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FINANCIAL STABILITY REPORT 2010 H1

October 2010

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PREFACE

This is the fourth issue of the Bank of Albania's Financial Stability Report, which will be produced half-yearly starting from year 2010. The purpose of this Report is to detect and assess the risks posed to the financial system and its infrastructure, to give public authorities the opportunity to identify relevant measures for necessary corrections. The Report is opened with the Financial Stability Statement, whose half-yearly publication is a legal requirement.

This Report is produced by making use of Bank of Albania's available data and the information shared among authorities supervising the financial market activity. It has also used information and analyses from public and private international financial institutions. The data and analyses mainly cover the 2010 H1 developments. If not otherwise stated in the Report, expectations for future economic and financial outlook are extended until year-end.

The financial system stability has been assessed on the basis of the performance and risks arising from its interaction with the overall internal and external economic environment, as well as from its activity. In order to assess the risks arising from its interaction with the surrounding environment, we have analyzed the latest developments in the international financial markets and in advanced and regional economies. We have also assessed their impact on the Albanian financial system and the banking sector. As far as domestic indicators are concerned, the present Report makes an assessment of the overall developments and expectations for the economic growth, trade balance, overall price level, exchange rate and fiscal indicators. It also provides an analysis of employment, personal income and its impact on the banking sector borrowers' solvency.

CLARIFICATIONS

As at end-June 2010:

a) Banks Peer Group 1 (banks sharing 0-2% of the banking sector's total assets) are: United Bank of Albania, Veneto Banca (former Italian Development Bank), International Commercial Bank, First Investment Bank, Credit Bank of Albania, Union Bank;
b) Banks Peer Group 2 (banks sharing 2-7% of the banking sector's total assets) are: ProCredit Bank, Emporiki Bank, Branch of National Bank of Greece - Tirana, Credins Bank, Banka Popullore;
c) Banks Peer Group 3 (banks sharing more than 7% of the banking sector's total assets) are: Raiffeisen Bank, National Commercial Bank, Intesa-Sanpaolo Bank - Albania, Tirana Bank, Alpha Bank-Albania.

As at end-June 2010:

a) Austrian-owned banks[1] are: Raiffeisen Bank;
b) Italian-owned banks are: Intesa-Sanpaolo Bank - Albania, Veneto Banca (former Italian Development Bank);
c) Greek-owned banks are: Alpha Bank - Albania, Tirana Bank, Branch of National Bank of Greece-Tirana;
d) French-owned banks are: Banka Popullore (currently, the Societe General - Albania), Emporiki Bank;
e) Albanian-owned banks are: Credins Bank, Union Bank;
f) Branches of foreign banks are: Alpha Bank - Albania, Branch of National Bank of Greece - Tirana.

[1] *By capital origin, when foreign capital accounts for more than 50% of bank paid-in capital.*

FINANCIAL STABLITY STATEMENT ON THE FIRST HALF OF 2010

Pursuant to provisions stipulated under Article 69 of the Law No.8269, dated 23/12/1997 “On the Bank of Albania”, as amended, and Article 8 of the Law No.9662, dated 18/12/2006 “On Banks in the Republic of Albania”, informing the Council of Ministers and the Parliament of the Republic of Albania and drawing the attention of the financial institutions and the public at large on the situation of the Albanian financial system and potential risks that may jeopardize its stability, the Bank of Albania releases the following periodical statement, part of the Financial Stability Report.

Over 2010 H1, Albania’s financial and banking sector has been stable. The need to stabilize and improve credit quality is the main challenge posed to the banking sector. Capitalization level and operational liquidity positions are good. At sectoral level, net operating income has improved. Stress-testing of the banking sector’s resilience to any potential adverse economic or financial scenarios showed robustness.

Financial and banking system risks posed from domestic economic developments over 2010 H1 have subsided. The main positive factors include reining budget and trade deficits, exchange rate stability, moderate inflationary pressures and interest rate cut. Over the said period, the interbank market liquidity was sufficient to meet commercial banks’ short-term liquidity needs. Also, the financial market has operated smoothly. However, these positive developments would have a more lasting impact if they promoted a more rapid improvement of the financial position of both enterprises and individuals/households, thereby stimulating the domestic demand.

In 2010 H1, international economic developments also highlighted a recovered situation. The global economy expanded by 4.7% year on year. Inflationary pressures were moderate. Financial markets were generally steadier and banking groups’ financial position was generally better. However, bank credit availability has remained restricted and public authorities have taken measures for fiscal consolidation. Consequently, new investments in the economy are weak and unemployment rate, especially in Southern countries of the euro area, remains high. Therefore, the growth outlook for the period ahead remains uncertain.

Albania’s financial system expanded over the first half of the year, increasing its share to Gross Domestic Product (GDP), at 84.5%. The banking sector continues to remain the dominant segment of financial intermediation. Banking sector assets rose to ALL 934.7 billion, accounting for 94.4% of the financial system’s total assets.

Smooth functioning of payment systems infrastructure has also contributed to expansion of banking sector activity. The banking activity is well-capitalized and capital adequacy indicator is steady, at 16.2%. Liquid assets account for 27.8% of the banking sector's total assets. Loans to deposits ratio has amounted to 63.2%. Banking sector's profit posted a positive figure, ALL 3.6 billion, up substantially from the same period of the previous year. The rise in the financial profit was due to higher net interest income and better control over operating costs. However, the positive financial profit has a high concentration and the banking sector still faces loan quality impairment, with non-performing loans accounting for 12.2% of total loans. Due to high credit risk perception, the banking sector decelerated the annual credit growth rate, cut its average maturity term and further decreased the consumer credit. Credit risk provisioning increased by about 20%, accounting for 52.5% of non-performing loans at the end of the first half of the year.

The Bank of Albania has underscored that banks should continue to cautiously monitor the credit quality performance and timely set aside appropriate provisions. Banks' relevant structures should assess the non-performing loan concentration by sector and borrower, and try to increase the loan portfolio diversification. Paying attention to regulatory requirements, banks should support borrowing entities that incur temporary difficulties but have any worthwhile project that ensures loan repayment. In case this opportunity is small, relevant bank structures should implement contractual rights, in order to recover the loan.

In terms of assessing the banking sector risks, the Bank of Albania consistently performs simulations to test the banking sector's resilience to adverse scenarios assumed in several macroeconomic and financial indicators, both individually and combined. The analysis of scenarios combining the impact of some macroeconomic and financial indicators, as well as the performance of several banking sector indicators, show that the banking sector's overall financial position is good and as such, it can withstand an impairment of the situation. The sensitivity analysis of these simulations highlights that the banking sector shows a greater sensitivity to credit risk and indirect credit risk posed from adverse foreign exchange rate movements. Notwithstanding these results, bank management structures should stress-test the viability of institutions they manage by conducting similar exercises and making preliminary and ongoing assessment of their needs for additional capital.

In line with the banking activity challenges and in implementation of the legal objective to ensure a healthy banking sector, the Bank of Albania will assess the need for amendments to the regulatory and supervisory framework. It will constantly monitor the risk spectrum posed to the country's financial system, in order to take timely preventive measures.

SUMMARY

GLOBAL ECONOMY AND FINANCIAL MARKET HIGHLIGHTS

The global economy grew by about 4.7% year on year in 2010 H1, owing to ongoing stimulating policies of public authorities and gradual improvement in financial market operation. In line with the stage of development, the annual economic growth rate as of mid-2010 was higher in developing countries, recording about 7.25% versus about 3% in developed economies. Despite moderate inflation developments, developing economies experienced a higher inflationary pressure.

The 2010 Q1 attested to more positive economic developments: industrial production and trade posted double-digit growth; employment growth resumed in advanced economies; and consumer confidence continued to improve. This period experienced a better functioning of financial markets, owing to sustained growth of activity, better liquidity conditions and downward interest rate trend. In 2010 Q2, due to concerns about fiscal sustainability in several euro-area countries, the uncertainty of markets and economic agents was renewed. In the short run, this led to contracted activity of financial markets and tightened liquidity conditions. Strong measures taken by the authorities of the European Union (EU) and the European Central Bank (ECB), helped overcome the critical situation and restore the smooth functioning of markets. These movements, however, supported expectations for downward global economic growth paces over the current period.

The United States economy in 2010 Q1 and Q2 continued to post positive but slower growth paces, compared to 2009 Q4. In Q1, real GDP grew at a 3.7% annualized rate, while in Q2, it increased 2.4%. GDP growth was supported by business investments, while consumption was generally weak. Annual unemployment rate eased somewhat in 2010 Q1 and Q2, compared to 2009 Q4, stabilizing at 9.7% on average. During 2010 H1, inflationary pressures remained low and annual inflation rate was 1.8%. Therefore, the United Sates Federal Reserve kept the key interest rate unchanged, at 0.25%. In the fiscal area, the public sector posted a high deficit, due to the combined impact of financial stimulus and rescue packages, and automatic stabilizers of the budget.

The European economy continued to improve in 2010 H1, but at slower rates than in the United States and with pronounced heterogeneity across countries. In Q1, annual GDP increased by 0.5% in the EU and 0.6% in the euro area. In Q2, it increased by 1.7% in both the EU and the euro area. The growth in Q1 primarily reflected the positive contribution of private sector inventories and investments, which exceeded the negative effect of domestic demand and net exports. Inflationary pressures in 2010 H1 generally remained moderate in both the EU and the euro area. In June 2010, the annual inflation rates for EU and the euro area were 1.9% and 1.4% respectively. The euro area labour market conditions seem to have been stabilized. The euro area unemployment rate remained unchanged, at 10% for the first months of 2010. Indicators of fiscal situation performance in the euro area continued to deteriorate during 2010 H1. The situation was aggravated in Q2 of the year, after hard difficulties posed to Greece and the fears about their spilling over to other countries in the region. Markets began to speculate on euro-area stability project. Therefore, the European Union, supported by the IMF, immediately decided a 110 billion euro bailout for Greece, in exchange for commitments from the Greek government to rein the extraordinary budget deficit by curtailing expenditure and raising taxes. Almost each Member State rushed to announce targets on reining the budget deficits, as a preventive measure against various speculations in the markets. In a more formalized way, in May the European Union Member States decided to adopt the European Commission's proposal to establish a European Financial Stabilization Mechanism. The scope of this undertaking was to respond swiftly, effectively and in a harmonized way to acute difficulties in budget deficit financing of each Member State, thus reducing the negative speculations in the markets. Simultaneously, the European Commission submitted proposals for accelerating the process of drafting and embarking on more aggressive policies for fiscal consolidation, in compliance with the Stability and Growth Pact (SGP). In monetary area, the European Central Bank (ECB) took the necessary measures to restore liquidity to the government debt securities market.

The macroeconomic situation for Central and Eastern Europe is gradually improving. In general, confidence and industrial production indices, as well as trade figures from the countries in this region, point to a recovered economic activity. On the other hand, the steady unemployment rate and weak financing conditions from the banking sector fuel the weakening of domestic demand and make the economic growth volatile. Inflationary pressures were held in check.

World growth expectations for the rest of the year are positive but slower than in 2010 H1. The growth rate hinges on the way public authorities will embark on the process of fiscal consolidation and on financial market performance, driven by the need for a sustained credit recovery. The growth in advanced economies is expected to be 2.5% in 2010 and 2011. Somewhat stronger projected growth in the United States is offset by slightly weaker growth in the euro area, albeit with substantial differences among its Member States. The major challenge posed to the recovery in these economies is fiscal consolidation, control over unemployment and bank lending recovery. Inflation pressures are expected to remain subdued in advanced economies, owing to still-low levels of capacity utilization and well-anchored inflation expectations. For 2011, growth in emerging and developing economies is projected at 6.5% on an annual basis. Key emerging economies in Asia and in Latin America continue to lead the recovery. In contrast to advanced economies, in emerging and developing economies, inflation is expected to edge up to 6¼ percent in 2010 before subsiding to 5 percent in 2011. Uneven economic performance is expected even across different countries of the South East Europe.

Financial markets speeded up the stabilization and recovery stage that had started last year and was largely supported by monetary authorities. Interest rates continued to fall gradually almost in the entire spectrum of maturities and the volume of activity increased dramatically in money markets, and in securities and equity markets. This trend was even more apparent in the markets of developing countries. During 2010 Q1, the banking sector performance worldwide was generally positive, marking significant steps towards financial recovery. For large and complex banking groups (LCBG), return on equity (ROE) and return on assets (ROA) accounted for 12.5% and 0.9% respectively, compared with 6% and 0.3% at end-2009. However, at the beginning of the second quarter, the increased credit risk on sovereign debt securities had a markedly adverse impact on the European interbank market, where transactions were sharply reduced due to uncertainty about banks' exposure to government debt securities. The ECB assessed that this situation might adversely affect the functioning of other segments of the financial market and harm its monetary policy effectiveness. Therefore, it decided to improve liquidity and functioning of these markets through direct purchase of sovereign debt of the euro-area Member States and resumption of fixed-rate liquidity-providing operations. These measures and those taken by the European Commission helped weather money market tension. Over that period, stock markets also suffered steep decline.

Concerning credit markets, improved overall economic situation in 2010 H1 was accompanied by reduced funding costs and wider access to funding. As regards the foreign exchange markets, the euro was depreciated against the American dollar and Japanese yen. Primary commodity prices were stable, supported by a better performance of the global economy. In the conditions of export-oriented policies, the stable demand in the developing countries has been sustained by a more flexible supply.

ALBANIAN ECONOMY HIGHLIGHTS

After the negative economic growth in 2009 Q4, the 2% expansion in 2010 Q1 and the real sector indicators suggest that Albanian economy has had a positive performance over the first half of the year. A moderate inflation rate, stable exchange rate, increased foreign investments and significant correction of external trade position characterize this period. Slower rise of wage and employment indicators, decreased remittances and still tight financing conditions have adversely influenced the performance of private consumption. In line with the objective to rein the budget deficit of the year, the fiscal policy has been tighter.

In Q1 economic growth, the sustained demand for primary commodity exports supported the high growth of the industrial sector by 27.5%, compared with the same period a year earlier. Construction sector has contracted by 21.1% in annual terms. Service sector, having the largest share to domestic product, grew by 3.4% in 2010 Q1, continuing the slowdown noted in 2009 H2.

The improved banking sector liquidity, reflected in deposit growth, has provided better conditions for private investments. However, firms' lower capacity utilization due to falling demand has not supported private investment growth. Consumer confidence survey over this period shows that their tendency to increase savings and postpone unnecessary spending is strengthened. On the other hand, the banking sector financing cost remains relatively high. However, several signals coming from increased imports of capital assets from private entities and increased business demand for bank loans inspire optimism, a contained optimism for private sector credit demand recovery.

Public sector's contribution to aggregate demand continued to be positive but much less important than last year. Fiscal policy has been more prudential about debt indicators, which is positive for the public debt risk premium. In 2010 H1, budget deficit decreased by 36% y-o-y. This performance was primarily influenced by budget expenditure cut, since revenue growth was lower than the projection. In terms of budget deficit financing, there was a high demand by market participants for government debt securities.

In terms of foreign trade, 2010 H1 highlights a significant correction of trade deficit, where exports increased by 14%, whilst imports decreased by 3 % compared to 2009 H1. Consequently, the six-month trade deficit has contracted by about 19% vs. 2009 H1 and by 12% vs. end-2009. Ensuring timely stability in export improvement requires supportive public policies and assumes importance against the backdrop of relatively unstable funding sources of trade deficit and current account. Actually, in 2010 Q1, remittances decreased by 7.3% in annual terms. In the light of weak labour market indicators in the euro-area countries and the crucial situation in Greece, the flow of remittances may be volatile in the future. On the other hand, annual increase of foreign direct investments by 25.8% in 2010 Q1, and positive tourism development trend, are factors that held drive growth of foreign exchange inflows in the future.

In 2010 H1, inflationary pressures were held in check and inflation rate fluctuated within the 2-4% targeted rate of the Bank of Albania.

FINANCIAL MARKET HIGHLIGHTS

The financial market was dominated by operations in the interbank market, government bond market and foreign exchange market.

The value of interbank market transactions was sustained, whilst interest rates fell slightly. In terms of government debt securities market, the auction bid amount exceeded the amount asked. The primary market T-bill yield continued its downward trend that had started since November 2009, in response to loose monetary policy. The decline was more significant in 12-month debt issuance. The interest rate cut in the financial market for lek-denominated operations reflected the ample liquidity conditions, mainly in the banking sector, as well as the reduced amount offered for government T-bills in the conditions of decreased need for financing the contracted budget deficit.

The downward interest rate trend in interbank market and government debt securities market is also reflected, to a lesser extent, in average interest rate spread between loans and deposits. Over that period, this spread narrowed by 0.26 percentage point for lek-denominated transactions. Loan interest rate cut from 13.2% to 12.7% made the main contribution to spread narrowing. Lek time deposit rates were more stable, down from 5.37% to 5.18% over this period. In terms of foreign currencies, this spread has narrowed by 0.76 percentage point for transactions in euro, but has expanded by 0.51 percentage point for those in U.S. dollar. Overall, interest rate spread between loans and deposits by currency, has reflected the key interest rate changes, liquidity situation, and the banking sector's reluctance to lend at higher paces, because of heightened risk perception about this activity.

In terms of the domestic market, the narrowing of both trade and budget deficits has led to alleviation of the Lek's depreciating pressure. Nominal effective exchange rate and trade indicators against the primary currencies in the basket highlight the lek's exchange rate stability over this period. Related to nominal value, the lek has appreciated against the euro by 1% and depreciated against the U.S. dollar and Pound sterling by 16.6% and 9.4% respectively. The lek's exchange rate against the above currencies has mainly reflected their performance in international markets, where the U.S. dollar and the Pound sterling have appreciated against the euro.

Financial market activity is supported by smooth functioning of AECH and AIPS payment systems that are managed by the Bank of Alban. The value of transactions carried out through the AECH system was about 2.4 times higher than in the same period of the previous year. The banking sector statistics show that over that period, banks have made about 3.5 million customer payments, totalling Lek 1.570 billion. This period highlights increased payment transactions made via the banking sector. They were performed via the Internet infrastructure and electronic devices. Hence, the number of debit / credit cards and payments or withdrawals effected via them at automated electronic machines (ATM) and points of sale (POS) has picked up.

FINANCIAL SYSTEM HIGHLIGHTS

Financial intermediation in Albania, measured as a ratio of financial sector's assets to Gross Domestic Product (GDP), is estimated at 84.5% in 2010 H1 vs. 82% at year-end 2009 and 76.3% at the end of 2009 H1. Financial institutions' assets grew about 5.8% vs. end-2009, and 13.6% vs. 2009 H1. The banking sector remains the dominant segment of financial intermediation in Albania. As at end-2010 H1, the banking sector assets averaged 94.4% of total financial system assets, accounting for 79.7% of GDP.

This period highlights an increased contribution of non-bank financial sector, though its share is relatively small to the entire financial system. The non-bank financial sector's total assets account for about 5.6% of total financial system's assets, from 5.3% and 4.6% at end-2009 and end-2009 H1, respectively. As a share of GDP, they account for about 4.8%, from about 4.4% and 3.5% respectively, at end-2009 and end-2009 H1.

BANKING SYSTEM HIGHLIGHTS

At end-June 2010, banking sector assets totalled ALL 934.7 billion, up by 5.5% from end-2009 and by 12.4% from the previous year[2]. G3 banks account for 72% of the sector's total assets.

Banking sector asset composition highlights:

- Loan portfolio (excluding accrued interests[3]) has amounted to ALL 465.4 billion, up by 4.3% from end-2009 and by 11.1% from the previous year. G3 banks account for 64.8% of the sector's total loan portfolio. Foreign-currency loans account for about 70% of total loans;
- Treasury and interbank operations recorded ALL 275.5 billion, up by 8.3% from end-2009 and 20.6% from the same period of the previous year;
- Bank investments in private and public debt securities (excluding accrued interests), both domestic and foreign, totalled ALL 190.4 billion, up by 7.1% from end-2009 and 11% from the same period of the previous year. G3 banks account for 90.8% of total investments. Investments in Albanian government debt securities of over one-year initial maturity, represent 86.7% of total investments;
- Banking system's foreign currency assets totalled ALL 479.2 billion, up by 7.7% from end-2009 and 19.1% from the same period of the previous year. G3 banks account for 64.7% of total foreign currency assets;
- Bank investments in non-resident assets amounted to ALL 104.8 billion, up by 25.5% from end-2009 and 73.9% from the same period of the previous year. G3 banks account for 71.2% of total investments. Banks' placements at bank holding groups are estimated at ALL 55.7

[2] Related to all comparisons with the previous year, the lek's depreciation should be considered, which impacts on the increased lek-denominated reported value of foreign currency-denominated items. Hence, on 30/06/2009, the average official exchange rate was 1 euro = 130.76 lek and 1 USD = 92.73 lek. On 30/06/2010, the above ratios were 136.45 lek and 111.44 lek respectively.

[3] Estimated at around 4.3 billion

billion, of which ALL 49.8 billion are in the form of current accounts and deposits and ALL 5.9 billion are in the form of loans.

Banking sector liability composition highlights:

- Deposits (excluding accrued interests[4]) totalled around ALL 730 billion, up by 6.8% from end-2009. G3 banks represent 74.1% of total deposits;
- Shareholders' equity amounted to ALL 100.8 billion, up 4.9% from end-2009 and 15.9% from end-June 2009. G3 banks represent 67.2% of total shareholders' equity;
- Foreign currency liabilities totalled ALL 461.7 billion, up 6.5% from end-2009 and 16.9% from the same period of the previous year. G3 banks represent 65.1% of total foreign currency liabilities;
- Banking sector liabilities to non-residents totalled ALL 61.5 billion, up by 4.4% from end-2009, and down by 8.9% from the same period of the previous year. The used amount of lines of credit from bank holding groups totals around ALL 34.6 billion, whilst the committed and unused[5] one totals around ALL 31.6 billion.

As at end-June 2010, off-balance sheet items account for 97.4% of total banking sector assets, up by 3.4 percentage points from end-2009 and down by 5 percentage points from the previous year.

In terms of capitalization of banking sector activity, we highlight:

- Paid-in capital totalled ALL 63.6 billion, up 4.5% from end-2009 and 12.2% from the previous year. Paid-in capital accounts for 6.8% of total assets, an unchanged figure compared to the same period of the previous year;
- Shareholders' equity totalled ALL 89.7 billion, up 5.8% from end-2009 and 15.5% from the same period of the previous year. Shareholders' equity represents 9.6% of total assets from 9.3% a year earlier. G3 banks account for 70.6% of the sector's shareholders' equity;
- Regulatory capital[6] totalled ALL 87.1 billion, up 7.1% from end-2009 and 14.4% from the previous year.

Banking system's liquidity position highlights:

- As at June 2010, banking sector deposits account for 79.5% of total liabilities, or around 2.5 percentage points more than at the same period previous year;
- Banking sector liquid assets account for ALL 260.4 billion or around 27.8% of the sector's total assets. This indicator has fallen slightly by around 0.03 percentage point relative to June 2009 and has grown

[4] *Estimated at ALL 13.1 billion*
[5] *Recorded as off-balance sheet item*
[6] *It represents a supervisory concept, composed of tier 1 capital and additional capital. It incorporates the paid-in capital, reserve requirement, net retained profit, net profit over the exercise period, subordinated debt, outstanding liabilities, etc.*

by about 0.2 percentage point relative to December 2009;

- Loan / deposit ratio is 63.2% or around 1.6 percentage point lower than in end-2009 and nearly 2.7 percentage points lower than in the previous year. This decline has been driven by slower lending growth pace than the deposit one, especially in foreign currency. Foreign currency-denominated loan to deposit ratio is 95.2%, around 4.2 percentage points lower than at end-2009 and around 12.3 percentage points lower than in the previous year. Lek-denominated loan to deposit ratio is 35.4%, being generally stable, around end-2009 level, and nearly 1.4 percentage point higher than in the previous year. However, banking sector lending recovery would raise the loan / deposit ratio again.

Financial performance of the banking sector:

- As at June 2010, average earning assets amounted to ALL 833.5 billion, accounting for approximately 91.2% of the banking sector's average total assets. This indicator has been almost at similar levels with those of end-2009. The ratio of "average interest-bearing liabilities / average interest-earning assets" is 93%, up 1.3 percentage point from end-2009 and 1.7 percentage point from the previous year;
- Operating income[7] of the banking sector is 3.8 billion or up 21.7% from the previous year. Operating costs[8] are ALL 11.4 billion or up 10.9% from the previous year. Consequently, operating cost to income ratio is 53.4%, down from 57.2% at end-2009 and 58.6% in the previous year. General operating expenses[9] to income ratio is 80.9%, down from 94.5% at end-2009 and 94% in the previous year. The above ratios show the banks' efforts to offset increased loan loss provisions (and other reserves) by cutting their operating costs;
- Net profit posted a positive figure, totalling ALL 3.6 billion, about 5 times higher than in the previous year, accounting for 37.2% of total profit generated over 2009. The accumulated profit generated by largest banks, which constitute G3, is ALL 4.8 billion. Accumulated financial loss is ALL 1.8 billion;
- Return on assets (ROA) is 0.8% y-o-y, from 0.2% at the same period a year earlier;
- Return on equity (ROE) is 8.3% y-o-y, from 1.8% at the same period a year earlier.

Highlights from banking system risk assessment and management

a) With respect to exchange rate risk:

- Foreign currency assets and foreign currency liabilities are roughly equal, thereby determining a balanced balance-sheet structure of the banking sector and markedly restricting the adverse effect of exchange rate fluctuations on the banks' balance sheets;

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7 *Net interest income plus other net income.*
8 *Net of provisioning expenses*
9 *Operating cost plus provisioning expenses and other reserves*

- Net open position in foreign exchange as at June 2010 was in "long position", accounting for ALL 6.3 billion or about 7.3% of the regulatory capital. For one quarter, this relative index has been the highest since September 2008, featuring a higher exposure to exchange rate volatility;
- Stress-testing analysis on the banking sector vulnerabilities to adverse changes in exchange rates shows a very moderate impact.

b) With respect to interest rate risk:

- Interest sensitive assets and interest sensitive liabilities are at similar levels, by maturity term, as of June 2010. The gap between them for up to 1-month, up to 3-month and up to 12-month maturity term is negative. Overall, interest rate rise within a 12-month period would cause additional net cost to the banking sector, adversely impacting on its financial result, and in consequence, even on capital ratios. However, according to sensitivity analysis, part of stress-testing, such impact is limited and does not threaten the banking sector's capital adequacy;
- In June 2010, banking sector assets had an average residual maturity of 28.04 months from 29.5 months at end-2009. Meanwhile, referring to the same period, the average residual maturity of banking sector liabilities is 11.4 months, fluctuating slightly from end-2009 value (11.9 months). Narrowing the residual maturity gap of the banking sector assets and liabilities was mainly due to reduced lending pace and increased loan portfolio concentration in shorter terms.

c) With respect to credit risk:

- Banking sector's risky assets[10] account for ALL 537.2 billion, while risk-free assets account for ALL 399.4 billion. High-risk assets[11] amount to ALL 417.7 billion. The value of risky assets is up 6.8% from end-2009 and up 18.9% from the previous year. Risky assets account for 57.5% of total assets, too close to end-2009 figure and up by 3 percentage points from the previous year's one. Their increase to the previous year owes to rise in assets weighted by a higher risk-coefficient, due to regulatory framework provisions;
- The ratio of nonperforming loans to total loans on a gross basis rose to 12.2% from 10.5% at end-2009 and 8.73% on a year earlier. Banking sector loans rose to ALL 57.3 billion, up ALL 10.2 billion or 21.6% from end-2009 and up 20.5 billion or 55.5% from the previous year. According to credit classification, approximately 72.7% of the loan portfolio is considered as "standard". There is noted a credit classification downgrade. Hence, the share of "substandard loans" and "loan loss loans" rose to 5.4% and 3.6% respectively, compared with 4.7% and 3% at end-2009;

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[10] *Banks' risky assets, for the purpose of measuring the capital adequacy ratio, are risk weighted at 20%, 100%, or 150%. Overall, risky assets are dominated by the loan portfolio and include also the debt securities investments, as well as placements with financial institutions.*

[11] *Banking sector's high risk assets, for the purpose of measuring the capital adequacy ratio, are risk-weighted at 100% and 150% coefficient. They are represented mainly by credit, including the foreign-currency one for borrowers whose income is in ALL.*

- The ratio of net non-performing loans to regulatory capital rose to 31.2% from 28.2% at end-2009 and 24.6% a year ago.
- Loan portfolio quality - lending to households and businesses - has deteriorated. The ratio of nonperforming loans to loans outstanding for households and businesses is 13.8% and 10.3% respectively, versus 12.4% and 8.2% at end-2009. Also, the loan portfolio quality – for both lek-denominated portfolio and foreign currency one - has been downward. Hence, ALL non-performing loans to ALL outstanding loans is 12.7% (versus 10.1% at end-2009), whilst the foreign-currency one is 11.9% (versus 10.6% at end-2009);
- Outstanding foreign-currency credit (when borrower's income is in Lek) is about ALL 177.6 billion or 37.7% of total outstanding loans and about 54% of foreign currency outstanding loans. By currency, about 84% of this loan is in euro and about 15% is in USD. Against total foreign currency outstanding loans, the loan in euro shares 45.6% and it occupies 8.2% in USD. This part of credit represents a potential channel for a negative impact of adverse exchange rate changes on the banking sector. Such changes may be associated with increased indirect credit risk as a result of borrowers' difficulties in loan repayment;
- Credit risk provisions for loans to residents rose to ALL 30.1 billion, up by 24.6% from end-2009 and up by 66% from the previous year. The ratio of provisions to non-performing loans is 52.5%, almost unchanged from the previous three quarters. The ratio of provisions to total outstanding loan rose to 6.4% from 5.4% at end-2009 and 4.3% a year earlier. Also, the coverage of non-performing loans by collateral is 78%, which shows a satisfactory level.

d) With respect to liquidity risk:

- The ratio of liquid assets to short-term liabilities (of a maturity term of up to one-year) is 32.8% versus 32.6% at end-2009, while remaining above the 20% minimum defined under the regulatory framework. By currency, the value of this ratio is lower for the euro by about 13.7%, and higher for the lek by about 46.5%;
- The maturity gap between assets and liabilities by maturity structure[12] - for both balance sheet and off-balance sheet items – results in negative values. However, such mismatches are covered several times by liquid assets' value, presenting a full capacity for paying off the liabilities when they fall due. However, in this context, the foreign currency liquidity position, especially the one in euro should be cautiously monitored;
- Borrowing from the interbank market or from the Bank of Albania is another form of managing short-term liquidity needs. It is generally a collateralized borrowing, and the type and adequacy of assets that may serve as collateral in such a case is another element that should be monitored to assess banks' ability to meet their short-term needs for liquidity.

e) With respect to solvency:

[12] *Assuming assets and liabilities are held to maturity.*

- As at end of 2010 Q2, the Albanian banking sector is estimated as well-capitalised. Capital adequacy ratio is 16.2%, similar to end-2009 figure, but 0.6 percentage point lower than a year earlier. The minimum level of this indicator, defined under the regulatory framework, is 12%. By banks peer groups, G2 banks hit the lowest record by 14%;

We have built and measured the financial strength index quarterly to assess the banking sector's overall condition through a single index. It takes into account the performance of several sub-indices, encompassing: asset quality, liquidity, exchange rate risk, profitability, capital adequacy and interest rate risk. It is estimated that at end-2010H1, the value of the financial strength index amounted to about 85.2, slightly falling by 0.3% compared with end-2009. Over the last quarter, the index performance was determined by asset quality impairment, exchange rate volatility (due to a higher risk as a result of increased foreign exchange open position) and liquidity. Profitability and interest rate sub-indices have had a rising positive performance. Capital adequacy sub-index has been stable. The index decline below its average is interrupted, becoming stable in last four quarters.

We have conducted stress-testing, in order to assess the banking sector's resilience to assumed adverse economic events and its needs for additional capital. It contains the "sensitivity" and "scenarios" analysis. According to sensitivity analysis, the banking sector proved to be resilient to exchange rate risk and interest rate risk. If a doubling of credit value is assumed, the banking sector would be more sensitive to credit risk. According to scenario analysis, the banking sector's needs for additional capital are assessed in view of the combined impact of several macroeconomic factors and internal developments of financial indicators of the banking sector, which include adverse changes to exchange rates, interest rates, economic performance, credit growth rate performance and their reflection in non-performing loan performance. The analysis shows that the banking sector can cope well with further loan portfolio impairment, extended over a one-year span. Also, according to this analysis, the banks' capital requirements are reflected in the case of markedly impaired economic situation. In general, the scenario analysis, part of stress-testing exercise, reveals that concerning the baseline scenarios containing likely developments for 2010-2011, the banking sector is resilient to any severe shocks caused from adverse volatility in economic factors and credit quality impairment. However, individual banks would need additional capital, depending on the situation. In the likelihood of extreme events, the banking sector poses problems regarding capital ratio and capital requirements of certain banks which are particularly sensitive. Although this is just an exercise making assumptions that are less likely to materialize, the banks must test their resilience by carrying out similar exercises and making ongoing and preliminary assessment of their needs for additional capital.

1. GLOBAL DEVELOPMENTS

1.1. OVERALL GLOBAL ECONOMIC DEVELOPMENTS

The global economy grew by about 4.7% year on year in 2010 H1, owing to ongoing stimulating policies of public authorities and gradual improvement of financial market operation. In line with the stage of development, the annual economic growth rate was higher in developing countries, recording about 7.25%. Asian countries exerted a major influence on the developing countries' economic growth, highlighting China, India and Indonesia. In Latin America, Brazil made a major contribution to economic growth. The sustainable domestic demand and significant recovery in the international trade are supportive factors to the developing countries' economic growth. The developed countries' annual economic growth rate as at end-2010H1 is about 3%.

Economic developments were more positive in 2010 Q1, when industrial production and trade recorded double-digit growth. Unemployment rate in the developed countries started to stabilize and generally consumer confidence indicators were improved. Global inflation developments were moderate; however, inflationary pressures were sharper in the developing countries, where economic growth was faster. This period has experienced a better operation of financial markets, owing to sustained growth of activity and downward interest rate trend. Investors' confidence has improved, bringing about a gradual shifting of investments from safe assets to high-risk ones, particularly to emerging markets. Consequently, market liquidity was significantly improved, providing the central banks with the opportunity to start gradually withdraw some support measures that were in place during the financial crisis.

In 2010 Q2, due to fiscal sustainability concerns of some euro area countries, the uncertainty of markets and economic agents returned. In the short run, this brought about contracted activity of financial markets and tightening liquidity conditions. Decisive actions taken by the authorities of the European Union (EU) and the European Central Bank (ECB) helped overcome a critical situation and restore the smooth functioning of the markets. However, the turmoil in European financial markets was transmitted to emerging markets through a decline in investors' demand for public and private sector's assets. Consequently, in currency, securities and debt capital markets, as well as in raw materials production ones, the fluctuations were obvious but short-term. These fluctuations, however, support expectations for a decline in world economy growth rate in the period ahead.

The United States economy in 2010 Q1 and Q2 continued to post positive but slower growth paces, compared to 2009 Q4. In 2010 Q1, real GDP increased at an annual rate of 3.7%, while in 2010 Q2[13], it increased 2.4%. GDP growth over the course of both quarters has reflected the positive contribution of business investments, while it has been contained from the negative contribution of foreign trade balance. Also, consumption remains generally weak due to persistence in unemployment rate and volatility in real estate value. Annual unemployment rate eased slightly in 2010 Q1 and Q2, compared to 2009 Q4, being stabilized at 9.7% on average. During 2010 H1, inflationary pressures remained low and annual inflation rate was 1.8%. Therefore, the United Sates Federal Reserve kept the key interest rate unchanged, at 0.25%. With respect to foreign trade, current account deficit rose to about 3% of GDP in 2010 Q1, compared with 2.8% of GDP for the last quarter of 2009[14].

In the fiscal area, the public sector posted a high deficit, due to the combined effect between financial stimulus and rescue packages, and automatic stabilizers of the budget.

Authorities' projections[15] show a gradual improvement of budget deficit, but public debt values are expected to remain high in several years ahead.

Table 1 Key macroeconomic indicators in the USA

	Q3 '09	Q4'09	Q1'10	Q2'10
Real GDP growth (% y-o-y)	1.6	5.0	3.7	2.4
Inflation rate (% y-o-y)	-1.6	1.4	2.4	1.8
Unemployment rate (% y-o-y)	9.6	10	9.7	9.7
Budget deficit (% of GDP)	-11.6	-11.1	-10.9	..
Gross government debt (% of GDP)	65.8	67.6	70.7	..

Source: ECB database, ECB-Monthly Bulletin, BEA

Persistent funding needs of the U.S. government and, overall, insufficient funding needs of the private sector, have put into question the achievement of the objective for a gradual phasing out of market liquidity support measures by the United States Federal Reserve. At the same time, steady unemployment rate and trade deficit, as well as moderate inflation rate, will affect the implementation of an accommodative monetary policy in the foreseeable period.

The European economy continued to improve in 2010 H1, but at slower rates than in the United States and with pronounced heterogeneity across countries. Germany and Sweden headed the economic growth in EU countries, while Greece and Spain have continued to experience economic downturn. It is estimated[16] that the GDP for the EU and the euro area rose by 0.2% in 2010 Q1 and 1% in 2010 Q2. In annual terms[17], GDP growth in the first quarter resulted 0.5% for the EU region and 0.6% for the euro-area region.

13 *According to Economic Analysis Office*
14 *The figures are released by BEA in its publication of 17 July 2010.*
15 *Congressional Budget Office (COB)*
16 *Eurostat, Publication of 13 August, 2010*
17 *Difference in percentage between the actual quarter and last year's same quarter.*

In the second quarter, growth is estimated at 1.7% in each region (Table 2). In the first quarter, growth is attributed to positive contribution of inventories and private sector's investments, which have exceeded the negative effect of domestic demand and net exports. Inflationary pressures in the EU and the euro area in general, remained moderate over the first half of the year. In June 2010, annual inflation rates for the EU and the euro-area resulted 1.9% and 1.4% respectively. Lowest inflation rates were reached in Ireland (-2.0%) and Latvia (-1.6%), while the record highs were reached in Greece (5.2%) and Hungary (5.0%).

In terms of euro-area trade developments, 2010 Q1 attested to increased imports and exports; however, the net effect on the economic growth was negative. High trade growth rate over this period can be regarded as a redress of its sharp decline in 2008 and 2009 H1. The latest data show that the level of the euro-area trade has continued to grow even after the first quarter, but at a slightly slower pace. The euro-area labour market conditions seem to have stabilized. In 2010 Q1, the average employment rate in the euro area remained unchanged, which is assessed as positive compared with the sharp contraction observed in the previous periods. Unemployment rate of this region remained stady, at 10%, for several months until July 2010, suggesting a stabilization of the labour market even for the months ahead.

Table 2 Key macroeconomic indicators in the EU and the euro area

	GDP growth (%)			Inflation (annual rate)			Monthly unemployment (in %)	
	Q4-09/ Q4-08	Q1-10/ Q1-09	Q2-10/ Q2-09	July 10/ July 09	June 10/ June 09	April 10/ April 09	June '10	June '10
EU	-2.3	0.5	1.7	2.1	1.9	2.0	9.6	9.6
Euro area	-2.1	0.6	1.7	1.7	1.4	1.6	10.0	10.0
Germany	-2.0	2.0	3.7	1.2	0.8	1.2	7.0	7.0
France	-0.5	1.2	1.7	1.9	1.7	1.9	9.9	10.0
Italy	-0.8	0.5	1.1	1.8	1.5	1.6	8.6	8.5
Greece	-2.6	-2.3	-3.5	5.5	5.2	5.3	..	11*
Non-euro area								
United Kingdom	-2.9	-0.2	1.6	..	3.2	3.4	..	7.9*

Source: Eurostat, ECB database

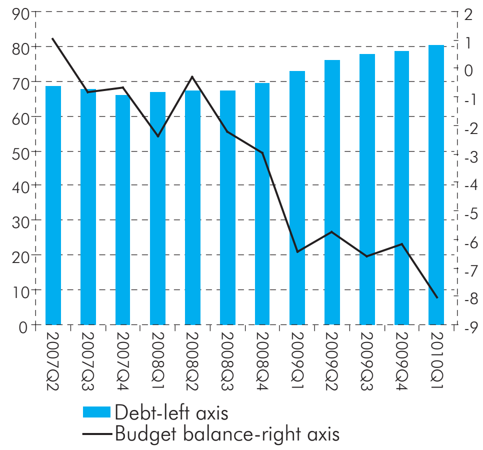
Euro area fiscal positions continued to deteriorate during 2010 H1.

The situation became dramatic in Q2 of the year, after acute difficulties posed to Greece and the fears about their spilling over to other countries, such as Spain, Ireland and Portugal. Markets began to speculate on euro-area stability project. Therefore, the European Union, supported by the IMF, immediately decided a 110 billion euro bailout for Greece, in exchange for commitments from the Greek government to rein the extraordinary budget deficit by curtailing expenditure and raising taxes. Almost each Member State rushed to announce targets on reining budget deficits[18], as a preventive measure against various speculations in the markets. In a more formalized way,

18 See Box 1.

in May the European Union Member States decided to adopt the European Commission's proposal to establish a European Financial Stabilization Mechanism. The scope of this undertaking was to respond swiftly, effectively and in a harmonized way to acute difficulties in budget deficit financing of each Member State, thus reducing the negative speculations in the markets. Simultaneously, the European Commission submitted proposals for a strong commitment to accelerating fiscal consolidation, in compliance with the Stability and Growth Pact (SGP). Under the proposals, the national budgets of each Member State would go through an early-peer review to ensure that they are in compliance with the SGP targets and consistent over time. The budget-rule breakers of the Stability and Growth Pact shall be subject to disciplinary action and financial sanctions, in order to help improve the situation. In terms of monetary policy stance, the European Central Bank (ECB) took necessary actions to restore liquidity to government debt securities markets.

Chart 1 Euro area budget balance and public debt



Source: Eurostat

The situation of public sector finances in the euro area is expected to remain difficult during the rest of 2010, when the average budget deficit is expected to account for 6.6% of GDP. A gradual improvement[19] is expected over the next year, when the euro area average budget deficit is expected to fall to 6.1% of GDP. In general, over the next year, budget deficits of most Member States are expected to stabilize and in several cases even to decline.

In the Central and Eastern Europe, the macroeconomic situation has been improving gradually. Among the largest central and Eastern European EU countries, only Romania registered negative growth in real GDP in 2010 Q1 (-0.3%), standing at -0.3 quarter on quarter. In general, confidence indicators, industrial production and trade figures on the countries of this region show an improved economic activity. On the other hand, rising unemployment and weak credit conditions (particularly in Hungary and Romania), point to continued weakness in domestic demand and make the growth rate volatile. Moreover, in this region, inflation has been hovering at a low level.

[19] According to European Commission, Forecast Spring 2010

Table 3 Macroeconomic indicators in Central and Eastern Europe and Balkan countries

	Real GGP growth (%)			Inflation (annual average)			Monthly Unemployment (%)	
	Q4-09/ Q4-08	Q1-10/ Q1-09	Q2-10/ Q2-09	July 10/ July 09	June 10/ June 09	April 10/ April 09	May '10	June'10
Hungary	-4.8	-1.2	0.1	3.6	5.0	4.9	10.4	10.4
Czech Republic	-3.2	0.9	2.2	10.0	1.0	0.9	7.5	7.4
Poland	2.8	2.8	..	2.4	2.3	2.7	9.7	9.6
Balkan region								
Bulgaria	-5.9	-3.6	-1.5	3.2	2.5	3.0	9.7	9.7
Romania	-6.9	-3.2	..	7.1	4.3	4.4	..	..
Serbia		0.6			4.2			
FYROM		0.9			1.8			
Baltic countries								
Estonia	-9.5	-2	3.5	2.8	3.4	2.8		
Latvia	-16.8	-5.1	-3.9	-0.7	-1.6	-2.4		
Lithuania	-12.5	-2.7	1.1	1.7	0.9	0.5		

Source: Eurostat database, Eurostat Newsrelease, respective central banks
** Data on 2010 Q1*

World growth expectations for the rest of the year are positive but slower than in 2010 H1. The growth rate hinges on the way public authorities will embark on the process of fiscal consolidation and on financial market performance, driven by the need for a sustained credit recovery. Growth in advanced economies is expected to be 2.5% in 2010 and 2011[20]. Somewhat stronger projected growth in the United States is offset by slightly weaker growth in the euro area, albeit with substantial differences among its Member States. The major challenge posed to the recovery in these economies is fiscal consolidation, control over unemployment and bank lending recovery. Inflation pressures are expected to remain subdued in advanced economies, owing to still-low levels of capacity utilization and well-anchored inflation expectations. For 2011, growth in emerging and developing economies is projected at 6.5% on an annual basis. Key emerging economies in Asia and Latin America continue to lead the recovery. In contrast to advanced economies, in emerging and developing economies, inflation is expected to edge up to 6.25 percent in 2010 before subsiding to 5 percent in 2011. Uneven economic performance is expected even across different countries of the South East Europe.

Economies that faced the financial crisis relatively well, like Poland, and those that have successfully withstood the external shocks, such as Turkey, are expected to have a satisfactory growth, supported by return of capital inflows and further improvement in world trade. On the other hand, countries that were faced with the crisis against a setting of pronounced negative current account balance, such as Bulgaria, Latvia, Lithuania, or that had a weak fiscal position, such as Hungary and Romania, are expected to register a slow economic recovery.

[20] *International Monetary Fund: World Economic Outlook" July 2010.*

Box 1 Fiscal consolidation programmes in some EU countries

Greece - The Greek government is committed to cut the budget deficit to 3% of GDP by '2014 (from its 2009 level of 13.6%), as set forth by the Stability Pact, which means cutting government spending by EUR 30 billion. Some of the projected measures are: pension scheme reorganization and retirement age rise; bonus abolishment for civil servants; three-year freeze on civil service pays and pensions; VAT rate rise to 23 % (from 19%); tax rise on tobacco, fuel and alcohol by 10%.

Italy - The Italian government has adopted measures to cut the budget deficit by EUR 24 billion (or 1.6% of GDP) over the course of 2011-2012, in order to reduce the deficit below the threshold of 3% of GDP. Austerity measures include: public sector wage cuts; three-year freeze on new recruitments; progressive pay cuts of up to 10% for high earners in the public sector; retirement age rise, etc.

Spain – Spain's prolonged economic recession has deepened its budget deficit to more than 11% of GDP, much higher than the EU threshold. On May 12, the Spanish government announced government spending cut up to EUR 15 billion over the course of 2010-2011. Some measures include: civil service pay cut by 5%, starting in June and keeping them unchanged for 2011; EUR 6 billion cut from public sector investment; pensions payment freeze.

Republic of Ireland - Irish government has announced three austerity budgets in just over a year. Currently, Ireland's fiscal deficit is 12% of GDP and the government aims to reduce it to 2.9% of GDP by 2014. Measures include: about EUR 760 million savings on Social Welfare payments; about EUR 960 million savings on investment projects; reduction of allowances for families with many children; introduction of a carbon tax of EUR 15 per tonne of CO2 emissions, etc.

Germany - The German government has proposed plans to cut the budget deficit by a record 80 bn euros, or 3% of GDP, by 2014. The total deficit in 2009 was 3.1%, but is projected to grow to more than 5% in 2010. The plans include: a cut in subsidies to parents; 10,000 government job cuts over four years; postponement of some public investments....

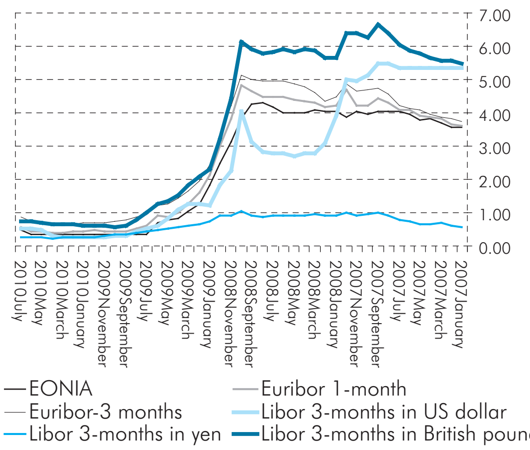
United Kingdom – Britain's Government has announced government spending cut by 6.2 billion pounds (EUR 7.2 billion) over 2010-2011, however, making it clear that this is only the first step towards deep budget deficit cut by 156 billion pounds, or 11% of GDP.

Portugal - The Portuguese government has announced a range of austerity measures aimed at curbing the budget deficit to 7.3% of GDP in 2010 and 4.6% in 2011. In 2009, Portugal's budget deficit amounted to 9.4% of GDP, which caused a massive selling of Portuguese assets by investors. The austerity measures include: A 5% pay cut for top earners in the public sector; 1% rise in VAT; income tax hikes for those earning above 150,000 euros a year; by 2013 military spending will have been cut by 40%.

1.2. KEY DEVELOPMENTS IN THE INTERNATIONAL FINANCIAL MARKETS

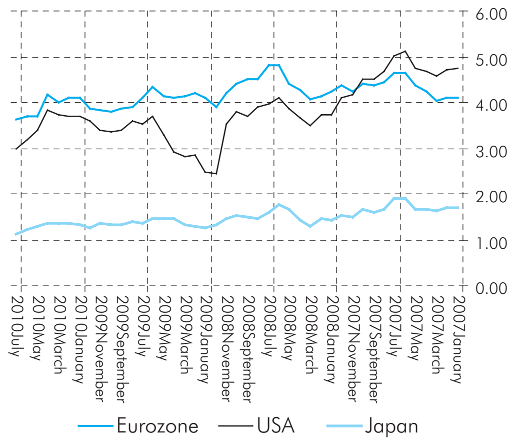
Stabilization and recovery of international financial markets, which had started since last year and was largely supported by the monetary authorities,

Chart 2 Key interest rates in the money market



Source: ECB, Eurostat

Chart 3 10-year government bond yields



Source: ECB database

continued steadily over the first months of 2010. Interest rates went on falling gradually in the whole spectrum of maturity terms and the volume of activity increased dramatically in money markets, debt securities and capital markets. This trend was even more pronounced in developing economies.

During 2010 Q1, the global banking sector performance was generally positive, making significant steps towards financial recovery. Large and complex banking groups' return on equity (ROE) and return on assets (ROA) reached 12.5% and 0.9% respectively, compared with 6% and 0.3% at end-2009[21].

This performance reflected the overall improved economic climate and very accommodative monetary policies pursued in the advanced economies of the world[22]. Driven by these positive developments, the U.S. Federal Reserve and the ECB announced their willingness to start a gradual withdrawal from the support measures of the crisis.

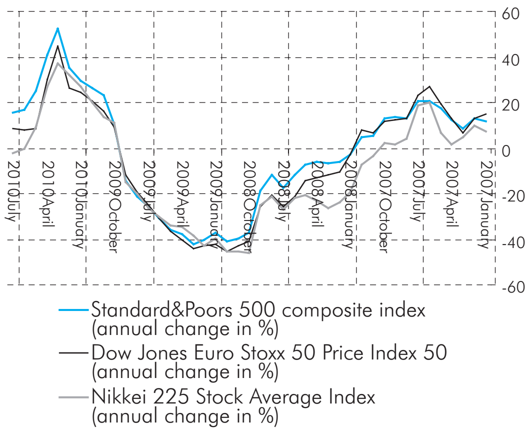
However, at the beginning of the second quarter, the relative calmness in financial markets was hit by a severely deteriorated fiscal situation in some euro-area countries, particularly in Greece. Increased sovereign credit risk exerted a greater influence on the European interbank market, where transactions fell sharply due to uncertainty on banks' exposure to government debt securities. In financial markets, worries about the real magnitude of such an exposure were intensified and were associated with a decline and volatility in the European banks' stock price and markedly raised the risk premiums for hedging against credit risk (Collateralized Debt Securities). According to the ECB, this situation could impair the functioning of other financial market segments and harm the effective conduct of monetary policy. Hence, on May 10, 2010, the ECB announced the validity of government debt securities of Greece as collateral in market liquidity-providing operations, regardless of their quality decline below the minimum threshold, previously agreed on by the ECB. Furthermore, the ECB made an unprecedented step, by deciding to purchase euro-area public debt, in order to restore the functioning of certain market segments. In terms of open market operations, the ECB resumed liquidity-providing operations at a fixed interest rate in the regular auctions and also decided to re-establish foreign exchange swap lines with the U.S.

[21] *ECB Financial Stability Review, June 2010.*

[22] *The ECB kept the key interest rate at 1%, whereas the Federal Reserve held it at 0-0.25%. The Bank of England and Japan held it at 0.1%.*

Federal Reserve. These measures accompanied those taken by the European Commission and the IMF to help Greece and yielded downward tension in the money markets. However, euro-area banks continue to have a high demand for liquidity and hold funds at ECB's liquidity support facilities. Amid waning confidence, investors sought safer assets, leading to a further shift in investors' demand for gold and debt securities of the government of USA and Germany. At the same time, stock markets dropped markedly over the course of this period.

Chart 4 Main indices of the stock market



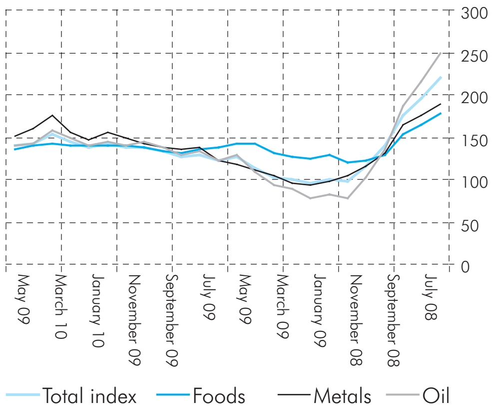
Source: ECB database

The tightened conditions in the interbank market and in sovereign debt securities, as well as the insufficient growth, have put into question the usefulness of exit from monetary and fiscal stimulus measures that public authorities had taken several months earlier. Financial markets expect from main central banks to pursue a very accommodative monetary policy over a longer period.

In terms of credit market, the improved overall economic situation in 2010 H1 was associated with decreased funding costs and larger access to funding. The volume of new issues in the American private sector edged up and additional cost of corporate debt to sovereign debt narrowed. In the European market as well, better liquidity conditions and funding cost cut created better grounds for extending the corporate debt issuance term. However, the growth rate of issues has been downward, especially for financial corporations. In the covered bond markets of the euro-area, the issue level was quite high, especially in the first four months of the year, significantly exceeding the previous year's volume. The newly-issued bonds maturity term was also upward, reflecting improved financial conditions in financial markets. Anyway, these positive developments were greatly backed by the Eurosystem's covered bond purchase program. As regards structured products, despite a slight improvement in 2010 Q1, their activity remained contracted in both USA and Europe. In terms of the U.S. mortgage market, the activity was weak due to low prices in the housing market and high rate of default related to these products. The Federal Reserve has continued to play an important role in the functioning of U.S. credit markets, especially in mortgage-backed securities.

In foreign exchange markets, the euro has depreciated against the U.S. dollar and Japanese yen. In mid-May 2010, concerns about the fiscal situation in the euro area, made the euro hit the lowest level in four years vs. the dollar, to $ 1.20 per euro, down by 14% against the 2009 average. On the other hand, the euro has been weakening gradually but steadily vs. the Japanese yen. The rapid growth of Chinese economy has raised the authorities' concerns about inflationary effects on the country and has led to the need for a more active policy in controlling the domestic demand. Therefore, in

Chart 6 Primary commodity price indices



Source: IMF database

June 2010, China's central bank announced that it would allow greater flexibility in the value of the Chinese currency, after pegging it to the dollar at the value of 1 $ = 6.83 yuan for nearly two years. However, the statement was the clearest sign yet that the country would allow its currency to appreciate gradually against the dollar.

Primary commodity prices were steadier, due to better economic performance world-wide. Developing countries' stable demand was offset by a higher flexibility of supply, in terms of export support policies.

The short-term forecast on the performance of primary commodity markets will hinge on the speed and sustainability of global economic recovery. The rise in the global economic activity is expected to maintain a high demand, thus positively impacting on oil and other primary commodity prices. However, these pressures are expected to alleviate owing to high unused capacity levels and supply growth in line with the demand and rising prices.

Box 2 Financial data on foreign bank groups present in Albania

1. RAIFFEISEN INTERNATIONAL (AUSTRI)[2]
As at 2010 H1 end, the Raiffeisen International's balance sheet total rose by 2.4% compared with the end of 2009 to Eur 78.1 billion. Deposits from customers rose by 1.6% to Eur 43.26 billion versus the end of 2009. Loans to customers rose by 4%, or Eur 1.9 billion. The loan/deposit ratio rose by 2 percentage points to 121% versus the end of 2009.

The ratio of nonperforming loans to total credit risk (loans and advances, securities, and off-balance sheet items) was 6.0% (from 5.1% at the end of 2009).

Consolidated profit after tax was Eur 171 million in 2010 H1, or a plus of 118.6% from the same period of the previous year. Net allocations to provisioning for impairment losses were reduced significantly in 2010 H1. They amounted to Eur 560 million and were thus 42%, or Eur 409 million, below the comparable period last year.

Return on equity before tax climbed by 3.7 percentage points to 8.6% on the comparable period last year. Capital adequacy ratio of Raiffeisen International, as at 2010 H1 end was 16.1% versus 16.3% at year-end 2009.

As at 2010 H1 end, the Raiffeisen Bank Albania accounted for about 2.5% of total assets of the Raiffeisen International.

1 *The following information and data are obtained from respective banking groups' websites.*
2 *Source: www.ri.co.at "Semi-Annual Financial Report, 30 June 2010".*

2. INTESA SANPAOLO (ITALI)[3]
Intesa Sanpaolo closed 2010 H1 with total assets of around Eur 655 billion, up 4.6% versus end-2009. Loans to customers accounted for EUR 374.8 billion, down 0.2% versus end-2009, while customer deposits amounted to EUR 436.5 billion, up 3.3% from end-2009.

In 2010 H1, net income grew to EUR 1.69 billion, up 6.4% from EUR 1.59 million in the same period of 2009. Provisioning and depreciation expenses totalled EUR 1.47 billion, down 17.9% compared to the same period last year.

Return on average equity was 4.9% in 2010 H1, from 5.2% in 2009 H1.
Capital adequacy ratio was 12.2%, from 11.8% at end-2009.

As at 2010 H1 end, Intesa Sanpaolo Bank Albania accounted for 0.1% of Intesa Sanpaolo's total assets.

[3] Source:www.group.intesasanpaolo.com "Press Release – Intesa Sanpaolo, Consolidated results as at June 2010".

3. ALPHA BANK (GREECE)[5]
As at 2010 H1 end, Alpha Bank reported EUR 68.0 billion total assets, or down 8.1% from the same period of the previous year. Total deposits stood at EUR 39.7 billion, down 7.4% from the previous year. In Greece, deposits declined by 8.9%, while in SEE they grew by 1.0% compared to the first half of last year. Loans and advances to customers reached EUR 53.3 billion, up 2.0% versus the same period of the previous year. This development was driven by a 2.6% volume expansion in Greece and a 3.7% expansion in SEE portfolio.

Impairment loan losses amounted to EUR 421.3 million (with a 28.9% annual increase), of which 95.6 million belonged to SEE (53.0% higher than in the first half of last year). NPL ratio reached 6.9%, from 7.2% in the Balkan.

At the end of 2010 H1, Alpha Bank posted a net profit of EUR 38.2 million[6] (a decline of 82.2% versus the same period last year, reflecting the slowdown of economic activity in Greece and the region, and a one-off tax imposed by the Greek government on 2009 profit.

At 2010 H1 end, Alpha Bank had a capital adequacy ratio of 13.0%, from 13.3% at year-end 2009.

As at end of 2010 H1, Alpha Bank, Albania (branch), accounted for about 0.7% of total assets of Alpha Bank (Greece).

[5] www.alpha.gr/page/ "Press statement on the results of the second quarter 2010".
[6] If one-off tax imposed by the Greek Government on 2009 profit is not considered, the first half would have been closed with a net profit of EUR 100.2 million.

4. PIRAEUS BANK (GREECE)[7]
As at the end of first half of 2010, the Piraeus Bank's assets totalled about EUR 56.6 billion, by 5% from the same period of 2009. Net loans were about EUR 38.5 billion, up 3% compared to the previous year, while deposits were EUR 29.7 billion, down 7% compared to the previous year.

Net profit was EUR 10 million, falling sharply by about 92% compared to 2009 H1, as a consequence of considerable annual increase of provisioning by about 30%. Return on average equity in second quarter 2010 was about 0.4 percent, down from the 0.9% figure of the first quarter.

The capital adequacy ratio is 9.7%, a steady figure since year-end 2009.
As at the end of 2010 H1, total assets of the Tirana Bank accounted for about 1.1% of the Piraeus Bank's ones.[7]

[7] Source: www.piraeusbank.gr/. "Results of 2010 H1"

5. NATIONAL BANK OF GREECE (GREECE)[8]
At the end of H1 2010, the NBG Group's total assets reached EUR 122.1 billion, up 10% from the same period of the previous year.

Total credit in SEE reached EUR 7.8 billion, slightly down 4%, compared to H1 2009. In this region, deposits went up 4%, to EUR 4.5 billion.

Group net profit in H1 2010 reached EUR 146 million, down 79% yoy. Greece contributed negatively to this result (-159 million euros), while SEE and Cyprus contributed positively (+ 54 million euros, down 16% versus H1 2009). The net profit was burdened by extraordinary tax charge, mark-to-marked valuation losses in the Greek sovereign bond portfolio, and continued high provisions for NPLs the. Nevertheless, Group operating income (before tax, provisions and trading activity) grew 4% yoy. In spite of high provisions and the effect of the crisis, the Group continued to post profitability in all the SEE countries. The net profit of their SE European units amounted to EUR 50 million, down 11% yoy.

Group capital adequacy ratio at the end of H1 2010 was 10.5%, from 11.3% at year-end 2009.

As at end of H1 2010, the National Bank of Greece-Albania branch accounted for about 0.3% of total assets of NBG Group.

[8] Source: www.nbg.gr/ Press Release on "NPG Group Results Q2 2010", and ther released data.

6. SOCIÉTÉ GÉNÉRALE (FRANCE)[9]
At the end of H1 2010, the Societe Generale's total assets were EUR 1 133.7 billion, up 11% versus end-year figure. Loans to customers were EUR 362.7 billion, up 5% vs year-end 2009. Customer deposits rose by 5% vs year-end 2009, to EUR 316.4 billion at the end of the first half.

Societe Generale Group net banking income in H1 2010 was EUR 2.15 billion (from EUR 31 million in H1 2009). Group ROE after tax was 11.0%.
The international network's contribution to Group net income totaled EUR 239 million in H1 2010 (down 3.2% yoy), with a 13.2% ROE.

At the end of H1 2010, the Group modified adequacy ratio 10.7%, unchanged from the 2009 figure. As at end H1 2010, Banka Popullore (currently the Societe Generale-Albania) accounted for about 0.03% of the Group's total assets.

[9] Source www.societegenerale.com/ Press Release "Q2 2010 Financial Result".

7. CREDIT AGRICOLE (FRANCE) and EMPORIKI (GREECE)[10]

As at H1 2010, Credit Agricole Group's total assets were Eur 1,900.6 billion, up 12.2% from end-2009. Loans amounted to EUR 877.2 billion (up 8.3% vs. end-2009), while deposits were EUR 748.9 billion (up 8.6% vs. end 2009).

Group net income was EUR 849 million, about twice higher yoy.

At the end of H1 2010, costs associated with the risk amounted to EUR 569 million, up 58.1% yoy, reflecting the developments in the Greek economy. Meanwhile, net income from banking activities increased 8.7% yoy, making a contribution of EUR 364 million.

Group capital adequacy ratio was 13.1% vs. 12.8 percent at end-2009.

At the end of H1 2010, Emporiki Bank in Albania accounted for about 0.01% of Credit Agricole Group's total assets.

[10] *Source: www.credit-agricole.fr "Financial review, 30 June 2010".*

2. MACROECONOMIC DEVELOPMENTS OVER 2010 H1

After the negative economic growth in 2009 Q4, the 2% expansion in 2010 Q1 and the real sector indicators suggest that Albanian economy has performed positively over the first half of the year. A moderate inflation rate, stable exchange rate, increased foreign investments and significant correction of external trade position characterize this period. Slower rise of wage and employment indicators, decreased remittances and still tight financing conditions have adversely influenced the performance of private consumption. In line with the objective to rein the budget deficit of the year, the fiscal policy has been tighter.

Improved banking sector liquidity, reflected in the growth of deposits, has provided better conditions supportive to private investments. However, low capacity utilization rate by firms has not supported the increased demand for private sector investment. On the other hand, the banking sector's financing cost remains relatively high. Increased imports of capital assets by private entities, as well as businesses' greater interest in banks, support expectations for a gradual recovery of credit demand by the private sector.

The public sector's contribution to aggregate demand continued to be positive, but much less important than last year. Fiscal policy has been more prudential in terms of debt indicators, which is assessed as positive for the country's risk premium. In 2010 H1 the budget deficit fell by 36% y-o-y. Greatest impact on such a performance was given by budget expenditure cut, since revenue growth was lower than the projection. In terms of budget deficit financing, there was a high demand of market participants for government debt securities.

In 2010 H1, foreign trade position highlighted a significant correction of the trade deficit. Exports grew by 14%, whilst imports fell by 3% y-o-y. As a result, trade deficit was contracted by 19% vs. 2009 H1 and 12% vs. end-2009.

Ensuring timely stability in export improvement requires supportive public policies and assumes importance against the backdrop of relatively unstable funding sources of trade deficit and current account. Actually, in 2010 Q1, remittances decreased by 7.3% y-o-y. In the light of weak labour market indicators in the euro-area countries and the crucial situation in Greece, the flow of remittances may be volatile in the future. On the other hand, the positive tourism development trend represents a factor that promotes the growth of foreign exchange inflows in the future.

In 2010 H1, inflationary pressures were held in check and inflation rate fluctuated within the 2-4% targeted rate of the Bank of Albania.

Table 4 Key macroeconomic indicators

	2002	2003	2004	2005	2006	2007	2008	2009	H1 2010
Annual Real GDP growth in %	4.23	5.77	5.71	5.72	5.4	6	7.7	3.3	2*
GDP at current prices, in million ALL	622,711	694,098	750,785	814,797	882,209	966,651	1,087,867	1,153,000	1,217,000**
Number of employed persons, in thousand	921	928	917	932	934	935	970	899	900***
Unemployment rate	15.8	15	14.6	14.2	13.8	13.4	12.6	13.75	13.83***
Inflation rate, y-o-y	1.7	3.3	2.2	2	2.5	2.9	3.4	3.5	3.2
Budget deficit (including grants, in % of GDP)	-6.6	-4.5	-5.1	-3.6	-3.1	-3.5	-5.7	-7	-1.7****
Public debt (in % of GDP)	65.3	61.7	56.6	56.7	55.9	52.2	55.9	59.6**	57.8**
External debt (in % of GDP)	23.5	20.6	18	17.5	17.2	14.4	18.3	23.38**	23. 6**
ALL/USD average exchange rate	140.1	121.9	102.8	99.8	98.1	90.4	83.9	95.0	104.25
ALL/EUR average exchange rate	132.4	137.5	127.7	124.2	123.1	123.6	122.8	132.1	137.99

** Growth in 2010 Q1*
*** IMF, July 2010*
****2010 Q1*
*****Cumulative deficit of the six-month period vs. annual GDP*
Source: INSTAT, Bank of Albania, Ministry of Finance, IMF.

2.1. PERFORMANCE OF ALBANIAN ECONOMY AND BUSINESSES

Real annual growth rate was 2% in 2010 Q1 vs. 1.8% at end-2009. Owing to sustained demand for primary commodity exports, the industrial sector had the highest growth, up 27.5% y-o-y. Construction sector has contracted by 21.1% y-o-y. The decline in this sector's contribution, coupled with decreased real estate investments by households and firms, and reduced real estate lending, reflect public spending contraction in this sector. Service sector, having the largest share to domestic product, grew by 3.4% in 2010 Q1, continuing the slowdown noted in 2009 H2.

Table 5 GDP by economic activity, annual percentage changes

	Q1-08	Q2-08	Q3-08	Q4-08	Q1-09	Q2-09	Q3-09	Q4-09	Q1-10
Agriculture, animal farming, hunting and forestry	8.2	7.2	6.6	7.4	2.8	2.9	2.7	1.7	2.3
Industry	-12	2.4	14.3	20.8	3.2	-0.7	-7.1	-3.6	27.5
Construction	9.3	22.6	18.6	-1.4	0.3	19.2	0.7	-15	-21.1
Trade, hotels and restaurants	13	7.4	8.7	3	2.1	3.6	6.7	6.9	4.8
Transportation	2	-10.6	-10	5.1	-1	12.8	19	2.9	11.4
Post and communication	6.5	18.4	17.3	31.5	54.4	26	36.6	10.6	1
Other services	18.5	8.3	4.9	-4.7	0.8	3.3	-0.2	1.4	1.7
Total value added	9.3	8.4	8.6	3.6	3.9	6.7	4.2	-0.3	2
FISIM	9.4	1.5	1.5	6.7	10.5	14.8	14	10.6	0.1
Gross value added at base prices	9.3	8.7	8.9	3.5	3.6	6.4	3.8	-0.7	2

Source: INSTAT, Quarterly GDP, July 2010

Table 6 GDP by economic activity, percentage changes q-o-q

	Q1-08	Q2-08	Q3-08	Q4-08	Q1-09	Q2-09	Q3-09	Q4-09	Q1-10
Agriculture, animal farming, hunting and forestry	2.3	1.9	0.8	2	0.4	-0.2	0.6	0.8	0.9
Industry	6.8	11.6	3	-1.5	-8.3	6.5	-3.6	2.6	19.9
Construction	2.3	-7.3	3.2	1.7	3.4	8.6	-12	-13.4	-4.3
Trade, hotels and restaurants	2.8	0.3	1.3	0	1.7	1.4	1.9	1.1	0.4
Transportation	6	-8.2	-1.1	9.3	-2.2	6.6	4.2	-4.2	3.5
Post and communication	-15.2	19	10.2	18.2	-0.4	-2.9	19.5	-4.3	-9
Other services	2.7	-4.8	1.3	-2.9	4.1	-0.6	0.9	-0.1	1.4
Total value added	2.2	-0.7	2	1.2	1	2.2	-0.3	-1.9	1.4
FISIM	-0.9	-2.1	2.9	6.9	2.6	1.7	2.2	3.8	-7.2
Gross value added at base prices	2.3	-0.6	1.9	0.9	1	2.2	-0.4	-2.2	1.8

Source: INSTAT, Quarterly GDP, July 2010

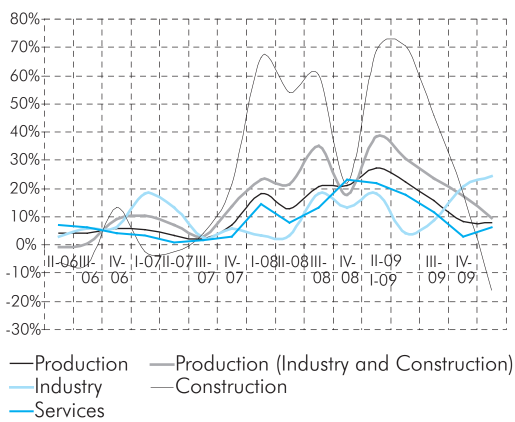
Also, in Q1 2010, the turnover volume index recorded 153.2% vs. the base quarter (2005=100), up by 7.7% vs. Q1 2009 and down by 3.0% vs. the previous quarter. The turnover volume indices show a good performance for extracting industry, energy, and trade and a poor performance for construction.

Table 7 Turnover volume index (2005=100)

Turnover Volume Index	I-08	II-08	III-08	IV-08	I-09	II-09	III-09	IV-09	I-10
Production and services	111.8	119.1	136.2	146	142.2	145.9	157.9	157.9	153.2
Production (industry and construction)	113.5	137.4	146	158.9	157.1	179.6	180.6	186.4	172.3
Industry	112.4	130.3	133.3	127.5	132.9	135.5	144.7	153.6	165.2
Extracting industry	117.6	177.3	147.3	109.5	87.5	128	154.7	143.8	170.1
Processing industry	109.7	132.1	138.8	131	131.4	140.3	144.7	151.4	149.2
Energy, gas and water	115.1	109	110.7	119.1	148.7	121.4	132.9		
Construction	114.8	146.8	162.8	201	193.8	250.6	237.1	237.2	163.2
Services	110.1	109.1	130.8	138.9	134.1	128.3	145.8	142.9	142.6
-Trade	110.6	108.5	129.2	141.5	129.8	121.8	138.4	137.7	137.6
-Transportation and Communication	111.1	110.7	138.8	126.5	143.6	144.4	171.7	163.6	157.4
-Hotels	103.1	114.1	142.9	108.6	82.3	110.8	131.5	104.6	80.8

Source: INSTAT, January –March Conjecture, 2010.

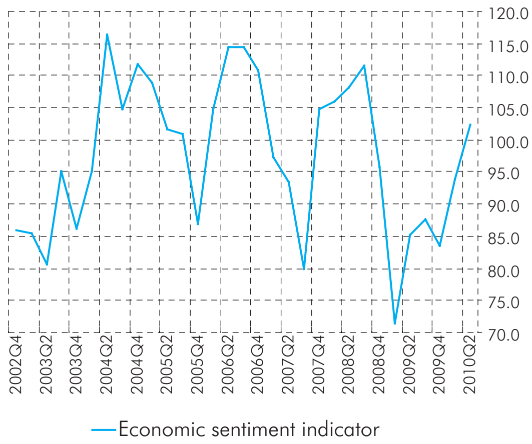
Chart 7 Turnover index



Source: INSTAT, January - March Conjecture, 2010

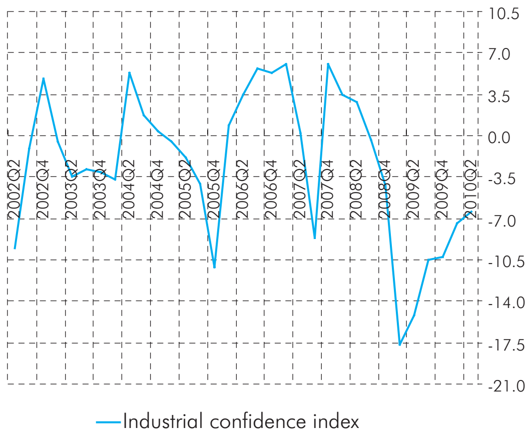
With respect to real sector of the economy in 2010 Q2, the confidence index and its composite elements are used as a proxy. It turns out that the economic sentiment indicator showed improvement signs in 2010 Q2, reaching 102.3 (up 8.4 percentage points vs. the previous quarter). The indicator is built upon its long-term average for the first time since 2008 Q4. Each of the considered sectors, namely industry, construction, services and consumer, attest to raised confidence of the respondents. Industrial confidence index has increased by about 1 percentage point due to a better assessment of employment and industrial production. Construction confidence index has increased by 3.7 percentage points due to a relative improvement of the demand, production and employment. Service confidence index has increased by about 3.7 percentage points due to a better assessment of the economy, employment situation and the financial position of businesses in this sector. Consumer confidence index has interrupted the downward trend that had started since 2009 Q2, up by about 6.3 percentage points vs. the previous quarter. Unlike two other index components, the service confidence index and consumer confidence index have climbed above their respective long-term average. In their answers, respondents have assessed a better financial position for the second quarter of the year. With respect to economic developments in the short run, they have expressed downward expectations for services and industry sectors and upward ones for consumer and construction sectors. However, except the service sector, other sectors' volatility is insignificant.

Chart 8 Economic sentiment indicator



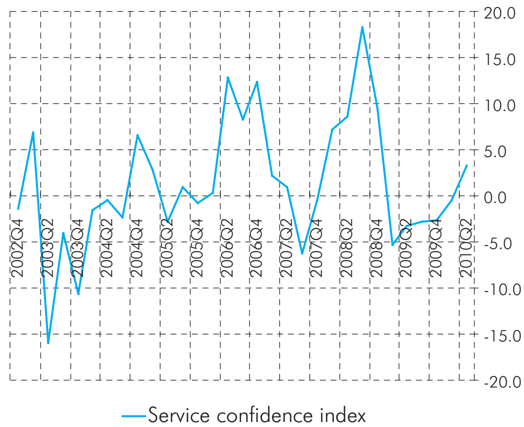
Source: Bank of Albania

Chart 9 Industrial confidence index



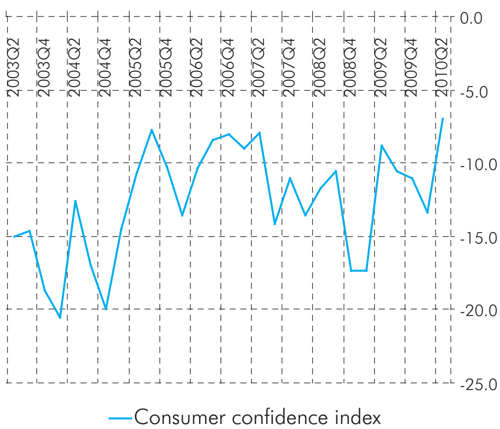
Source: Bank of Albania

Chart 10 Service confidence index



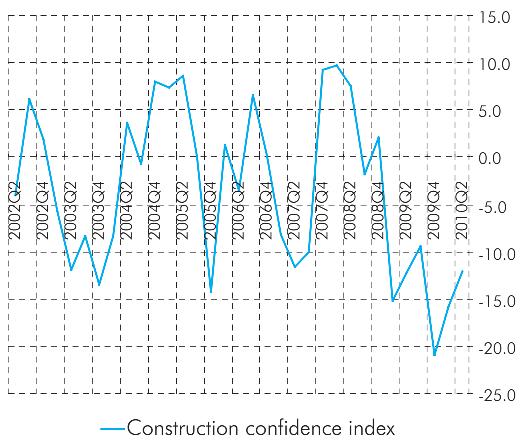
Source: Bank of Albania

Chart 11 Consumer confidence index



Source: Bank of Albania

Chart 12 Construction confidence index



Source: Bank of Albania

2.2. HOUSEHOLD WELFARE

Employment and income performance analyses help assess household welfare.

In light of employment rate, changes in the number of "employed persons in the private agriculture sector" contributed to changes in the number of "employed persons" and "labour force". The number of "employed persons in the private non-agriculture sector" appears stable, recording a slight increase. However, the number of "unemployed persons" increased by 2.8% compared with the last year. Hence, as at end 2010 Q1, unemployment rate was 13.8%. Table 6 shows the dynamics of employment indicators.

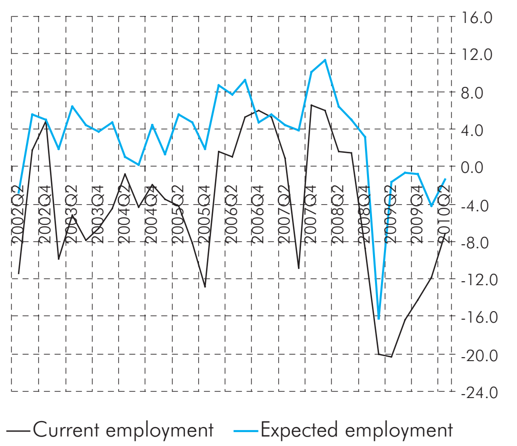
Table 8 Employment indicators

		IV-07	I-08	II-08	III-08	IV-08	I-09	II-09	III-09	IV-09	I-10
Labour forces	no.	1,082	1,080	1,079	1,110	1,116	1,114	1,114	1,114	1,043	1,045
Employed persons	no.	939	939	939	970	974	973	973	972	899	901
a) Public sector	no.	167	167	167	167	167	167	166	166	166	166
b) Private non-agriculture sector	no.	230	231	231	235	239	238	238	237	237	238
Private agriculture sector	no.	542	542	542	569	569	569	569	569	496	496
Unemployed persons	no.	143	141	140	140	141	141	141	142	143	145
Unemployment rate	%	13.2	13.04	12.97	12.62	12.68	12.68	12.7	12.76	13.75	13.83
Average wage in the public sector	lek	36	36	36	36	38	39	40	42	42	42

Source: INSTAT

In light of employment performance over 2010 Q2, we refer to business confidence survey data on employment. Generally, figures indicate that over this period, employment has remained at almost similar levels as those of the previous quarter. Here is excluded the industrial sector, which highlights an upward employment. On the other hand, expected employment rate appears weaker in the service sector, due to seasonal factors.

Chart 13 Current and expected employment - Industry



Source: Bank of Albania

Chart 14 Current and expected employment - Construction

Source: Bank of Albania

As far as labour income is concerned, according to INSTAT, in 2010 Q1, the average wage rose 9.6% in nominal terms and 5.3% in real terms vs. the same period of the previous year. The average wage growth rate was slightly higher from a year earlier. Public sector average wage rise was slower, 6.6% in nominal terms and 2.4% in real terms. The average wage was up 5.4% in production sector and up 19.9% in the service sector.

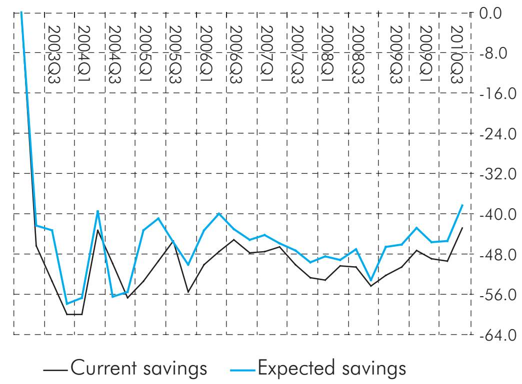
Remittances are another important source of household income. In 2010 Q1, they reached EUR 391.6 million, down 7.3% from 2009 H1. The decline of remittances was greatly impacted by the global economic crisis, which has caused increased unemployment and has forced governments to drastically cut costs / public investments, to achieve the necessary fiscal consolidation. The situation is not expected to improve significantly in the near future, particularly in Greece; therefore, income from remittances will be volatile.

Also, 2010 H1 consumer confidence survey highlights that income was volatile. The answers show consumers' strengthened tendency to increase their savings and postpone unnecessary expenditures. Furthermore, consumers continue to expect an adverse employment situation over the six months ahead. However, the balance of answers to this question turns out to be improved by around 4.8 percentage points vs. 2010 Q1.

Chart 15 Current and expected employment - Services

Source: Bank of Albania

Chart 16 Current and expected indicators



Source: Bank of Albania

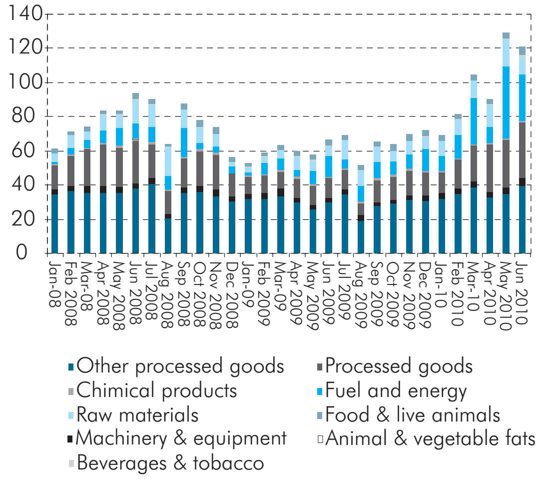
2.3. BALANCE OF PAYMENTS

Balance of Payments performance highlights, in the narrow sense, along with the information on the country's economic competitiveness, the stability of foreign exchange resources at home and their impact on the financial stability over time.

During 2010 H1, a significant correction of trade balance was recorded, down 19% y-o-y.

The following chart shows that the high growth of exports in 2010 Q1 and Q2 owes mainly to increased exports of "fuel and energy", and also to stable performance of "processed goods ", "other processed goods" and "raw materials", including export of minerals and clothing articles. Good performance of such exports was favoured by objective-but-volatile factors related to weather conditions and international market price conjecture,

Chart 17 Exports by composition



Source: Bank of Albania

favouring the growth of product quantities[23] and the value of such exports. In spite of a considerable dependence of exports on uncontrollable external factors, it is important to make use of this positive situation, in order to enhance the technology and production capacity of export sectors, thus improving cost management and quality over time.

At the end of the six-month period, the value of exports of goods and services covered about 57% of the value of imports. In 2009, this indicator fluctuated around 48% in H1 and 57% in H2.

The accelerated growth of the value of exports of goods, with about 65% compared to the same period of the previous year, under the conditions of a relative stability in the value of imports, as well as the good performance of services, have helped improve the current account balance, which recorded a deficit of about € 460 million, or down 35.5% from 2009 H2 and down 28% from 2009 H1.

Increased exports and good performance of services have offset the decline of net foreign inflows of capital and financial account, which recorded € 280.3 million, down about 61% compared with a year earlier, primarily owing to the fall of capital transfers and net financial flows. The capital and financial account surplus could fund only 61% of the current account deficit at the end of 2010 H1 vs. 112% and 46%, respectively in 2009 H1 and H2.

In 2010 H1 the flow of private and public borrowing by non-residents totalled €86.2 million, down 58% vs. the same period a year earlier. Upon the stabilization of liquidity situation in the banking sector, the value of financing lines and non-residents' deposits at domestic banks has diminished. On the other hand, the significant decline in foreign-currency lending to private sector is associated with increased placements (loan/short-term deposits) of our banks at non-resident financial institutions. In general, long-term credit was primarily destined to public sector and other sectors in the form of government guaranteed debt.

In 2010 H1, foreign direct investments totalled € 328.9 million, down 23% in annual terms, but up 19% vs. 2009 H2.

Workers' remittances amounted to € 391.6 million, down 7.3% y-o-y. Their contribution to trade deficit financing was about 42%.

[23] *According to Balance of Electricity, in 2010 H1 (INSTAT), the export of electricity grew 2.5 times vs. 2009 H1.*

2.4. FISCAL DEVELOPMENTS OVER 2010 H1

In 2010 H1, fiscal policy was much less expansionary than in the same period a year earlier. Total budget revenues grew by 3.3%, whilst total expenditures fell by about 4%. In general, budget revenues and expenditures met 45% and 46% of the projection, respectively. Revenues' slowed trend is reflected in almost all the entry items. Grants and tax revenues have positively contributed to overall revenues, whilst non-tax revenues have declined. On the expenditure side, current expenditures were up 7%, whilst capital expenditures were down 33.6% vs. the first half of the previous year.

Changes in the realization of budget revenues and expenditures have dictated the budget deficit level, which as at the end of 2010 H1 was about 21 billion or down 36.4% from the same period a year earlier. However, based on objectives for carrying out the budget deficit in line with the 2010 budget review, the deficit realized over the first half of the year accounted for 55.2% of the annual plan. Hence, care should be shown in terms of realizing the annual planned deficit for the rest of the year.

Table 9 Key fiscal indicators

	June 2008	June 2009	June 2010	Annual change in %	
				June 2009	June 2010
Total revenues	134,889	145,172	150,012	7.62	3.33
- Grants revenues	521	1,196	1,853	129.56	54.93
- Tax revenues	124,085	131,795	136,731	6.21	3.75
- Non-tax revenues	10,283	12,180	11,428	18.45	-6.17
Total expenditures	138,298	178,243	171,038	28.88	-4.04
-Current expenditures	107,766	129,606	138,778	20.27	7.08
- Capital expenditures	28,016	48,552	32,261	73.30	-33.55
Budget deficit	-3,410	-33,071	-21,027	869.82	-36.42

Data are in ALL million, progressive.
Source: Ministry of Finance

As at end of 2010 H1, given the unsteady performance of revenues, the government announced the objective for revising the budget, aiming at correcting downward the revenues and expenditures, and further curtailing the budget deficit.

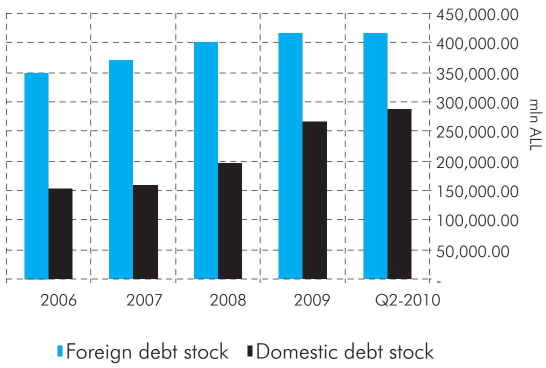
Table 10 Budget review

(in ALL million	2010 Budget (26.11.2009)	2010 revised budget (26.07.2010)
Total revenues	360,955	333,658
Total expenditures	410,722	371,767

Source: Ministry of Finances

This necessary fiscal consolidation process will lead to meeting the medium-term target on reducing public debt to 54% of GDP in 2013, according to targets specified under the 2011-2013 Macroeconomic and Fiscal Framework. According to the revised plan, spending decline will be carried out mainly through reduction of capital expenditures, which amounted to 8.8% of Gross Domestic Product in 2009. It seems as if the need for a rapid consolidation of the fiscal policy, has conditioned this choice. Against this setting, a higher contribution of current expenditure to cutting the overall budget expenditures should be chosen. Even after revising the 2010 budget values, the realization of the projected budget deficit would be significantly influenced by the ability to realise revenue.

Chart 18 Public debt components



Source: Ministry of Finance

Budget deficit financing in 2010 H1 was supported by 85% domestic financing and 15% foreign financing, bringing about relevant changes to debt stock. Unlike previous years, in the domestic financing that consists primarily of ALL debt security issuance[24] (treasury bills and bonds), privatization receipts have accounted for a trifle share, only 0.4%, reflecting lower opportunities for further privatization over time and investors' reluctance.

The overall public debt stock consists of domestic debt (60% of the overall figure) and foreign debt (representing the rest).

Regarding the domestic debt portfolio term, the number of average days to maturity until end 2010 H1 has dropped to 382 days, from 406 days at end-2009. This period highlighted an active participation of investors in government debt security auctions, where demand exceeded the supply. This phenomenon, along with the transmission of further eased monetary policy effect in October 2009, have led to decreased rate of return on investment in government debt securities, affecting the debt cost reduction and improving the possibility of its service.

In setting the objectives related to public debt composition, along with the main objective to control the debt service size and cost, other factors should be taken into consideration, relating to: a) funding sustainability over time, b) preserving of financing space for private sector's needs; c) risks arising from the dynamics of economic developments and their impact on market liquidity, and the interest and exchange rate level.

Risks associated with debt management process would be more under check, if public's and investors' confidence for a stable long-term fiscal policy were maintained. This could be accomplished by providing stronger, more accountable and more transparent legal guarantees, as part of the process otherwise known as "defining the fiscal rule." Such a process would facilitate a better harmonization between fiscal and monetary policy, aiming at maintaining macroeconomic indicators and ensuring financial stability. Therefore, the Bank of Albania has announced its support related to the need for defining the fiscal rule in line with best international standards, at an earlier time possible.

[24] *Because of the decision to postpone forex debt issuance for the international market and to better access forex resources in the domestic market, as at June the Government issued a EUR 25 million T-bill of 9-month maturity.*

3. DOMESTIC MARKETS

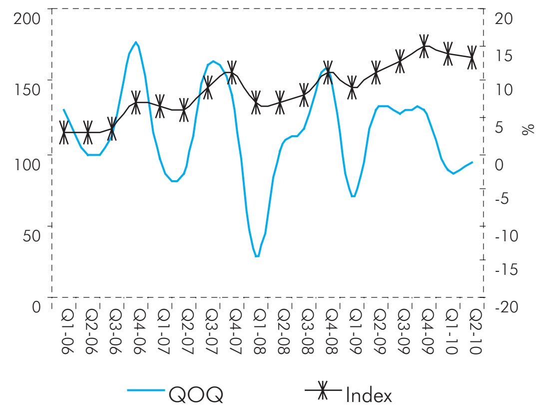
3.1. REAL ESTATE MARKET

To assess the performance of the real estate market, house price index calculated for Tirana is considered as a proxy indicator. In 2010 H1, this index fell slightly by 1.4% vs. the previous half, following a gradual but steady growth during 2009. However, the index continues to be about 7.7% higher, compared to 2009 H1.

House price index performance in Tirana, reflects the fragile situation the construction sector is faced with, against the backdrop of decreased volume of activity and weaker demand.

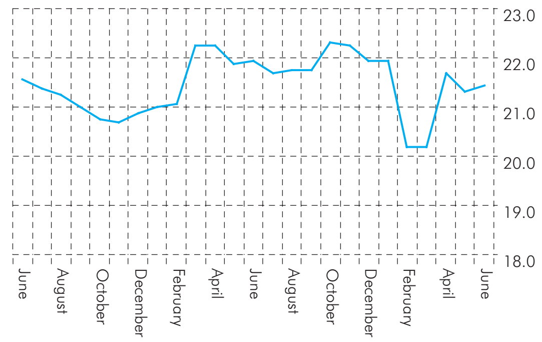
According to turnover volume index (INSTAT, January-March 2010 conjecture), it is assessed that construction activity fell by about 18.8% compared to the same period a year earlier. On the other hand, real estate demand has been weaker, due to contracted financing by the banking sector as a consequence of tighter lending policies in general, exchange rate volatility and households' more pessimistic expectations for their financial position.

Chart 19 House price index for Tirana



Source: Bank of Albania

Chart 20 Share of real estate loans as a percentage to outstanding loans



Source: Bank of Albania

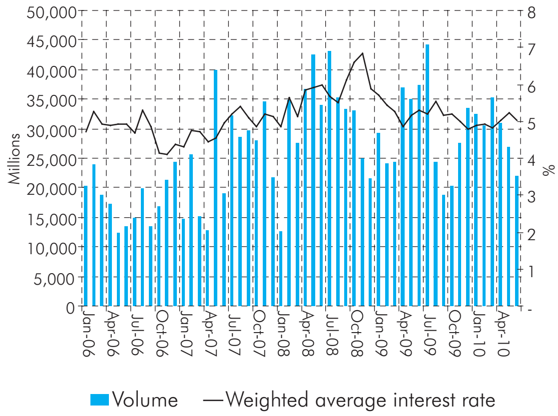
3.2. FINANCIAL MARKETS

Albanian financial market is dominated by operations in the interbank market, government debt security market and foreign exchange market. In 2010 H1 the liquidity position in these markets is presented as generally improved compared to 2009.

3.2.1. INTERBANK MARKET

In 2010 H1, the volume of interbank market increased by 5.8% compared to 2009 H2, but it went down 4.7% vs. 2009 H1. Over the same period, the weighted average interest rate fell to

Chart 21 Interbank market yields and volume in ALL million



Source: Bank of Albania

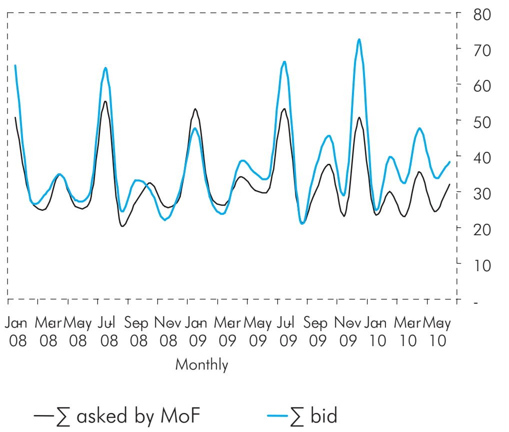
4.97%, from 5.13%. Lower interbank lending cost reflected the decreased policy rate in 2009 Q4 and the improved structural liquidity of the banking sector, against the backdrop of increased stability in deposits.

3.2.2. PRIMARY SECURITIES MARKET

This market represents main operations carried out by participants in government securities auctions. During 2010 H1, the participants' bid to government T-bill auctions has always exceeded the ammount asked by the Ministry of Finance, and has fluctuated hinging on it.

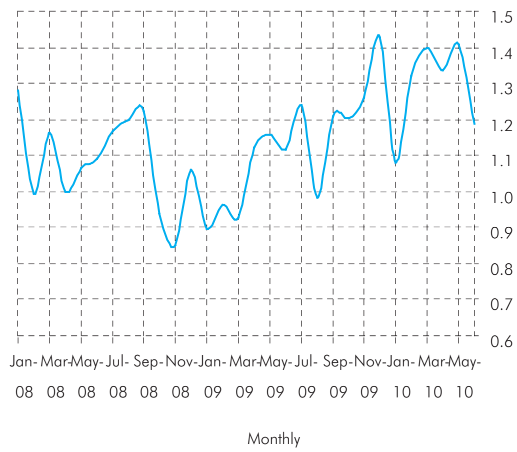
This performance has reflected the ample liquidity conditions, mainly of the banking sector, and the decreased supply of government T-bills in the

Chart 22 T-bill bid-ask volume



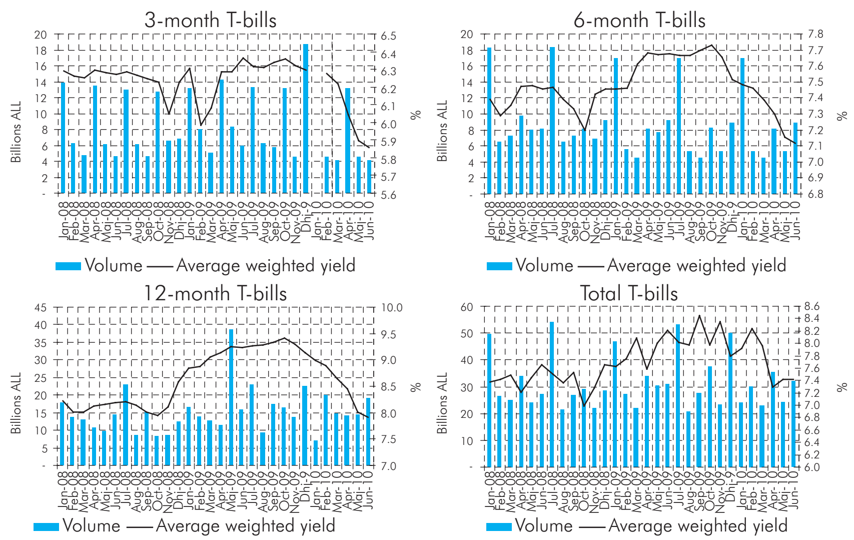
Source: Bank of Albania

Chart 23 T-bill bid-to cover ratio



Source: Bank of Albania

Chart 24 T-bill yield and volume in the primary market

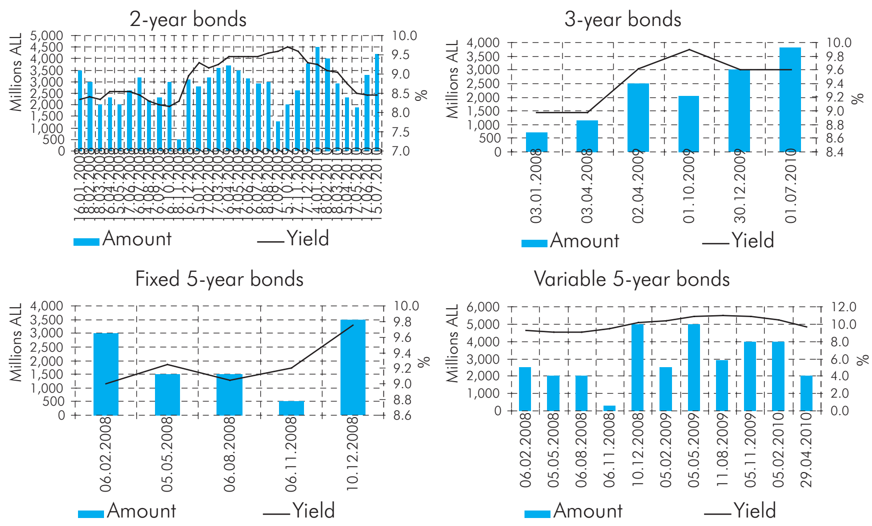


Source: Bank of Albania

conditions of reduced budget deficit and lower need for financing it with domestic resources.

Primary market's T-bill yields continued the downward trend that had started since November 2009, in response to easing monetary policy. The following charts present the performance of weighted average yield on T-bills and their volume since January 2008.

Chart 25 Volume and yield in primary bond market



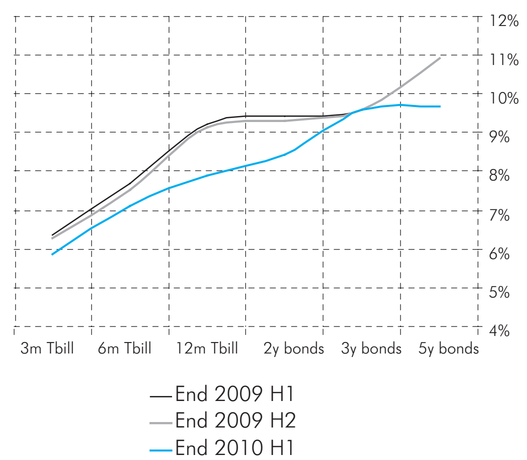
Source: Bank of Albania

The 12-month T-bill yield dropped sharply, impacting similarly on bond yields parameterized with this indicator. At the end of June 2010, the T-bill yield of 12-month maturity dropped to 7.9%, from 9.4% in October 2009. Yields on other T-bill maturities were also downward, but at a lower spread. The significant decline in 12-month T-bills has reflected the intention of primary market participants to earn a higher return on investment, against the backdrop of expectations for a yield decline, due to better liquidity conditions and decreased issuance supply by the government.

The primary bond market attested to a similar tendency as the T-bill market. In 2010 H1, 2-year and 5-year bond yields continued to fall, while the spread of yield on 3-year bonds was negligible. During 2010 H1, the bid-to-cover ratio in bond auctions averaged 1.2. This analysis should take into consideration the fact that the frequency and amount of 3-year and 5-year maturity bond issuance is lower than that of other government debt securities.

Government bond yield curve slope went on being normal, where shorter-term notes offered a lower rate of return.

Chart 26 Yield curve

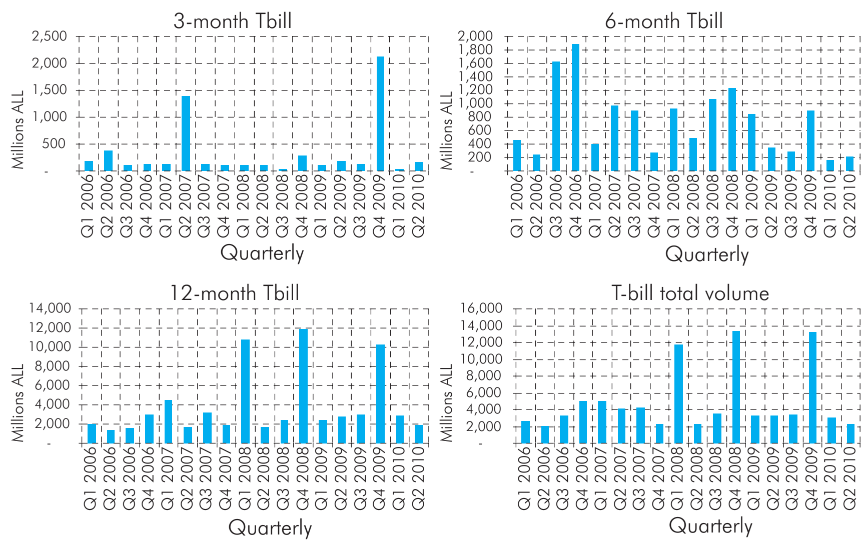


Source: Bank of Albania

3.2.3. SECONDARY SECURITIES MARKET

Secondary market includes trading of government debt securities, practically only T-bills, which are not traded in the primary market. During 2010 H1, the volume of transactions carried out in this market totalled ALL 5.4 billion, down from the 2009 H1 figure (ALL 6.7) and 2009 H2 figure (ALL 16.7 billion). This market is characterized by generally low and volatile trading values. Therefore, the trading decline in 2010 H1 represents a return to more normal trading volumes, owing to a households' lower demand.

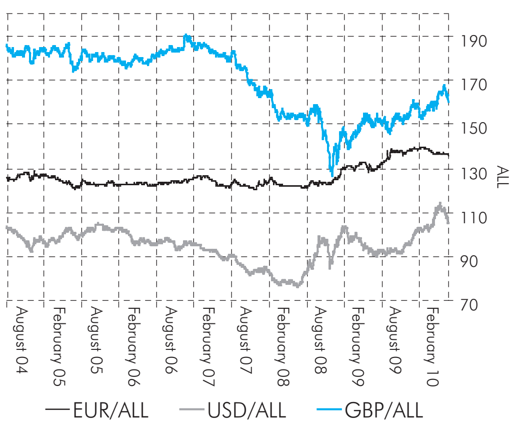
Chart 27 Volume of T-bills traded in the secondary market



Source: Bank of Albania

3.2.4. FOREIGN EXCHANGE MARKET

Chart 28 The lek's exchange rate vs. the primary currencies



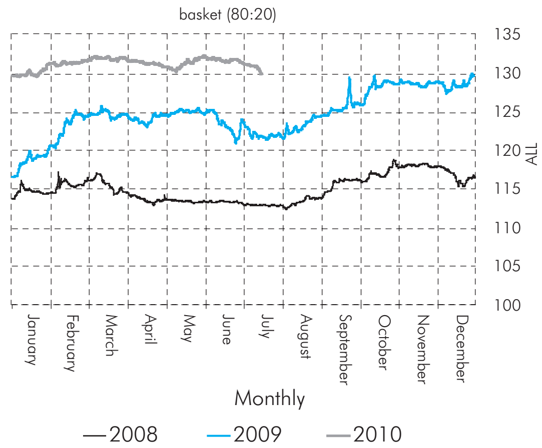
Source: Bank of Albania

In 2010 H1, the euro depreciated by 1% against the lek, whilst the U.S. dollar and British pound are appreciated by 16.6 and 9.4%, respectively. The Lek's exchange rate vs. the above currencies has reflected mainly their performance in international markets, where the U.S. dollar and British pound have appreciated vs. the euro. As at end-June, the euro was exchanged with 136.5 lek, from 137.8 lek at early January. During 2010 H1, the depreciating pressures against the lek have dropped, due to contracted trade and budget deficits.

In 2010 H1, the lek's exchange rate has been steadier vs. the main foreign currencies basket, where the weight of the euro is 80% and that of the American dollar is 20%, compared with the same period a year earlier.

Exchange rate's greater stability in 2010 H1 is also highlighted by the performance of the nominal effective exchange rate (NEER), which is built on the basis of weights of our country's main partners to foreign trade. The rising performance since 2008, as shown by the chart, highlights the lek's depreciating trend. During this period, the country's trade deficit also improved. Since early 2010, the lek's exchange rate has been stabilized.

Chart 29 Foreign currencies basket

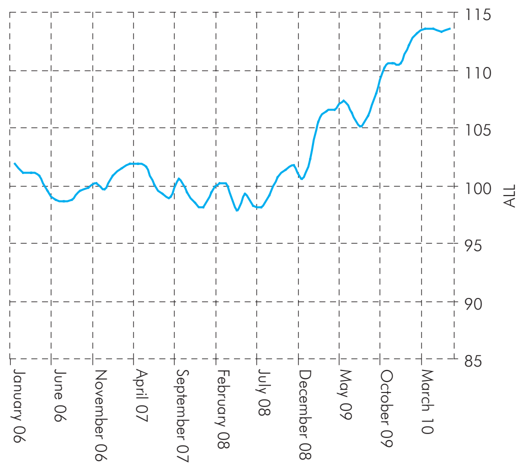


Source: Bank of Albania

3.2.5. BANK OF ALBANIA OPERATIONS

In January 2010, following the analysis that confirmed the improved liquidity situation in the banking sector, the Bank of Albania reinstated limited-amount and competitive interest-rate auctions for its liquidity-providing operations in the interbank market. Since November 2008, the auction had offered to inject unlimited liquidity at an equal rate with the base interest rate. During 2010 H1, the base interest rate was held unchanged, to 5.25% since end-October 2009. Also, the magnitude of the spread between the base interest rate and the overnight deposit/loan interest rates did not change, maintaining the asymmetric corridor established on 24 December 2008, when the Bank of Albania decided to narrow the overnight loan interest rate spread by 100 basis points, to "base interest rate + 0.75%".

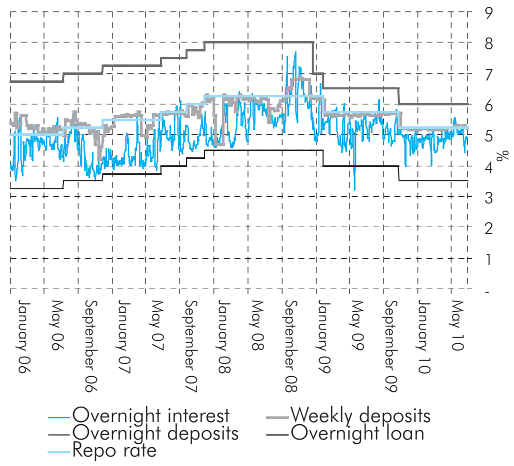
Chart 30 Nominal effective exchange rate index



Source: Bank of Albania

At the same time, to increase banks' opportunities for a better management of their liquidity situation, since December 2008, banks were allowed to use up to 40% of their required reserves in ALL during the required reserve maintenance period. It is estimated that these Bank of Albania's auctions have helped normalize liquidity amount and cost in the banking sector.

Chart 31 Money market rates

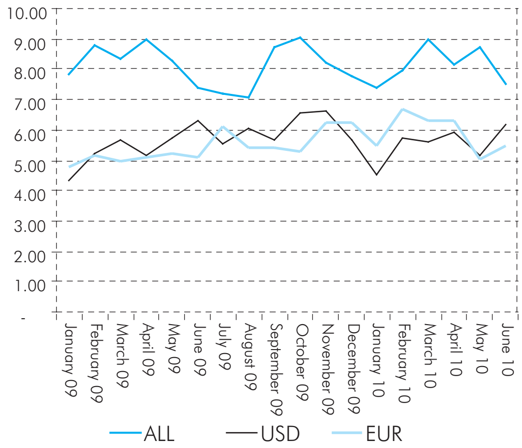


Source: Bank of Albania

3.2.6. SPREAD BETWEEN INTEREST RATES ON NEW LOANS AND DEPOSITS

During 2010 H1, the spread between average lending rate and average deposit rate was volatile

Chart 32 Loan/Time Deposit Spread



Source: Bank of Albania

for the three primary currencies[25]. Over the course of this period, this spread narrowed to 0.26 and 0.76 percentage points, respectively for lek and euro operations, however it expanded by 0.51 percentage points for those in American dollar. Loan interest rate cut - from 13.2% to 12.7% - contributed substantially to narrowing the spread for ALL operations. ALL time deposit rates were steadier, falling from 5.37% to 5.18%[26] over this period. The performance of interest rate spread for euro operations is conditioned mainly by the falling interest rate on time deposits, which as at end-June 2010 dropped to 2.25%. The interest rates on American dollar time deposits dropped to 1.2% at period-end, whilst the ones on American dollar loans have fluctuated between 6% and 8% over the course of this period.[27]

In general, the performance of loan and deposit interest rates by currency has reflected the base interest rate changes, the liquidity condition and the banking sector's reluctance to lend at higher paces because of a high risk perception in this activity.

PAYMENT SYSTEM DEVELOPMENTS IN 2010 H1[28]

To assess the payment system developments, the functioning of payment system infrastructure operating at the Bank of Albania is monitored and the performance of the number and value of payment transactions and forms of carrying them out in the banking sector is attended.

A positive change in the functioning of payment system infrastructure in 2010 H1 represents the implementation of the project for transferring payments to the Treasury through the electronic interface between the Treasury system at the Ministry of Finance and AIPS and AECH systems at the Bank of Albania. Thus, starting from 1st March 2010, the processing of ALL payments, initiated by the Treasury branches in the favour of individuals and other institutions benefiting from public funds, is automatic.

Therefore, 2010 H1 was characterized by an increased number of transactions processed via the payment systems and a decline in the average value per transaction, compared to the same period of 2009. Over January - June 2010, on average 283 transactions a day were processed via the AIPS, with an average daily value of ALL 17 billion liquidity circulating in the system. Meanwhile, on average 1,010 transactions a day were processed via

25 *The difference between weighted interest rate of new term deposits and new loans has been used to estimate the interest rate spreads.*

26 *Time deposit rates have varied around 5 and 6% since September 2008.*

27 *As at June 2010, the weighted credit rate for the dollar was 7.37%.*

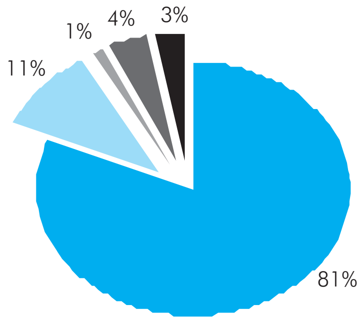
28 *The following information is based on the material about the payment system performance over 2010 H1, prepared by the Payment System Department.*

the AECH, with an average daily value of ALL 0.13 billion, 2.4 times higher than in 2009 H1.

Banks participating in AIPS may use the intra-day credit to meet their liquidity needs during their operational activity. Compared to the same period a year earlier, 2010 H1 highlighted an increased number of this instrument usage, to 24%, whilst the value of such loans disbursed over this period dropped sharply. In general, this reflects a better conception of this instrument on the side of banks and a better liquidity situation.

In terms of assessing the performance of payment transactions and the form of carrying them out via banks, we refer to statistics reported by banks for January - June 2010, in line with the methodology "On reporting payment instruments." They show that during this period, banks have made around 3.5 million customer payments, with a total value of ALL 1.570 billion.

Chart 33 Share of customer payments in the banking system by payment instruments (in number) for January – June 2010



Source: Bank of Albania

Out of total customer payments, about 81% are payment orders (credit transfers) of which: about 97.3% are instructed payments in "paper" form (in writing or by other electronic devices, which necessarily require bank staff's intervention to be processed as payments); and only 2.7% are electronically executed payments (home banking).

As at end-June 2010, ten banks offer their products through home banking service, enabling the use of bank accounts in the distance, through an internet line, a phone line or software that the bank makes available to its client. Compared with the same period of 2009, 2010 H1 recorded a 25% increase in the number of "home banking" transactions, while the transaction value increased by about 8%.

Payments by debit / credit cards at points of sale (POS) in shops or other service-providers, accounted for about 7% of total customer payments, of which about 4% were made using debit cards and 3% using credit cards. Compared to the same period a year earlier, an increased number and value of transactions using cards (11 and 9%, respectively) is recorded.

During January to June 2010 about 5 million transactions were processed using cards (at ATM and POS), with a total turnover of above ALL 53 billion. Out of the total, about 95% make cash withdrawals from ATMs and the rest are customer payments using cards at POS, an indicator of an economy with a high use of cash.

However, the number of bank cards is increasing. As at end-June 2010 vs. end-2009, it picked up by about 77.572 card payments or up 14% using debit cards and up 15% using credit ones.

4. FINANCIAL SYSTEM PERFORMANCE[29]

Financial intermediation in Albania, measured as the ratio of financial sector assets[30] to Gross Domestic Product[31] (GDP), is estimated at 84.5% in 2010 H1, from 82% at year-end 2009 and 76.3% at the end of 2009 H1. Financial institutions' assets grew about 5.8% vs. end-2009, and 13.6% vs. end 2009 H1. The banking sector remains the dominant segment of financial intermediation in Albania. As at end-2010 H1, the banking sector assets averaged 94.4% of total financial system's assets, accounting for 79.7% of GDP.

Table 11 Share of financial system assets to GDP through the years (in %)

Licensing and Supervisory Authority	Financial system	Years					
		2005	2006	2007	2008	2009	2010[1]
Bank of Albania	Banking system	60.4	69.6	75.9	76.7	77.5	79.7
	Non-bank institutions	1.32	1.52	1.48	1.66	2.2	2.54
	SLAs and their Unions	0.46	0.52	0.63	0.7	0.77	0.8
Financial Supervision Authority	Insurance Companies	1.24	1.29	1.36	1.45	1.5	1.42
	Pension Funds	-	-	-	-	0.01	0.01

Source: Bank of Albania, Financial Supervision Authority

Box 3 Non-bank financial sector

Non-bank financial sector includes financial institutions supervised by the Bank of Albania and the ones supervised by the Financial Supervision Authority (FSA). Institutions supervised by the Bank of Albania include a) non-bank financial institutions (leasing and crediting companies), b) savings and loan associations and their unions and c) other institutions providing payment and foreign exchange services. Institutions supervised by the FSA, include a) insurance companies and b) private supplementary pension funds. Securities market, also supervised by the FSA, has a negligible weight.

[29] The analysis on financial system developments will be based on the latest reports that financial entities have submitted to the Bank of Albania. Hence, the data on the banking sector activity, on contributions of private supplementary pension funds, on savings and credit associations and non-bank financial institutions belong to 2010 H1, whereas the data on insurance companies' assets belong to 2010 Q1.

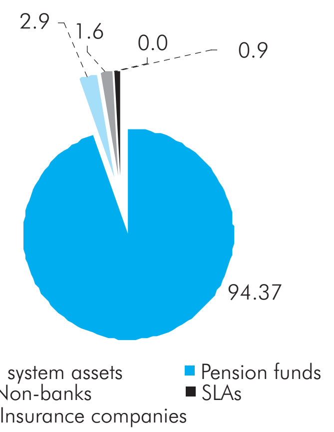
[30] The financial system is composed of: banks, non-bank financial institutions, insurance companies, savings and loan associations and private supplementary pension funds.

[31] The GDP value of ALL 1.217 billion, an IMF estimate for 2010 ("IMF-Country Report, No. 10/217) has been used. As at end June, the GDP value is estimated at ALL 1,173.5 billion

2010 H1 attested to an increased contribution of non-bank financial sector, albeit continuing to account for a relatively small share to the total financial system. As a share of overall financial system assets, non-bank financial sector's total assets accounted for about 5.6%, from 5.3% and 4.6%, respectively at end-2009 and end-2009 H1. As a share of GDP, non-bank financial sector's total assets accounted for about 4.8%, from about 4.4% and 3.5%, respectively at end-2009 and end-2009 H1.

The following chart shows the financial system structure for each system operating in Albania.

Chart 34 Share of financial system entities's assets to total financial system assets, in %

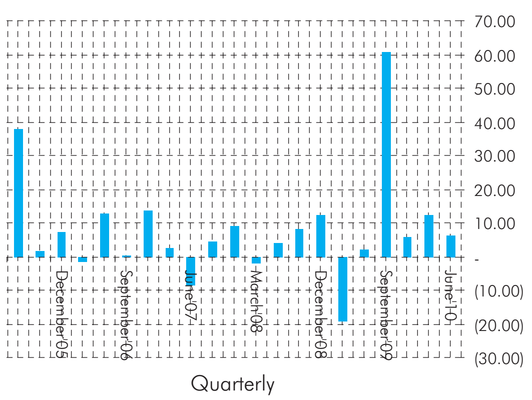


Source: Bank of Albania

FINANCIAL ANALYSIS ON NON-BANK FINANCIAL INSTITUTIONS' ACTIVITY

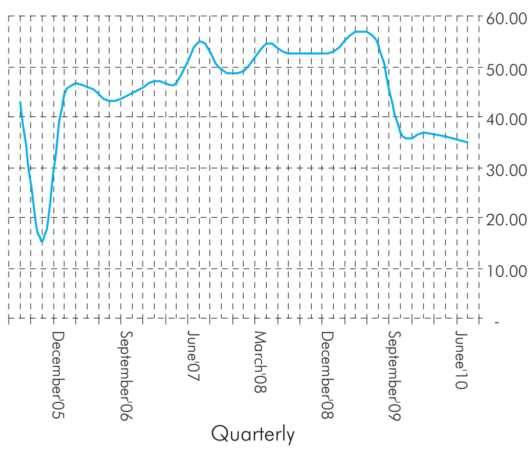
During 2010 H1, the activity of non-bank financial institutions supervised by the Bank of Albania, despite the slowed capitalization level and impaired loan portfolio quality in gross terms, attests to positive developments as concerns growth of assets, loan portfolio and financial profit. In 2010 H1, these institutions' assets accounted for about ALL 29.8 billion, up ALL 4.8 billion or 19.4% from the end-2009 figure[32]. Lending activity made the main contribution (by about 87%) to growth of these institutions' assets, as compared to end-2009. Meanwhile, "Loans received" item made the main contribution to liability growth, by about 86%.

Chart 35 Quarterly non-bank assets' growth, in %



Source: Bank of Albania

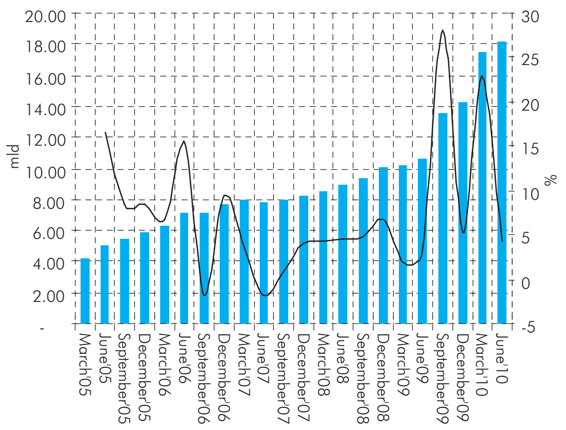
Chart 36 Capital account to total assets, in %



Source: Bank of Albania

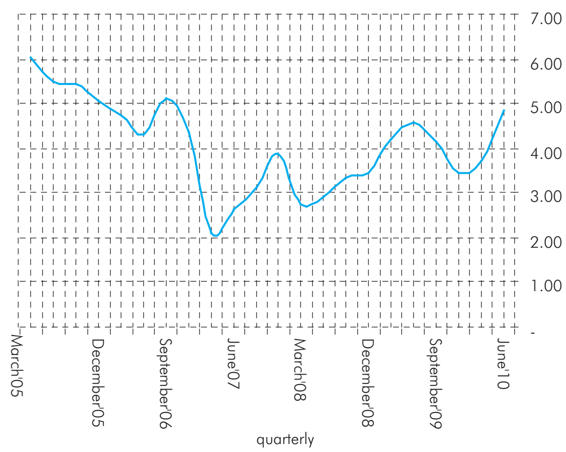
32 *The considerable growth of assets and several other indicators, such as loan portfolio, capitalization level, financial profit, etc., owes also to first-time reporting made by 4 new non-bank financial institutions operating in leasing area, to the Bank of Albania.*

Chart 37 Loans and their growth performance (quarterly)



Source: Bank of Albania

Chart 38 Non-performing loans to total loans, in %



Source: Bank of Albania

In 2010 H1, capitalization level, measured as the ratio of "capital account to total assets", fell to 35%, from 37% at end-2009, though remaining well above the 10% minimum threshold required by the regulatory framework.

Loan portfolio has the main share to total assets of non-bank financial institutions, about 61.6% as at end-June 2010. Total loans (gross) climbed to ALL 18.2 billion, about ALL 3.9 billion more than end-2009 figure.

In 2010 Q2, non-performing loans (gross) to outstanding loans climbed to 4.85%, from 3.4% at end-2009, also owing to inclusion of leasing companies' activity in calculations.

Non-bank financial institutions' profitability increased in 2010 H1, recording a net profit of ALL 540.8 million, from ALL 318.8 million in 2009 H1.

Overall income as at the end of 2010 H1 amounted to ALL 2.9 billion, about ALL 514.6 million more that the same period a year earlier. Within income items, interest income has the largest share (about 55%), followed by commissions (about 13%). Within expenditure items, general operating expenses have the largest share, which dropped to 34.7%, from 48.6% in 2009 H1.

SAVINGS AND LOAN ASSOCIATIONS (SLAS)

In 2010 H1, savings and loan associations and their unions continued to expand their activity at a faster pace than credit growth. Loan portfolio quality declined. However, earning asset growth has offset the increased costs and the financial profit has improved.

In 2010 H1, total assets of SLAs and their unions grew to ALL9.4 billion or up 7% from year-end 2009, and about ALL 1.1 billion or up 13.6% vs. 2009 H1.

Lending activity continues to have the largest share in financial operations of savings and loan associations and their unions. For 2010 H1, they reported about 75.9% of total assets invested in lending. Loan portfolio quality (on a gross basis) of SLAs and their unions has worsened, as shown by the ratio of non-performing loans to outstanding loans (on a gross basis), which increased by 1.4 percentage points, to 3.3% from 1.9% at end-2009. The growth rate of non-performing loans was about 75.3%, while that of outstanding loans was 3.4%. The following table presents the performance of some indicators on the activity of SLAs and their unions.

Table 12 SLA's activity indicators

	QIV-08	QI-09	QII-09	QIII-09	QIV-09	QI-10	QII-10
Total assets (ALL mln)	7,657	7,866	8,251	8,670	8,765	8,825	9,378
Outstanding loans (ALL mln)	6,284	6,419	6,438	6,634	6,893	7,003	7,125
Outstanding loans /total assets (%)	82.1	81.6	78.03	76.5	78.6	79.4	75.9
Non-performing loans (ALL mln)	82.4	103.8	118.6	132.1	135.2	198.8	237,1
Nonperforming loans / outstanding loans (%)	1.31	1.62	1.84	1.99	1.96	2.84	3.3

Source: Bank of Albania

In 2010 H1, the net profit of SLAs and their unions climbed to ALL 62 million, from ALL 28 million in 2009 H1.

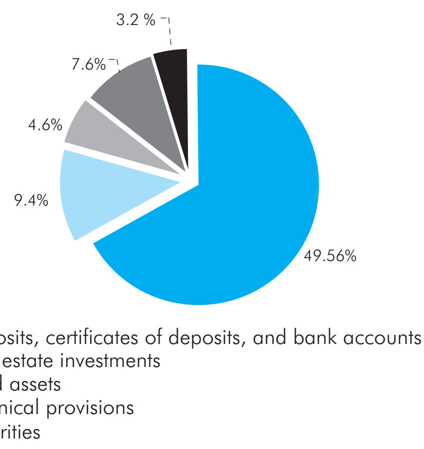
INSURANCE COMPANIES AND PRIVATE SUPPLEMENTARY PENSION FUNDS

As concerns insurance companies, income on insurance premiums for January - June 2010 reached about ALL 3.974 million or down 2.15% from the same period a year earlier[33]. The number of insurance contracts over January-June 2010 amounted to 306.501, down 15.4% from the same period a year earlier. Insurance companies have paid about 30.5% more claims throughout 2010 H1 relative to the same period a year earlier, with the highest concentration on non-life insurance business. Claims to premium (gross) ratio, albeit at a low level, was about 25% from 22% in 2009. In terms of market share and by type of insurance, gross written premiums of voluntary and compulsory insurance shared 49.8% and 50.2%, respectively, of the market.

As at 2010 Q1, insurance sector's assets were roughly ALL 16.7 billion, up ALL 463 million or 2.85% from end-2009. "Deposits, certificates of deposits and accounts with banks" have the largest share to total insurance companies' assets (about 49.5%), followed by "real estate investments" (about 9.4%) and "technical provisions" (7.6 %).

Capital to total assets ratio, which measures the insurance companies' capitalization level, rose slightly to 53.4% in 2010 Q1, from 52.6% at end-2009, and 56.5% at 2009 H1. Capital to technical reserves ratio is another indicator that measures the capacity to cover losses incurred from exposure to potential risks. As at 2010 Q1, this ratio was 72.7%, without the substantial fluctuations of year-end 2009, significantly lower than the 2009 Q1 figure (163%). The decline of this ratio owes to

Chart 39 Share of insurance companies asset items to total assets in %, 2010 Q1



Source: FSA, Bank of Albania

[33] *Referring to the FSA's report published in July 2010. Currently, there are operating 9 non-life insurance companies and 3 life insurance ones.*

higher technical reserves (by about 13.3%) than the decline of capital level (by about 4.3%).

Insurance companies' profit over 2010 Q1 totalled about ALL 362.4 million, down ALL 132 million or 27% from the same period a year earlier. The slowed financial profit is also reflected in the performance of both indicators, return on assets (ROA) and return on equity (RoE[34]), which in 2010 Q1 were 2.2% and 4%, respectively, from 3.2% and 5.8% at the same period a year earlier.

Private supplementary pension companies expanded their activity during January to June 2010, compared to the same period a year earlier. At period-end, the number of contributors to these companies picked up to 4.658 vs. 4.288 at the same period a year earlier. The value of these contributions is about ALL 87 million, up by 40.8% from the same period a year earlier.

4.1. GENERAL DEVELOPMENTS IN THE ALBANIAN BANKING SECTOR[35]

4.1.1. ASSET-LIABILITY PERFORMANCE AND THEIR COMPOSITION

As at end of 2010 H1, banking sector assets accounted for 79.7% of GDP[36], vs. 77.5% at end-2009. Banking sector assets amounted to ALL 934.7 billion, up 5.5% vs. end-2009 and 12.4% vs. a year earlier[37].

As concerns banking sector asset composition, "Operations with customers (gross)", which represents the banks' loan portfolio, was the main item. At end of 2010 H1, the loan portfolio amounted to ALL 469.6 billion, accounting for 50.2 % of banking sector's total assets. During the last year, the banking sector's lending weight to total assets has broken the growth that went on for several years. Higher risk perception in lending activity is associated with greater preference of banks to raise their placements at other financial institutions, chiefly foreign ones. However, the breaking of the lending trend growth is assessed as temporary. Over the medium run, the lending rising trend will

34 *ROA is estimated as a ratio of the financial profit of the period (for example, 2009 Q1) to average assets (average assets for two periods March 2009 and March 2010). The same formula is used for estimating ROE, but to average equity.*

35 *Summarized data on banking sector's financial position are provided in the Annex 1, attached.*

36 *The value of GDP, by ALL 1,217 billion, an IMF estimate for 2010 ("IMF-Country Report, No.10/205", July 2010) has been used. For end-June, the GDP value is estimated at ALL 1,173.5 billion".*

37 *If we exclude the exchange rate volatility pass-through, for comparison reasons, the banking sector assets would be up 4.5% vs. end-2009 and 8.8% vs. June 2009. Over the period of 31/12/2009 – 30/06/2010, the lek's nominal value was depreciated by 16.3% against the American dollar, while it was appreciated by 1.1% against the euro. Over 30/06/09 – 30/06/10, the lek's nominal value was depreciated by 20.2% against the American dollar and 4.4% against the euro.*

go on, albeit at a lower pace. "Treasury and interbank transactions"[38] is the second major item in the banking sector's assets. As at the end of 2010 H1, it amounted to ALL 275.5 billion and accounted for 29.5 % to total assets. The growth of its share owes to growth of transactions with other banks[39], from 5% of assets in June 2009 to 8% in June 2010. Within this item, "Transactions with the Bank of Albania" remained almost unchanged versus the previous year, while "T-bills transactions" that totalled ALL 109 billion, account for 11.7 % of total assets, thus continuing the downward trend noted in the latest years.

The share of "Securities transactions" accounts for 20.7% of total assets and does not present any significant change from the previous year.

The following table shows details on the performance of constituent items of banking sector assets through years.

Table 13 Share of assets by items (June '04 – June '10)

Share to total assets (in %)	June '04	June '05	June '06	June '07	June '08	June '09	June '10	The value in ALL billion (June '10)
1. Treasury and interbank transactions, of which:	76.1	64.6	55.3	45.1	35.6	27.5	29.5	275.5
- Transactions with the Central Bank	9.1	8.5	9.1	8.4	8.4	7.7	7.6	70.9
- Treasury bills	49.7	40.1	31.8	22.2	14.7	12.6	11.7	109.0
- Transactions with other banks	15.3	14.0	12.4	12.5	10.6	5.0	8.0	74.6
2. Operations with customers (gross)	14.5	20.8	28.9	35.9	43.0	50.7	50.2	469.6
3. Securities transactions	5.6	11.0	13.1	16.7	19.3	21.0	20.7	193.6
4. Other assets	0.8	0.8	0.7	0.6	0.8	0.8	1.0	8.9
5. Fixed assets	1.5	1.7	1.5	1.5	1.6	1.9	1.5	14.0
Total assets	100	100	100	100	100	100	100.0	934.7

As regards the banking sector liability composition, the item "Operations with customers", which represents deposits with banks, accounts for the major share. As at the end of 2010 H1, they amounted to ALL 743.1 billion[40], or 79.5% of total liabilities. The share of deposits to total liabilities of the banking sector has been increasing over the past year, following the rising pace of deposits' return to the banking sector. In such a case, we deem that we have to do with a temporary breaking of the long-term downward trend of deposits share to banking sector's total liabilities. Though deposit growth in absolute terms is a phenomenon that will persist, the banks' objectives to control costs and expand financing sources for enhancing the efficiency, will exert a restraining pressure on the growth of deposits' share to banking sector's total liabilities in the long run. Parallel to deposit growth, banks have decreased the liabilities

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[38] *This item includes: transactions made by banks with the Central Bank (deposits, required reserve, open market operations), T-bill transactions, as well as operations among commercial banks - deposits, current accounts, loans, etc.*

[39] *This item includes: current accounts, deposits with banks, credit institutions and other financial institutions, loans, etc.*

[40] *Customer deposits grew by ALL 49 billion relative to year-end 2009 and ALL 103 billion relative to the same period of a year earlier.*

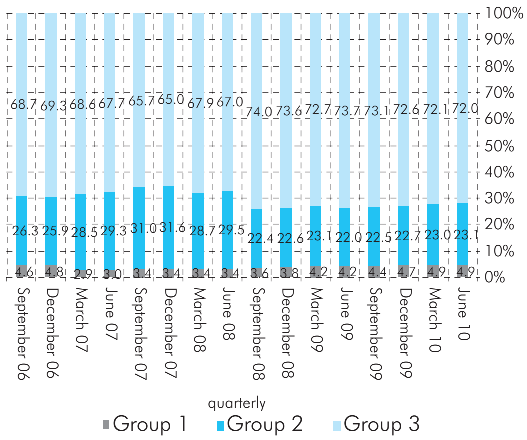
arising from "Treasury and interbank transactions"[41], which amounted to ALL 80.5 billion, accounting for 8.6% of liabilities. At period-end, their share fell by 1.5 percentage points relative to end-2009 and by 3.2 percentage points relative to the same period last year. "Permanent resources[42]" amounted to ALL 100.8 billion, continuing their upward trend. The annual growth of this item's share to total liabilities was only 0.3 percentage points. The main element of "Permanent resources" consists of "Shareholders' equity, which at the end of the period amounted to ALL 89.7 billion, up ALL 12 billion or 15.5% versus a year earlier. Paid-in capital was ALL 63.6 billion, up 2.7 billion or 4.5% from the previous year-end, due to capital injection carried out in several banks during the first half of the year. The following table shows the performance of constituent items of the banking sector liabilities in more details.

Table 14 Share of liabilities by item (June '04 – June '10)

Share to total liabilities (in %)	June '04	June '05	June '06	June '07	June '08	June '09	June '10	The value in ALL billion (June '10)
1. Treasury and interbank transactions, of which:	4.1	5.4	6.0	8.0	9.5	11.8	8.6	80.5
- Transactions with the Central Bank	0.4	0.1	0.2	0.1	0.2	0.2	0.1	1.1
- T-bills	0.0	0.0	2.0	1.1	1.0	3.7	2.5	23.4
- Interbank transactions	3.7	5.3	3.8	5.4	8.2	7.5	5.7	53.7
2. Operations with customers (gross)	88.5	86.8	85.7	82.7	80.6	77.0	79.5	743.1
3. Other liabilities	1.2	0.9	1.0	1.3	0.9	0.7	1.1	10.0
4. Permanent resources, of which	6.2	6.8	7.3	7.9	8.9	10.5	10.8	100.8
- Shareholders' equity	5.9	6.4	6.7	7.1	7.9	9.3	9.6	89.7
Total liabilities	100	100	100	100	100	100	100	934.7

Source: Bank of Albania

Chart 40 Share of banks peer groups to total assets



Source: Bank of Albania

As at end of 2010 H1, the banks peer Group 3[43], peer Group 2 and peer Group 1 shared 72.0%, 23.1% and 4.9% respectively, of the banking sector's total average assets (Chart 40). Compared to 2009 H1, the share of banks peer Group 3 is down 1.7 percentage point, whereas the share of banks peer Group 2 and Group 1 is up 1.1 percentage point and 0.7 percentage point, respectively. The following chart shows banks peer groups' asset share.

4.1.2. BALANCE SHEET COMPOSITION BY CURRENCY AND NET OPEN POSITION IN FOREIGN CURRENCY

As at end of 2010 H1, the banking sector's foreign currency-denominated assets accounted

[41] *"Treasury and interbank transactions" include: Transactions with the Central Bank and T-bills sold by repurchase agreement, as well as transactions with (loans from) foreign banks (primarily from the banking group they belong to).*

[42] *It includes capital account (shareholders' equity, retained earning/loss, the year's profit/loss), reserve account (general, specific ones), re-evaluation one, etc.*

[43] *Asset size serves as the criteria for banks' division into peer groups. In concrete terms, banks peer G1 includes small-sized banks (which share less than 2% of the banking sector's total assets); G2 includes mid-sized banks (which share 2-7% of the banking sector's total assets) and G3 includes large banks (which share above 7% of the banking sector's total assets).*

for about 51.3% of total assets, up 2.9 percentage point from the previous year. The banking sector's foreign currency-denominated liabilities accounted for 49.4% of total assets, up 1.9 percentage point from the previous year. The difference between foreign currency-denominated assets and liabilities hit record high in latest years, by about 1.9 percentage point, though yet regarded as limited.

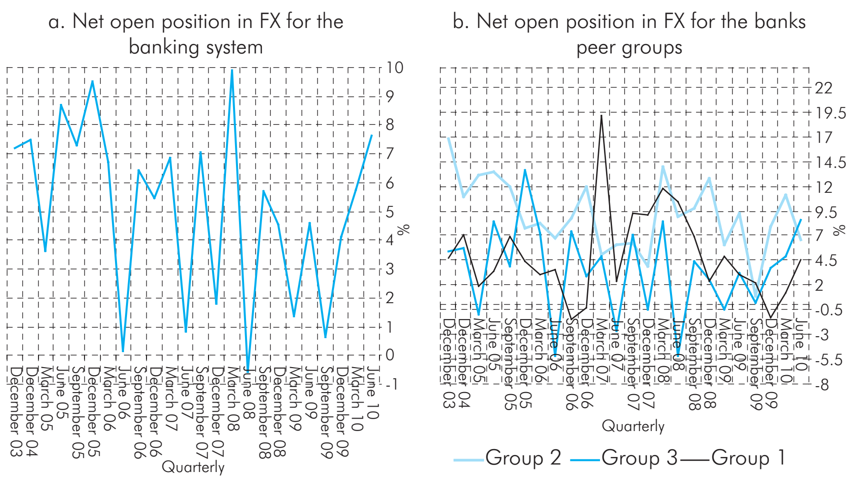
Table 15 Share of foreign-currency denominated assets and liabilities to banking sector's total assets, in % (December '05 – June '10)

Period	Foreign currency-denominated assets	Foreign currency-denominated liabilities	Difference (1)-(2)
December 2005	41.1	41	0.1
March 2006	41.5	41	0.5
June	41.6	41.6	0
September	43.3	43.2	0.1
December	44.2	44	0.2
March 2007	45.6	45.2	0.4
June	45.7	45.7	0
September	46.6	46.5	0.1
December	46.8	46.9	-0.1
March 2008	47.9	47.7	0.2
June	48	48.1	-0.1
September	50.6	50.2	0.4
December 2008	48.9	48.5	0.4
March 2009	50.2	49.7	0.6
June	48.4	47.5	0.9
September	49.5	48.3	1.2
December 2009	50.2	48.9	1.3
March 2010	50.9	49.3	1.6
June 2010	51.3	49.4	1.9

Source: Bank of Albania

As at end-June 2010, the net open position in foreign currency accounted for about 7.6% of Tier 1 capital of the banking sector. This indicator remained in the "long position", within the 0-10% range noted over the latest years. The FX open position is regarded as limited, and therefore the exchange rate risk is assessed as moderate.

Chart 41 Exposure to exchange rate risk for the banking sector and the banks peer groups by size

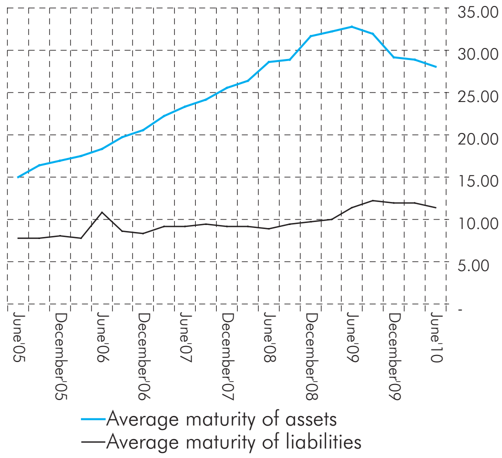


Source: Bank of Albania

4.1.3. COMPOSITION BY MATURITY TERM

As at end of 2010 H1, the banking sector assets had an average remaining maturity[44] of about 28.3 months, from 29 months at end-2009 and 32.8 months at the same period the previous year. Over the same period, the banking sector liabilities had an average remaining maturity[45] of about 11.4 months, from 11.9 months at end-2009, maintaining almost the same average maturity as on a year earlier. Chart 42 shows the performance of average remaining maturity of assets and liabilities.

Chart 42 Average remaining maturity of assets and liabilities



Source: Bank of Albania

It is noted that as at 2010 H1, the maturity gap between assets and liabilities narrowed to 16.6 months, from 17.3 months at end-2009 and 21.4 months at the same period a year earlier. The narrowing of the gap is a result of reduced loan portfolio average maturity, which since October 2008 – when it hit record high by about 47.7 months – has started to drop constantly, hitting record low level in 5 last years. Specifically, at the end of 2010 H1, the average maturity term of loans[46] was about 43.4 months, from 44.7 months as at end-2009 and 46.5 months as at June 2009. On the other hand, the average maturity term of deposits has fluctuated around steadier limits. At the end of the

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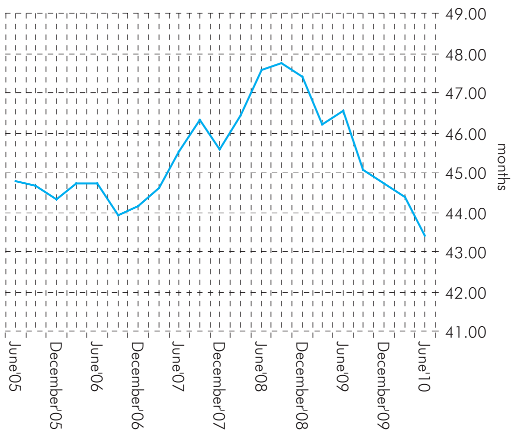
44 *The weighted average of assets' distribution is calculated on the basis of the reported maturity terms. For each interval, the mid-value is taken "a priori". Specifically, for the interval including the "0-7 days" remaining maturity assets, the average duration considered is 3.5 days; for the one of "7 days to 1 month", the average duration considered is 18.5 days; for the "1-3 months", the average duration considered is 2 months; for the "3-6 months", the average duration considered is 4.5 months; for the interval of "6-12 months", the average duration considered is 9 months; for the interval of "1-5 years", the average duration considered is 36 months; for the interval of "over 5 years", the average duration considered is 10 years or 120 months (since the majority of this segment is represented by mortgage loans of an initial maturity of 15 years).*

45 *The weighted average of liabilities' distribution is calculated based on the reported maturity terms. For each interval, the mid-value is taken "a priori". Specifically, for the interval that includes the "0-7 days" liabilities, the average duration considered is 3.5 days; for the one of "7 days-1 month", the average duration considered is 18.5 days; for the "1-3 months", the average duration considered is 2 months; for the "3-6 months", the average duration considered is 4.5 months; for the "6-12 months", the average duration considered is 9 months; for the interval of "1-5 years", the average duration considered is 36 months; for the interval of "over 5 years", the average duration is 6 years or 72 months.*

46 *The weighted average of loans' distribution is calculated based on the reported maturity terms. For each interval, the mid-value is taken "a priori". Specifically, for the interval that includes the "up to 7 days" loans, the average duration considered is 3.5 months; for the "7 days-1 month" interval, the average duration considered is 18.5 days; for the "3-6 months" interval, the average duration considered is 4.5 months; for the "6-12 months" interval, the average duration considered is 9 months; for the "1-5 years" interval, the average duration considered is 36 months; for the "over 5 years" interval, the average duration considered is 10 years or 120 months..*

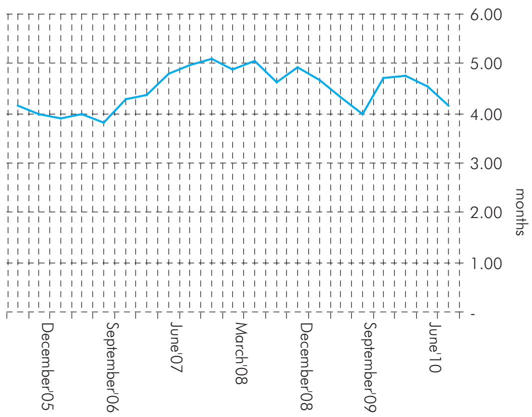
period, deposit average maturity term[47] was about 4.15 months, from 4.7 months at end-2009 and 4 months at end of June 2009.

Chart 43 Average remaining maturity of credit



Source: Bank of Albania

Chart 44 Average remaining maturity of deposits



Source: Bank of Albania

4.1.4. OFF-BALANCE SHEET ITEMS

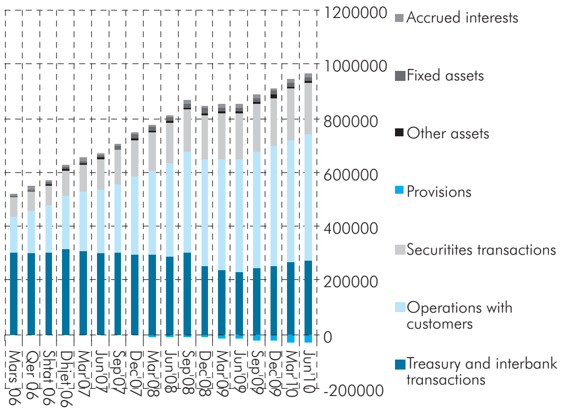
At the end of 2010 H1, off-balance sheet items were about ALL 910.8 billion, or 97.4% of banking sector's total assets. After the peak reached in June 2009 by about 102.4% of total assets, the performance of off-balance sheet items has been steadier, remaining below 100%. Compared with end-2009, off-balance sheet items grew about ALL 77.8 billion, influenced primarily by increased value of "commitments received" by approximately ALL 57.8 billion, to ALL 821 billion. "Guarantees received from customers" made the major impact on "Commitments received", up about ALL 55.7 billion, to ALL 796.4 billion. These operations attest to protective measures taken by banks to hedge against credit risk. A significant rise is also noted in "Foreign exchange transactions: foreign currency purchased/sold", which were up ALL 19.1 billion, to ALL 34.1 billion over the period. Term foreign currency purchased and foreign currency sold have recorded almost equal values.

4.1.5. INVESTMENT/ASSET DISTRIBUTION AND QUALITY

During January – June 2010, the banking sector activity expanded by about ALL 48.4 billion.

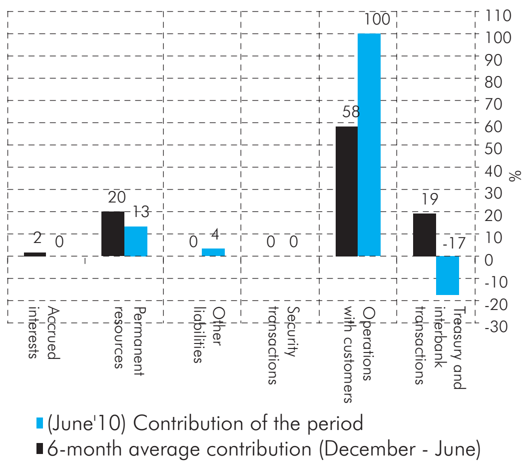
[47] *The weighted average of deposits' distribution is calculated based on the reported maturity terms. For each interval, the mid-value is taken "a priori". Specifically, for the interval that includes the "up to 7 days" deposits, the average duration considered is 3.5 days; for the "7 days-1 month" interval, the average duration considered is 18.5 days; for the "3-6 months" interval, the average duration considered is 4.5 months; for the "6-12 months" interval, the average duration considered is 9 months; for the "1-5 years" interval, the average duration considered is 36 months; for the "over 5 years" interval, the average duration considered is 6 years or 72 months.*

Chart 45 Performance of asset items



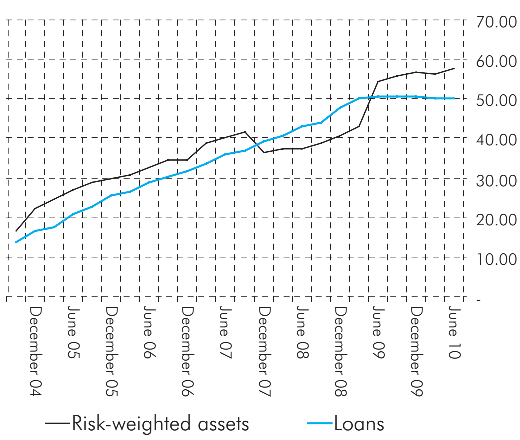
Source: Bank of Albania

Chart 46 Contribution of liabilities to asset growth



Source: Bank of Albania

Chart 47 Risk-weighted assets and loan portfolio to total assets



Source: Bank of Albania

The overall performance of the banking sector was featured by some activities making a positive contribution and some others making a negative one.

Lending, security investments, and treasury and interbank transactions are among activities that made a positive impact. Specifically, the "Operations with customers, gross" item, which represents the lending activity, grew about ALL 19.3 billion or 4.3% vs. end-2009, hence contributing by 39.9% to the banking sector growth. "Treasury and interbank transactions" item grew by ALL 21.2 billion or 7.7% over the same period, contributing by 43.7% to the banking sector's asset growth. "Securities transactions" grew by about 6.7% from end-2009, contributing by 26.2% to the six-month growth of the banking sector's assets. A negative contribution was made by "Fixed assets" (about 1.5%), "Other assets" (about 1.5%), "Accrued interests" (about 3.2%) and "Reserves" including loan-loss provisions (about 13%).

On the liability side, "Operations with customers", which represents the depositing activity, provided the highest contribution (about 95.3%) to activity expansion, followed by "Permanent resources" (9.8%) and "Other liabilities" (8.9%). Meanwhile, "Treasury and interbank transactions" is the only item of liabilities that made a negative contribution to activity expansion (about 19.5%). The decreased value of this activity is a result of improved banking sector liquidity condition. Simultaneously, it reflects the decreased funding support for banks operating in our country, which were made available by bank-holding groups to cope with the difficult liquidity condition during end-2008 and early 2009.

RISK-WEIGHTED ASSETS

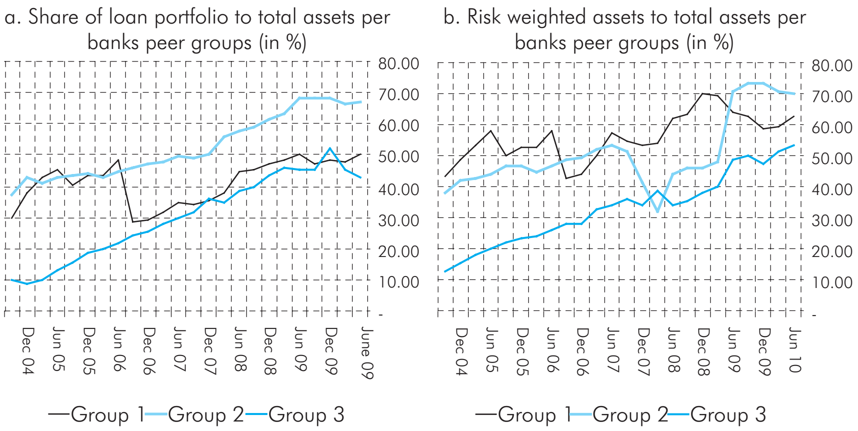
In order to assess banking sector investment quality and risk posed bank investments, we shall first of all make an analysis of banking sector's risk weighted assets:

Banks' risk-weighted assets as at the end of 2010 H1 increased by ALL 34.4 billion or 6.8%, up ALL

537.2 billion[48]. Their share to the banking system's total assets has increased slightly, to 57.5% from 56.7% at end-2009. The increased share mainly owes to a higher growth of risk-weighted assets (by about 6.8%) than that of total assets (by 5.2%). In terms of banks peer groups, the ratio of "risk-weighted assets to total assets" posted increase for banks peer Group 3 (up 5.8 percentage points, to 53.1%), and banks peer Group 1 (up 3.9 percentage points , to 62.4%).

The performance of risk-weighted assets is mainly determined by the loan portfolio performance, which as of June 2010 shared 50.2% of total assets, an almost unchanged level during 2010 H1. By banks peer groups, G2 has a greater concentration of loan portfolio to total assets, with about 66.7%.

Chart 48 Risk-weighted assets and loan portfolio to total assets per banks peer groups



Source: Bank of Albania

LENDING

Lending performance is determined by addition realized over the course of the period, which is measured as the difference between new loans and loans repayment collected by the banking sector.

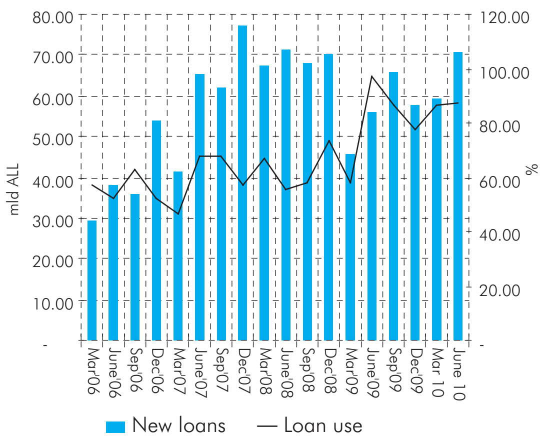
NEW LOAN

In 2010 H1, new loan amounted to ALL 127.2 billion[49], up by ALL 24.3 billion or 23.6% from the same period a year earlier. In terms of original currency, new loans in ALL increased by ALL 1.1 billion or up 2.6%; new loans in foreign currency increased by $ 61.7 million or 63.6% and € 128 million or 35.1%, new loans in other currencies decreased by ALL 96.4 million or 89.7%. Over the same period, collected loans amounted to ALL 113.8 billion, up by ALL 33.1 billion or 41% compared to the same period a year earlier. In

[48] *High-risk assets, risk-weighted at 150%, have contributed by 71.7% to risk-weighted assets growth for 2010 H1, compared to end-2009.*

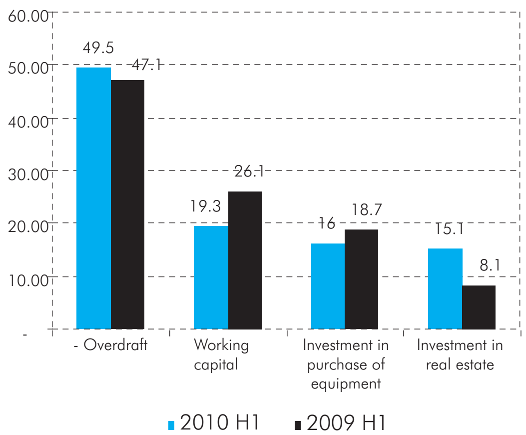
[49] *New loan value, excluding exchange rate effect.*

Chart 49 New loans and loan use



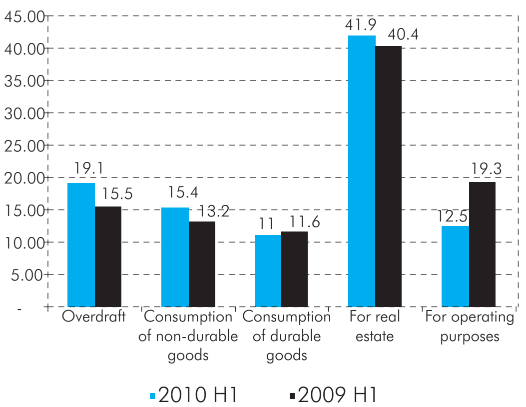
Source: Bank of Albania

Chart 50 New business loan by purpose of use (in %)



Source: Bank of Albania

Chart 51 New household loan by purpose of use (in %)



Source: Bank of Albania

2010 H1, the ratio of "Collected loans to extended loans", which represents the loan use indicator was 87.3%, from 82.4% at end-2009 and 79.4% at end of 2009 H1. The following chart presents new loan performance and loan use indicator q-on-q.

New loan value in 2010 H1 was higher than the figure for each half of 2009, and close to the highest levels as at 2007 and 2008. Meanwhile, the loan use indicator remains close to historical peaks. In general, a faster loan turnover reflects a shortened average maturity of loan and its extension, mainly to meet borrowers' short-term needs.

In terms of users, in 2010 H1, the business sector accounted for about 84.6% of new loan, from 79.1% in 2009 H1. As a result, the share of new loan to households fell to 15.4%, from 20.9% in 2009 H1.

In 2010 H1, compared to 2009 H1, the new business loan was used for the following purposes: about 49.5% (from 47.1%) for overdrafts; about 19.3% (from 26.1%) for working capital; about 16% (from 18.6) for investment in purchase of equipment; and about 15.5% (from 8.1%) for investment in real estate. This period attests to shifting of new loan from "working capital" category to "investments in real estate" one.

In 2010 H1 new household loan by purpose of use highlights three main developments: increased share of new loan extended in the form of "overdraft', to 19.1%, from 15.5% a year earlier; decreased share of new loan extended for "operating purposes", down to 12.5%, from 19.3% a year earlier; as well as the concentration of new household loans primarily in "real estate investment", accounting for 41.9%.

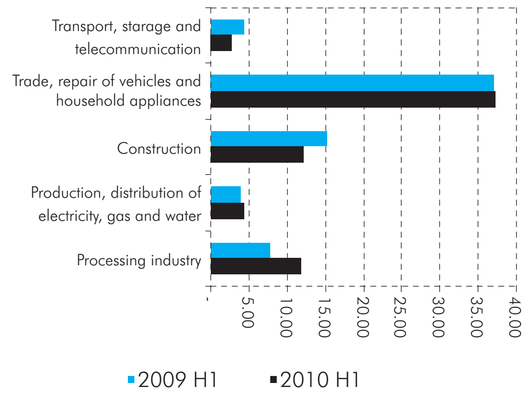
In terms of currency, in 2010 H1 the new loan denominated in euro and U.S. dollar increased, while the one in domestic currency decreased, compared to the same period a year earlier. Specifically, the new loan denominated in euro amounted to 52.2% (from about 46.9%); the new loan denominated in U.S. dollar amounted to 12.8% (from 9.3%); and the new loan denominated in ALL fell to 34.9% (from 43.7%).

In terms of maturity, it is highlighted that the banking sector expanded lending activity for almost all terms of use, but further increased the concentration in short-term loans. During this period, new short-term loan totalled ALL 82 billion, up ALL 23.8 billion or 41% from the previous year, sharing 63% from 57.3% a year earlier. New medium-term loan totalled ALL 26 billion, up by ALL 3 billion or 12.8% from the previous year, sharing 20% of total new loans. The share of new long-term loan fell to 17%, from 19.9% a year earlier.

In terms of new loan distribution by sectors of the economy for 2010 H1, it is noted that the banking sector has provided greater financial support to "Processing industry", sharing 11.8% (from 7.7% in the previous year). The financial support to "trade, repair of vehicles and household appliances", which accounts for the largest share of new loan (about 37.2%), has remained stable.

The share of new loan extended to "Construction sector" has dropped to 12.1%, from about 15.3% a year earlier.

Chart 52 Distribution of new loan by sectors of the economy (in %)

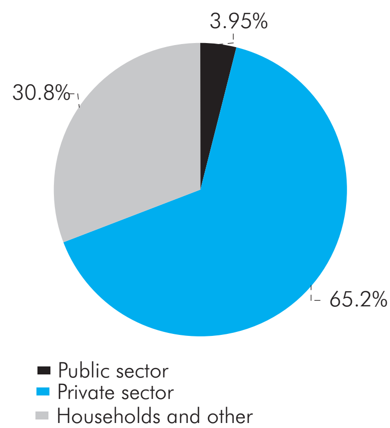


Source: Bank of Albania

OUTSTANDING LOANS

As at end of 2010 H1, outstanding loan portfolio amounted to ALL 465.4 billion, net of accrued interests[50], up by 4.3% from end-2009 and up by 11.1% from a year earlier. Including accrued interests, the loan portfolio grew by ALL 19.8 billion or 4.4%[51], to ALL 469.6 billion[52] or 40% of GDP. By original currency, compared to end-2009 figure, loan in ALL grew above ALL 8.3 billion or 6.2%; loan in U.S. dollar grew by $ 30.5 million or 10%; loan in euro grew by EUR 21.5 million or 1.1%; loan in other currencies grew by ALL 20 million or 1.7%.

Chart 53 Distribution of lending to public and private sectors

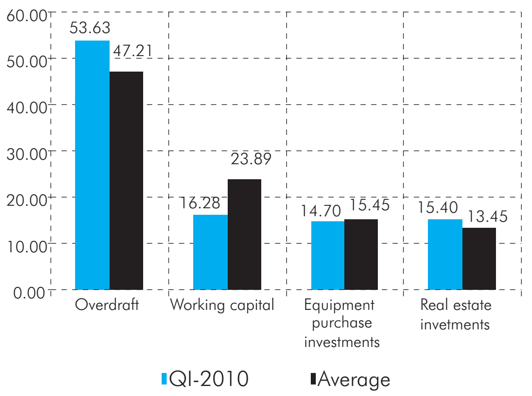


Source: Bank of Albania

In June 2010, likewise in the preceding months, the shares of outstanding loans denominated in FX and ALL were held almost unchangeable, around 70% and 30%, respectively. By maturity term, short-term loan resulted about ALL 157.7 billion or 33.6% of outstanding loan; medium-term loan resulted about ALL 94.9 billion or 20% of outstanding loan; and long-term loan resulted about ALL 216.4 billion or 46.1% of outstanding loan, without any

50 *It is estimated at about ALL 4.3 billion.*
51 *The real outstanding loan growth, taking into account the exchange rate pass-through was 3.3% or about ALL 14.5 billion more than end-2009 figure.*
52 *Conclusions and values of ratios presented in the following are based on this figure.*

Chart 54 Distribution of outstanding loan to businesses



Source: Bank of Albania

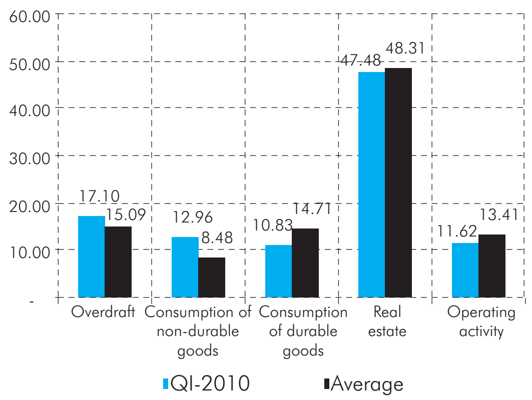
significant fluctuations from end-2009 figure and end of the same period a year earlier.

The following chart shows distribution of outstanding loans by sectors of public and private usage (to businesses and households).

At the end of the period, outstanding loan to businesses[53] is estimated at about ALL 308 billion, up by ALL 17 billion or 5.8% from end-2009. Outstanding loan to households was about ALL 139 billion, down by ALL 646 million or 0.5% from end-2009. The rest of outstanding loan was granted to the public sector. Of credit to businesses, about ALL 101.4 billion or 32.8% was in the form of "overdraft", above the average share[54] of 29.3%[55] for this category.

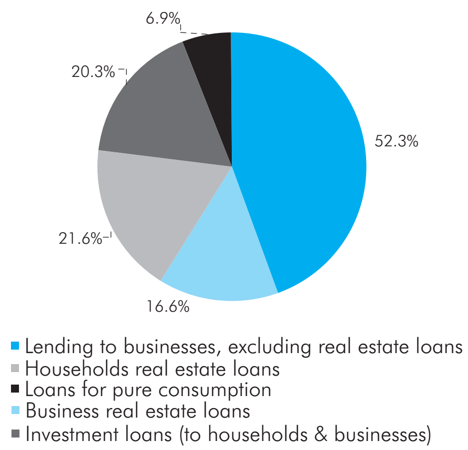
Distribution of outstanding loan to households, by purpose of use, highlights that "real estate loans" account for 69.5%, above the 66.4%[56] period average.

Chart 55 Distribution of outstanding loan to households



Source: Bank of Albania

Chart 56 Distribution of total outstanding loan



Source: Bank of Albania

[53] *It includes lending to residents (along with credit granted to non-bank financial institutions), net of accrued interests.*

[54] *For the period of March 2007 – June 2010*

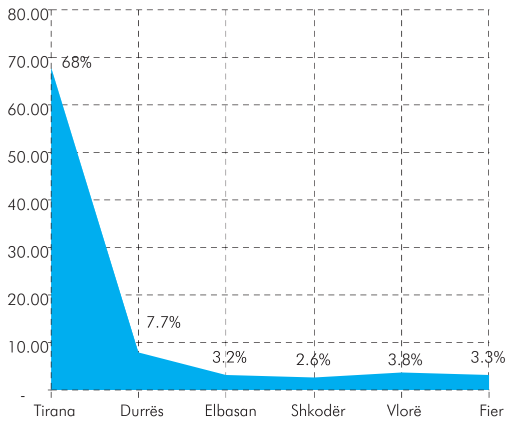
[55] *About ALL 53 billion (or 17.2%) of outstanding loan to businesses is for working capital, below the 18.9% average for the period. About ALL 79.5 billion (or 25.8%) represents investment in equipment purchase, below the 29.1% average for the period. About ALL 74.3 billion (or 24.1) represents investment in real estate, above the 22.7% average for the period.*

[56] *About ALL 6.7 billion (or 4.8%) of outstanding loan to households is in the form of "overdraft", slightly above the period average. About ALL 15.9 billion (or 11.5%) represents loan for consumption of non-durable goods, significantly above the 6.3% period average. About ALL 8.4 billion (or 6%) represents loan for consumption of durable goods, significantly below the 12.7% period average. About ALL 11.4 billion (or 8.2%) represents loan for "operating activity", below the 9.7% period average.*

At the end of 2010 H1, loan for consumption, identified as loans to households in the form of "overdraft" for consumption of non-durable and durable goods, is estimated at ALL 31 billion or 6.9% of total loan portfolio, about 22% of the household loan portfolio and approximately 2.65% of GDP. Loan for investment purposes (purchase of equipment and operating activity) is estimated at ALL 90.8 billion or 20.3% of total loan portfolio, and 7.74% of GDP. Credit for real estate investment (to businesses and households) is estimated at ALL 171 billion or about 14.6% of GDP.

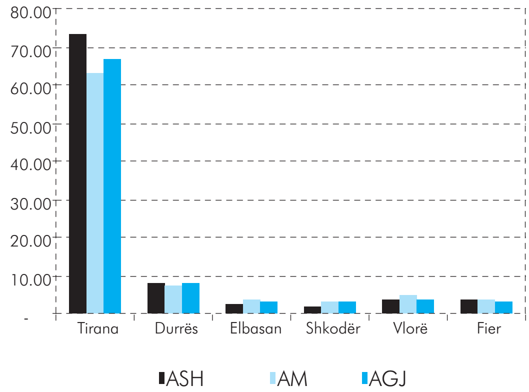
In terms of geographical distribution, banking sector lending is concentrated in Tirana, Durrës, Elbasan, Shkodra, Vlora and Fier.

Chart 57 Distribution by districts



Source: Bank of Albania

Chart 58 Average share of loan by terms



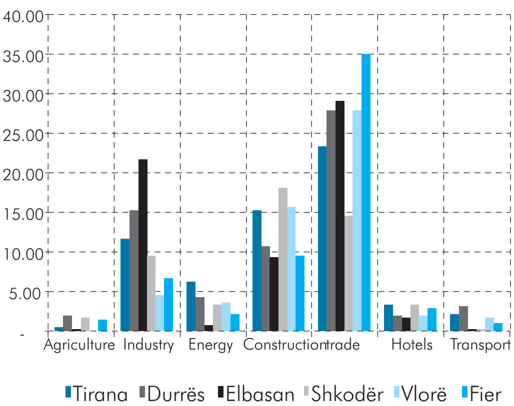
Source: Bank of Albania

As at June 2010, lending to these districts shared 89% of total credit. The lending activity, extended over the whole maturity structure, is chiefly focused in Tirana, with the highest average share[57] of outstanding loans (about 68%), followed by Durrës (about 7.7%). Out of main districts with lending activity concentration, Shkodra shares the lowest figure (by about 2.6%).

Lending structure by currency highlights that foreign-currency loan has the major share in Tirana, by 74.2%, whereas lek-denominated credit dominates in other districts.

As regards credit distribution by sectors of the economy, in each of the main districts, trade sector accounts for the major share of outstanding loans.

Chart 59 Distribution of loan to main cities, by sectors of the economy

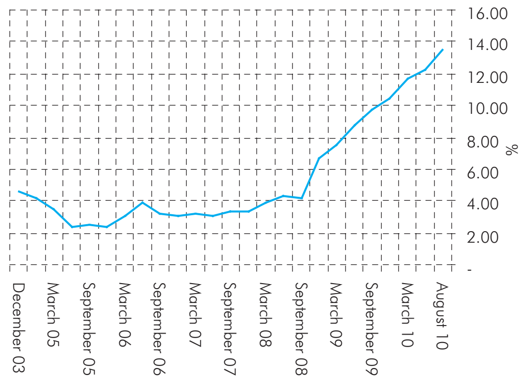


Source: Bank of Albania

[57] *The average share of credit outstanding by district to total credit refers to December 2007 – June 2010.*

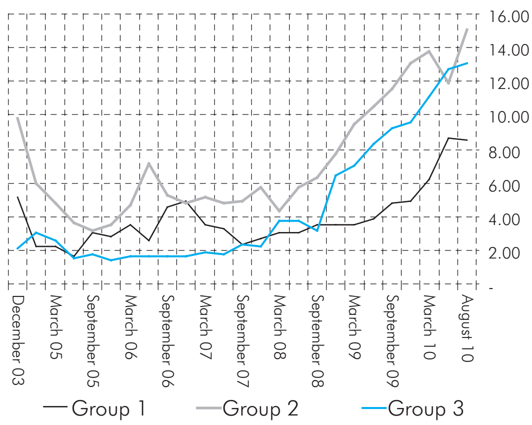
Also, Elbasan district shares a significant concentration of outstanding loan to industrial sector (by about 21.6%), while Shkodra district shares a significant concentration of outstanding loan to construction sector (by about 18.1%). In each district of the country, less financial support is granted to agriculture and transport sectors.

Chart 60 Non-performing loans to total loans



Source: Bank of Albania

Chart 61 Non-performing loans to total gross loans by banks peer groups



Source: Bank of Albania

LOAN QUALITY

Loan portfolio quality continued its downward trend even in 2010 H1. The ratio of "non-performing loans to total loan portfolio (gross)" amounted to 12.2%, vs. 10.48% at end-2009 and 8.7% at the same period a year earlier.

During 2010 H1, non-performing loans of the banking sector increased by ALL 10.2 billion or up 21.6% compared to end-2009 and up by ALL 20.5 billion or 55.5% compared to a year earlier. Over the course of this period, outstanding loan rose by about 4.4%. Since early 2009, the quarterly loan growth has been constantly declining. Hence, loan growth rate was 19.7% in 2009 Q1, and 7% in 2010 Q2.

In terms of loan classification, approximately 72.7% of the loan portfolio is considered as "standard". In general, this period attested to a shift of loan to lower quality classes, specifically to "sub-standard loans" or "loss loans". Their share is estimated at 5.4% and 3.6%, respectively, from 4.7 % and 3% at end-2009.

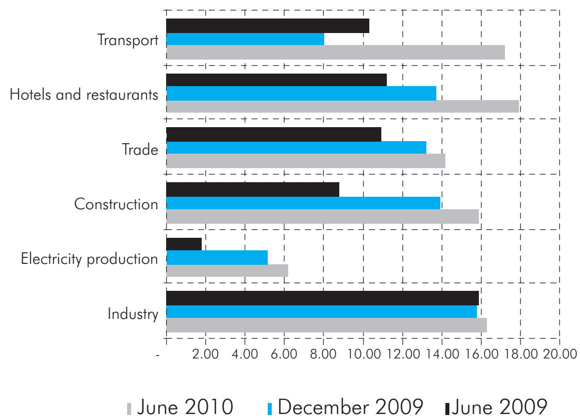
In terms of users, the loan portfolio quality has decreased for both, businesses and households. The ratio of non-performing loans to outstanding loan for these users was 13.8% and 10.3%, respectively as of June 2010, versus 12.3% and 8.2% at end-2009, and 10% and 7.3% at the same period a year earlier.

In terms of currency, as at the end of 2010 H1, the ratio of "non-performing lek loans to total outstanding lek loans" and the ratio of "non-performing foreign-currency loans to total outstanding foreign-currency loans" posted 12.7% and 11.9 %, respectively, versus 10.1% and 10.6% at end-2009.

As at the end of 2010 H1, the ratio of "non-performing foreign-currency loans, when the borrower is unhedged against exchange rate risk, to outstanding foreign-currency loan, when the borrower is unhedged against exchange rate risk, was estimated at about 11.5% , versus 9.6% at end-2009, and 8.8% at the same period a year earlier. By currency, for the euro, this ratio was 11.9% vs. 9.8% as at end-2009 and 8.8% as at the same period the previous year. For the American dollar, for each period, this ratio was 8.1%, 8.5% and 8.9%, respectively. Improved U.S. dollar portfolio quality, when the borrower's income is not in US dollar, owes to higher increase of this total portfolio than its non-performing categories. Hence, for 2010 H1, this outstanding loan increased by ALL 5.3 billion or 24.7%, while this non-performing outstanding loan increased by 370 million or 20.7%.

As of June 2010, the loan portfolio quality declined substantiality in some sectors of the economy. "Hotels and restaurants" recorded a higher ratio of non-performing loans to outstanding loans, around 17.9% vs. 13.7% at end-2009 and 11.2% at the same period a year earlier. Construction sector recorded the highest increase, by about 7 percentage points compared with the previous year, to 15.9%, because non-performing loans increased by 96%, while outstanding loan to this sector increased by 7.9%. The following chart shows the performance of loan portfolio quality even for other sectors of the economy.

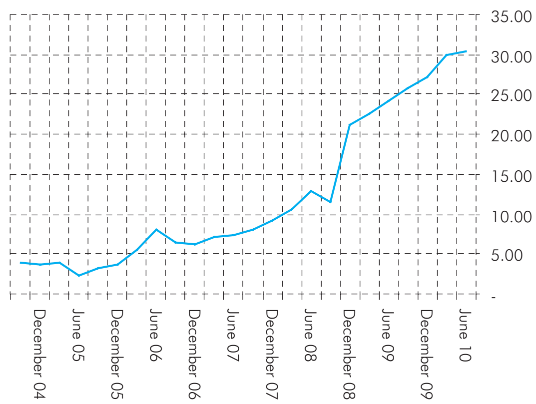
Chart 62 Loan portfolio quality by sectors of the economy



Source: Bank of Albania

Increase of non-performing loans, net, is associated with increased share of capital indicators. On average, the indicator "non-performing loans net of provisions to capital" was up 3 percentage points from year-end 2009, to 31.5%. More specifically, the ratio of "non-performing loans net of provisions to Tier 1 capital" amounted to about 32.8% vs. about 30% as at end-2009 and 25.7% as at a year earlier. The ratios of "non-performing loans net of provisions to regulatory capital" and "non-performing loans net of provisions to shareholders' equity" were estimated at 31.2% and 30%, respectively, versus 28.2% and 27% at end-2009, and 24.6% and 24% at the same period a year earlier.

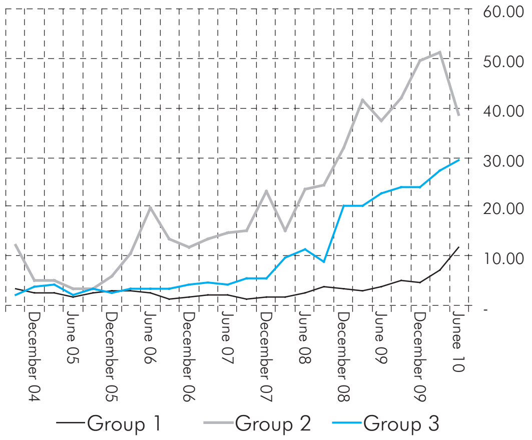
Chart 63 Non-performing loans net of provisions to regulatory capital



Source: Bank of Albania

In terms of banks peer groups, peer Group 1 and Group 3 posted the highest average increase of non-performing loans net of provisions to capital. As at June 2010, for the peer Group 1, this indicator averaged up 7 percentage points from end-2009, to 11.9%. For peer Group 3, it averaged up 5.5 percentage points from end-2009, to 31.3%. In the meantime, loan quality of

Chart 64 Non-performing loans net of provisions to regulatory capital by banks peer groups



Source: Bank of Albania

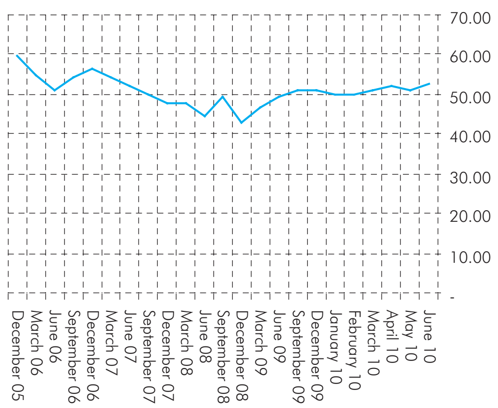
peer Group 2 has improved[58], recording a decline of "non-performing loans net of provisions to capital" ratio, to 37.7%, down 9.9 percentage points on average from end-2009.

LOAN-LOSS PROVISIONING AND COLLATERAL COVERAGE

Against the backdrop of impaired loan portfolio quality, the banking sector has raised loan-loss provisions. As of the end of 2010 H1, they amounted to ALL 30 billion, up ALL 5.9 billion or 24.6% from end-2009 figure, and up 66% from the previous year. As of June 2010, the ratio of "provisions for non-performing loans to non-performing loans" – coverage ratio – amounted to 52.5%, from 51.3% estimated at end-2009 and 49% as at the same period last year.

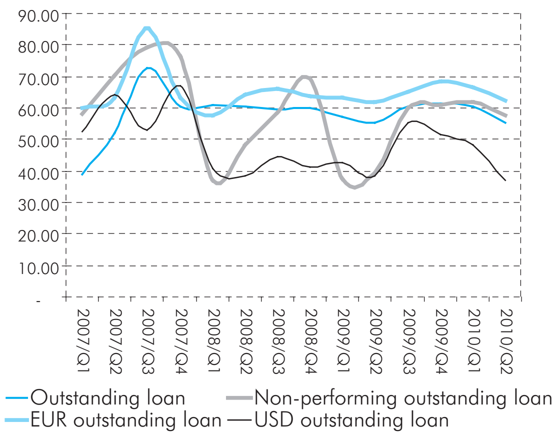
Collateral, as a partial or full credit recovery instrument, plays an important role in the lending process. As at end of 2010 H1, the value of guaranteed collateral loans[59] is around 78% of the loan portfolio, from 79% at end-2009. Over the course of this period, loans collateralized by real estate to total loans declined to 55.4%, down by 5.6 percentage points from end-2009 figure. The share of non-performing loans secured by collateral fell to 57.8% of gross non-performing loans, compared to 61% as at end-2009. In terms of foreign-currency loans, it is estimated that 62.5% of euro outstanding loans and 37.2% of US dollar ones are collateralized by real estate.

Chart 65 Performance of provision ratio for impaired loans



Source: Bank of Albania

Chart 66 Collateralized loans by real estate, in %



Source: Bank of Albania

[58] *As of June 2010, net outstanding non-performing loans for peer Group 2 dropped by ALL 262 million or 3.1% compared to end-2009 figure, while the shareholders' equity size increased by ALL 1.3 billion or 7.7% for the same period.*

[59] *Collateral by real estate (residential, trade or land one), cash, etc.*

4.1.7. DEPOSITS AND THEIR PERFORMANCE

Deposits (excluding accrued interests[60]) amounted to about ALL 730 billion, up by 6.8% from end-2009 and 16.3% from the same period a year earlier. Including accrued interests, deposits amounted to ALL 743.1 billion.

In 2010 H1, the performance of banking sector deposits attested to a steady growth, following the trend noted over the course of 2009 H2. Deposits remained concentrated in the largest banks of the banking sector[61]; however, the degree of their concentration has dropped substantially.

In June 2010, total deposits were up 7% from end-2009 figure, whilst their growth over the past six-month period was around 8.4%.

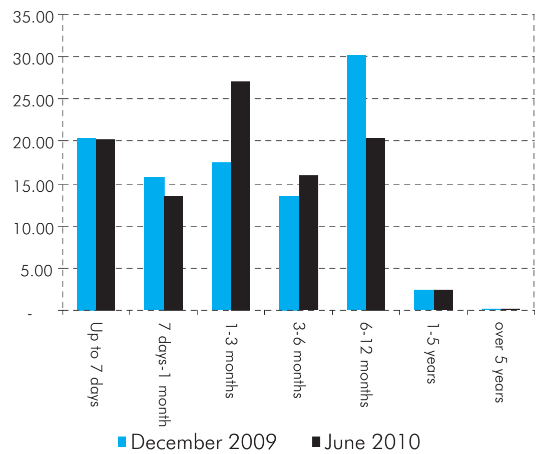
Table 16 Annual growth of banking sector's total deposits through 2004-2009

	2004	2005	2006	2007	2008	2009	H1- 2010
Total deposit growth (in %)	13.4	16.4	20.1	19.9	2.4	7.6	7.04

Source: Bank of Albania.

In terms of their maturity, it is noted that as at end-June 2010, about 77% of deposits were of up to 6-month maturity. (Chart 86). Over the course of this period, their growth is concentrated in those of a maturity term of 1-3 months and 3-6 months.

Chart 67 Deposit structure by maturity term



Source: Bank of Albania

In terms of currency, it is noted that as of June 2010, ALL deposits accounted for 53.5% of total deposits, or ALL 398 billion. Foreign-currency deposits accounted for 46.5% of total deposits or ALL 345 billion. The share of ALL deposits grew by 0.3 percentage points versus end-December 2009 and dropped by 3.1 percentage points versus June 2009.

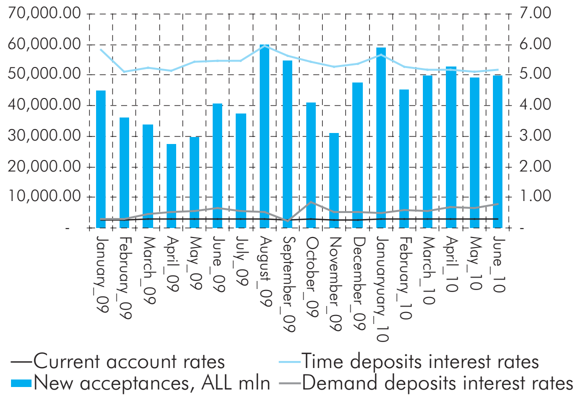
New lek deposits increased in 2010 H1. Hence, as of June 2010, new deposits accepted were up 44% from 2009 H1 figure. It is worth noting that such a growth is recorded at a time when ALL deposit interest rates slightly decreased. Hence, the average interest rate on new ALL deposits was 5.27% in 2010 H1, compared to 5.4% at the same period last year. Regarding the maturity structure of new ALL deposits, June 2010 highlighted a slightly decreased share (10.26 percentage points) of new 6-month deposits vs. the same period a year earlier, whilst those of all other maturity terms picked up.

[60] *They are estimated at ALL 13.1 billion.*

[61] *Deposit concentration in the banking system is estimated by using the Herfindahl index. In June 2010, its value was 1525, from 1667 in June 2009. This shows a still high concentration of deposits in the banking system, although downward.*

In 2010 H1, new EUR deposits accepted by the banking sector were €3.1 billion, down by 24.4% versus 2009 H1. Regarding the new EUR deposits by maturity term, a shift of 1-month deposits to those of a longer maturity is noted. However, deposits of a 1-month maturity term continue to dominate the structure of new EUR deposits. The average interest rate on new EUR deposits was 2.32% in 2010 H1, versus 2.64% at the same period last year. The decline in new EUR deposits is due to economic difficulties faced by neighbouring countries, being transmitted to reduced level of remittances.

Chart 68 Total volume of new ALL acceptances against average interest rates on current accounts, time and demand deposits in ALL

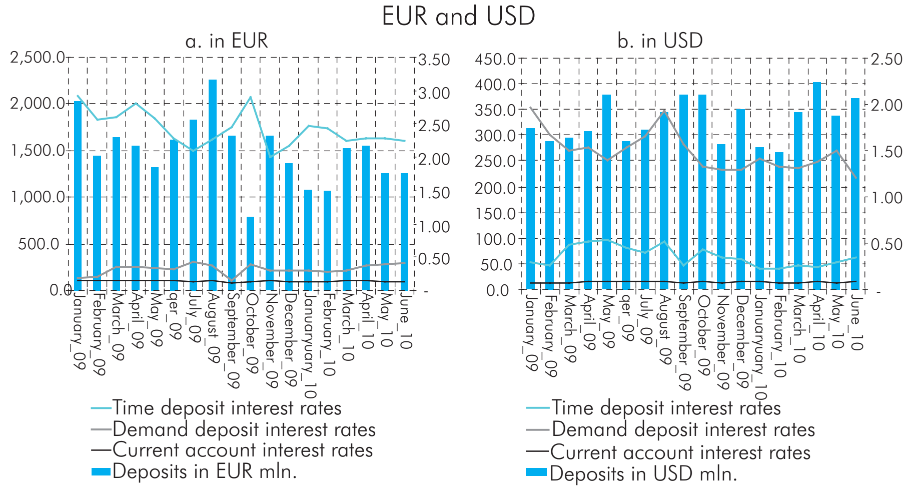


Source: Bank of Albania

New USD deposits accepted by the banking sector in 2010 H1 totalled $ 526.7 million, down 10.9% from the same period last year. It is noted that deposits of a longer maturity term have a larger share to total new deposits, compared to the six-month period of the previous year. Meanwhile, deposits of up to 3-month maturity term account for over 70% of total new USD deposits.

In 2010 H1, new ALL deposits and current accounts generally reflected the interest rate performance. Hence, the largest value of new deposits coincides with the highest interest rate over the course of the period.

Chart 69 Total volume of new acceptances in foreign currency against average interest rates on current accounts, time and demand deposits in EUR and USD



Source: Bank of Albania

Acceptances of new EUR deposits and current accounts declined in early 2010, to stabilize later on. Also, new USD acceptances attested to similar development; two first months of 2010 recorded a decline, to hit high values in the following months.

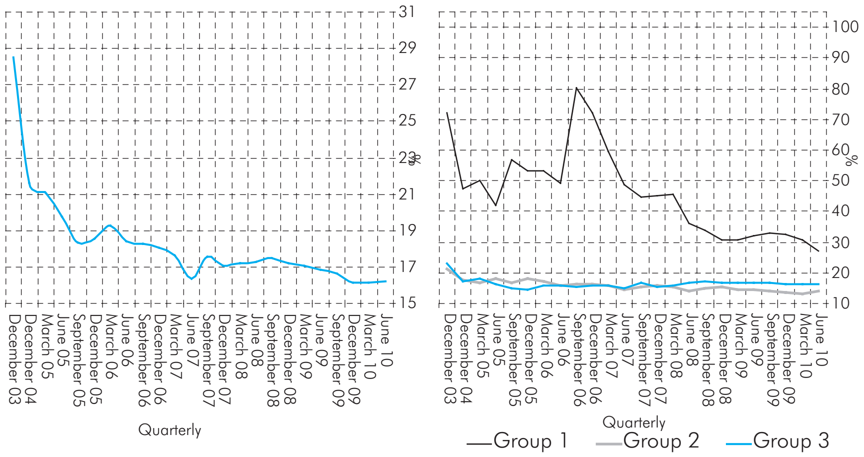
CAPITAL INDICATORS

During 2010 H1, capital indicators showed consistency in their values. As of end-June, banking sector's capital adequacy ratio[62] was 16.2%, at the same level as at end-2009 and down 0.6 percentage point from the same period a year earlier (Chart 70.a.).

In terms of banks peer groups, capital adequacy ratio was 27% for peer Group 1, 14.1% for peer Group 2, and 16.3% for peer Group 3. Over the period, this ratio fell by 6 points for peer Group 1; however, remaining at higher levels than the average of the sector. Banks of both other groups showed a marginal increase of this ratio vs. end-2009.

Chart 70 Capital adequacy ratio (the ratio of regulatory capital to risk-weighted assets)

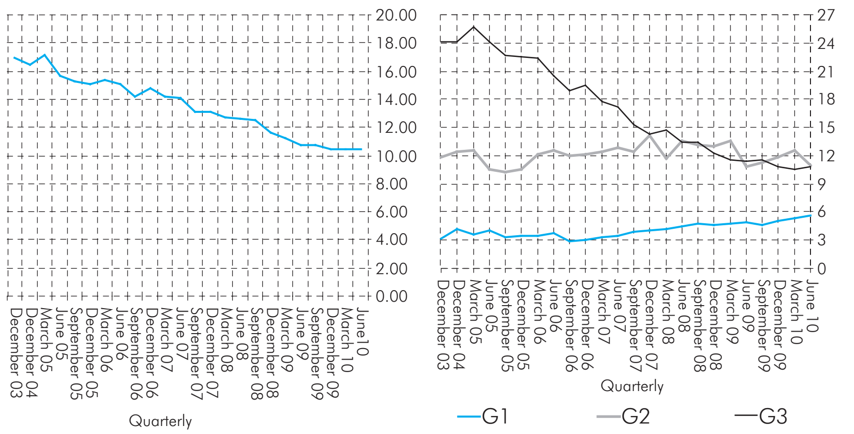
a. Banking sector's capital adequacy ratio b. Banks peer groups' capital adequacy ratios



Source: Bank of Albania

Chart 71 Financial leverage indicator (total assets to shareholders' equity)

a. Financial leverage for the banking sector b. Financial leverage for the banks peer groups



Source: Bank of Albania

62 *The regulatory capital ratio to risk weighted assets by relevant coefficients. The minimum level of this indicator, under the regulatory framework of supervision, is 1%. As at end of 2010 H1, all the individual banks have observed the regulatory benchmark.*

At the end of 2010 H1, the banking sector's regulatory capital totalled roughly ALL 87.1 billion, up by 7.1% from end-2009 and 14.4% from the previous year. The regulatory capital covered 3.2 times the value of net non-performing loans, from 3.5 times as at end-2009 and 4 times as at the previous year.

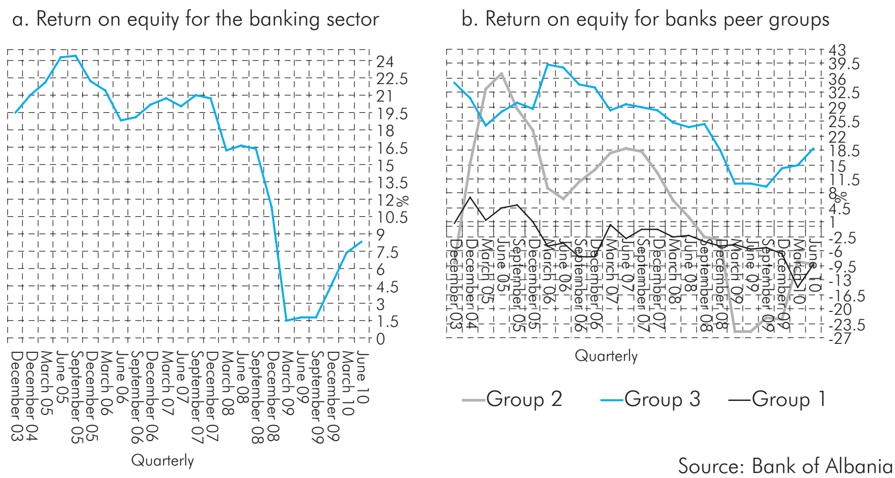
In end-June 2010, financial leverage indicator, measured as a ratio of total assets to shareholders' equity, was 10.4, almost unchanging from end-2009 figure. In general, the performance of this indicator has been downward, reflecting the banks' efforts to maintain higher growth rates in shareholders' equity than in activity expansion.

4.1.6. PROFITABILITY AND EFFICIENCY IN USING RESOURCES

Average earning assets, as of June 2010, amounted to ALL 833.5 billion, accounting for about 91.2% of the banking sector's total average assets. This indicator shows similar levels as at end-2009 and a year earlier. The ratio of "average paying liabilities/average earning assets" amounted to 93%, up by 1.3 percentage point from end-2009 and up 1.7 percentage point from the previous year.

Banking sector's operating income[63] was ALL 21.4 billion or up 21.7% from the previous year. Operating expenses[64] were ALL 11.4 billion or up 10.9% from the previous year. As a result, the ratio of operating costs to income resulted 53.4%, vs. 57.2% as at end-2009 and 58.6% on a year earlier. The ratio of gross operating expenses[65] to income resulted 80.9%, vs. 94.5% as at end-2009 and 94% on a year earlier. This ratio's performance attested to

Chart 72 Return on equity (RoE)



Source: Bank of Albania

[63] Net interest income plus other net income.

[64] Excluding provisioning expenses

[65] Operational costs plus provisioning expenses and other reserves.

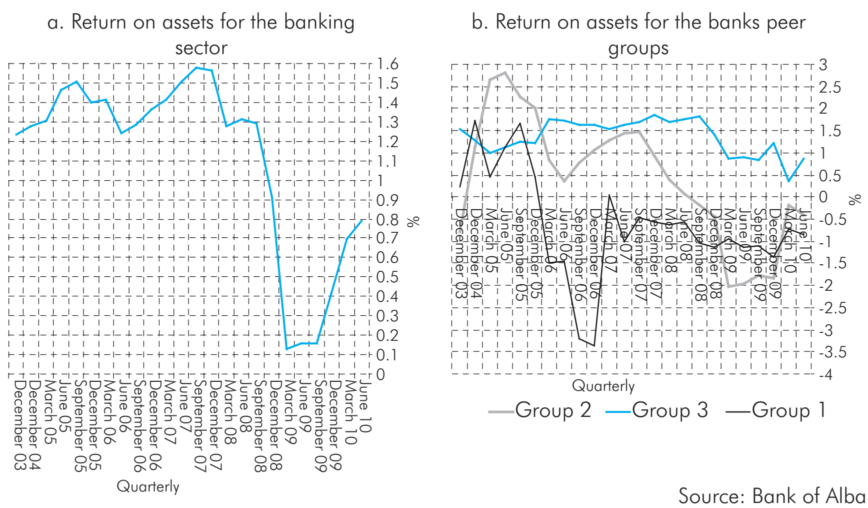
banks' efforts to offset increased provisioning expenses (and other reserves) by reducing operating costs.

Net profit posted a positive figure, totalling ALL 3.6 billion, about 5 times higher than the previous year's figure. The accumulated profit generated by banks peer G3 totalled ALL 4.8 billion. Accumulated financial loss totalled ALL 1.8 billion in 2010 H1;

Banking sector's annualized return on equity (ROE)[66] was 8.3%, up 3.7 percentage points from end-2009 and up 6.5 percentage points year-on-year.

As at the end of 2010 H1, annualised return on average asset (RoAA) was 0.79% for the banking sector, up 0.4 percentage point from end-2009 and up 0.6 percentage point year-on-year. Excluding the first months of the year, this indicator has also presented an ongoing positive performance. (Chart 73, a)

Chart 73 Return on assets (RoA)



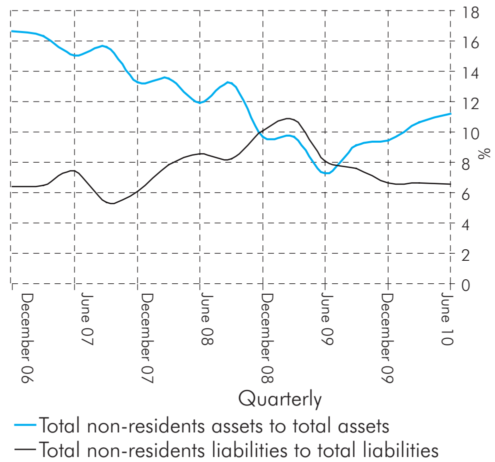
Source: Bank of Albania

4.1.8. BANKING SECTOR LIQUIDITY INDICATORS

As at end-June 2010, liquidity indicators, measured by the ratio of "liquid assets/total assets" and "liquid assets/short-term liabilities" recorded 27.85% and 32.85%, respectively, each marking a marginal rise from end-2009 figures. Over the course of 2010 H1, both indicators were relatively stable, hitting above 20%, the minimum threshold allowed under the new Regulation "On Liquidity Risk Management", adopted by the Bank of Albania. According to activity size criterion, banks peer Group 1 has recorded downward values for both indicators since end-2009, down 2.4% and 3.9%, respectively, while both other groups have recorded upward values.

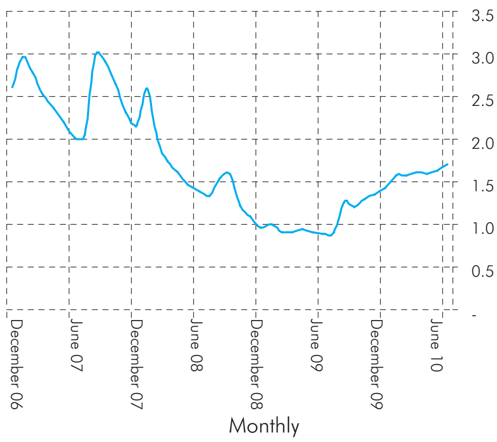
66 *Profitability indicators, both RoE and RoA, are annualized.*

Chart 74 Banking sector net position to non-residents



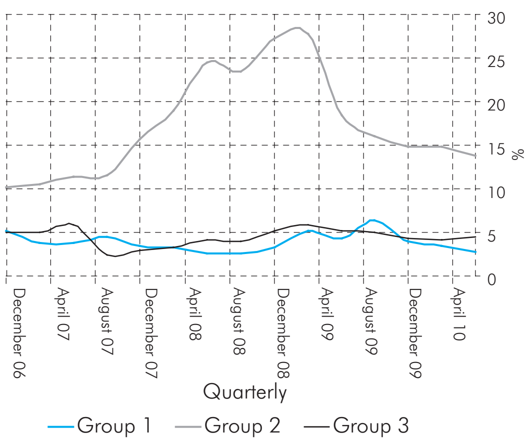
Source: Bank of Albania

Chart 75 Non-residents assets to non-residents liabilities



Source: Bank of Albania

Chart 76 Non-residents liabilities to total liabilities according to banks peer groups



Source: Bank of Albania

The "loan/deposit" ratio has declined since early 2009, to 63.8% as of June-2010, down 1.4 percentage point from December-2009 and down 2.9 percentage points from a year earlier. Throughout this period, the deposit growth pace has exceeded that of loan. The same ratio in foreign currency attested to similar performance. As at end-June 2010, it was 95.2%, down 4.2 percentage points from end-2009, and down 12.3 percentage points from a year earlier.

Following a decline in 2009 H2, "non-residents liabilities to total liabilities" maintained similar level in 2010 H1, about 6.6%. Also, "non-residents assets to total assets" amounted to 11.2% in 2010 H1, from 7.2% in 2009 H1.

Over the last quarter 2008 and first quarter 2009, non-residents liabilities picked up, as a result of financial support granted by parent banks. In March 2009, the ratio of "non-residents assets" to "non-residents liabilities" dropped substantially, hitting record low levels since December 2006, when the banking sector had become "a net borrower" for three consecutive quarters. In September 2009, the banking sector returned to "net lending", reflecting the recovered financial condition. This upward trend has persisted even over the course of next quarters.

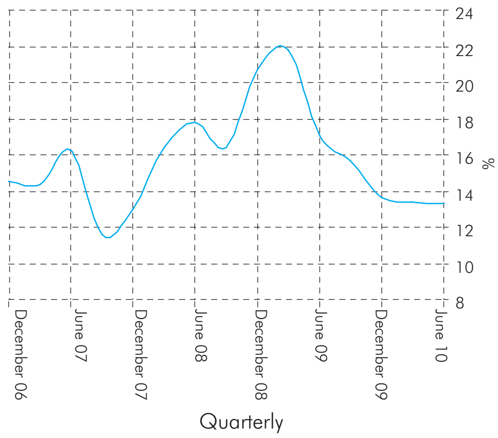
The main impact on the ratio of "non-residents liabilities/total liabilities" is attributed to banks peer Group 2, which are more exposed to non-resident institutions. However, the situation was normalized over the last quarters, showing a downward trend, thus attesting to a stabilized financial condition.

Actually, borrowing from parent banks has almost been made in foreign currency. These funds compete with other bank financing resources in foreign currency, mainly foreign currency deposits from customers. Therefore, it is of interest to recognize the share of "non-residents liabilities to total liabilities in foreign currency". As of June 2010, this indicator dropped to 13.3%, from 17.1% as of June 2009, reflecting the banks' ability to ensure resident foreign-currency funding, specifically FX customer deposits.

The above indicator "non-residents liabilities to total foreign-currency liabilities" is presented graphically for banks peer groups. Group 2 attested to the largest concentration in non-residents, showing their exposure to their parent banks' funding. Exposure to non-residents was downward in the last quarter, due to increased foreign-currency deposits.

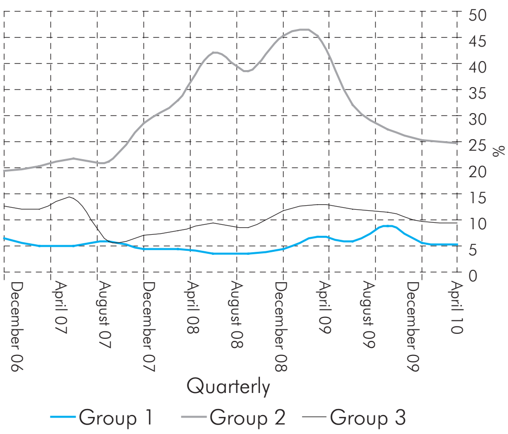
Herfindahl index is used for estimating the concentration level of exposure to non-residents.[67] In 2010 H1, the banking sector attested to a moderate concentration in non-residents liabilities, to 0.16 (or 1,600). The decreased concentration owes to reduced non-residents liabilities for banks peer Group 2, which shares the largest support from parent banks' funding.

Chart 77 Non-residents liabilities to total foreign-currency liabilities



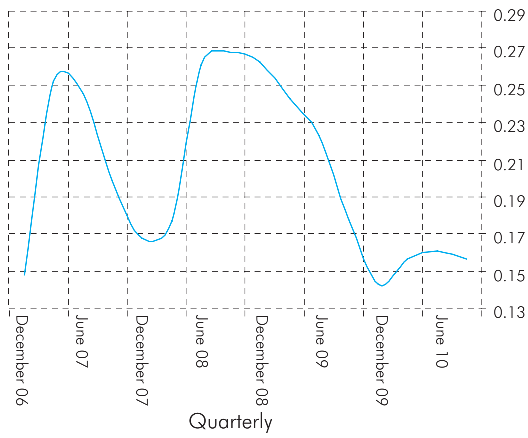
Source: Bank of Albania

Chart 78 Non-residents liabilities to total foreign-currency liabilities by banks peer groups



Source: Bank of Albania

Chart 79 Herfindahl index for non-residents liabilities

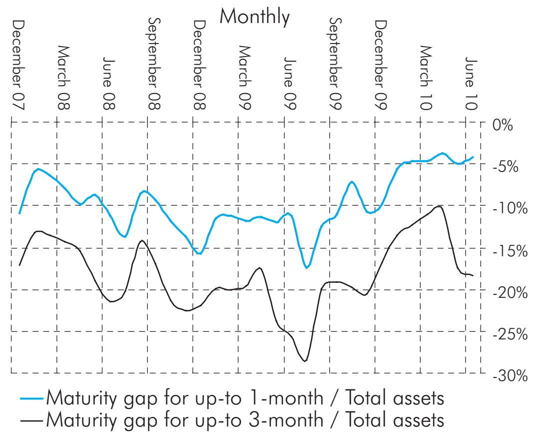


Source: Bank of Albania

Asset-liability gap by maturity terms is another indicator used for estimating the liquidity risk management. Short-term assets and liabilities are divided into three baskets according to remaining maturity: "up to 1-week", "1 week to 1 month", and "1 to 3 months" maturity baskets. A negative gap means that short-term liabilities – divided according to above baskets – exceed short-term assets. This analysis is necessary to realize the system and individual banks' ability to pay off their short-term liabilities through liquidation of short-term asset.

[67] *Herfindahl index is interpreted as: 0.01 (or 100) = distributed amount; 0.1 (or 1,000) = non concentrated; 0.1 – 0.18 (or 1,000 to 1,800) = moderate concentration; above 0.18 (or 1,800) = concentrated amount.*

Chart 80 Maturity gap for up-to 1-month and up-to 3-month basket



Source: Bank of Albania

In 2010 H1, the negative cumulative gap of assets and liabilities of three-month maturity term has expanded to -18.4%, from -16.7 at end-2009 H2.[68] During the first half of the year, up-to-3-month liabilities increased by ALL 75 billion, while assets grew by ALL 50 billion, influencing the negative gap expansion. The basket of 1-to-3-month maturity made the largest contribution to liability rise, which was up ALL 88 billion (70%). Up-to-one week basket and one-week to one-month one were changed by about ALL 10 billion (5.4%) and ALL -23 billion (-16.9%), respectively.

4.2 ASSESSING THE BANKING SECTOR'S RESILIENCE BY STRESS-TESTING[69] METHODOLOGY

Stress-testing analysis comprises two approaches: a) an analysis of the banking sector's sensitivity to market and credit risks, assessing the sensitivity of the banking sector's adequacy ratio to certain exchange rate or interest rate changes or to increased non-performing loans; b) an analysis of scenarios, assessing the response of the banking sector's capital adequacy ratio to the combined effect of several (macroeconomic and financial) interacting indicators. The assessment is based on end-period database, i.e., June 2010.

4.2.1 ANALYSING THE BANKING SECTOR'S SENSITIVITY TO RISKS

Direct FX risk: The banking sector's sensitivity to the lek's exchange rate volatility (depreciation/appreciation) is measured using the impact of size of open foreign exchange positions -in the primary currencies, the euro and dollar- on the balance-sheet. The size of open foreign exchange positions in the balance sheet is held constant[70] during the exercise. Certain changes causing a financial loss that erodes the capital value are applied on the exchange rate level. The exercise reveals that applying a range of shocks, such as exchange rate depreciation/appreciation by 5%, 10%, etc.., would result in a negligible fall of the banking sector's capital adequacy ratio. The

[68] *As at end 2009 H1, the cumulative gap of up to 3-month maturity term was -25.7%.*

[69] *We underscore that stress-testing is not a forecasting method. Intentionally, scenarios contain adverse events to test the banking sector's resilience to them. The scenarios contain assumptions that represent extreme developments at a low probability of likelihood. Though banks are encouraged to assess the capacity of their financial condition to cope with the impact of such scenarios, they should not regard them as events expected by the Bank of Albania to occur in the future. The scenarios are changeable over time, hinging on economic and financial developments.*

[70] *In fact, banks may change their open foreign exchange positions, depending on the trend of foreign exchange volatility. In this way, they may mitigate losses and also tend to grow their earnings.*

restricted open foreign exchange position values would hedge the banking sector against direct foreign exchange risk. Only extraordinary exchange rate fluctuations, almost unfeasible in practice, would alone cause drop of the banking sector's capital adequacy ratio below the 12% benchmark.

Interest rate risk: This exercise assesses capital adequacy ratio sensitivity to interest rate volatility (average interest rate on assets and liabilities) for the three currencies, the lek, euro, and dollar.

The 5 percentage point assumed rise in average interest rate on the lek (from 6.24% to 11.2%), would make the banking sector's capital adequacy ratio fall by 1.7 percentage point, to 14.5%. The largest contribution to this fall is made by G3 banks, whose capital adequacy ratio would fall by 2.4 percentage points.

As regards the 5 percentage point assumed rise in average interest rate for the U.S. dollar (from 1.9% to 6.9%), the banking sector appears hedged, because the capital adequacy ratio volatility appears insignificant even under the assumed shock.

Also, the 5 percentage point assumed rise in average interest rate for the euro (from 3.1% to 8.1%) would make the banking sector's capital adequacy ratio fall by only 0.4 percentage points. At banks peer group level by activity size, the peer G1 appears to have the largest exposure to euro interest rate shock. The capital adequacy ratio for this peer group would fall by 0.7 percentage point, to 26.3%.

A rise in the average interest rate for the lek by 15 percentage point[71] would make the banking sector's capital adequacy ratio slide below the minimum required benchmark. In the case of foreign currencies, such a rise would be much greater.

Credit risk: Such a risk represents the sensitivity of the banking sector's capital adequacy ratio to loan portfolio impairment from increased defaults. This exercise assumes a 95% and 110% rise in non-performing loans. The first shock represents the limit where the banking sector's capital adequacy ratio would fall below the minimum regulatory ratio, to 11.7%. Concerning the second shock, the drop of capital adequacy ratio would be more considerable, to 11%. At banks peer group level by activity size, peer G2 proved to be more sensitive to credit risk after applying each shock.

Indirect credit risk induced by foreign exchange rate: Such risk is mainly related to foreign currency loans to customers whose income is in national currency.

A 5% depreciation of the lek vs. the euro would lead to 0.7 pp decline in the capital adequacy ratio, to 15.5%. The banking sector would breach the

[71] *Regarding the euro and dollar interest rate, the banking sector does not present any critical level (adequacy ratio below 12%) to any shock.*

minimum regulatory requirement and would appear undercapitalized only against a 28% depreciation of the lek vs. the euro.

A 5% depreciation of the lek against the U.S. dollar would lead to a slight decline, by only 0.1 percentage point of the banking sector's capital adequacy ratio. Only an extraordinary depreciation of the lek vs. the U.S. dollar would make the banking sector undercapitalized.

SCENARIO ANALYSIS

This exercise assesses the impact of scenarios that combine several economic and financial indicators on the banking sector's financial position and capital adequacy over the current and next year, holding the capital value constant. Such shock is conducted by assuming loan portfolio quality impairment. The exercise contains two cases.

In the first case, the loan portfolio quality impairment is measured through assumptions performed in light of performance of macroeconomic indicators and internal activity of the banking sector, based on empirically assessed correlations. In such a case, there are identified situations when the banking sector's capital position falls below the specified regulatory requirements.

In the second case, the loan portfolio quality impairment is measured through a model that defines the correlations among macroeconomic indicators. In such a case, the changed nonperforming loan ratio and additional sector-wide capital requirements are assessed, in order to meet the minimum capital adequacy ratio.

The first case contains two scenarios. The first one is constructed on economic and financial indicators forecast, based mainly on their historical performance, whilst the second assumes a more "stressed" condition, at a low likelihood of event occurring.

The following table shows the performance of non-performing loans.

Table 17 Assessing non-performing loan portfolio growth by each scenario

	Scenario 1		Scenario 2	
	2010	2011	2010	2011
Rise in non-performing loans outstanding (in %) for the remaining period	17.02%	25.86%	59.18%	109.19%

Under scenario 1, growth is assumed 2.68% and 3.2%[72] respectively for 2010 and 2011. Market interest rate is assumed to increase by 1 percentage point and 0.5 percentage point, respectively for 2010 and 2011. The national currency is assumed as moderately depreciated against both primary currencies, the euro and the dollar, in the periods ahead. Net interest income and other bank income are assumed to follow their performance in 2010 H1, whilst the loan portfolio is assumed to grow by 7% and 13.8% for 2010 and 2011, respectively.

[72] *In June 2010, IMF forecasted a 3.2% growth for Albania over 2011. The figure is based on "IMF, Country Report No. 10/205.*

The following table shows estimates of the impact of non-performing loan portfolio growth on capital size and banking sector's risk-weighted assets, by years.

Table 18 Undercapitalized banks by scenario 1

	Year-end 2010		Year-end 2011	
	Individual banks	Banking system	Individual banks	Banking system
Regulatory capital				
Modest undecapitalization/1	Yes	Well-capitalized	Yes	Well-capitalized
Severe undecapitalization/2	No		Yes	
Tier 1 capital (Core equity/Total risk-weighted assets)				
Modest undecapitalization/3	No	Well-capitalized	Yes	Well-capitalized
Severe undecapitalization/4	No		Yes	

/1 = below the 12% ratio;
/2 = below the 6% ratio;
/3 = below the 6% ratio;
/4 = below the 3% ratio.

In such a case, individual banks may require growth of capital at the end of 2010. The overall sector is well-capitalized.

Scenario 2 assumes a more impaired economic situation. GDP is assumed to fall by 4 percentage points for 2010, based on the macroeconomic forecasting model, and by 2 percentage points, based on the latest IMF projection for Albania, 2011. The exchange rate depreciation is assumed greater than the one envisaged under scenario 1. Market interest rate rise is assumed 2 percentage points for each year and banks' net interest income, coupled with net income from other activities, are assumed respectively 80% and 90 % of their 2009 level, considering the latter as the most difficult one for generating positive income. Finally, a severe scenario assumes zero growth of the loan portfolio, respectively for 2010 and 2011.

The following table shows estimates of the impact of non-performing loan portfolio on the capital size and the banking sector's risk-weighted assets, by years.

Table 19 Undercapitalized banks by scenario 2

	Year-end 2010		Year-end 2011	
	Individual banks	Banking system	Individual banks	Banking system
Regulatory capital				
Modest undecapitalization/1	Yes	Well-capitalized	Yes	Capitalized
Severe undecapitalization/2	Yes		Yes	
Tier 1 capital (Core equity/Total risk-weighted assets)				
Modest undecapitalization/3	Yes	Well-capitalized	Yes	Well-capitalized
Severe undecapitalization/4	yes		Yes	

/1 = below the 12% ratio;
/2 = below the 6% ratio;
/3 = below the 6% ratio;
/4 = below the 3% ratio.

Under that extreme scenario, individual bank's needs for capital would be great.

The Albanian banking sector proved to be resilient to severe macroeconomic shocks that would affect the banking sector's loan portfolio impairment, bringing about increased costs and eroding the capital size. However, the Bank of Albania encourages commercial banks to assess the impact on their financial position of these scenarios or other similar scenarios, in line with their business terms, so as to know in advance their likely needs for additional capital and make timely decisions.

The second case integrates the impact of several macroeconomic factors on the ratio of nonperforming loans to outstanding loans for the next four quarters. The following tables show assumptions about hypothetical scenarios that combine adverse developments of economic growth, exchange rate vs. the euro and the EURIBOR rate. The exercise contains four scenarios. The estimation of credit impairment size per scenario makes possible the assessment of the needs for additional capital, should capital adequacy ratio slide below the 12% benchmark.

The first and second scenarios (tables 16 and 17) are considered as baseline ones, as they are closer to the actual situation[73]. Scenarios 3 and 4 (tables 18 and 19) are considered as extreme situations, with a low likelihood of event occurring.

Table 20 Scenario 1 (Baseline)

Scenario 1 (Baseline)	Q1_10	Q2_10	Q3_10	Q4_10	Q1_11	Q2_11	
Euro/ALL exchange rate	Exchange rate depreciation over 2 quarters and then its appreciation over the actual period						Assumptions
Euribor rate	Constant						Assumptions
Economic growth	2	1.68	2.43	2.12	3.17	2.62	Assumptions
Non-performing loan ratio	11.68%	12.20%	13.24%	13.35%	15.71%	14.72%	Assumption-based estimates
Need for additional capital	-	-	-	-	-	-	Assumption-based estimates

Table 21 Scenario 2 (Baseline)

Scenario 2 (Baseline)	Q1_10	Q2_10	Q3_10	Q4_10	Q1_11	Q2_11	
Euro/ALL exchange rate	Exchange rate depreciation over 2 quarters and then its appreciation over the actual period (similar to scenario 1); lower growth of outstanding loans, compared with scenario 1						Assumptions
Euribor rate	+ 100 basis points each year						Assumptions
Economic growth	2	Assumptions	2.43	2.12	3.17	2.62	Assumptions
Non-performing loan ratio	11.68%	12.20%	13.24%	13.75%	17.16%	16.97%	Assumption-based estimates
The system's need for additional capital	-	-	-	-	-	-	Assumption-based estimates

Under these scenarios, the banking sector proved to be resilient to assumed developments in macroeconomic and financial indicators, without raising the need for additional capital.

If scenario 3 occurred, the nonperforming loan ratio would average about 25% at the end of 2011 H1. In such a case, the banking sector's capital adequacy ratio would slide below the 12% benchmark and an additional

[73] *The said scenarios do not contain the NPL forecast, since their performance depends on a variety of both micro and macro factors. However, they serve as a reference to assess the impact of changed macroeconomic conditions on loan portfolio.*

capital of about ALL 3 billion would be needed to return it to above the minimum required ratio.

Table 22 Scenario 3

Scenario 3	Q1_10	Q2_10	Q3_10	Q4_10	Q1_11	Q2_11	
Euro/ALL exchange rate	Annual depreciation by 10%; slower total credit growth						Assumptions
Euribor rate	+ 400 basis points each year						Assumptions
Economic growth	2.00	Assumptions	0.08	1.35	3.18	3.31	Assumptions
Non-performing loan ratio	11.68%	12.20%	13.24%	15.58%	20.86%	25.17%	Assumption-based estimates
The system's need for additional capital (ALL million)	-	-	-	-	-	2,936	Assumption-based estimates

If scenario 2 occurred, at the end of 2011 Q2 the ratio of non-performing loans to outstanding loans would climb to around 28%. In such a case, the banking sector would need an additional capital of about ALL 9.6 billion to maintain the 12% minimum capital adequacy ratio.

Table 23 Scenario 4

Scenario 4	Q1_10	Q2_10	Q3_10	Q4_10	Q1_11	Q2_11	
Euro/ALL exchange rate	Annual depreciation by 20%; slower total credit growth						Assumptions
Euribor rate	+ 400 basis points each year						Assumptions
Economic growth	2.00	1.68	0.08	1.93	4.11	4.31	Assumptions
Non-performing loan ratio	11.68%	12.20%	13.24%	16.28%	22.82%	28.53%	Assumption-based estimates
The system's need for additional capital (ALL million)	-	-	-	-	-	9610	Assumption-based estimates

The following table shows the standard deviations of non-performing loan ratio tested under each scenario, and the confidence interval estimates of 90% and 80%.

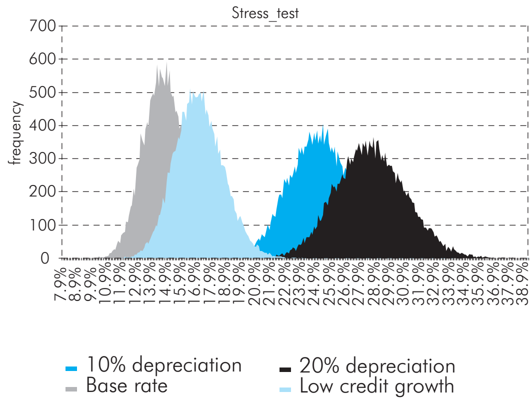
Table 24 Standard deviations of non-performing loan ratio under each scenario and interval estimates

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Mean	14.8%	16.97%	25.17%	28.53%
A 90% confidence interval estimate	12.49%-17.27%	14.47%-19.83%	21.77%-28.93%	24.83%-32.57%
An 80% confidence interval estimate	12.95%-16.66%	14.98%-19.15%	22.48%-28.04%	25.61%-31.63%

The following chart shows the density distribution of nonperforming loan ratio for 2010 Q2, simulated using the Monte Carlo method, for the four above scenarios. As the chart shows, the probability of having extreme values (far from the estimated average) of the non-performing loan ratio increases from scenario 1 to scenario 4.

In conclusion, the banking system is well-capitalized and resilient to severe shocks of economic factors that impair the loan quality. However, individual banks may need additional capital, hinging on the situations.

Chart 81 Probability distribution of non-performing loan ratio under the four scenarios



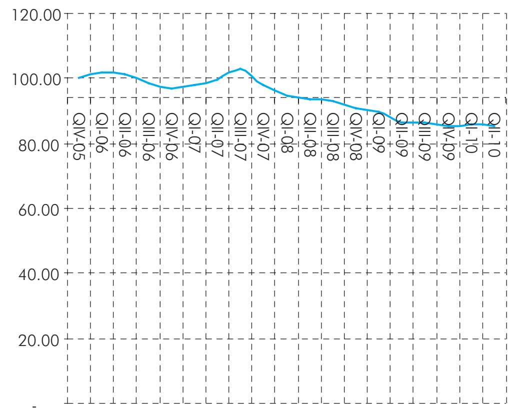
Source: Bank of Albania

4.3. FINANCIAL STRENGTH INDEX

Financial strength index[74] is constructed on the basis of latest banking sector developments for the Albanian banking sector and for banks peer groups by activity size.

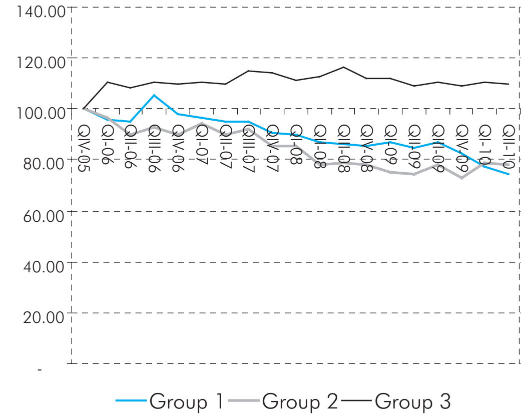
It is estimated that as at the end of 2010 H1, the financial strength index amounted to about 85.2, slightly down by 0.3% compared with end-2009. This decline was triggered by asset quality impairment, increased exposure

Chart 82 Financial strength index for the system and peer groups by activity size



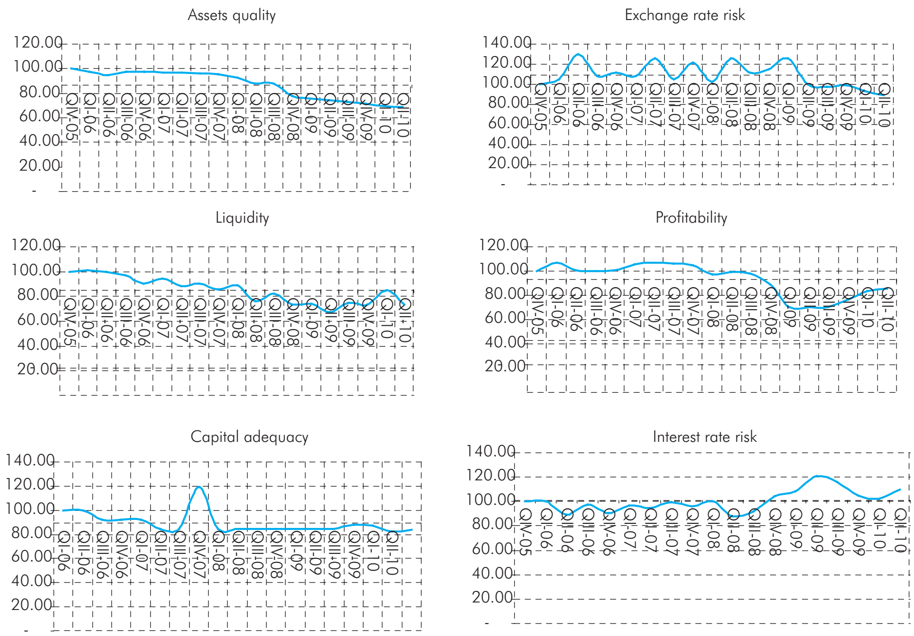
Source: Bank of Albania, FSD estimates

Chart 83 Financial strength index for banks peer groups by activity size



Source: Bank of Albania, FSD estimates

Chart 84 Sector-wide financial strength sub-indices (December 2005=100)



Source: Bank of Albania

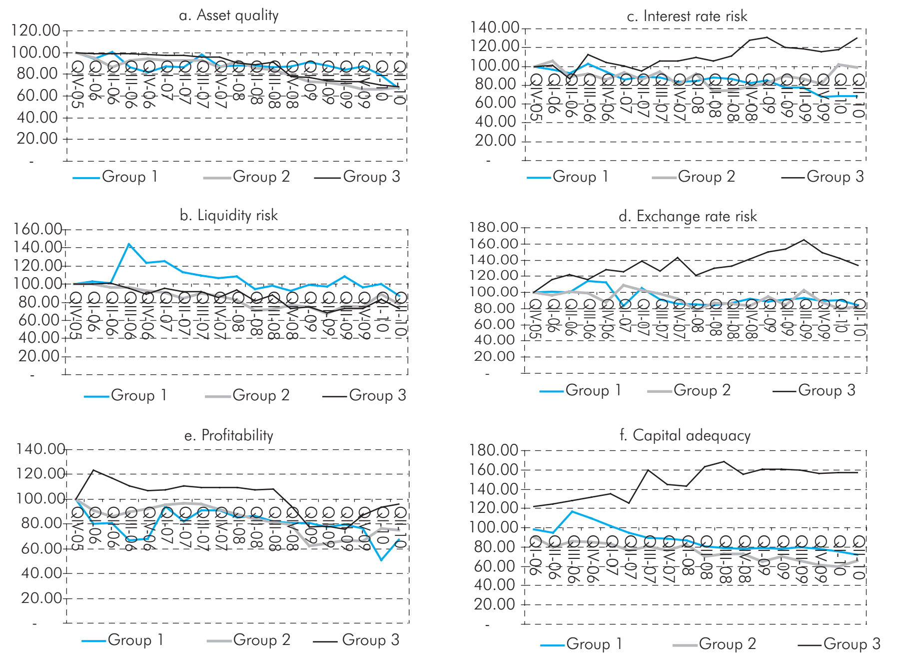
[74] *The index construction methodology is presented in Annex 2 attached. Time series of the index and its constituent sub-indices are presented in Annex 3 attached.*

to exchange rate volatility and slowed capital adequacy sub-index. Liquidity, profitability and interest rate sub-indices have had a rising positive performance (with a lower exposure to risks).

At banks peer group level, the financial strength index has marked the largest decline for peer G1 and largest increase for peer G2.

The following charts present individual key sub-indices for measuring the financial strength index on the banking system and banks peer groups by activity size, over December 2005 – June 2010.

Chart 85 Financial strength sub-indices for banks peer groups (December 2005=100)



Source: Bank of Albania

ANNEXES

ANNEX 1. BANKING SYSTEM INDICATORS

Table 25 Banking sector

(%)	June '09	Sept. '09	Dec '09	March '10	June '10
Capital-based indicators					
Regulatory capital to risk-weighted assets	16.85	16.67	16.17	16.13	16.21
Tier 1 capital to risk-weighted assets	16.10	15.88	15.27	15.19	15.43
Tier 1 capital to total assets	8.74	8.83	8.66	8.56	8.87
Regulatory capital to total assets	9.15	9.27	9.17	9.09	9.32
Shareholders' equity to total assets	9.34	9.32	9.57	9.58	9.60
Net non-performing loans to capital					
Net non-performing loans to tier 1 capital	25.72	27.25	29.93	33.57	32.81
Net non-performing loans to regulatory capital	24.58	25.94	28.24	31.63	31.24
Net non-performing loans to shareholders' equity	24.07	25.80	27.07	29.99	30.32
Gross non-performing loans to total loans	8.73	9.75	10.48	11.67	12.21
Return on Equity, RoA (y-o-y)	1.78	1.79	4.58	7.33	8.31
Return on Assets, RoA (y-o-y)	0.16	0.16	0.42	0.70	0.79
Income and expenses					
Interest margin to gross income	129.11	131.51	119.55	119.06	116.16
Non-interest expenses to gross income	201.61	266.99	231.40	202.09	213.05
Liquidity					
Liquid assets to total assets	40.90	41.34	27.65	27.88	27.85
Liquid assets to short-term liabilities (up to 1-year)	56.85	63.93	32.58	33.07	32.85
Net open position in foreign currency to capital					
Net open position in foreign currency to tier 1 capital	4.60	0.63	4.12	5.76	7.64
Net open position in foreign currency to regulatory capital	4.40	0.60	3.89	5.43	7.27
Net open position in foreign currency to shareholders' EQUITY	5.06	0.70	4.31	5.97	8.09

Table 26 Banks Peer Groups.

	June '09			Sept. '09			Dec. '09			March '10			June '10		
(%)	G1	G2	G3	G1	G2	G3	G1	G2	G3	G1	G2	G3	G1	G2	G3
Capital-based indicators															
Regulatory capital to risk-weighted assets	32.06	14.36	16.79	32.98	13.98	16.64	32.73	13.64	16.08	30.52	13.33	16.20	27.03	14.05	16.26
Tier 1 capital to risk-weighted assets	30.36	12.44	16.62	33.13	11.63	16.48	32.73	10.91	15.92	30.52	10.46	16.04	27.03	11.64	16.12
Tier 1 capital to total assets	19.39	8.81	8.11	20.62	8.51	8.21	19.14	8.03	8.17	18.18	7.41	8.26	16.88	8.79	8.31
Regulatory capital to total assets	20.48	10.17	8.20	20.62	10.23	8.29	19.14	10.04	8.26	18.18	9.44	8.34	16.88	10.09	8.39
Shareholders' equity to total assets	20.15	9.27	8.75	21.51	8.92	8.71	19.96	8.44	9.25	18.71	8.00	9.47	17.62	9.09	9.23
Net non-performing loans to capital															
Net non-performing loans to tier 1 capital	3.98	39.13	24.35	5.15	43.95	25.29	4.91	51.88	26.98	7.54	55.36	31.28	12.14	39.85	32.53
Net non-performing loans to regulatory capital	3.77	33.89	24.10	5.15	36.57	25.04	4.91	41.49	26.71	7.54	43.45	30.98	12.14	34.72	32.20
Net non-performing loans to shareholders' equity	3.83	37.21	22.58	4.93	41.96	23.84	4.71	49.33	23.84	7.32	51.25	27.29	11.63	38.52	29.27
Gross non-performing loans to total loans	3.84	10.54	8.23	4.77	11.52	9.24	4.90	13.13	9.61	6.19	13.79	11.07	8.61	11.87	12.77
Return on Equity, RoE (y-o-y)	(5.38)	(25.38)	10.45	(5.23)	(22.06)	9.72	(6.54)	(22.48)	14.07	(14.94)	(8.45)	14.79	(9.09)	(9.40)	19.05
Return on Assets, RoA (y-o-y)	(1.14)	(1.96)	0.89	(1.09)	(1.79)	0.83	(1.36)	(1.85)	1.22	(0.73)	(0.17)	0.34	(0.86)	(0.42)	0.86
Income and expenses															
Interest margin to gross income	84.79	227.23	117.56	85.00	210.67	121.46	89.87	209.59	107.61	155.65	130.07	115.15	98.63	147.61	108.41
Non-interest expenses to gross income	164.20	244.81	197.82	159.07	228.47	281.67	167.53	255.81	231.62	331.15	209.41	195.72	181.78	771.45	59.26
Liquidity															
Liquid assets to total assets	37.80	25.14	45.78	41.11	25.93	46.10	29.70	18.41	30.41	32.49	23.43	29.00	27.27	22.35	30.45
Liquid assets to short-term liabilities (up to 1-year)	59.51	39.28	61.21	74.01	44.68	68.54	38.60	23.18	34.92	41.79	30.18	33.37	34.68	28.48	34.52
Net open position in foreign currency to capital															
Net open position in foreign currency to tier 1 capital	3.10	9.27	3.29	2.28	0.91	0.29	(1.32)	7.97	3.77	1.20	11.10	4.93	4.54	6.57	8.64
Net open position in foreign currency to regulatory capital	2.94	8.03	3.26	2.28	0.75	0.29	(1.32)	6.38	3.73	1.20	8.71	4.88	4.54	5.72	8.55
Net open position in foreign currency to shareholders' equity	2.99	12.10	3.51	2.18	1.17	0.31	(1.26)	9.89	3.80	1.16	13.95	4.90	4.35	11.52	7.77

Table 27 Banks Peer Groups by Origin of Capital

	June '09				Sept. '09				Dec. '09				March '10				June '10			
(%)	Italian	French	Greek	Albania	Italian	French	Greek	Alba-nian	Italian	French	Greek	Alba-nian	Italian	French	Greek	Alba-nian	Italian	French	Greek	Alba-nian
Capital-based indicators																				
Regulatory capital to risk-weighted assets	17.59	14.82	14.76	15.63	18.38	13.50	14.37	15.12	18.80	14.22	14.07	14.22	18.48	13.65	14.54	13.06	19.42	15.38	14.65	13.30
Tier 1 capital to risk-weighted assets	16.73	12.72	14.76	11.23	17.52	11.59	14.37	12.03	17.89	11.26	14.07	11.19	17.57	10.80	14.26	10.25	18.62	12.53	14.38	10.56
Tier 1 capital to total assets	8.43	8.81	11.10	7.84	8.81	8.61	11.29	8.15	8.54	8.58	11.18	7.80	8.38	7.97	11.13	7.01	9.54	8.71	11.43	7.05
Regulatory capital to total assets	8.86	10.26	11.10	10.92	9.24	10.04	11.29	10.32	8.98	10.84	11.18	9.91	8.81	10.07	11.34	8.93	9.95	10.69	11.64	8.88
Shareholders' equity to total assets	9.31	9.43	11.52	8.43	10.26	9.35	11.76	8.52	10.53	9.48	11.63	8.15	10.64	8.95	11.88	7.21	10.21	9.40	11.90	7.24
Net non-performing loans to capital																				
Net non-performing loans to tier 1 capital	25.24	57.26	21.10	25.18	20.00	59.65	22.86	22.75	25.00	70.02	22.80	42.43	28.70	83.29	23.89	41.47	29.85	62.49	23.14	50.77
Net non-performing loans to regulatory capital	24.00	49.14	21.10	18.10	19.06	51.20	22.86	17.97	23.78	55.45	22.80	33.39	27.29	65.93	23.44	32.55	28.62	50.91	22.72	40.33
Net non-performing loans to shareholders' equity	22.85	53.48	20.35	23.43	17.17	54.97	21.96	21.76	20.29	63.37	21.90	40.64	22.60	74.23	22.38	40.34	27.90	57.91	22.22	49.42
Gross non-performing loans to total loans	8.02	16.33	6.54	4.89	7.48	16.78	7.07	5.21	8.83	18.63	8.06	8.13	9.76	20.71	8.19	8.75	11.99	19.64	8.75	10.49
Return on equity, roe (y-o-y)	9.54	(38.52)	(5.87)	6.89	14.40	(37.95)	(2.87)	6.80	15.67	(30.83)	(5.72)	4.47	11.35	(25.41)	12.22	(19.81)	5.05	(20.06)	5.03	(10.81)
Return on assets, roa (y-o-y)	0.86	(3.40)	(0.58)	0.59	1.33	(3.39)	(0.30)	0.57	1.49	(2.79)	(0.61)	0.37	0.30	(0.58)	0.36	(0.38)	0.26	(0.91)	0.30	(0.40)

Income and expenses																				
Interest margin to gross income	89.04	8,374.91	173.17	103.16	78.37	203,104.30	147.85	106.38	73.27	381.76	171.74	110.79	82.47	337.93	87.61	267.41	101.45	225.88	112.00	180.59
Non-interest expenses to gross income	98.81	9,156.19	796.43	85.14	79.37	215,872.58	1,045.35	85.73	74.84	537.29	1,125.13	91.02	76.12	716.85	483.17	225.94	103.62	540.79	636.36	144.10
Liquidity																				
Liquid assets to total assets	47.26	30.26	19.14	26.41	46.53	29.23	17.96	30.32	33.98	26.74	18.65	21.73	32.44	30.83	19.94	23.76	32.66	30.68	20.29	24.15
Liquid assets to short-term liabilities (up to 1-year)	67.48	56.08	25.14	39.61	73.34	57.60	24.21	52.72	40.12	37.64	22.37	25.69	38.29	44.80	24.61	27.65	38.38	45.60	24.44	28.20
Net open position in foreign currency to capital																				
Net open position in foreign currency to tier 1 capital	1.60	31.44	(0.14)	8.47	0.58	1.05	0.42	1.17	0.64	15.65	(1.68)	6.76	0.71	10.89	0.72	5.02	2.65	12.83	(0.83)	16.37
Net open position in foreign currency to regulatory capital	1.52	26.98	(0.14)	6.08	0.55	0.90	0.42	0.92	0.61	12.39	(1.68)	5.32	0.68	8.62	0.70	3.94	2.54	10.45	(0.81)	13.00
Net open position in foreign currency to shareholders' equity	1.45	29.37	(0.28)	7.88	0.50	0.97	0.85	1.12	0.52	14.16	(3.30)	6.48	0.56	9.71	1.39	4.89	2.48	11.89	(1.60)	15.93

ANNEX 2. METHODOLOGY OF BUILDING THE FINANCIAL STRENGTH INDEX

This index is constructed on the basis of a similar model used by Central Bank of Turkey, with several changes. The following table shows financial indicators that help calculate the index. These indicators estimate the banking sector's financial strength, developments and size of main risks it is exposed to. Table 28 also shows the sign of impact of indicators, as well as the weights assigned and the formulae used to calculate each sub-index. A positive sign signifies that the index will rise due to the increase in the ratio, whereas a negative sign signifies that the index will decline due to the increase in the ratio.

Table 28 Financial Strength Indicators

	Financial Strength Indicators	Direction of the impact	Weights
Asset quality	Gross non-performing loans/Gross loans	negative	0.33
	Net NPLs/Shareholders' Equity	negative	0.33
	Fixed assets/Total assets*	negative	0.33
Liquidity	Liquid assets/Total assets	positive	0.40
	Assets with a maturity up to 3 months/Liabilities with a maturity up to 3 months	positive	0.60
Exchange rate risk	On-balance sheet FX position/Own funds	negative	0.50
	FX net general position/Own funds	negative	0.50
Profitability	Net profit/Total assets	positive	0.50
	Net profit/Shareholders equity	positive	0.50
Capital adequacy	Free capital/Total assets**	positive	0.50
	Capital adequacy ratio	positive	0.50
Interest rate risk	(Interest sensitive domestic currency assets with a maturity up to 1 month – interest sensitive domestic currency liabilities with a maturity up to 1 month)/Equity) ***	negative	0.50
	(Interest sensitive FX assets with a maturity up to 1 month – interest sensitive FX liabilities with a maturity up to 1 Month) / Equity	negative	0.50

* *Fixed Assets consist of fixed assets and net non-performing loans..*

** *Free capital is calculated by deducting fixed assets from equity.*

*** *The difference between assets and liabilities up to 1 month in both national currency and in FX signifies short term asset-liability mismatch sensitive to interest rate, which may cause loss in case of adverse volatility of this rate.*

The time series of indicators (ratios) used to construct sub-indices are standardized. The standardization process is carried out by measuring the distance of the real value of the indicator (the ratio) for a certain moment from the average value of the ratio calculated for the period, in terms of standard deviation.[1]

Through this calculation, the new series Z is obtained, according to the following formulae:

$$Z=X-\mu/ \qquad (1)$$

1 *The average calculated for the period December 2005-June 2010 is subtracted from the average value of the ratio calculated for that period and then divided by the standard deviation for the same period.*

Where: X represents the value of the ratio calculated for each period analyzed, μ represents the average value of the ratio calculated for the period under analysis, and -ma represents the standard deviation. In constructing each above sub-index, the standardized values of the ratios according to the formulae (1) are multiplied by the weights assigned in the above table and then summed up for each period. At the same time, an adjustment is made in order to make all of the standardized values of the Z time series positive. According to the methodology, a base period is chosen, which is taken as 100[2] and the indices are calculated by using direct proportions, if the increase in the ratio is favourable; conversely, if the increase in the ratio is unfavourable, the indices are calculated by using indirect proportion[3]. Finally, FSI is calculated by taking the arithmetic average of the sub-indices.

[2] *In our case, we refer to December 2005.*

[3] *A typical case of using the indirect proportion is related to asset quality sub-index, where the increase of the ratios constituting this sub-index (for example, non-performing loans to total loans or net non-performing loans to shareholders' equity) actually causes decline in asset quality sub-index, given that their increase is unfavourable for the banking sector. As a matter of fact, the signs or direction of the impact shown in Table 28, serve to determine whether to use direct or indirect proportion.*

ANNEX 3. SUMMARY OF FSI RESULTS FOR THE BANKING SYSTEM

Table 29 Summary of FSI results for the banking system

	Asset quality index	Liquidity risk index	Interest rate risk index	Exchange rate risk index	Profitability index	Capital adequacy index	Financial strength index
December 05	100.00	100.00	100.00	100.00	100.00	100.00	100.00
March 06	97.25	100.85	100.31	104.68	106.73	100.00	101.64
June 06	94.65	99.99	89.25	129.89	100.81	92.42	101.17
September 06	97.25	97.00	97.21	108.23	100.21	92.42	98.72
December 06	97.25	90.18	90.27	111.33	100.60	92.42	97.01
March 07	96.69	94.44	97.00	108.28	105.42	84.83	97.77
June 07	96.69	88.46	95.02	125.69	107.07	84.83	99.63
September 07	96.13	90.16	99.23	105.30	106.53	119.19	102.75
December 07	95.58	85.47	95.92	121.92	104.83	84.83	98.09
March 08	93.06	88.87	100.29	102.60	97.27	84.83	94.49
June 08	87.72	76.51	87.97	125.75	99.59	84.83	93.73
September 08	88.18	82.47	91.73	111.43	98.00	84.83	92.77
December 08	77.50	73.51	104.32	114.72	89.10	84.83	90.67
March 09	75.84	73.93	108.41	125.75	70.05	84.83	89.80
June 09	74.58	67.54	121.05	100.21	70.64	84.83	86.48
September 09	73.03	74.55	115.79	97.37	70.57	88.27	86.60
December 09	71.61	73.52	104.94	98.83	76.45	87.26	85.43
March 10	69.28	85.07	102.03	93.47	83.48	82.16	85.91
June 10	68.84	73.63	109.83	89.23	85.44	84.14	85.19

Source: Bank of Albania, FSD estimates