risk decreased over the last twelve months, due to an expansion in the ratio of liquid assets to total assets, and the contribution of this component to the aggregate level of risk over time has generally decreased, especially during the last year[20].

[19] *The value of the profitability indicator fell from 0.54 to 0.50 during December 2020 - December 2021 showing a decrease of risk. During 2020, this indicator recorded the highest values since 2013.*

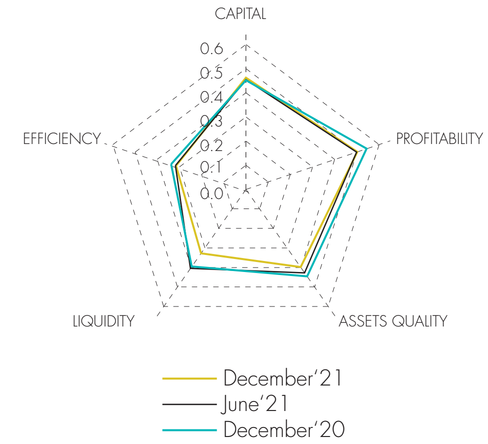
[20] *The value of the liquidity indicator fell from 0.33 to 0.40 during December 2020 - December 2021.*

Chart 41 Banking soundness Index*



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

Chart 42 Banking soundness map*



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

The quality of assets has improved slightly 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 0.71 in March 2015 to 0.40 in December 2021, and the main role in this performance was played by a significant decline in the ratio of non-performing loans. For systemic banks, the soundness index improved compared to the previous year. For this group of banks there was an improvement in four of the five indicators, but in particular improvement was recorded in the liquidity and asset quality indicators. The capital ratio for systemic banks marked a slight decline during 2021, due to a slight decrease in the capital adequacy ratio and at the same time an increase in the financial leverage. Overall, during 2014-2021, the aggregate banking soundness index trended upward, showing an improvement of soundness and increased stability of the banking sector.

4.1.1.2 Capitalisation of activity

CAPITAL ADEQUACY RATIO

The banking sector was well-capitalised and no bank of the sector reported a capital adequacy ratio below the minimum value required by the regulatory framework of 12%. At the end of 2021, the capital adequacy ratio was 18%, remaining unchanged during the period, but decreasing by 0.7 percentage points compared to the level of the previous year. The decline reflected the faster growth of risk-weighted assets compared to the change in the level of regulatory capital. European capital banks and systemic banks report the highest level of capital adequacy ratio. The level of capitalisation of the banking sector ranges between 14% -16%. During the period, changes in the level of regulatory capital and the level of risk-weighted assets had impacts in opposite directions but to almost the same extent, with a change in the capital adequacy ratio of

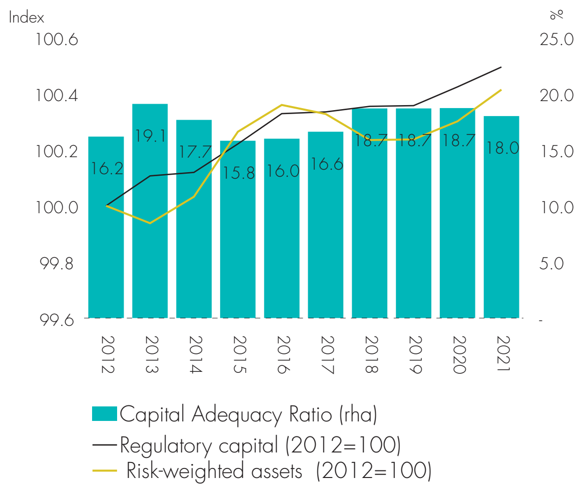
The banking sector was well-capitalized. The capital adequacy ratio at the end of the period was 18%.

The indicator remained unchanged during the period, but decreased compared to the previous year due to the rapid growth of risk-weighted assets. All banks meet the required minimum capital adequacy ratio of 12%.

The financial leverage ratio increased during the year, and was higher for banks with Albanian capital.

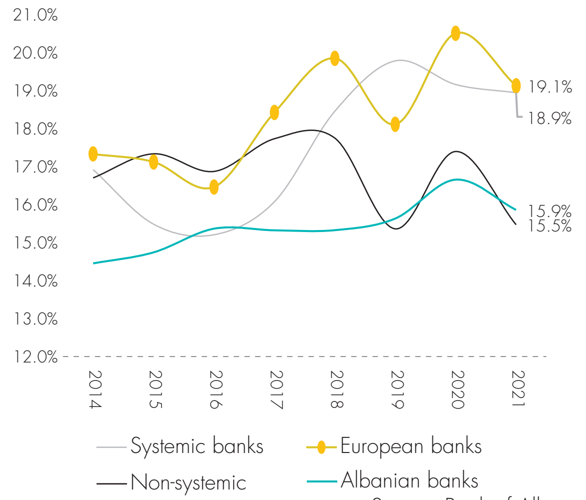
about 1 percentage point. The level of the banking sector's regulatory capital increased by ALL 9 billion, reaching ALL 167 billion at the end of 2021.

Chart 43 Capital Adequacy Ratio



Source: Bank of Albania.

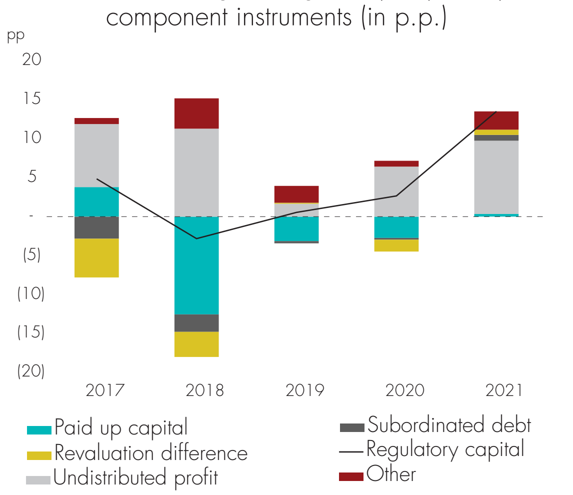
Chart 44 Capital Adequacy Ratio of groups by importance and origin of capital



Source: Bank of Albania.

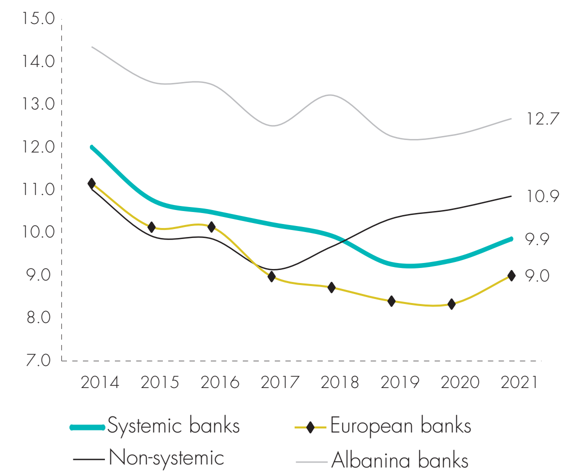
The increase in regulatory capital was mainly influenced by an increase in retained profit. Retained profit from previous periods has been the main element affecting the increase of share capital and regulatory capital over the last two years. The preservation of retained profit from previous periods affected by the Decisions of the Bank of Albania in January 2021[21], on suspending the distribution of profit from banks. On the other hand, risk-weighted assets increased compared to the previous six months, as well as to the previous year, reaching ALL 930 billion. The increase in risk-weighted assets is mainly related to an increase in exposures from lending activity.

Chart 45 Change in regulatory capital by component instruments (in p.p.)



Source: Bank of Albania.

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



Source: Bank of Albania.

21 *Decision of the Supervisory Council of the Bank of Albania no. 4, dated 13.01.2021 "On the suspension of profit distribution of banks" with effect until 31 December 2021.*

The structure of risk-weighted assets by risks did not change during the period and continued to be dominated by credit risk-weighted assets (86%), followed by those of operational and market risks, at 11% and 3%, respectively. The banking sector maintained the structure of credit risk weighted assets, which was dominated by exposure to companies and non-performing loans. The ratio of financial leverage[22] in December 2021 was 10 times, and this value was higher compared to the previous level of 2020 (9.6), and the average of the last 5 years. Analysis of the performance of financial leverage for certain groups of banks shows that banks with Albanian capital have the highest level of financial leverage.

The surplus capital and fulfilment of regulatory requirements on macro prudential capital buffers

Macro prudential capital increases are aimed at improving banks' resistance to 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. In accordance with the regulation "On macro prudential capital buffers"[23], banks are subject to a capital conservation buffer (KONS), a countercyclical capital buffer (KUNC); capital buffers for systemic banks (SIST) and systemic a risk buffer (STRUK). The capital conservation buffer for 2021 is 1% for all banks of the sector, while the effective buffer for systemic banks varies from 0.5% to 1% depending on the systemic importance of the bank.

Even after meeting the minimum regulatory threshold, requirements for specific supervisory and macro-prudential capital buffers, the banking sector registered a surplus capital of about 5% of risk-weighted assets. This surplus was higher for banks of systemic importance.

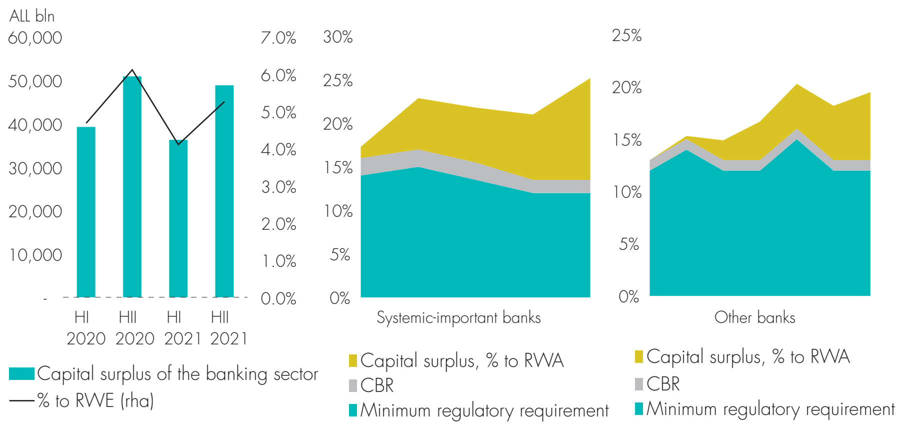
The countercyclical capital buffer is 0% and currently the Bank of Albania has not announced buffers for systemic risk. Taking into account the above buffers as well as the specific buffer that some banks of the banking sector have, the capital adequacy ratio limit varies between 14% and 17% for systemically important banks and 13% and 16% for other banks. Capital adequacy ratios for systemically important banks and other banks are currently higher than the aforementioned regulatory levels.

From the calculation of all capital requirements at the end of 2021, the banking sector had a capital[24] surplus. The performance of surplus capital is dictated by the performance of banks' profits, the behaviour of instruments of Common Equity Tier 1 Capital, as well as the requirements for macro prudential capital buffers. At the end of 2021, capital surplus or own funds reached the level of ALL 50 billion or 5.3% of risk weighted assets (RWA). During 2021 H1, capital surplus decreased compared to the end of 2020 and at the end of June amounted to ALL 36 billion (4.1% compared to RWA). This decrease was a result of an increase in macro prudential capital buffers that were applied to

[22] *The financial leverage ratio is measured as the ratio of assets to share capital.*
[23] *Regulation no.41, dated 5.6.2019 "On macro prudential capital buffers".*
[24] *Capital surplus refers to the remaining capital available to banks after meeting all applicable regulatory requirements (legal limit of 12%, specific supervisory buffers and macro prudential capital buffers).*

banks according to the relevant decisions of the Bank of Albania. The increase consisted of the growth from 0.5% to 1.0% of the KONS surcharge and the increase by 0.5% of the SIST buffer applied on systemically important banks. This performance prompted banks to take measures to strengthen capital positions by increasing retained earnings, supported by good financial performance, as well as by increasing the use of subordinated debt.

Chart 47 Surplus capital for the banking sector and macro prudential capital buffers by groups of banks (December 2021)



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 2021, the capital surplus for these banks reached ALL 40 billion, or ALL 10 billion more than the surplus calculated at the end of the first half of the year and this surplus was as much as 6% of risk-weighted assets. Banks of systemic importance must meet a higher level of macro prudential buffers and therefore they must regularly monitor and report their capital position. What was noticed at the end of 2021 was that these banks report a high level of net profit and consequently high levels of core equity tier one capital, and that enables them to meet the regulatory requirements in force. Other banks reported lower levels of core equity tier one capital, and consequently the capital surplus remaining after meeting regulatory requirements was smaller than that of systemically important banks. At the end of 2021, this surplus was ALL 8 billion, up from ALL 6 billion which was the level reported at the end of the first half of the year.

4.1.1.3 Financial result

The banking sector ended the year with a positive net financial result of ALL 21.6 billion, or about 30% higher compared to the previous year. The majority of banks contributed to this increase of the financial result of the banking sector. The increase in the sector's profit was also reflected in an increase in the average profitability indicators of the banking sector: compared to the previous year, RoA increased by 0.2 percentage points to 1.3%, while RoE increased by 2.2 percentage points, to 12.9%. The biggest impact on the improvement of the net result of the banking sector for 2021 was made by a significant decrease of expenses for provisions and an increase in the net result from interest rates. At the same time, the banking sector collected more income from other non-interest related activities. On the other hand, operating expenses increased by over 10%.

The banking sector ended the year with a profit almost 30% higher than in the previous year. The annual increase in the financial result was influenced by an increase in net interest income and other activities, and a decrease in expenses for loan provision.

Total operating expenses have increased and their ratio to operating income has increased slightly compared to the previous year. By currency, the activity in the domestic currency has mainly contributed to the increase of the financial result in the sector.

For the sector, net interest income continued to represent the main item of revenue and non-interest expenses remained the main item of expenditure. The net interest result was ALL 46 billion, or 7.4% higher than the previous year. The only contribution here was made by an increase in interest income. Interest income collected from customers was about 5% more than in the previous year and amounted to ALL 32 billion. Interest received from investments in securities amounted to ALL 20 billion, being about 5% higher compared to the revenues of 2020.

Non-interest income, mainly represented by commission income, has become an important source of income for the banking sector. These revenues increased by about 8% compared to the previous year, reaching ALL 16 billion at the end of the year. They have registered a gradual increase in recent years and their share in relation to net interest income has reached 35%, from 20% a decade ago.

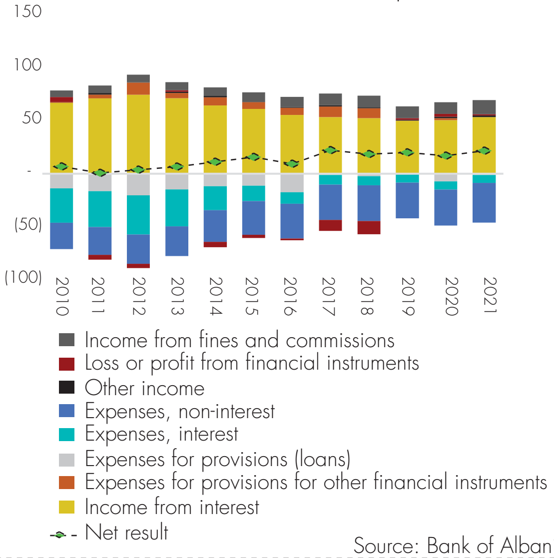
Table 6 Income and expenditure of the banking sector for 2020-2021 (ALL bln)

	2021			2020
	In ALL	In foreign currency	Total	Total
Income from interest	34	19.4	53.3	50.4
Expenses for interest	5.4	1.9	7.4	7.7
Non-interest income	28.5	17.5	46	42.8
Non-interest income	10.8	5.3	16.2	14.7
Fines and commissions	7.8	5.6	13.4	10.9
Loss or profit from financial instruments	1.9	(0.8);	1.2	2.6
Non-interest expenses	29.3	8.1	37.5	33.9
Provisions (net)	0.6	0.6	1.2	5.7
For loans	0.0	0.8	0.8	7.3
For other financial means	0.6	(0.2);	0.4	(1.6);
Uncommon items	(0.9);	(0.7);	(1.6);	(1.3);
Income taxes	3.4	-	3.4	2.6
Net result	7	14.7	21.6	16.5

Source: Bank of Albania

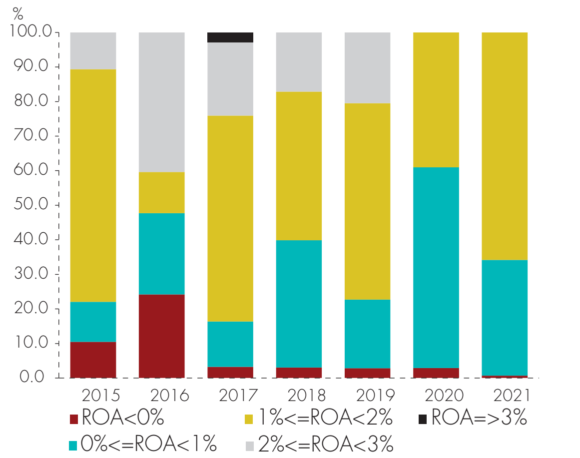
On the other hand, operating expenses also increased by 10% to about ALL 38 billion, while operating costs continued to be adequately covered by banks' revenues. The ratio of operating expenses to income increased slightly to 60% as a result of a larger increase in the value of expenses compared to that in income. Despite an increase in interest income, the net interest margin remained almost unchanged at 3.4% due to a similar increase in average income-generating assets.

Chart 48 Financial result components



Source: Bank of Albania.

Chart 49 ROA by banks' share in the assets of the sector

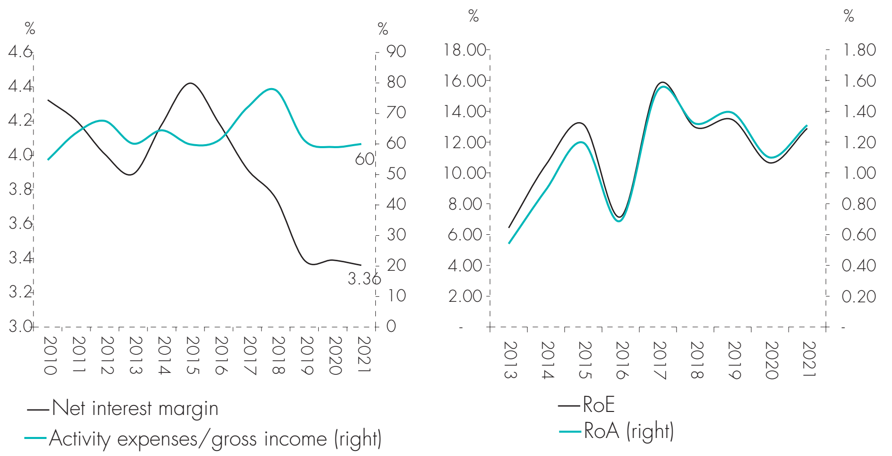


Source: Bank of Albania.

A steep fall of provision expenses for credit during 2021 significantly affected the increase of banks' profits. These expenditures were several times lower compared to the expenditures recorded during 2020 and comparable to the levels reported during 2017-2019. For 2021, the expenses for loan provisions were less than ALL 1 billion. During 2020, due to difficulties related to the restrictions on the activity of commercial units and consumers, these expenses increased significantly to ALL 7 billion, and were comparable to the value of banks' expenses for interest payments. At the same time, during 2021, banks reported about ALL 2 billion more expenditure for the provisioning of other financial assets.

According to currency, an increase in the net result and overall positive developments in the profitability of the domestic banking sector were mainly observed in activity in lek, while small changes were registered in banking activity in foreign currency. For the activity in lek, banks recorded a significant increase in net interest income rather than in non-interest income and a significant decrease in provision expense.

Chart 50 Profitability and expense indicators of the banking sector



Source: Bank of Albania.

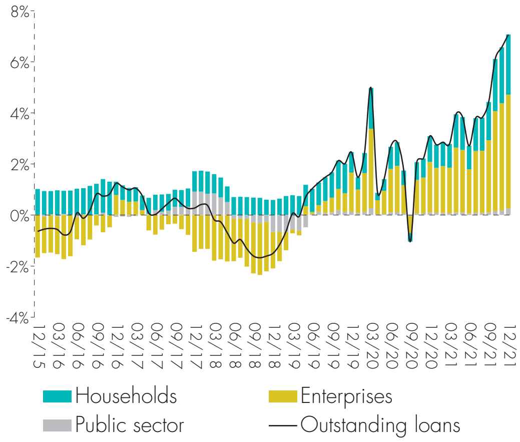
4.1.1.4 Loans

The stock of loans granted by banks expanded rapidly over the period. Outstanding loans at the end of the period reached ALL 670 billion, 7% and 10% higher, respectively, than the previous six months and the previous year. The main impact on the expansion of the credit stock during the period was made by the buffers from new credit, which during the period was about 40% higher compared to the new credit registered during the first half of the year. New loans were granted mainly to the business sector and for short-term purposes. All types of loans by term, maturity and entity, increased during the period. The largest increase was recorded in the portfolio of loans in foreign currency (10%), business loans (6%) and short-term loans (15%). The annual change in the stock of foreign currency loans was 12%. Excluding the statistical effect of the exchange rate, which was negative by ALL 6 billion, this change would be 14%.

Table 7 Loans by maturity, sector and currency

	ALL billion	Weight (%)		Change (%)	
	12/21	12/21	12/20	6-month	Annual
Lek	328	49	50	4	8
Foreign currency	343	51	50	10	12
Public sector	26	4	3	70	29
Enterprises	422	63	64	6	8
Individuals	223	33	33	6	12
Short-term	170	25	25	15	10
Medium-term	99	15	15	3	5
Long-term	403	60	59	6	12
LOANS	671	100	100	7	10

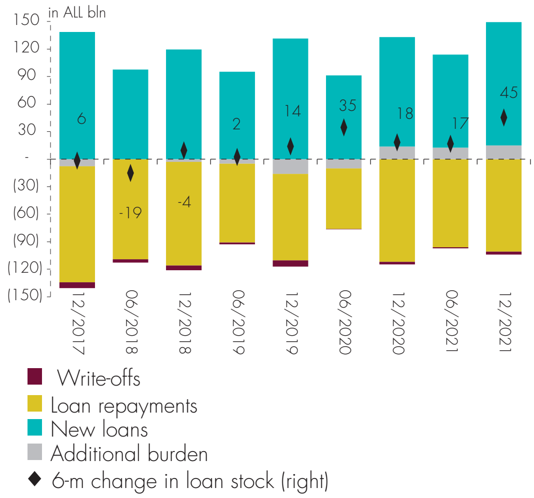
Chart 51 Loans by sector, contribution in percentage points, 6-month changes



Source: Bank of Albania.

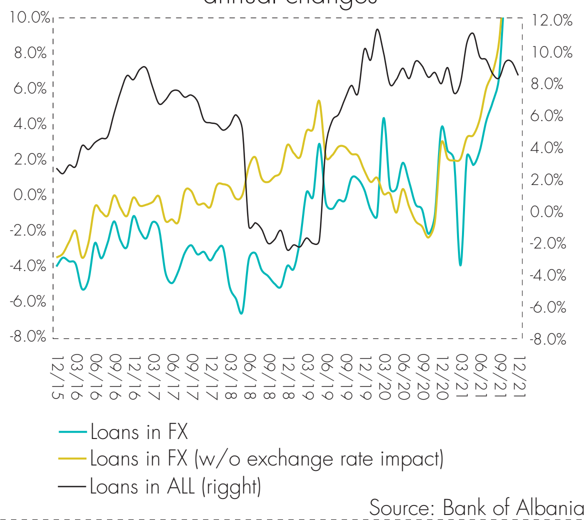
The process of writing off lost loans continued during the second half of the year, but the value was[25] lower compared to earlier years. Throughout 2021, about ALL 4 billion of non-performing loans were written off and 70% of this volume belonged to loans granted to local businesses in foreign currency. The value of loans written off last year was as much as 10% of the total balance of non-performing loans in the banks' portfolio at the end of December 2021, while for 2020 this ratio was equal to 6%. If outstanding loans, in addition to the statistical effect of the exchange rate, included the stock of loans written off during the last twelve months, the annual credit growth would be 12%, up from 10%.

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



Source: Bank of Albania.

Chart 53 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 represent 95% of the bank's outstanding loans and expanded by 7% during the period. Loans to resident enterprises, which accounted for about 60% of total loans to residents, reached ALL 400 billion at the end of the year and the increase during the period was about ALL 20 billion or 5%. The main contribution to the growth of loans to resident businesses was made by the expansion of the stock of loans for short-term purposes. Compared to the previous year, outstanding loans to enterprises expanded by 7%, and in this growth the main impact was made by an increase in the stock of 'Overdraft' and loans for equipment purchases.

[25] *About ALL 3 billion.*

The main share of credit to resident businesses was occupied by loans for investments in real estate and loans for equipment purchase with 30% of the total stock. Loans for these purposes were disbursed mainly in foreign currency. For short-term loans used primarily to purchase equipment and as working capital, businesses continued to prefer borrowing in domestic currency.

Chart 54 Annual performance of loans to enterprises by purpose of use and currency, (2016=100)

Source: Bank of Albania.

The increase in outstanding loans during the period was observed in all three loan portfolios by size of enterprise. Despite the fact that the largest relative increase was recorded in the loan portfolio for medium-sized enterprises, the main contribution to the growth of outstanding loans to businesses continued to be made by loans granted to large enterprises[26]. For the sector of medium-sized and large enterprises, there was a decrease in the share of long-term loans and an increase in the share of short-term loans, while for medium-sized businesses, banks reported a contraction in the stock of medium-term loans and an increase in outstanding short-term and long-term loans. Systemically important banks granted about 70% of loans to enterprises.

LOANS TO RESIDENT ENTITIES - HOUSEHOLDS AND PUBLIC SECTOR

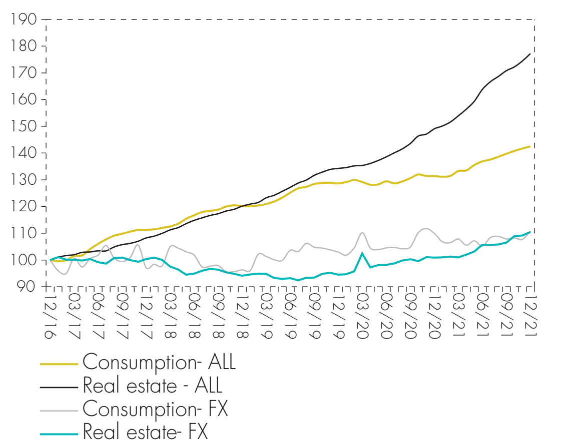
Loans to resident households increased by 6% over the period. The fastest growth and the largest contribution to the positive performance of loans to households was made by loans for the purchase of real estate (mortgages) and those for the consumption of volatile goods. Credit to these categories expanded by 6.5% and 5.6%, respectively, during the period. The main share, with about 70%, in the loan portfolio to households continued to be occupied by loans for the purchase of real estate. From the end of 2016 until the end of 2021, the stock of this loan expanded by about 40%. The rapid growth of credit stock to households in recent years has been influenced by the rapid growth of credit stock in lek, while credit to households in foreign currency has

[26] *The loan portfolio for large, medium-sized and small enterprises increased by ALL 8, 7 and 3 billion, respectively, during the period.*

had small fluctuations, and at the end of 2021 stood only slightly above the level of five years ago.

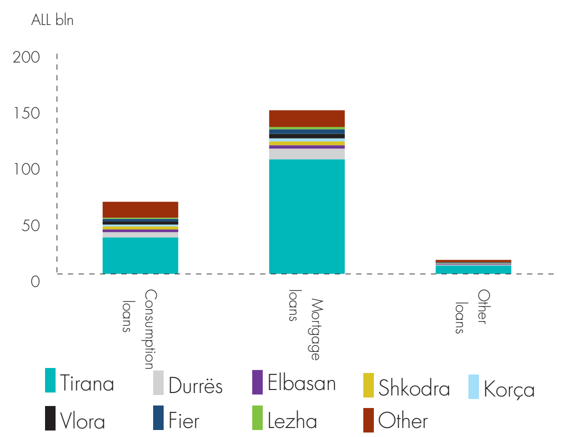
About 65% of the entire stock of loans to households was provided for those in Tirana. Durrësi came second, with 7%, while Vlora, Fieri, Elbasan and Shkodra had 3% of the total stock of loans to households. The share of Tirana was even greater in the stock of real estate loans or mortgage loans, as for this distribution of loans to households, Tirana occupied about 70% 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 about 60% and 20% in the stock of this part of the loan for Tirana and Durrësi. Mortgage lending to households in other districts during this period has remained unchanged or has shrunk. The large share and rapid growth of mortgage to households in Tirana and Durrësi 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 quality and the price of real estate.

Chart 55 Loans to households by purpose of use and currency (index, 2016 = 100)



Source: Bank of Albania.

Chart 56 Loans to households by purpose of use and districts (December 2021)



Source: Bank of Albania.

Loans to public non-financial corporations continued to account for a small share of total loans to residents (4%), however during 2021 H2, its stock almost doubled.

LOANS TO NON-RESIDENT ENTITIES

The credit stock for non-resident entities expanded by about 20% during 2021 H2 and by 40% compared to the previous year. At the end of December, loans to non-residents were about ALL 27 billion and accounted for about 4% of the outstanding loans of the banking sector, from 3.2% in the previous year. The main contribution to the expansion of loans to non-residents was made by an increase in the stock of loans to enterprises, loans in foreign currency and long-term loans. These are also the categories with the largest share in the credit stock for non-resident entities.

UNHEDGED FOREIGN CURRENCY LOANS

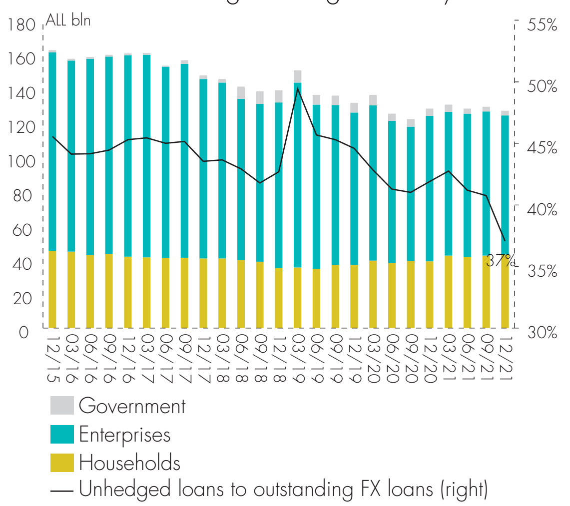
The growth rates of unhedged foreign currency loans and its share in relation to total foreign currency loans are two of the indicators that are continuously monitored as indicators of indirect exchange rate risk. The stock of unhedged foreign currency loans fell slightly during the period, reaching the lowest level recorded since 2011[27]. The decline in unhedged credit stock and an increase in the stock of foreign currency loans caused the share of unhedged loans against outstanding foreign currency loans to fall from 41% to 37% during the period. The share of unhedged loans to total outstanding loans also fell by 2 percentage points, down to 19%. The main share of non-performing loans (64%) was occupied by loans to enterprises, which fell slightly during the period, mainly due to the contraction of the non-performing loan portfolio in euro.

Outstanding unhedged foreign currency loans fell slightly during the period. As a result, the share of unhedged foreign currency loans against foreign currency loans and total outstanding loans, decreased.

The majority of unhedged loans are represented by loans to enterprises in euro and loans for investing in real estate.

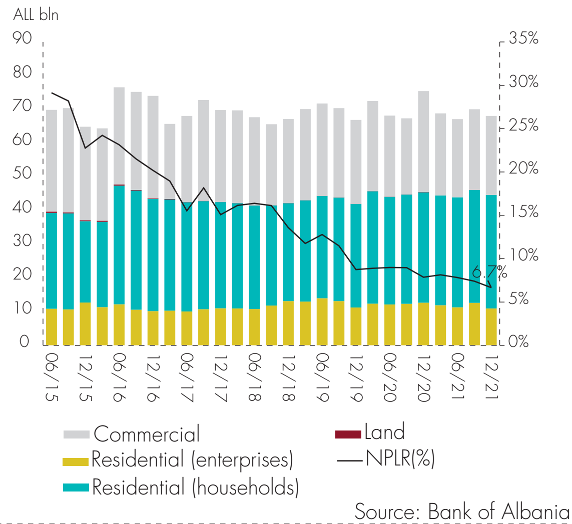
At the same time, unhedged loans to households increased by 4% during the second half of the year, due to an increase in loans for investment in real estate. Despite this performance, as non-performing loans to households accounted for only 34% of unhedged loans, the impact of the growth of this portfolio on the performance of the overall unhedged loan stock was limited. The main part of unhedged loans in foreign currency consisted of loans in euro (about 90%) and the stock of this portfolio decreased over the period. In annual terms, unhedged loans in foreign currency shrank by 1%, mainly due to the decline of unhedged loans to enterprises businesses and loans in euro.

Chart 57 Unhedged foreign currency loans



Source: Bank of Albania.

Chart 58 Unhedged foreign currency loans for real estate and its quality (right)



Source: Bank of Albania.

27 *About ALL 130 billion.*

Unhedged loans granted for real estate investments continued to hold the main share (about 54%) of total unhedged foreign currency loans, followed by loans for trade (by 25%). The rest of the unhedged foreign currency loans were provided for development of business, consumption, government and other purposes. Developments in the performance of the unhedged loans stock during the period were influenced by the contraction of unhedged loans for business development and that granted for other purposes.

Unhedged real estate loans were granted for the purchase of residential, commercial, and land purchase, and increased slightly during the period. Its main share continued to be occupied by unhedged residential real estate loans to households (50%), which increased by 3% during the period, and provided the main contribution to the performance of unhedged real estate loans for the period.

NEW LOANS AND RESTRUCTURED LOANS

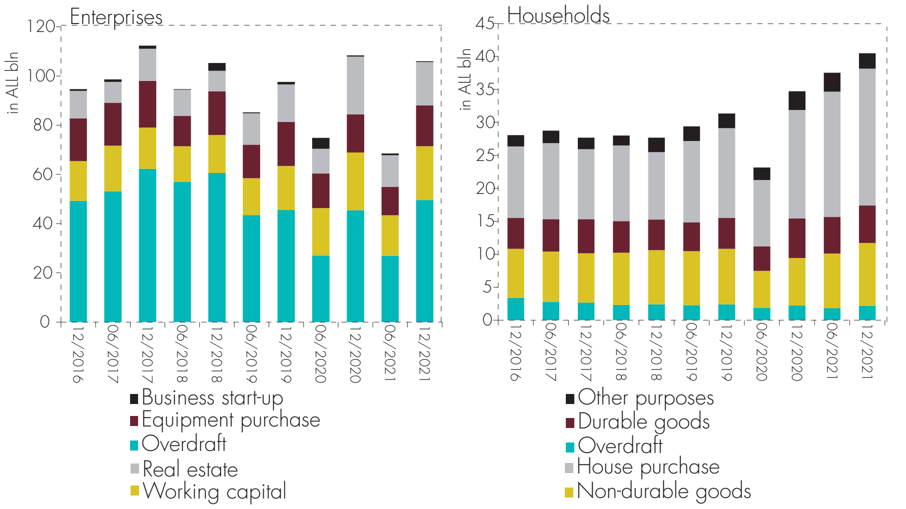
New loans granted by the banking sector, during the period, were 40% higher compared with 2021 H1. These loans, concentrated to enterprises, were mainly granted for short-term purposes, dominated in both domestic and foreign currencies. New loans to households were mainly used for housing purchases.

Restructured loans, during the period, accounted for 1/4 of restructured loans over 2021, and were mainly concentrated in loans to households, loans dominated in foreign currency, and loans for commercial purposes.

New loans granted by the banking sector during this period were around ALL 160 billion. This amount was around 40% higher than the new loans reported by banks in 2021 H1, and 6% higher than in 2020 H2. By currency, the flow of new loans grew in both lek and foreign currency. The business sector provided the main contribution to the growth of the flow of new loans, by attracting around 55% more loans compared with 2021 H1. The main part of this flow (70%) to enterprises was granted for short-term purposes, as overdraft loans and working-capital loans. More than half of new loans to enterprises were granted in the euro. New loans to households were around 8% higher compared to 2021 H1, driven by the increase in new loans for house purchases and non-durable goods consumption. New loans for house purchases, similarly to the outstanding loans ratio, accounted for 50% of the new loans granted to households over this period. New loans in the domestic currency to household also recoded a considerable surge, accounting for around 70% of new loans to households sector.

In 2021, the restructured loans were around ALL 30 billion, equal to the 11% annual flow of the new loans. Banks reported that around 76% of restructured loans were realised during the first half of 2021. Credit restructuring mostly affected the credit portfolio to households, the credit portfolio to trade sector, and the credit portfolio granted in foreign currency.

Chart 59 New loans to enterprises (left) and households (right) by purpose of use



Source: Bank of Albania.

WEIGHTED INTEREST RATES ON NEW LOANS

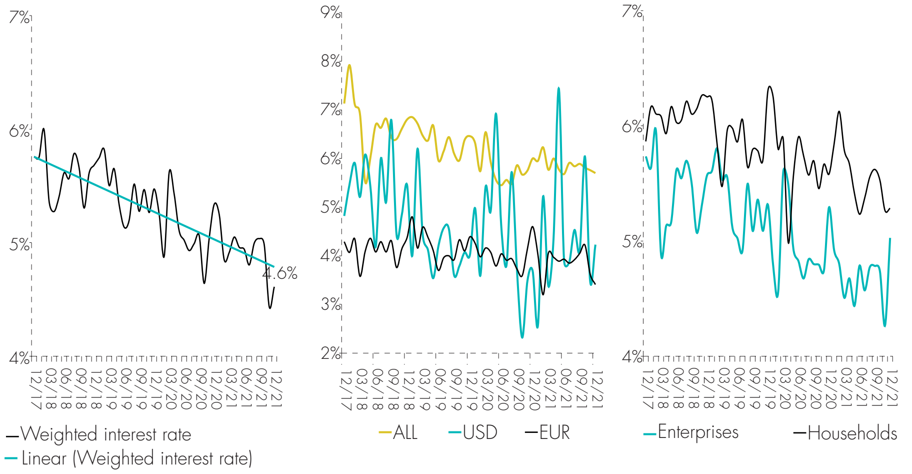
As at end of 2021, the weighted interest rate on new loans during the period[28] was 4.8%, and 0.2 percentage point lower than in 2021 H1. The fall in the weighted interest rate has mainly occurred in 2021 Q4, and was mainly noted in rates on loans to households and on foreign currency denominate loans (the euro and the US dollar). The interest rate on new loans in lek continues to record higher levels than the interest rate on the other two currencies (the euro and the US dollar). This interest rate has fluctuated around the level 5.8% during the second half of year.

The weighted interest rates on new loans granted over the period has declined. This fall was noted in the weighted rates on loans to households, including loans granted in both foreign currency and lek.

The weighted interest rate on new loans in lek has edged down over 2021 and the average interest rate in December 2021 was 0.3 percentage point lower than a year earlier. The interest rate on new loans to households continues to remain higher compared to those on loans to enterprises, though, during 2021, it has decreased considerably. In 2021 H2, this rate has fluctuated around the average level of 5.4%, around 0.3 percentage point lower than the average interest rate on loans to households in the previous year. The average interest rate on new loans to business sector has edged down in the last five years. Nevertheless, in the last months bank have reported a slight increase of this rate compared to the level reported at the end of 2021 H1.

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

Chart 60 Weighted interest rates on new loans, in %; aggregate rate (left); rate by currency (middle); rate by entity (right)



Source: Bank of Albania.

BOX 4 RESTRUCTURED LOANS IN 2021

The value of restructured loans over 2021 months was around ALL 30 billion, out of which ALL 7 billion restructured loans during 2021 H2. In most cases (77%) restructuring is realised upon a client's request. The restructured loans during the period accounted for 4% of the overall outstanding loans and 77% of the stock of non-performing loans. Restructured loans accounted for around 80% of the "special-mention loans" portfolio. Half of restructured loans are loans granted to enterprises, mainly to medium-sized enterprises. Restructured loans over 2021, account for around 3% of the outstanding loans granted to enterprises. Meanwhile, restructured loans to households accounted for 7% of the outstanding loans to households sector.

In terms of sectors of the economy by type of manufacturing activity, the trade sector is the one with the highest demand for loan restructuring. Borrowing enterprises operating in the trade sector have restructured around 5% of the overall stock of loans, and the restructured loans for this sector accounted for around 24% of the total volume of loans restructured by the banking sector during 2021. Around 80% of restructuring volume from enterprises operating in trade sector has taken place in the credit portfolio classified as "special mention loans". Trade sector has submitted restructuring requests also for loans classified as "lost", which accounts for 11% of restructures conducted for the trade sector.

During 2021, the other two sectors of the economy, with a considerable share in the volume of restructured loans, were the sectors of industry (8%) and construction (5%). Both sectors have the highest share in the stock of non-performing loans after the trade sector. Restructured loans for these sectors were around ALL 14 billion, or 14% of the overall restructured loans during the year. In 2021, the share of non-performing loans held by enterprises in industry sector fell from 28% to 20% of the overall stock of non-performing loans, due to the contraction by around 50% of outstanding non-performing loans of this sector.

Loans denominated in foreign currency accounted for around 90% of the value of restructured loans. Loans affected by restructuring were for the most *part classified as standards loans and special-mention loans, whereas loans classified as non-performing were restructured as well. Standard loans account for the main share of restructures, but the volume of restructured loans was only 2% of outstanding standard loans. Restructures in the "special-mention" class, during 2021, accounted for 30% of loans stock. The value of restructures for non-performing loans was relatively low (around ALL 11 billion), but as a share to outstanding non-performing loans, this volume was a considerable one (around 30%).*

The main forms of restructuring used by banks were: extension of maturity term; capitalisation of interest and/or charges payable for default; changes to principal; and assigning a grace period for the principal or credit interest. Over 40% of restructured loans were carried out in the form of maturity extension. The rest was carried out through: changing the principal (30%); capitalisation of interest and/or charges payable for default (13%); and providing an overdue period for the principal or the interest (10%).

Table 8 Data on restructured loans during 2020 and 2021

	12/20	12/21	Share*		12/20	12/21	Share*
Share in the restructured loans				Share in the restructured loans			
Entity				Restructuring form			
Households	11	50	7	Extension of maturity term	62	43	
Enterprises	89	50	3	Capitalisation of interest and/or charges payable for default	10	13	
Large	58	15	2	Changes to payment frequency	3	1	
Medium-sized	9	28	8	Changes to principal	12	30	
Small	21	7	2	Period of principal/ interest granting	11	10	
				Transferring the loan to another borrower.		2	
Currency				Other	3	2	
Lek	25	11	1				
Foreign currency	75	89	8				
Classes				Sectors of the Economy			
Standard	54	35	2	Trade, automobile repair	14	24	5
Special mention loans	23	27	30	Construction	4	5	3
Sub-standard	7	7	22	Industry	41	8	4
Doubtful	7	14	51	Energy, gas, water	5	0	0
Lost	8	16	24	Agriculture, Forestry, Fishing	2	0	1
Destination				Hotels and restaurants	11	4	4
Business loans	90	50		Other	11	8	4
Mortgage loans	6	23					
Consumer credit	4	27		Restructured loans (flow, ALL bln)	20.9	29.1	4

Source: Bank of Albania.

**Share in outstanding loans reported in December 2021.*

4.1.1.5 Deposits

During the period, deposits stock expanded almost twice higher than their growth in in the first half of year. The increase in current accounts and deposits in foreign currency underpinned the strong growth of deposits. The share of time deposits to the stock of deposits has continued to decline, in favour of current accounts and demand deposits.

Enterprises' deposits mainly consist in current accounts and demand deposits, while they appear balanced by currency. Households' deposits, mainly time deposits, continue to dominate the overall deposits. The share of households' deposits in foreign currency has been climbing.

The interest rates did not record any considerable change during the period, though they trended slightly up during the end of the period.

During the period, deposits expanded by around ALL 100 billion, while they recorded ALL 1,430 billion at the end of year. Current accounts, households' deposits and foreign currency-denominated deposits recorded the strongest growth. Deposits in lek and enterprises' deposits recorded a considerable increase, as well. Also, time deposits showed an upward trend during this period. Deposits were around 7% higher compared with the level recorded at the end of 2021 H1. Meanwhile, the annual growth reached at 11%. The share of time deposits to the total stock of deposits has continued to decline, in favour of current accounts and demand deposits. Distribution of deposits by foreign currency continues to be balanced, though during 2021 the share of deposits in foreign currency increased slightly. The latter accounted for 52% of the total stock of deposits at the end of year. Households' deposits continue to account for around 80% of total deposits, while their structure by term and foreign currency is overall balanced. Current accounts and demand deposits in foreign currency dominate the deposits of business sector. Interest rates on deposits in lek and euro continue to maintain low levels and have not changed notably during the period.

Deposits, both in lek and foreign currency, grew during the period, but deposits in foreign currency recorded a growth and provided a contribution around twice higher than deposits in lek. In 2021 H2, deposits in foreign currency recorded the strongest growth in the last 10 years. The half-yearly and annual change rate of deposits in foreign currency were 10% and 14%, respectively. At end of year, the stock of deposits in the euro was EUR 5.33 billion, from EUR 4.75 billion recorded at the end of 2020, meanwhile they increased by EUR 580 million during the second half of 2021. The strong growth of deposits in euro, during the period, is due to the increase in net foreign currency flows in the balance of payments, the upsurge in credit and the slight rise of interest rates in the last months.

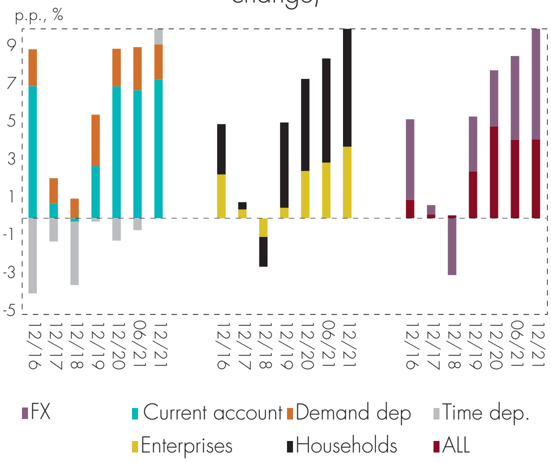
Table 9 Data on the performance of deposits by maturity, sector and currency

	12/21		12/21 to 06/21		V/V
	ALL billion	Share	(%)	(p.p.)	(%)
Current account	590	41	12	5	19
Demand deposits	191	14	7	1	14
Time deposits	619	43	2	1	3
Public sector	45	3	32	1	37
Enterprises	241	17	18	3	25
Individuals	1,147	80	4	4	8
Lek	690	48	5	2	8
Foreign currency	743	52	10	5	14
Deposit stock	1,433	100	7	7	11

Source: Bank of Albania.

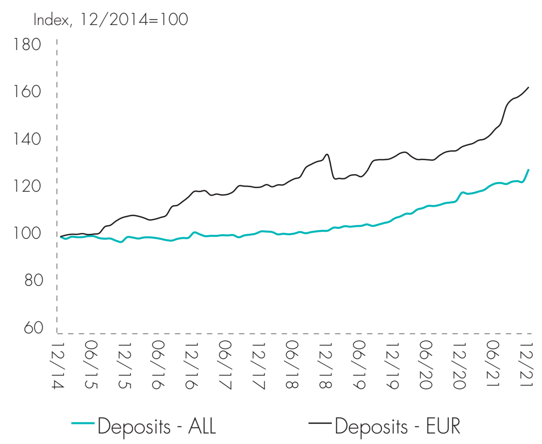
Fluctuations in the exchange rate of the lek against the US dollar and the euro have not provided a considerable contribution to the equivalent value in Albanian lek of foreign currency deposits. Distribution of deposits by term, currency and institutional sector have not recorded notable changes during the period, but the shares of current accounts, deposits of enterprises and deposits in foreign currency have been slightly up compared to the previous year. At the end of 2021, current accounts, demand deposits and time deposits accounted for 41%, 14%, and 43%, respectively of deposits, from 39%, 13% and 47%, respectively, in the previous year. The sector of households continues to own most part of deposits, accounting for 80% of total, though, this share has decreased slightly due to the rapid increase in the deposits of enterprises sector.

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



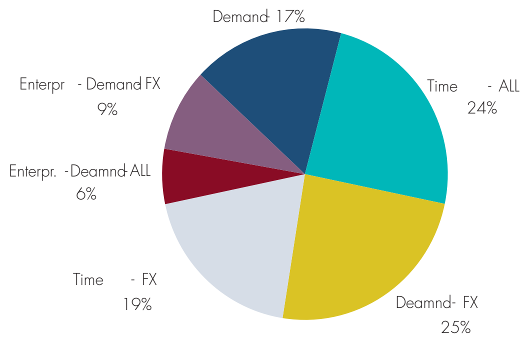
Source: Bank of Albania.

Chart 62 Performance of deposits in ALL and EUR



Source: Bank of Albania.

Chart 63 Structure of deposits by term, sector and currency



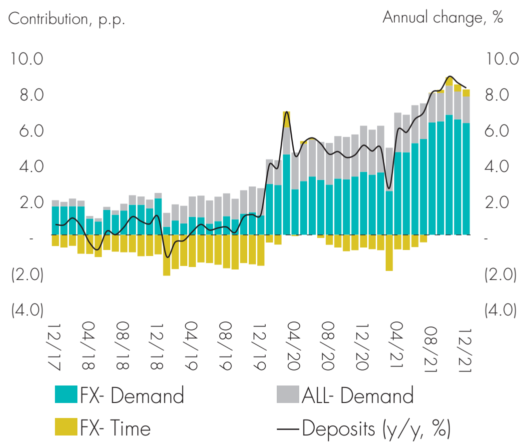
Source: Bank of Albania.

Structure of deposits by currency has changed slightly in favour of foreign currencies, in a ratio 48%/52% broken by lek/foreign currency, due to the strong growth in foreign currency-denominated deposits.

Current accounts and demand deposits continue to dominate the deposits of enterprises, while their distribution by currency is almost balanced. Time deposits have almost an insignificant share in held by enterprises, as most of enterprises' accounts with banks are used for supporting their operational activities and needs of more than as genuine saving instruments. In households' portfolio, time deposits account for around 60% of the total deposits of this sector. Households hold time deposits mainly in the domestic currency, while current accounts and demand deposits are in foreign currencies (euro and

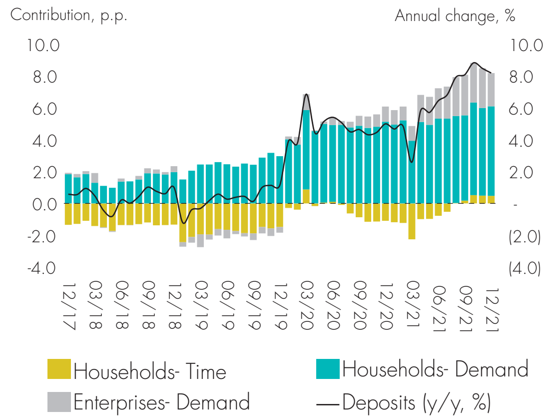
US dollar). Time deposits of households' sector mainly dominated in foreign currency increased slightly during the second half of year.

Chart 64 Deposits by maturity and currency



Source: Bank of Albania.

Chart 65 Deposits by maturity and sector



Source: Bank of Albania.

The interest rates on all types of deposits, by maturity and foreign currency, remain at low levels and have recorded no strong changes during the period. The interest rates on new time deposits in lek have increased slightly compared to the average in both 2021 H1 and 2020 H2, and at the end of 2021 they have ranged around the value 0.7%. Also time deposits in euro show a slight increase in the interest rate, at 0.3%, from 0.2% and 0.15%, respectively in the two previous semi-annual periods. Though the interest rates on deposits in euro remain at a rather low level, they are the highest rates recorded in the last five years.

During the period, the non-performing loans ratio continued to decline, reaching at 5.6%, as at end of 2021. All types of loans, by maturity, sector and currency were improved.

The considerable contraction in the non-performing loans stock was driven by: the reduced flow of new non-performing loans; the reclassification of non-performing loans to performing classes of loans; and the lost loans write-offs.

Also, other complementary indicators affirm the improved credit quality. The creation of provisions for credit risk was lower than in the previous periods. The provisioning ratio for the non-performing loans was up at 69%.

4.1.2 RISKS TO THE ACTIVITY OF THE BANKING SECTOR

4.1.2.1 Credit risk

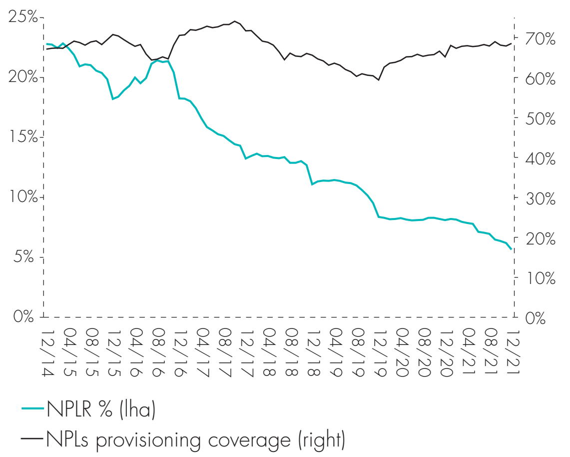
Credit quality improved considerably during this period. The reduced credit stock in the classes of "sub-standard loans" and "lost loans" contributed in the improvement of credit quality. The reclassification process of non-performing loans in the performing classes has the most important role in improving the credit quality, coupled with the lost loans write-off from banks' balance sheets. The non-performing loans ratio (NPLR) fell by 1.5 percentage points, at 5.6%., as at end of 2021. Non-performing loans stock reduced by around ALL 7 billion, while it stood at ALL 40 billion at the end of year. By size of contribution, the contraction of the non-performing loans stock was driven by the restructuring of a part of non-performing loans, the write-off of lost loans from banks' balance sheets and the reduction of the flow of performing loans that have shifted to non-performing loans classes. The volume of loan repayments in non-performing loans classes, during the period, was comparable to the volume in 2021

H1. During the period, banks have reported improved credit quality for long-term credit portfolio, credit to enterprises and foreign-currency denominated loans, compared to the previous year. During January 2015-December 2021, banks wrote off around ALL 70 billion of lost loans from their balance sheets. Nevertheless, this value amounts only ALL 4 billion, in 2021, being concentrated to enterprises, mainly in the euro.

Within the non-performing loans portfolio, banks have reported a fall in the outstanding loans across all classes of non-performing loans. The share of lost loans to the total of non-performing loans increases at 52%, from 46% in the previous year, due to the higher fall in the stock of doubtful loans and in special-mention loans. Banks have reported improved credit quality mainly for long-term credit portfolio, credit to enterprises and foreign-currency denominated loans, compared to the previous year. At the same time, these credit portfolios have the highest rates of non-performing loans. As at end of 2021, the non-performing loans ratio for loans to enterprises, foreign currency loans and long-term loans were 6.6%, 5.7% and 5.5%, respectively.

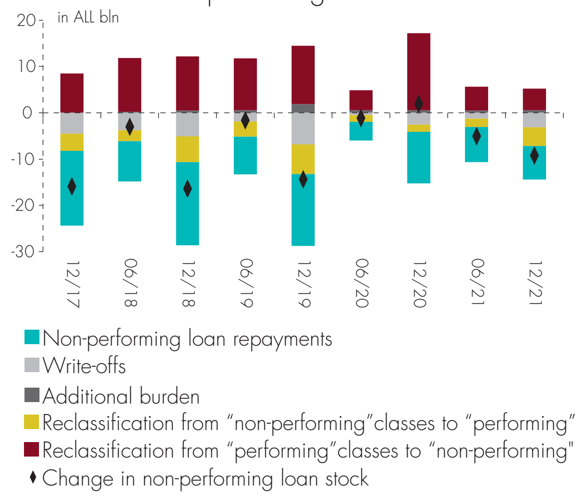
Banks have continued to create provisions for non-performing loans, but the provisioning level has been decreasing, similarly to the stock of non-performing loans. Given that the decrease in the stock of non-performing loans was higher compared to the decreased provision fund during 2021, the coverage ratio of non-performing loans increased to 69%, from 65% at the end of 2020.

Chart 66 Non-performing loans ratio and provisioning



Source: Bank of Albania.

Chart 67 Contribution to the semi-annual change of the non-performing loans stock



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[29]; bankruptcy rate[30] and the recovery rate of non-

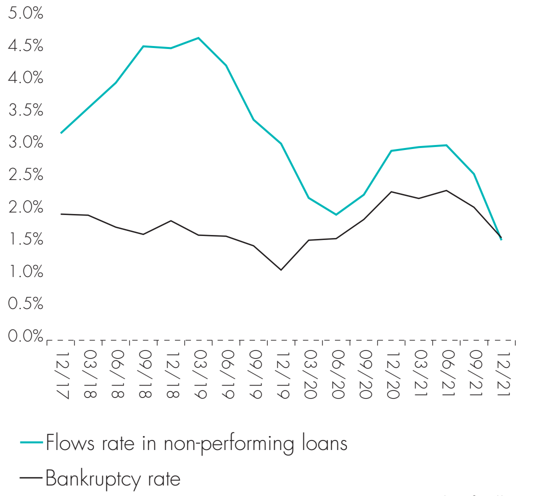
[29] *The flow of new non-performing loans during the period against the outstanding regular loans at the end of the period.*

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

performing loans[31]. Data reveals that, at the end of December 2021 "the flow of new non-performing loans" was equal to 1.5% of regular loans, lower than the value recorded at the end of 2020 H1. This rate has recorded the maximum of 5% in 2019, and temporary increasing 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, reached at 1.6% as at end-2021, from 2.6% as at end-2021 H1. Also, "the recovery rate of non-performing loans" reached at 15%, from 7% in the first six months of the year.

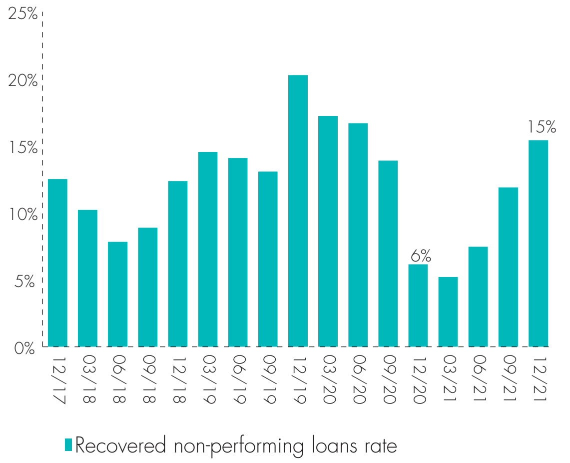
This performance shows the considerable improvement in the ability of banks for recovering non-performing loans. In the last four years, the recovery rate suggests that banks have improved the gathering of non-performing loans since the mid-2018 up to the end of 2019, and throughout 2021, while they have encountered difficulties in this process in the first part of 2018, and throughout 2020. All the complementary indicators of credit quality suggest that in 2021 H1, 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.

Chart 68 Flow rate of non-performing loans and bankruptcy rate



Source: Bank of Albania.

Chart 69 Recovery rate of non-performing loans



Source: Bank of Albania.

The quality of loans unhedged against exchange rate volatility has improved considerably compared to both the end of 2021 H1 and 2020. NPLR for this portfolio fell at 4.7% as at end-December 2021, compared to 6.2% and 7.1%, as at end 2021 H1 and end-2020, respectively. 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 foreign currency loans.

The main share[32] in the outstanding loans unhedged from exchange rate fluctuations continues to be held by loans for investments in real estate and the

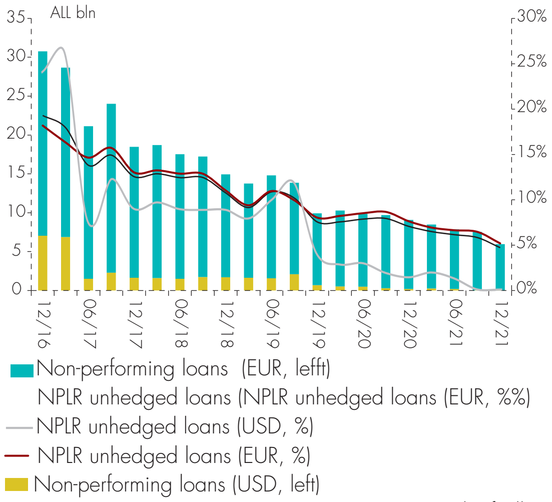
[31] *The flow of new non-performing loans that have been reclassified to performing classes against the outstanding non-performing loans at the end of the period.*

[32] *Around 76% of total.*

NPLR for this category of loans fell to around 6.7% from 7.9% 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 5.2 percentage points during 2021, at the low level of 1.7% as at end-2021. Credit quality also improved across other unhedged loan portfolios by purpose of use, in the last years. NPLR for "business development" declined at 6.2%, from 7.8%, while NPLR for loans for consumption fell slightly at 3.4%.

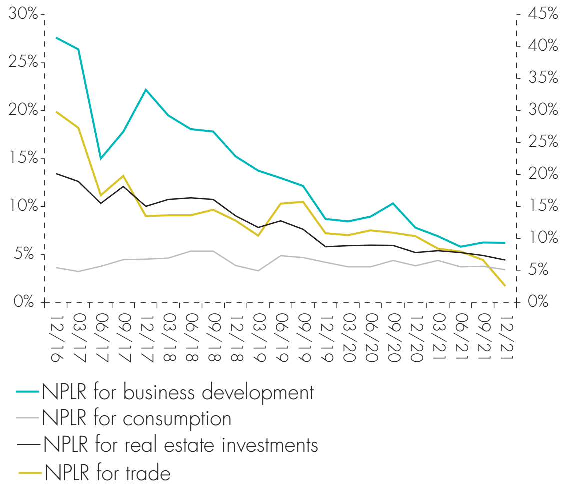
The quality of loans granted from domestic banks to non-resident entities, which is represented by loans to enterprises in euro, continues to be good and improved during the period. NPLR for these entities fell close to 0.3%, while this ratio stood at 1.7% as at end-2020.

Chart 70 NPLR for loans unhedged against exchange rate fluctuations, by currency



Source: Bank of Albania.

Chart 71 NPLR for loans unhedged against exchange rate, by purpose of use



Source: Bank of Albania.

The coverage ratio of non-performing loans with provisions expanded by 1 percentage point compared with June 2021, and by 3.4 percentage points compared with the previous year, reaching at 69% driven by the more rapid fall in non-performing loans stock compared with the contraction of provisions. The provisioning ratio for individual banks fluctuates between 56% and 80% range. Capital coverage of net non-performing loans[33] increased to 14 times from 11.1 times at the end of 2021 H1. This increase was mainly driven by the decline in net non-performing loans[34]. As at end-2021, the net non-performing loan ratio against outstanding loans registered 1.8%

Collateralization loans[35], which represents a key element in the group of hedging instruments of banking sector from the risk arising from non-returned loans, was slightly up during the period. This ratio continues to maintain high levels, providing room to banks to manage the risk arising from non-returned loans. During the period, collateralization expanded by around 0.3 percentage

33 Non-performing loans after the deduction of provisions.

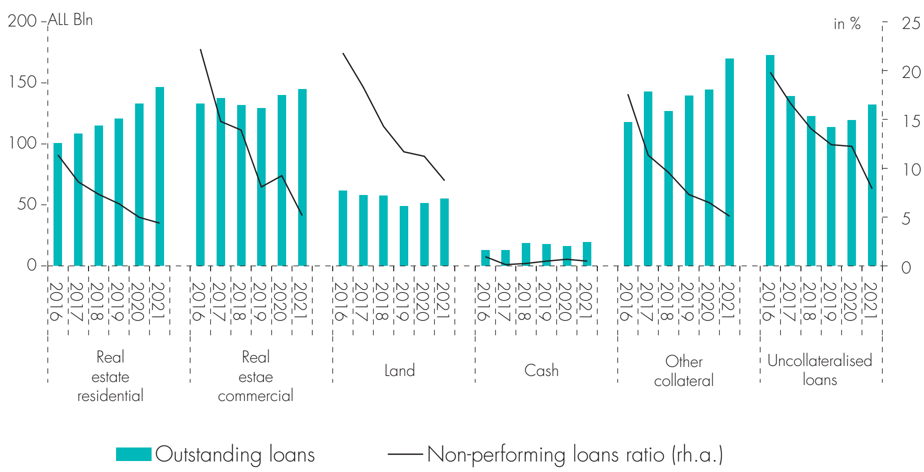
34 As a result of the narrowing in outstanding net non-performing loans by almost 17%, the "net non-performing loans/regulatory capital" fell to 7.1%, from 9% as at end-June 2021.

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

point, reaching at 80.2%. Loans collateralised with collateral in the form of real estate account for the main share, or around 65% of collateralized loans, and 52% of overall outstanding loans. Collaterised loans stock expanded by around 7% compared to the previous year.

Quality of loans for the category of loans collaterised in the form of real estate has considerably improved in the last year. Loans collaterised in the form of cash continues 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 continues to fluctuate around the same level (20%). Quality of loans for this category has improved in the last year, but the level of NPLR continues to record higher rates compared to other categories, with a level of 8% as reported at the end of 2021.

Chart 72 Outstanding loans and non-performing loans ratio by collateral



Source: Bank of Albania.

4.1.2.2 Liquidity risk

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

For short-term maturities, gaps between assets and liabilities remain at notably negative rates. Nevertheless, these gaps are covered by the ample presence of liquid assets. The mismatch of average maturity of assets and liabilities has slightly increased during the period.

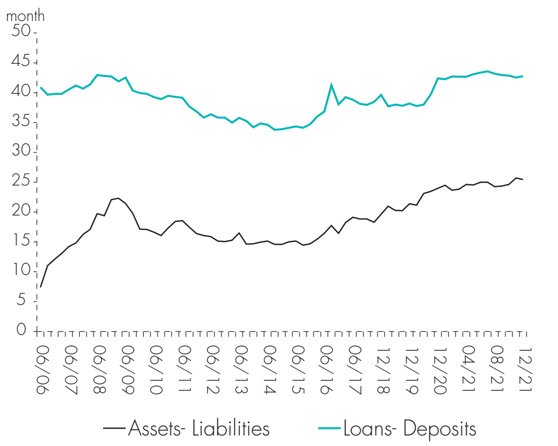
Deposits remain the main source of funding, which cover twice the loans volume, in both lek and foreign currencies.

The liquidity risk in the activity of the banking sector remains contained, and some indicators signal the slight mitigation of this risk during the period. The liquidity indicators, both in lek and foreign currency, continue to be notably above the minimum regulatory ratios. Similar to the previous period, the banking sector did not report the use of funding lines by the parent groups. The overall gap between assets and liabilities by maturity has remained almost unchanged, at around 5% of the overall assets of banking sector, but their increase in time deposits has driven to a slight contraction of this gap for the maturity basket up to 3 months. The average maturity mismatch between loans and deposits has shown a stable performance, which has remained unchanged during the first half of year, and slightly down in the second half of year.

Liquid assets of the banking sector grew faster compared with the overall assets and their short-term liabilities. Deposits remain the main source of funding, which cover twice the loans volume of the sector. At the end of the period, "loans/deposits" ratio was 46.8%, unchanged from the previous six months, as both total deposits and loans have recorded a similar growth pace. The growth of deposits in the domestic currency was stronger than the increase of the stock of lek-denominated loans, driving to the slight fall of the "loans/deposits" ratio in lek to 47.5%, from 47.8% at the end June 2021. "Loans/deposits" ratio in foreign currency was slightly up at 46.1% from 45.9%.

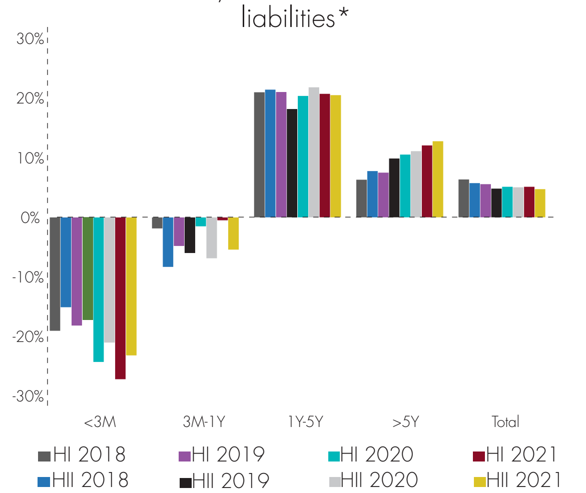
During the period, liquid assets of the banking sector increased by ALL 30 billion, reaching at ALL 590 billion as at end-2021. Liquid assets ratio to total assets in banks' balance sheets continues to remain high. As at end-2021, this ratio stood at 34.4% from 34.1% at the end of 2021 H1. This performance reflects the faster growth of liquid assets in banks' balance sheets compared to the expansion of total assets. At the same manner, due to the faster growth of liquid assets than short-term liabilities, the liquid assets ratio grew by around 0.2 percentage point during the period, at 46.7%.

Chart 73 Average residual maturity mismatch between assets-liabilities and loans-deposits



Source: Bank of Albania.

Chart 74 Maturity mismatch between assets and liabilities*



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

The negative gap between assets and liabilities by residual contractual maturity segments, as a ratio total asset in short run, continues to be high, though it recorded a slight fall during the period. The gap between short-term assets and liabilities by residual contractual maturity segments for the period up to 3 months,[36] that continue to remain the largest negative gap for the whole horizon of maturities, reduced at 23%, from 27% to the total assets in the first six months. At the same time, the negative gap for maturities 3 months up to 1 year has recorded an increase at a similar size. Nevertheless as a ratio to total

[36] *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.*

assets, the size of this gap remains contained close to an average rate of 5%. 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, an increase in the mismatch of average maturity of assets and liabilities was observed, due to an increase of the average maturity of assets against the maturity of liabilities. At the end of the period, this mismatch was around 25.5 months, from 25 months at the end of 2021 H1. Deposits' residual maturity, which represents the most significant category of liabilities, increased to 7.7 months from 7. 3 months, due to the slight growth in the stock of time deposits. The residual credit maturity recorded a slight fall to 50.5 months.

4.1.2.3 Market risks

EXCHANGE RATE RISK

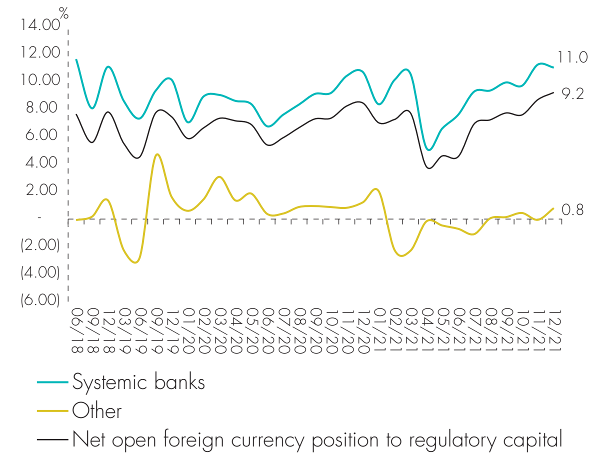
The exposure of banking sector to direct exchange rate risk has increased during the period, though it remains considerably below the regulatory limit. The exposure of banks to indirect exchange rate risk has decreased.

The ratio of the net open foreign currency position of the banking sector to regulatory capital was up to 9.2% during the period, in reflection of the increasing exposure to the direct impact of exchange rate fluctuations on banks' balance sheets. Nevertheless, this ratio remains below the higher level recorded in the previous periods and is three times less than the upper regulatory limit of 30%. This conclusion is also valid for the aggregate indicator to both systemic banks and non-systemic banks, which recorded 11% and 0.8%, respectively, as at end-2021.

The exposure of the banking sector to indirect exchange rate risk, as measured by foreign currency mismatch indicator [37] was slightly down during the period. As at end-2021, the foreign currency mismatch indicator was equal to 15.4% of banking sector assets. Foreign currency-denominated assets and liabilities of banks grew by 10% and 9%, respectively, compared with the level in the previous six months, while credit in foreign currency to resident entities grew by 7%. The sub-index in the European currency, slightly down at 15.8% of assets as at end-2021 H2, continues to dominate the overall index.

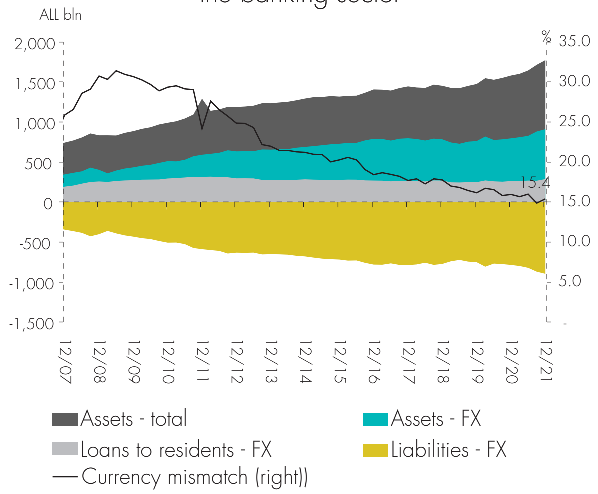
[37] *The foreign currency mismatch indicator measures the hedging rate of the banking sector's liabilities with assets set off by resident credit in foreign currency. A low value of this indicator's ratio to assets shows a low exposure to movements in the exchange rate. For the calculation of the exchange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

Chart 75 Open foreign currency position to regulatory capital for the sector and groups



Source: Bank of Albania.

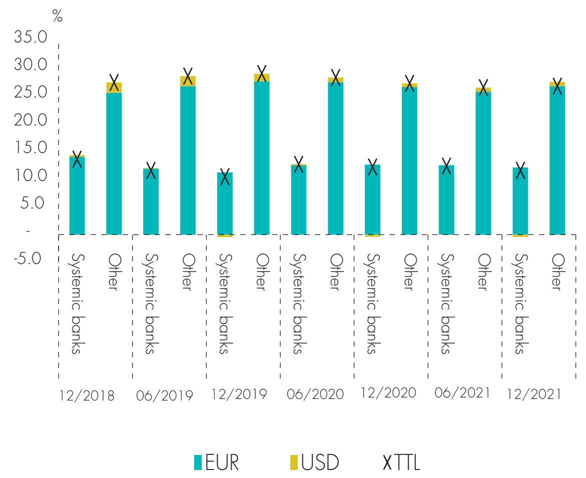
Chart 76 Performance of Indexes components for the banking sector



Source: Bank of Albania.

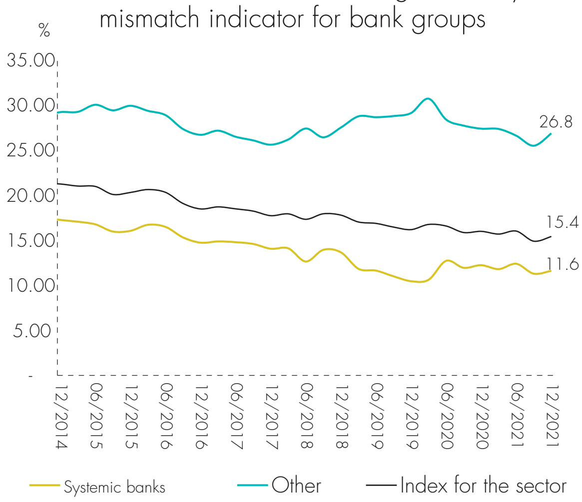
The group of systemic banks continues to provide the main contribution to the performance of the foreign currency mismatch index. For this group of banks, the indirect exchange rate risk has slightly decreased by around 1 percentage point, from the level in the previous six months and previous year. At the end of the period, the index for systemic banks was equal to 11.6% of assets from 12.4% in the previous period, and 12.2% in the previous year By currency, the main contribution of this group was made by the index of the European currency, which is equal to 12.1% of assets, slightly down from 15.5% level in the previous six months. The index of foreign currency mismatch for the group of non-systemic banks has notably higher values that the index for systemic banks and it has been increased slightly during the period, reaching at 26.8% at the end of 2021. This index has decreased slightly compared with a year earlier.

Chart 77 Currency mismatch by groups and currency



Source: Bank of Albania.

Chart 78 Performance of foreign currency mismatch indicator for bank groups



Source: Bank of Albania.

The banking sector's exposure to interest rate risk increased slightly during the period. Nevertheless, the indicator of exposure to this risk remains significantly below the upper regulatory limit.

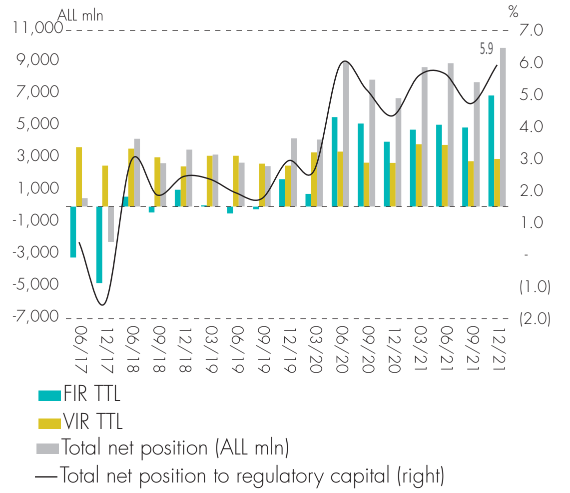
The banking sector is more exposed to the interest rate risk for: the positions in lek; the fixed interest rate; and the long-term maturity.

INTEREST RATE RISK

The exposure of banks to the interest rate risk increased slightly in 2021 H2, though the exposure indicator stands notably below the upper regulatory limit of 20%, showing a moderate exposure at sector level. As at end-2021, the weighted total net position in banks' balance sheet was at 5.9% of regulatory capital, slightly higher compared to the previous period and the previous year. The weighted difference of assets to liabilities with fixed interest rates (FIR) was equal to 4.1% of the regulatory capital of the sector, or somewhat higher than the value recorded in both previous period and year[38]. The indicator for assets and liabilities with variable interest rates (VIR) was equal to 1.8% of the regulatory capital, slightly down from the level as at end-2021 H1. The total net position for both groups of banks by importance increased by 0.3 percentage point during the period. Systemic banks have a lower exposure than the group of non-systemic banks, as the net position indicator for each group stands at 5.5% and 7.4%, respectively.

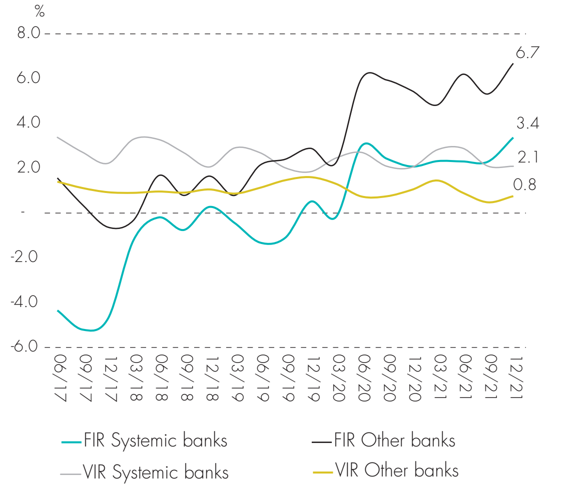
By groups of banks, systemic banks have maintained a positive exposure to the fluctuation in the variable interest rates (VIR), while they have gradually closed the negative exposure[39] to fixed interest rates (FIR) fluctuation, which recorded positive values since around two years. In 2021 H2, the exposure indicator to variable interest rate (VIR) fluctuations was at 2.1% of regulatory capital, or 1 percentage point below the level in the previous period. In 2021 H2, the exposure indicator to fixed interest rate (FIR) fluctuations was slightly up, reaching at 3.4% of regulatory capital of systemic banks. Non-systemic banks, overall, show a higher exposure for assets and liabilities with fixed interest rate (FIR), and this position expanded by 0.5 percentage point, during the period, reaching at 6.7% of regulatory capital as at end-December 2021. The exposure for assets and liabilities with variable interest rate (VIR) for other banks is positive, but has always ranged around an average of 1% throughout the recent years.

Chart 79 Weighted total net position in bank's balance sheets against regulatory capital, in %



Source: Bank of Albania.

Chart 80 Performance by groups of net position for fixed interest (FIR) and variable interest (VIR) rates



Source: Bank of Albania.

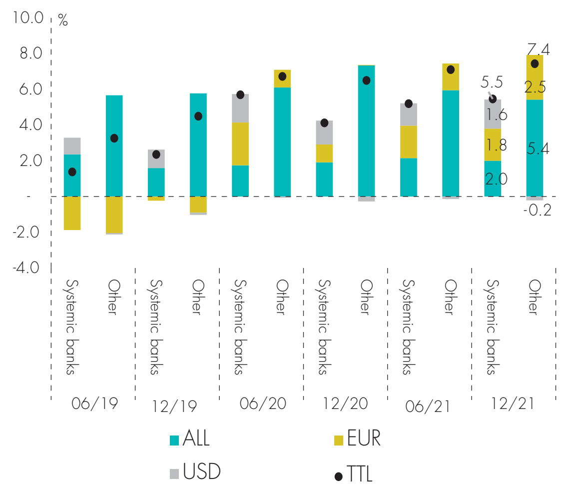
[38] *3.2% and 2.6%, respectively.*

[39] *Higher liabilities than assets with fixed interest rate.*

By currency, net position in the domestic currency, reaching at 2.8% of regulatory capital as at end-2021, continues to provide the main contribution in the value of the weighted net position for the banking sector. The exposure of assets and liabilities, sensitive to the interest rate fluctuations in euro, is more contained compared to the exposure in lek. The respective indicator was 2% at the end of the period. Notwithstanding the exposure in the US dollar is very low compared with the exposure in both the lek and the euro, this exposure has provided the main contribution in the increase of the overall position during the period, and is related to the 0.4 percentage point expansion of the position in the US dollar of system banks, reaching at 1.6% of the regulatory capital. For the group of other banks, the total indicator has reflected the increase in the indicator of net position in euro up to 2.5%, and the fall of the indicator for the position in lek up to 5.4%. Meanwhile, the indicator of the position in the US dollar has not changed from the previous periods.

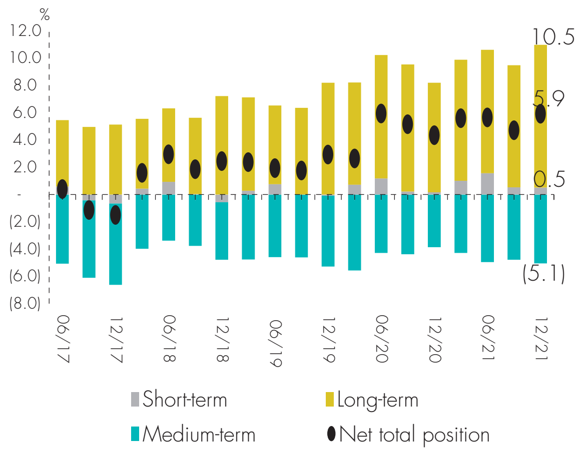
By maturity, the change in the total net position was mainly driven by the increase in the positive exposure for long-term maturity, whose indicator was up to 10.5% of regulatory capital, from 9% and 8%, respectively, in 2021 H1 and 2020. The position for short-term instruments remained positive, though it contracted at 0.5%, from 1.6% in 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. At end-2021, this position was equal to 5.1% of regulatory capital of banks, somewhat higher from the level in the previous year.

Chart 81 Gap by group and currency against regulatory capital, in %



Source: Bank of Albania.

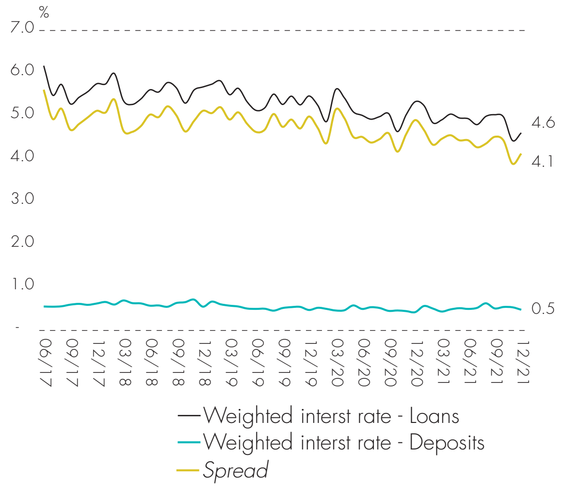
Chart 82 Weighted net position by maturity against regulatory capital, in %



Source: Bank of Albania.

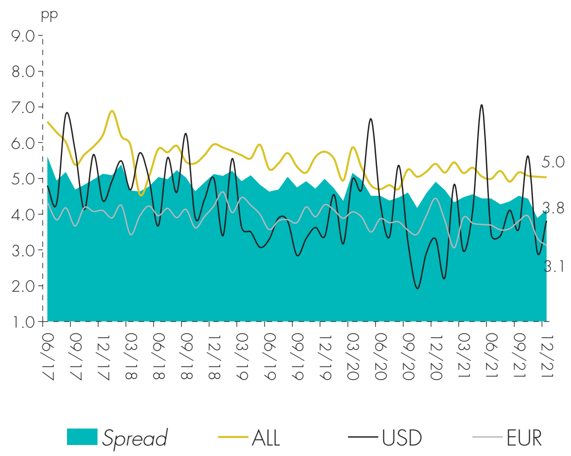
Indirect risk to interest rate change[40] showed a downward trend in the second half of 2021. As at end-2021, the overall spread between the weighted interest rate on loans and deposits was 4.1%, lower from the previous six months and the previous year. The fall in the spread for the euro by 0.6 and 1.3 percentage points, compared to the value in the previous six months and previous year, provided the main contribution in this regard. This performance is related to the sharp fall in the interest rate on credit compared to the interest rate on deposits in this currency.

Chart 83 Loans and time deposits weighted interest rates and interest rates spread, in %



Source: Bank of Albania.

Chart 84 Spread of weighted interest rates of loans and time deposits by currency, in p.p.



Source: Bank of Albania.

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

BOX 5 EXPOSURE OF THE BANKING SECTOR TO COUNTRIES INVOLVED IN THE MILITARY AGGRESSION AGAINST UKRAINE

In the context of the Russian military aggression in Ukraine and the sanctions that Western countries are undertaking on Russia and Belarus, we have assessed the possible impact of these developments on banks operating in Albania. The eventual exposures to Russian, Ukrainian or even Belarus entities would be the transmission channel of this impact.

Exposure can be perceived in the following forms: a) the presence of banks with Russian , Belarussian or Ukrainian capital in Albania; b) the presence of assets (investments) or resources (liabilities) held on the balance sheet of a bank operating in Albania, to Russian, Belarussian or Ukrainian entities; c) the presence of branches or subsidiaries of banks operating in our country, in Russia, Ukraine or Belarus; d) interconnection due to ownership relations with banks or other financial institutions having exposures in Russia, Belarus or Ukraine, in the form of b) or c). In this regard, the Bank of Albania deems that:

- *a) There are no banks in Albania with capital controlled by legal or natural entities of Russian, Belarussian or Ukrainian origin;*
- *b) Based on the full data reported by banks until the end of January 2022 and following the operational communications of recent days, it turns out that the banking sector had an exposure of assets in the balance, which is estimated at 0.34% of the value of banking sector's assets or 3.4% of the value of shareholding capital. The eventual provisioning of this value by the banking sector does not significantly affect either the capital or liquidity positions of the banking sector. Banks operating in Albania have insignificant obligations to Russian, Belarussian or Ukrainian entities.*
- *c) Banks operating in Albania do not have branches or subsidiaries in Russia, Belarus or Ukraine.*
- *d) Some of the European banking groups that have subsidiaries in Albania, have branches or subsidiaries in Russia, Belarus or Ukraine, with exposures on their balance sheets or property relations to Russian physical and legal entities.*

First, it should be emphasised that currently the financial situation of these European banking groups is quite good, providing a strong resilience to eventual shocks arising from the group structure.

Second, the capital structure of these European banking groups does not appear to be critically dependent on shareholders of Russian or Belarussian origin. The instruments available to the European supervisory authorities enable a rapid change of shareholder structure whenever it is needed and preservation of the financial stability of the institution.

Third, during March 2022, the banking groups themselves performed assessments in terms of the impacts that may result from the war in Ukraine and the sanctions imposed on Russian or Belarussian entities. Despite the objective difficulties in conducting business in Ukraine, banking groups estimate that the negative impact is currently affordable. The reasons are mainly related to the low values of net balance sheet exposure, the lack of a significant correlation as the branches of the conflict zone depend essentially on local resources and the corrective actions that the banking groups have taken so far.

For banks operating in Albania that are subsidiaries of these banking groups, the impacts that may arise from the group structure are considered limited. These banks are well-capitalized, profitable, and liquid and depend on the financial resources of Albanian legal and natural entities.

Overall, it is estimated that banks operating in Albania are not expected to feel a significant impact from developments in Ukraine and the sanctions imposed on Russian and Belarussian legal and physical entities. However, the situation is still evolving and the Bank of Albania remains fully committed to monitoring and assessing the impact of developments on the banking sector. In this process, close communication has been established not only with the banks but also with other public authorities in Albania, with the relevant institutions of the European Union and international financial institutions. We deem that the framework of monetary, prudential and emergency intervention instruments remains adequate to safeguard financial system stability.

4.1.3 STRESS TEST EXERCISE

Results of stress test exercises in terms of solvency conducted for the years 2022 and 2023 show that the banking sector is resilient against possible macroeconomic shocks, but particular banks may need to strengthen their capital positions.

Stress test exercise in terms of liquidity risk for the same period shows that as at end-2021, banks own a high level of expanded liquid assets that they may liquidate in case of liquidity stress, and their resilience has been improved compared to the previous year.

The stress test exercise serves to determine if banks are adequately capitalised to withstand assumed shocks beyond a normal situation. This type of exercise is also known as the exercise "on solvency assessment". The solvency stress test exercise assesses the main risks to the banking sector's balance sheet, as: credit risk; interest rate risk; exchange rate risk; and the indirect risks through lending in foreign currency and the change in interest rates. In terms of the solvency stress test exercise, a new methodology is applied, which has been carried out for more than one year, while it has been verified in advance for two consecutive quarters. We assess that this methodology - which is achieved with the support of international experts - provides some priorities against the existing one. It enables to: deepening the analysis due to the quality of data; employing more analytical methods in assessing risks; better combining the composing modules; and a more understandable visual appearance of results, with conclusions that are considered more realistic and closer to the experts' expectations.

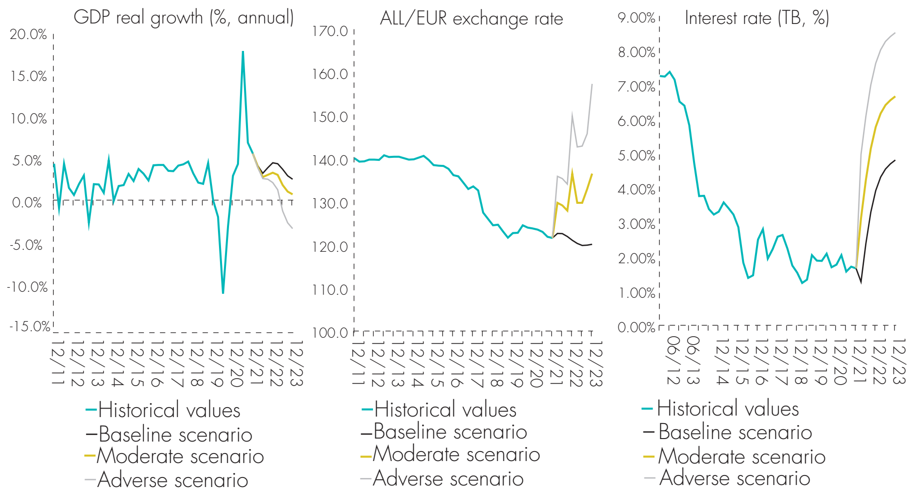
The stress test exercise in terms of liquidity risk is conducted on annual frequency and provides insights on the resilience of individual banks and the banking sector to withstand possible shock in the form of liquidity shortage for all currencies and for particular currencies within the 2-year horizon.

4.1.3.1 The stress test exercise in terms of solvency

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 2023.

The baseline scenario assumes a positive economic growth rate for the time frame of the exercise. In this scenario, the economic growth is accompanied with considerable growth rate of lending and an improvement of the quality of the credit portfolio as a result of the expected lost loans write-offs from banks' portfolios. In terms of market risk, this scenario has also assumed the revaluation of investment and placement securities. 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; while regarding the revaluation of securities, this scenario has considered only the revaluation of investment securities. The adverse scenario assumes a positive growth rate at the end of the first year of the exercise, followed by an economic contraction. Also, all the three scenarios assume the suspension of dividends allocation from banks[41], till the end of 2022.

Chart 85 Projections on the key macroeconomic indicators

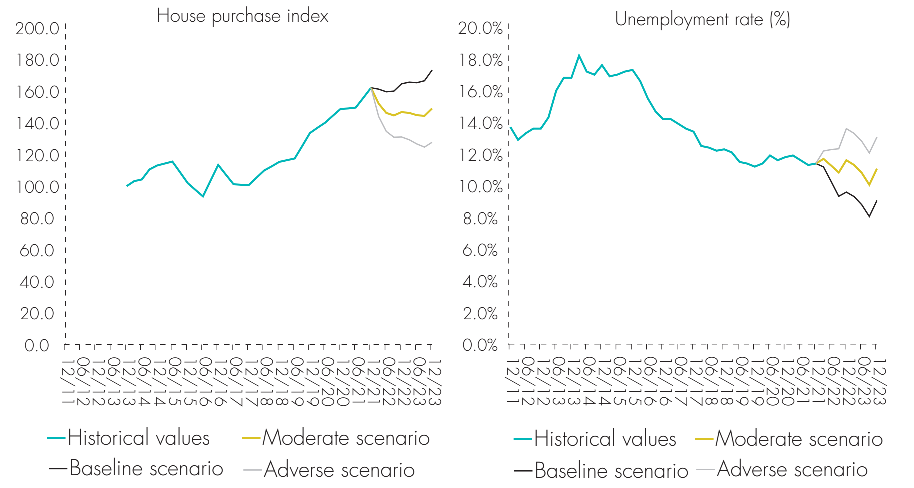


Source: Bank of Albania.

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

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

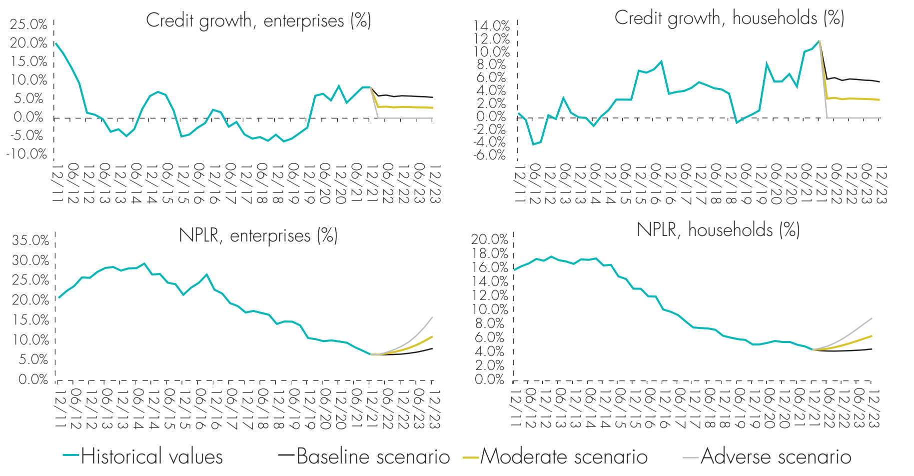
Chart 86 Projections on the new macroeconomic indicators



Source: Bank of Albania.

Also, forecasts on the new macroeconomic indicators included in the exercise, show 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 2023.

Chart 87 Projections on credit portfolio by relevant models to enterprises and households

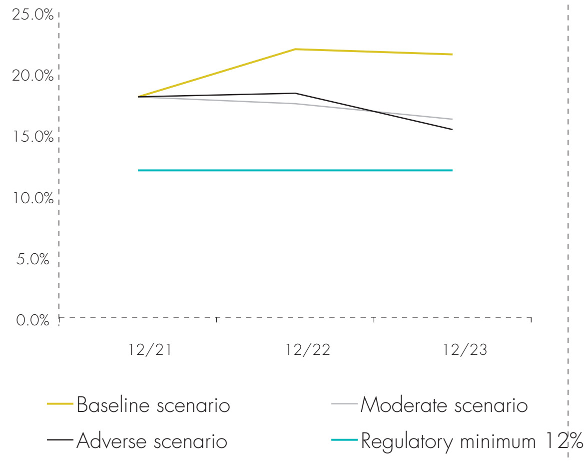


Source: Bank of Albania.

Stress test results in terms of capital adequacy show that:

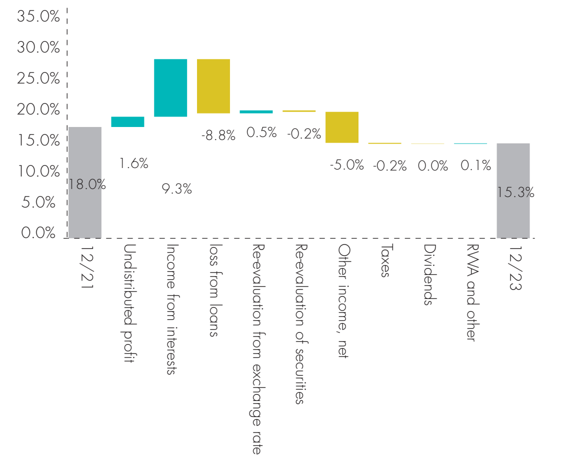
- In the baseline scenario, the Capital Adequacy Ratio (CAR) of the sector tends to grow; it increases at 21.9% at the end of 2022, and 21.5% at the end of 2023. Stress test results present a stable situation and high levels of capitalisation for the entire banking sector. Nevertheless, taking into consideration the additional regulatory requirements by individual banks, developments in particular banks evidence the need for capital injection during the period of the exercise. Five banks appear under-capitalised by the end of 2023 in this scenario, accounting for around 17.2% of the sector's assets. In this case, the need for additional capital is assessed to amount up to around ALL 3.5 billion.
- In the moderate scenario, the banking sector's CAR is slightly lower at 17.5% at end-2022, and 16.2% at end-2023. Based on the results obtained, developments in particular banks evidence the need for capital injection at the end of the period of the exercise. Eight banks appear under-capitalized by the end of 2023, in this scenario, accounting for around 54.2% of the sector's assets. In this case, the need for additional capital is assessed to amount up to around ALL 16.6 billion.
- Also, in the adverse scenario the banking sector remains capitalized, but CAR falls from 18.3% at end-2022, to 15.3% at end-2023.

Chart 88 CAR over the time frame of the exercise



Source: Bank of Albania.

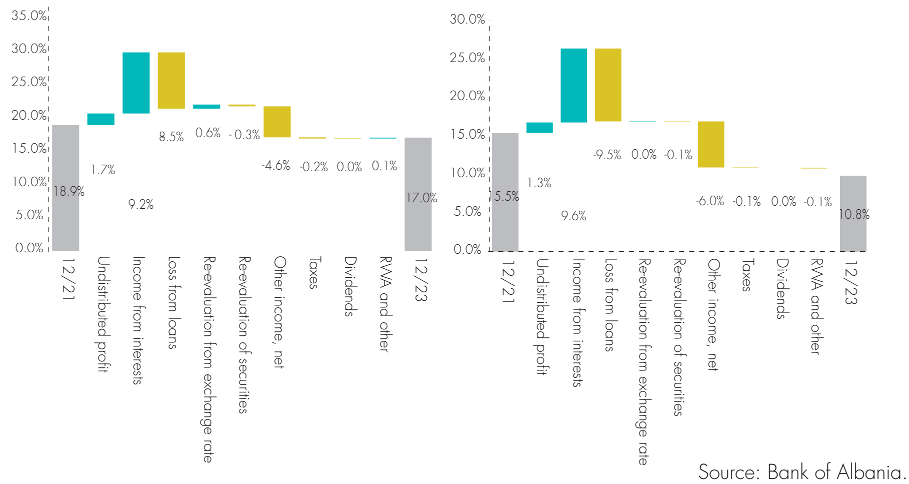
Chart 89 Contribution of the main balance sheet's items in CAR change in adverse scenario



Source: Bank of Albania.

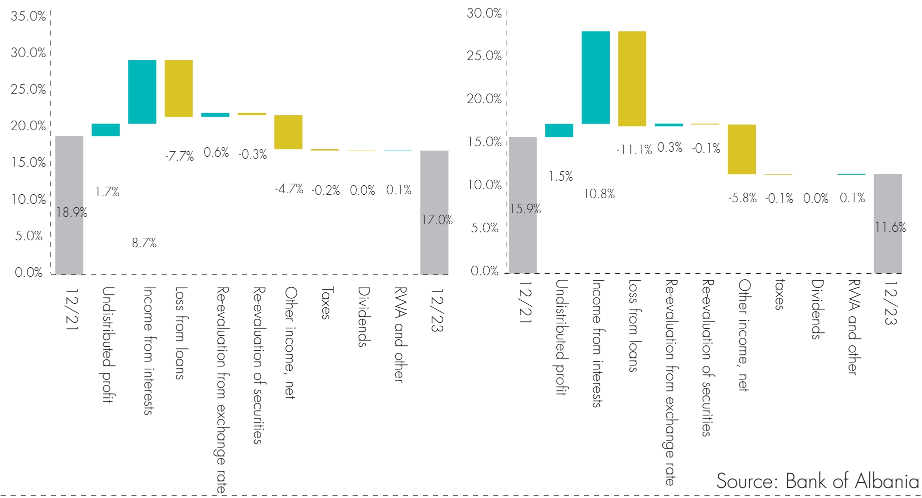
Losses from loans and from other net operating income present the main contribution in the capital shortfall in this scenario. Seven banks appear under-capitalized by the end of 2023 in this scenario, accounting for around 48.7% of the sector's assets. In this case, the need for additional capital is assessed to amount up to around ALL 20.1 billion.

Chart 90 Contribution in CAR in adverse scenario, for Systemically Important Banks - SIBA (top) and Other Banks (bottom)



Source: Bank of Albania.

Chart 91 Contribution in CAR in adverse scenario, for Banks with foreign capital (top) and Albanian capital (bottom)

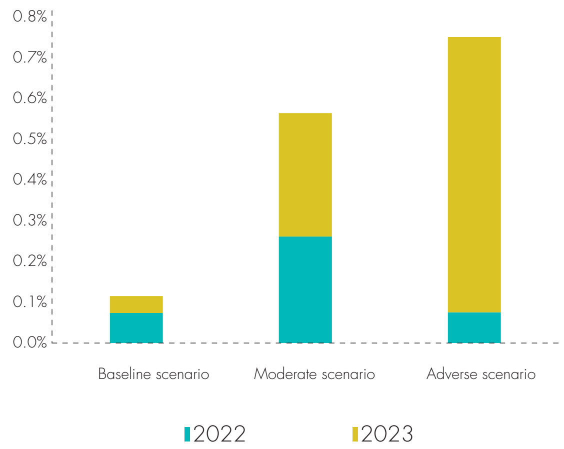


Source: Bank of Albania.

In the adverse scenario, overall, systemic banks (SIBS) show a stable capitalization ratio of 17% at end-2023, while the other banks appears under-capitalized, reaching at a CAR of 10.6%. 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 stable capitalization ratio of 17% at end-2023, while banks with Albanian capital reach at a CAR of 11.6%. 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 0.8% of GDP at end 2023, in the adverse scenario.

Chart 92 Needs for additional capital to GDP*



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

4.1.3.2 Liquidity stress test

The purpose of the liquidity stress test is to assess the capability of individual banks and of the banking sector overall to withstand extreme but possible shocks in financing their activity. These tests aim to evidence weaknesses or deficiencies of the sector and particular banks in certain currencies, instruments or time horizons; assess banks' readiness to cope with extreme liquidity shortfall scenarios; and, assist the supervision authority to undertake specific policies that address liquidity management, including measures aimed at reducing exposures or creating specific buffers. The liquidity stress test is implemented according to the "top-down" approach, with data reported by banks, once per year at the end of the year. The exercise uses data on forecasts for money inflows and outflows according to the main instruments and for a time period constituted by 8 maturity baskets that cover a period from "up to 1 day" to "over 1 and up to 2 years".

The test is implemented for the lek, the euro and the US dollar and is based on the condition that the liquidity excess in a currency may not be used to cover the liquidity shortfall in other currencies, due to the probability of the fast depreciation of the exchange rate in times of liquidity crises. In real situations, this is not a restrictive element. To calculate the liquidity gap, specific coefficients are applied for the withdrawal of funding sources (of deposits) and for the reinvestment of assets (loans) by all the maturity baskets. For financing sources, the coefficient shows only that part of the liabilities amount that matures in the relevant basket, which will be withdrawn to be reinvested by the client. For money inflows, the reinvestment coefficient means that part of the amount rights that matures in the relevant basket, which will be converted in money inflow and will not be reinvested by the bank. A bank is considered as failing the stress test only if expanded liquid assets, which are sold with haircuts defined by the exercise shrink to the level when additional liquidity by the Bank of Albania is needed, in the form of "loan for liquidity support.

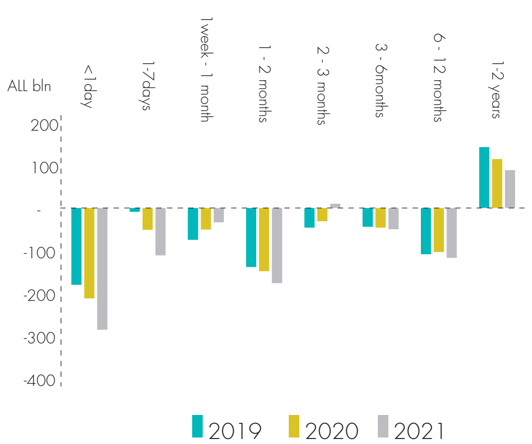
4.1.4.2 Results

The results of the stress test show that the resilience of the banking sector to possible liquidity shocks according to the data of November 2021, for the time horizon up 2022 - 2023, is assessed as "good" and have marked no significant changes compared with the previous year. The overall gap of liquidity has expanded for the three currencies, but the resilience of banks to a liquidity shock has been strengthened compared with the previous year. The preservation of the resilience of banks to possible liquidity shocks is related to the fact that banks at the end of 2021 owned a high level of counterweighting capacities or expanded liquid assets available for liquidation in the event of a liquidity crisis. The expansion of counterweighting capacities is related to the increase of banks' assets in the form of Government debt securities in the euro and the international central banks in the euro and the US dollar.

The overall liquidity situation of the banking sector by the expected inflows and outflows of money for the one - to two-year horizon, starting from 1 December 2021, and results to be somewhat more challenging compared with the previous year. The expected inflows and outflows result 4% lower and 9% higher, respectively than in the previous year, and the simple gap between inflows and outflows is around 30% higher. The highest negative values between inflows and outflows continue to be recorded in the baskets "up to 1 day "; "1 to 2 months"; and "6 to 12 months"; while for the basket "1-2 years" the gap between inflows and outflows continues to have a positive value, by reflecting the longer maturity of assets compared to the maturity of liquidities of banks.

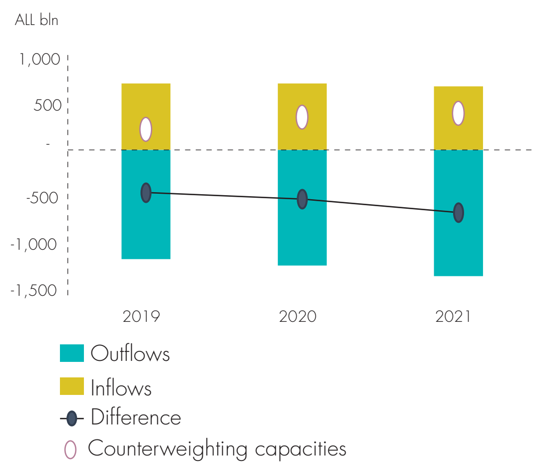
The liquidity gap has expanded across the three currencies (lek, euro and US dollar), but the highest growth is noted in the national currency denominated position, as the banking sector expect at the same time a fall in inflows and increase in outflows in this currency. The expected inflows and outflows in the euro are higher compared to those reported in the previous year, but the increase in outflows is higher than that in inflows.

Chart 93 Gap between inflows and outflows by maturity baskets



Source: Bank of Albania.

Chart 94 Overall inflows and outflows and counterweighting capacities



Source: Bank of Albania.

The resilience of banks differs by currency, and is assessed as "very good" for the lek and the US dollar and "good" for the euro. Overall, banks in terms of domestic currency have a higher gap between inflows and outflows, compared with the euro, but liquid assets that banks may use to cover the liquidity gap in lek are somewhat higher compared with those in the euro. The number of banks that fail the test for each currency and the size of the remained gap as a ratio to the banking sector's assets are comparable with the values calculated in the previous year. The number of banks which have a simple negative gap for each currency, prior to the use of counterweighting capacities has been increase compared with the previous year.

Table 10 Test results for the simple gap by currency and baskets

	(11 banks)	< 1 day	1 day - 1 week	1- week to 1-month	1-month - 2-month	2-month - 3-month	3-month - 6-month	6-Month - 1-year	1- Year - 2-year
ALL	No. of banks with negative gap	11	10	10	10	8	3	2	1
	Gap as a % to assets	-4	-6	-6	-5	-3	-1	-1	-1
EUR	No. of banks with negative gap	7	6	7	7	7	6	7	7
	Gap as a % to assets	-2	-2	-2	-3	-3	-2	-3	-2
USD	No. of banks with negative gap	4	4	2	2	3	3	3	3
	Gap as a % to assets	-1	-1	-1	-1	-1	-1	-1	-1

Source: Bank of Albania.

The maximum number of banks that have a negative gap for each basket in lek, euro and US dollar is 10, 7 and 4, respectively. While these values were 10, 5, and 4 in the previous year. The maximum value of the liquidity gap in relation to banking sector assets in the respective currency ranges from an almost inconsiderable value for the US dollar; up to 3% for the euro; and 1-6% for the lek. From the scenario that assumes to use counterweighting capacities for closing the gap in each basket, the maximum number of banks that continue to have a negative gap in at least one of the baskets is 1, 3 and 1 for the activity in lek, euro and US dollar. Compared with the results in the previous year, the banking sector has slightly improved its resilience in euro, due to the lower number of banks and the reduced remained negative gap as a ratio to the bank assets in this currency. The expansion by around 30% of counterweighting capacities in euro has impacted on the improved resilience in this currency.

All other segments of the financial system have recorded an expansion of activity and a growth of financial result in the second half of year.

This part of the financial system continues to remain well-capitalised and with a good quality of credit portfolio of credit institutions, except of non-bank segment that have reported an increase in non-performing loans ratio.

The sensitivity of the non-banking sector to the activity of the banking sector remains, though it has been trending downwards during the period.

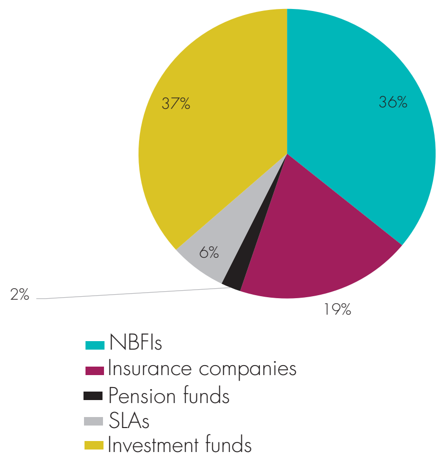
4.2 NON-BANKING SECTOR

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. 36 NBFIS, 16 SLAs, 12 insurance companies, 11 investment funds and 4 pension funds operate in the financial market. Non-bank sector's asses account for around 11% of the total assets of the financial system and around 12% of GDP. Investment funds have the main share in the activity of non-bank sector, followed by non-banking financial institutions.

Almost all segments of the non-banking sector expanded the activity in 2021 H2. Lending NBFIs had the main share, followed by those that provide payment and transfer services. Households share around 45% of the credit portfolio granted by non-banks, while enterprises the rest. NBFIs are more active in lending to the sector of wholesale and retail trade (20, by around 20% of the total loan stock to enterprises, followed by other service activities (15%). Albanian capital accounts for around 70% of shareholding equity of the non-bank financial institutions. NBFIs ended 2021 with a positive financial result, around ALL 4 billion, twice higher compared to the previous year. The capitalisation of activity of these entities continues to remain high, while the quality of loan portfolio fell in annual terms, as the non-performing loans ration increased at 14% from 11%.

Chart 95 Structure of non-banking sector



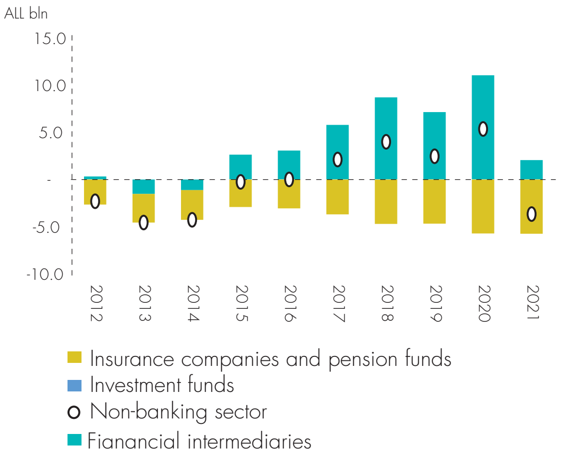
Source: Bank of Albania, Albanian Financial Supervisory Authority.

Savings and Loan Associations expanded their lending activity and recorded a positive net profit. This segment has recorded a slight improvement of portfolio quality from the previous year, which is reflected in the fall of non-performing loans to 5.2% from 5.8%. Investments in loans and investments in banks in the form of time deposits have the main share in the investment portfolio of SLAs, by 70% and 20 %, respectively. The sector that has attracted the largest funding from the activity of the members is the agricultural sector (32%), followed by the wholesale and retail trade sector (12%).

Insurance companies and supplementary private pension funds expanded their activity driven by the increase in gross written premiums and investments in in government debt securities. Investment funds expanded their activity mainly in investments in government bonds. In terms of liabilities, these funds recorded an increase in the item "capital and shares in investment funds".

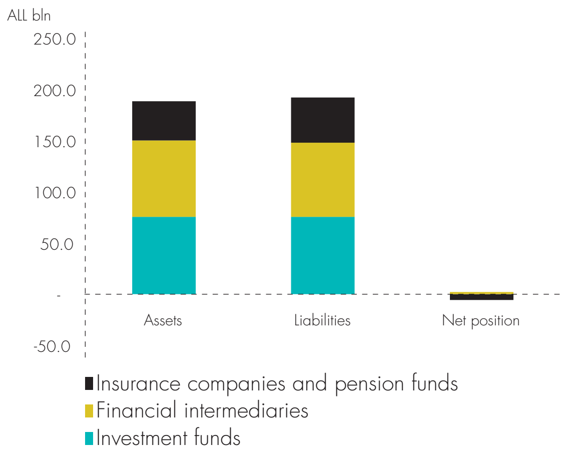
The non-banking sector has continuously recorded a balanced position of financial assets and liabilities[42]. At the end of 2021 Q3, assets and liabilities of this sector were around ALL 190 billion. Main assets are in the form of debt and loan securities, while liabilities are represented by currencies and deposits; capital and shares in investment funds. The net position of the non-banking sector resulted negative for the first time in five years. The higher expansion of liabilities, mainly in the form of capital and shares in investment funds provided the main impact on the shifting of the position, compared to the growth in assets. Within the non-banking sector, insurance companies and pension funds have a net negative (debtor) position, while the other financial intermediaries (non-bank 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 2021 Q3.

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 (September 2021)

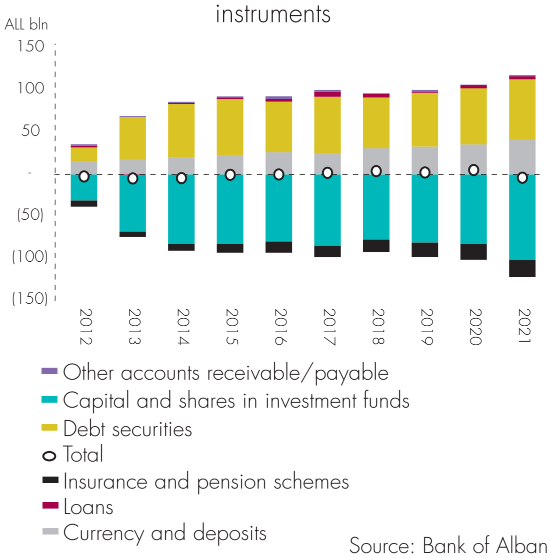


Source: Bank of Albania.

Debt securities account for around 40% of the financial assets of non-banking sector, while loans and currencies and deposits account for 22%, respectively. These ratios differ across various segments in this part of the financial system. Debt securities in investment funds account for around 84% of assets, while loans have the highest share in the assets of other financial intermediaries. Both the insurance companies and pension funds, have the most heterogeneous distribution of assets. Around 34% of their assets are in the form of currency and deposits, while 23%, 17% and 10% of assets are in the form of debt securities, insurances and pension schemes and capital and shares in investment funds. By instrument, 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.

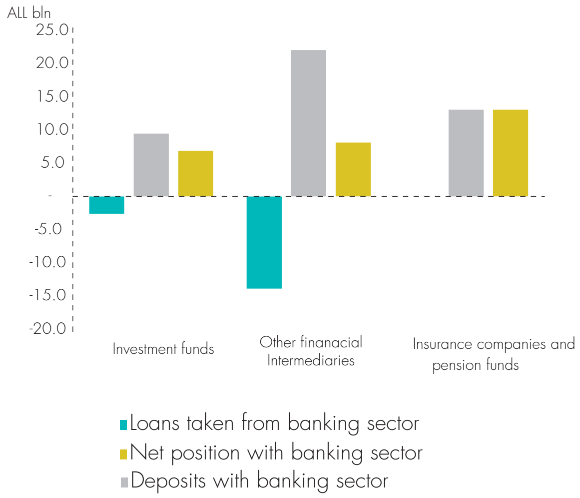
[42] *The analysis of assets and liabilities of non-banking sector is based on the data of financial accounts for the third quarter of 2021.*

Chart 98 Net position of non-banking sector by instruments



Source: Bank of Albania.

Chart 99 Non-banking sector interconnection with banking sector (September 2021)



Source: Bank of Albania.

RISKS AND EXPOSURES BETWEEN BANKING AND NON-BANK SECTORS

The exposure of the banking sector to non-banking sector remains contained, at minimum values, and stable. On assets side of banks, this exposure is mainly represented by loans to non-bank financial institutions. Financial intermediators (non-banks and SLAs) are the segment with the highest financing stock from banking sector, as at end of 2021 Q3, at ALL 14 billion, followed by investment funds of around ALL 3 billion. Overall financing in the form of loans from banking sector to other resident financial institutions is around ALL 17 billion, 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 trending downwards during the period. 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, as at end-September 2021, amounted ALL 45 billion, or accounting for 24% of total assets of the non-banking sector, from 26% as at end-2021. Financial intermediaries (non-banks, SLAs) have the largest placements.

These placements account for around 50% of total placements of non-banking sector in banks, but they are slightly down compared to the level at the end of 2020. As a 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 currencies and deposits in banks have increased.

Currently, non-banking sector has a net creditor position to the banking sector, reaching at ALL 28 billion from ALL 30 billion reported at the end of 2020. An expansion of this net position increases the sensitivity or exposure of the non-banking sector to the performance of the banking sector's activity, and vice-versa. Insurance companies and pension funds have the highest net creditor position, as they have only placements in the banking sector, followed by the other financial intermediaries. 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 IN ALBANIA

The Bank of Albania, in collaboration with other authorities contributes in safeguarding financial stability. As part of this contribution, the Bank of Albania drafts and implements the macro-prudential policy, which analyses and assesses the systemic risk and implements the measures to prevent and mitigate this risks, in two aspects:

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 drafts 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 macroprudential[43] indicators in full compliance with the recommendations of the European Systemic Risk Board (ESRB), which are grouped into four objectives[44]. Despite the difficulties created by the situation of the COVID-19 pandemic, in the second half of 2021, the indicators of the Macroprudential 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) continued to remain in negative values, marking a further decline in the second half of 2021. The negative values of this indicator signal the lack of a credit bubble, but also the low level of credit growth as a ratio to gross domestic product (GDP). The largest expansion in negative values was recorded in the loan portfolio to enterprises. Also, the performance of the real estate loan and the connection it creates with the increase of housing prices should be taken into consideration, in order to assess the sustainability of these developments and the eventual risks to financial stability.

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43 *For each objective, those indicators are 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.*

44 *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/*

Objective II: In 2021 H2, liquid assets have continued to be at satisfactory levels, accounting for 33.3% of total assets, or a decrease of 0.85 pp compared to the end of 2021 H2. Also, there was a significant negative gap between assets and liabilities for all maturity baskets. Meanwhile, the exchange rate spread for the euro in the interbank market has further expanded in 2021 H2.

At the same time, the exchange rate volatility for the domestic currency has increased during the second half of 2021, due to the situation in the international markets.

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: Exposure to five main countries as a percentage to the total has maintained a rough level. Regarding the exposure of the financial system to a certain economic sector[45], and during the second half of 2021, credit has continued to be concentrated mainly in the sectors of trade, construction and manufacturing industry continued, mainly in the trade, construction and manufacturing industries. Foreign exchange rate remains high, accompanied by negative effects on monetary policy transmission channels and on the management of foreign currency liquidity. Unhedged foreign currency loans expose the banking sector to exchange rate fluctuations, especially against the euro. In the framework of the Memorandum of Cooperation, signed on April 18, 2017 with the Ministry of Finance and Economy, and the Financial Supervision Authority, to reduce the level of euroization in the country, the Bank of Albania has implemented a package of concrete measures to promote the use of the national currency. A detailed analysis of the effect of de-euroization measures is published periodically on the official website of the Bank of Albania.[46]

Objective IV: Total assets of the banking sector in terms of GDP declined slightly compared to the end of the 2021 H1 (after changing the methodology used in the calculation), signalling a slower growth of the banking sector in relation to the performance economic. On the other hand, non-resident liabilities and interbank exposures have remained almost unchanged compared to the end of 2021 H1.

5.2 MACROPRUDENTIAL MEASURES IN ALBANIA

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

The banking sector has conducted its activity without the prudential support measures that the Bank of Albania implemented in the framework of mitigating

[45] *The Herfindahl index method was used to monitor the concentration of exposures.*
[46] *https://www.bankofalbania.org/Financial_Stability/De-euroization_Package/*

the effects of the pandemic (which ended in March 2021). Despite expectations, there were no adverse reactions to the credit quality of the banking sector. Developments in lending took place rapidly, driving to a decline in the capital adequacy ratio compared to the previous year. Geopolitical developments are facing the Albania's economy with the possibility of slowing down the growth and this may lead to a decline in the volume and quality of the loan portfolio. Under these conditions, it would be necessary for banks to maintain the best possible capital positions, including through the retention of a higher value of undistributed profits.

Pursuant to the Regulation 41/2019 "On macro-prudential capital buffers", the decisions of the Governor on the implementation of these buffers have continued[47], 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.

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