Bank of Albania

# FINANCIAL STABILITY REPORT

2022/H2

**Approved by Decision No. 18, dated 5.04.2023 of the Supervisory Council of the Bank of Albania.*

Published by: Bank of Albania
Sheshi "Skënderbej", Nr.1, Tirana, Albania
Tel.: + 355 4 2419301/2/3; + 355 4 2419401/2/3
Fax: + 355 4 2419408
E-mail: public@bankofalbania.org

www.bankofalbania.org

# C O N T E N T S

## BOXES



## TABLES

# CHARTS

# INTRODUCTION

This is the twenty-ninth 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 2022 (hereinafter "the period"). Overall, unless otherwise stated, expectations for the economic and financial outlook extend through a period of up to 12 months.

The stability of the financial system has been assessed based on its performance, 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. Regarding the risks and developments related to the domestic economy, this Report assesses the economic growth indicators, balance of payments, overall price level, exchange rate and fiscal indicators. Also, by analysing the performance of employment and income, and by referencing specific surveys, it evaluates the financial situation of enterprises and households, and the impact on the solvency of borrowers in the banking sector. The Report also presents the results of the stress test, which assesses the banking sector's resilience against macroeconomic and financial shocks, expressed in terms of capital adequacy.

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

## NOTES:

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

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

- Systemically important banks: National Commercial Bank, Credins Bank, Raiffeisen Bank, and OTP Bank Albania.

- Other banks: Intesa Sanpaolo 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); National Commercial Bank (Turkey); OTP Bank, Albania (Hungary); Procredit Bank (Germany); First Investment Bank, Albania (Bulgaria). These banks share around 66% in total assets of the banking sector.

- Banks with Albanian capital: Credins Bank, Union Bank, American Bank of Investments, Tirana Bank and United Bank of Albania. These banks share around 34% in total assets of the banking sector.

III. By geographical expansion of banking network. Banks showing an expansion of their network abroad are: the National Commercial Bank and Credins bank with their respective affiliates 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 in the balance sheets of the period under review. It includes outstanding credit granted by the banking sector to non-financial private and public, resident and non-resident entities. Outstanding

[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/tes*

[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.*

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

# FINANCIAL STABILITY STATEMENT FOR 2022 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, dated18 December 2006 "On banks in the Republic of Albania", as amended; to inform the Assembly of the Republic of Albania and the Council of Ministers, and promote awareness among financial institutions and the public at large of the situation in the Albanian financial system and potential risks to its stability, the Bank of Albania (BoA) releases this periodic statement. This statement is an integral part of the Financial Stability Report for the same-stated period.

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

*The Bank of Albania deems that in 2022 H2 (hereinafter 'the period'), operations of the banking sector were stable. Overall, banking sector activity, deposits and loans expanded, but at a lower growth pace than in the previous periods, in reflection also of the exchange rate appreciation impact. Credit quality continued to improve, while the other indicators of financial performance and resilience remain at adequate levels. Overall, the exposure of the banking sector to risks appears contained, but credit and market risks should be carefully assessed on an ongoing basis. Economic developments, throughout the period, were positive. Economic growth was accompanied by a reduction of unemployment and increase in both employment and wages. Fiscal policy maintained a consolidation trend for most part of the period. Inflationary pressures remained elevated and the Bank of Albania continued the normalisation of monetary policy. Though inflation rate has slowed recently, risks to economic and financial developments in Albania remain present. These risks relate to the uncertainty about the geopolitical developments and across international markets, the path of inflation, cybernetic security issues and the heightened impact of market risks. Against this backdrop, it is important that economic policies aim at safeguarding the macroeconomic stability, while financial institutions and supervisory authorities maintain a prudential monitoring of developments in the financial activity and undertake the necessary actions for enhancing the resilience of financial system and avoiding risks to financial stability.*

In more concrete terms, the developments over the period showed that:

**Global economic activity has slowed as inflationary pressures were heightened and financing conditions were tightened.** The upsurge in international energy prices in 2022 Q3, coupled with the supply chain disruptions pushed average inflation up, at unprecedented rates after the 1990s. Central banks reacted swiftly, though the size and frequency of the increase in the key interest rates varied across countries. This reaction reflected the economic cycle of the country, the dependence of production processes on energy imports, as well as the fiscal and administrative capacities to mitigate the shock on more vulnerable sectors and social groups. Developments in labour markets have been overall positive. Inflationary pressures have titled downward by the end of the period, mainly reflecting the fall in oil and natural gas prices, while commodity and food prices remain at elevated levels. Financing conditions remain tight across all market segments, accompanied by decreased values in capital markets, slower lending and increased risk premia. These developments were similar in both advanced and emerging economies. As a result, experts' forecasts suggest economic growth to further slow in 2023[3], while the weak purchasing power and the tighter financial conditions will curtail consumption and investments. Inflationary pressures are expected to reduce gradually. Short-term outlook remains surrounded by heightened uncertainty, on the back of how military conflict in Ukraine will evolve and with economic costs that accompany the necessary normalisation of the monetary policy. In addition, short-term risks to financial stability are considered picking up, but there is confidence that the undertaken reforms in regulating and supervising the financial activity after the global financial crisis of 2007 - 2008, have strengthened the resilience of financial system against eventual shocks.

**Economic growth in Albania recorded positive and stable values up to the end of year.** In annual terms, economic growth was 4.7% in the fourth quarter of year. Services and production contributed by 2.6 and 2.2 percentage points, respectively, in this growth. Consumption and investments of private sector coupled with the exports of goods and services have underpinned the economic growth. Foreign currency-denominated inflows in the form of tourism services, remittances and foreign direct investments, recorded a strong growth. Developments in labour market were positive: employment increased, unemployment rate decreased and wages grew. The soaring import and commodity prices have continued to pass through in higher prices in Albania over the second half of year, being accompanied with the continuation of monetary policy normalisation of the Bank of Albania. Throughout the period, fiscal policy was, overall, consolidating, except of the last quarter, as the realisation of planned public spending took place. International developments and the meeting of energy needs posed a challenge to the Albanian economy in 2022. The improved hydride situation across hydropowers in the last quarter

*[3] The International Monetary Fund (IMF), in the projection of January 2023, estimates that the global economic growth will fall to 2.9% in 2023 (from an estimated 3.4% in 2022 ) then rise to 3.1% in 2024 (World Economic Outlook, update).*

of year, contributed in managing the economy demands for energy and eased the relevant burden on the budget. Dealing with similar shocks in the future, boosts the importance to create fiscal reserves in the shorter term and of reforms for increasing energy production and trading capacities in the long term.

The rise in interest rates was the highlight of the period across financial markets. In the primary market of debt securities, all issuance by the Government, for the period, was in the domestic currency. The issuance volume was lower compared to the volume of the previous half-year, with the main contribution from the decrease in the issue of long-term securities. This performance has reflected the reluctance of investors to finance the demand for long-term borrowing given the uncertainty about the rise in interest rates, and the Government's intention to moderate the cost of borrowing. The average rate increased around 2.5 percentage points (pp) for both short and long-term securities over the period. At the end of the year, the weighted average interest rate on lek-denominated securities reached at 4.8%. In the secondary market of securities, volumes remain low and transactions were carried out at higher interest rates. In the interbank market, the volume of financing transactions grew during the period compared to the volume in the previous two six-month periods. The interest rate on interbank transactions has increased following closely the performance of the key interest rate, and reflecting the monetary policy decisions of the Bank of Albania. In line with the performance of foreign currency flows in the balance of payments, the lek exchange rate has been stable during the period, appreciating against both the euro and the US dollar. During the period, the Bank of Albania continued to hold auctions for the purchase of the euro, according to the previously published schedule, in order to increase the international reserve. Overall, the foreign exchange market appeared calm and was characterized by normal parameters of trade.

Indicators of real estate market give miscellaneous signals about the development of housing demand, supply and prices. The reports by real estate agents in the specific survey of the Bank of Albania, show that the demand has been stable, as sales during the period have been somewhat higher compared to the previous two six-month periods, while the number of unsold properties has been down. Meanwhile, the survey at banks shows that they have tightened the conditions on loans for real estate, while the households' demand has been declining. However, outstanding credit for real estate in the banks' balance sheets has edged up. The lower credit demand for real estate may reflect the increase in prices and interest rates in the economy. During the period, a lower number of construction permits and construction area was granted, compared to the previous period, suggesting a slowdown in the house supply in the future. Construction costs have risen considerably due to the strong surge in spending for energy, construction materials and wages. According to data collected by the Bank of Albania's special survey, the Fischer House Price Index - at national level- fell by 9% in six-month terms, but it remains around 17% higher compared to the average level of the previous year. Although during the period there was a better distribution of transactions according to the type of property, it is observed that the share of transactions where the purchase price is lower than the price requested by the seller has increased. However, real estate market agents reported a positive position regarding the performance of the housing market in the short term, while remaining optimistic about its performance in the longer term, albeit at lower values than the historical average.

**The core infrastructure for payment clearing and settlement has continued to operate in an effective and secured manner.** The AIPS and AECH systems have experienced an increase in the number and value of transactions in lek that have been processed through them. The number and value of banks customers' payments increased compared to the same period of the previous year. Credit transfers in non-paper form (internet banking, mobile banking) have exceeded credit transfers in paper form for the first time. Over 2022, values of payments in the new AIPS-EURO, which processes euro-denominated payments only for customers within Albania, have continued to increase. In turn, benefits in the form of reduced costs of these payments for the users of the system, have been augmented.

**Indicators of financial situation and debt burden of households and enterprises have not displayed significant changes.** The data obtained from the statistics of the country's financial accounts for the previous year, confirm the significant values of the creditor position of households and the debtor position of enterprises. This trend is related to the increase in deposits and capital invested by households, and the raise in the liabilities of domestic enterprises to both households and to the non-resident sector. In 2022, the performance of loans and deposits of enterprises and households contributed to the increase in the creditor position of households and the reduction in the debtor position of enterprises. The tailored survey of the Bank of Albania conducted on the financial situation and debt burden, shows that the share of households that have a loan to pay increased during the period. Households estimate that their solvency has declined due to the upswing in prices, while they expect this decline in solvency to continue in the first half of 2023, by negatively affecting their demand for loans in the short run. In the period under review, the performance of sales and of the financial result has continued to improve for most enterprises, compared with the first half of 2022. Expectations of enterprises regarding the performance of investments and the activity continue to remain optimistic, despite the problems related to finding the market, the increase in production and labour costs, as well as the finding of qualified staff have continued. The share of borrowing enterprises has been slightly downward during the year. The debt burden, in the form of debt ratio to capital and in the form of its servicing to the income of the enterprise, is estimated at affordable levels for most of enterprises. Enterprises expect their credit demand to remain stable in the first half of 2023.

**Despite the expansion in the activity of the financial system, its share to the Gross Domestic Product has declined.** As at end of 2022, the share of financial system assets to Gross Domestic Product (GDP) fell by 10 p.p.

at 96.8%, compared to the end of 2021. This performance reflects the fact that the annual growth rate of nominal GDP was higher compared to the growth rate of the balance sheet of the financial system. The fall in the share of banking sector's assets, by almost 8 p.p, provided the main contribution in this performance, despite its expansion in absolute value, coupled with the decline in the share of investments fund, by almost 2 p.p. The banking sector continues to dominate by around 91% of total assets, in the financial system. The exposure of the banking sector to the non-banking sector remains low and steady, while the sensitivity of the non-banking sector to the activity of the banking sector remains high, but has not changed during the period.

The main indicators of the banking activity show a higher volatility, but remain at good levels. During the period, the banking sector expanded its activity by around 4%; its assets reached ALL 1,880 billion. Treasury transactions and investments in securities provided the main contribution in this growth. The increase in loans and the contraction in provisions for assets' quality provided also a positive impact on the performance of assets. The balance sheet of the banking sector grew 6% in annual terms. The share of assets and liabilities in foreign currency to total balance fluctuates around the values 53% and 51%, respectively, and this structure appears stable over the period. In terms of assets, the use of foreign currency is higher in interbank credit and investments. In terms of liabilities, the use of foreign currency is higher in deposits. The statistical effect of the exchange rate related to the lek appreciation against the euro, has affected the reported share in the balance sheet items denominated in foreign currency and has been vulnerable during the period. Despite the fall in liabilities to non-residents compared to non-resident assets, the net creditor position of banking sector against them as a ratio to total assets has not changed. The banking soundness index shows good financial situation of banking sector as at end of 2022. This assessment was based on: the improvement of the signals emitted by the profitability and efficiency sub-indexes, the stability conveyed by the capitalisation sub-index and the fall signalled by liquidity sub-index. Over a longer-term period, the performance of the banking soundness index confirms the improvement recorded in the banking sector activity, in terms of the quality of assets, capitalisation, and liquidity. The stock of the bank loans expanded by 2% during the period and by 6.6% compared to the previous year, climbing to ALL 715 billion. New loans supported this growth. Loans to households, loans in foreign currency and short-term loans recorded the highest growth. The expanded loans stock for short-term purposes provided the main contribution in the increase of loans to enterprises. Meanwhile, the expansion in loans to households is related to loans for real estate purchases, which accounted for 2/3 of loans to households.

Unhedged outstanding loans in foreign currency increased during the period, and slightly declined in annual terms. The relative share of this portfolio to outstanding loans and foreign currency loans has not changed. Unhedged foreign currency loans to households, for the purpose of financing real estate purchases experienced the strongest growth over the period. Loans to enterprises in the euro and oriented for investments in real estates, account for the main share in unhedged outstanding loans in foreign currency. Loans to non-residents have been slightly up during the period, but its outstanding remains at relatively low values. Banks have continued to restructure and write off loans, mainly in the loans portfolio to enterprises, but at a much slower pace compared to previous periods. If outstanding loans were to include the stock of written-off loans during the past twelve months, in addition to the statistical effect of the exchange rate, the annual growth of loans would be around 10%.

Banks granted around ALL 140 billion new loans during the period a somewhat higher amount than the loans granted in the first half of 2022, but slightly lower compared to the same period in 2021. New loans to enterprises were granted to meet their short-term liquidity needs. New loans to households, during last year, were mainly used for house purchases and non-durable consumer goods, and were granted mainly in foreign currency. The weighted average interest rate on new loans granted during the period increased across all categories of new loans. Within various categories, the raise in the interest rates on loans in lek and in foreign currency to purchase real estate, has been relatively lower.

Deposits in banks jumped to ALL 1,520 billion, expanding by 4% over the period. The deposits of households, in foreign currency and current accounts, recorded the sharpest increase. The annual growth of deposits slowed down compared to 2-3 years ago. The robust growth in time deposits in foreign currency was a marked development during the period. Interest rates for all types of new deposits by term, sector and currency remain at relatively low levels, though they have been slightly up during 2022 H2.

The liquidity and capitalisation indicators are at adequate levels. At the end of 2022, the capital adequacy ratio of the banking sector stood at 18.1%, or down by around 1.0 p.p. than in the previous six months. This performance was driven mainly by the fall in the regulatory capital, which in turn pushed down the financial leverage ratio. The Bank of Albania requires banks to maintain certain capital levels, including requirements on macroprudential capital buffers as well. By the end of 2022, the banking sector appears to have the adequate capital surplus, overall, in order to fulfil these requirements. Nevertheless, this surplus has been reduced over the past 12 months, with systemically-important banks being the main contributors, due to the decline in the regulatory capital and the higher capital requirements demanded to banks. When planning future capital values and the elements that affect it, for banks is important to take into consideration the developments in the banking activity and the relevant regulatory requirements.

The net accumulated profit of the banking system at the end of 2022 amounted around ALL 22 billion, unchanged from the previous year, with the main contribution from the activity in foreign currency. Net interest income grew significantly on the back of the higher increase in interest income than in interest expenses. The growth in interest income was also reflected by the higher net interest margin, which reached 3.5%. Non-interest income was positive, but around 30% lower than in the previous year, due to losses in the investments of financial instruments. The activity costs continue to be adequately covered by banks' income. The activity expenditures to income ratio at the end of the year remained unchanged during the period, at 60%, as the growth in the activity's total expenses and revenues have had a similar pace. Provisions for credit risk increased, but the negative impact of this development on banks profit was partially offset as a result of the reversal return of provisions for other financial assets.

Overall, the Albanian economy and the domestic financial system appeared well stable against the risks of the period, but challenges remain present.

**Despite rising production costs and higher uncertainties on the supply side and energy prices following the geopolitical developments, overall, the economy continued to grow during the period; the financial system expanded the intermediation activity; and the financial situation of economic operators remains stable**. Public authorities, through the coordination of fiscal and monetary policies, undertook measures to control the elevated inflationary pressures and mitigate their shock on the most vulnerable groups of the society. Inflationary pressures became more manageable given the stability of the exchange rate of lek against the main currencies, and the falling energy and food prices in global markets. The key indicators on the activity of the financial system remain stable. However, internationally, geopolitical developments still pose a high degree of uncertainty and, currently, there has been a great deal of concern in global financial markets regarding the stability of financial institutions. In Albania, despite a downward trend, inflationary pressures are still elevated, and the interest rates have gone up. When asked about their activity's risk assessment, in addition to inflation and potential economic slowdown, banks also identify other risks related to cyber protection, rising interest rates, or international developments. Against this backdrop, it is important that economic policies aim at safeguarding the macroeconomic stability, while financial institutions and supervisory authorities maintain a prudential monitoring of developments in the financial activity and undertake the necessary actions for enhancing the resilience of financial system and avoiding risks to financial stability.

In terms of specific risks to banking sector activity, it is assessed that:

**Credit quality has continued to improve during the period, but it did not change the expectations for a fall in the quality in the medium term.** Outstanding non-performing loans reduced by almost 2% over the period, while non-performing loans ratio fell at 5%. The contraction in the non-performing loans stock was driven by: the reclassification of non-performing loans to performing classes of loans; the lost loan write-offs; and the re-payment of a part of non-performing loans. The quality improved across all credit categories, by maturity and sectors, though the quality was slightly down in credit portfolio denominated in the domestic currency. The quality of foreign currency loans unhedged against exchange rate fluctuations, has improved. The non-performing ratio for this credit portfolio fell to 3.8% as at end of 2022. The decrease in non-performing loans stock was slower compared to the reduction in the fund of provisions during the last twelve months, and the provisioning ratio for non-performing loans fell at 64%. The clearing flows have declined compared to the previous year, whereas the volume of qualitative loans shifting to non-performing loan classes has been somewhat higher. The credit quality might be affected by rising loan rates, in cases when the cost of debt servicing is higher than the increase of borrower's disposable income.

**The liquidity position of the banking sector remains at good levels and the liquidity indicators continue to remain notably above the regulatory thresholds.** Over the period, liquid assets of banks have grown faster than short-term liabilities, but they have recorded a decline compared to the previous year. The assets - liabilities gap in the basket of maturities up to three months contracted, and the overall gap remains positive and stable. The average maturity mismatch between loans and deposits has increased, mainly due to the increase in the average residual maturity of loans. The banking sector does not use credit lines from parent banking groups.

**Overall, the exposure of banking sector to market risks remains contained, but risks related to the performance of interest rates should be managed carefully.** The exposure of the banking sector to direct exchange rate risk has decreased during the period, mainly driven by systemically important banks. The exposure of the banking sector to indirect exchange rate risk has remained unchanged, but credit in foreign currency, particularly the credit unhedged against the exchange rate risk, needs to be closely monitored. The banking sector's exposure to direct interest rate risk decreased during the period and it continues to remain notably below the upper regulatory limit. Nevertheless, the banking sector is more exposed to interest rate risk for positions in lek, those with variable interest rate, and for long-term maturity. During the period, there were additional pressures on the interest rate risk pass-through to credit risk, due to rising loan rates and its resulting negative impact on borrowers' solvency. In parallel, the rise in interest rates may impact on the fall in the value of securities portfolio, which are classified as available for sale. The specific stress-testing exercises on the sensitivity suggest that the existing outstanding capitals of banks are sufficient to withstand the effects of a further increase in interest rates, by assumed scenarios. It is crucial that banks test their sustainability against unfavourable interest rates movements, carry on the measures that actively manage vulnerable balance sheet position, and act to strengthen its sustainability when necessary.

**The results of the stress-testing exercises support the assessments on the good financial situation of the banking sector, but they evidence the increase in terms of sensitivity to assumed stress scenarios.** The Bank of Albania conducts stress-testing exercises on a regular basis, in order to assess the banking sector's resilience against shocks from the real economy or financial markets in the medium-term horizon. The stress tests on capital adequacy or borrowers' solvency shows the degree of resilience of individual banks in terms of capital, and aims to identify their ability to withstand assumed shocks on economic growth, credit, exchange rate, and interest rates. Alongside with it, the Bank of Albania has also conducted the periodical annual exercise of liquidity stress test.

Overall, the tests carried out for the end of 2022 and extended across the 2023-2024 period, show that the banking sector is resilient to the assumed macroeconomic shocks and maintains a robust liquidity situation. Also, results show that specific banks are more sensitive against assumed shocks. Following, it is assessed that the financial system and the banking sector have continued to perform in a stable manner over the second half of 2022. But challenges to the Albanian economy, financial system and banking sector's activity remain present, given the uncertainty about the international developments, and the vulnerabilities accompanying developments in the information technology field and of exposures to both credit and market risks.

Thus, banks, in the medium term, should strengthen the general control system and increase investments to guarantee the resilience and safe use of the employed technology. In the short run, it is necessary that banks preserve and bolster the capitalisation levels of the activity, to face eventual financial losses, which are signalled from the stress test exercises.

As always, the Bank of Albania will carefully monitor the developments in the banking sector and in the macroeconomic and financial indicators. The Bank of Albania, through closely communicating with banking industry, the other public authorities and with the international financial institutions, will act in a proactive manner to safeguard the macroeconomic and financial stability in Albania.

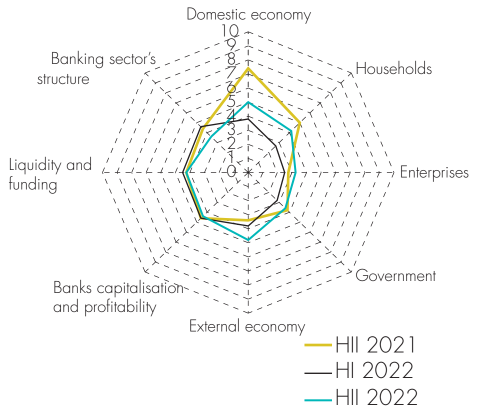
# 1. MACROECONOMIC DEVELOPMENTS

## 1.1 FINANCIAL STABILITY MAP

The Financial Stability Map shows a generally contained level of risks in the overall domestic and external macroeconomic environment. There is a mitigation of risks related to households and the domestic economy, compared to the previous year, but the risk from the developments in the external economy is somewhat higher. The risks related to the activity of the banking sector have been mitigated at some extent during the period, but changes have been insignificant.

In the following, the developments in the indicators of the Financial Stability Map are analysed in more concrete terms.

Chart 1 Financial Stability Map




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

Source: Bank of Albania.

*The Financial Stability Map, which summarizes the most important risks from the internal and external environment shows overall, that these risks were contained during 2022 H2.*

*Compared to the previous year, the risks from the households sector and the domestic economy have mitigated, but the risks related to the external economy have somewhat increased. The contribution to risk from other sectors was low.*

*Risks related to the activity of the banking sector remain at contained levels and with no significant changes compared to the previous year.*

### *RISKS IN THE OVERALL ECONOMIC ENVIRONMENT[4]*

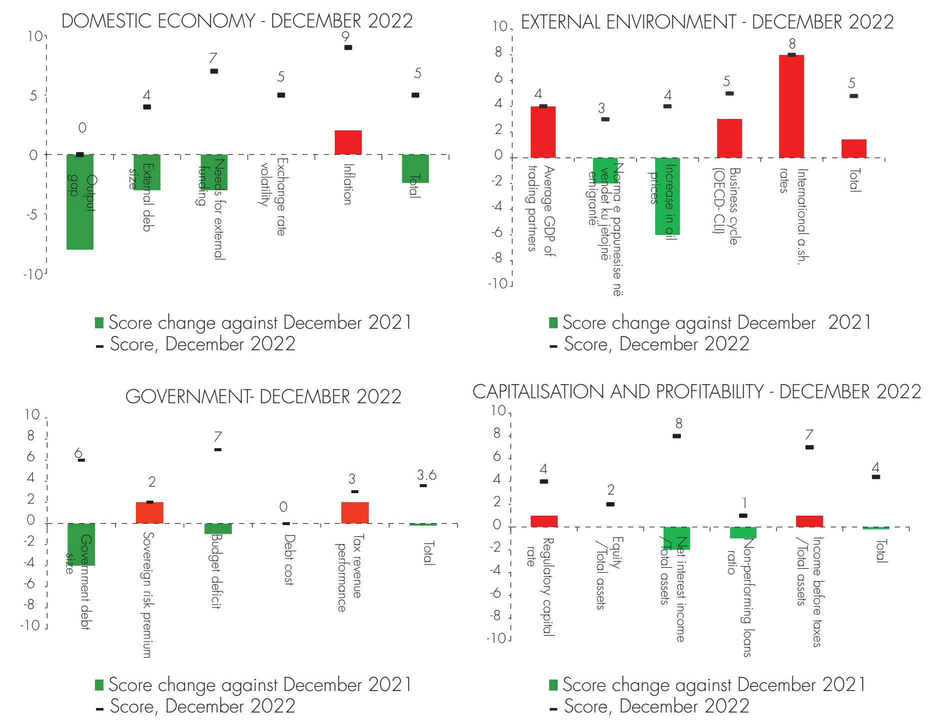
Risk from the "Domestic economy" remains rated as "average", but it has been reduced during the period under review. Inflation rate has been at high levels, but the risk has been restrained as a result of the slowdown in the increase of the inflation rate and the reduction in the external debt. The appreciation of the exchange rate has mitigated the shocks to the economy from the external sector. The overall risk from the "external environment" has been assessed as "average", though upwards compared to the previous year. This increase is related to the economic slowdown of trading partners[5] and the increase in short-term interest rates across international markets. The fall in unemployment rates in the countries where most Albanian immigrants work and live, as well as the normalisation of oil prices in the last quarter of 2022, have affected the mitigation of this risk.

4 *Assessments have been conducted based on the latest published official data, 2022 Q3.*
5 *The OECD-CLI index (Composite Leading Indicator) gives early warning signals on the turning points of the business cycle at a global level. The decline of its values signals the decline of the economic activity below its long-term potential.*

## RISKS RELATED TO THE ACTIVITY OF AGENTS IN THE REAL ECONOMY[6]

Risk from enterprises continues to be rated as "low", and has remained unchanged in 2022. Risk from households remains "average", and has decreased compared to the previous year. The decline is related to the improvement of credit quality and the performance of house prices, while the unemployment rate, remittances and households' expectations neither have changed nor have affected the change in the risk index. Risk from "Government" is assessed as "average," and unchanged from the previous year. The increase in the sovereign debt risk premium and the decrease in the share of tax revenues to GDP (as quarterly flows) impacted negatively this performance, in comparison to a year earlier, while developments in budget balance and the contraction in public debt ratio to GDP provided a positive impact on this performance.

Chart 2 Annual change of the risk rating by sector




Source: Bank of Albania.

## RISKS TO THE ACTIVITY OF THE BANKING SECTOR

Risk from "Capitalisation and profitability" is assessed as "average", and somewhat downward compared to the previous year. The increase in income from interests on assets and the further decrease in the ratio of non-performing loans have contributed to the decrease of risk. The liquidity and financing risk remained at the "average" level and unchanged during the year. The slight increase in the risk index has been affected by the slowdown in the growth of deposits, while the decrease in the financing by non-residents has

[6] Assessments have been conducted based on the latest published official data, 2022 Q3.

impacted its mitigation. The risk related to the structure of the banking sector is rated as "average" and has been mitigated compared to the previous year, dictated mainly by the improved indicators of the concentration in bank credit to enterprises and the financing sources of the banking sector.

## 1.2 EXTERNAL MACROECONOMIC ENVIRONMENT

Global economic growth, during the second half of the year, was negatively affected by the significant increase in inflation worldwide, the prolongation of the war in Ukraine and the return of anti-Covid measures in China. In 2022 Q3, global economic activity recovered significantly and global growth exceeded forecasts. The growth was driven by developments in domestic factors across individual economies, such as increased consumption and investments, which were underpinned by the strengthening of the labour market and increased financial support of governments. At the same time, easing of uncertainties about the acute consequences of Russia's war in Ukraine and the decrease in prices of transport, helped normalize business costs and make global production chains function better. During the last quarter of the year, a tightening of financial conditions was observed in many countries as a response to inflationary pressures. High inflation and geopolitical developments are expected to continue to restrain the global economic activity during 2023 as well.

*After a sustained growth in the third quarter, global activity has slowed down in the last quarter of the year. The slowdown was a result of the weakening in the demand and trade due to elevated inflation and the tighter financial conditions.*

*The central banks have continued with the measures for the normalization of the monetary policy in order to curb the increase in prices. Financing conditions in the world markets remain tight and volatile, affected by expectations for a rapid increase in interest rates and expectations for a slowdown in the global economy.*

In response to the situation, central banks in the world have continued their efforts to return inflation to the target levels, through increasing interest rates and reducing monetary stimuli. The speeds of raise in interest rates by major central banks such as the European Central Bank, the US Federal Reserve and the Bank of England have varied, in some cases they have exceeded market expectations. As a result, inflationary pressures seem to have been mitigated somehow, but financing conditions have remained tight and volatile across all segments of the market, accompanied by a decrease in values of the capital markets, and increase of risk premiums.

*The factors that have supported the economic growth in both the euro area and Western Balkan region are the stable labour market conditions, fiscal support packages and domestic demand, which recovered after the removal of Covid-19 restrictions. The high inflation and tighter financial conditions have affected the weakening of the economic growth pace.*

*Lending volumes have been high but have shown signs of a slowdown. Credit quality has remained at good levels, but it is expected to decline in the medium term.*

Currency prices in foreign exchange markets have reflected the market's reaction in regard to the pace of normalisation of the central banks' monetary policy and the expectations on the economic recovery in specific regions. The euro is generally appreciated against the main currencies, such as the US Dollar, the British Pound and the Swiss franc, but depreciated against the currencies of the developing countries. Prices remained high in commodities and food markets, as a result of supply chain disruptions. Metal prices also soared due to the optimist expectations for demand after the strengthened expectations for a recovery in the economic activity in China. In the energy markets, the price of natural gas fell at the end of the year, reflecting: the decrease in demand for gas in Europe, as a result of an unusually warm winter; the positive effect of energy-saving-measures taken by the citizens; as well as the strategies followed for creating gas reserves and reducing dependence on Russian gas. In the oil markets, the weakening of global demand over the last months of the year led to a drop in the price. In the short-and-medium-term experts expect a further slowdown of the economic activity during 2023[7] related to the tightening of financing conditions and the curbing of consumption and investments, as a result of the weakening of purchasing power. In advanced countries, economic growth is expected to decline to 1.2% during 2023, from 2.7% in 2022, while in emerging countries, the economic growth is expected to expand by 4.0% from 3.9% in 2022. Inflationary pressure are expected to decline gradually during the upcoming period, in the context of monetary tightening on a global scale and the drop of prices in the oil markets.

The IMF predicts that global inflation will fall to an average of 6.6% in 2023 and 4.3% in 2024, from 8.8% in 2022, but remaining above pre-pandemic levels. The short-term economic outlook still remains surrounded by a high level of uncertainty and under pressure from the risks associated with the war in Ukraine and the extent of its consequences, the future dynamics of inflation and the economic costs of monetary policy normalisation. Short-term risks to global financial stability are also considered upwards, and are mainly related to the impact of the increase in interest rates on the debt burden and on the financial stability of economic agents globally.

### EURO AREA

The economic growth in the euro area during 2022 H2 was more stable than expected, but the pace of growth slowed compared to previous periods, down at 0.4% in 2022 Q3 (2.5% in annual terms) and at 0.0% in the fourth quarter (1.9% in annual terms). Economic growth, expressed more in consumption and investment indicators, was supported by the recovery of the service sectors after the economic reopening of countries and by the governments' financial aid packages for households and enterprises hit by the energy crisis. At the same time, the drop in energy prices and the provision of gas reserves have mitigated the decline in purchasing power, influencing the improvement of confidence indicators in the euro area. The slowdown of the activity on a global scale, geopolitical uncertainty related to the prolonged war in Ukraine, high inflation and the tightening of financial conditions impacted negatively the economic recovery in the euro area. In the labour market, conditions remain generally stable and unemployment rate at the end of the year has stabilized at 6.6% or around 1 p.p. below the pre-pandemic level. With the restrictive measures coming to an end, and the economic activity retuning back to normality, the countries have also stopped the employment support schemes (ESS).

Geopolitical developments and disruptions in production chains materialized in a significant increase in inflationary pressures during the second half of the

[7] *The International Monetary Fund (IMF), in the projection of January 2023, estimates that the global economic growth will fall to 2.9% in 2023 (from an estimated 3.4% in 2022 ) then rise to 3.1% in 2024 (World Economic Outlook, update).*

year. Inflation rate in the euro area reached 9.2% in December 2022, up from 5.0% in the previous year. While food prices have been increasing across the region, energy prices have declined, but uneven across countries, due to the level of production and local demand, the regulatory framework and the amount of fiscal support. Against this backdrop, the European Central Bank (ECB) has increased the refinancing rate and has announced further increases during 2023, until inflation returns to the target. These movements have accompanied the reduction in the volumes of quantitative monetary easing programs (asset purchase programme) and other liquidity injection mechanisms, while the ECB has taken care of mitigating disorderly market dynamics strengthening the effectiveness of monetary policy in the euro area.

In the European financial markets, the increase in interest rates was accompanied by a tightening of credit standards and weakening of demand, increasing the probability of higher credit risk and deterioration of credit quality. According to the latest forecasts published by the ECB, economic activity in the euro area is expected to continue its slowdown in 2023 Q1 and begin to expand in the following quarters. The recovery of the economy is expected to be supported by stable conditions in the labour market and by supportive fiscal policies that will offset the effect of inflation on revenues and consumption. In the short term, the economic outlook of this region will continue to be affected by the still present bottlenecks in production chains, persistent inflation and the high level of uncertainty. In the longer term, the decline in confidence, the slowdown in external demand and the tightening of financing conditions are expected to affect the performance of investments in the euro area. In response to the situation, the ECB and other European institutions have stated their availability to adopt the necessary policies in order to support the economic and financial stability of the region.

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

| | GDP change (annual %) | | | Inflation (annual %) | | Unemployment (annual %) | | Gross government debt (% of GDP) | |
|---|---|---|---|---|---|---|---|---|---|
| | 2023* | 2022 Q3 | 2022 Q4 | Sep'22 | Dec' 22 | Sep'22 | Dec' 22 | Q2'22 | Q3'22 |
| USA | 1.4 | 1.9 | 0.9(0.7) | 8.2 | 6.5 | 3.5 | 3.5 | 121.1 | 120.2 |
| Euro area | 0.7 | 2.5 | 1.9(0.0) | 9.9 | 9.2 | 6.7 | 6.7 | 94.2 | 93.0 |
| Germany | 0.1 | 1.4 | 0.9(-0.4) | 10.9 | 9.6 | 3.0 | 3.0 | 67.2 | 66.6 |
| France | 0.7 | 1.0 | 0.5(0.1) | 6.2 | 6.7 | 7.1 | 7.2 | 113.1 | 113.4 |
| Italy | 0.6 | 2.7 | 1.4(-0.1) | 9.4 | 12.3 | 7.9 | 7.8 | 150.4 | 147.3 |
| Greece | : | 2.8 | 5.2(1.4) | 12.1 | 7.6 | 11.9 | 11.6 | 183.5 | 178.2 |

*Source: ECB, Eurostat, *-IMF Assessment (January 2023), Economic Analysis Office; Bureau of Economic Analysis (US Bureau of Labour Statistics.);'': "- ": no available data.*
*** In brackets are the quarterly GPD growth.*

## WESTERN BALKANS

Economic growth in Western Balkans region continued to slow down in 2022 Q2 and Q3. The region's GDP expanded by 2.1% in annual terms in the third quarter, from 4.3% a quarter earlier, as a result of the economic slowdown in Serbia and Bosnia-Herzegovina. Growth was supported by private consumption and exports, while investments have shown different trends, also marking a decline in some of regional countries. The contraction in public consumption in most countries was partly conditioned by the end of supportive measures related to the pandemic. The pace of job creation slowed down, but unemployment rates have fallen or have remained unchanged across all regional countries. The expansion of economic activity and the rise in prices have contributed to the increase in budget revenues from taxes and to the improvement of the fiscal balance in all countries. This progress has resulted in the reduction of public debt ratio to GDP. In the external sector, developments have been characterized by the deepening of the current account deficit, where the contribution of the significant increase in imports generally exceeded the positive effect of the recovery in service exports and the increase in remittances.

The war of Russia in Ukraine had a negative impact on the regional economies. The significant surge in energy, food and transport prices has fuelled an inflationary spiral in all countries and inflation has significantly exceeded the target levels of central banks. In response to this situation, countries with independent monetary policy have taken measures to normalise monetary policy, by increasing the key interest rate. The governments of the region have also taken temporary measures to limit the spike in oil, electricity and food prices, through the reduction of fees, price management or the limitation of profit margins, and have also activated financial packages to support the most vulnerable categories in the sector of households and enterprises. These measures, together with the drop in energy prices in international markets, contributed to mitigating the increase in inflation across most regional countries during the last quarter of 2022.

*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 | Q3'22 | 2022 | 2023p | Q2'22 | Q3'22 | Q3'22 | Q4'22* | Q3'22 | Q4'22 |
| Bosnia and Herzegovina | 5.5 | 2.6 | : | : | 15.7 | 14.9 | 4.5 | 4.3 | 4.9 | : |
| North Macedonia | 4.0 | 2.0 | 3.0 | 2.5 | 14.6 | 14.4 | 9.8 | 9.7 | 3.2 | : |
| Montenegro | 12.7 | 3.2 | 3.8 | 2.9 | 14.9 | 13.4 | 4.2 | 6.0 | 5.9 | 6.1 |
| Kosovo | 2.1 | 3.3 | : | : | 2.1 | 3.3 | 11.7 | 13.7 | 2.0 | 2.0 |
| Serbia | 3.8 | 1.0 | 3.4 | 2.4 | 8.9 | 8.9 | 11.6 | 8.9 | 3.2 | : |
| Albania** | 2.6 | 4.0 | 2.7 | 2.6 | 11.5 | 10.8 | 12.4 | 6.6** | 5.1 | 5.0 |

*Source: European Commission, respective central banks. Explanations f- Forecast of ECFIN for January, 2023; ':' no available information; "*": data refer to November 2022; "**": data refer to December 2022.*

Lending activity has continued to expand accross all regional countries, though slowing in Albania, Serbia and Bosnia-Herzegovina. Credit to households grew faster than credit to enterprises, for most countries. At the same time, the non-performing loans ratio decreased or remained unchanged for most countries. Despite the resilience to date, NPL indicators may not have yet fully reflected the financial shocks of the period. High inflationary pressures, the tightening of financing conditions and the slowdown of activity can be transmitted to the balance sheets of economic agents and contribute to the increase of non-performing loans in the medium term.

## 1.3 MACROECONOMIC ENVIRONMENT IN ALBANIA

### *THE REAL SECTOR AND THE LABOUR MARKET*

In 2022 Q4, the annual economic growth rate was 4.7%, downward somewhat compared to the value of the previous quarters, but remaining close to the value of the annual average[8]. Services and production contributed by 2.6 and 2.2 p.p, respectively, to this growth. Economic growth was supported by final consumption, private sector's investments and exports of goods and services, while the contraction of government consumption and the expansion of imports of goods and services had the opposite effect. Data on the fourth quarter show that growth came mainly from the construction sector and from "information and communication", which increased by around 14%, respectively, in annual terms. Despite having a lower share, the "financial services and insurances" and "real estate" sectors also contributed positively to this growth, expanding by 13% and 9%, respectively. The economic sentiment indicator signalled an improvement in the overall situation in regard specifically toward improved confidence in the construction and industry sectors.

*At the end of 2022 Q4, the annual economic growth rate was 4.7%. Services and production contributed by 2.6 and 2.2 p.p, respectively, to this growth. Economic growth was supported by financial consumption, private sector investments and the narrowing of the current account deficit in the balance of payments.*

*Growth in net foreign currency flows from tourism services, remittances and foreign direct investments was strong. The labour market was characterized by positive developments such as: the increase of employment, the decrease in the unemployment rate and the growth in wages.*

*The increase in both import and commodity prices continued to lead to an increase in consumer prices in Albania during the second half of the year. As a result, the Bank of Albania has continued the normalisation of the monetary policy, raising the key interest rate by 1 p.p during the period, at 2.75%.*

*During the period, the fiscal policy has been mostly consolidating, with the exception of the last quarter of the year, which was characterized by the highest realization of planned public expenditures.*

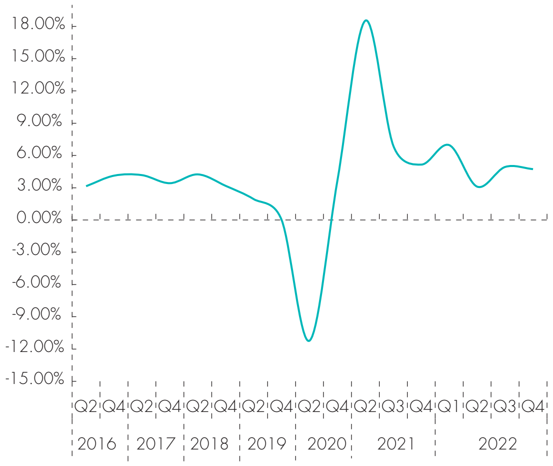
Developments in the labour market during the period were positive. The unemployment rate fell to 10.8% and employment grew by 4.2% in annual terms, mainly as a result of the increase in the number of employees in the services and agriculture sectors. The unemployment rate for the 30-64 age group fell to 7.6%, or by 1.3 p.p. compared to the previous year, while unemployment among youth (15-29 years old), although slightly up by 0.9 p.p. compared to the previous year, it remains in figures comparable to the average of the last five years by 21.5%. The annual growth in wages[9] reached at 10.8% during the fourth quarter. This increase reflects the growth by 14.2% in the wages in the private sector and the 5.6% increase in the average wage in the public sector. The increase in wages in the private sector was observed in almost all branches of production and services, but it was more pronounced in the services sector.

[8] *Annual GDP growth in the first, second and third quarters of 2022 was about 6.9%, 3.1% and 4.9%, respectively. After the publication of the economic growth in the fourth quarter, the economic growth for the entire 2022 is estimated at about 4.8%.*

[9] *Average monthly gross wage.*

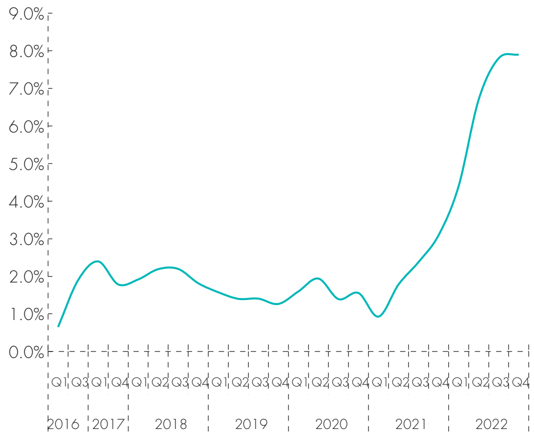
## MONETARY AND FINANCIAL DEVELOPMENTS

Chart 3 Annual GDP growth



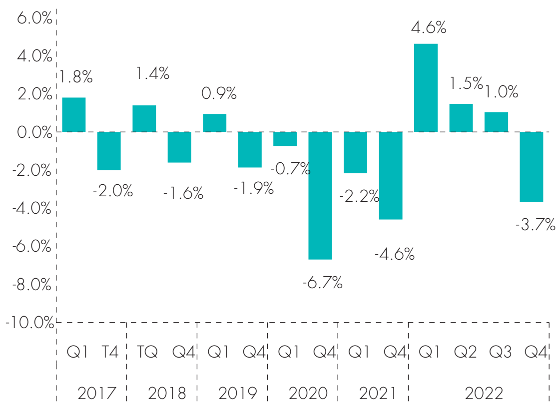

Source: INSTAT.

Chart 4 Inflation rate




Source: INSTAT.

Chart 5 Budget deficit to GDP




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

The increase in consumer prices, which began in mid-2021, accelerated during 2022, reaching he peak around the third quarter of the year, in line with the performance of energy and commodities prices in international markets. During the last three months of the year, the annual inflation slowed down, but prices continued to remain high and in December, the annual inflation reached at 7.4%, being about twice as much compared to the previous year[10]. This performance of prices has reflected foreign supply-side shocks, which have been transmitted directly to production costs and consumer prices. In addition to import prices, the inflation of consumer prices in the country has also been affected by domestic demand, which was supported by the improvement in labour market conditions and the increase in wages. Developments in the foreign exchange market, and especially the strengthening of the lek against the euro, have contributed to mitigating the effect of imported inflation, by offsetting a part of the increase in foreign prices. The Bank of Albania continued the normalisation of monetary policy, which was materialized in a progressive increase of the key interest rate up to 2.75%[11]. According to the statements of the Supervisory Council of the Bank of Albania, the normalisation of monetary policy is creating adequate conditions for preserving price stability and for inflation returning to

[10] *The annual change of the consumer price index for December 2021 was 3.7%.*

[11] *The normalization process continued during the period and the last decision belongs to November, when the key interest rate increased to 2.75%, from 2.25% in October and 1.75% in August.*

the target within the medium-term horizon, without compromising the premises for economic growth.

Throughout the period, fiscal policy was, overall, consolidating, except of the last quarter, as the realisation of planned public spending took place[12]. All indicators of fiscal sustainability, such as the budget deficit and domestic and external public debt as a ratio to GDP, showed a downward trend during 2022. At the end-December-2022, the budget balance recorded a deficit of around ALL 78 billion against a deficit of ALL 86 billion in the previous year. The narrowing of the fiscal deficit in annual terms was due to the increase in income. The annual increase by around ALL 60 billion, or 12% in the revenues of the state budget, is mainly related to the significant increase in the income from taxes and customs, which were affected by the dynamics of prices accross international markets. On the other hand, expenses increased by around ALL 55 billion or by 9%, and were oriented towards current expenses focused on expenses for special funds and those for wages. A part of the budget expenditures were used to help the most vulnerable groups impacted from the increase in consumer and energy prices. International developments and the aim of meeting the energy needs posed a challenge to the Albanian economy in 2022. The improved hydride situation across hydro powers in the last quarter of year, contributed in managing the economy demands for energy and eased the relevant burden on the budget. Dealing with similar shocks in the future, imposes the importance of creating fiscal reserves in the shorter term and increasing energy production and trading capacities in the long term.

External sector

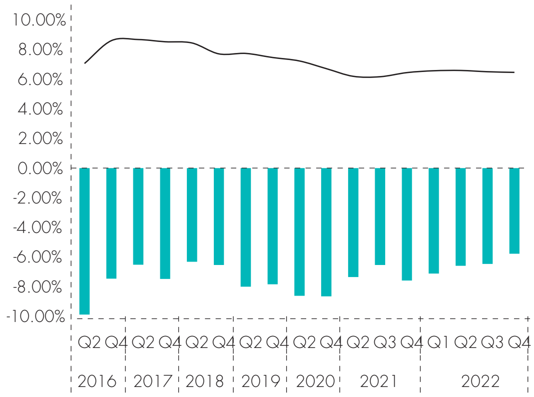
In the fourth quarter of 2022, the current account deficit reached EUR 0.48 billion, narrowing by around 12%. The increase in the export of goods and services provided a positive impact on this trend. Exports of goods grew by around 30%, while those of services by around 33%. Among the latter, exports of tourism services increased by around 48%. Imports of goods and services negatively affected the current account balance, increasing by around 14.1%. Only imports of goods increased by 7.7%, while imports of services and at the same time imports of tourism services increased by 38%. In terms of imports of goods, the expenses for "energy and fuel" were considerably up, reflecting the soaring prices in international markets. Investments in infrastructure and construction have also affected the growth in imports in the "machinery and equipment" item.

The "primary income" account recorded a deficit of EUR 0.1 billion, tripling in annual terms. Income outflows from investments remain the main determining factor in the performance of this account. On the other hand, income inflows from labour, although with a high growth pace, failed to reverse the effect from investment income. In the case of secondary income, the positive

[12] *In December 2022, the fiscal policy changed towards following the higher values of expenditures against revenues, namely about ALL 650 billion against around ALL 570 billion collected.*

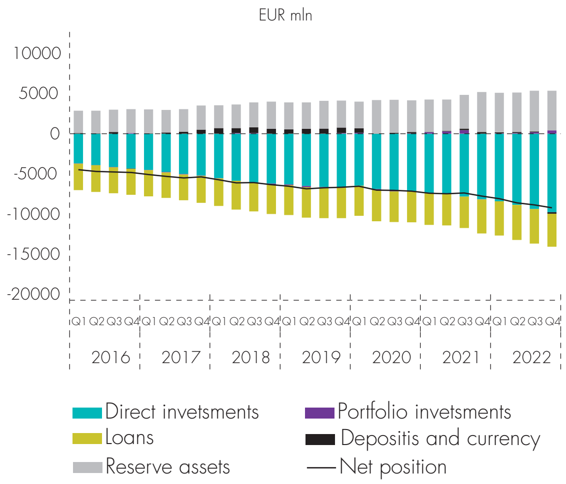
surplus increased by 9.2%. This is related to the rather positive performance of remittances inflows. In the fourth quarter, these flows remain at EUR 0.24 billion, with an annual growth of around 9%. In the fourth quarter, net inflows of foreign direct investments reached at EUR 0.35 billion, increasing by 20.1% compared to the previous year. The net flows of foreign direct investments during 2022 are estimated at around EUR 1.21 billion.

Chart 6 Current account and direct foreign investment




Source: Bank of Albania and INSTAT.

Chart 7 International Investment Position




Source: Bank of Albania.

## 1.4 FINANCIAL POSITION OF HOUSEHOLDS AND ENTERPRISES

### 1.4.1 FINANCIAL ACCOUNTS

*In 2021, the creditor position of households and the debtor position of enterprises continued to expand in the financial accounts of Albania. This trend is related to the increase in deposits and capital invested by households and the increase in the liabilities of domestic enterprises to them and to the non-resident sector.*

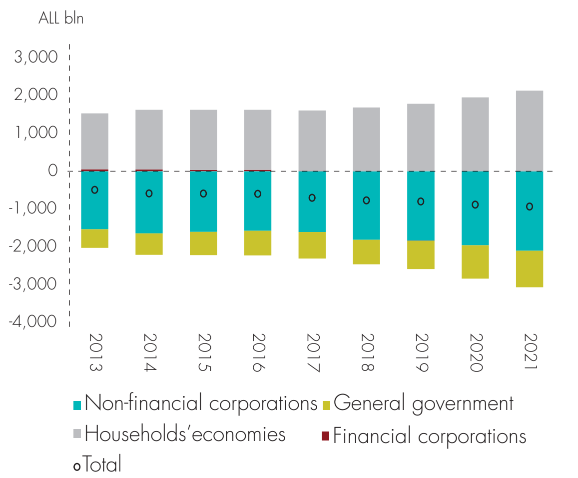
*The performance of lending and deposits of enterprises and households during 2022 contributed to the increase in the credit position of households and the narrowing of the debtor position of enterprises.*

*The financial stability of the business sector and that of financial corporations is important for the well-being of other sectors of the economy, due of the liabilities of other sectors.*

According to financial accounts statistics, the non-financial corporations or businesses sector and the household or individuals sector continue to be the largest debtor and creditor sectors of the domestic economy, respectively. Regarding the liabilities of enterprises, liabilities in the form of capital invested by resident and non-resident entities, as well as loans received from domestic and foreign banks, prevail. The assets or financial wealth of households consist of currency and bank deposits, as well as the capital that this sector has invested in domestic businesses. During 2021, the debtor position of businesses expanded to ALL 2,200 billion from ALL 1,950 billion in the previous year. The expansion of this position by about ALL 250 billion has come as a result of the increase by around ALL 200 billion in liabilities in the form of capital investments and the increase of ALL 130 billion in liabilities in the form of loans received from the government, from domestic financial institutions and from foreign entities. The growth of around ALL 180 billion in the creditor position of households, which at the end of 2021 reached at ALL 2,130 billion, came from the growth in deposits and from the expansion of households' investments in the capital of domestic enterprises.

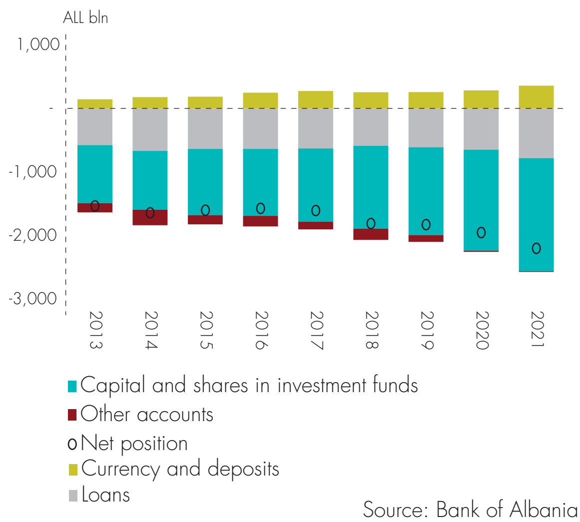
The performance of loans and deposits of enterprises and households during 2022 suggests that the creditor financial position of households edged up, while the debtor financial position of enterprises decreased slightly. For the households sector, the increase in the credit position was attributable to the growth by around 3 times higher in deposits compared to the increase in bank credit (respectively ALL 60 billion against ALL 27 billion ALL). Other data beyond the banking sector statistics show that, during 2022 H2, the households sector has expanded investments in treasury bills, but it has decreased investments in bonds and investment funds. The enterprises sector has slightly reduced its debtor position towards the banking sector, registering a somewhat higher increase in deposits compared to the increase in credit (ALL 22 billion against ALL 18 billion, respectively).

Chart 8 Net position by sectors



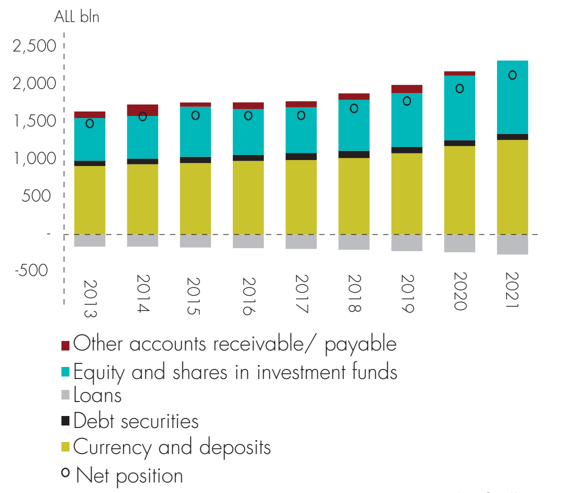

Source: Bank of Albania.

Chart 9 Net position of enterprises



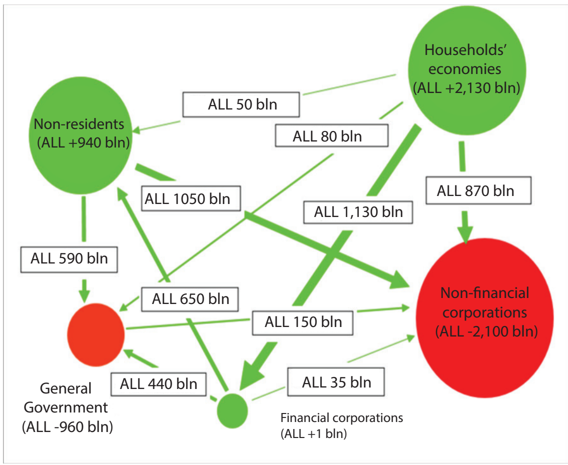

Source: Bank of Albania.

Chart 10 Net position of households




Source: Bank of Albania.

Chart 11 Net position and net financing between sectors




Source: Bank of Albania.

From the mutual exposures between the sectors of the domestic economy and the non-resident sector, it can be observed that the largest creditor sectors remain the sector of household's economies and that of non-residents; the largest debtor sectors continue to be the non-financial corporations and general government sectors. The latter is mainly financed by the non-resident sector and by financial corporations (financial institutions), while the business sector is financed from all other sectors, but mainly by non-resident entities and the households sector. The largest claims of the financial corporations sector are towards non-residents (loans and deposits abroad) and towards the general government (securities), while the argest liablilities of this sector are towards the sector of households (deposits).

The relations of liabilities and claims between sectors also represent the importance of the stability of one sector for the success of another sector. The results of the simulation of a shock in the form of a partial or complete loss of the value of the liabilities of a debtor sector to each of the other creditor sectors, according to the positions for the end of 2021, show that the sectors with the greatest and fastest impact in the soundness of other sectors are the business sector, financial corporations and the non-resident sector. On the other hand, the sector with the highest sensitivity or the greatest exposure as a lender to other sectors is the financial corporations sector, followed by the households sector.

*The share of households that have a loan to repay increased during the period. Households estimate that their solvency has deteriorated due to rising prices, while they expect this decline in solvency to continue during 2023 H1.*

*Households' demand for loans may be weaker during 2023 H1, due to the rising interest rates on loans and the uncertainty about further price dynamics.*

## 1.4.2 SURVEY RESULTS ON SOLVENCY

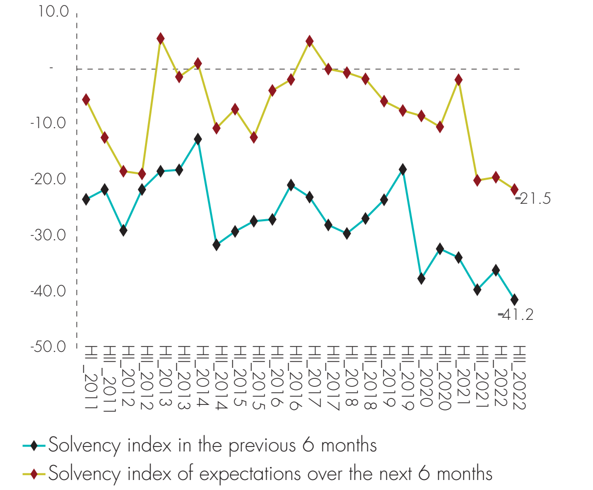
### *HOUSEHOLDS*

The results of the six-monthly survey[13] carried out among households to assess the financial situation and debt burden show that around 26% of households had at least one loan to repay at the time of the survey. This share increased compared with the previous six months and the previous year, by 4 percentage points and 2 percentage points, respectively, though the ratio remains close to the average historical indicator of 27%. Around 70% of borrowing households declared that the loan repayment accounts for less than 30% of the monthly income[14] and this indicator decreased by 9 p.p. compared to the previous year. Around 47% of borrowing households declared that their solvency "has

[13] *This survey, for 2022 H2, was conducted on a sample of around 1205 households and the response rate was 89%. The sample is selected and periodically reviewed by the Institute of Statistics based on the registrars used by the of households' questionnaires.*

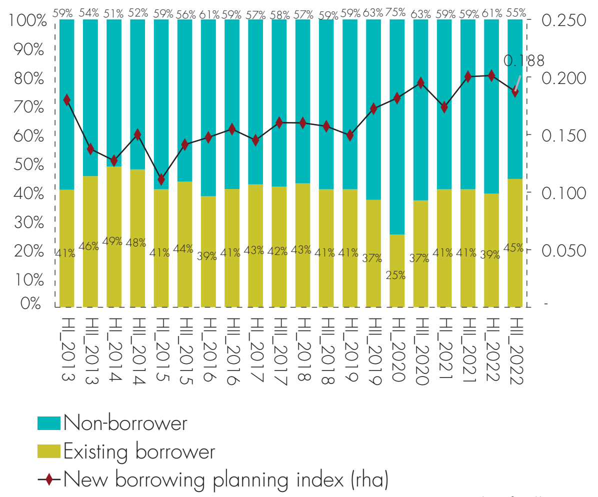
[14] *"Up to 10% of income" for 26% of borrowing households, "10-30% of income" for 46% of households.*

Chart 12 Solvency in the previous 6 months and the next 6 months




Source: Bank of Albania.

Chart 13 New borrowing planning/rollover index and households planning to borrow




Source: Bank of Albania.

not changed" during the period, while the rest reported a deterioration in their solvency compared to the previous period, due to the considerable increase in prices in Albania. The index of expectations on solvency for 2023 H1 shows a similar trend, which signals more pessimistic expectations of households compared to the last six months and the previous year.

Around 56% of responding households declared that they "do not expect to take a new loan in the upcoming six months". The share of those who declare that they consider the possibility of obtaining/recovering a new loan with varying degrees of certainty[15] decreased by 3 p.p. compared to the previous six months and with 1 p.p. compared to the previous year. In the group of households planning to take a new loan, around 55% are "new borrowers" who have no debt to repay at the moment of investment, and this share decreased by 5 percentage points, compared to the previous six months, and the previous year. The decline in the value of the borrowing planning/rollover index may signal a slowdown in the households' demand for loans during 2023 H1. These trends are predictable given the soaring interest rates environment on the back of monetary policy normalisation, and uncertainties regarding price dynamics in the future.

*For most enterprises, sales and financial result continued to improve compared to 2022 H1; while issues related to finding a market, increasing production and labour costs, as well as finding qualified staff remain present. Enterprises' expectations for the performance of investments and activity continue to remain optimistic.*

*The share of borrowing enterprises has been slightly decreasing during the year. The debt burden, in the form of debt ratio to capital and in the form of its servicing to the income of the enterprise, is estimated at affordable levels for most of enterprises.*

*Enterprises expect their demand for loans to remain stable in the first half of 2023.*

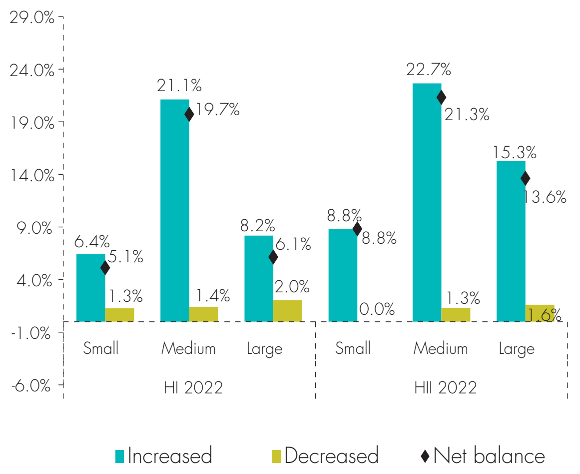
## ENTERPRISES

A specific six-month survey is used to assess the financial situation and debt burden in the[16] enterprises sector. According to small enterprises, the most important challenges for conducting their activity during 2022 H2 were

[15] *The given alternatives are: "little possibility", "a lot of possibilities" and "certain."*
[16] *This survey was conducted on a sample of around 1,352 enterprises of various sizes, geographically located in various regions of the country and operating in the main sectors of the economy. The sample is selected and periodically reviewed by the Institute of Statistics based on the registrars used by the enterprises' questionnaires.*

competition and finding a market. For medium-sized and large enterprises, the main difficulties have been related to production and labour costs, as well as finding qualified staff.

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




Source: Bank of Albania.

Around 93% of enterprises reported profit during the period. The sales and the financial result performance continued to improve compared to 2022 H1 across all groups of enterprises by size. During the period, around 57% of enterprises continued to finance their activity only through sales, and this share has been up for small and medium-sized enterprises. Expectations for the expansion of activity or increase in investments during the next period remain optimistic, but for small enterprises the indicator has somewhat weakened compared to previous periods.

Around 40% responding enterprises declared that they currently have a loan to repay. This share is slightly down compared to the last six-months and by 3.3 pp compared to the previous year. Around 80% of small enterprises, 84% of medium-sized enterprises and 82% of large enterprises consider their borrowing level as adequate. Borrowing is denominated in the domestic currency for 65% of small borrowing enterprises, 54% of medium-sized enterprises and 48% of large enterprises; while the rest is in foreign currency or combined.

Compared to the previous six months, the share of enterprises with loans in foreign currency has increased by 1.7 p.p. for small enterprises, but it has decreased by about 1-2 p.p. for medium-sized and large enterprises. The share of enterprises with loans in foreign currency is also affected by the currency in which they carry out their bisiness. Nevertheless, the fact that enterprises with foreign currency-denominated loans are more in number than enterprises that conduct their business in foreign currency suggests the need for an attentive and regular assessment by the banking sector of the enterprises' exposure to exchange rate risk. The total value of the loan is about approximately half the value of the enterprise's equity for around 75% of total borrowing enterprises, and almost at the same level of the value of equity for around 11% of them, whilst the remaining of 14% declare that the value of loan exceeds the value of equity. The loan/equity ratio has been increasing and resulted higher for large enterprises, with 25% of them declaring that this ratio is equal or exceeds the value of equity. At the sectoral level, the debt burden has increased across all branches of the economy where companies operate.

*Table 3 Share of enterprises with an equal/higher value of debt to equity*

| Sector | Industry | Services | Construction | Trade |
|---|---|---|---|---|
| 2021 H1 | 22.3% | 26.5% | 29.9% | 27.0% |
| 2021 H2 | 22.7% | 24.7% | 24.4% | 22.1% |
| 2022 H1 | 20.7% | 21.2% | 25.3% | 22.5% |
| 2022 H2 | 21.9% | 28.9% | 26.4% | 25.3% |

*Source: Bank of Albania.*

Most of the borrowing enterprises (about 70%) declare that loan repayment amounts up to 20% of their income. The share of these enterprises has decreased by 2.1 p.p compared to the previous survey. Most of enterprises report that the debt service cost has remained unchanged during the period. The responses of the rest resulted in net positive balances, for all sizes of enterprises, showing an increase of this expenditure as a ratio to income. This balance has increased in six-month and annual terms for all sizes of enterprises. Regarding the planning for borrowing in the next six months, enterprises stated that the demand for loan is expected to remain in the positive side. Around 40% of them declare that "there is no possibility" that they will request for a bank loan during the next period. This share has continued to fall for all sizes of enterprises compared to the previous period. On the other hand, it is observed an increase of the share of enterprises that claim that there is little possibility to take a loan in 2023 H1, as well as the share of enterprises that declare that there is a high possibility for this to happen in the next period. Meanwhile, the share of enterprises that have chosen the alternative "it is certain" has decreased, although this remains the chosen alternative with the least share. The borrowing plan index in the next six months has increased for all sizes of enterprises, but more significantly for small enterprises.

*The entire government debt issue for the period was denominated in domestic currency. The issuance volume was lower compared to the volume of the previous half-year, as a result of the reduction in the issue of long-term securities. This performance has reflected the reluctance of investors to finance the demand for long-term borrowing given the uncertainty about the performance in yields, and the Government's intention to moderate the cost of borrowing.*

*The considerable increase in yields was the most prominent development in the domestic securities market during 2022 H2. The average yield increased around 2.5 percentage points on both short and long-term securities throughout the period. At the end of the year, the weighted average yield on lek-denominated securities reached at 4.8%. In the secondary market of securities, the volumes remain low and transactions were carried out at a higher yields.*

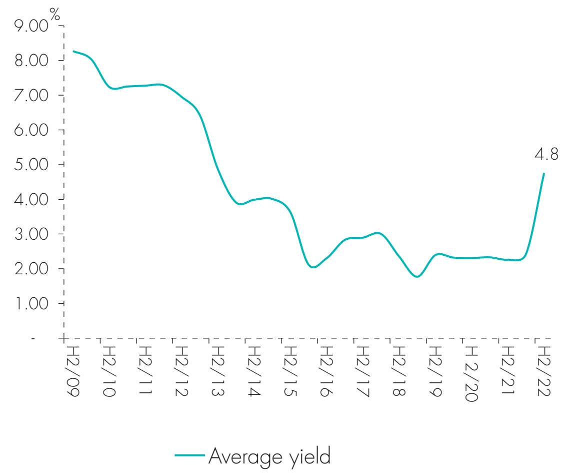
# 2. MARKETS AND PAYMENT SYSTEMS

## 2.1 EQUITY MARKET, INTERBANK MARKET AND FOREIGN EXCHANGE MARKET

### 2.1.1 SECURITIES MARKET

The primary debt securities market is dominated by Albanian Government debt securities and the entire debt issuance in the second half of the year was carried out in the domestic currency. The issuances of short-term securities are dominated by12-month T-bills, whereas the long-terms ones by 2-year bonds. In the second six months of the year, there were around ALL 170 billion securities issued. This volume was about 13% lower compared to the volume of securities issued in the previous six months, but around 8% higher compared to the same period in the previous year. During the second half of the year, the weighted average yield on all maturities of securities issued in lek, increased by more than 2.2 percentage points, reaching 4.8% at the end of the period. Issuances in short-term securities continue to dominate in the volume of issued securities, accounting for around 76% of the domestic debt. During the period, around ALL 130 billion were issued in short-term securities, and this amount was similar to the issuance of the previous six-months, but around 33% higher compared to the same six-months in the previous year.

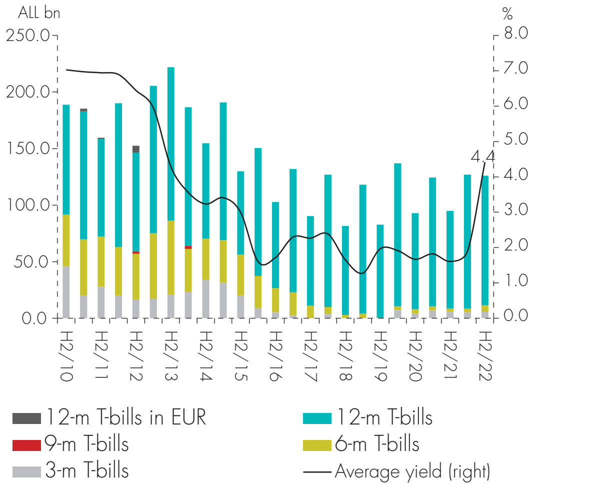
Chart 15 Weighted average yield on debt securities (in %)




Source: Bank of Albania.

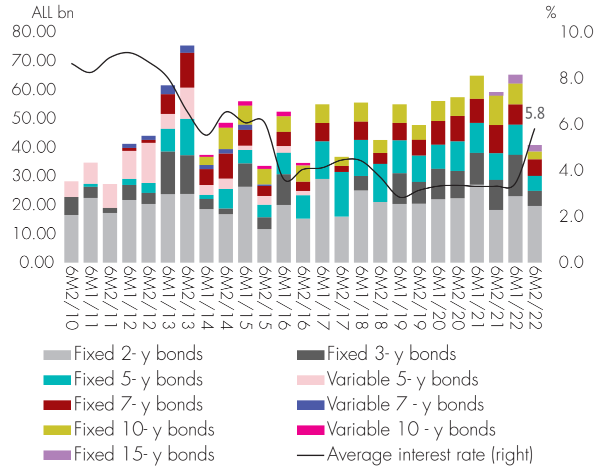
The twelve-month securities were around ALL 115 billion, accounting for 90% of the short-term securities and 70% of the total securities issued during the period. The volume of six-month securities issued during the period were somewhat higher than the value recorded during the previous two six-months, while the volume of three-year securities was comparable to that of the two previous six months. The yields on short-term securities increased considerably during the second half of the year. At the end of the year, the average yield on short-term debt reached 4.4%, increasing by 2.5 p.p. compared to the previous six months and by 2.8 p.p. compared to the previous year. Yields increased for all maturities in this segment. For instance, the average yield on 12-month securities was 4.6% or 2.6 p.p higher compared to the value at the end of the first six months of the year. The yields for this maturity marked a more pronounced increase since the end of the third quarter of the year, and reached 5.8%, in the issuance of December, the highest level in the last 8 years. The rise in yields has affected the increase in investors' interest, who in most cases have met the government's borrowing demand.

Chart 16 Volume and weighted average yield on T-bills in the primary market




Source: Bank of Albania.

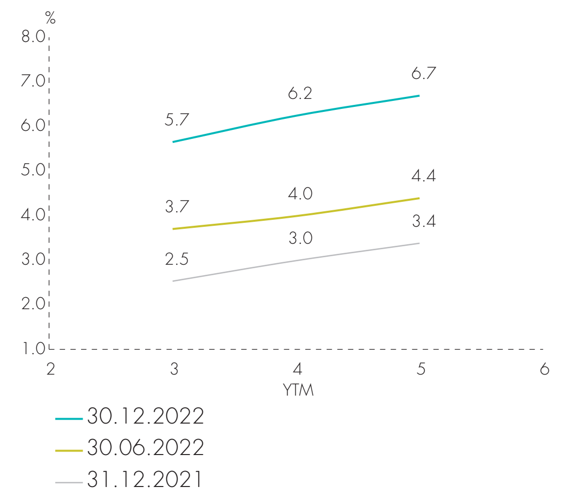
Chart 17 Volume and weighted average yield on bonds in the primary market




Source: Bank of Albania.

The volume of long-term securities issued during the period was around ALL 40 billion, or 40% and 30% less compared to the first half of this year and the second half of last year. Around 50% of the volume of long-term securities issued during the period was in the form of 2-year bonds. In the second half of the year, there were around ALL 20 billion of 2-year bonds issued. This volume was notably lower than the previous six months, albeit comparable with that of the second half of the previous year. The issuance of 3-year securities was around ALL 5 billion, and this volume was significantly lower compared to the issuance of ALL 15 billion in the first half of the year. A decrease in the issued volume was also recorded for bonds with 5, 7, 10 and 15-year maturities. The decline in the issuance of long-term securities has reflected the reluctance of investors to finance the demand in the conditions of uncertainty about the progress of interest rates and the government's intention to moderate the cost of borrowing. In fact, the weighted average yield on long-term securities increased by 2.4 p.p. at 5.8%. The sharpest increase in the yield was recorded for bonds with 7-year maturity, by 2.8 p.p at 7.5%. Yields on 2- and 3-year securities increased by 2.6 p.p. each, at 4.9% and 5.6% respectively, while yields on 5-and-15-year maturities increased by 2.5 p.p. each, at 6.1% and 8.7%, respectively. Long-term securities with 10-year maturity recorded the lowest yield increase for the period, by 1.3 p.p., reaching at 6.6%.

Chart 18 Yield to Maturity (YTM) on 31.12.2022




Source: Bank of Albania.

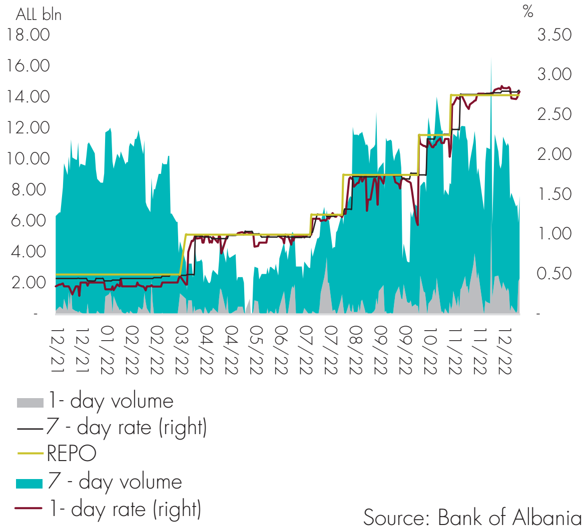
In the secondary market of securities, the trade volumes remain low. Securities transactions between banks for their portfolios account for about ¾ of the total transactions in this market, including transactions between banks for their clients. Aiming at developing this market, the model of market-makers has been operating for a few years now, offering daily quotes of benchmarks with 3- and 5-year maturities. Daily quotation of benchmarks provides for the calculation of the yield curve, which serves as a benchmark for other debt securities in the market, and the price of securities. The yield curve at the end of the period appears shifted upwards, reflecting the increase in the yields on securities for each maturity. Despite its upward shift, the yield curve has shown normal slopes, with higher yields for longer maturities.

*During the period, the volume of transactions in the interbank market increased compared to the volume recorded in the previous two six months.*
*The interest rate on interbank transactions increased following closely the performance of the key interest rate, and reflecting the monetary policy decisions of the Bank of Albania.*

## 2.1.2 THE INTERBANK MARKET OF FINANCING

The volume of financing transactions in the interbank market has recorded a significant increase of around 60% compared to the volume of transactions of the first half of the year, and an increase of around 20% compared to the volume recorded in 2021 H2. Interest rates in the interbank market have reflected the increase in the key interest rate announced by the Bank of Albania in August, October and November, and have fluctuated close to the key interest rate.

Chart 19 Volume of transactions and interest rates in the interbank market




Source: Bank of Albania.

The 7-day transactions continued to dominate the interbank market, accounting for around 84% of the volume of interbank borrowing. During the period, around ALL 980 billion were recorded in 7-day transactions, and this value was around 50% higher compared to the volume in the first half of the year, and 16% higher compared to the value in the previous year. The overnight transactions carried out during this six-month period were around ALL 130 billion, or 3 times higher compared to the previous six-months and 2 times higher compared to the previous year. The volume of overnight transactions accounts for around 11% of the total volume of transactions conducted during the period. The rest of the transactions are represented by 3-month transactions, which increased by 30% compared to the first six months. During the period, the Bank of Albania continued to carry out regular operations, injecting liquidity through one-week reverse repurchase agreements, which represent its main instrument. Likewise, injections with 3-month maturity have been present, but at a lesser extent.

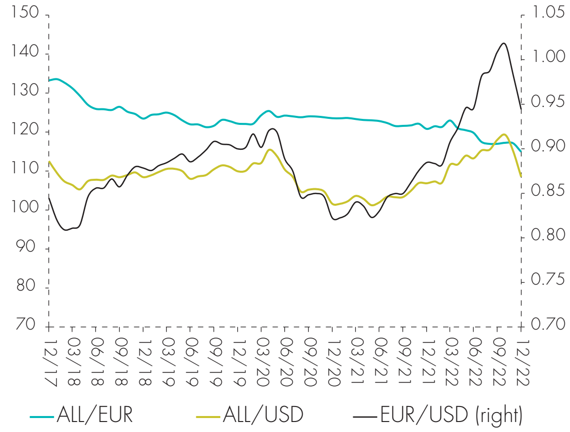
*In line with the performance of foreign currency flows in the balance of payments, the lek exchange rate has been stable during the period, by appreciating against both the euro and the US dollar.*

*During the period, the Bank of Albania continued to hold auctions for the purchase of the euro, according to the previously published schedule, in order to increase the foreign reserves. Overall, the foreign exchange market appeared calm and was characterized by normal parameters of trade.*

## 2.1.3 FOREIGN EXCHANGE MARKET

In 2022 H2, the lek followed an appreciating trend against the euro in line with the dynamics of foreign exchange flows in the balance of payments. As at end-2022, the average exchange rate of the euro was ALL 114.9, showing an appreciation of lek by 4.1% and 4.9%, respectively compared with the end of the two previous six-month periods. The Bank of Albania has continued to hold auction for the purchase of the euro, pursuant to the published schedule, in order to increase the foreign reserves The performance of the exchange rate of the lek against the US dollar is dictated by the performance of the latter in international markets. During November-December, the domestic currency appreciated, reflecting the depreciation of the US dollar against the euro in the international market. In December, 1 US dollar was exchanged by around ALL 108.5, which reflects an appreciation of the domestic currency by 4.2% compared to the previous six months. Compared to the last price of 2021, lek depreciated by around 1.6% at the end of 2002. Overall, the foreign exchange market appeared calm and was characterized by normal trade parameters.

Chart 20 Exchange rate in the domestic foreign exchange market




Source: Bank of Albania.

*Indicators on real estate market performance give miscellaneous signals about the development in housing demand, supply and prices, during 2022 H2.*

*The reports by real estate agents show that sales during the period have been somewhat higher compared to the previous two six-month periods, while the number of unsold properties has been down.*

*Meanwhile, the survey at banks shows that they have tightened the conditions on loans for real estate while the households' demand has decreased. However, outstanding loans in the banks' balance sheets has edged up. The lower loan demand for real estate may reflect the increase in prices and interest rates in the economy.*

*During the period, a lower number of permits and construction area was granted, compared to the previous period. Construction costs have risen considerably due to strong upsurge in spending for energy, construction materials and wages. Outstanding loans for construction increased during the period.*

*According to data collected by the Bank of Albania's special survey, the Fischer House Price Index - at national level- fell by 9% in six-month terms, but remains around 17% higher compared to the average level of a year ago. Although during the period there was a better distribution of transactions according to the type of property, it is observed that the share of transactions where the purchase price is lower than the price requested by the seller has increased.*

*Agents reported a positive position regarding the performance of the housing market in the short term, and remain optimistic about its performance in a longer term, though at lower vlaues than the historical average.*

## 2.2 THE REAL ESTATE MARKET

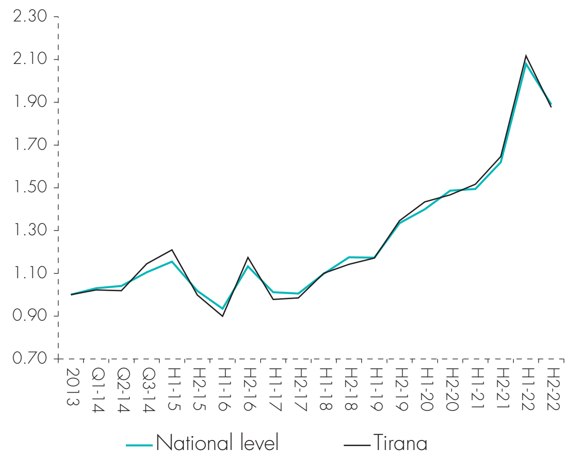
Indicators on real estate market performance give miscellaneous signals about the development of the demand, supply and prices, during 2022 H2. Based on the data on the real estate market survey and the developments in the house prices, the data reported by banks and other administrative data, it is assessed that:

Real estate agents report steady sales volume and a fall in the number of unsold properties, but demand in this market is likely to have been negatively impacted over the period due to rising interest rates and tighter conditions on loans, as well as the increase of the living cost due to the hike in inflation. Although new loans for this segment were lower than in the previous period, the outstanding loans for the purchase of real estate from the households sector reached ALL 170 billion, increasing by 4.7% during the period and by 14.2% compared to the previous year. The quality of these loans remains at good levels, as the non-performing loans ratio fell to 2.3%, from around 2.7% in the previous six months, and 3.6% in the previous year. At the end of the period, the stock of real estate collateralized loans was around ALL 340 billion, or ALL 20 billion lower than the level of six months ago, and the decline is mainly related to the contraction in the stock of commercial real estate loans. Around 44% of loans collateralized with real estate is held by the households' sector.

At the same time, supply indicators signal for a slowdown of the flow of new constructions in the future, as well as a significant increase in construction costs.

The number of construction permits granted during 2022 H2 was about 14% lower than in the same period a year ago, while the corresponding area was 17% lower. Compared to 2022 H1, the above indicators fell by 7% and 40%, respectively. Construction costs measured by the Construction Cost Index continued to grow at a fast pace during the second half of the year. The annual change in the overall index was 7%, while the items with the highest growth were the energy expenditure (+16%), construction materials (+8%) and expenditures for wages (+5%). Construction loans expanded by 4.6% during the six months and by 16.6% compared to the previous year. The share of the loan for construction account for 18% of the outstanding loans to enterprises and this share has remained unchanged from the previous periods.

Chart 21 Fischer Index - National level, and Tirana

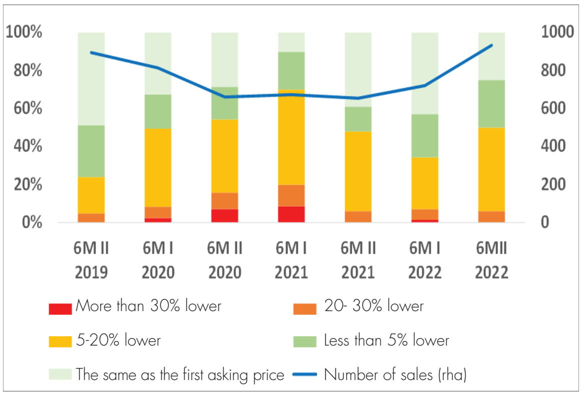



Source: Bank of Albania.

Despite robust demand and rising construction costs, real estate agents have reported lower sales prices compared to the previous six months. The average house prices calculated according to the Fischer Index[17], for sales made during the period, decreased by 9.1% compared to the previous six months and it remains around 16.6% higher compared to the previous year. The index of sales prices in the Tirana decreased by 11.4% compared to the previous period, remaining at around 13.9% above the level of the previous year.

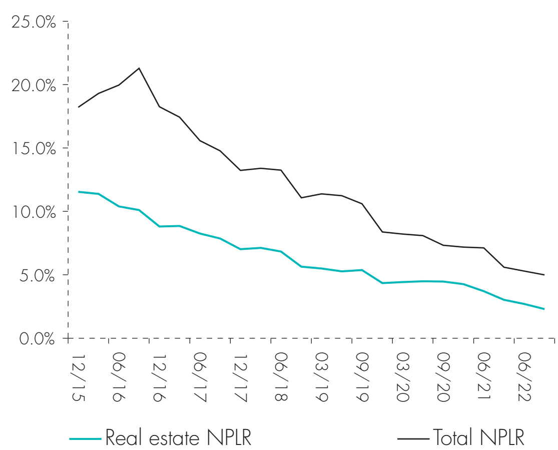
This trend suggests that price surge may have entered a normalisation phase, after increasing by 28.4% in the first half of the year. It should be noted

Chart 22 The sale transaction price compared to the requested price




Source: Bank of Albania.

Chart 23 Credit quality for real estate purchase




Source: Bank of Albania.

17 *This index is built on the basis of a specific survey. The survey analysis is published on the website of the Bank of Albania: https://www.bankofalbania.org/Financial_Stability/Analysis_and_studies/Surveys/Survey_on_the_developments_in_the_real_estate_market_in_Albania.html*

that the estimated prices in the last six months were significantly dictated by the high number of sales in areas with relatively higher prices, while for the second half of the year the distribution of sales according to the areas, type and value of residences is somewhat more heterogeneous. On the other hand, it is observed that in the second half of the year, the share of transactions increased where the purchase price for the sold properties was lower than the price requested by the seller.

Entities' assessments of the market situation and prices in the housing market remain, overall, positive for the short term, despite uncertainties associated with the situation. In the longer term, the expectations of these entities on the situation and performance of the housing market, remain optimistic, at lower values than the historical average.

*BOX 1 SUMMARY OF RESULTS FROM THE "REAL ESTATE MARKET" SURVEY AND HOUSE PRICES INDEX FOR 2022 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 of 230 entities, whose main business is the trading of real estate. The selected entities are real estate agents and construction companies whose sales represent about 75%-80% of the turnover of the entire population. The Bank of Albania compiles the questionnaire and realises the data entry and processing, while the Institute of Statistics conducts the field interviews, the main processes of sampling and the physical check of the filled in questionnaire. In addition to the data on performance of the Fischer House Prices Index, for Albania, aforementioned in this report, the data from the survey shows that:*

**General assessment.** *The assessment of agents for the overall situation of the market was more optimistic compared with the previous period. Responding to the question "How do you assess the market situation compared with the previous period (six-months)", the net balance of responses was 13%, whereas around 1/2 of responses gave a neutral report - "no change". The balance value for this question is significantly more positive than the long-term average of around -19%. The same indicator assessed only for entities reporting sales was significantly more positive during the period, with a net balance of around 27%.*

**The number of new listed properties** *by agents has remained almost unchanged compared to the previous period. The net balance of those reporting an increase in the number of listed properties and those that report a decrease was around -1%, or very close to the neutral level. The number of unsold properties, both for residential and commercial buildings has been down for several six-month periods in a raw.*

**The average sale period** *at national level fell at 10 months from 10.8 months in the previous period, as a result of the significant decrease in the sale's time of properties in other areas. In Tirana, the interviewed entities reported the average sales time was 10.7 months, and this value was 1 month longer compared to the previous six months. In the coastal area, sale time of properties has increased from 6 to 7.3 months. As regard to other areas, the sale's time of properties was reported to be significantly lower, from 13.1 to 9.6 months.*

**Financing through bank credit.** *A considerable number of sold residential and commercial properties were purchased with a bank loan. According to agents, around more than half of properties (56%) for both residential and commercial buildings sold by them are purchased via bank loans. For 80% of these cases, the loan covered up to 60% of the value.*

**Expectations for the future** *appear positive, regardless of uncertainties related to the situation. Agents have positive expectations about the market performance in the territory they operate in the short-term future, and are optimistic for a longer-term period (up to two years). The expected new listings for sale during the forthcoming period are expected to not change much since the agents' responses show a balanced outcome. On the other hand, agents also expect increases in real estate prices for residential and commercial properties; net balances of price expectations were positive and around 30%, reflecting the optimistic outlook of agents.*

**Rent prices.** *According to the interviewed agents rent prices have increased. Overall the demand for rental properties is reported as higher compared to the demand in the past six months. It should be emphasised that these responses are concentrated in Tirana.*

## 2.3 PAYMENT SYSTEMS

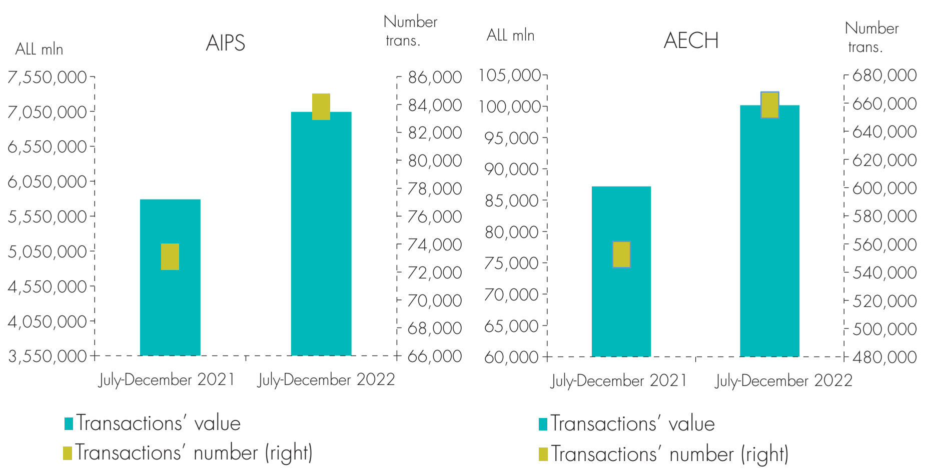
*The core infrastructure for clearing and settlement of payments has continued to function safely and efficiently. The number and value of transactions processed in AIPS and AECH have edged up.*

*The number and value of bank customer payments increased compared to the same period in the previous year. Credit transfers in non-paper form (internet banking, mobile banking) have exceeded the credit transfers in paper form for the first time.*

*Over 2022, values of payments administered through the AIPS-EURO system, which processes only payments for customers within Albania in Euro, have continued to increase. In turn, benefits in the form of reduced costs of these payments for the users of the system, have edged up.*

Over the second half of the year, AIPS and AECH have operated safely and efficiently, and the transactions processed through them have increased considerably in number and value. Around 84,000 payments accounting for ALL 7,000 billion were cleared in AIPS during the period, while the number and value of transactions increased by 14.7% and 21.6%, respectively, compared to the same period a year ago. At the same time, in the small value payment system (AECH) 660,000 payments were cleared, with an average value per transaction of around ALL 152.000. Compared with the first half of 2021, the activity of the AECH registered a significant increase both in volume and value,

Chart 24 AIPS and AECH activity in 2021 H2 and 2022 H2

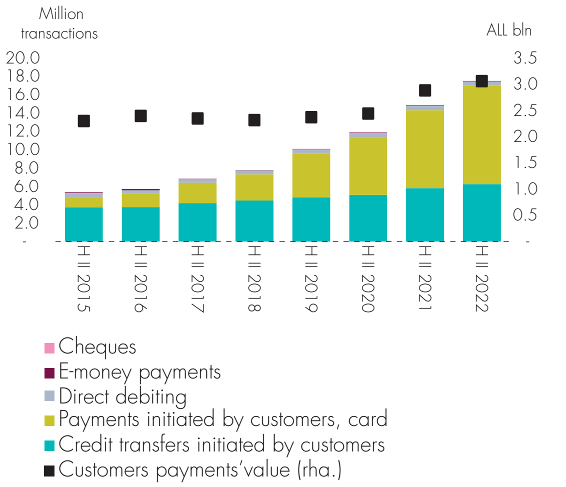



Source: Bank of Albania.

by 19.2% and 14.9%, respectively. During the period, 17.8 million payments were processed for banks' clients (households and enterprises), accounting for ALL 3.000 billion. The number of conducted transactions increased by 17.6%, while their total value is 6.16% higher compared to the second half of the previous year.

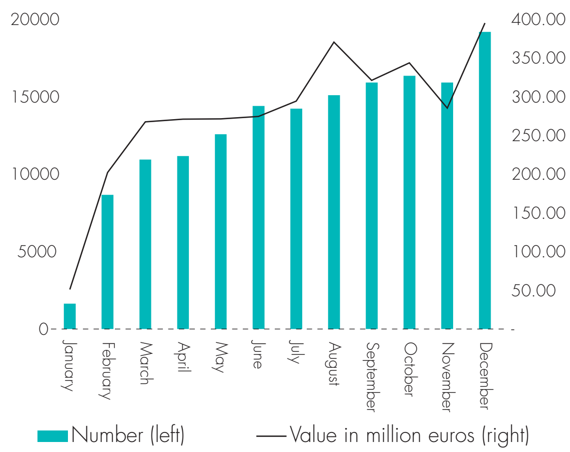
Card payments have the main share in the number of transactions, with 60%, remaining for the third consecutive year, the main payment instrument used by customers. For this six-month period, it is worth noting that for the first time credit transfers in non-paper form (internet banking, mobile banking) have exceeded the number of credit transfers in paper form, which reflects a higher degree of public familiarity with this form of payment, which is relatively new in the domestic market. An important development during 2022 was the launching of the AIPS-EURO system at the end of January. This system enables payments in euros for customers in Albania, without the need to involve correspondent banks abroad. As a result, a significant part of the applied commissions will circulate in the domestic economy. The AIPS-EURO system aims to reduce the time and costs of processing payments in the euro for the public, as well as contribute to reducing the volume of cash in the euro which is managed by domestic banks. A total of 156,000payments were processed through this system, with a total value of about EUR 3,350 million and an average value per transaction of EUR 21,450. The use of AIPS-EURO by the clients has increased, especially during the second half of the year.

Chart 25 The performance of payment instruments in volume and value




Source: Bank of Albania.

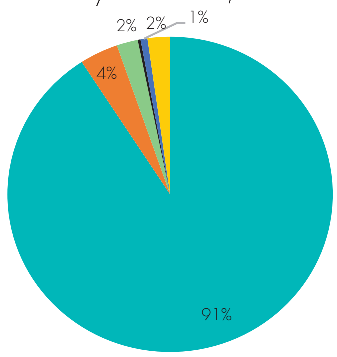
Chart 26 Progress of payments for customers in the AIPS - EURO system throughout 2022




Source: Bank of Albania.

# 3. FINANCIAL SYSTEM

Chart 27 Share of financial system segments to total financial system assets, December 2022




Source: Bank of Albania, Albanian Financial Supervisory Authority.

During the period, the share of financial system assets[18] to Gross Domestic Product (GDP) dropped by 10 p.p. at 96.8%. This performance reflects the fact that the annual growth rate of GDP was higher compared to growth of the financial system balance. The fall in the share of banking sector assets, by almost 8 p.p, provided the main contribution in this performance, despite its expansion in absolute value, coupled with the decline in the share of investments fund, by almost 2 p.p.. The banking sector continues to dominate by around 91% of total assets, in the financial system. The exposure of the banking sector to the non-banking sector remains low and stable, while the sensitivity of the non-banking sector to the activity of the banking sector remains high, upward during the period. The Bank of Albania regularly monitors correlation indicators within the periodic assessment of systemic risks.

*Table 4. Share of the 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 sector | NBFIs | SLAs and Union | 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 | 107.5 |
| 2021 | 95.5 | 4.1 | 0.7 | 2.2 | 0.2 | 4.2 | 107.0 |
| 2022 | 88.0 | 3.7 | 0.7 | 2.0 | 0.3 | 2.2 | 96.8 |

*Source: Bank of Albania, Albanian Financial Supervisory Authority.*
** The shares are calculated using nominal GDP at current prices according to INSTAT.*

[18] *The financial system consists of the banking sector and the non-banking sector. The database for non-bank financial institutions are from 2022 Q3, while the rest of the segments of the financial system together with GDP are from 2022 Q4.*

# 3.1 BANKING SECTOR

## 3.1.1 MAIN DEVELOPMENTS IN THE BANKING SECTOR

The balance sheet of the banking sector expanded by around 4% during the period, with the main contribution from the increase in treasury operations and investments in securities on the asset side, supported by the increase in customer deposits on the liability side. The increase in loans to the economy has also given a modest contribution to the increase in assets. In annual terms, the growth rate of the banking sector's balance sheet was 6%, or half of the growth rate of the previous year. The banking sector has continued as usual its main functions of the activity and has financed the economy. The reported value of assets increased by around ALL 70 billion during the period, reaching around ALL 1,880 billion at the end of the year. The main contribution to the growth in assets was given by the expansion in treasury transactions by around ALL 33 billion and investments in securities by around ALL 20 billion. Treasury transactions expanded due to the increase by around ALL 30 billion in the ''Relations with the central bank'' item. At the same time, interbank transactions decreased by around ALL 16 billion (or 8%), affected by the decrease of deposits with banks and other financial institutions, mainly non-residents. Investments in loans expanded compared to the previous six months by around ALL 13 billion (or 2%), supported by loans to the private sector and short-term loans. The contraction of the provisioning funds of the banking sector expanded the level of assets by around ALL 2 billion during the period.

*The banking sector expanded its activity during the period by around 4% and by 6% in annual terms, and the value of its balance reached at ALL 1,880 billion. The main contribution to this growth was given by transactions with the treasury and investments in securities. The increase in loans and the contraction in provisions for assets' quality provided also a positive impact on the performance of assets.*

*The share of assets and liabilities in foreign currency to total balance fluctuates around the values 53% and 51%, respectively, and this structure appears stable over the period. In terms of assets, the use of foreign currency is higher in inter-bank investments and loans. In terms of liabilities, the use of foreign currency is higher in deposits.*

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

| Assets | % of assets | Annual change, % | Liability | % of liability | Annual change, % |
|---|---|---|---|---|---|
| I Treasury and interbank transactions | 28 | 6 | I Treasury and interbank transactions | 6 | 1 |
| II. Customer transactions (credit) | 38 | 7 | II. Customer transactions (deposits) | 81 | 6 |
| Of which: public sector | 1 | -51 | Of which: public sector | 1 | 6 |
| Of which: private sector | 37 | 7 | Of which: private sector | 80 | 6 |
| III Securities transactions | 33 | 6 | III Securities transactions | 0 | 0 |
| IV. Created Reserve funds | 2 | 19 | IV. Other liabilities | 2 | 21 |
| V. Other* | 3 | 5 | V. Permanent sources | 11 | 6 |
| | | | Of which: Subordinated debt | 1 | 19 |
| | | | Of which: Shareholders' equity | 10 | 5 |
| Total assets | 100 | 6 | Total liabilities | 100 | 6 |

*Source: Bank of Albania.*
** "Other" in the balance sheet refers to " Other assets", "Fixed assets" and "Accrued interests".*

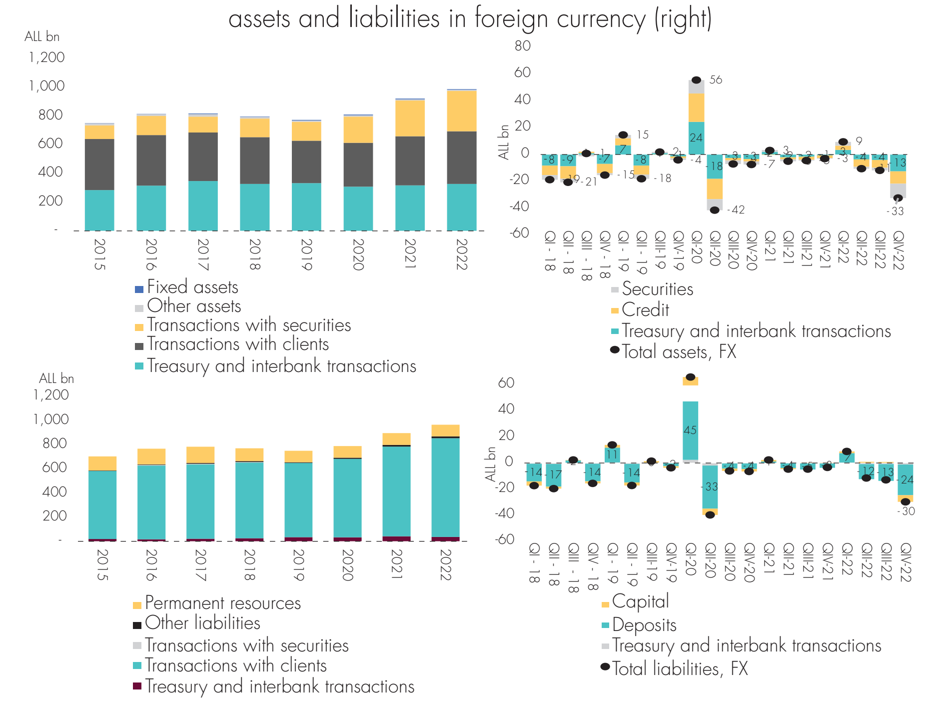
*The statistical effect of the exchange rate related to the lek appreciation against the euro, has affected the reported share in the balance sheet items denominated in foreign currency and has been vulnerable during the period.*

*Despite the fall in liabilities to non-residents compared to non-resident assets, the net creditor position of banking sector against them as a ratio to total assess has not changed.*

At the end of the period, assets and liabilities in foreign currency of the banking sector accounted for 53% and 51% of total balance, respectively, and these ratios have not changed during the period. In absolute terms, banks reported similar levels of foreign currency assets and liabilities, of ALL 900 billion and ALL 970 billion, respectively, thus maintaining an almost consistent exposure to foreign currency activity. On the foreign exchange assets side, lending activity and interbank investments remain the most important items, while during the last three 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 is dominated by deposits in foreign currency.

The significant presence of the activity in foreign currency means that foreign currency indicators expressed in the domestic currency are affected by the performance of the exchange rate of the lek against the euro and other main currencies. During 2022 H2, this effect had a diminishing and a considerable impact.

Chart 28 Performance of the assets and liabilities in foreign currency (left) and the effect of the exchange rate on the equivalent value in lek of the main items of the assets and liabilities in foreign currency (right)

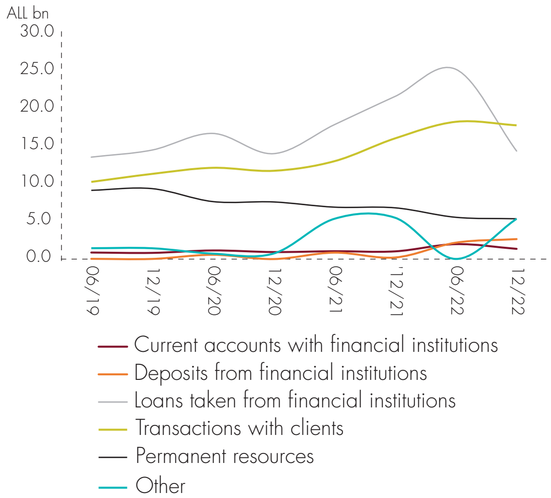



Source: Bank of Albania.

The appreciation of lek during 2022 Q4 has caused the statistical effect of the exchange rate on the reported value of the foreign exchange balance of the banking sector to be negative (about - ALL 33 billion). On the assets side, the strengthening of the domestic currency has had a greater impact on the main balance sheet items such as treasury and interbank transactions (ALL -13 billion) and investments in securities (ALL-11 billion), while on the liability side, almost the entire statistical effect of the exchange rate is reflected on the equivalent value in lek of foreign currency deposits (ALL -24 billion).

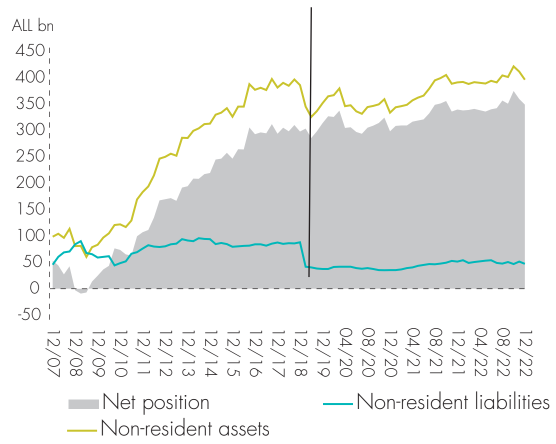
Deposits and own funds continue to be the main funding source of the banking sector's activity, accounting for 92% of the total liabilities, and this structure has been stable during the period. Reliance on external funding remains low and has further decreased during the period, as a result of the decrease in banks' liabilities in the form of loans to non-residents. On the other hand, permanent resources which represent own funds have decreased over the past 3 years, as a result of the contraction of subordinated debt and structural changes in banks' capital. Regarding the liabilities to non-residents, in November 2022, the item of "other liabilities" related to the dividend to be paid (to non-residents), edged up. The increase in assets on non-resident entities during the period, came from the expansion in investments in securities and placements in the form of current accounts with banks and financial institutions. At the end of the period, claims to non-residents amounted for 21% of total assets, while liabilities to non-residents accounted for only 3% of the total balance sheet. The net creditor position did not show any changes in absolute nor relative terms compared to the previous six months and the previous year, remaining at 19% of the total assets of the banking sector.

Chart 29 Liabilities to non-residents




Source: Bank of Albania.

Chart 30 Net position with non-residents*




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

### 3.1.1.1 Banking Soundness index

*The banking soundness index shows good financial situation of banking sector as at end of 2022.*

*This assessment was based on the improvement of the signals emitted by the profitability and efficiency sub-indexes, the stability conveyed by the capitalisation sub-index and the fall signalled by liquidity sub-index.*

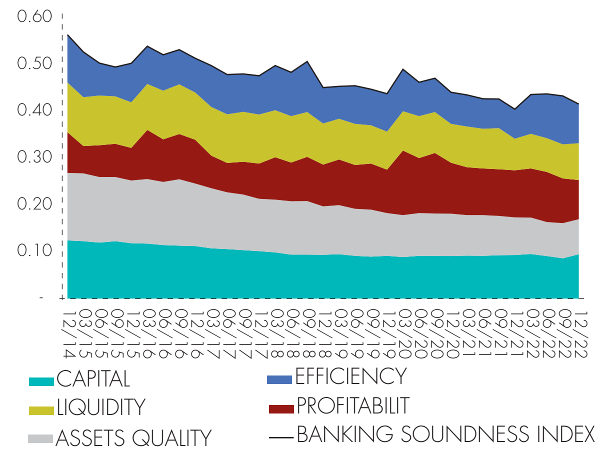
*Over a longer-term period, the performance of the banking soundness index confirms the improvement recorded in the banking sector activity, in terms of the quality of assets, capitalisation, and liquidity.*

**Banking Soundness Index**[19] reached at 0.415 and indicated a good financial condition of the banking sector at the end of 2022. This development was mainly dictated by the improvement of the profitability indicator, which was as a result of the increase in the return on assets of the banking sector. The banking Soundness Sub-Index (related to the activity expenses) and assets' quality, slightly improved during the period. The asset quality sub-index decreased to 0.37 at the end of the year, from 0.73 at the end of 2014,

[19] *An increase in the index indicates a deterioration of the financial situation and vice versa.*

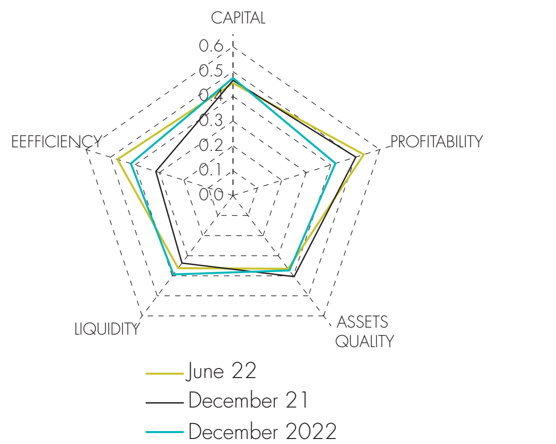
as a result of the significant decline in the ratio of non-performing loans. The activity capitalization sub-index hasn't changed much during the year, while the liquidity sub-index increased during the period, as a result of the decrease in the ratio of customer deposits to total assets. However, the contribution of this sub-index to the aggregate level of risk over time has been decreasing, especially during the last 2 years[20]. For the group of systemic banks, the index signals improvement compared to the previous six months and previous year. These banks show improvement in three of the five indicators, but in particular

Chart 31 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 32 Banking Soundness map*




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

the improvement is observed in the profitability indicator, which shows the growth in return on assets and net interest margin.

The index shows a less good performance of Albanian-owned banks. For these banks, there is an improvement in terms of liquidity, while the other four indicators and, in particular, profitability and efficiency are presented at less good levels compared to the two previous periods. As a whole, during 2014-2022, the aggregated banking soundness index indicates improved soundness and increased stability of the banking sector. This improvement is particularly related to the improvement of asset quality and liquidity and capital levels. At the same time, the sensitivity of the index to profitability levels has become more important starting from 2020 Q1.

[20] *The value of the liquidity indicator fell from 0.45 to 0.39 during December 2020 - December 2022.*

## 3.1.1.2 Capitalisation of activity

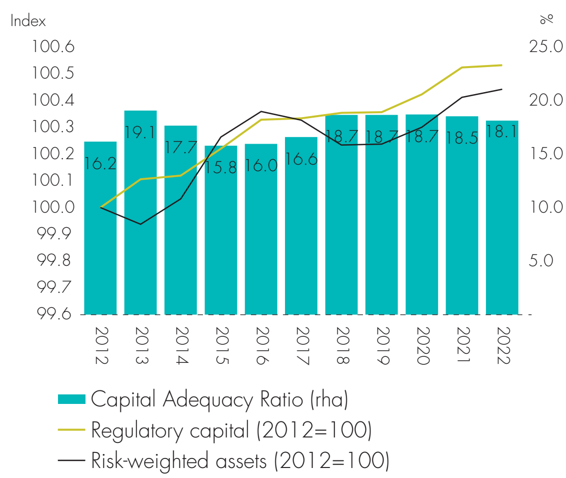
### CAPITAL ADEQUACY RATIO

The capital adequacy ratio fell to 18.1% at the end of 2022, from 19% in the previous six-months. In each bank this indicator stands above the minimum required level of 12%. Banks with European capital and non-systemic banks show the highest level of Capital Adequacy Ratio. The increase in the capital adequacy ratio during the period was determined by the decrease in banks' regulatory capital (with an effect of -1.1p.p), while the slight contraction in risk-weighted assets provided a small positive effect. At the end of the period, the regulatory capital of banks recorded ALL 170 billion, down by around ALL 8 billion compared to 2022 H1. The decrease in regulatory capital was impacted by the exchange rate effect of, the reduction of retained earnings, as well as the expansion in the negative credit negative spreads.

*At the end of 2022, the capital adequacy ratio of the banking sector stood at 18.1%, or down by around 1.1 p.p. compared to the previous six months.*

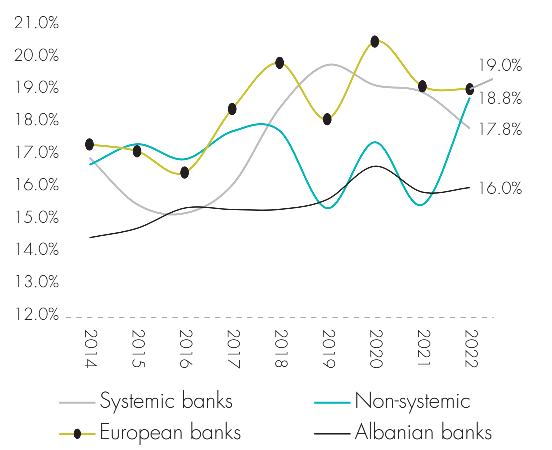
*This performance was driven mainly by the fall in the regulatory capital, which in turn pushed down the financial leverage ratio.*

Chart 33 Capital Adequacy Ratio




Source: Bank of Albania.

Chart 34 Capital Adequacy Ratio of groups by importance and origin of capital



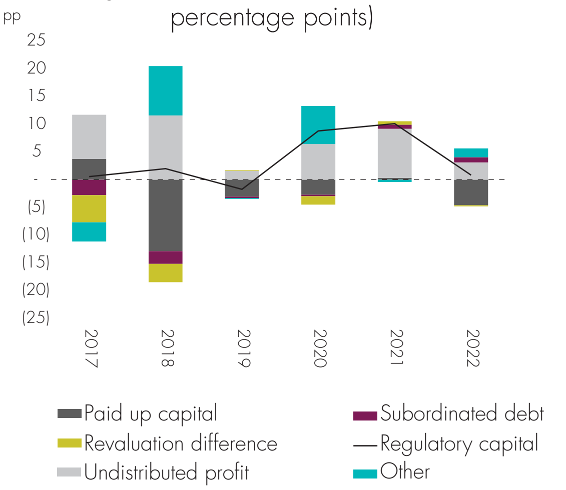

Source: Bank of Albania.

In annual terms, the increase in regulatory capital was somewhat lower compared to the previous year, mainly due to the decrease in paid-in capital in foreign currency as a result of structural changes in the banking sector and the effect of the exchange rate. The retained earnings of previous periods have contributed to the growth of regulatory capital, but this contribution has been downward. The intervention of the Bank of Albania with its decisions on the suspension of the distribution of retained earnings by banks has also affected the preservation of retained earnings from previous periods[21]. On the other hand, risk-weighted assets registered a slight decrease in semi-annual terms, down to ALL 960 billion. This decrease is related to the fall in risky assets for market risk, and in particular in risky assets for the risk of both debt securities position and exchange rate. Meanwhile, risk-weighted assets for credit risk and operational risk have

[21] *Decision No. 6, dated 2.2.2022 "On the suspension of profit distribution of banks" with effect until 31 December 2021.*

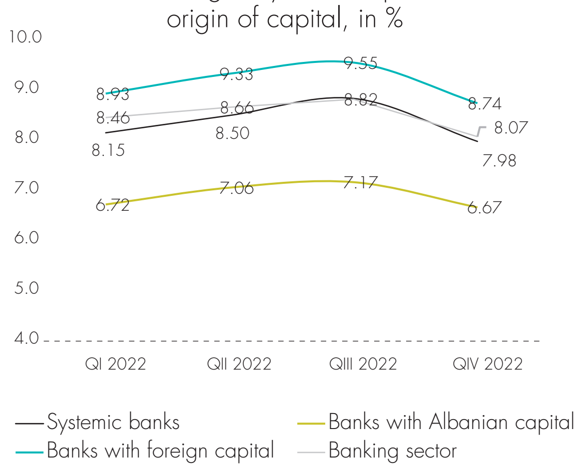
increased. Credit risk exposures increased as a result of the increased exposures to categories classified as high risk and non-performing (loans) exposures. As a ratio to total assets, the share of risk-weighted assets appears stable and it ranges around 51%. Risk-weighted assets by risks continue to be dominated by credit risk-weighted assets (87%), while market and operational risk-weighted assets account for 2% and 11% of the total, respectively.

Chart 35 Performance of regulatory capital according to constituent elements (contribution in percentage points)




Source: Bank of Albania.

Chart 36 Performance of financial leverage for banks according to systemic importance and origin of capital, in %




Source: Bank of Albania.

The financial leverage ratio[22] in December 2022 slightly decreased at 8.1%, from 8.7% in the first half of the year, as a result of the decrease in Tier 1 capital. Banks have maintained a financial leverage ratio above the required regulatory level of 5.75% on an individual basis. For the banking sector this ratio is mainly determined by the systemically important banks. Foreign capital banks have the highest level of financial leverage ratio compared to banks with Albanian capital.

## CAPITAL SURPLUS AND FULFILMENT OF REGULATORY REQUIREMENTS ON MACROPRUDENTIAL CAPITAL BUFFERS

Macroprudential capital buffers are aimed at improving banks' resilience to systemic risks of a cyclical and structural nature. To this end, in a period of normal developments, banks build up capital reserves to absorb potential losses and create the possibility of supporting the real economy with financing in difficult times.

[22] *On 1 January 2022, regulation No. 63/2020 "On the leverage ratio of banks" according to which the financial leverage ratio is calculated as the ratio of the bank's Tier 1 capital to the bank's total exposure on the reporting date.*

*The Bank of Albania requires banks to maintain certain capital levels, including requirements for macroprudential capital buffers.*

*By the end of 2022, the banking sector appears to have the adequate capital surplus, overall, in order to fulfil these requirements.*

*Nevertheless, this surplus has been reduced over the past 12 months, with systemically-important banks being the main contributors, due to the decline in the regulatory capital and the higher capital requirements demanded to banks.*

*When planning future capital values that affect it, it is important for banks to take into consideration the developments in the relevant regulatory requirements.*

In accordance with the regulation "On macro prudential capital buffers"[23], banks are subject to the capital conservation buffer (CCoB), the countercyclical capital buffer (CCyB); the buffers for systemically important banks ( SIBs) and the systemic a risk buffer (SyRB). The capital conservation buffer for 2022 is 1.5% for all banks of the sector, while the effective buffer for systemically important banks varies from 0.5%, 1% and 1.5% depending on the systemic importance of the bank The countercyclical capital buffer, according to the latest decision in 2022, was 0%, and currently the Bank of Albania has not announced buffers for systemic risk.

In December 2022, banks have started reporting the fulfilment of the "minimum requirement for regulatory capital instruments and eligible liabilities - MREL"[24]. The inclusion of this requirement affects the degree of fulfilment of macroprudential buffers for banks that are subject to the implementation of MREL, insofar as the latter is fulfilled with Common Equity Tier 1 (CET1) Capital instruments.

Taking into consideration the above buffers, as well as the specific buffers that some banks in the sector have, the limit of the required capital adequacy ratio ranges between 16% and 19% for systemically important banks, and 14% and 17% for other banks. According to end-of-period reporting, adequacy rates for systemically important banks and other banks remain above the aforementioned regulatory levels.

From the calculation of all capital requirements according to the data reported for the end of 2022, the banking sector results with capital surplus, i.e. with higher capital than capital requirements. The performance of the capital surplus is dictated by the performance of the banks' profit, the performance of the elements of the Common Equity Tier 1 Capital, as well as the expected capital requirements (MREL and macro prudential capital buffer). The capital surplus by the end of the period reached ALL 36 billion, or ALL 10 billion less than the surplus reported by the banks at the end of the first half of the year. The decrease of own funds (available capital) was due to the increase in capital requirements for 2022, and changes in the value of regulatory capital[25].

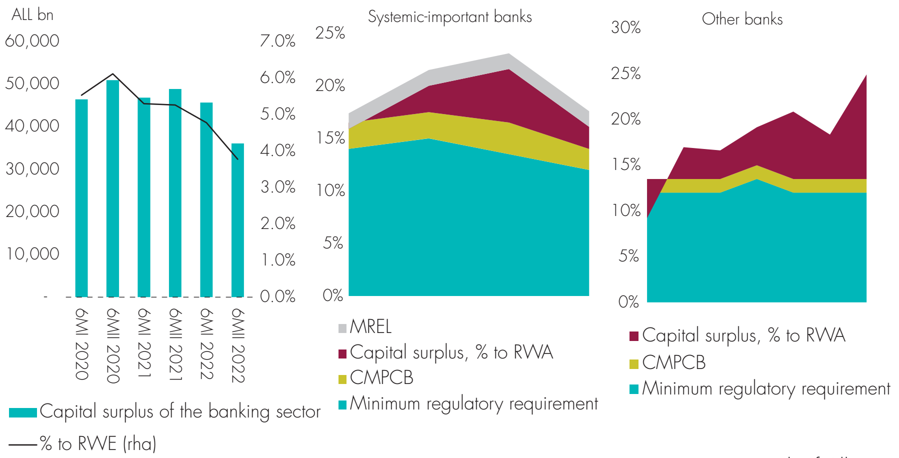
Systemically important banks determine the performance of the capital surplus of the banking sector, given that these banks own more capital compared to other banks. At the end of the period, the capital surplus for these banks amounted ALL 17 billion, or ALL 9 billion less than the surplus in the previous six months, and it accounted for around 3% of risk-weighted assets.

23 *Regulation No. 41, dated 5.6.2019, "On macro prudential capital buffers".*

24 *Five banks are subject to meeting the "minimum requirement for regulatory capital instruments and eligible liabilities" (MREL), in accordance with the requirements provided for in regulation No. 78, dated 16.12.2020, of the Supervisory Council of the Bank of Albania. The bank is obliged to meet the minimum requirements for regulatory capital, the minimum requirement for MREL, which until December 2023 is 1.5%, and the macro prudential capital buffers.*

25 *The performance of regulatory capital in December 2022 was determined by the decrease in paid-in capital, the reduction of retained earnings, as well as the expansion of negative creditor spreads.*

Chart 37 Capital surplus for the banking sector and macroprudential capital buffers by groups of banks, December 2022




Source: Bank of Albania.

*The Bank of Albania requires banks to maintain he net accumulated profit of the banking system at the end of 2022 amounted around ALL 22 billion, unchanged from the previous year, with the main contribution from the activity in foreign currency.*

*Net interest income grew significantly due to the higher increase in interest income than interest expenses.*

*The growth in interest income was also reflected by the higher net interest margin, which reached 3.5%.*

*Non-interest income was positive, but around 30% lower than in the previous year, due to losses in the investments of financial instruments.*

*The activity costs continue to be adequately covered by banks' income. Expenditures to revenues ratio of the activity remained unchanged during the period, at 60%, as the growth in the operating expenses and total revenues have had a similar pace.*

*Expenses for provisions for loans rose, but at a slower pace, partially as a result of the reversal return of provisions for other financial assets.*

Other banks, at the end of the year, result with a higher capital surplus than systemic banks, as a result of the lower level of regulatory requirements that apply to them. This surplus was ALL 19 billion ALL, in December 2022, the same level of the previous six months, but around ALL 11 billion more compared to the level of the previous year. It is important that when planning capital levels and its component items for the future, banks carefully consider market developments and the progress in relevant regulatory requirements.

### 3.1.1.3 Financial result

The accumulated net financial result of the banking sector at the end of 2022 recorded a profit of ALL 21.7 billion, remaining unchanged from the previous year. The stability in the financial result of the banking sector is reflected in the stability of the profitability indicators of the banking sector RoA and RoE, which were 1.2% and 12.3%, respectively, from 1.3% and 12.9% in the previous year.

*Table 6 Income and expenses of the banking system (ALL Bln)*

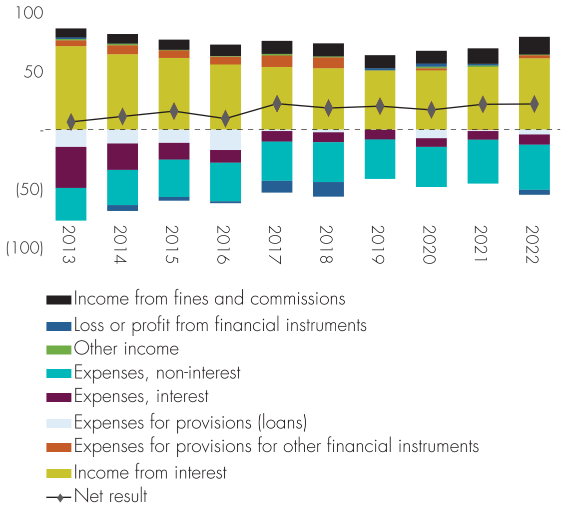
| | 2022 | | | 2021 |
|---|---|---|---|---|
| | In ALL | In FX | Total | Total |
| Income from interest | 36.9 | 24 | 61 | 54 |
| Expenses for interest | 6.3 | 2.5 | 8.8 | 7.5 |
| Net interest income | 30.6 | 21.5 | 52 | 46.3 |
| Non-interest income | 8.1 | 3.7 | 11.8 | 16.1 |
| - Fines and commissions | 8.5 | 6.5 | 15 | 13.3 |
| - Loss or profit from financial instruments | -0.9 | -3.2 | -4.1 | 1.1 |
| Non-interest expenses | 30.1 | 8.4 | 38.5 | 37.5 |
| Provisions (net) | 0.9 | 0.6 | 1.5 | 1.7 |
| - For loans | 3.1 | 0.9 | 4.1 | 0.9 |
| - For other financial means | -2.2 | -0.3 | -2.6 | 0.7 |
| Uncommon items | -0.9 | -0.4 | -1.4 | -1.6 |
| Income taxes | 3.5 | - | 3.5 | 3.6 |
| Net result | 5.1 | 16.6 | 21.7 | 21.6 |

*Source: Bank of Albania.*

The banking sector has recorded a significant growth in net interest income, which has been set off by losses from financial instruments and the increase in expenses of the activity. Expenses for the provisioning of loans increased by ALL 3.2 billion, while reversal of provisions for other financial assets mitigated to a considerable extent the negative effect of the total expenses for provisions (net) on the financial result of the sector. Net interest income continues to represent the main item in revenues. Non-interest expenses remain the main item in expenses. Income from commissions continues to remain stable and has become an important source of income for the banking sector during recent years. Financial intermediation activity, reflected in the performance of net interest income increased, maintaining the trend during 2020-2021. The increased net interest income result for the activity in foreign currency was about twice as high compared to the increase in the income from the activity in lek. This development was mainly affected by the increase in interest income, since interest expenses until the end of the year were somewhat higher compared to the expenses in the previous year

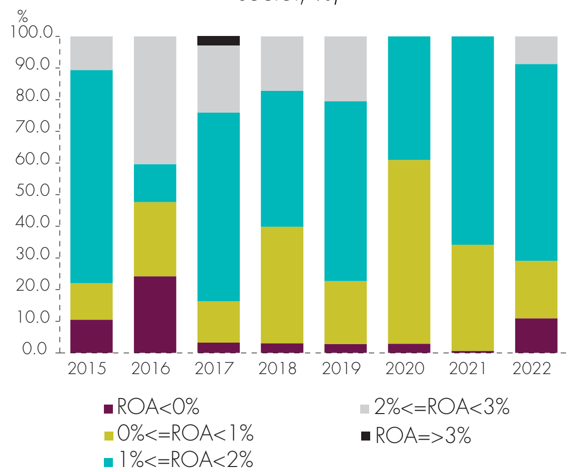
In terms of value, the net interest result was ALL 52 billion, or 13% higher than a year ago. Income from interest collected from customers was about 9.3% higher than in the previous year and reached about ALL 35 billion, while interest collected from investments in securities reached ALL 24 billion, also around 17.3% higher compared to income in the previous year. The growth in interest income was also reflected by the higher net interest margin, which reached 3.5% from 3.3% in the previous year. The increase in net interest margin reflects higher growth in interest income, compared to the 4% annual increase in the level of average income-generating assets.

Chart 38 Financial result components ALL billion




Source: Bank of Albania.

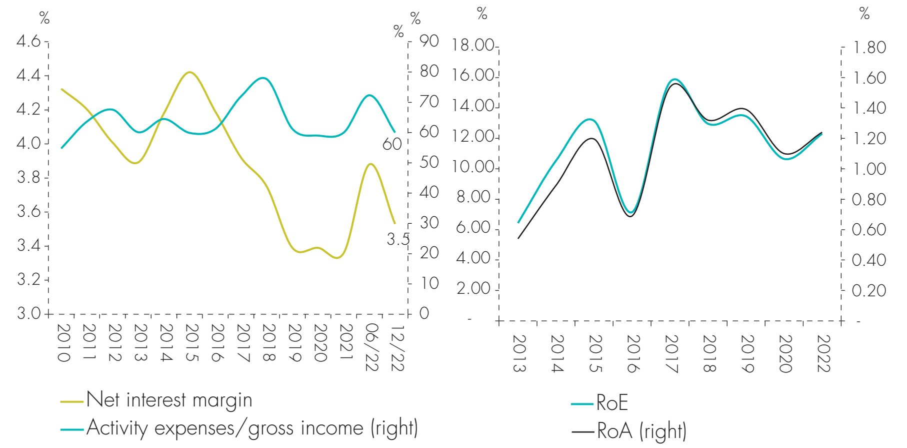
Chart 39 ROA (banks' share in the assets of the sector, %)




Source: Bank of Albania.

Non-interest income collected by banks during the period fell to ALL 12 billion from ALL 16 billion, as the sector reported a loss of ALL 4.1 billion from financial instruments. On the other hand, during this six-month period, banks recorded a 12% higher increase in their income from commissions compared to the previous year. At the same time, the operating expenses slightly increased to about ALL 38.5 billion. The activity costs continue to be adequately covered by banks' income. The ratio of operating expenses to income remained unchanged during the period, at 60%, as both operating expenses and total income grew at a similar pace.

Chart 40 Profitability and expense indicators of the banking sector




Source: Bank of Albania.

*The stock of bank credit expanded during the period by 2%, and by 6.6% compared to the previous year, up to ALL 715 billion. The growth was underpinned by new loans. Loans to households, loans in foreign currency and short-term loans recorded the highest growth.*

*Credit for real estate purchases, which accounts for 2/3rds of loans to households, recorded the fastest growth in this portfolio. Enterprises recorded positive growth rates for short-term loans, mainly for the working capital.*

*In the portfolio of unhedged foreign currency loans, the stock of loans for real estate to households has recorded a growth.*

*Banks have continued to restructure and write off loans, mainly in the loans-to-enterprises portfolio, but at a slower pace compared to the previous periods.*

*If outstanding loans were to include the stock of written-off loans during the past twelve months, in addition to the statistical effect of the exchange rate, the annual growth of loans would be around 10%. Loans to non-residents have been slightly up, but its outstanding value remains relatively low.*

Loan loss provisions significantly increased compared to the previous year, from 0.8 to ALL 4.1 billion. At the same time, the banking sector reported reversal of provisions for other financial assets, amounting to ALL 2.6 billion, which mitigated to a considerable extent the total net effect of provisions in the sector's profit.

### 3.1.1.4 Loans

Outstanding loans expanded during the period, reaching ALL 715 billion at the end of it. In relative terms, its growth was 2% and 6.6%, respectively, compared to the previous six months and the previous year. The increase of outstanding loans during the period was affected by the performance of new loans, which was granted mainly to the business sector and for short-term purposes. The highest increase in outstanding loans was recorded in the portfolio of loans in foreign currency (2.9%), loans to households (3.9%), and short-term loans (8.0%). In annual terms, the credit portfolios with the highest impact on the growth of total outstanding loans were loans to household, long-term loans, and loans in foreign currency. Loans to households expanded at a particularly high rate during the last quarters, and the annual change at the end of 2022 reached 11.9%. Loans in lek expanded by 5.9%, whereas those in foreign currency by 7.1%. Excluding the statistical effect of the exchange rate, which was negative, by ALL 17.4 billion, the annual change of loans in foreign currency would be calculated at 12.2%.

The value of restructured credit over the last twelve months was around ALL 3.6 billion, or 1.3% of the annual new credit flow and 10% of the non-performing loans stock. Credit restructuring had the biggest impact on the portfolio of loans to enterprises, and loans to the industry sector in particular. Credit restructuring was conducted on both loans in lek and loans in foreign currency. During the first half of 2022, customers have requested mostly changes in the product of loans, while in the second half of 2022, credit restructuring was in the form of extending maturity and adjustments to principal. The annual flow of restructured credit has dropped significantly in the past two years. The value of restructured credit in 2022 was equal to 35% and 15% of the value of credit restructured during 2021 and 2020, respectively.

*Table 7 Loans by maturity, sector and currency,*

| | ALL billion | Weight (%) | | Change (%) | |
|---|---|---|---|---|---|
| | 2022 | 2022 | 2021 | 6-month | Annual |
| Lek | 348 | 49 | 49 | 1 | 6 |
| Foreign currency | 367 | 51 | 51 | 3 | 7 |
| Public sector | 25 | 4 | 4 | (4) | (1) |
| Enterprises | 440 | 61 | 63 | 1 | 4 |
| Households | 250 | 35 | 33 | 4 | 12 |
| Short-term | 191 | 27 | 25 | 8 | 12 |
| Medium-term | 94 | 13 | 15 | (4) | (4) |
| Long-term | 430 | 60 | 60 | 1 | 7 |
| Loans | 715 | 100 | 100 | 2 | 7 |

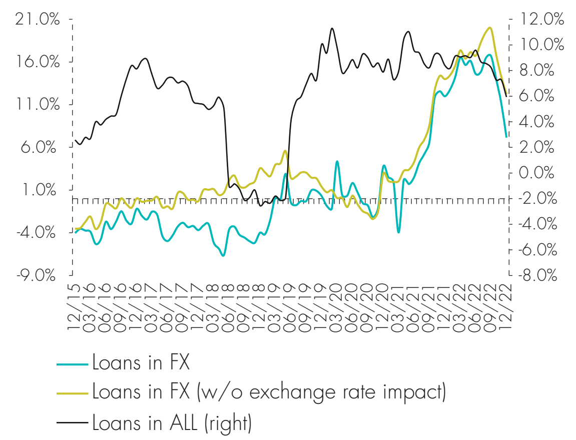
*Source: Bank of Albania.*

During the second half of 2022, banks continued to write off lost loans from their balance sheets, and their value amounted to around ALL 2.2 billion. During the last twelve months, around ALL 5.5 billion of lost loans were written off, and over 80% of this volume consisted of loans granted to domestic businesses. Written-off loans in the last year accounted for 15.4% of the overall outstanding non-performing loans in the banks' portfolio at the end of 2022, whereas in 2021 this ratio was equal to 10%. If outstanding loans were to include written-off loans during the past twelve months, in addition to the statistical effect of the exchange rate, the annual growth of loans would be around 10% (from 6.6%).

Chart 41 Six-month change in outstanding credit by composing elements


Source: Bank of Albania.

Chart 42 Loans in lek and loans in foreign currency including and excluding the exchange rate effect, annual changes

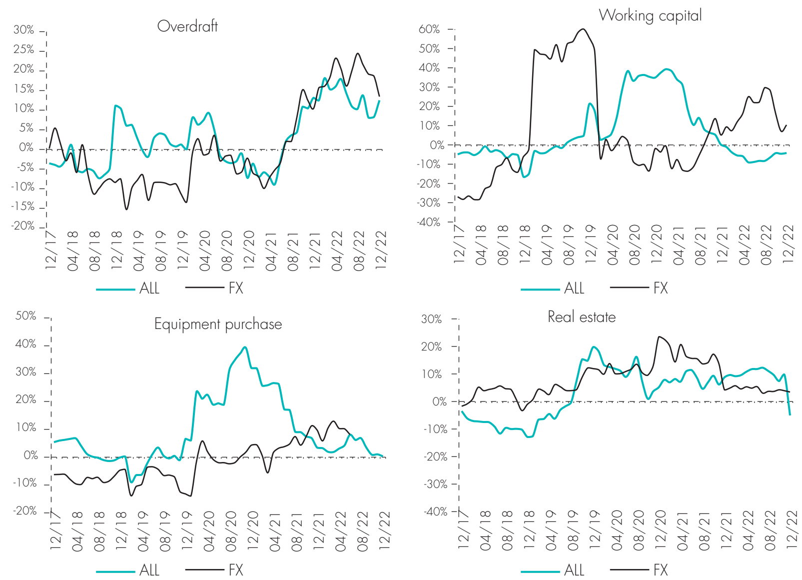



Source: Bank of Albania.

## LOANS TO RESIDENT BUSINESSES - ENTERPRISES

Loans to resident businesses (private and public) recorded around ALL 435 billion, up by around 2% during the period, and by 4.3% in annual terms. The expanded stock of loans for short-term purposes (overdrafts and working capital) provided the main contribution in loans to resident enterprises, whereas loans for investments in real estate, and loans for equipment purchase recorded a decline. Loans for investments in real estate, overdraft and loans for equipment purchase have the main share in credit to resident enterprises, accounting for 80% of the total stock. Loans granted for these purposes were mainly in euro. Over the last years, banks reported a particularly sharp rise in the portfolio of loans in the euro, which have been granted to enterprises to purchase real estate. For short-term loans[26], in the last years, enterprises have preferred borrowing in the domestic currency. At the end of the period, loans to public non-financial corporations accounted for around ALL 24 billion, dropping by roughly 4%, during the second half of the year.

Chart 43 Annual performance of loans to enterprises by purpose of use and currency (2016=100)



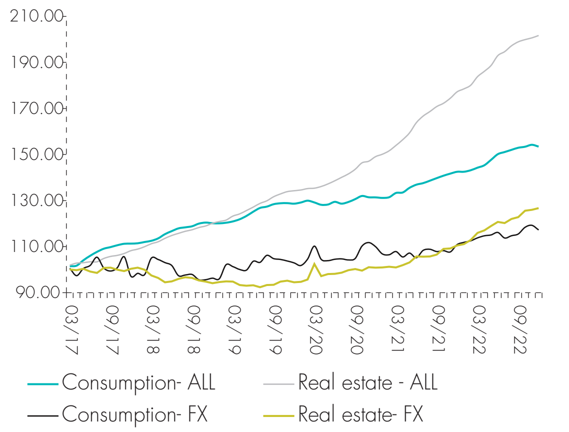

Source: Bank of Albania.

Stock of loans to households reached ALL 250 billion, and expanded by 3.8% during the period. Loans for the purchase of real estate (mortgages) recorded the fastest growth and in turn provided the largest contribution to the performance of loans to households. Also, the stock of consumer loans recorded a somewhat more moderate increase. Loans for real estate investments expanded by 4.7% during the period, and continued to have the main share, around 70%, in the loan portfolio to households. From the end of 2016 until the end of June 2022, the stock of these loans expanded by around 60%. In recent years, the fast

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

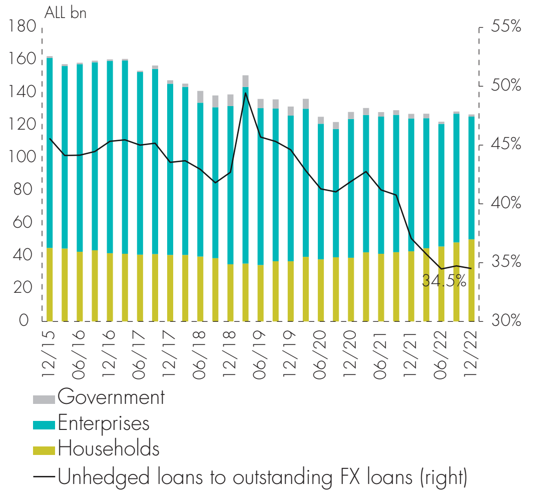
increase of credit stock in lek has driven the rapid growth of credit stock to households. Credit to households in foreign currency grew by around 13% in the past 12 months.

Chart 44 Loans to households by purpose of use and currency (index, 2016 = 100)




Source: Bank of Albania.

Chart 45 Unhedged foreign currency loans




Source: Bank of Albania.

At the end of 2022, loans to non-residents, granted mainly to enterprises, was around ALL 30 billion, and accounted for roughly 4% of the outstanding loans of the banking sector. The credit stock to non-residents grew by around 13.4% during 2022 H2, and by 4.6% compared to the previous year. Loans to enterprises and loans in the euro dominate, in annual terms, both the increase and outstanding loans to non-residents.

*Outstanding unhedged foreign currency loans increased during the period and declined in annual terms. The relative share of this portfolio to outstanding loans and foreign currency loans has not changed.*

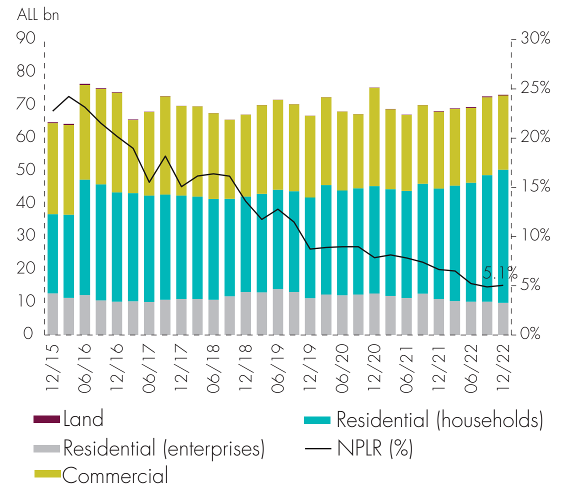
*During the period, unhedged foreign currency loans to households to finance real estate purchasing recorded the highest growth.*

*Loans to enterprises in the euro, oriented for investments in real estates, account for the main share of unhedged outstanding loans.*

## UNHEDGED FOREIGN CURRENCY LOANS

During the period, the stock of unhedged foreign currency loans grew by 3.6%, reaching at around ALL 130 billion, at the end of 2022. The growth pace of unhedged foreign currency loans during 2022, was similar to the one of total loans and foreign currency loans. This performance has preserved the share of unhedged foreign currency loans, against both foreign currency loans and outstanding loans at values fluctuating around 18% and 34%. The continuous decline in the share of unhedged foreign currency loans, against both total loans and foreign currency loans, related to the deceleration in the unhedged loans during 2020-2021, suggests that banks' exposure towards indirect exchange rate risk has been mitigated.

Chart 46 Unhedged foreign currency loans for real estate and its quality




Source: Bank of Albania.

Almost the entire period's growth recorded for this credit, is related to the increase of outstanding unhedged loans to households. The unhedged loans to households rose by 9.7% during the second half of the year, and by 17% in annual terms, due to the growth recorded in the stock of loans for investments in residential real estate. Unhedged loans to enterprises, which account for 60% of the stock of these loans, has remained unchanged during the period, and has slightly fallen in annual terms. Overall, unhedged foreign currency loans have slightly declined during 2022, mainly due to the fall in unhedged loans to enterprises and in euro-denominated loans.

Unhedged foreign currency loans for real estate were granted for the purchase of residential, commercial real estate, and land and expanded during the period by 5.4%. Unhedged loans for residential real estate granted to households have the main share (55%), up by 12% during the period. The overall stock of unhedged foreign currency loans has expanded at a contained pace, which suggests that banks' exposure to indirect exchange rate risk has mitigated, nonetheless, the fast growth of the unhedged loans for real estate granted to households, requires the prudential monitoring of the banking sector.

## NEW LOANS

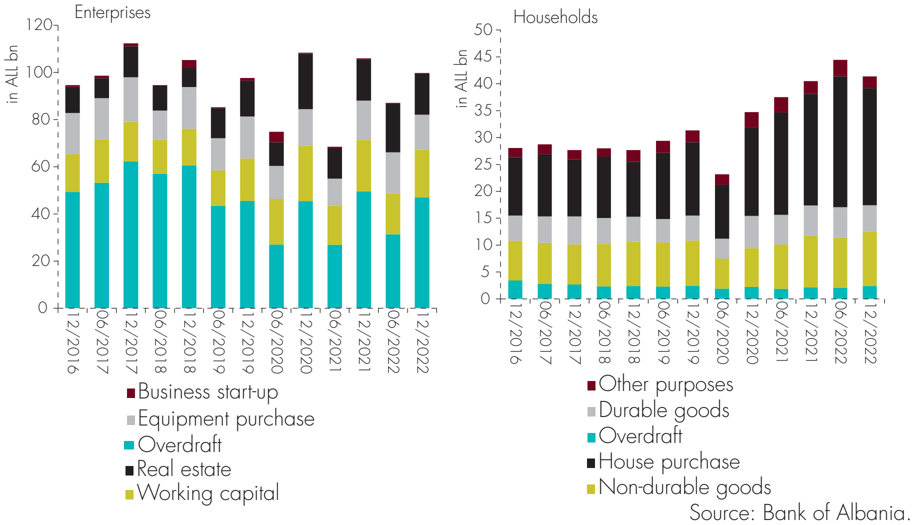
*In 2022 H2, banks granted more new loans than in the first half.*

*New loans to enterprises were mainly granted for short-term liquidity purposes, whereas new loans to households were mainly used for house purchases and consumption of non-durable goods, and were mainly granted in foreign currency.*

New loans granted during the period were around ALL 140 billion. This flow was 5% higher than the value of new loans granted by banks in 2022 H1, but around 8% lower than the new loans reported in 2021 H2. The performance of new loans during 2022 was driven by developments in new loans to enterprises. In annual terms, new loans granted to enterprises were around 12% lower. This credit was mainly used to finance the working capital and overdrafts. The most significant contraction occurred in the first half of the year, whereas, banks granted around ALL 6 billion more new loans to enterprises in 2022 H2. Around 2/3rds of these new loans were used for short-term purposes, in the form of overdrafts and working capital, and more than half of it was in the euro. The flow of new loans granted during the period remains higher than the average semi-annual flow of the last five years.

New loans to households were somewhat higher (by 2%) compared to the previous year. These new loans were mainly used for house purchases and consumption of non-durable goods. New loans to households in lek recorded a decline compared to the previous year, whereas the level of new loans granted in euro was higher. The data by year demonstrate that the flow of new loans to households has risen considerably, close to an average level of ALL 80 billion during 2021-2022, from ALL 60 billion recorded in 2017-2020. The annual flow of new loans to enterprises has fluctuated close to an average of ALL 190 billion, throughout this period.

Chart 47 New loans to enterprises (left) and households (right) by purpose of use




Source: Bank of Albania.

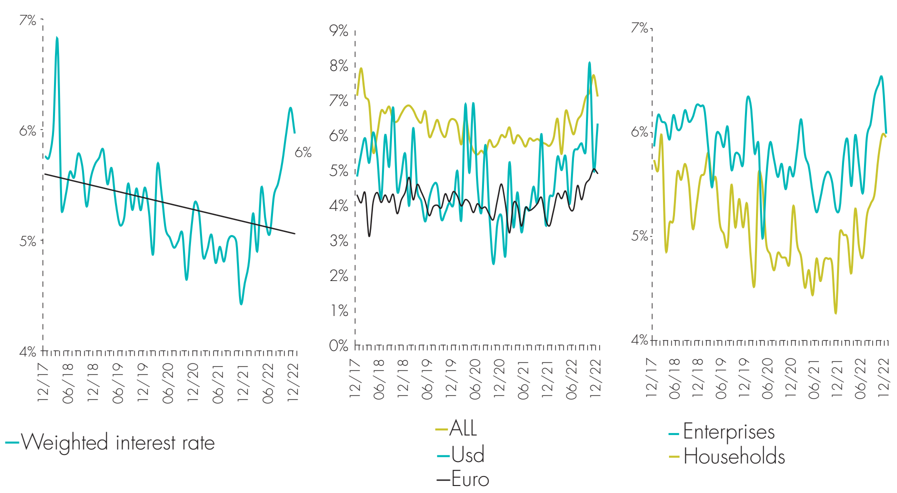
## WEIGHTED INTEREST RATES ON NEW LOANS

The weighted interest rate edged up across all new loans during the period, standing at 6%, at the end of December. The increase of interest rate on new loans both in lek and foreign currency, is in line with the recent decisions of central banks on monetary policy normalisation. This increase is noted across all types of loans by sector and purpose of use, but is more restrained on new loans for house purchases. The average interest rate on new loans in lek was 7.1%, up by 1.1 percentage points during the last year, remaining higher than the average interest rate on new loans in the euro and US dollar. The average interest rate on new loans to households and enterprises stood close to around 6%, as at the end of year.

*The weighted average interest rate on new loans granted during the period has increased, which is mainly reflected in the average interest rates on each of the new loans categories.*

*The increase was relatively lower for average interest rates on loans for real estate purchases, denominated in both lek and foreign currency.*

Chart 48 Weighted interest rates on new loans, in %; aggregate rate (left); rate by currency (middle); rate by entity (right)



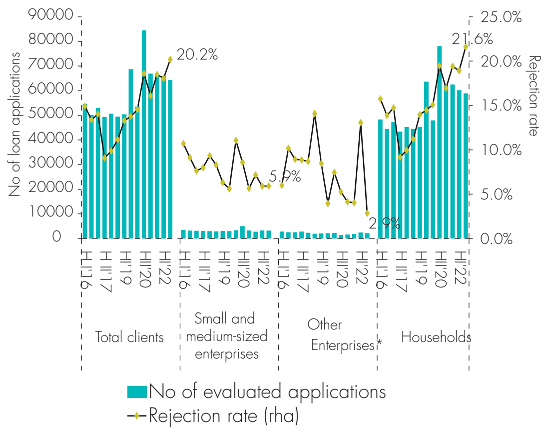

Source: Bank of Albania.

The rise in interest rate on new loans has started to affect also the weighted interest rates on loan stock by the relevant categories. During the period December 2018 - June 2022, the average interest rate on the loan stock to households in lek, enterprises in lek, enterprises in euro and households in lek fluctuated at around 6.8%, 6.6%, 5.1%, and 4.7%, respectively. The comparison of interest rates on the loan stock by maturity for the same period, shows that borrowers have paid the lowest interest rate on loans for real estate, despite the currency. The spread between the interest rate on loan stock in lek and the euro, in the last four years, has been relatively stable, and has fluctuated around an average of 1.5 percentage points. During 2022, this spread expanded slightly, mainly due to the faster rise of the interest rate in the domestic currency. As at end of 2022, this spread reached at 1.7 percentage points.

*BOX 2 NUMBER OF LOAN APPLICATIONS AND THE REJECTION RATE BY BANKS IN THE COUNTRY, 2022 H2*

*During 2022 H2, banks reported that they considered a total of 64,338 loan applications, of which 8% from enterprise' sector (3,231 applications from "small and medium-sized enterprises" and 2,148 applications from "other enterprises"), and 92% from "households sector" (58,959 applications). Compared to the previous year, this structure marked a shift in favour of enterprises.*

Chart 49 Number of evaluated applications and rejection rate analysis



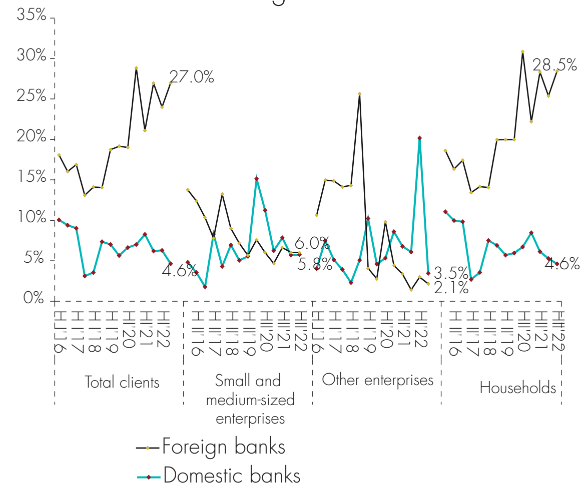

*Item "other enterprises" mainly includes large enterprises and any other enterprise which does not fall in the classification "small and medium-sized enterprises".
Source: Bank of Albania.

*Total number of loan applications screened by banks recorded a decrease by 2.6% compared to the previous six months, for all three categories of customers, but the decline is more pronounced in the number of applications from "other enterprises". Compared to the previous year, the number of applications has also decreased by 4.2%, and this decline is only related to the applications from "households" (down by 5.7%), whereas the other two groups have recorded an increase.*

*From the total applications screened during the period, around 20.2% of them were rejected from banks. This rate increased by 2.1 percentage points and 1.7 percentage points compared to the previous six months and the previous year, respectively. This performance seems to have been affected by the increase in the rejection rate to households at 21.6% (from almost 18.9% in the previous survey and 19.4% in the previous year); meanwhile the rejection rates to small and medium-sized enterprises and other enterprises have decreased by 5.9% and 2.9%, respectively. The total rejection rate of loan applications from banks with domestic capital has continued the downward trend of the past two years, registering 4.6% (from 6.3% in the previous six-months), while for banks with foreign capital this rate increased to 28.5%, from 24% in the previous six months, reaching the same level of the previous year.*

*It is noted that during the period, both groups of banks remain more focused on lending to the enterprises segment, especially to large enterprises, while the loan rejection rate to large enterprises has fallen in both semi-annual and annual terms. As regards households, the two banking groups showed different attitudes. Banks with domestic capital continued to ease the access of loans to households, rejecting only 4.6% of applications, meanwhile banks with foreign capital were less interested toward this segment, rejecting 28.5% of the applications.*

Chart 50 Rejection rate of loans, by domestic and foreign banks




Source: Bank of Albania.

*Overall, from the above analysis, it may be concluded that the progress of applications reviewed by banks during 2022 H2, indicates a further moderated loan demand from households, both in semi-annual and annual terms, returning to the level of the previous year in the case of enterprises. The shocks of the external environment in the first half of the year – being translated in fast rising prices domestically, which in turn led to the normalisation of the monetary policy and higher uncertainty for households and small and medium-sized enterprises, by reducing their need for bank-financed investments (i.e., loans). On the other hand, the banking sector in Albania remains selective toward the loan demand from both sectors, and unlike the previous period, it seems to have shifted its focus on financing large enterprises.*

### *3.1.1.5 Deposits*

Deposits held in the banking sector expanded by ALL 60 billion or by 4%, during July-December 2022, reaching ALL 1,520 billion at the end of period. This growth was higher than the expansion of deposits recorded during the first half of the year, but the growth pace of deposits has slowed down in annual terms. Deposits growth was recorded in all types of deposits by sector, maturity and currency, with the exception of demand deposits, which have declined slightly. The categories with the highest contribution to the expansion of deposits were deposits in foreign currency, current accounts, and households' deposits. Time deposits have continued to grow since 2021 Q2, expanding considerably during 2022 H2. In annual terms, the growth rate of deposits was 5.9%, with the largest contribution coming from the expansion of deposits in foreign currency. This growth rate was lower than the 11.4% increase recorded during 2021.

*Deposits held in the banking sector reached ALL 1,520 billion, expanding by 4% over the period. Households' deposits, foreign currency-denominated deposits and current accounts recorded the strongest increase. The annual growth of deposits slowed down compared to 2-3 years ago.*

*The robust growth in time deposits in foreign currency was a marked development during the period.*

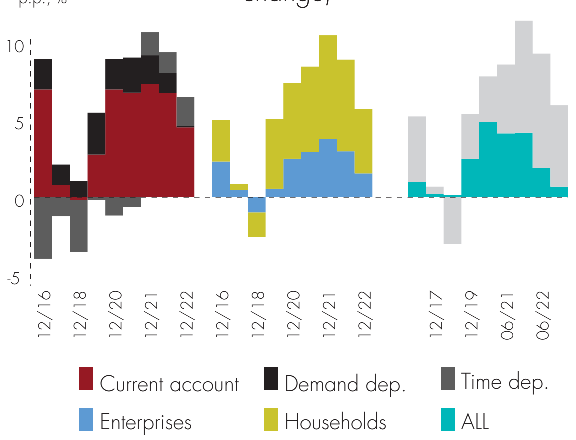
*The interest rates across all types of new deposits by maturity, sector and currency remain at low levels, though they trended slightly up during 2022 H2*

*Table 8 Data on the performance of deposits by maturity, sector and currency*

| | 2022 | | 12/22 to 06/22 | | Y/Y |
|---|---|---|---|---|---|
| | ALL billion | Share | (%) | (p.p.) | (%) |
| Current account | 654 | 43 | 6 | 3 | 11 |
| Demand deposits | 198 | 13 | (2) | (0) | 1 |
| Time deposits | 646 | 43 | 4 | 2 | 4 |
| Public sector | 49 | 3 | 24 | 0 | 8 |
| Enterprises | 263 | 17 | 8 | 1 | 9 |
| Households | 1.207 | 79 | 3 | 3 | 5 |
| Lek | 700 | 46 | 3 | 1 | 1 |
| Foreign currency | 818 | 54 | 5 | 3 | 10 |
| Deposits | 1.518 | 100 | 4 | 4 | 6 |

*Source: Bank of Albania.*

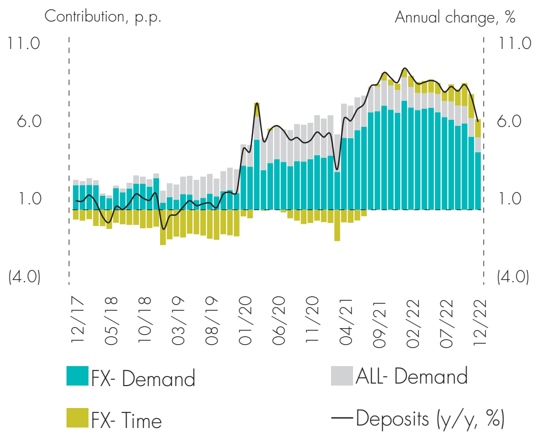
Chart 51 Performance of deposits, by maturity, sector and currency (contribution to the annual rate change)




Source: Bank of Albania.

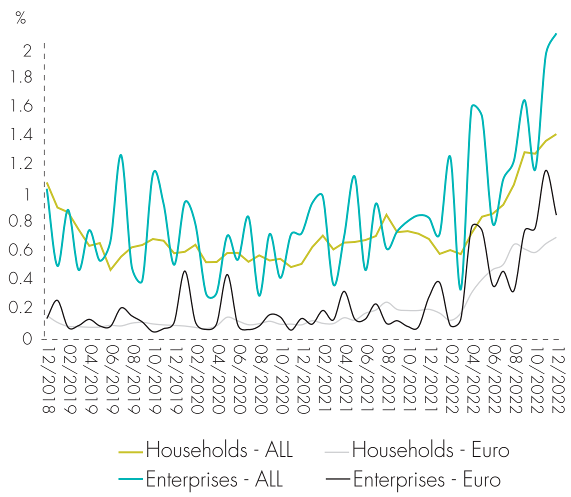
Structure of deposits by term and sector does not show considerable changes in the last year. Meanwhile, structure of deposits by currency has slightly changed in favour of deposits in foreign currency. As at end of 2022, deposits in foreign currency accounted for 54% of total deposits, from 53% and 52%, respectively, in the previous period and previous year. Deposits in foreign currency grew by 5.3%, during the period, and by 10.1% in annual terms. Deposits denominated in euro account for around 90% of deposits in foreign currency. At the end of the period, deposits denominated in euro amounted EUR 6.3 billion, from EUR 5.7 billion as at end of 2022. These deposits increased by around EUR 1 billion during the last 12 months.

Chart 52 Deposits by maturity and currency




Source: Bank of Albania.

Chart 53 Interest rates on new deposits




Source: Bank of Albania.

In the previous years, current accounts and demand deposits had a considerable role in the overall growth of deposits, whereas changes in time deposits, which account for 45% of total deposits, were of a lesser importance and had a reducing impact for the most part. During 2022, particularly in the second half of the year, time deposits provided an important contribution to the growth of deposits in the banking sector, following current accounts. The growth in this category is entirely attributable to the expansion in demand deposits in foreign currency, of both enterprises and households, whereas time deposits in lek reduced. The performance of interest rates affects the preference of public to choose between time deposits and demand deposits.

The rise in the interest rates on new time deposits in lek and in foreign currency, has increased public's interest to invest their savings in bank deposits. The interest rates across all types of new deposits by maturity, sector and currency remain at low levels, but they have been on a significant upward trend in 2022 H2. At the end of the period, the average interest rate on time deposits in lek to households was 1.4%, from 0.9% in the previous period. The average interest rate on time deposits in euro to households was 0.7%, from 0.5% at the end of at June. This performance has been reflected in a slight increase of the interest rate on deposit stock, for both lek and euro deposits.

In 2022 Q4, households' investments in government debt securities have increased considerably. Nonetheless, this type of investments which provide a higher return rate, grew at lower degree than households' deposits in the banking sector. The government's call to invest in debt securities, with rising return rates, in November 2022, has boosted public's interest for this type of investment, as a competitive alternative to bank deposits, which remain the main type of investment, nonetheless.

## 3.1.2 RISKS TO THE ACTIVITY OF THE BANKING SECTOR

### *3.1.2.1 Credit risk*

Credit quality improved slightly during this period. This performance was driven by the reduced credit stock in the classes of "sub-standard loans" and "lost loans". Also, the lost loans write-off from banks' balance sheets, the re-payment of non-performing loans coupled with the reclassification of non-performing loans in performing classes have driven to this improvement in credit quality. In contrast to the previous year, the new loan repayment flows have declined, whereas the reclassification of performing loans to non-performing loans has increased. The non-performing loans ratio (NPLR) fell by 0.3 percentage point, at 5%, as at end of the period. At the end of the year, the stock of non-performing loans dropped to ALL 36 billion, the lowest level recorded in the last thirteen years.

*Credit quality improved during the second half of the year. Outstanding non-performing loans reduced, while non-performing loans ratio fell to 5%.*

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

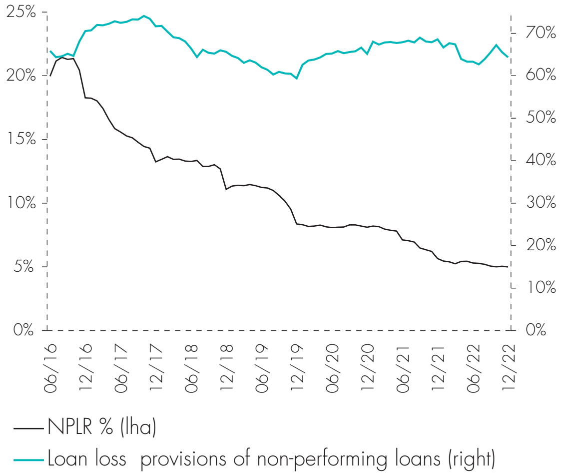
*The quality improved across all credit categories, by maturity and sectors, though the quality of the credit portfolio denominated in the domestic currency was slightly down. The quality of foreign currency loans unhedged against exchange rate fluctuations, has improved. As at end of December 2022, the non-performing ratio for this credit portfolio fell to 3.8%.*

*Loan repayment flows have declined compared to the previous year, whereas the volume of quality loans shifting toward the non-performing loans category has been somewhat higher. The decrease in non-performing loans stock was slower compared to the reduction in provision fund during the last twelve months, and the provisioning ratio for the non-performing loans fell to 64%.*

*Loan collateralisation dropped to 74%. Loans collateralised with real estate have the main share, or account for around 65% of collateralized loans, and 48% of overall outstanding loans.*

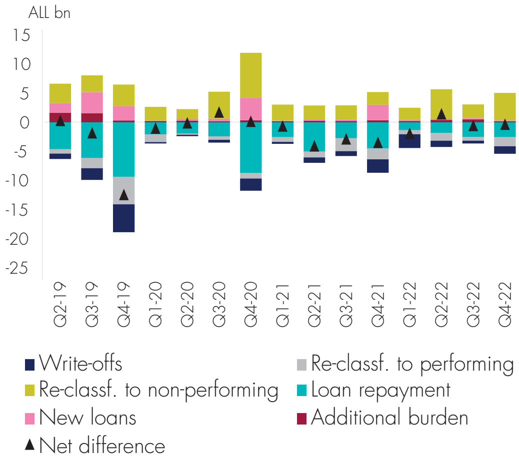
Compared to the previous year, the non-performing loans ratio (NPLR) fell by around 1 percentage point. Banks have reported improved credit quality for loans to enterprises, long-term loans, and foreign-currency denominated loans, compared to the previous year. During January 2015 - June 2022, around ALL 80 billion lost loans have been written off from banks' balance sheets. In the last 12 months, the written off lost loans amounted close to ALL 6 billion, mainly represented by loans to enterprises in euro. Within the non-performing loans portfolio, banks have reported a fall in the outstanding loans for the "lost" class, whereas the "sub-standard" loans class expanded during last year. Its share in outstanding non-performing loans increased at 31%, from 27% in the previous year. Around 46% of non-performing loans are composed of loans classified as "lost".

Chart 54 Non-performing loan ratio and provisioning




Source: Bank of Albania.

Chart 55 Contribution to the change of the non-performing loans stock




Source: Bank of Albania.

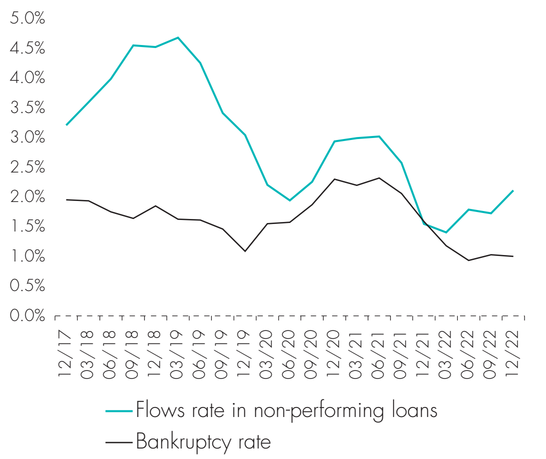
Medium-term loans, loans to enterprises and lek-denominated loans have the highest values of non-performing loans ratio. As at end of December 2022, the non-performing loans ratios for these portfolios were 7%, 6% and 6%, respectively. Banks have continued to create provisions for non-performing loans, but the provisioning level has been decreasing, due to the process of writing off lost loans and loan repayments. The decrease in the stock of non-performing loans was slower compared to the reduced provision fund during the last twelve months, the coverage ratio of non-performing loans fell to 64%, from 68% recorded a year earlier.

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[27]; bankruptcy rate[28]; and the recovery rate of non-

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

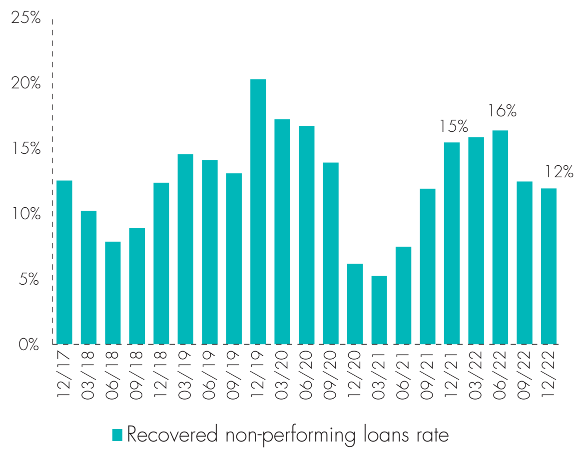
[28] *The flow of new lost loans during the period against the overall outstanding loans at the end of the period.*

Chart 56 Flow rate of non-performing loans and bankruptcy rate




Source: Bank of Albania.

Chart 57 Recovery rate of non-performing loans




Source: Bank of Albania.

performing loans[29]. These indicators, with the exception of the bankruptcy rate, suggest that in the last twelve months, the banking sector has recorded more new non-performing loans, which are expected to be reflected in the credit quality indicators. In the last quarter of 2022, the flow of new non-performing loans was equal to 2.1% of regular loans, from 1.8% and 1.5% recorded in the previous six-months and the previous year, respectively. This rate has recorded the maximum of 5% in 2019, and a temporary increase at 3% in 2021 H1. On the other hand, the "bankruptcy rate" that shows the rate by which the lost loans are accumulated compared to the overall loan portfolio, recorded 1%, remaining at the same level of the previous six months, but dropping slightly from the 1.6% level of the previous year. The recovery rate of non-performing loans fell to 12%, from 15% in the previous year. This performance shows that banks are faced with increased difficulties when recovering non-performing loans.

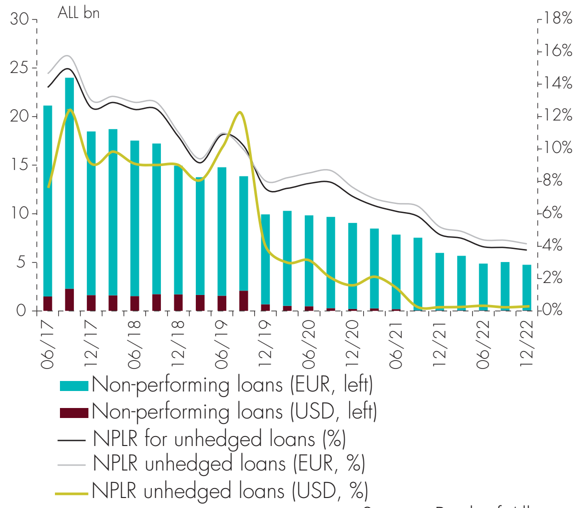
The quality of loans unhedged against exchange rate fluctuations has improved compared to six months ago and the previous year. The NPLR for this credit portfolio fell at 3.8% as at end-December 2022, compared to 4% and 4.7% in the previous six months and the previous year, respectively. This is the lowest non-performing loans ratio for unhedged foreign currency loans since 2009. The reduction in the stock of non-performing loans for business investments and loans for trade has affected the improvement in the quality of unhedged loans. The main share, or 80%, of the total outstanding loans unhedged from exchange rate fluctuations, continues to be held by loans for investments in real estate. The NPLR for this category of loans fell to around 5.1% from 6.7% 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. The NPLR for this

[29] *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.*

type of loans reached its lowest historical level of 0.9%, in December 2022. In the portfolio of loans unhedged exchange rate fluctuations, the NPLR for consumer credit appears slightly up for the period.

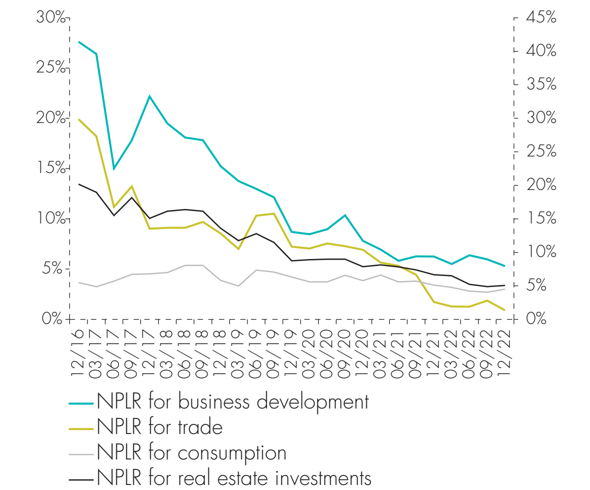
Loan collateralization[30] which represents a key element in the group of hedging instruments of the banking sector against the risk arising from non-returned loans, declined compared to the previous six months and the previous year, down to 74% and 80%, respectively. Loans collateralized with real estate have the main share, or account for around 65% of collateralized loans, and 48% of overall outstanding loans. The stock of collaterized loans has gone slightly down from the previous year. With the exception of loans collateralised with land and other collateral, the quality of loans collateralised with real estate has improved during the year[31], as a result of developments in loans collaterized with residential real estates.

Chart 58 NPLR for loans unhedged against exchange rate fluctuations, by currency




Source: Bank of Albania.

Chart 59 NPLR for unhedged loans, by purpose of use



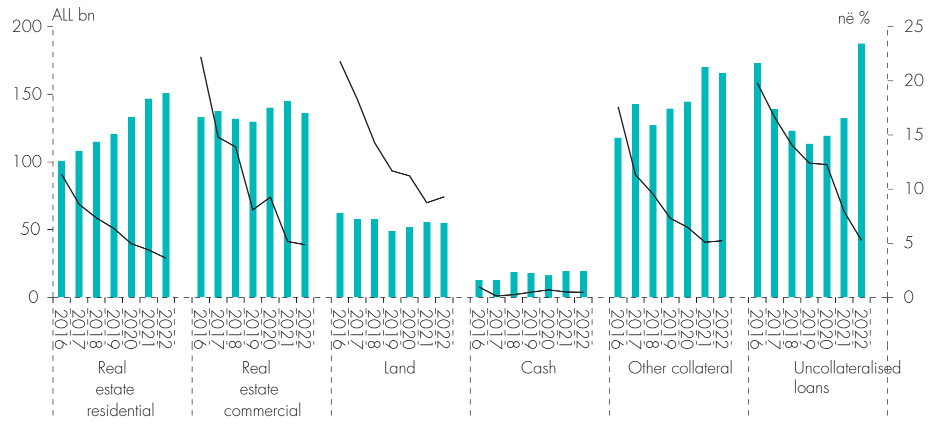

Source: Bank of Albania.

Loans collaterized in the form of cash continue to maintain the lowest level of NPLR. Meanwhile, the share in non-performing loans stock for this type of loans to the total non-performing loans is rather low. Outstanding non-collateralized loans expanded as well during the period and compared to the previous year. The share of non-collateralized loans against the overall outstanding loans increased to 26%. The quality of loans across this category has improved considerably in the last two years, and NPLR recorded 5% in December 2022, from around 8% reported at the end of 2021, and 12% in 2020.

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

31 *The NPLR of loans collaterized with "land" rose to 9.3% in December 2022, from 8.7% in the previous year. The NPLR of loans collaterized with "other collateral" increased to 5.2%, from 5.1% in the previous year.*

Chart 60 Outstanding loans and non-performing loans ratio by collateral




Source: Bank of Albania.

### 3.1.2.2 Liquidity risk

The liquidity risk in the activity of the banking sector remains contained. The main liquidity indicators, both in lek and foreign currency, continue to be notably above the minimum regulatory ratios. Liquid assets grew at a faster rate than short-term liabilities, during the period, driving the ratio between them to increase slightly. Meanwhile, in contrast to the previous year, total liquid assets have been declining. The gap between assets and liabilities for maturities up to three months narrowed down. The overall gap between assets and liabilities has remained almost unchanged, at around 5% of the overall assets of the banking sector. The average maturity mismatch between loans and deposits has increased, mainly due to the increase in the average maturity of loans.

*The liquidity position of the banking sector remains at good levels and the liquidity indicators continue to remain notably above the regulatory ratios.*

*Liquid assets of banks have grown faster than short-term liabilities, but they have recorded a decline compared to the previous year.*

*The gap between assets and liabilities in the basket of maturities up to three months contracted, and the overall gap remains positive and stable.*

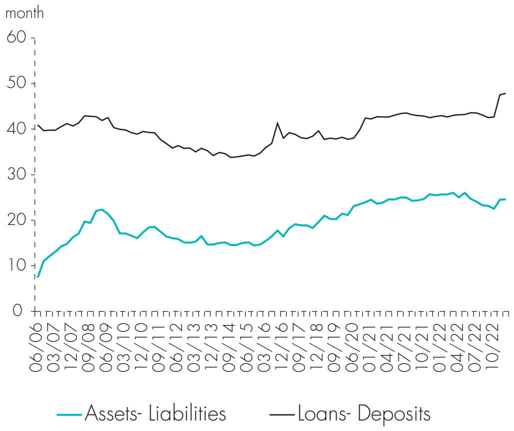
*The average maturity mismatch between assets and liabilities has expanded by around 4 months, mainly due to the increase in the average residual maturity of loans.*

Deposits remain the main funding source of lending activity of banks, covering above twice the loans volume of the sector. At the end of the period, the "loans/deposits" ratio was 47.1%, or 1.1 percentage points lower than the level in the previous six months, as the stock of deposits grew at a higher pace than loans. This performance is evidenced in loans and deposits portfolio both in lek and foreign currency. Thus, in comparison with the previous six months, the "loans/deposits" ratio for lek fell to 49.7%, from 50.4% and the "loans/deposits" ratio in foreign currency fell to 44.9%, from 45.9%.

During the period, liquid assets of the banking sector grew by around ALL 34 billion, reaching ALL 555 billion as at end of the period. The ratio of liquid assets to total assets in banks' balance sheets continues to remain high. As at end of 2022, this ratio stood at 29.6%, from 28.9% at the end of June 2022. This performance reflects the fact that liquid assets in banks' balance sheets have grown faster than the overall assets during the period.

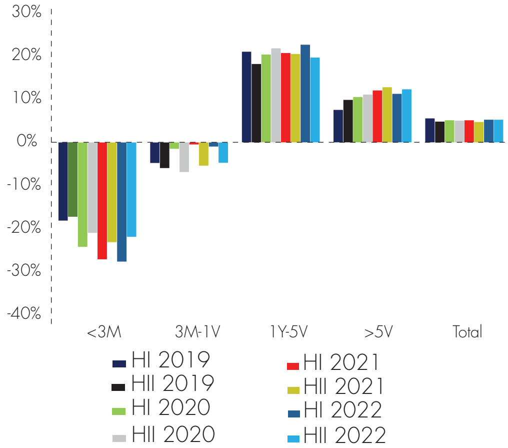
Also, the ratio of liquid assets to short-term liabilities increased by 41.1%, from 39.9% at the end of the previous six months. The performance of this ratio was affected by the 2.6 p.p. increase of liquid assets and by the -1.4 percentage points in short-term liabilities.

Chart 61 Average residual maturity mismatch between assets-liabilities and loans-deposits




Source: Bank of Albania.

Chart 62 Maturity mismatch between assets and liabilities*




*Off-balance 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 to total short-term assets, decreased during the period. The gap for the residual contractual maturity segments for the period up to 3 months,[32] that continues to remain the largest negative gap for the whole horizon of maturities, contracted to 22%, from 28% in the previous six months. At the same time, the negative gap for maturities 3 months up to 1 year, has recorded an expansion of a similar size. Despite these developments, the size of this gap remains limited close to a -5% average in relation to overall assets. 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. For roughly 3 years, this gap has fluctuated around 5% of assets in the banking sector. During the period, the mismatch of average maturity of assets and liabilities has remained almost unchanged, because the average maturity of liabilities and assets have fluctuated just slightly. This mismatch was around 24.6 months in December 2022. On the other hand, the gap between the average residual maturity of loans and deposits expanded considerably from 43.6 to 47.8 months, due to the increase in the average residual maturity of loans from 51.2 to 56 months. The banking sector continued to report the use of funding lines by the parent groups.

[32] *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.*

### 3.1.2.3 Market risks

#### EXCHANGE RATE RISK

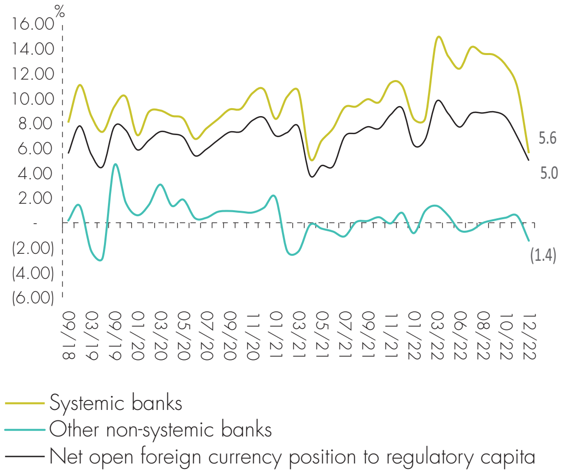
*The exposure of the banking sector to direct exchange rate risk has decreased during the period, mainly driven by systemically important banks.*

*The exposure to indirect exchange rate risk has remained unchanged.*

The exposure ratio of banks to direct exchange rate risk declined compared to the level of the previous six months and the previous year. At the end of the period, the ratio of the net open foreign currency position of the banking sector was long and accounted for 5.0% of the regulatory capital of the banking sector. This value was 2.7 percentage points and 4.2 percentage points lower compared to the previous six months and the previous year, respectively, and somewhat lower than the average ratio recorded in the last past years.

The performance of the overall index was determined by the performance of systemic banks, for which the long net open position in foreign currency accounted for 5.6% of the regulatory capital. This ratio was down by 6.8 percentage points and by 5.4 percentage points, compared with the previous period and the previous year, respectively. Non-systemic banks have a short net open position in foreign currency, accounting for 1.4% of their regulatory capital. Overall, they show a low and stable exposure to exchange rate fluctuations.

Chart 63 Open foreign currency position to regulatory capital for the sector and groups



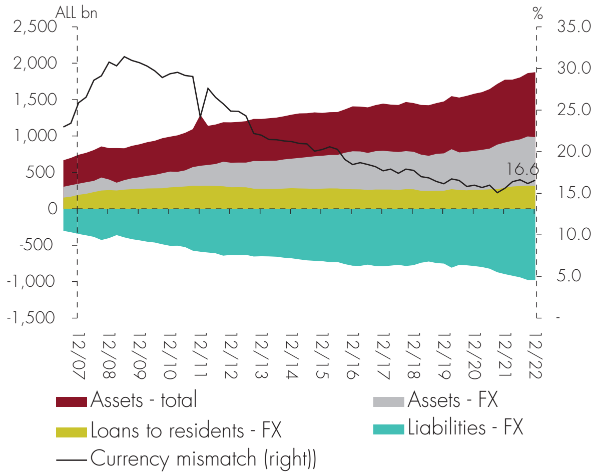

Source: Bank of Albania.

The exposure of the banking sector to indirect exchange rate risk, as measured by foreign currency mismatch indicator[33] has remained close to the level of the previous six months. At the end of the year, the foreign currency mismatch indicator was equal to 16.6% of banking sector's assets. During the period, foreign currency-denominated assets and liabilities of banks expanded by around 3-4%, while credit in foreign currency to resident entities grew by 1.4%. As compared to the level recorded at the end of 2021, the indicator was up by 1 percentage point, which was driven mainly by the 9% increase of credit in foreign currency to residents. The group of systemic banks continues to provide the main contribution to the performance of the foreign currency mismatch index. In 2022 H2, the indirect exchange rate risk for systemic banks increased by 1.2 percentage points, equal to 13.4% of group assets, from 11.6% of assets a year earlier. The index of foreign currency mismatch for the group of non-systemic banks has a higher value and shows a larger exposure of these banks to indirect exchange rate risk. At the end of 2022 H2, this index was equal to 23.1% of the group's assets. This value was lower

[33] *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. Meanwhile, the indicator increases and decreases based on the level of exposure. For the calculation of the exchange rate indicator, refer to the Financial Stability Report 2016 H1.*

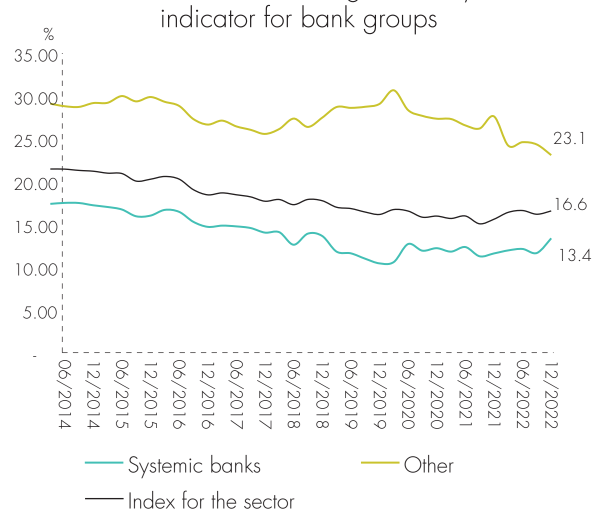
form the previous six months and previous year by 1.5 percentage points 4.5 percentage points, respectively.

Chart 64 Performance of Indexes components for the banking sector




Source: Bank of Albania.

Chart 65 Performance of foreign currency mismatch indicator for bank groups




Source: Bank of Albania.

## *INTEREST RATE RISK*

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

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

*During the period, there were added pressures regarding interest rate risk transferring to credit risk, due to rising credit interest rates, and its resulting negative impact on borrowers' solvency.*

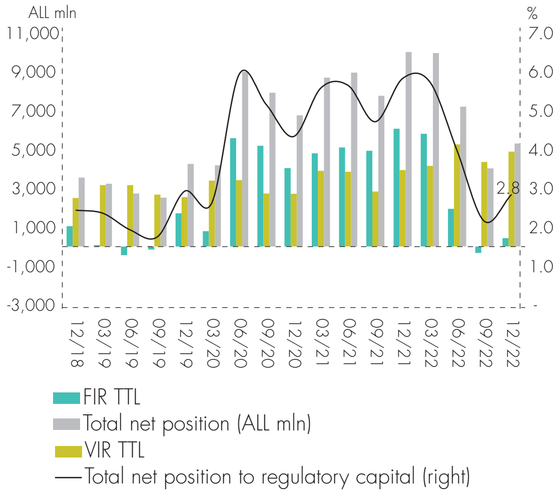
At the end of 2022, the exposure of banks to interest rate risk was more limited compared to the previous six months. As at end of year, the weighted total net position in banks' balance sheet was at 2.8% of regulatory capital, or around 1 p.p. and 3.0 p.p. below the level recorded in the previous six months and the previous year, respectively. The maximum regulatory limit for this indicator is 20% of regulatory capital. Compared to the previous six months, the weighted difference of assets and liabilities with fixed interest rates (FIR) fell by 0.8 percentage points, at 0.2% of regulatory capital of the sector. Also, the weighted difference of assets to liabilities with variable interest rates (VIR) declined by 0.3 percentage point, at 2.6% of regulatory capital.

The indicator of the weighted net position fell for both systemic and non-systemic banks, respectively at 4.4% and 0.4% of regulatory capital. For non-systemic banks, the indicator decreased due to a lower exposure to assets and liabilities with fixed interest rate (FIR). At the end of the year, this indicator was equal to 1.9% of the group's regulatory capital. The exposure indicator to variable of interest rates (VIR) fluctuations fell to 2.5% of the regulatory capital. Non-systemic banks deepened their negative position[34] regarding their exposure to fixed interest rate (FIR) fluctuation, at 3.1%. For the same period, their exposure indicator to variable interest rate (VIR) fluctuations was slightly up to 3.5% of

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

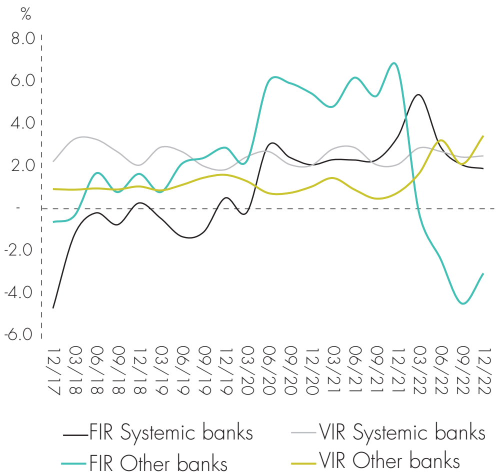
regulatory capital. The net position in the domestic currency, reaching at 1.9% of regulatory capital at the end of the period, continues to provide the main contribution in the exposure to interest rate fluctuations. This indicator remained unchanged compared to the previous six months, but around 1 p.p. lower compared to the previous year. The exposure of assets and liabilities, sensitive to the interest rate fluctuations in euro, recorded a greater decline during the period, by around 1 percentage point, standing at 0.3% of regulatory capital. Compared to the previous year, the indicator dropped by 1.7 p.p.

Chart 66 Weighted total net position in bank's balance sheets against regulatory capital, in %




Source: Bank of Albania.

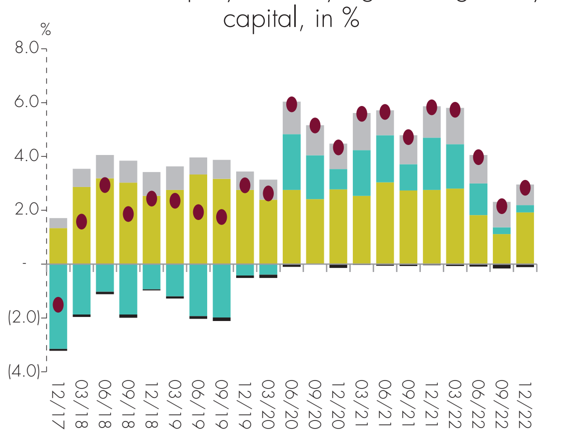
Chart 67 Performance by groups of net position for fixed interest (FIR) and variable interest (VIR) rates




Source: Bank of Albania.

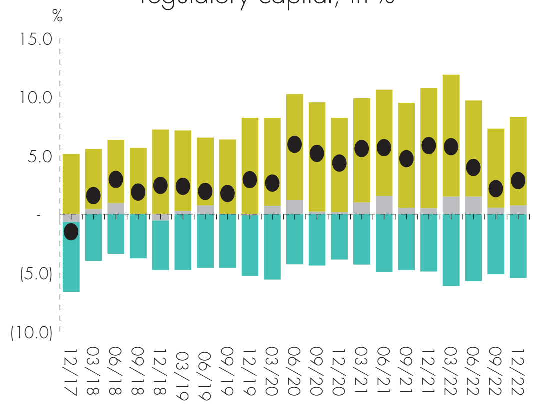
During the period, the change in the total net position was mainly driven by decrease in the positive exposure for long-term maturity basket, whose indicator was down by 0.8 p.p., at 0.7% of regulatory capital. Exposure from long-term maturity basket declined by 0.6 p.p., as compared to the previous period, and dropped significantly by 3 p.p., as compared with the previous year. At the year-end, this indicator accounted for 7.5% of regulatory capital, which represents the main exposure by maturity terms. 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 the end of the year, this position was equal to 5.4% of the bank's regulatory capital.

Chart 68 Gap by currency against regulatory capital, in %




Source: Bank of Albania.

Chart 69 Weighted net position by maturity against regulatory capital, in %



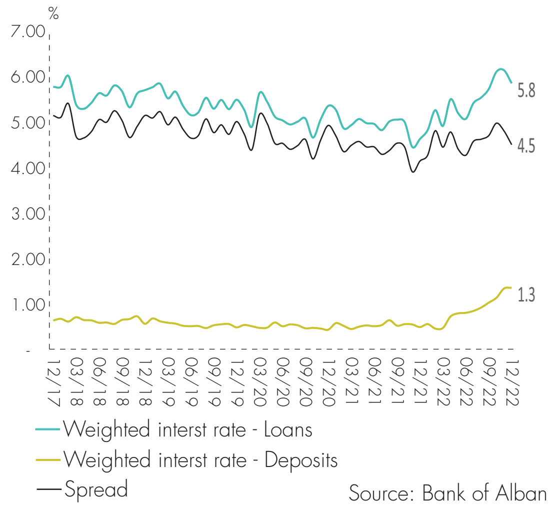

Source: Bank of Albania.

Indirect risk to interest rate change[35] has trended upwards, during the period. The necessary normalisation of monetary policy in 2022, was followed by rising interest rates on loans and deposits. The weighted interest rate on loans to households and enterprises reached at 6.1% in October 2022, the highest level recorded in the past five years. In October, the overall spread between the weighted interest rate on loans and deposits rose to 5.0%, since deposit rates grew at a slower pace than loan rates.

In November-December, the weighted interest rate on loans fell slightly, narrowing the spread, which dropped to 4.5% at the end of the year, reaming somewhat higher than the 4.3% and 4.1% recorded during the previous six months and the previous year, respectively. The increase in the spread for the euro by 0.6-0.8 percentage point, provided the main contribution in this regard. This performance is due to the interest rate on credit rising more than the interest rate on deposits, in this currency. The spread for the domestic currency was 5.0% at the end of 2022, remaining at the same level of the previous six months and the previous year. The spread for lek remained unchanged because the rise in the interest rate on loans and deposits was the same.

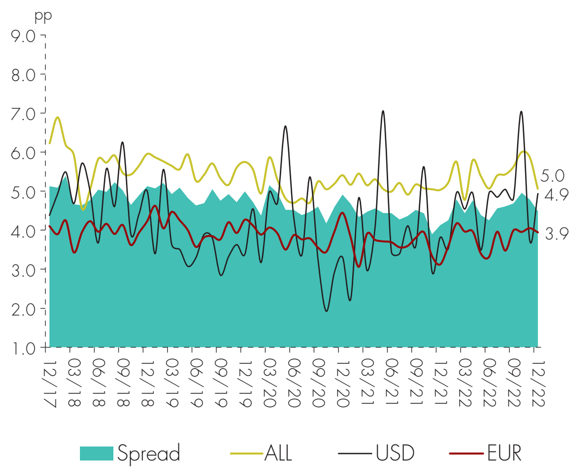
[35] *This risk refers to the impact that the change in the interest rate has on banks' clients. For example, despite the fact that the increase of the interest rate may have a positive impact on bank's balance sheet (due to positive value of the net position between assets and liabilities sensitive 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).*

Chart 70 Loans and time deposits weighted interest rates and interest rates spread, in %




Source: Bank of Albania.

Chart 71 Spread of weighted interest rates of loans and time deposits by currency, in p.p.




Source: Bank of Albania.

The perspective of interest rates going further up as the monetary policy maintains its normalisation stance, should draw the banking system's attention towards the importance to carefully monitoring the structure of assets and liabilities by type of interest rate and terms of maturity. Also, the possible rise of policy rate for the group of loans with variable interest rate may be accompanied by the transformation of interest rate risk into credit risk, due to the impact on the borrowers' solvency.

## 3.1.3 BANKING SECTOR RESILIENCE

### *3.1.3.1 Stress test exercise in terms of capital adequacy*

*Results of stress test exercises conducted for the period 2023-2024 show that the banking sector remains resilient to possible macroeconomic shocks.*

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

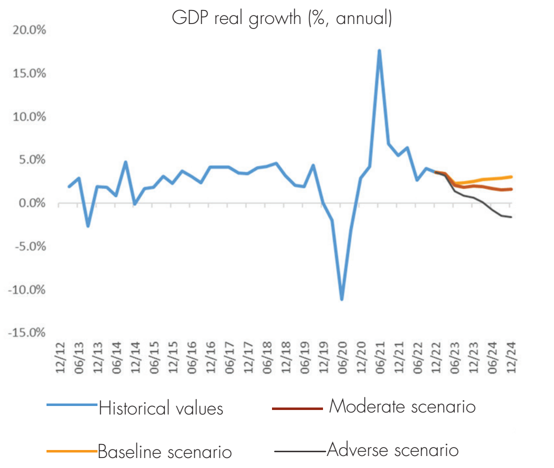
*Stress test exercises in terms of liquidity risk for the same period shows that the banking sector has a good liquidity situation.*

*Compared to the previous year, the liquid situation in lek and US dollar has improved, meanwhile, liquid situation in the euro appears somewhat more weakened. The gap between expected inflows and outflows over the upcoming two years, appears wider when compared with the previous year, but, on the other hand, the banking sector has expanded its counterbalancing capacities that could be used to cover liquidity needs, thus safeguarding its resilience against potential shocks.*

The Supervisory Authority carries out regular stress test exercises to assess the banking sector's resilience against shocks from real economy. Stress test on capital adequacy shows the degree of resilience of individual banks in terms of capital and aims at identifying its adequacy to withstand assumed shocks on: economic growth; the credit portfolio; exchange rate; and the interest rate levels.

The exercise is conducted by applying three scenarios: the baseline scenario; the moderate scenario; and the adverse scenario, for the period up to the end of 2024. The baseline scenario assumes a positive economic growth rate for this time frame, which is accompanied with a considerable growth rate of lending and an improvement in the quality of the credit portfolio, based also on the process of writing off lost loans from banks' portfolio. In the moderate scenario, the economic growth is assessed to be positive over the time frame

Chart 72 Projections on the key macroeconomic indicators (GDP)

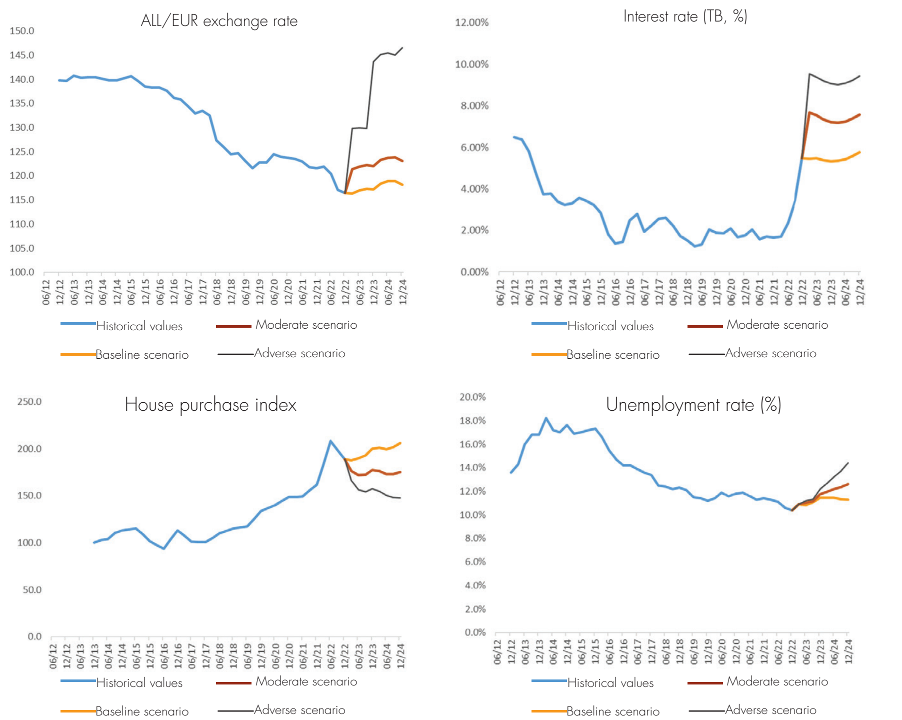



Source: Bank of Albania.

of the exercise, but at a lower growth rate than the baseline scenario. The adverse scenario initially assumes a positive growth rate, followed by an economic contraction in the second year of the time frame of the exercise.

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

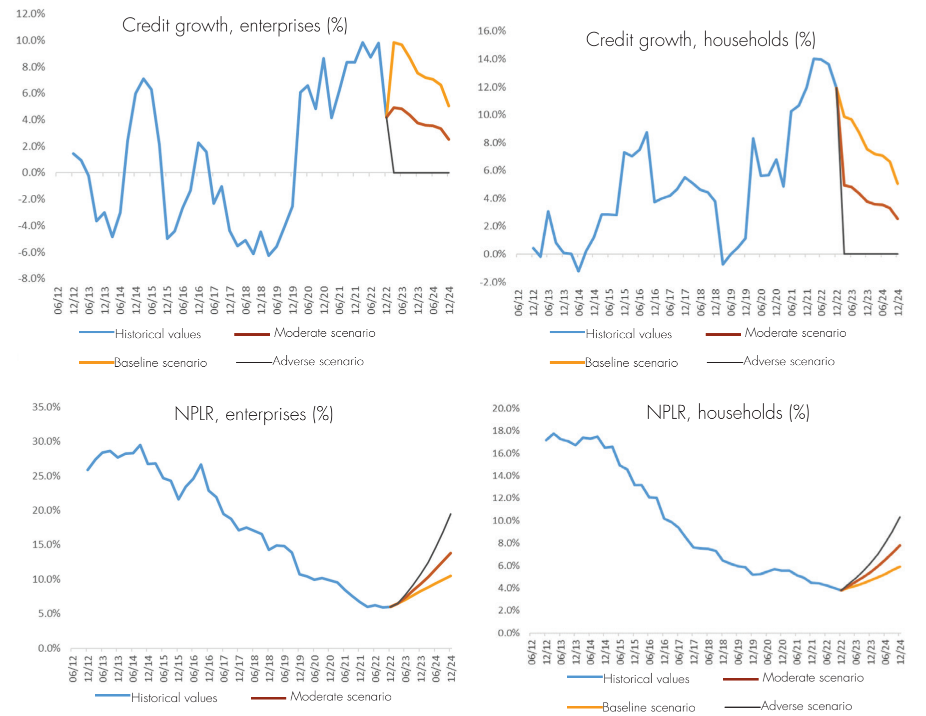
Chart 73 Projections on the key macroeconomic indicators - up, and the new macroeconomic indicators - down




Source: Bank of Albania.

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

Chart 74 Projections on credit portfolio by relevant models to enterprises and households




Source: Bank of Albania.

Stress test results in terms of capital adequacy show that:

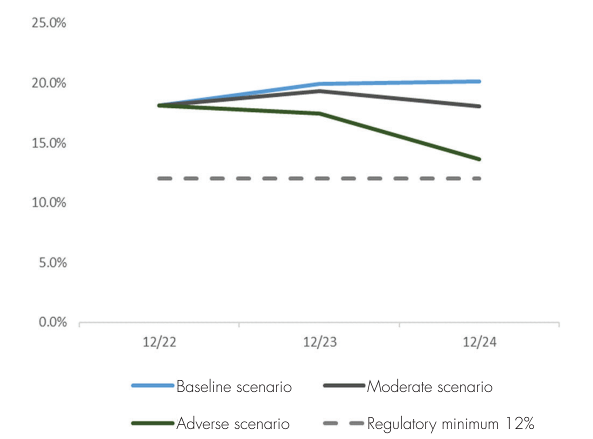
- *In the baseline scenario*, the Capital Adequacy Ratio (CAR) of the sector registers around 20%, respectively, for the 2023-2024 period. Stress test results present a stable situation and high levels of capitalisation for the entire banking sector. Nevertheless, taking into consideration the additional regulatory requirements[36], developments in particular banks evidence the need for capital injection during the period of the exercise. At the end of 2024, the number of banks that need capital injection reaches up to three, and these banks account for around 13% of the sector's assets. In this case, the need for additional capital is assessed to amount up to around ALL 1.3 billion.

- *In the moderate scenario*, the banking sector's CAR stands at 19.3% at end-2023, and 18.1% at end-2024, by continuing to maintain adequate capital levels throughout the two years period. Nevertheless, particular banks may need additional capital until the end of the exercise period. In more concrete terms, the number of these banks increases to six by the end of 2024, and the share of their assets accounts for around 50% of the sector's asset In this case, the need for additional capital is assessed to amount up to around ALL 11.7 billion.

[36] *In addition to requirements on macroprudential and microprudential requirements, in accordance with Regulation 78/2020 "The minimum requirement for regulatory capital instruments and eligible liabilities - MREL" banks shall also fulfil the minimum MREL levels starting from 2022.*

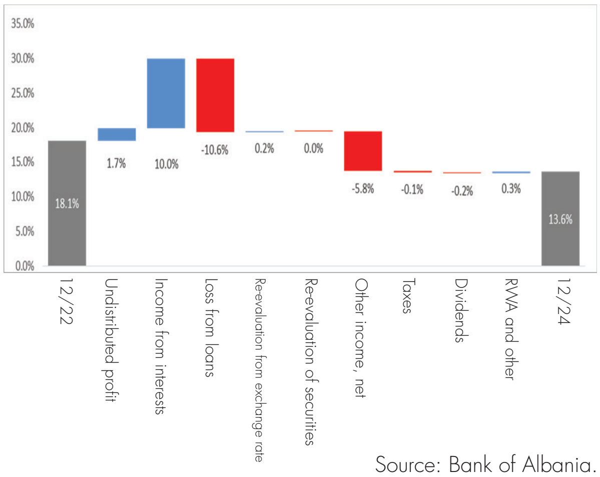
- In the adverse scenario, the banking sector remains capitalized in 2023 and 2024, with CAR at 17.3% and 13.6%, respectively.

Chart 75 CAR over the time frame of the exercise




Source: Bank of Albania.

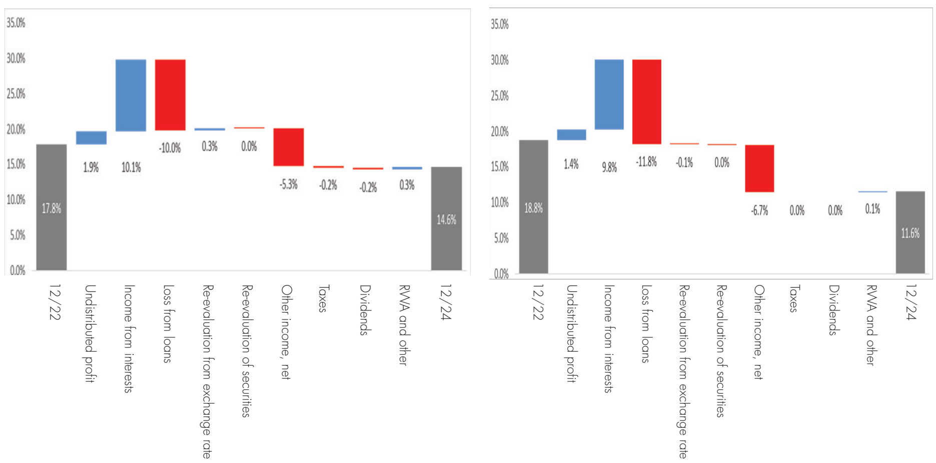
Chart 76 Contribution of the main balance sheet's items in CAR change in adverse scenario




Source: Bank of Albania.

Losses from loans and the decline in other operating income show the main contribution in the capital shortfall in this scenario[37]. Eight banks appear under-capitalized by the end of 2024 in this scenario, accounting for around 57% of the sector's assets. In this case, the need for additional capital is assessed to amount up to around ALL 43.6 billion.

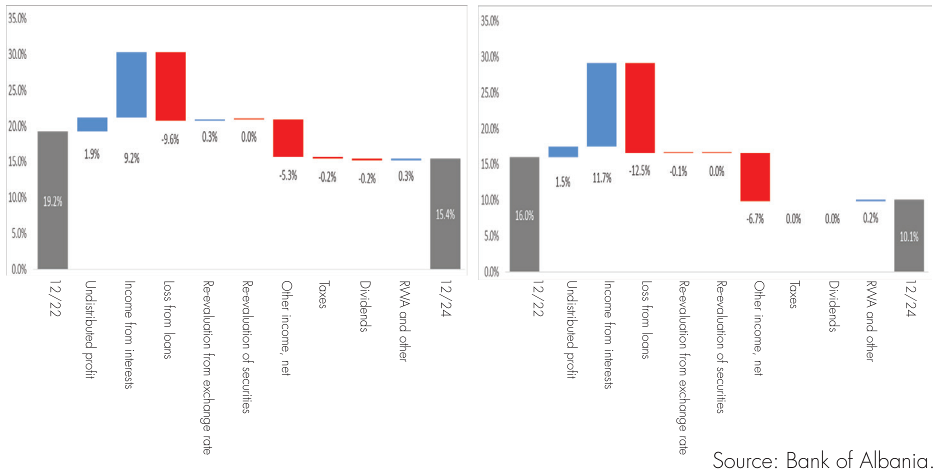
Chart 77 Contribution in CAR in adverse scenario, for Systemically Important Banks - SIBA (top) and Other Banks (bottom)




Source: Bank of Albania.

[37] *This was driven mainly due to "Receivable fines and commissions" on the income side, not from interest in the Income and Expenditure Statement.*

Chart 78 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 14.6% at end-2024, while the other banks appear under-capitalized, reaching at a CAR of 11.6%. Systemic banks are in a better capitalisation position compared to other banks, since their losses from loans are lower. In the adverse scenario, banks with foreign capital show a capitalisation ratio of 15.4% at end-2024, while banks with Albanian capital reach at a CAR of 10.1%. The difference between the two groups originates from a higher contribution of loss from loans and a drop of other net operating income for banks with domestic capital.

At the conclusion of the exercise, the analysis shows that banking sector is resilient to macroeconomic shocks, but particular banks show high sensitivity to assumed scenarios. In extreme scenarios, the worst-case scenario claims that the need for potential capital injection may reach a maximum weight of around 1.5% of GDP at end-2024, or 0.6 p.p. lower compared to the results obtained in the first six months of the year.

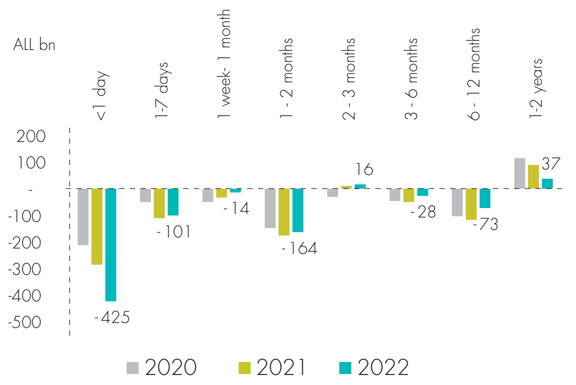
## *LIQUIDITY STRESS TEST*

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. 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. 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.

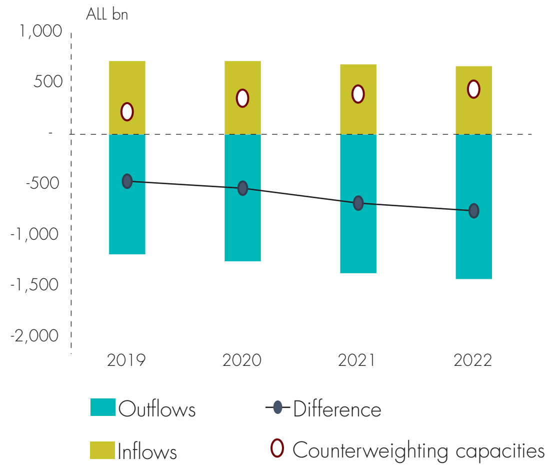
The results of the stress test show that the resilience of the banking sector to possible liquidity shocks according to the data of November 2022, for the time horizon up 2023-2024, is assessed as "good. Compared to the previous year, the situation of liquid lek and US dollar has improved, meanwhile, the liquid situation in the euro appears slightly weak. The gap between expected inflows and outflows over the upcoming two years, appears wider when compared with the previous year, but, on the other hand, the banking sector has expanded its counterweighting capacities or expanded liquid assets that could be used to cover liquidity needs, preserving its resilience against potential shocks. The expansion of counterweighting capacities is related to the increase of banks' assets in the form of Albanian Government debt securities in the euro and the lek. The overall liquidity situation of the banking sector by the expected inflows and outflows of money for the one - to two-year time horizon, starting from 1 December 2022 results somewhat more challenging compared with the previous year. The expected inflows and outflows result 3% lower and 4% higher, respectively than in the previous year. The expected deterioration in both inflows and outflows may result in a deeper inflow-outflow gap of 11%. The highest negative values between inflows and outflows continue to be recorded in the baskets "up to 1 day "; "1 to 2 months"; and "1 to 7 days"; while for the baskets "2 to 3 months" and "1 to 2 years" the gap between inflows and outflows continues to have a positive value.  The liquidity gap has expanded for the euro and the lek inflows-outflows, but the highest growth is noted in the euro-denominated position, as the banking sector expects at the same time a fall in inflows and increase in outflows in this currency. The expected outflows in the domestic currency are lower compared to those reported in the previous year, but the decline in  inflows is higher than that in outflows, driving to the increase in the overall gap.

Chart 79 Gap between inflows and outflows by maturity baskets




Source: Bank of Albania.

Chart 80 Overall inflows and outflows and counterweighting capacities




Source: Bank of Albania.

The liquidity situation prior to the use of cash and counterweighting capacities, measured by the simple liquid gap[38], appears weaker for lek regarding both the number of banks with a simple negative gap (10 from 11), as well as the maximum size of the gap (6% of assets in lek, compared to 3% of assets in the euro, and an almost inconsiderable value of assets in US dollar). Compared to the previous year, the size of the gap in relation to total assets has maintained the same level for the euro and the lek, and has declined for the US dollar for most of maturity baskets. The number of banks that report a negative gap for at least one of the baskets, has fallen from 11 to 10 banks for the basket in lek; for the euro, it has increased from 7 to 9 banks; and for the US dollar, it has also increased from 3 to 6 banks.

From the scenario that assumes to use counterweighting capacities for closing the gap in each basket, the situation for the banks in the sector improves considerably 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. After the use of counterweighting capacities, the number of banks that continue to have a negative gap in at least one of the baskets is 1 and 3 for the activity in lek and euro, respectively. Regarding the US dollar, all the banks close their negative gap after using their counterweighting capacities. Compared with the previous year, as for the number of banks with a remaining negative gap and the ratio of the gap size to bank's assets, it results that the liquidity situation in both the lek and the US dollar has improved, whereas the liquidity situation in the euro has weakened.

[38] *The simple liquidity gap is calculated as the difference between the expected inflows and outflows multiplied by the withdrawal coefficients (for the funding sources/deposits) and reinvestment (for assets/loans) by all the remaining maturity baskets for each of the currencies.*

*The activity of every segment of the financial system has expanded, with the exception of investment funds.*

*The non-banking part of the financial system remains well-capitalised, and the quality of the credit portfolio of credit institutions is high, as the non-performing loans ratio has fallen compared to the previous year.*

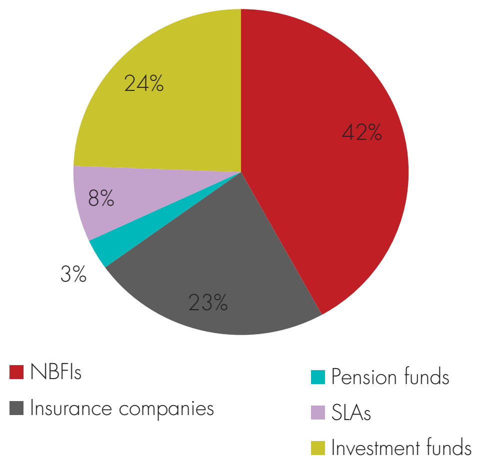
*The exposure of the banking sector to the non-banking sector remains low and stable, while the sensitivity of the non-banking sector to the activity of the banking sector remains high and on the rise, compared to December 2021.*

## 3.2 NON-BANKING SECTOR

### 3.2.1 NON-BANKING SECTOR PERFORMANCE

As at end of 2022 Q3[39], the Albanian non-banking sector consisted of non-bank financial institutions (NBFIs), Savings and Loan Associations (SLAs) and their unions, insurance companies, investment funds and pension funds. There are currently 38 NBFIs, 16 SLAs and 1 Union, 12 insurance companies, 11 investment funds, and 6 pension funds operating in the market. Non-banking sector's assets account for around 9% of the total assets of the financial system and around 9% of GDP. Non-bank financial institutions supervised by the Bank of Albania have the main share in the activity of non-banking sector, followed by investment funds which are supervised by the Albanian Financial Supervisory Authority.

Chart 81 Non-banking sector structure




Source: Bank of Albania, Financial Supervision Authority.

Lending is the main activity of NBFIs (43%), followed by payment and transfer services (21%). NBFIs are more active in lending to the sector of wholesale and retail trade and in other service activities (18% of the total loan stock to enterprises), followed by construction (13%). Credit to households accounted for 54% of total loans, while 46% was granted to enterprises. Albanian capital accounts for around 83% of paid-in capital of the non-bank financial institutions. As at-end of the period, NBFIs reported a positive financial result of around ALL 3 billion, or comparable to the previous year. The capitalisation of activity of these entities continues to remain high, while the quality of loan portfolio declined in quarterly terms, as NPLR was up to 14% from 13%, although it improved compared to the end of 2021.

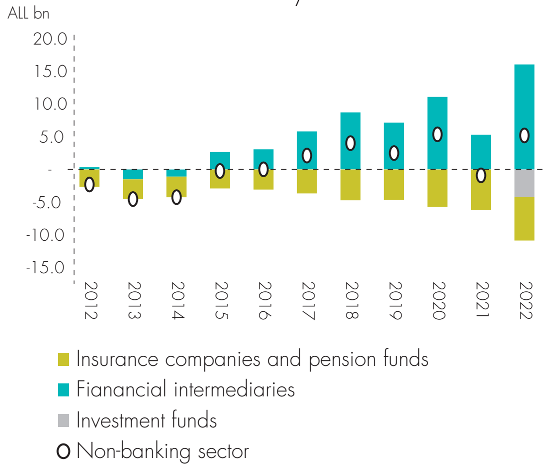
The Savings and Loan Associations (SLAs) expanded their lending activity to their members and recorded a positive net profit. This segment recorded an improvement of the credit portfolio quality in 2022. The non-performing loans ratio dropped to 4.7%, from 5.2% at the end of 2021. Investments in loans and investments in banks in the form of time deposits have the main share in the investment portfolio of SLAs, by 72% and 18%, respectively. Agricultural sector has attracted the largest funding from the activity of the members (30%), followed by the wholesale and retail trade sector (14%).

Insurance companies and pension funds expanded their activity driven by the increase in gross written premiums and investments in government debt securities. In 2022 Q3, investment funds reported a slowdown of their activity

[39] *The data on non-bank financial institutions, insurance companies and investment funds is from 2022 Q3. Pension funds and SLAs data is from December 2022.*

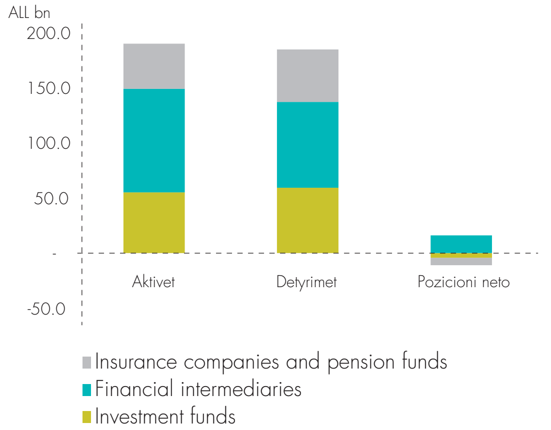
compared to the previous quarter and the end of the previous year, as a result of the contraction of investments in government's bonds.

Chart 82 Net position of non-banking sector by entity




Source: Bank of Albania.

Chart 83 Assets, liabilities and net position by entities of non-banking sector (September 2022)



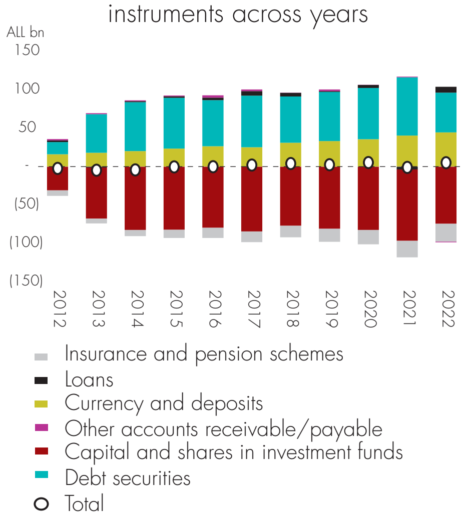

Source: Bank of Albania.

The non-banking sector has continuously recorded a balanced position of financial assets and liabilities[40]. Debt securities and loans represent the main items of SLAs' assets, while capital and shares in investment funds represent the SLAs' liabilities. Then non-banking sector has slightly narrowed its net creditor position compared to the first half of year, driven by a contraction in debt securities investments. Compared to the end of the previous year, the contraction of liabilities in the form of capital and shares in investment funds expanded the net creditor position of the non-banking sector. Within the non-banking sector, investment funds, and insurance companies with pension funds have a net negative (debtor) position, while the other financial intermediaries (non-banks and SLAs) have e net positive (creditor) position. For the sub-sectors of investment funds and insurance companies with pension funds, debtor position accounted for 6% of total assets as at end of 2022 Q3.

Debt securities account for around 27% of the financial assets of non-banking sector, while loans, currencies and deposits account for 24%, respectively. These ratios differ across entities of this sector. Debt securities in investment funds account for around 75% of their assets, while loans account for around 50% in the assets of other financial intermediaries. Both insurance companies and pension funds, have the most heterogeneous distribution of assets, into: currency and deposits (36%); debt securities (26%); insurance and pension schemes (17%); and capital and shares in investment fund (9%). 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, loans, currencies and deposits.

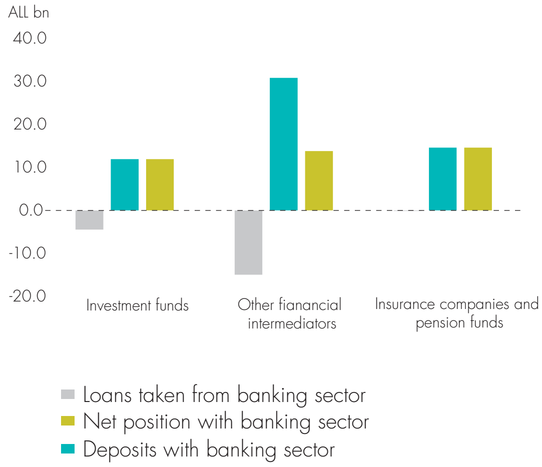
40 *The analysis of assets and liabilities of non-banking sector is based on the data of financial accounts for the first quarter of 2022.*

Chart 84 Net position of non-banking sector by instruments across years




Source: Bank of Albania.

Chart 85 Non-banking sector interconnection with banking sector (September 2022)




Source: Bank of Albania.

### 3.2.2 RISKS AND EXPOSURES BETWEEN BANKING AND NON-BANKING SECTORS

The Bank of Albania monitors regularly the exposure of non-banking sector to the banking sector, and vice-versa, in the framework of the regular assessment of systemic risks and for monitoring the fulfilment of intermediate objectives of macroprudential policy. The banking sector's exposure to the non-banking sector in Albania remains low and stable. This exposure on the side of banks' assets is represented by loans granted to non-bank financial institutions. Financial intermediators (non-banks and SLAs) are the most financed segments by the banking sector. The total stock financed by the banking sector amounts to around ALL 17 billion. This stock has slightly increased compared with the amount recorded at the end of 2021, and accounts for only 1% of the banking sector's balance sheet.

The sensitivity of the non-banking sector to the activity of the banking sector remains high, but it has maintained the level of December 2021. Claims of non-banking sector to banks are in the form of placements (current accounts, demand and time deposits). Stock of funds placed in banks, during the period, amounted to around ALL 60 billion, accounting for around 30% of total assets of the non-banking sector. The other financial intermediaries (non-banks, SLAs) have the largest placements in the banking sector, but this stock has declined during 2022. 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 36% of their assets. Investment funds have increased the sensitivity to developments in the banking sector, as the placements in the form of currency and deposits in banks have increased. The non-banking sector has expanded its net creditor position to the banking sector, reaching

ALL 40 billion, from ALL 38 billion reported at the end of 2021. The expanded net position increases the sensitivity of non-banking sector to the activity of the banking sector. Insurance companies and pension funds have the highest net creditor position, as these entities have more claims toward the banking sector compared to liabilities, followed by the other financial intermediaries.

# 4. SYSTEMIC RISKS AND MACROPRUDENTIAL POLICY

This chapter includes the risk performance assessment and methods for monitoring risks which, due to unexpected developments, banks' perception and the interconnection within the financial system, may become systemic risks.

## 4.1 THE MACROPRUDENTIAL MAP OF SYSTEMIC RISKS

Systemic risks in the banking sector and the financial system are analysed in the context of intermediate macroprudential goals and relate to the excessive growth of loans and lending; the concentration of exposures; the shortage in liquid assets and lack of liquidity; as well as the contribution of systemically-important financial institutions to the systemic risk. The performance of risk indicators shows that systemic risks in the banking sector and financial system, were contained during 2022. The indicators related to credit growth, liquidity position, foreign exchange market volatility, concentration of exposures, and the financial system activity show that the situation is balanced. The areas in the Macroprudential Map of Systemic Risks which expose a moderate or somewhat higher accumulation of risks are related to indicators measuring: loans in foreign currency; the gap between assets and liabilities for short-term maturities; construction and real estate purchase loans; and prices in the real estate market. According to the analysis of the Bank of Albania, these risks are mitigated by the following factors: the sustainability of unhedged loans in foreign currency; the high level of liquid assets of banks and the trend of banks to tighten credit standards to households and enterprises, accompanied by the rising interest rates on loans.

*Banks perceive a new systemic risks ranking for the second half of 2022 and the following period. The risk assessment conducted by banks emphasise the risk related to the rapid increase of inflation in Albania and heightened uncertainties on its long-term consequences.*

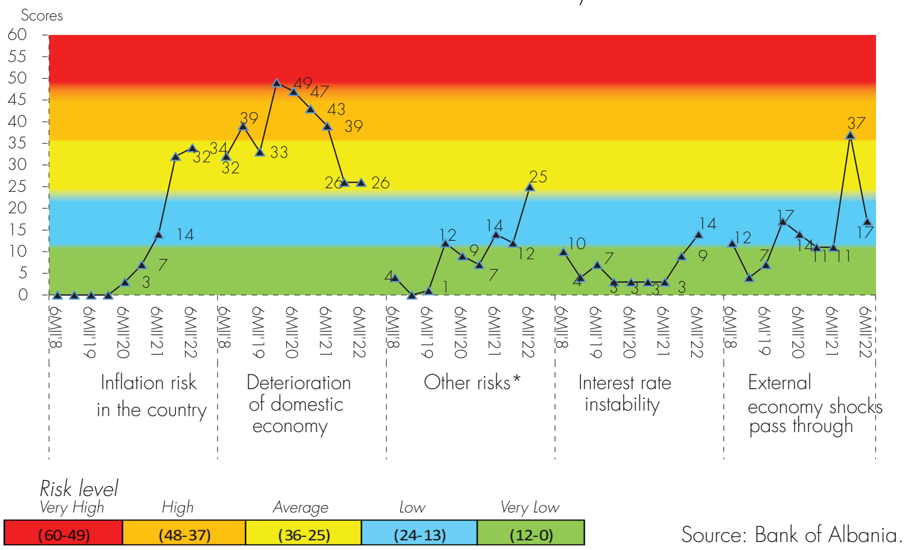
*The risk of the deterioration of domestic economy is ranked as the second highest systemic risk in Albania.*

*For the first time, the classification of the main systemic risks in Albania includes the "other risks" category, dominated by the cyber-attacks risk.*

## 4.2 THE PERCEPTION OF THE BANKING SECTOR ON THE SYSTEMIC RISK

Survey results on the perception of systemic risks by the banking industry in Albania, suggest a new ranking of the main systemic risks during 2022 H2, driven by the rapid increase of inflation and heightened uncertainties on its long-term effects, as well as the rising interest rates.

Chart 86 Bank assessment of main systemic risks




Source: Bank of Albania.

The banking sector ranks the inflation risk as the main systemic risk during the second half of the year, and its level assessment has continued to pick up. The deterioration risk of domestic economy is ranked as the second highest systemic risk in Albania. For the first time, the classification of the main systemic risks in Albania includes the "other risks" category, dominated by the cyber-attacks risk. As these attacks have become more frequent, banks have become more alert regarding the potential damages caused by them, and some banks have announced to have taken actual steps to improve their security systems. The risk of negative external shocks remains in the list of the five main systemic risks, but assessments show that their impact on the Albanian economy has become less severe. Last, the normalisation of monetary policy within Albania and abroad, as a response to address the soaring inflation, seems to have increased banks' concerns regarding the fluctuation risk of interest rates and its consequences on their portfolios, thus, the importance level of this risk has been assessed upwards. On the other hand, given a good capitalisation and liquidity situation, which enables banks to absorb shocks, banks' confidence on the sustainability of financial system has not changed during the period, standing above the level of "sufficient" in the short-term (up to 1 year) and medium-term future (1-3 years).

## 4.3 THE STRESS IN INTERNATIONAL MARKETS DUE TO BANKS' EXPOSURE IN SECURITIES AND TO RISING INTEREST RATES

Recently, some banks in the USA and the EU are currently facing an acute stress situation. Silicon Valley Bank (SVB), the 16th largest bank in the USA, with total assets valued at ALL 209 billion, has been put under the management of Federal Deposit Insurance Corporation (FDIC), as it is waiting to find a buyer. The Federal Reserve announced the implementation of a programme designed specifically to provide liquidity to banks in distress; also, some large US banks agreed to deposit their funds in smaller regional banks, which face pressing liquidity needs. In Europe, the most sensitive case was that of Credit Suisse, which after losing around 24% of its stock value in the financial market on 15 March 2023, asked for the support of the National Bank of Switzerland. The latter provided the mechanism that enabled another Swiss bank, UBS, to overtake Credit Suisse. Overall, the stock prices of banks have declined rapidly in the past few weeks, where the USA alone has lost around USD 230 billion, or 17%.

The stress situation is caused by the expansion of the negative gap of maturities in banks' balance sheets, in other words, the negative gap between assets and liabilities by basket of short-term maturities has increased. This performance was driven by the prolonged (multi-year) period of low interest rates, during which banks, seeking the highest return rates, extended the average maturity of asset investment, while the average maturity of liabilities underwent insignificant changes. Most of these investments were in debt securities and bonds. The global surge in inflation, for already known reasons, is accompanied by the fast normalisation of the monetary policy in many countries, which in turn drove to the increase in interest rates across markets. Among others, due to the indirect correlation between the interest rate and the price of security, this performance has driven to the drop in the value of securities portfolio in banks' balance sheets and originated considerable financial losses, which have eroded the equity value, in some cases.

In terms of accounting, banks may classify their investments in debt securities in three categories:

- securities trading (TR), if the bank aims to be active in trading of these securities. This is the case when bank intends to maximise profits from trading of this portfolio;
- available for sale (AFS) security, if the bank intends to sell these securities before they reach maturity; and
- held-to-maturity (HTM) securities, if the bank intends to hold these securities until they mature. These are high-value securities and the bank is expecting to realise small but secure returns, until maturity.

Securities Trading (TR) are initially recorded (as long) and are assigned at fair value (subsequently) on a regular bases; interest income (the coupon) or the positive and negative movements of value (although an actual transaction has not taken place and the value is "unrealised" as a result) are immediately recognized in the income statement (consequently, they are also recognized in the equity accounts), without the need for provision of the decline in value.

Available-for-sale securities (AFS) are initially recorded and assigned at fair value (plus purchasing costs), and interest income (coupon) are recognized in the income statement of the period. The provisions created based on expected losses and the positive and negative changes in the fair value (although an actual transaction has not taken place and the value is "unrealised" as a result) are recorded only in equity accounts (i.e., in the "re-evaluation" account or alternatively "other comprehensive income").

Held-to-maturity (HTM) securities are initially assigned at the fair market value (plus purchasing costs), and interest income (coupon) are recognized in the profit and loss statement of the period. Fair value movements whether positive or negative (although an actual transaction has not taken place, and the value is "unrealised" as a result) are not considered during the "lifespan" of this type of security. They are recognized in the income statement of the period only at maturity date.  In general, when expectations for rising interest rates increased, banks had a tendency to re-classify securities portfolio to HTM, in order to mitigate the impact from their value decline on the balance sheets.

Although markets were concerned that a similar crises to the one of 2008-2009 would repeat, the reforms undertaken to regulate the banking activity since that period have made banks more secure as the capital/liquidity situation has improved, and supervision authorities and central banks possess a wider range of instruments, which are more flexible and effective in withstanding such shocks, on a timely basis. Nonetheless, there is higher awareness that the moral hazard that accompanies this "guarantee" should be mitigated to the maximum through the other changes that aim to improve the banking activity regulation.

### 4.3.1 THE CONTENT AND VALUE OF SECURITIES PORTFOLIO OF BANKS THAT OPERATE IN ALBANIA

The securities issued by resident and non-resident entities and held by the banking sector in Albania account for 39% of the banks' assets. Around 73% of the stock has been invested in securities issued by the resident sector, represented by the Albanian government, and the rest (27%) is invested in issuances of the non-resident sector. Overall, banks are prudent regarding investments in securities, as around 84% of their portfolio is invested in government securities (Albanian government and foreign governments), which have a low level of risk. The other part is invested in securities, mainly in the international market of the banking sector (10%), non-financial corporations (5%), other financial intermediaries and financial supporters. Banks' investments in securities of investment funds, pension funds, and international organisations, account for less than 1% of the total securities portfolio purchased by banks.

In terms of investments in non-resident securities, around 56% represent investments in the EU securities (51% within the euro area). By currency, non-resident securities held by the banking sector are issued mainly in the European currency (around 67%), followed by the US dollar (around 29%). The British pound and Turkish lira have the smallest share in this regard. Banks report data also on the average modified duration of the securities portfolio, an indicator which recorded an average value of 3 years at the end of 2022. Around 83% of securities have a duration of over one year.

The highest the value of the average modified duration indicator, the highest the sensitivity of the value of portfolio toward market fluctuations of the interest rate. At the same time, the value of the average modified duration represents the change in the value of the portfolio for a 1% change to the interest rate (for example: a 1% increase in the interest rate, would bring the value of portfolio down by 3%).

### 4.3.2 THE SENSITIVITY OF INVESTMENT PORTFOLIO VALUE IN SECURITIES TOWARD INTEREST RATE CHANGES

*Approach 1: Sensitivity to interest rate volatility*

Including the entire value of the securities portfolio in the shock scenario is unrealistic, particularly when around 60% of the portfolio consists of securities intended to be held to maturity (classified as HTM), while interest rates volatilities, under normal conditions, do not impact the balance sheet in their case. Furthermore, the value of this securities portfolio is dominated by securities in lek, which allows public authorities the possibility to discount them in various forms, if needed.

Thus, the analysis focuses in securities classified as ASF, which consists a more realistic case. Taking into consideration the value of this portfolio and the average modified duration for specific banks, the analysis shows that raising the interest rates further up to 2%, would not cause the under-capitalisation of any bank, whereas the raise of interest rate by 3% may require certain banks to increase their equity level.

In addition, it would also be more realistic if assumptions take into consideration differences arising from the residency, focusing on non-resident securities. For these securities, it is assumed that the possibility for discount/liquidation in the domestic market is (currently) limited, and liquidation in international market, under stressful conditions, may be accompanied by financial losses. In the same vein, if the entire value of non-resident securities portfolio was to be considered, raising the interest rate by 1% or 2%, would not constitute under-capitalisation for any of the banks. Raising the interest rate by 3% may require specific banks to increase their equity level. This performance will be driven by the non-resident securities portfolio classified as HTM. For the non-resident securities portfolio, classified as ASF, none of the banks would be suffering under-capitalisation even if the interest rate were to rise by 3%.

*Approach 2: Indirect analysis of non-resident securities portfolio*

This approach assesses the necessary loss in the value of non-resident securities portfolio, which would cause the under-capitalisation of the banking sector. The assessments are carried out on the general securities portfolio by classification (i.e., TR, AFS and HTM) and by residence (i.e., securities issued by the EU, the euro area and outside the EU).

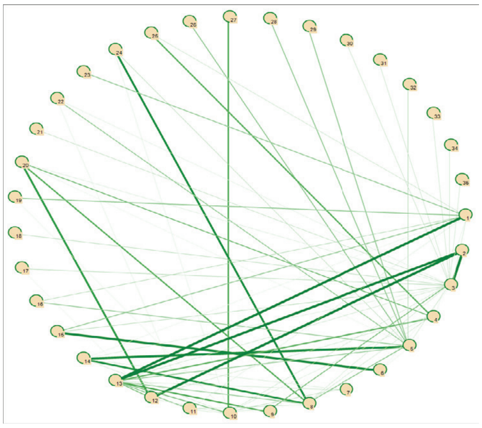
The analysis show that a fall in the value of the portfolio by around 30% (critical decline) would suffice for the banking sector to experience under-capitalisation (CAR to fall below 12%). According to the classification of these securities (AFS or HTM) or their residence (i.e., EU, Euro area, outside the EU), the value of the portfolio would have to decline by at least 50%, in order for the banking sector to experience under-capitalisation. For each portfolio mentioned above, the necessary losses for specific banks vary close to the sector' average values, and the analysis suggests that certain banks may need to strengthen their capital positions. However, in general, it is assessed that the amount of the loss necessary to cause capitalisation issues for banks is high, while the probability of its occurrence low.

## 4.4 THE SPILLOVER RISK OF CRISES IN THE FINANCIAL SYSTEM

Exposure to securities, whether resident or non-resident, is an activity noticed in every bank, in various degrees. Despite such common exposures, banks may be also faced with risks engendered due to their connection to each other, non-resident financial institutions, non-bank financial institutions, and different sectors of the economy. In reality, it is possible for a shock experienced by one bank could spread across other segments of the financial system and the economy, through these interconnections.

Against this backdrop, in 2021, the Bank of Albania has started to conduct an interconnectedness analysis and the risk of crises spreading across the financial system. This analysis is built like a stress test that evaluates the capital adequacy of banks and other financial institutions, to withstand shocks brought about by foreign banks and other segments of the domestic financial system such as: investment funds, pension funds, non-bank institutions, savings and lending associations, and insurance companies. The exercise consists of several modules which elaborate on the interconnectedness and spillover of crises within the banking sector and between its components, on the one hand, and counter-parties, on the other. In the case of the other segments of financial system, the counter-party is represented by individual entities of each segment such as non-bank financial institutions, insurance companies or investment funds. One exercise module assesses banks' capacity to withstand changes to the value of securities, while another one elaborates on banks' resilience against shocks brought about by various sectors of production and services in the domestic economy.

Chart 87 The connection network* between national banks and non-resident banks



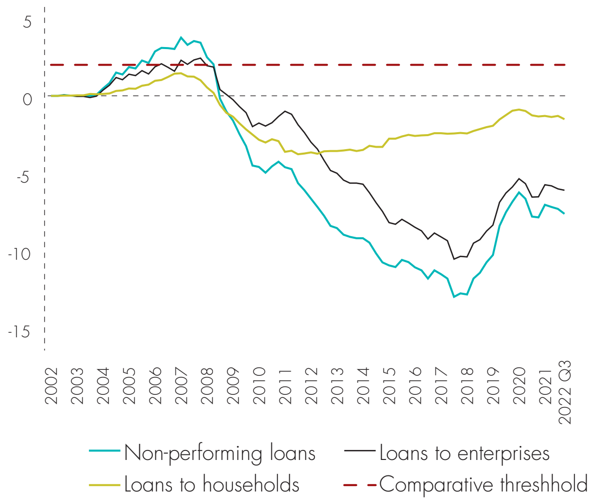
*Each knot represent an entity, while the line that connects the knots represent exposures between banks. The thickness of the line is directly correlated with the degree of exposure.

The exercise shows that the interconnectedness between banks operating in Albania does not pose a risk to their soundness, since interbank exposures at the moment of exercise (as well as historically) are quite limited compared to the capital surplus of banks. The other segments of the financial system do not pose a threat to the stability of banks either, whereas the banking sector appears exposed toward some non-resident banks, which have established business relationships with banks operating in Albania. The analysis shows that the sectors of trade, industry and households have the highest potential to affect banks' financial results through credit shock. This exercise is an important instrument for assessing the systemic risk and the spillover risk across both the banking sector and the entire financial system of Albania.

# 5. THE MACROPRUDENTIAL POLICY OF THE BANK OF ALBANIA

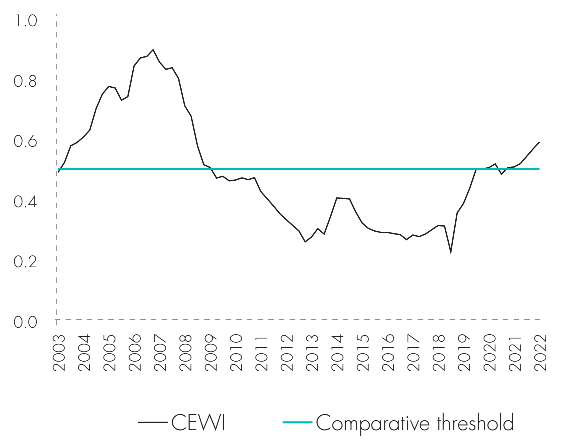
The Bank of Albania has continued to implement the requirements provided for in the Regulation "On macroprudential capital buffers"[41] (Regulation 41/2019), and follow banks' quarterly reports in order to assess the degree of fulfilment of these requirements. Since 2020, banks have started to fulfil their annual buffers of 0.5 p.p. in compliance with the requirement on capital conservation buffer (CCB), and systemically important banks buffers (SIBs), announced once a year, at the end of March. The countercyclical capital buffer (CCyB) is used to mitigate or decelerate the excessive growth of credit, and to enhance banks' resilience when the credit market is overheated. Although this instrument is active, the buffer rate for Albania has remained unchanged at 0%, since the credit gap to GDP has remained in the negative territory. With a view to support the decision on the countercyclical capital buffer, the Bank of Albania takes into consideration the performance of some additional indicators as well, such as: real estate loans, house price index, the credit intensity indicator and the early warning indicator. Overall, the banking sector, supported by a satisfactory initial capital position, has been able to meet these requirements. The BoA recognizes that fulfilling these requirements as well as the new ones related to resolution[42], will continue to contribute in strengthening the resilience and the soundness of the banking sector.

Chart 88 Lending to the economy/GDP ratio gap




Source: Bank of Albania.

Chart 89 The performance of the Complementary Early Warning Indicator




Source: Bank of Albania.

41 *The buffers applied currently are: capital conservation buffer (KONS), capital conservation buffer (KUNC) and capital buffers for systemic banks (SIST). For more information visit: https://www.bankofalbania.org/Financial_Stability/Macro-prudential_policies/Instruments_of_Macroprudential_Policy/Instruments_and_Decisions/*

42 *The requirements laid out on the Regulation No 78/2020 "The minimum requirement for regulatory capital instruments and eligible liabilities."*

During 2022, the Bank of Albania has worked to complete the regulatory framework related to the implementation of instruments with the borrower as a subject. To this end, the draft-regulation "On data reporting, the identification and monitoring of borrowing and real estate investments indicators," has been compiled and distributed for opinion. This regulation aims to standardise the methods used by banks to identify, monitor, and report the borrowing standards indicators, and their exposures to real estate. It also lays down the methods banks may use to implement critical values and thresholds of debt-to-income ratio indicator, debt-to-equity ratio and debt-to-income ratio, and provides the right of the Bank of Albania to use these indicators as macroprudential policy instruments, by applying upper and lower limits over their values, if needed. The approval and implementation of this sub-legal act is expected to be an important step toward the approximation of the macroprudential framework of Albania with the practices adopted by the European Union.

Another key instrument adopted with various degrees of success by the macroprudential authority is the systemic risk buffer (SyRB). SyRB is the only buffer provided in Regulation 41/2019, but not currently implemented by the Bank of Albania. According to the latest directive issued by the European Union on capital requirements, the systemic risk buffer may be used to mitigate and prevent all systemic risks unable to be addressed by other instruments. The regulation stipulates that the Bank of Albania may implement the SyRB when the banking sector reflects developments and events of a structural and non-cyclical nature, which may risk the stability of the entire financial system or a certain area of it. SyRB may be applied on all banks or some of them, over all exposures or part of them, without limitations as regards the jurisdiction of exposures, and in similar or different degrees at each bank. During 2021-2022, the Bank of Albania has drafted a methodological manual on how to use SyRB, which includes the conditions for determining the risk indicators, the formulas for extracting the threshold values, and the method for calculating the amount of SyRB. The methodology takes the case when SyRB is used to address the structural systemic risk engendered from a high level of euroisation/dollarisation, but SyRB may be similarly used to mitigate or prevent risks related to: exposures of banks to a certain market, maturity gaps etc. With the publishing of this methodology in 2023, the Bank of Albania aims to enhance the transparency of its macroprudential policy, as well as make banks aware about the technical aspects involved in the potential implementation of this key macroprudential instrument.