B a n k o f A l b a n i a

FINANCIAL STABILITY REPORT 2011 H1

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PREFACE

This is the sixth issue of the Bank of Albania's Financial Stability Report, which is produced half-yearly. The purpose of this Report is to detect and assess the risks faced by the financial system and its infrastructure, in order to provide the public authorities with the opportunity to identify relevant measures for necessary adjustments. The Report is opened with the Financial Stability Statement, whose half-yearly release is a legal requirement.

In producing this Report, we have used data available at the Bank of Albania, and information has been exchanged with other authorities supervising the financial market activity. We have also used information and analyses of public and private, national and international financial institutions. The data and analyses cover mainly the developments over 2011 H1. Unless otherwise stated, the expectations on the economic and financial outlook generally extend until mid-2012.

The financial system stability has been assessed on the basis of the performance and risks from its interaction with the overall internal and external economic environment, as well as from its activity. In order to assess the risks 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 about the economic growth, balance of trade, overall price level, exchange rate and fiscal indicators. By making an analysis of employment and income, the Report also provides an assessment of businesses' and households' financial situation and the impact on the banking sector borrowers' solvency.

NOTES

As at end-June 2011, Albanian banking sector banks are divided into the following groups, according to their share:

a) Banks Peer Group 1 (each sharing 0-2% of total banking sector's assets) were: United Bank of Albania, Veneto Bank (former Italian Development Bank), International Commercial Bank, First Investment Bank, and Credit Bank of Albania;

b) Banks Peer Group 2 (each sharing 2-7% of total banking sector's assets) were: ProCredit Bank, Emporiki Bank, Branch of National Bank of Greece, Société Générale Albania Bank (former Banka Popullore), Alpha Bank - Albania, and Union Bank;

c) Banks Peer Group 3 (each sharing over 7% of total banking sector's assets) were: Raiffeisen Bank, Credins Bank, National Commercial Bank, Intesa Sanpaolo Bank – Albania, and Tirana Bank.

As at end-June 2011, according to capital origin, the banks operating in the Albanian banking sector were as follows:

a) Austrian-owned banks[1]: Raiffeisen Bank;

b) Italian-owned banks: Intesa Sanpaolo Bank – Albania, and Veneto Bank (former Italian Development Bank);

c) Greek-owned banks: Alpha Bank - Albania, Tirana Bank, and Branch of National Bank of Greece;

d) French-owned banks: Société Générale Albania Bank (former Banka Popullore), and Emporiki Bank;

e) Albanian-owned banks: Credins Bank, and Union Bank;

As at end-June 2011, by form of establishment, Albanian banking sector's bank branches were: Alpha Bank - Albania, and Branch of National Bank of Greece. Also, the following banks are evidenced as having extended their branch network abroad: National Commercial Bank and Intesa Sanpaolo Bank – Albania, respectively in Prizren, Kosovo and Athens, Greece.

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

FINANCIAL STABILITY STATEMENT FOR 2011 H1

Pursuant to provisions stipulated under Article 69 of the Law No. 8269, dated 23 December 1997 "On the Bank of Albania", as amended, and Article 8 of the Law No. 9962, dated 18 December 2006 "On Banks in the Republic of Albania", to inform the Parliament of the Republic of Albania and the Council of Ministers, and to draw the attention of financial institutions and the public at large on the situation of the Albanian financial system and the potential risks that may jeopardize its stability, the Bank of Albania releases the following interim statement, which is an integral part of the Financial Stability Report for the same stated period.

The financial system and the banking sector, through their financial intermediation, provide a valuable contribution to the country's economic development and the welfare of the society. However, the banking activity is associated with several risks from the surrounding economic environment and the development of its activity. These risks should be analyzed and assessed in order to be addressed in due time and to ensure the financial system stability.

Concerning developments in the surrounding economic environment, it is assessed that despite a good economic growth in 2011 H1, the growth outlook for 2011 H2 remains more uncertain, against the backdrop of expected slowdown in the global economic growth, lack of room to deploy fiscal policy stimulus, and pressures on the contribution of consumption and investments to economic growth, in consequence of households' increased propensity to save. Should the economy slow down, it might adversely affect the volume of activity and businesses' decisions on investment expansion, hence restraining the vigour of the demand for bank loans.

In terms of the financial system performance, as at end-2011 H1, the financial system and the banking sector position is assessed as stable. The banking sector continues to dominate the financial system activity. It has further expanded its operations and increased its share in the domestic economy. Liquidity situation appears better due to satisfactory paces of public deposit growth. They cover the value of loans more than one time and borrowing from non-residents is at low levels. The pace of credit growth is getting better; however the loan portfolio quality has continued to decline. The banking sector has maintained stable growth rates of net interest income and gross operating profit. Nevertheless, the necessary increase in loan-loss provisions has led to the decline in the banking sector's net financial profit, compared with the same period last year. However, the financial profit remains positive and concentrated. Capital adequacy indicator has been downward; however, it remains well above the minimum capital requirement.

The generation of an insufficient positive financial profit and the decline in capital adequacy have increased the banks' vulnerability to various risks, as also confirmed by the stress-testing exercises. Among these risks, the banking sector appears more resilient to direct market risks; however, it remains exposed to the impact of adverse exchange rate and interest rate fluctuations on credit quality. Credit risk represents the main risk facing the Albanian banking sector. Related to this matter, the Bank of Albania, through its supervisory function, has required from commercial banks to ensure, in parallel, the duly and timely identification of non-performing loans and the establishment of respective loan-loss provisions, as well as to take appropriate actions in order to recover loan-loss funds through the execution of collaterals. These actions, coupled with the measures taken to further reduce the operating costs, will gradually create conditions for generating a stable and positive financial profit, which would better support the banking sector's mid-term needs for capital.

In the short-term outlook, the Bank of Albania has assessed and required that the banking sector should strengthen the capitalization of its activity, raising the capital from shareholders. The Bank of Albania has oriented and monitored this process, so that it is carried out in line with the banking activity development strategies and the performance of relevant risks. The process of strengthening the banking sector's capitalization indicators involves creating adequate capital sizes above its required minimum level. The process is taking place in line with the communications of the Bank of Albania with the banking sector. Subsequently, the banking sector will remain stable and will create conditions for enhancing its contribution to the economic development in Albania.

SUMMARY

Global economy and financial market highlights. In early 2011, the pace of global economic growth was slower than its 2010 average. In 2011 Q1, global economy expanded at an annualized rate of 4.3%, from 5% in 2010. In 2011 Q2, the annualized global economic growth declined to 3.7%, down by 1.6 percentage points from a year earlier. These developments have reflected the financial markets' higher funding costs for investments and the private sector's slower aggregate demand, which has reinforced the effect of the decreased public spending as a result of efforts for fiscal consolidation.

The economic growth rates in advanced economies varied significantly from those of emerging and developing economies. At end-2011 H1, advanced economies posted a 1.5% growth rate, from 6.8% posted by emerging and developing economies. During this 6-month period, global inflation rate also rose, mainly driven by upward primary commodity prices. However, the future inflation pressures are expected to be downward, due to mitigated pressures on energy and primary commodity price rises. As a consequence of a higher pace of economic growth, emerging and developing economies are expected to face higher inflationary pressures.

The uncertainty induced by the public debt size, low consumption levels, tight funding conditions, and the significantly limited room to deploy the economic policy stimulus by public authorities, have led to a downward revision of the global growth forecast for 2011, to 4%. Advanced economies will continue to expand modestly, mainly owing to slow progress of the U.S. economy and the Euro area. In the meantime, the decline in foreign demand is expected to be reflected in the economic growth of emerging and developing economies. Subsequently, growth in these economies is expected to moderate to 6.4% in 2011, from 7.3% in 2010.

In 2011 H1, the U.S. economy grew at slow paces. It expanded at an annualized rate of 0.4% in Q1 and 1.0% in Q2, reflecting the significantly weaker consumer spending that grew only 0.1% in Q2. The contribution of public expenditures to economic growth has been downward, since they fell by an annualized rate of 5.8% in Q1 and 1.1% in Q2. Overall, the U.S. economic recovery remains uncertain, under the conditions when the performance of the housing market and of consumer spending remains weak, whereas the public debt level remains too high. Expectations about the outlook of the U.S. economy for the remainder of 2011 reflect the slowdown observed in the first two quarters of 2011. According to the World Economic Outlook[2], the U.S. is expected to grow by 1.5% in 2011 and by 1.8% in 2012.

[2] *September 2011.*

The European Union (EU) and the euro-area countries also posted an uneven growth in the first two quarters of 2011. On average, they expanded by 2.5% in 2011 Q1, from 1.9% in the same period in 2010. Sustainable consumption and government spending were key drivers to this growth. Preliminary data on the second-quarter growth of the EU and the euro-area countries show a lower growth rate, about 1.7%. These developments were influenced by the slower pace of economic growth in Germany, which was halved to the annualized rate of 2.8%, as well as by the lack of economic growth in France. During 2011 H1, inflationary pressures in the euro-area countries were upward. Therefore, the European Central Bank (ECB) raised the key interest rate to 1.25% in April 2011, because of the concern that inflation would remain above the 2% target in the next months.

The recovery of economic activity in the Central and South-eastern Europe[3] gained further strength in 2011 H1, mainly due to the external demand. However, at the same time, domestic demand was restrained by weak labour market conditions, higher commodity prices and short-term effects of fiscal consolidation. Real Gross Domestic Product (GDP) recovered steadily in some of these countries. Inflation was higher than at end-2010 in most Central and Southeast European countries, especially over 2011 Q1, reflecting the elevated energy and food prices. However, 2011 Q2 highlighted mitigated inflation rates. Looking ahead, the short-term indicators suggest that the recovery is likely to continue in most countries. Also, the revised projections[4] for the Central and South-eastern Europe appear more optimistic compared to preliminary estimates and the 2010 levels, expecting from this region a 4.3% real GDP growth for 2011.

The performance of international financial markets. As at end-2011 H1, global financial markets were volatile, reflecting concerns about sovereign debt sustainability in the Euro area and the sluggish economic activity in the U.S.[5]

In the United States, the accommodating monetary policy and buoyant liquidity contributed to keeping money market interest rates low, whereas in the Euro area, due to upward inflationary pressures, the ECB lifted the key interest rate[6] by 25 basis points, to 1.25%. Interbank interest rates followed an upward trend throughout the six-month period.

Long-term government bond yields in the United States have shown an upward trend since end-2010; however, during the period under review, they showed considerable volatility. The same trend has been observed even in the Euro area, whereas the Japanese government bond yields have declined. Uncertainties about future yields on government bonds have increased, as a consequence of the volatility in global economic situation, inflation expectations and political tensions.

[3] *According to ECB's Monthly Bulletin, June 2011.*
[4] *World Economic Outlook, September 2011.*
[5] *World Economic Outlook Updated 17/06/2011.*
[6] *ECB Monthly Bulletin, June 2011.*

In capital markets, stock prices in the major stock markets have generally increased compared to end-2010, as a reflection of improvements in the financial situation of traded companies. However, uncertainties about the economic developments and geopolitical tensions have raised the volatility of these markets.

In foreign exchange markets, the Federal Reserve's decision to maintain an easing monetary policy has contributed to the U.S. dollar's depreciation against the major currencies. The European currency was volatile during this six-month period, primarily influenced by developments in the fiscal position across various euro-area countries. However, compared to end-2010, the European currency has appreciated against the major currencies.

In primary commodity markets, in 2011 Q1, prices picked up significantly for all items, compared to end-2010. This pickup appears in opposite direction with their slowing consumption worldwide. Food prices were stabilized following earlier supply-side shocks because of weather conditions. Uncertainties about the future of nuclear energy induced from concerns created in this area following the earthquake in Japan, and the political tensions in some Arab countries heightened the oil price pressure over the period.

The performance of the banking sector, assessed for Global Large and Complex Banking Groups (GLCBG), appears to have improved in 2011 Q1, based on their capacity to cope with the shocks. This improvement is an outcome of a better capital condition, better control of operating costs and earnings recovery. In 2011 Q1, the average return on equity improved to 7.2%, from 4.5% at end-2010. Return on assets registered 0.53% over this quarter, from 0.34% in 2010 Q4. Capital adequacy ratio rose to 13.4% in 2011 Q1, due to non-allocation by some banks of a substantial share of profits, in order to increase the capital. However, for some banks, it is assessed that they should achieve a higher quality of capital and further reduce the level of financial leverage, in order to boost market confidence and to better cope with the shocks and potential losses. Despite the improved conditions, the environment in which these banks operate remains challenging, mainly due to some banks' exposure to the sovereign debt of peripheral euro-area countries.

Albanian economy highlights. During 2011 Q1, the Albanian economy expanded, mainly driven by domestic demand, higher pace of growth of exports and moderate growth of imports, which are reflected in an improved trade deficit. However, in 2011 Q2, the negative values of trade deficit picked up and its contribution to economic growth exacerbated. Private consumption continues to take place sluggishly because employment rate and wage incomes have grown moderately and the propensity to save appears stable. Remittances continue to drop, adversely influencing the level of consumption in Albania.

Investment growth in the country has decelerated, due to the slowdown in banking sector credit and capital spending of the fiscal policy. At end-2011

H1, the banking sector outstanding loans rose to ALL 518.7 billion, about ALL 32.5 billion or 6.6% more than at end-2010. The share of outstanding loans made to non-residents was 4.7%, up ALL 5.5 billion or 28.6%, compared with end-2010. Over the period, outstanding loans made to non-residents were only 3.9% of total banking sector credit. Credit growth rate in 2011 H1 was up 2.2 percentage points from the same period a year earlier. The decelerated growth of investments was driven by the slowdown in capital spending. During 2011 H1, they increased by 1.82%, compared to the same period a year earlier.

However, private investments were supported by improved liquidity in the banking sector through deposit growth. All sectors of the economy - industry, services and construction - have increased their capacity utilization, though they remain below their long-term average. Expectations for the remainder of 2011 H1 are positive, mainly due to increased domestic demand in industry or improved economic activity in services and positive developments in the construction sector, which were also reflected in the first quarter.

In 2011 H1, the contribution of fiscal policy was reflected mainly in terms of current expenditure growth. Total revenues increased slightly, only 1.1% y-o-y, while total expenditures increased 7.7%, contributing to budget deficit growth by ALL 26.9 billion. The percentage of annual plan realization is 42.9% for total revenues and 44.5% for total expenditures, reflecting obvious difficulties in revenue growth and prompting their revision for the remainder of the year. Public debt stock increased by 5% in absolute terms, as compared to end-2010, marking a higher increase in the domestic debt stock than in the external one[7].

In 2011 H1, current account deficit was EUR 588.5 million or 14% of GDP, expanding by about 4.9 percentage points on a year earlier. Compared with end-2010, however, the current account deficit has narrowed by 2.8 percentage points. Trade balance deficit is EUR 1053.4 million over the same period, up 14% on a year earlier. As a share of GDP, the trade balance deficit is 24.5%, up 4.2 percentage points on a year earlier, but down 1.6 percentage points from end-2010. These developments reflect the positive growth rates of exports by 12% y-o-y, compared to 13% growth of imports. During 2011 H1, net foreign inflows of capital and financial account recorded EUR 434.9 million, about 41% more than a year earlier. Foreign direct investments and portfolio investments have narrowed by 15% and 68% y-o-y, respectively. However, the improvement in capital transfers was reflected in a positive capital and financial account balance by 9.7% of GDP, from 7.7% a year earlier.

In terms of price performance in the country, during 2011 H1, inflationary pressures were on the rise. In February and May 2011, the inflation rate was above the Bank of Albania's upper targeted band of 3% (2% -4%). These developments have mainly reflected the impact of food and oil price rises in international markets. In response to these inflationary pressures, at end-

[7] *Ministry of Finance, "Debt Indicators as at 2011 H1".*

March, the Bank of Albania lifted its key interest rate by 0.25 percentage points, to 5.25%. In 2011 H1, annual inflation averaged 4.0%.

In 2011 H1, business and household borrowing performed positively. In June 2011, business borrowing[8] increased by 14.6%, compared to the same month in 2010. Household borrowing also improved, increasing by 5.3% y-o-y, from 1.5% at end-2010 and 0.7% in June 2010. On the other hand, compared with end-2010, businesses have slowed the pace of deposit placements at financial institutions. In June 2011, businesses increased their deposits by 10.2% y-o-y. Subsequently, businesses' debtor position, which shows the difference between their claims on financial institutions (deposits) and their liabilities to these institutions (loans received) registered ALL 255.6 billion at end-2011 H1, deepening by ALL 35 billion compared with a year earlier. On the other hand, households' creditor position amounted to ALL 559 billion, about ALL 97.6 billion more than a year earlier.

Increased lending to businesses and households ensures the meeting of their financial needs. However, depending even on the form of loan, businesses and households may be unevenly exposed to credit risk. In terms of indirect credit risk arising from adverse exchange rate moves, businesses present a higher exposure. They have a much deeper financial foreign exchange position (net debtor), as compared to their domestic net debtor position. In June 2011, they were debtors to financial institutions for about ALL 191.4 billion in the form of foreign currency loans and about ALL 64.2 billion in national currency. Despite the improved lending in 2011 H1, these developments have been reflected in the increased ratio of outstanding loans unhedged against exchange rate risk to total outstanding loans for businesses.

At an aggregate level, households are by and large hedged against indirect credit risk arising from exchange rate depreciation. At end-2011 H1, households borrowed from the financial system a total of ALL 236.7 billion in foreign currency. It is, however, estimated that about 41% of total outstanding household loans made by banks is unhedged against exchange rate risk, providing evidence for the presence of exposure to this type of risk.

In terms of indirect credit risk arising from adverse interest rate moves, it is estimated that at end-2011 H1, all in all, the total outstanding variable interest rate loans made to businesses and households was up 0.79 percentage points on a year earlier. Again, businesses appear more exposed than households. In fact, 60.8% of outstanding loans made to businesses were at variable interest rate, up 1.6 percentage points on a year earlier. Over the same period, 26.5% of outstanding loans made to households were at variable interest rate, leading to the decline in their exposure to interest rate risk by 1.4 percentage points.

Financial market highlights. The Albanian financial market is dominated by operations in the interbank market, government debt securities and foreign

[8] *It includes loans granted by deposit-taking financial institutions (commercial banks and savings and loan associations) in the form of pure loans and other debt instruments.*

exchange. Other segments that relate to insurance, reinsurance and pension funds account for a small share of total financial market volume.

In 2011 H1, the trading volume in the interbank market decreased by 22.7% compared to 2010 H2, while the weighted average interest rate maintained almost similar levels. In the Government debt security market, the auction ask amount exceeded the bid amount. However, starting from January 2011, the primary market government debt yield started to edge up, as a result of increased government borrowing. The increase was more pronounced in the 12-month debt security yields, followed by bond yields indexed to this indicator.

Concerning the banking sector's intermediation cost, it is noted that the average interest rate spread between loans and deposits for lek-denominated operations narrowed by 0.04 percentage points, as a consequence of a higher interest rate cut in lek-denominated loans against the lek-denominated deposit interest rate. Compared to December 2010, this spread has expanded by 2.04 percentage points for operations in U.S. dollar and 0.44 percentage points for those in euro, respectively due to the increase in average USD-denominated loan interest rate by 2.1 percentage points and higher increase in euro-denominated loan interest rate against euro-denominated deposits.

In the domestic market, in 2011 H1, the euro appreciated against the Lek by 1.9%, whereas the U.S. dollar and Pound sterling depreciated by 6.1% and 3.3%, respectively. The lek's appreciation against the above currencies has mainly reflected the developments in the international foreign exchange markets.

The financial market activity has been supported by the smooth functioning of AECH and AIPS payment systems, which are managed by the Bank of Albania. In 2011 H1, the number of transactions increased by about 3.9% in the AIPS (Real-Time Gross Settlement System) and about 34.7% in the AECH (Automated Clearing House System). During January-June 2011, there was processed a total of about 5.6 million card (ATM and POS) transactions, with a total turnover of ALL 56 billion. Out of the total, about 96% are cash withdrawals from ATMs and only 4% are customer payments executed via POS terminals, thus providing evidence for the large use of cash in the Albanian economy.

Financial system highlights. Financial intermediation in Albania, measured as the ratio of financial sector[9] assets to GDP[10] is estimated at 86.9% in 2011 H1, from 85.9% at end-2010 and 84.4% in 2010 H1. Financial institutions' assets grew about 5% compared to end-2010. The banking sector remains the dominant segment of financial intermediation in Albania. Its assets accounted for about 94.5% of total financial system assets and 82.2% of GDP. Non-

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

[10] *IMF's forecast for quarterly nominal GDP based on the quarterly real GDP released by INSTAT. In 2011, GDP totalled ALL 1,321.5 billion.*

bank financial sector continues to have a small share in the total financial system. Hence, the non-bank financial sector's total assets[11] accounted for about 5.5% of the financial system assets, a downward share as compared to 5.7% at end-2010. As a share of GDP, this sector's activity accounts for about 4.8%, from 4.9% at end-2010.

Banking sector highlights. In 2011 H1, banking sector assets totalled ALL 1,043.9 billion, up about 5.4% from end-2010 and 11.7% from 2010 H1.

In terms of banking sector asset composition, the loan portfolio (excluding accrued interests[12]) has reached ALL 518.7 billion, increasing by 6.6% from end-2010. Foreign currency loans account for about 68.7% of total loans. The banks' foreign currency assets reached ALL 547.9 billion, increasing by 4.3% from end-2010. Banks' investments in non-resident assets rose to ALL 129 billion, up 6% from end-2010 and 23.5% from a year earlier. Banks peer group 3 accounts for 81.7% of the total value of these investments. In the meantime, banking sector placements with non-resident institutions are estimated at ALL 69.4 billion, of which ALL 59 billion are in the form of current and deposit accounts and ALL 10.4 billion are in the form of loans.

In terms of banking sector liability composition, deposits (excluding accrued interests[13]) have reached around ALL 842.5 billion, increasing by 4.6% from end-2010. Equity funds picked up to ALL 105.3 billion, about 0.5% higher than at end-2010. Foreign currency liabilities amounted to ALL 525.4 billion, increasing by 4% compared to end-2010. Banking sector liabilities to non-residents amounted to ALL 66.2 billion, increasing by 37% compared with December 2010 and 7.7% compared with a year earlier. Credit lines extended from bank holding companies and the used proportion are estimated at about ALL 19.5 billion. The committed and unused proportion[14] of credit lines is estimated at around ALL 46.1 billion. As at end-2011 H1, off-balance sheet items represented 97.8%15 of total banking sector assets, from 88.7% at end-2010, increasing by 16.2% over the period and 12.1% on a year earlier.

As at end-June 2011, the banking sector paid-in capital was ALL 73.1 billion, up by around ALL 2.4 billion or 3.4% from end-2010, due to capital injection carried out in several banks. Paid-in capital represented 7% of total assets, almost equal to end-2010, but higher than a year earlier. With respect to banking sector liquidity position, we note that as at June 2011, the banking sector deposits represent 82.1% of total liabilities, down around 0.4 percentage points from end-2010. Banking sector liquid assets amounted to ALL 266.7 billion, accounting for 25.5% of total assets. This indicator has decreased by about 0.4 percentage points relative to December 2010.

[11] *The data on non-bank financial institutions, insurance companies and SLAs refer to 2011 Q1, while the data on supplementary pension funds refer to end-2010 (according to AFSA's release).*
[12] *Estimated at ALL 4.7 billion.*
[13] *Estimated at ALL 14.4 billion.*
[14] *Registered as off-balance sheet item.*
[15] *As at June 2010, off-balance sheet items represented 97.4% of total banking sector assets.*

In 2011 H1, the banking sector net profit was positive at 1.1 billion, down 69% from 2010 H1. It remained concentrated in the largest banks. Annualized Return on Assets (RoA) is estimated at 0.22%, from 0.79% in the same period a year earlier. Annualized Return on Equity (RoE) is estimated at 2.4% from 8.31% in 2010 H1.

Risk assessment. The following analysis focuses on the banking sector risks related mainly to market, liquidity and credit risks. The following makes an analysis of the capitalization position of the banking sector activity.

With regard to market risks, it is assessed that the impact of direct exchange rate and interest rate risks on the banks' balance sheets has been low. As regards the exchange rate risk, the impact has been driven by the low open foreign exchange position, whereas as regards the interest rate risk it has been driven by the moderate spread between assets and liabilities sensitive to the interest rate.

In terms of liquidity risk, the situation has been stable, almost similar to end-2010. At end-2011 H1, the ratio of liquid assets to short-term liabilities (of up to one year maturity) was 30.2%, from 30.6% at end-2010 and 32.8% over the same period a year ago. By currency, this ratio is higher for the lek (41.2%) and the dollar (28.5%), but lower for the euro (14.9%). The maturity gap between assets and liabilities[16], for both balance sheet and off-balance sheet items, has resulted negative. However, the gap has been covered several times by the value of liquid assets, thus providing evidence for a full capacity for paying off the liabilities as they fall due. Against this backdrop, however, the foreign currency liquidity position, especially in euro, requires cautious monitoring. Loan to deposit ratio is estimated at 61%, very close to end-2010's figure, but 2.2 percentage points less than in the same period a year earlier. Over a one-year time horizon, deposits have increased by around 3.9 percentage points more than loans. Loan to deposit ratio for operations in foreign currency was 87.4%, 1.5 percentage points higher than at end-2010 and around 7.8 percentage points lower than in 2010 H1. Loan to deposit ratio for operations in lek was 36.7%, from 35.4% at end-2010. The increase in this indicator is attributed to the higher growth of lek-denominated loans (10.4%) than lek-denominated deposits (6.5%) from end-2010.

Borrowing in the interbank market or from the Bank of Albania is another way banks manage their short-term liquidity needs. This is generally a collateralized borrowing and the type and adequacy of assets that may serve as collateral are additional elements that should be monitored, in order to assess the banks' ability to meet their short-term needs for liquidity.

Credit risk remains the main risk facing the Albanian banking sector. As at end-2011 H1, the ratio of non-performing loans to total loan portfolio, on a gross basis, rose to 17%, from 13.9% at end-2010 and 12.2% in the same period a year earlier. The ratio of non-performing loans, net, to regulatory capital, rose to 48.8%, around 12.5 percentage points more than at end-

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

2010. Loan portfolio quality fell for both businesses and households. Non-performing loans to business and household outstanding loans is estimated at 19.1% and 13.9%, respectively, compared with 15.5% and 11.7% at end-2010. Also, in terms of currency, the loan portfolio quality worsened for both lek and foreign currency loan portfolios. The ratios of non-performing loans in lek to outstanding loans in lek and non-performing loans in foreign currency to outstanding loans in foreign currency were 16.7% and 17.1%, respectively, compared with 14.4% and 13.8% at end-2010. With regard to loan quality by economy sectors, the construction sector is pointed out as having the highest value of the above indicator, 28%, followed by trade (20%) and processing industry (18%). The ratio of non-performing loans to outstanding loans is high even for hotels and restaurants sector (27%), although the share of lending to this sector in total outstanding loans is only 2.9%.

In response to the credit risk situation, the banking sector continued to increase its provisions to cope with any potential losses. At the end of 2011 H1, loan loss provisions rose to ALL 46 billion, around 27.3% more than their level as at December 2010. The ratio of provisions to non-performing loans (gross) fell to 51.7%, from 52.7% at the end of 2010 H2, remaining close to the 5-year historical average of around 51%. The ratio of provisions to total outstanding loans (gross) rose to 8.8%, compared with 7.4% at end-December 2010 and 6.4% in 2010 H1. Also, coverage of non-performing loan portfolio with collateral is estimated at 81.7% of the loan portfolio, from 79.3% at end-2010.

The lower credit quality and the need to raise loan loss provisions impairs the banking sector's ability to generate a positive financial profit, adequate to support the growth of capital by means of domestic resources and to allow the normal expansion of banking activity. Actually, the data show that as at end-2011 H1, the total revenues of the banking sector grew by about 2.7% compared with 2010 H1. The main contribution to this growth was provided by interest income, which increased by around 7% compared with 2010 H1. Over the same period, operating expenses of the banking sector picked up by only 1.7%. Therefore, the value of gross operating profit resulted positive, at ALL 10.4 billion, around 3.9% higher than in the same period last year. This indicates that the banking sector has managed to maintain steady levels of net operating income. Furthermore, provisions to cover any probable asset losses (mainly loan losses) over the period were about ALL 8.8 billion, around ALL 3 billion higher than in 2010 H1, leading to decreased net financial profit (after tax) to ALL 1.1 billion. If credit risks remain constant, the banking sector's capacity to earn a sufficient level of gross operating profit may be compromised. Regarding this matter, through its supervisory function, the Bank of Albania has required commercial banks to ensure, in parallel, the duly and timely identification of non-performing loans and the making of provisions, as well as to carry out the specified operations to recover loan loss values through collateral execution. These operations, coupled with the measures to further cut operating costs and accelerate lending, will gradually create the conditions for generating a stable and positive financial profit, which would better support the banks' mid-term needs for capital.

Regarding solvency, as at end-2011 H1, the capital adequacy ratio, which measures the capital coverage of the banking sector's risky activities, resulted 14.6%, around 0.7 percentage points lower than at end-2010 and 1.6 percentage points lower than in the same period a year earlier. The regulatory framework sets a minimum threshold of the CAR of 12%.

Concerning the assessment of risks facing the Albanian banking sector, the Bank of Albania conducts periodic stress-testing exercises, in order to assess the banking sector's resilience to any potential adverse economic events in several macroeconomic and financial indicators, on an individual and combined way.

These exercises have revealed that the banking sector appears sensitive to indirect credit risk arising from exchange rate and interest rate volatility. In the case of exchange rate risk, the pass-through channel is the share of foreign-currency loan portfolio, where the borrower has insufficient income in foreign currency. In the case of interest rate risk, the pass-through channel is the variable interest-rate loan portfolio. In such a case, we should bear in mind the fact that benchmark interest rates, especially on foreign currency, are close to historical lows and the unstable global economic situation suggests that they may settle at these levels in the foreseeable future. However, various factors related to the geopolitical situation, performance of primary commodity prices, exchange rate volatility and monetary policy stimulus, may expose inflation to shocks and may push up interest rates, which serve as benchmarks for the loan portfolio in the country. In the Albanian banking sector, the increase in loan interest rates, although gradually, would couple with increased burden on borrowers, thus affecting, in turn, their ability to service their debts. Therefore, commercial banks should consider the likelihood of these risk scenarios and be willing to make reserves duly.

After applying different scenarios, the stress-test results showed that the banking sector is by and large resilient to various shocks in respect to capital quality and adequacy. However, individual banks' sensitivity to these assumed shocks has increased. The continuation of the downward trend of the capital adequacy ratio would reduce the banking sector's ability to cope with various shocks and be associated with the reduction of this ratio to below the minimum capital required in certain banks. Each bank should, therefore, assess its needs for additional capital, taking into account the outlook on the financial profit and other constituent elements of the capital account, as well as ensure a higher pace of capital growth compared with the pace of risk-weighted asset growth. In this analysis, the banks should apply conservative risk scenarios to ensure a timely and optimal hedging.

The Bank of Albania has assessed and requires the banking sector to strengthen the capitalization of activity in the short term, by raising shareholders' equity. The Bank of Albania has oriented and monitored this process closely, so that it is carried out in accordance with the banking activity development strategies and performance of relevant risks. The process of strengthening the banking sector capitalization indicators includes the creation of adequate capital sizes above the minimum required ratio. The process is performing in line with the recommendations provided by the Bank of Albania in its communication with the banking sector. As an outcome of these measures, the banking sector remains robust and will create the conditions for enhancing its contribution to economic development.

1. GLOBAL DEVELOPMENTS

1.1 OVERALL GLOBAL ECONOMIC DEVELOPMENTS

In early 2011, the global economic growth was slower than its 2010 average. In 2011 Q1, global economy expanded at an annualized rate of 4.3%, from 5% in 2010. In 2011 Q2, the annualized global economic growth declined to 3.7%, down 1.6 percentage points on a year earlier. These developments have reflected the financial markets' higher funding costs for investments and the private sector's slower aggregate demand, which has reinforced the effect of the decreased public spending as a result of efforts for fiscal consolidation.

The economic growth rates in advanced economies varied significantly from those in emerging and developing economies. At end-2011 H1, advanced economies posted a 1.5% growth rate, from 6.8% posted by emerging and developing economies. During this 6-month period, global inflation rate also rose, mainly driven by upward primary commodity prices. However, the future inflation pressures are expected to be downward, due to mitigated pressures on energy and primary commodity price rises. As a consequence of a higher pace of economic growth, emerging and developing economies are expected to face higher inflationary pressures.

The uncertainty induced by the public debt size, low consumption levels, tight funding conditions, and the significantly limited room to deploy the economic policy stimulus by public authorities, have led to the downward revision of the global growth forecast for 2011, to 4%. Advanced economies will continue to expand modestly, mainly owing to the slow progress of the U.S. economy and the Euro area. In the meantime, the decline in foreign demand is expected to be reflected in the economic growth of emerging and developing economies. Subsequently, growth in these economies is expected to moderate to 6.4% in 2011, from 7.3% in 2010.

The U.S. economy. In 2011 H1, the U.S. economy grew at a slow pace. It expanded at an annualized rate of 0.4% in Q1 and 1.0% in Q2, reflecting the significantly weaker consumer spending that grew only 0.1% in Q2. The contribution of public expenditures to economic growth has been downward, since they fell by an annualized rate of 5.8% in Q1 and 1.1% in Q2. Overall, the U.S. economic recovery remains uncertain, under the conditions when the performance of the housing market and of consumer spending remains weak, whereas the public debt level remains too high. Expectations about the outlook of the U.S. economy for the remainder of 2011 reflect the slowdown observed in the first two quarters of 2011.

As at end-Q2, due to the marginally slight rebound in jobs, the U.S. unemployment rate marked 9.2%[17], 0.1 percentage points higher than in May. The U.S. unemployment rate hit record highs in October 2009 (10.1%) and post-crisis record lows in March 2011 (8.8%). The restructuring process and spending cut by businesses are expected to adversely affect the employment rates, making its return to the pre-crisis rates difficult. The U.S. labour market forecast suggests that it will continue to be sluggish, with an unemployment rate trending down slowly.

House price performance shows a slight increase in May compared with April, up by 0.4%[18]. At the end of the first quarter, the House Price Index picked up by 0.2%. However, over the past twelve months up to May 2011, the index fell by 6.3%, standing at 19.6% below its peak registered in April 2007 and almost at a similar level as in January 2004. U.S. house price forecasts show that it will continue to remain weak[19].

As at end-2011 H1, household incomes remained low and consumer confidence index fell in comparison with 2010 H1, though being at higher levels than as at end-2010. The Federal Reserve kept the interest rate unchanged throughout the period, at 0.25%. In the meantime, the U.S. fiscal imbalances continued to expand, with an increased gross government debt at 78.4% of GDP in 2011 Q1. During the same period, the deficit as a share of GDP narrowed to 9.9% compared with 10.7% in the previous year.

Table 1 Key indicators of the U.S. economy in 2010-2011

	Q1'10	Q2'10	Q3'10	Q4'10	Q1'11	Q2'11
Real GDP growth (%, y-o-y)	3.9	3.8	2.5	2.3	0.4	1.0
Annual inflation rate (%)	2.4	1.8	1.2	1.5	2.7	3.6
Unemployment rate (%, y-o-y)	9.7	9.6	9.6	9.6	8.8	9.2
Budget deficit (% of GDP)	-10.7	-11.1	-10.4	-10.3	-9.9	..
Gross government debt (% of GDP)	71.7	73.3	75.3	77.4	78.4	..

Source: Bureau of Economic Analysis, Bureau of Labour Statistics.

Forecasts for the future performance of the U.S. economy reflect the slowdown of the first two quarters of the year. According to the IMF[20], the U.S. is expected to grow by 1.5% in 2011 and by 1.8% in 2012.

The European Union (EU) and the euro-area countries posted uneven growth rates in the first two quarters of 2011. On average, they expanded by 2.5% in 2011 Q1, from 1.9% in the same period of 2010. In quarterly terms, the economy performed positively, with a quarterly growth rate of 0.8% in 2011 Q1, from 0.3% in 2010 Q4. The sustainable consumption and government spending were key drivers to this economic growth. Germany made the major contribution to this growth, posting a quarterly growth rate of 1.5%, underpinned mainly by increased domestic demand and consumption as a result of lower unemployment rate. For the quarter, Greece also recorded a sudden increase by 0.8%, compared with the economic decline by 2.8%

[17] *Bureau of Labour Statistics.*
[18] *Federal Housing Finance Agency.*
[19] *ECB, Financial Stability Review, July 2011.*
[20] *World Economic Outlook, September 2011.*

in 2010 Q4. As a result, at the end of 2011 Q1, the annualized economic contraction of Greece was 4.8%, from 7.8% in 2010. Portugal started to feel the economic downturn reflected in an economic contraction for the second consecutive quarter. Portugal's economy shrank 0.7% in the first quarter, continuing the economic contraction that had started since end-2010 (0.6%). These economic developments took place after the constraints imposed in the country as a result of the bail-out agreements with the IMF and the EU. Preliminary data on the second quarter growth rate for the EU and the euro-area countries show a lower growth rate at about 1.7%. These developments were influenced by the slower economic growth rate in Germany, which was halved to the annualized rate of 2.8%, as well as by the lack of economic growth in France.

Table 2 Selected macroeconomic indicators in EU and Euro area

	GDP growth (%, y-o-y)				Inflation (%, y-o-y)				Unemployment (%)			
	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2010	Q4 2010	Q1 2011	Q2 2011
EU	2.2	2.2	2.5	1.7	2.2	2.6	2.93	3.20	9.7	9.7	9.5	9.40
Euro area	2.0	2.0	2.5	1.7	1.8	2.2	2.47	2.73	10.0	10.0	9.97	9.90
Germany	3.9	3.8	4.6	2.8	1.3	1.9	2.17	2.50	6.6	6.6	6.3	6.13
France	1.7	1.4	2.1	1.6	1.8	2.0	2.00	2.23	9.7	9.7	9.7	9.70
Italy	1.4	1.5	1.0	0.8	1.6	2.1	2.27	2.97	8.5	8.6	8.1	8.03
Greece	-4.1	-7.4	-4.8	..	5.7	5.2	4.47	3.30	12.2	14.1	15.0	..
Non-euro area												
United Kingdom	2.5	1.5	1.6	0.7	3.1	3.4	4.13	4.40	7.8	7.8	7.67	7.7*

Source: Eurostat, publication date: 16.08.2011.
**The data as at April 2011.*

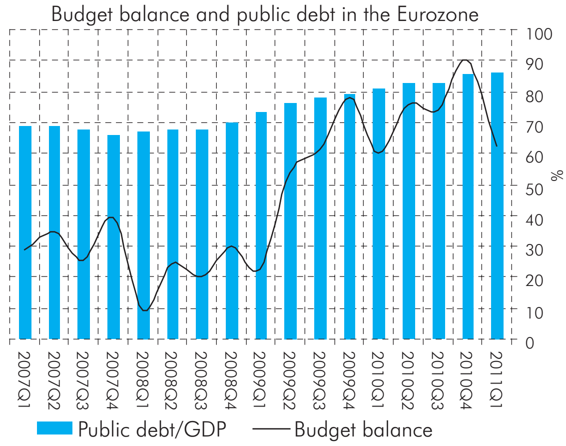
The inflation rates in the EU and the Euro area increased in 2011 H1. In 2011 Q2, EU's inflation rate edged up to 3.2%, exceeding the Q1's price rise rate by 1.3 percentage points. Over the same period, the Euro area's average inflation rate was 2.73%. Therefore, the European Central Bank (ECB) lifted the key interest rate in April because of the concern that inflation would remain above the 2% target in the next months. In the meantime, the Bank of England continued to keep the base policy rate at historical lows, to 0.5%, in spite of the inflation rate rise beyond the target. The vulnerability of economic growth in the UK and the uncertainty about its outlook for the future, have determined the central bank's stance.

Although economic developments in the EU are generally positive, their impact on improving the labour market has been weak. At end-2011 H1, the EU's unemployment rate improved by 0.3 percentage points compared with end-2010. In the euro-area countries, this improvement was only 0.1 percentage points.

The governments of the euro-area countries continued their fiscal consolidation policy, driven by the difficult public debt position. At the end of 2011 Q1, the euro area budget deficit was 5.8% of GDP, about 2.2 percentage points less than in the same quarter a year earlier. Nonetheless, the public debt remains high, reaching 86.2% of GDP in 2011 Q1, from 81.2% in the same period a year earlier.

The expectations about the pace of economic performance across EU Member States remain uneven. In Germany, the growth is expected to moderate; however, it will continue to record a higher economic growth than the EU Member States' average. In France, Italy and the United Kingdom, economic growth is projected to be weak. Employment in the Euro area is expected to pick up, but gradually and modestly. In late 2011, the inflation rate is expected to be 2.5% for the Euro area and 3.0% for the EU. Such price developments reflect the price stability in primary commodities and energy, and the slowdown in wage growth.

Chart 1 Fiscal position in the Eurozone



Source: European Central Bank.

Table 3 Selected macroeconomic indicators in European economies

	Real GDP (%)		Inflation (%)		Unemployment (%)	
	2010	2011	2010	2011	2010	2011
Europe	2.2	2.0	2.4	3.1	9.6	9.5
Euro area	1.8	1.6	1.6	2.5	10.1	9.9
Germany	3.6	2.7	1.2	2.2	7.1	6.0
France	1.4	1.7	1.7	2.1	9.8	9.5
Italy	1.3	0.6	1.6	2.6	8.4	8.2
Spain	-0.1	0.8	2.0	2.9	20.1	20.7
Greece	-4.4	-5.0	4.7	2.9	12.5	16.5
Netherlands	1.6	1.6	0.9	2.5	4.5	4.2
Belgium	2.1	2.4	2.3	3.2	8.4	7.9
Great Britain	1.4	1.1	3.3	4.5	7.9	7.8
Ireland	-0.4	0.4	-1.6	1.1	13.6	14.3

Source: World Economic Outlook, September 2011.

Developments in Central and Southeast Europe. The recovery of economic activity in Central and Southeast Europe[21] gained further strength in 2011 H1, mainly driven by the external demand. However, at the same time, domestic demand was restrained by weak labour market conditions, higher commodity prices, and the short-term effects of fiscal consolidation. Real Gross Domestic Product (GDP) recovered steadily in some of these countries. Inflation was higher than at end-2010 in most Central and Southeast European countries, especially in 2011 Q1, reflecting the elevated energy and food prices. However, 2011 Q2 highlighted mitigated inflation rates. As at end-2011 H1, the highest annual inflation rates in Central and Southeast Europe were registered in Romania and Serbia, by 8% and 12.7%, respectively.

[21] *According to ECB Monthly Bulletin, June 2011.*

Table 4 Selected macroeconomic indicators of Central and Southeast Europe

	Real GDP growth (annual rate, in %)			Inflation (annual rate, in %*)			Monthly unemployment (in %*)		
	Q4-10/ Q4-09	Q1-11/ Q1-10	Q2-11/ Q2-10	Q4-10/ Q4-09	Q1-11/ Q1-10	Q2-11/ Q2-10	Q4-10	Q1-11	Q2-11
Hungary	2.4	1.6	1.2	4.6	4.6	3.5	11.0	10.6	9.9
Czech Republic	2.7	2.8	2.4	2.3	1.9	1.9	7.2	6.7	6.5
Poland	3.9	4.3	..	2.9	4.0	3.7	9.5	9.2	9.0
The Balkans									
Bulgaria	3.8	3.4	1.9	4.4	4.6	3.5	11.4	11.1	11.4
Romania	-0.6	0.3	0.3	7.9	8.0	8.0	7.4	7.0	..
Serbia	1.0	3.4	2.2	10.3	14.1	12.7	19.2	..	22.2
FYROM	1.8	5.1	..	3.0	5.2	4.1	32.1	31.2	..
The Baltic countries									
Estonia	6.7	8.5	8.4	5.4	5.1	4.9	14.4	13.8	..
Latvia	3.5	3.4	5.7	2.4	4.1	4.7	17.0	16.2	..
Lithuania	4.6	6.8	5.9	3.6	3.7	4.8	17.3	16.3	..

Source: Eurostat database, Eurostat News release, respective central banks
** The data are as at the last month of the respective quarter.*

Looking ahead, the short-term indicators suggest that the recovery is likely to continue in most countries. Also, the revised projections[22] for the Central and Southeast Europe appear more optimistic compared to preliminary estimates and the 2010's figures, expecting from this region a 4.3% real GDP growth for 2011.

1.2 MAIN HIGHLIGHTS IN GLOBAL FINANCIAL MARKETS

At end-2011 H1, global financial markets were volatile, as a reflection of concerns about sovereign debt risks in Europe and the sluggish economic activity in the U.S.[23] Different trajectories of economic growth and monetary stances across developed and emerging and developing countries account for some of financial markets volatility over the period.

A key prevailing risk markets perceive to financial stability concerns the interplay between the vulnerabilities of public finances and the financial sector exposure. Other risks[24] are the risks related to the volatility of banks' funding costs; bank losses stemming from the decline in property prices; and, the tensions induced in macroeconomic indicators of individual countries related to international capital flows.

In the United States, the accommodating monetary policy and buoyant liquidity contributed to keeping money market interest rates low. During 2011 H1, the rate of overnight repurchase agreements in the U.S. dollar recorded a minimum of 0.01%. In the Euro area, the interbank interest rates followed an upward trend throughout the six-month period. In June, the one-month, three-month and twelve-month EURIBOR stood at 1.28%, 1.49% and 2.14%, respectively, compared with 0.81%, 1.02% and 1.53% as at end-

[22] *World Economic Outlook, September 2011.*
[23] *World Economic Outlook, September 2011.*
[24] *Financial Stability Review, June 2011, ECB.*

2010. The Euro Overnight Index Average (EONIA) rose significantly to 1.12%, from 0.5% as at end-December 2010.

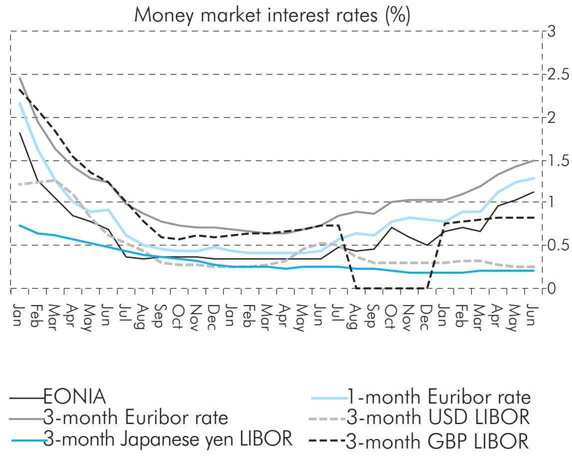
During this six-month period, the European Central Bank (ECB) raised the key interest rate[25] by 25 basis points, to 1.25%. As a result, the interest rate on the marginal lending facility and deposit facility rose to 2% and 0.5%, respectively.

The performance of long-term public debt securities in the major economies was dictated by sovereign debt risk and the possibility for a monetary policy tightening due to inflationary pressures. In the future, the uncertainty about economic growth and the fiscal consolidation operations will increase their influence on the performance of interest rates of these securities.

In the major stock-market exchanges, in the U.S. and Europe, the indexes have increased compared to end-2010, influenced by improvements in economic forecasts and corporate revenues, especially for 2011 Q1. However, the difficulties caused in the Japanese economy following the earthquake of March, and the geopolitical tensions in the North Africa, which influenced the performance of oil prices, have affected the volatility of these markets. However, the revival of tensions related to sovereign debt risk in Spain and Italy, led to price cut in the European markets, following May 2011.

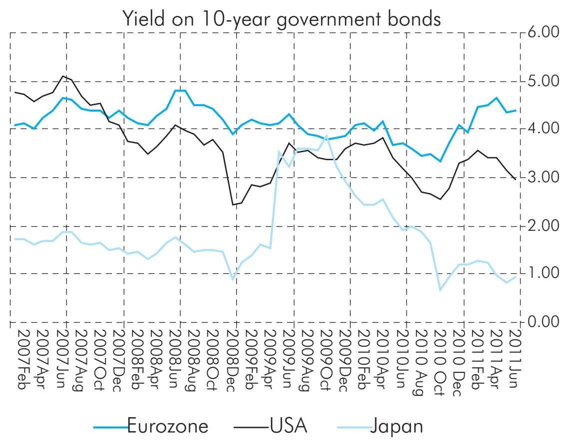
In foreign exchange markets, the Federal Reserve's decision to maintain an easing monetary policy contributed to the U.S. dollar's depreciation against the major currencies in 2011 H1. The euro was volatile during this six-month period, being appreciated in Q1 and further depreciated in Q2. The euro's depreciation against some currencies in 2011 Q2 was influenced by fiscal developments, when uncertainties about short-term exchange rate moves were markedly heightened. However, as at end-June 2011, the euro appreciated by 8.4% against the U.S. dollar, 5.4% against the British pound and 7.5% against the Japanese yen[26].

Chart 2 Money market interest rates



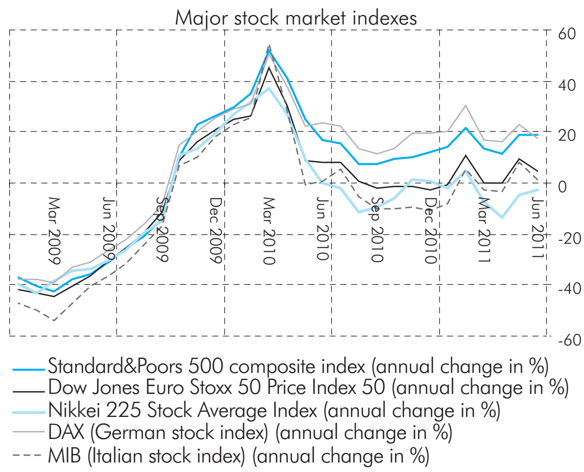
Source: European Central Bank.

Chart 3 Yield on 10-year government bonds



Source: ECB's database.

Chart 4 Major stock market indexes

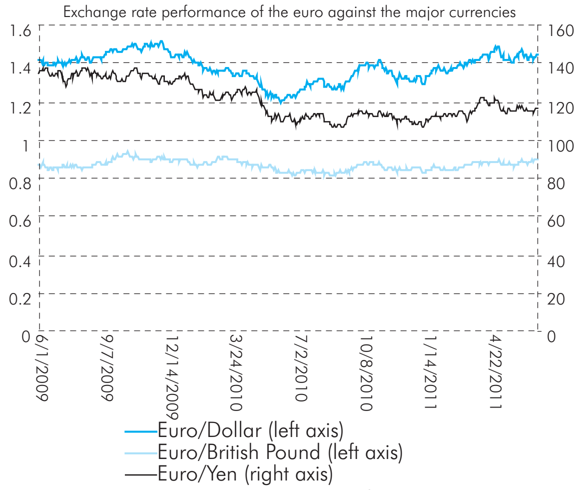


Source: ECB's database, Reuters.

25 *ECB Monthly Bulletin, June 2011.*

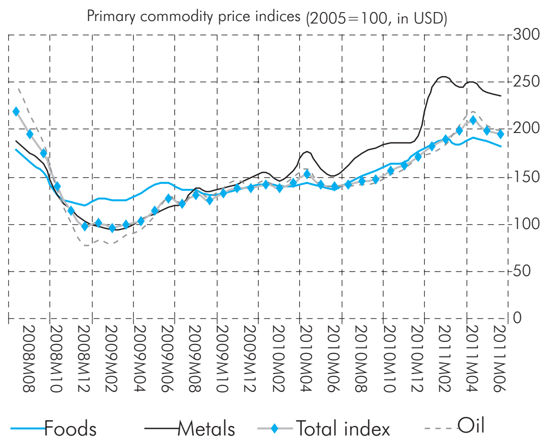
26 *1 euro traded at USD 1.45, GBP 0.9 and JPY 116.79.*

Chart 5 Exchange rate performance of the euro against the major currencies



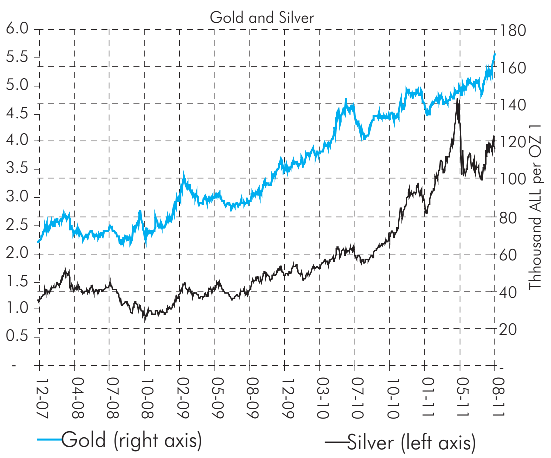
Source: Eurostat, Reuters.

Chart 6 Primary commodity price indices



Source: IMF's database.

Chart 7 Gold and silver trading (in USD per 28.35 g*).



*28.35g = 1 ounce
Source: Reuters.

In 2011 Q1, prices in primary commodity markets picked up significantly for all items, compared to end-2010. It seems contrary to their slowing consumption worldwide. Their overall slowdown in 2011 Q2 reflected the volatility of these markets[27]. Food prices were stabilized following earlier supply-side shocks because of weather conditions. Uncertainties about the future of nuclear energy induced from concerns that arose in Japan following the earthquake, coupled with political tensions, heightened the pressure on oil prices over the period. The total primary commodity price index as at the end of 2011 H1 was 195.1, about 40% higher than a year earlier. Food price sub-index was 181.4, whereas oil and metal sub-indices were 235.7 and 199.4, respectively, being increased by 33.1%, 55.9% and 42.3% y-o-y, respectively.

In terms of precious metals, gold price remained high, increasing by 0.43% in semi-annual terms and 6.6% in annual terms. The temporary decline at year start was followed by an increase in the remainder of the period, as a result of investors' shifting to safer assets, low interest rates, the nominal exchange rate effect of the U.S. dollar in which this metal is quoted, and expansion of investment base following the creation of gold exchange-traded funds. Silver prices showed some volatility over the period, but were 6.7% higher compared with the previous six-month period.

The performance of the banking sector, assessed by the performance of global Large and Complex Banking Groups (LCBG), improved in 2011 Q1, based on their capacity for shock absorption. This improvement is due to a higher regulatory capital, decline in risk-weighted assets and revived earnings. The earnings were triggered by a decline in provisions and improved net interest income. However, these incomes remained under pressure, while net interest margin narrowed for most of banks, due to the sluggish credit growth.

[27] *Financial Stability Review, June 2011.*

In 2011 Q1, return on equity (RoE) improved to 7.2%, from 4.5% at end-2010, but with a wider distribution across banks. Return on assets was 0.53% over the quarter, from 0.34% in 2010 Q4. Capital adequacy ratio reached 13.4% over the quarter, due to some banks' retaining a considerable portion of their earnings, aiming at capital growth.

Notwithstanding the improved conditions of the LCBG, the environment in which they operate remains challenging. The outlook related to them remains uncertain, while some of them have not yet fully recovered from the crisis. Moreover, they are still exposed to the financial market volatility, long-term yields, and any other adverse economic or fiscal events, which may pose risks to the loan portfolio quality or impede the access to financial markets.

Also, the latest data on large and complex banking groups (LCBG) in the Euro area show that all sources of income improved in early 2011, while the decline in provisions influenced earnings substantially, although there are obvious variations across various institutions. Regarding the latest developments[28], 2011 Q2 highlights that some European banks have improved their capital or have announced its projected growth. Nevertheless, some banks must achieve a higher quality capital level and a decreased financial leverage, in order to provide an effective buffer against any possible losses in the future, as well as a boosted confidence in the markets.

It should be emphasized that the pace of progress made by the banking system is inadequate, especially in Europe, while there are risks in place related to the financial leverage in different market segments[29].

[28] *Financial Stability Review, June 2011.*
[29] *Global Financial Stability Report (GFSR) Market Update.*

Box 1 Financial data on foreign banking groups operating in Albania

1. RAIFFEISEN BANK INTERNATIONAL[1] (AUSTRIA)

As at end-2011 H1, Raiffeisen Bank International's total assets were up 4.9% from end-2010, reaching EUR 137.6 billion. Loans and advances to customers reached EUR 79.4 billion, while deposits from customers registered EUR 63.6 billion, up by 5% and 10.4%, respectively, compared with the end of 2010.

Consolidated profit, net, as at 2011 H1, was EUR 615 million, up 30.3% on a year earlier. Notwithstanding the increased operating incomes by 2.3%, the net operating result fell by 2.2% compared with a year earlier, primarily due to increased general administrative expenses.

Return on equity (before tax) reached 17.1%, up 4.9 percentage points from the previous six-month period. Return on equity (after tax) reached 13.2%, up 2.3 percentage points. Return on assets reached 1.3%, up 0.5 percentage points.

As at end-2011 H1, Raiffeisen Bank Albania accounted for about 1.51% of total assets of the Raiffeisen International.

2. INTESA SANPAOLO[2] (ITALY)

As at end-2011 H1, Intesa Sanpaolo's total assets were EUR 644.7 billion, down 1.4% from end-2010. Loans to customers were EUR 372.4 billion, down 1%, whilst customer deposits and securities fell by 2.4% to EUR 387.4 billion.

Net income was EUR 1.4 billion, down 17% in annual terms. Operating margin increased by 12.6% compared with the same period last year, amounting to EUR 4.2 billion in 2011 H1.

Capital adequacy ratio as at 2011 H1 was 15.1%, compared with 13.2% at end-2010.

As at end-2011 H1, Intesa Sanpaolo Bank Albania accounted for 0.14% of Intesa Sanpaolo's total assets.

3. ALPHA BANK[3] (GREECE)

As at end-2011 H1, Alpha Bank reported about EUR 63.4 billion of total assets, down EUR 4.6 billion or 6.7% from the same period a year earlier. Net loans dropped by 6.7% to around EUR 48 billion. Deposits also declined by 15.6% to EUR 33.4 billion. Non-performing loans reached 10.3% at end-2011 H1. In the meantime, provisions accumulated over this six-month period were EUR 2.5 billion. Operating income fell by 1.5% to EUR 1.1 billion on a year earlier, of which net income on interests and commissions dropped by 4.1% and 16.1%, respectively. In the meantime, operating expenses fell by 2.6%, influenced by a 3.3% decline in staff expenses and 2.9% in overall expenses. Alpha Bank's net profit before tax dropped significantly by 80.4%, to EUR 27.6 million, while shareholders' net loss was EUR 524.8 million for this six-month period. Net interest margin was at the same level as in the previous year, at 2.7%, while capital adequacy ratio was 12.3%.

As at end-2011 H1, Alpha Bank - Albania accounted for about 0.76% of total assets of the Alpha Bank (Greece).

4. PIRAEUS BANK[4] (GREECE)

As at end-2011 H1, Piraeus Bank Group's total assets were reported at about EUR 57.1 billion, up 1% y-o-y. Net loans dropped by 5%, recording around EUR 36.6 billion, while deposits dropped by 11% to EUR 26.3 billion. Loan/deposit ratio increased by 936 basis points to 139%. In the meantime, the Group's non-performing loans increased to 9.6%.

Total net income increased by 7% compared with the previous year, of which net interest income grew by 6%. Provisioning expenses increased by 38% compared with the previous six-month period, amounting to EUR 371 million. Pre-tax profit for 2011 H1 was negative, by EUR 1.004 million. In the meantime, shareholders' net loss was EUR 820 million over this semi-annual period.

Capital adequacy ratio was 9.5% as at end of 2011 H1, from 9.7% in the same period of the previous year.

As at end-2011 H1, Tirana Bank accounted for around 1.1% of total assets of the Piraeus Bank (Greece).

5. NATIONAL BANK OF GREECE (GREECE)

As at end-2011 H1, National Bank of Greece's total assets were EUR 119.2 billion, falling by 2% from the same period in the previous year. Loans fell by 1% on annual basis, totalling EUR 74 billion. Deposits fell by 10%, totalling EUR 62.1 billion. Loan/deposit ratio was 110% as at end-H1, up 7 percentage points from 2010 H1. Provisioning expenses for H1 increased by 27% y-o-y to EUR 822 million. The Group's operating expenses dropped by 3% y-o-y. Net interest margin fell by 3.65%, with a spread of 33 basis points from the previous year. The Group's profit, net, was EUR 29 million in 2011 H1. Capital adequacy ratio was 11.2%.

As at end-2011 H1, total assets of the National Bank of Greece – Albania Branch accounted for about 0.25% of total assets of the National Bank of Greece.

6. SOCIÉTÉ GÉNÉRALE[5] (FRANCE)

As at end-2011 H1, Société Générale's total assets were EUR 1,158 billion, up 2% compared with end-2010. Based on the same period, customer loans increased by 1% to EUR 376 billion, while customer deposits increased to EUR 341.4 billion.

Net banking income as at end-H1 amounted to EUR 13.1 billion, falling by 1% y-o-y, while operating expenses increased by 6.8%. This Group's net income was down 22.5% from a year ago, totalling EUR 1,663 billion.

As at end-H1, the Group's return on equity (RoE) after tax was 7.8%, from 11% in the same period of the previous year. Capital adequacy ratio was 11.3% at the end of the period.

As at end-2011 H1, the total assets of the Société Générale Bank – Albania accounted for around 0.03% of the total assets of the Société Générale Group.

7. CRÉDIT AGRICOLE[6] (FRANCE) AND EMPORIKI[7] (GREECE)

As at end-2011 H1, the Crédit Agricole Group reported a total asset amount of around EUR 1,726.8 billion. Customer loans and advances totalled EUR 775.5

billion, up 2.1% from end-2010, while customer deposits totalled EUR 616.8 billion, down 1.1%.

As at end-H1, this Group increased its income by 4.8% on an annual basis, totalling EUR 18.1 billion. Operating expenses increased by 1.6%, while net income was around EUR 2.6 billion, 25.1% higher than in the previous year.

As at end-2011 H1, Emporiki Bank in Greece, as part of Crédit Agricole Group, reported an increase in net banking income by 2.6% y-o-y to EUR 377.9 million. Emporiki Group's total expenditures dropped by 19.4%, and as a consequence, operating income increased by 13.4%. In the meantime, post-tax profit dropped by 14.2%.

Total loans dropped 1.8% y-o-y to EUR 22.6 billion. Deposits performed similarly, down 14.7% to around EUR 11 billion.

As at end-2011 H1, Emporiki Bank in Albania accounted for about 0.01% of total assets of the Crédit Agricole Group.

[1] *Semi-annual financial report on H1 2011, URL: http://investor.rbinternational.com/index.php?id=498&L=1*

[2] *Consolidated results as at 30 June 2011, URL: http://www.group.intesasanpaolo.com/scriptIsir0/si09/eng_index.jsp*

[3] *Financial statements for H1 2011, URL: http://www.alpha.gr/page/defaultasp?la=2&id=78&pl=291&pk=1107*

[4] *Financial statements for H1 2011, URL: http://www.piraeusbank.gr/ecPage.asp?id=300892&lang=2&nt=96&sid=&fid=294541*

[5] *The results of 2011 H1, URL: http://www.societegenerale.com/en/essentiel*

[6] *Financial statements for H1 2011, URL: http://www.credit-agricole.com/en/Finance-and-Shareholders/Financial-reporting/Credit-Agricole-S.A.-financial-results*

[7] *The results of the first half of 2011, URL: http://www.emporiki.gr/cbgen/gr/press/press_releases_story.jsp?docid=9260DB5ECEE8FE9C7091BAB1574062&cabinet=PRESS_RELEASES&lang=gr*

2. MACROECONOMIC DEVELOPMENTS IN ALBANIA IN 2011 H1

In 2011 Q1, the Albanian economy expanded, mainly driven by domestic demand, higher pace of growth of exports and moderate growth of imports, which are reflected in an improved trade deficit. However, in 2011 Q2, the negative values of trade deficit picked up and its contribution to economic growth exacerbated. Private consumption continued to develop sluggishly because the employment rate and wages grew moderately and the propensity to save appeared stable. Remittances continued to drop, adversely influencing the level of consumption in Albania.

Domestic investments performed similarly, reflecting also the slowdown in terms of lending and capital spending of the fiscal policy. As at end-2011 H1, the banking sector outstanding credit rose to ALL 518.7 billion, about ALL 32.5 billion or 6.6% higher than at end-2010. Credit growth rate in 2011 H1 was 2.2 percentage points higher than in the same period a year earlier. Nonetheless, private investments were sustained by improved banking sector liquidity through deposit growth. All sectors of the economy - industry, services and construction – have increased their capacity utilization, though they remain below the long-term historical average of this indicator.

In 2011 H1, the fiscal policy did not manage to meet the projected level of revenue and expenditure and created a budget deficit that served as a stimulus to the economy. The percentage of the annual plan realization is 42.9% for total revenues and 44.5% for total expenditures. Relative to a year earlier, total revenues increased slightly, only 1.1% y-o-y, while total expenditures increased 7.7%, contributing to budget deficit growth by ALL 26.9 billion. Public debt stock increased by 5% compared with end-2010, marking a higher increase in the domestic debt stock than in the external one.

As at end-June 2011, current account deficit was EUR 588.5 million or 14% of GDP, expanding by about 4.9 percentage points on a year earlier. However, compared with end-2010, the current account deficit has narrowed by 2.8 percentage points. Trade balance deficit is estimated at EUR 1053.4 million over the same period, up 14% on a year earlier. As a share of GDP, the trade balance deficit accounts for 24.5%, up 4.2 percentage points on a year earlier, narrowing by 1.6 percentage points compared to end-2010. These developments reflect the positive growth rates of exports by 12% y-o-y, compared to 13% growth of imports. During 2011 H1, net foreign inflows of capital and financial account recorded EUR 434.9 million, about 41% more than a year ago. Foreign direct investments and portfolio investments have narrowed by 15% and 68% y-o-y, respectively. However, the improvement in capital transfers has been reflected in a positive capital and financial account balance by 9.7% of GDP, from 7.7% on a year earlier.

In terms of price performance in the country, during 2011 H1, inflationary pressures were on the rise. In February-May 2011, inflation rate was above the Bank of Albania's upper targeted band of 3% (+/-1 %). These developments have mainly reflected the impact of food and oil price rises in international markets. In response to these inflationary pressures, at end-March, the Bank of Albania lifted its key interest rate by 0.25 percentage points, to 5.25%. In 2011 H1, inflation averaged 4.0%.

Table 5 Selected macroeconomic indicators

	2006	2007	2008	2009	2010	2011 H1
Annual real GDP growth, in %	5.4	6	7.7	3.6	3.8	3.4(a)
GDP at current prices, in millions of ALL	882,209	966,651	1,087,867	1,153,000	1,223,850**	1,270,038.43 (b)
Number of employed (in thousand)	934	935	970	899	917	930
Unemployment rate	13.8	13.4	12.6	13.75	13.49	13.26
Inflation rate (y-o-y)	2.5	2.9	3.4	2.3	3.6	4.0
Budget deficit (including grants, in % of GDP)	-3.1	-3.5	-5.7	-7	-3.1	-2.1(c)
Public debt (in % of GDP)	55.9	52.2	55.9	59.6	58.4	59.2 (d)
External debt (in % of GDP)	17.2	14.4	18.3	23.38	25.1	24.8 (d)
ALL/USD average exchange rate	98.1	90.4	83.9	95.0	104.00	100.26
ALL/EUR average exchange rate	123.1	123.6	122.8	132.1	137.78	140.6

a. 2011 Q1.
b. IMF, for 2011 the figure is cumulative GDP for H1.
c. Cumulative deficit.
d. As a ratio of cumulative GDP for 2011 H1.
Source: INSTAT, Bank of Albania, Ministry of Finance, IMF.

2.1 PERFORMANCE OF ECONOMIC ACTIVITY

In 2011 Q1, the Albanian economy recorded a real annual growth of 3.4% and a quarterly growth of 1.2%, 1.4 percentage points higher than in the same quarter a year earlier, but 2.2 percentage points lower than at end-2010. All the sectors of the economy contributed positively to the economic growth in early 2011. Industry posted the highest growth rate, driven by the high demand for raw materials. In annual terms, industry grew 12.4% but contracted by 1% compared with the high growth rate registered in 2010 Q4. The services sector grew at the same rate as in the same period last year, posting 1.8% y-o-y. Their slowdown relative to end-2010 is substantial, contracting by 2.9% q-o-q. Within services, post and communication sub-sectors contracted y-o-y and q-o-q, by 5.1% and 1.7%, respectively, decelerating the growth of overall services. For the first time since 2009 Q4, construction posted a positive growth rate of 4.8% y-o-y and 11.8% q-o-q. Finally, agriculture slowed significantly by about 5.1 percentage points compared with a year ago, although it increased by 1.2 percentage points compared with end-2010.

Table 6 GDP by economic activity, annual changes

	Q1-09	Q2-09	Q3-09	Q4-09	Q1-10	Q2-10	Q3-10	Q4-10	Q1-11
Agriculture, animal farming, hunting and forestry	1.4	3.2	1.1	1.8	7.9	8.6	6.5	2.3	2.8
Industry	7.1	5.6	2.9	12.2	22.2	21.3	14.6	25	12.4
Construction	0.7	17.9	1.3	-14.7	-21.6	-30.1	-22.0	-13.3	4.8
Trade, hotels and restaurants	0.1	6.2	3.0	0.9	4.5	8.7	9.8	10.7	4.4
Transportation	-10.9	2.6	8.9	0.0	9.3	5.7	10.2	18.6	13.3
Post and communication	41.8	19.9	22.3	-1.5	-12.7	-3.1	-8.3	-5.8	-5.1
Other services	5.5	6.9	4.5	2.9	1.9	6.3	12.1	5.8	-0.6
Total value added	3.8	7.7	4.0	-0.5	1.6	2.3	4.4	5.3	3.5
FISIM	11.1	13.3	5.5	4.0	-7.3	-6.8	-4.5	-2.7	6.3
GDP at basic prices	3.5	7.5	3.9	-0.6	2.0	2.7	4.7	5.6	3.4

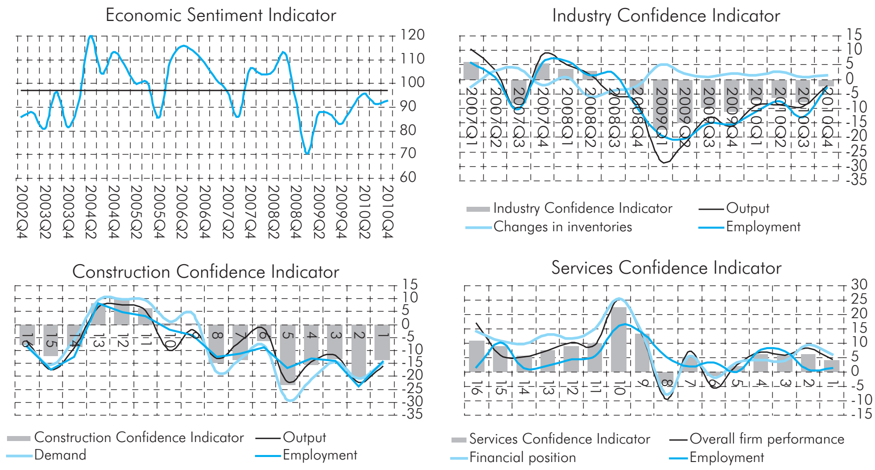
Source: INSTAT, Quarterly GDP, January 2011.

In order to assess the economic developments for 2011 Q2, we analyse the Business Confidence Survey and Turnover Volume Index.

· *BUSINESS CONFIDENCE SURVEY*

Economic Sentiment Indicator (ESI) increased slightly by 0.4 percentage points in 2011 Q2 compared with 2011 Q1. However, the ESI stands about 11.1 percentage points below its long-term average and 10.2 percentage points below the previous year's figure.

Chart 8 Economic Sentiment Indicator and Confidence Indicators by sectors

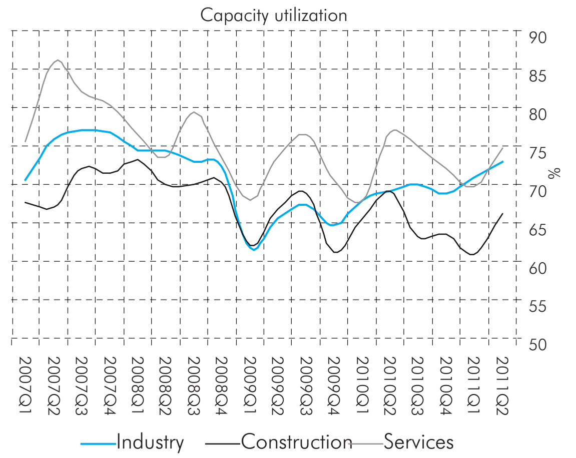


Source: Bank of Albania

The worsened industry and construction confidence indicators, coupled with the boosted confidence in services and consumer sectors, have determined such developments in the Economic Sentiment Indicator. Industry Confidence Indicator (ICI) fell by 6.9 percentage points compared with a year earlier and 0.3 percentage points compared with 2011 Q1. The worsening of the ICI reflects primarily the decrease in industrial output by about 17.3 percentage points, which is associated with an increase in inventories. Developments in the construction sector have been mainly characterized by a worsened situation of production and demand, which have, in turn, been reflected in the decreased employment indicator for the sector. Consequently, the construction confidence indicator (CCI) was down 7.9 percentage points from a year earlier and 11.2 percentage points from 2011 Q1. Only the services sector has improved all the indicators of the financial position, the overall business performance and employment. Services Confidence Indicator (SCI) increased by 4.7 percentage points compared to 2011 Q1, however, it is still 5.8 percentage points lower than a year ago.

Capacity utilization increased in all sectors, even though it is still below its long-term average. Industrial sector makes an exception, since its capacity utilization in 2011 Q2 was above its long-term average. However, the construction sector showed the most significant improvement in increasing its capacity utilization by 5.2 percentage points compared with early 2011.

Chart 9 Actual capacity utilization rate to total capacities



Source: Bank of Albania

These positive developments have been also reflected in the outlook for the economic developments over 2011 Q3, which are optimistic. The industrial sector expects that the increased domestic and foreign demand will lead to reduced inventories and will contribute to improving the overall business situation. Construction-related expectations on the economic developments, production and inventories for 2011 Q3 stand at a higher level than the current situation assessment. However, they remain weaker compared with early 2011. Lastly, the services sector has assessed that businesses will perform better over 2011 Q3, due to firm's improved economic activity, increased demand and improved overall economic situation.

- *TURNOVER VOLUME INDEX*

Turnover Volume Index, which is a good proxy for assessing the economic activity of economy sectors, shows a similar sectoral performance. The common index for the sectors of production and services pointed to 117.6% in 2011 Q1, down 22.4% from 2010 Q1. In the meantime, the same index for industry and construction sectors posted an annual increase by 11.8% in Q1, but it declined by 10% compared with 2010 Q4. These developments have mainly reflected the slowdown in the annual growth of the industry turnover volume index, which in annual terms expanded by 16.4% compared with an increase of 31.9% in 2010 Q1. Less deceleration is noted in the services sector. In the meantime, the construction sector has shown a positive performance, increasing its turnover index by 9% y-o-y in 2011 Q1. This is the first improvement that has taken place in the construction sector since early 2010.

2.2 HOUSEHOLD WELFARE

The analysis of employment and income indicators helps us assess the performance of household welfare.

· *EMPLOYMENT*

As at 2011 Q2, unemployment rate was 13.26%. This positive development reflects the increased number of employees in the private non-agricultural sector, up 9474 from the previous quarter and 10,162 on a year earlier. Public sector employment declined y-o-y and q-o-q, whereas the agricultural one remained unchanged compared with end-2010. As an outcome of these developments and the decline by 972 in the number of unemployed persons, the labour force has increased by 11.622 persons compared with 2010 Q4.

Table 7 Employment indicators

	Unit	Q1-08	Q2-08	Q3-08	Q4-08	Q1-09	Q2-09	Q3-09	Q4-09	Q1-10	Q2-10	Q3-10	Q4-10	Q1-11	Q2-11
Labour force	Thousand	1,080	1,106	1,110	1,116	1,114	1,114	1,114	1,043	1,045	1,049	1,059	1,060	1,063	1,072
Total employed	Thousand	939	966	970	974	973	973	972	899	901	905	916	917	920	930
Employed in the public sector	Thousand	167	167	167	167	167	166	166	166	166	167	167	166	165	165.0
Employed in the private non-agricultural sector	Thousand	231	231	235	239	238	238	237	237	238	242	243	244	248	258
Employed in the agricultural sector	Thousand	542	569	569	569	569	569	569	496	496	496	507	507	507	507
Registered unemployed	Thousand	141	140	140	141	141	141	142	143	145	145	143	143	143	142.1
Unemployment rate	%	13.04	12.66	12.62	12.68	12.68	12.7	12.76	13.75	13.83	13.78	13.52	13.49	13.43	13.26

Source: INSTAT

Services and industry sectors are optimistic about the expected outlook for employment in 2011 Q3. In the meantime, following the improvement in 2010 Q4, the construction sector has turned back to negative expectations for employment in the quarter ahead.

INCOME

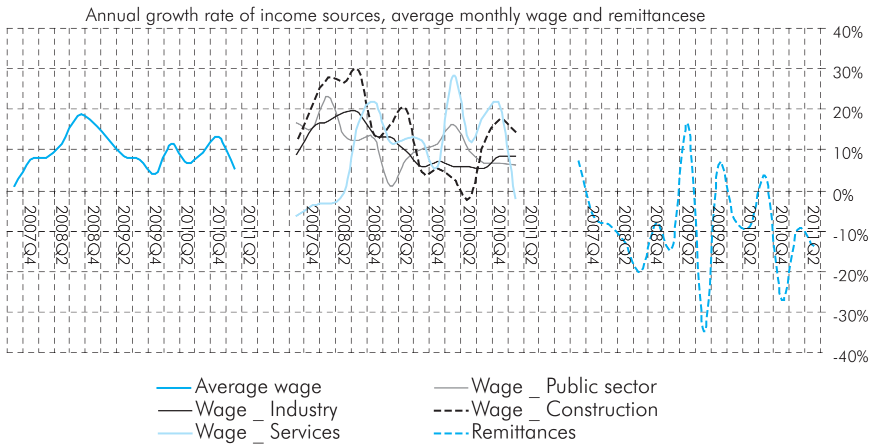
In 2011 Q1, the average quarterly wage rose 6.9% in nominal terms, compared with the same period in 2010. In real terms, average wage in economy rose by 2.8%, i.e., 1.5 percentage points less than in early 2010. The average monthly wage in the services sector registered the highest increase, by about 9.5% in annual real terms, while in industry and construction, it increased by 0.9% and 1.6%, respectively. The public sector monthly wage growth rate accelerated to 3.9%, compared with 2.2% in the previous year (real growth).

Chart 10 Employment figures according to Business Confidence Survey

Source: Bank of Albania

Remittances remain an important source of household income in Albania. In 2011 H1, remittances reached EUR 342.5 million, about 12% less than EUR 389.5 million in the same period a year ago. The forecasts[30] for a deteriorated unemployment rate in Greece and a slightly improved employment in Italy over 2011, suggest that the expectations about remittances in the months ahead are not positive.

Chart 11 Sources of income



Source: Bank of Albania and INSTAT.

In terms of savings, 2011 Q1 Consumer Confidence Survey highlights an upward propensity to save compared with the same period last year. Also, households expect their savings to continue to grow in 2011 Q3.

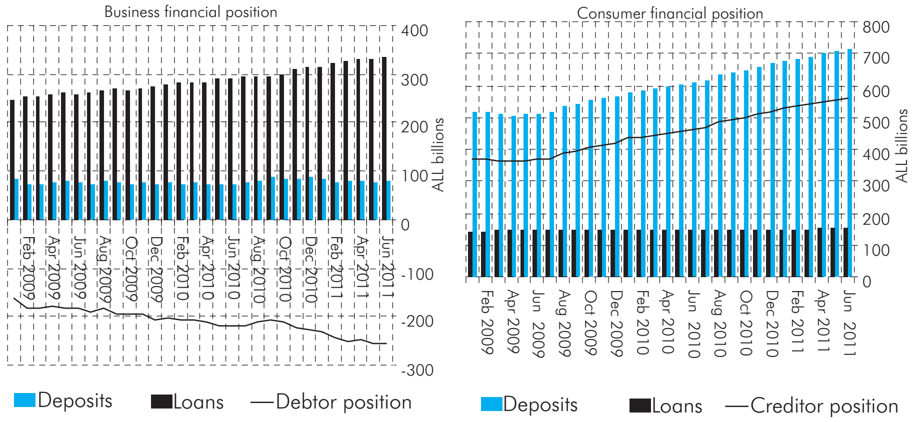
2.3 BUSINESS AND HOUSEHOLD BORROWING

Business and household borrowing performed positively during 2011 H1. In June 2011, business borrowing[31] increased by 14.6% compared with the same month a year ago. Household borrowing also improved, increasing by 5.3% in annual terms, compared with 1.5% as at end-2010 and 0.7% in the previous year's June. On the other hand, compared with end-2010, businesses have slowed the pace of deposit placements with financial institutions. In June 2011, businesses increased their deposits by 10.2% in annual terms or 15.1 percentage points less than in December 2010. As a result, the debtor position of businesses, which produces the difference between their claims on financial institutions (in the form of deposits) and their liabilities to these institutions (in the form of loans) amounted to ALL 255.6 billion at end-2011 H1, deepening by ALL 35 billion compared with a year earlier. On the other hand, households' financial debtor position amounted to ALL 559 billion, expanding by about ALL 97.6 billion on a year earlier and ALL 5.2 billion on a month earlier.

[30] *European Economic Forecast, Spring 2011.*

[31] *It includes loans granted from depository financial institutions (commercial banks, savings and loan associations) in the form of loans and other debt instruments.*

Chart 12 Financial positions of businesses and households



Source: Bank of Albania.

The increased lending to businesses and households ensures the meeting of their financial needs. However, depending on the form of lending, businesses and households may be exposed to various credit risks. Indirect credit risk arising from the exchange rate and interest rate are elaborated in the following.

· INDIRECT CREDIT RISK ARISING FROM THE EXCHANGE RATE

Indirect credit risk arising from the exchange rate determines the effect of exchange rate volatility on businesses' and households' ability to repay their foreign-currency loans, when their income is in the national currency. As at June 2011, foreign-currency loans accounted for 66.4% of total loans made by financial institutions, down by 1 percentage point from end-2010 and 0.9 percentage points from June 2010. To assess the developments in businesses' and households' exposure to exchange rate risk we use two indicators: a) the financial position in foreign currency, and b) outstanding loans unhedged against the exchange rate risk to total outstanding loans.

Financial position in foreign currency shows the difference between foreign-currency deposits and foreign-currency loans made to businesses or households by the financial institutions. The deepening of businesses' or households' debtor position in foreign currency implies a larger exposure to exchange rate risk. This indicator reflects the long-term exposure of businesses or households to indirect exchange rate risk.

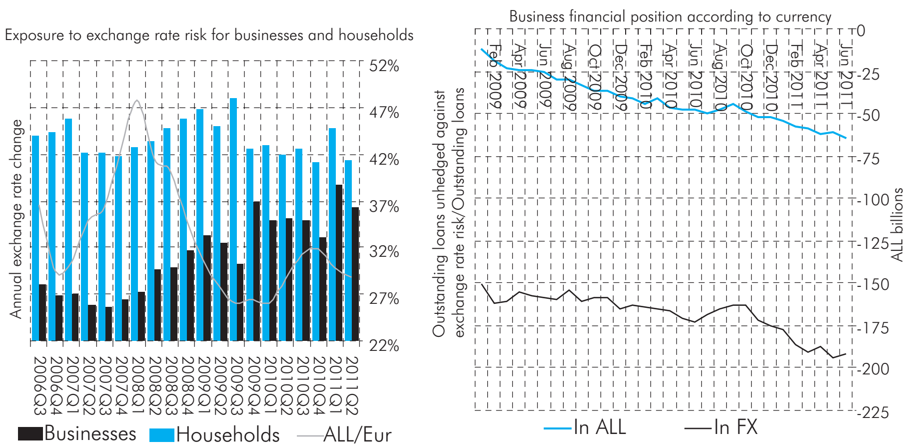
Outstanding loans unhedged against the exchange rate risk measure the performance of foreign-currency borrowing by businesses or households, whose income is in the national currency. The increase in the ratio of outstanding loans unhedged against the exchange rate risk to total outstanding loans signals a higher exposure to the exchange rate risk. This indicator measures directly businesses' or households' exposure to indirect exchange rate risk.

Regarding the first indicator, businesses' financial position (net debtor) is much deeper in foreign currency than in lek. As at June 2011, businesses were debtors to financial institutions for around ALL 191.4 billion in the form of foreign-currency loans and only for about ALL 64.2 billion in the national currency. The businesses' debtor position deepened by ALL 18.9 billion in foreign currency and ALL 16.4 billion in the national currency, compared with a year earlier. Despite the improved lending in 2011 H1, these developments have been reflected in the higher ratio of outstanding loans unhedged against the exchange rate risk to total outstanding loans for businesses. As at June 2011, this ratio was 36.3%, from 35.1% on a year earlier.

As at end-2011, households' foreign-currency borrowing from the financial system totalled ALL 236.7 billion, hence they are by and large hedged against the exchange rate depreciation risk. It is, however, estimated that around 41% of total outstanding household loans made by banks is unhedged against exchange rate risk, providing evidence for the presence of exposure to this type of risk. A year ago this ratio was 42.5%. It should be highlighted that although households at aggregate level appear more hedged than businesses against indirect credit risk stemming from the exchange rate, every individual or household exposed to foreign-currency borrowing should evaluate the adequacy of foreign-currency resources, in order to judge upon his/her loan repayment ability in the long run.

The exchange rate risk shall materialise in the event of significant exchange rate movements. Following the reduced lek/euro exchange rate depreciation rates that had started since end-2009, in 2011 Q2 it depreciated by 4.5% compared with a year ago. The increased depreciation rates, coupled with increased lending unhedged against the exchange rate risk, have led to a larger exposure of businesses and households to that risk.

Chart 13 Loans unhedged against the exchange rate risk and lek/euro exchange rate for businesses and households (left) and businesses' financial position by currency (right)



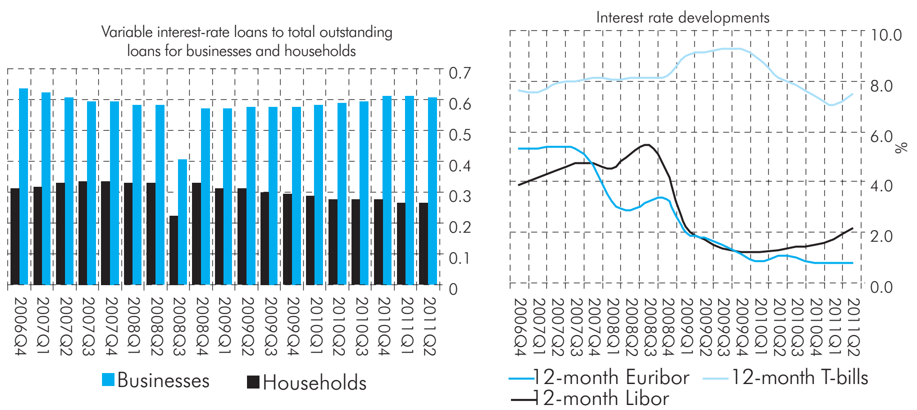
Source: Bank of Albania.

· INDIRECT CREDIT RISK ARISING FROM THE INTEREST RATE

Indirect credit risk arising from the interest rate for businesses or households determines the effect of interest rate change on their loan repayment ability. This type of risk is assessed by measuring the ratio of variable interest rate loans to outstanding loans for businesses or households. An increase in this ratio implies higher exposure to interest rate risk.

As at end-2011 H1, 60.8% of businesses' outstanding loans were of a variable interest rate. This ratio has increased by 1.6 percentage points compared with a year earlier, hence raising the businesses' exposure to interest rate volatility. On the other hand, households have decreased their exposure to interest rate volatility. As at June 2011, around 26.5% of outstanding loans were made at a variable interest rate. This ratio has decreased by 1.4 percentage points compared with a year earlier and 1.1 percentage points compared with the previous quarter.

Chart 14 Performance of variable interest rate loans and benchmark interest rates



Source: Bank of Albania, Bloomberg.

Exposure to indirect interest rate risk has increased also due to developments in the major benchmark interest rates on loans. The 12-month EURIBOR, LIBOR and T-bill rates increased in 2011 H1, raising their impact on businesses' and households' solvency. These developments are likely to occur because during the financial crisis, nominal interest rates hit historical lows on both foreign currency and the national one. Inflationary pressures were on the rise in early 2011, making central banks at home and abroad respond by lifting the base rate. On the other hand, the latest financial market developments suggest higher trends in terms of interest rate rise over the months ahead as compared with 2011, requiring a cautious management by businesses and households.

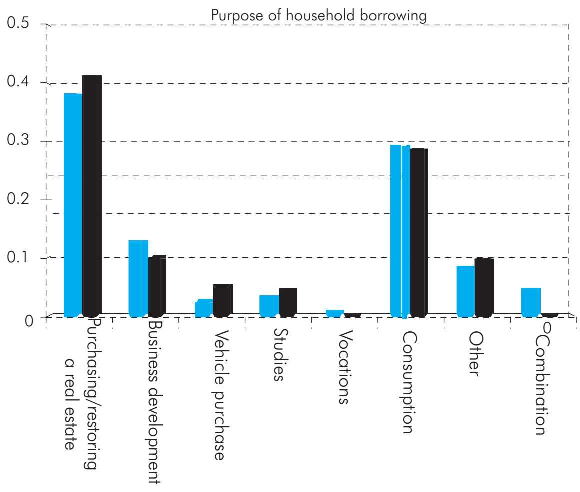
Box 2 A summary of survey results on the financial position and debt burden held by businesses and households

Monitoring the financial situation of Albanian business and household sectors is of great interest in view of assessing the impact it may provide on the real economy and on the financial sector. Lacking official data, in 2010, the Bank of Albania in cooperation with the Institute of Statistics carried out surveys on the financial position and debt level of households and businesses. These surveys are conducted semi-annually. The questionnaires consist of quantitative and qualitative questions that allow obtaining quantitative data from respondents, opinions on their past debt and expectations about the future. The following provides a brief presentation of some key findings from the 2011 H1 survey on the financial position and debt of businesses and households.

Financial position and performance of household borrowing

According to the survey results, the main source of household income is: private sector employment (29.8%); retirement (30.1%); and self-employment (20.9%) of the total number of employees. Only 14% of households state that they have other sources of income, besides those from work, mainly in the form of transfers from abroad.

Chart 15 Purpose of household borrowing



Source: Bank of Albania.

Out of the total number of interviewed households, 24.8% responded that they currently have a debt to pay. The main source of debt for 59.3% of borrowers is a natural person and for 37.4% is a bank. Compared with 2010 H2 (first-survey reference period), there is noted an increase in both bank borrowing (up 6.7%) and informal borrowing (up 4.4%). Purchasing/restoring a real estate is the main purpose of household borrowing, accounting for 41.6% of the cases; while 28.5% of it is used for consumption and 10.1% is used for business development.

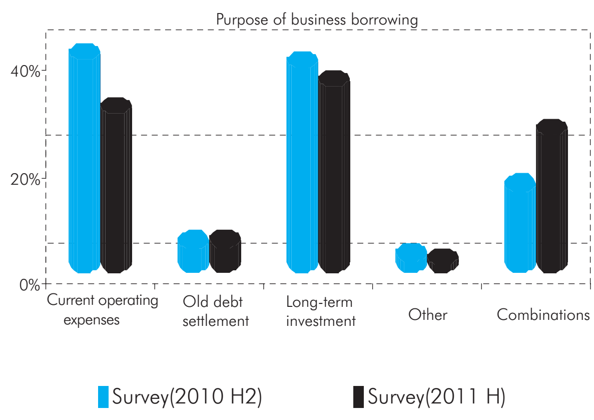
Euroisation of household borrowing, due to the inclusion of borrowing from physical persons, is not high (96% of debt is in the national currency). The remaining maturity for debt settlement is mainly a mid-term period of 1-3 years (33%) and a short-term period of 12 months (36%). 27% of households have reported reduced solvency over the past 6 months mainly due to lower household income and increased expenses. Regarding the expectations for 2011 H2, households assessed that the terms of income and expenditure would not change. In consequence, 50% of them are not likely to obtain any new debts.

Financial position and performance of business borrowing

The interviewed businesses state that they have not expanded their activity in 2011 H2 (53.3%). Raw materials have been obtained mainly at home (51.3%) and products have also been sold at home (66%). 76.2% of businesses reported that they conduct their activities in lek, or mainly in lek.

Out of the total number of interviewed businesses, 42.8% reported that they had actually a debt to pay. As at 2011 H1, selling was the main funding source for their activity (26.9% of businesses), while 27.3% of businesses used borrowing *as a separate source of funding or combined it with other funding sources. Compared with 2010 H2, the use of borrowing as a funding source has increased by 3 percentage points. Funding business activity through borrowing has been carried out within a one-year time span for 58.9% of respondent businesses. 20% of total businesses have borrowed over the past 6 months. The remainder of businesses have been granted a loan within the past 5 years, thus leaving a very small share in long-term borrowing. 30.8% of businesses have borrowed for long-term investments and 36.3% of them for coping with their current expenditures.*

Chart 16 Purpose of business borrowing



Source: Bank of Albania.

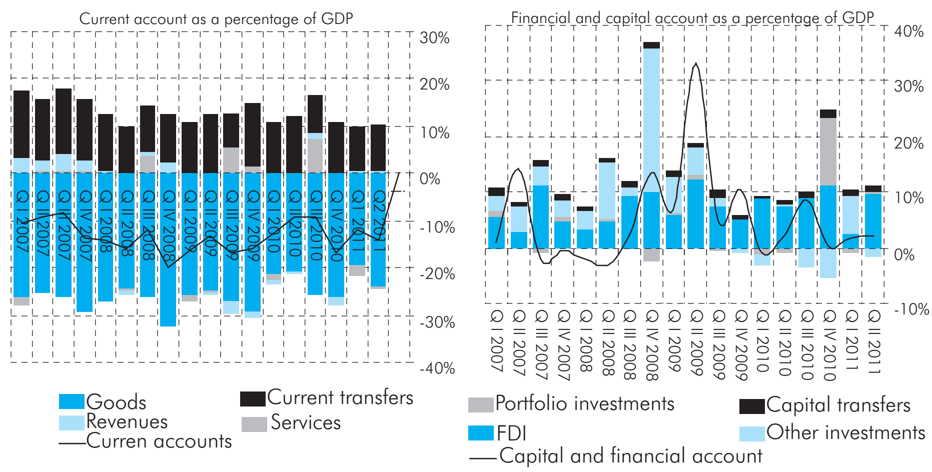
73.8% of borrowing businesses state that their debt level is appropriate. The level of those who would like to take on more debt is down by 1.3 percentage points to 10.2% in 2010 H2. With regard to loan-obtaining plans over the 6 months ahead, 57.6% of total interviewed businesses state that they have not planned any such thing for the period ahead, compared with 68% of businesses interviewed over the previous period.

2.4 BALANCE OF PAYMENTS

As at 2011 H1, current account deficit was EUR 588.5 million or 14% of GDP, expanding by about 4.9 percentage points compared with a year ago. However, compared with year-end 2010, the current account deficit has narrowed by 2.8 percentage points. Trade balance deficit recorded EUR 1053.4 million in the same period, 14% more than a year ago. As a share of GDP, trade balance deficit accounts for 24.5%, up 4.2 percentage points from a year earlier, however, narrowing by 1.6 percentage points compared to year-end 2010. These developments reflect the positive growth rates of exports by 12% y-o-y, compared with growth of imports by 13%.

As at 2011 H1, net foreign inflows of capital and financial account recorded EUR 434.9 million, about 41% more than a year ago. Foreign direct investments and portfolio investments narrowed by 15% and 68% y-o-y, respectively. However, the improvement in capital transfers is reflected in a positive capital and financial account balance by 9.7% of GDP, from 7.7% a year ago.

Chart 17 Balance of payments



Source: Bank of Albania.

2.5 FISCAL DEVELOPMENTS OVER 2011 H1

In 2011 H1, the contribution of fiscal policy was reflected mainly in terms of current expenditure growth. Total revenues increased slightly, by only 1.1% y-o-y, while total expenditures increased by 7.7%, contributing to budget deficit growth by ALL 26.9 billion. Tax revenues, which constitute the major share of revenues, have contributed to a slight increase in total revenues by 4.7%, while the non-tax revenues have declined. On the expenditure side, the increase was mainly due to increase in current expenditure, which changed by 7.6% y-o-y. The percentage of annual plan realization is 42.9% and 44.5% for total revenues and expenditure, respectively, leaving adequate room for the remainder of the year.

Table 8 Key fiscal indicators

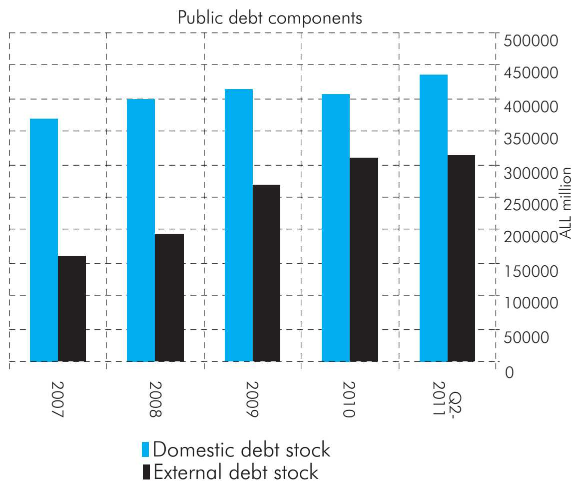
	June 2009	June 2010	June 2011	Annual change, in %	
				June 2010	June 2011
Total revenues	145,172	153,533	155,256	5.76	1.12
Grants	1,196	1,853	1,129	54.93	-39.07
Tax revenues	131,795	136,731	143,204	3.75	4.73
Non-tax revenues	12,180	14,949	10,923	22.73	-26.93
Total expenditure	178,243	169,133	182,166	-5.11	7.71
Current expenditure	129,606	138,782	149,317	7.08	7.59
Capital expenditure	48,552	32,261	32,849	-33.55	1.82
Budget deficit	-33,071	-15,600	-26,910	-52.83	72.50

Data in millions of ALL, progressive.
Source: Ministry of Finance.

73.6% of Government investments have been financed through domestic sources, a percentage that has been downward throughout 2011 H1 and compared with 2010 H1.

Budget balance has been achieved through domestic financing and foreign one, by 84.8% and 15.2%, respectively, turning the focus back on domestic financing.

Chart 18 Public debt components



Source: Ministry of Finance.

Public debt stock increased by 5% compared with year-end 2010, due to a negative budget balance, which has been reflected in a higher increase in the domestic debt stock than in the external one. As at end-2011 H1, the domestic debt stock accounted for 58.1% of the public debt. Short-term instruments, most of which are 6-month and 1-year T-bills, are the ones mostly used in this stock, accounting for 56.7%. Among long-term instruments, the major part consists of 2-year and 5-year bonds. In terms of external debt, the euro is still the major currency of its composition, accounting for 59.2%. Exchange rate risk remains present, due to the depreciation of the national currency against the euro. Also, the upward interest rate trend because of the uncertainty in the international markets may be reflected in the service of this stock over the periods ahead.

The public debt stock is estimated at around 59.2% of GDP, with the domestic debt accounting for 34.4% of GDP. Overall, the debt stock has not undergone any substantial changes in terms of its structure and composition relative to the previous period. Reducing it to 54% of GDP by 2013 remains its primary mid-term objective. Therefore, the fiscal policy decision-making should be constantly oriented towards this direction. Improving revenue collection and management will contribute to reducing and controlling the negative budget balance. Also, the downward revision of the budget spending at end-2011 H1 will further contribute to supporting the fiscal sustainability.

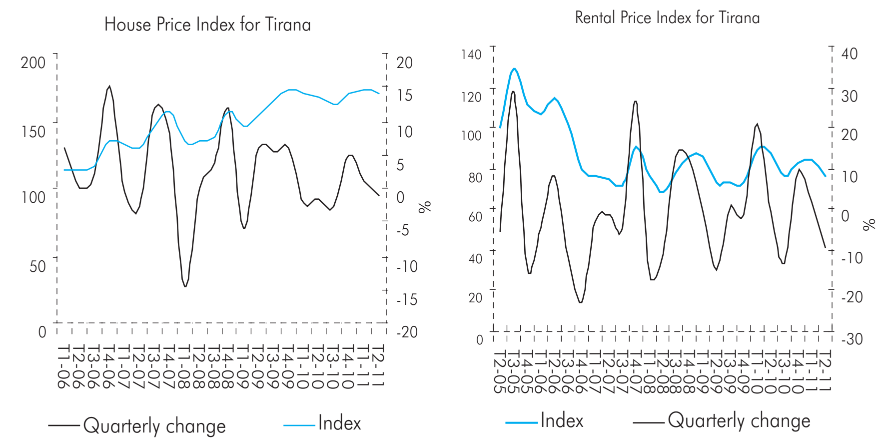
In the meantime, not very conducive current conditions in global financial markets transmit their impact on the Eurobond issued by the Albanian Government in 2010 Q4, whose interest rate is higher than at the time of its initial presence in the international market. This situation carries over another risk for the rising cost of debt and its refinancing in the future.

3. DOMESTIC MARKETS

3.1 REAL ESTATE MARKET

The performance of the real estate market is assessed by the House and Rental Price Indices, which are proxy indicators calculated for Tirana, the capital city[32]. In 2011 H1, the House Price Index increased by 1.6% y-o-y; however, compared with the preceding periods, this increase was slower. It reflects a slight decrease by 1.3% compared with 2011 Q1, following two quarters of growth.

Chart 19 House and Rental Price Indices for Tirana



Source: Bank of Albania.

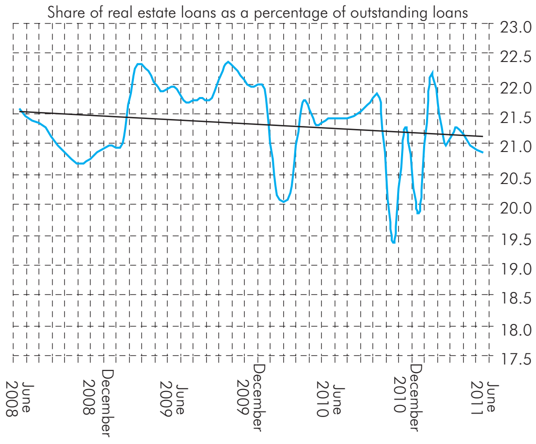
Rental Price Index decreased throughout 2011 H1, both y-o-y and q-o-q, by 12.8% and 9.4%, respectively.

Turnover Volume Index[33] for the construction sector has improved, up 9% in 2011 Q1 compared with 2010 Q1. However, it declined significantly by 26.4%, compared with the previous quarter, i.e., end-2010.

Construction Cost Index[34], which represents construction-related costs, remained constant, increasing by 0.2% y-o-y at end-2011 H1, driven by slightly higher costs of construction materials and electricity, as a key sub-item of material costs.

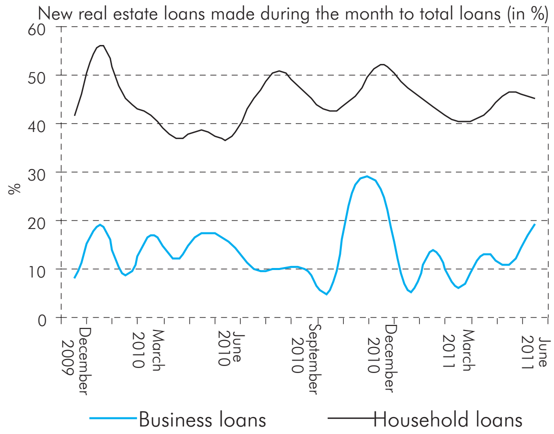
[32] *Both indices are calculated only for Tirana, excluding its suburban areas.*
[33] *Source: INSTAT.*
[34] *Source: INSTAT.*

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



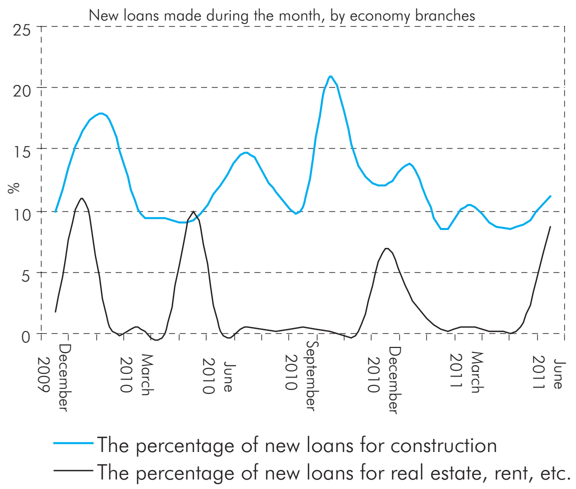
Source: Bank of Albania.

Chart 21 New real estate loans made during the month



Source: Bank of Albania

Chart 22 New loans made during the month, by economy branches



Source: Bank of Albania

By analyzing the banking sector data, we note that the share of real estate loans in outstanding loans has maintained almost the same rate, in spite of marginal fluctuations. The downward trend observed over the recent years is still present during the period, as a reflection of the supply and demand in this market.

New loans made in June, by purpose of use, account for a high percentage of real estate household loans, standing at 45.4% in June 2011, while real estate business loans account for 19.3% in the same month. However, the recent months have shown an upward tendency of business loans used for this purpose and a slight decline in new household loans. This fact may be indicative of the risk that banks want to take over in selecting their clients, as well as of the demand of these two categories for real estate loans.

In the meantime, out of the new business loans made each month, classified by economy branches, the percentage of new construction loans was 11.2 in June and for real estate and renting 8.7%, thus narrowing the spread between them. Construction loans have been downward since end-2010, with a slight recovery at end-2011 H1.

3.2 FINANCIAL MARKETS

The Albanian financial market is dominated by operations in the interbank market, government debt securities and foreign exchange. Other segments that relate to insurance, reinsurance and pension funds account for a small share in the total financial market volume. In 2011 H1, the financial market situation experienced increased liquidity through Bank of Albania's open market operations versus the downward volume of interbank market transactions.

3.2.1 INTERBANK MARKET

In 2011 H1, the volume of interbank market transactions fell by 22.7% compared with 2010 H2, at a time when the weighted average interest rate maintained almost the same value, from 4.98% in 2010 H2 to 5.07% in 2011 H1. Compared with 2010 H1, the volume of transactions declined by 16%, while the weighted average interest rate increased by only 0.1 percentage points. For the period under review, the interbank loan cost slope is almost flat, but open market liquidity provision through reverse repurchase agreements has replaced this form of financing.

3.2.2 PRIMARY SECURITY MARKET

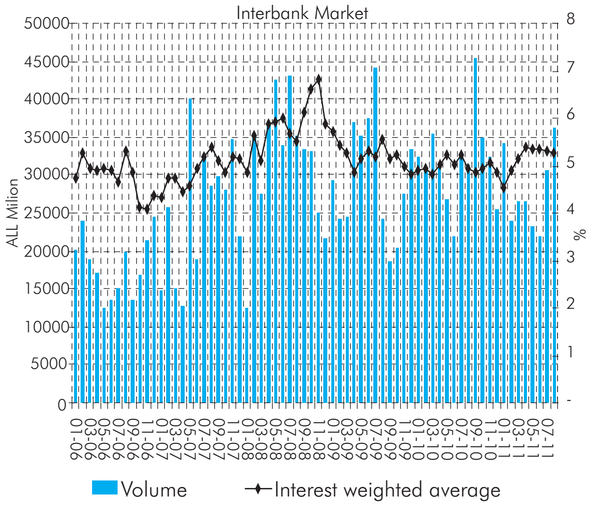
The volume asked in the Albanian government primary security market fell by 5.2% in 2011 H1 compared with 2010 H2, but it increased by 5.7% compared with a year ago. During 2011 H1, the total amount asked in the Albanian government security auctions amounted to ALL 204.2 billion or ALL 8.9 billion less than in 2010 H2 and around ALL 7 billion higher than in 2010 H1.

In June 2011, the bid-to-cover ratio, which measures the bid-to-cover ratio of T-bills in auctions, was 1.06. This ratio was 0.33 points lower than in December 2010 and 0.13 points lower than in June 2010 (see Chart 24).

The performance of primary market government debt yields changed its downward trend in 2011 H1, turning upward since January 2011. The following charts show the performance of the volume and the weighted average of T-bill yield, since January 2008.

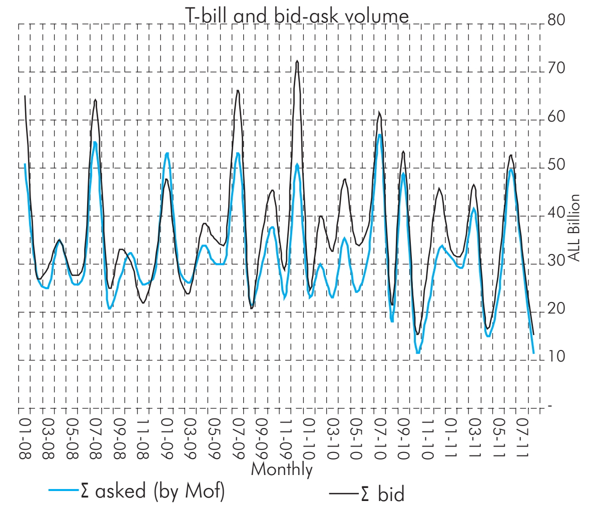
A more pronounced increase in T-bill yield, likewise the decline in the previous half, is noted for the 12-month maturity, followed subsequently by bond yield indexed to it. As at end-June 2011, the 12-month T-bill yield reached 7.52%, from 7.08% in December 2010 and 7.91% in June 2010. The same performance is noted also for 3-month and 6-month T-bill yields, albeit at a lesser extent. The 6-month T-bill yield, which marked 6.41% in December 2010 and 7.12% in June 2010, rose to 6.8% in June 2011. The 3-month T-bill yield rose to 5.64% in June 2011, from 5.28% in December 2010 and 5.86% in June 2010.

Chart 23 Interbank market volume and interest rates



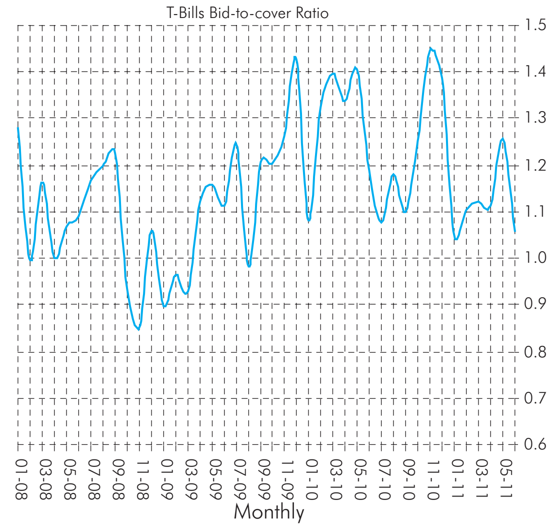
Source: Bank of Albania.

Chart 24 T-bill bid-ask volume



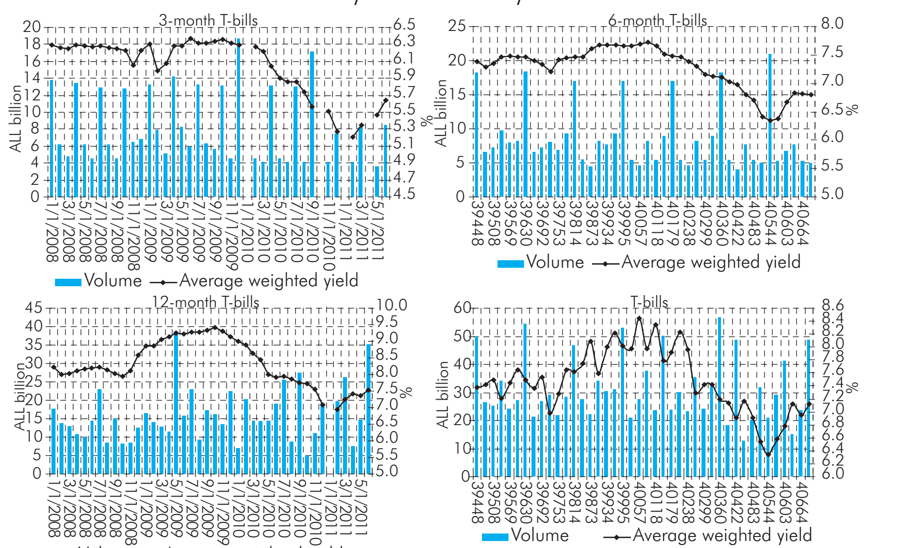
Source: Bank of Albania.

Chart 25 Bid-to cover ratio



Source: Bank of Albania.

Chart 26 Primary market T-bill yield and volume

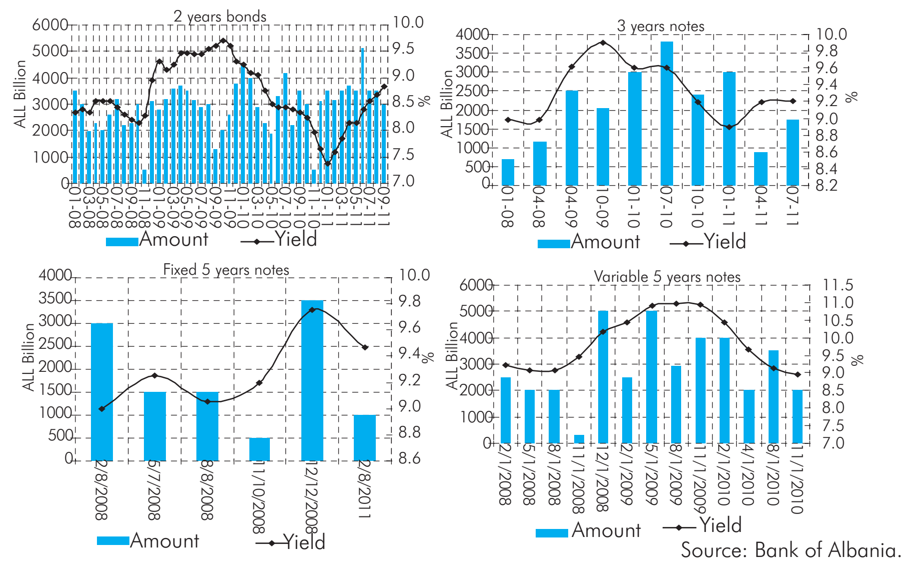


Source: Bank of Albania.

The yield on 2-year and 3-year bonds showed a similar tendency as T-bills. At end-2011 H1, the 2-year bond yield was 8.4%, from 7.65% at end-2010 H2 and 8.45% at end-2010 H1. The 3-year bond yield has also shown a similar performance, estimated at 9.21% at end-2011 H1, from 9.19% at end-2010 and 9.6% at end-2010 H1. Yields on (fixed and variable) 5-year bonds have decreased from the latest auction levels. As at end-2011 H1, they were 9.45% and 8.94%, respectively.

Chart 28 shows the yield curve of government debt securities as at end-2011 H1.

Chart 27 Primary market bond yield and volume



Source: Bank of Albania.

3.2.3 SECONDARY SECURITY MARKET

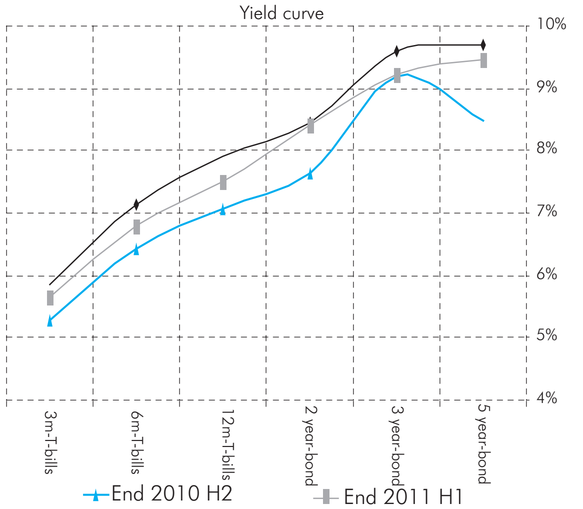
The volume in the secondary market, or debt security trading market, has been volatile, though still at low levels. In 2011 H1, the volume of transactions traded in the secondary market fell to ALL 4.7 billion, from ALL 5 billion in 2010 H2. In 2011 H1, the volume traded in the secondary market totalled ALL 5.4 billion. The 12-month T-bills account for the largest share in transactions carried out in the secondary market.

3.2.4 FOREIGN EXCHANGE MARKET

In 2011 H1, the euro appreciated 1.9% against the lek, whereas the US dollar and the British pound depreciated 6.1% and 3.3%, respectively. The lek's appreciation against both major currencies has reflected mainly the developments in the global foreign exchange markets.

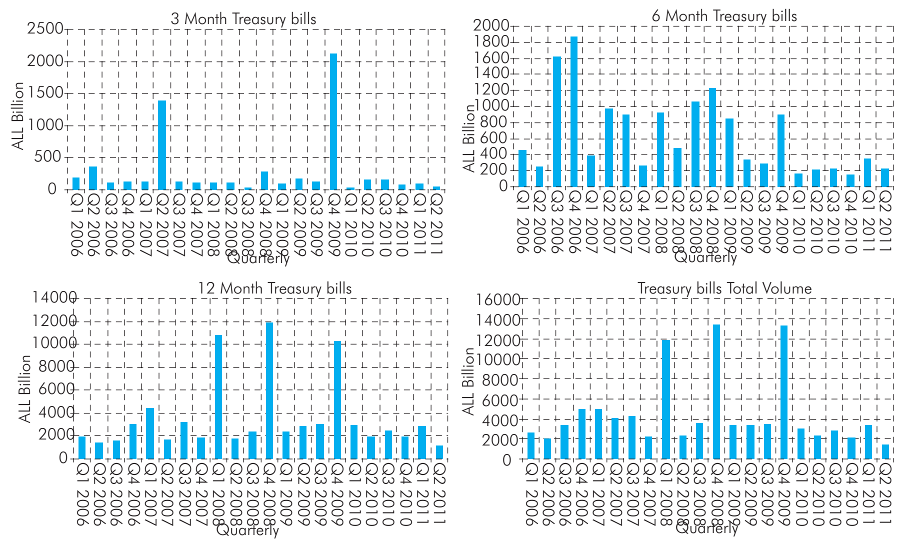
The foreign exchange market volatility increased markedly in 2009 due to the financial crisis that swept across the global financial markets. This situation increased the operating cost and risk to firms whose business is based on merchandise import and export, and to entities whose loans are denominated in foreign currency. In 2010 and 2011 H1, the lek's exchange rate, particularly against the euro, was more stable, resulting, in turn, in lower depreciation and volatility. Chart 31 shows the performance of the lek's exchange rate against the virtual basket of both major currencies, the euro (80%) and the U.S. dollar (20%) for 2008, 2009, 2010 and 2011 H1.

Chart 28 Yield curve



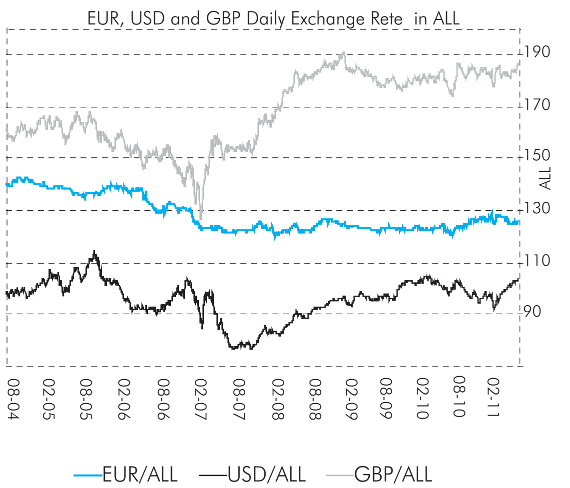
Source: Bank of Albania.

Chart 29 T-bill volume traded in the secondary market



Source: Bank of Albania.

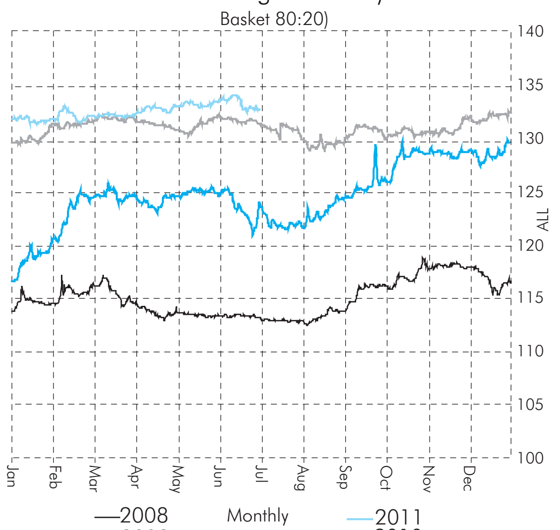
Chart 30 Lek's exchange rate against the major currencies



Source: Bank of Albania.

In order to assess the performance of the lek's exchange rate, we monitor the nominal effective

Chart 31 Foreign currency basket



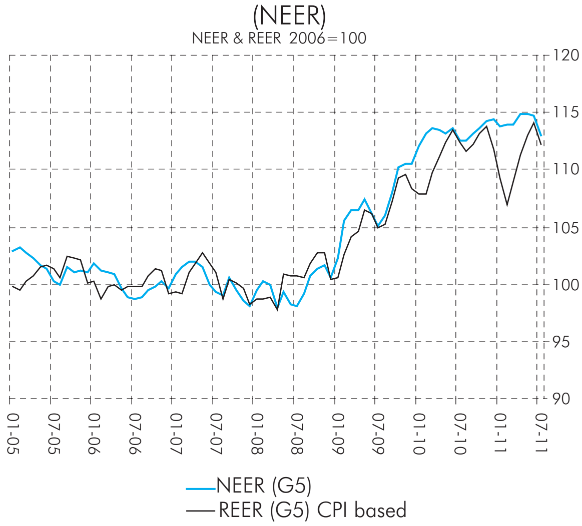
Source: Bank of Albania.

exchange rate (NEER) and the real effective exchange rate (REER) of the lek, which are constructed based on the share of trade with Italy, Greece, Turkey, China and Germany, Albania's five main trading partners. The indicators are expressed in lek per unit of foreign currency; therefore, the increase in the index shows the lek's depreciation. The slope of indicators, which shows the velocity and extent of the lek's depreciation, remained flatter, moreover downward during 2011 H1, reflecting a stable exchange rate over the period compared with 2010.

3.2.5 BANK OF ALBANIA OPERATIONS

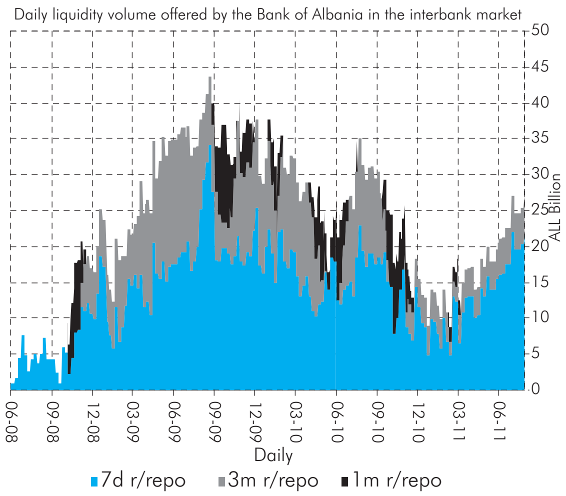
Since January 2010, the Bank of Albania has continued to inject liquidity into the interbank market and restored the fixed-amount and competitive bid auctions. Upon the improvement of the banking sector liquidity through deposit growth since 2009, the banks' bidding for liquidity from the Bank of Albania was lower during end-2010 and 2011 Q1.

Chart 32 Nominal Effective Exchange Rate Index (NEER)



Source: Bank of Albania.

Chart 33 Daily liquidity volume offered by the Bank of Albania in the interbank market



Source: Bank of Albania, MPD.

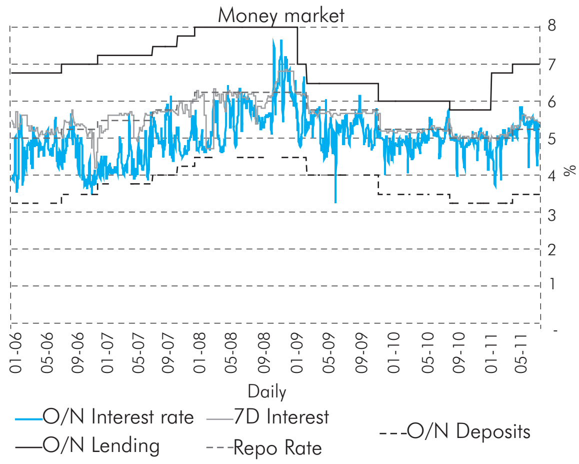
Therefore, the volume of Bank of Albania's transactions has been falling over these periods. However, 2011 Q2 evidenced the increase in liquidity injected by the Bank of Albania. The amount of liquidity injected by end-June 2011 was about ALL 26.8 billion, from ALL 13.9 billion in December 2010 and ALL 26.6 billion as at end-June 2010.

Concerning the monetary policy decisions, on 23 March 2011, the Bank of Albania decided to lift the key interest rate by 0.25 percentage points to 5.25%.

3.2.6 INTEREST RATE SPREAD BETWEEN NEW LOANS AND DEPOSITS

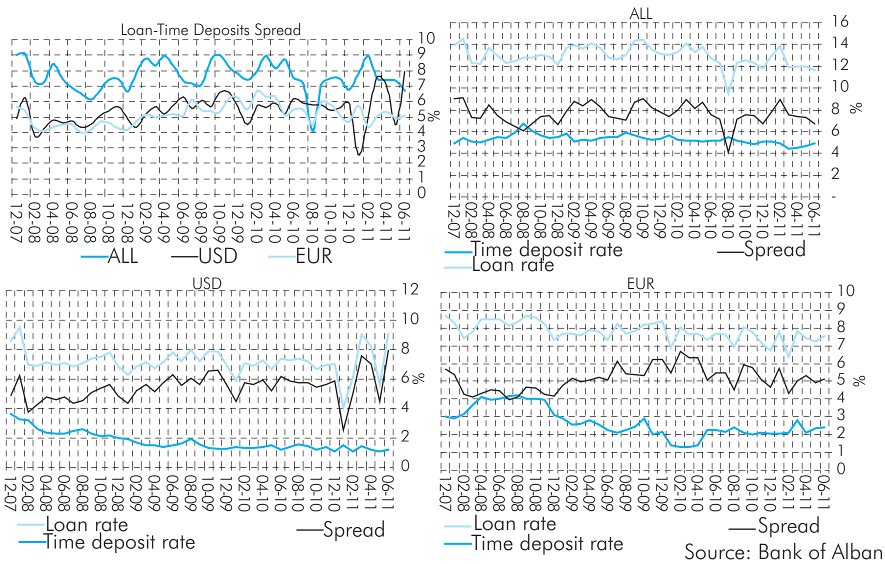
As at 2011 H1, the interest rate spread[35] between loans and deposits was volatile for the three major currencies. Over the period, this spread narrowed by 0.04 percentage points for operations in lek and widened by 2.04 and 0.44 percentage points, respectively, for operations in US dollar and euro.

Chart 34 Money market rates



Source: Bank of Albania.

Chart 35 Loan-time deposit spread



Source: Bank of Albania

[35] The spread is measured as a difference between the weighted average interest rate on new time deposits and the average interest rate on new loans.

4. PAYMENT SYSTEM DEVELOPMENTS IN 2011[36]

REAL TIME GROSS SETTLEMENT SYSTEM - AIPS

In 2011 H1, a volume of 37.045 transactions were carried out via AIPS, with a total value of ALL 1.873 billion liquidity in circulation and an average value of ALL 50.5 million per transaction. Compared with the same period a year earlier, in 2011, the number of settled transactions appears to have increased by 3.9%, whereas the value of settled transactions has decreased by 12.4%. The average daily volume processed and settled via AIPS is around 292 transactions, with an average daily value of ALL 14.75 billion.

Table 9 Volume of transactions processed in AIPS

AIPS	2007	2008	2009	2010	2011 H1
Number of transactions	45,480	56,717	55,701	80,356	37,045
Value of transactions (in billions of ALL)	3,745	5,146	4,718	4,437	1,873
Average value per transaction (in millions of ALL)	82	91	85	55	50.5

Source: Bank of Albania.

As at 2011 H1, there were processed 1,376 transactions more via the AIPS, or up 4% compared with the same period a year earlier. The upward volume over the past 2-3 years attributes to the automation of Ministry of Finance's treasury payments in March 2010, which account for a material share in terms of the number and value to total customer payments processed via the AIPS.

Worth noting is that a limited number of banks has the major share in total transactions carried out via the AIPS, which is an indicator of the concentration level.

AUTOMATED CLEARING HOUSE SYSTEM - AECH

The AECH processes and clears customer payments with a value of below ALL 1.5 million. As at 2011 H1, a total of 183,342 payment orders were cleared in the AIPS, with an average value settled per transaction of ALL 156 thousand. On average, 1,443 payments were processed daily in the AECH, with an average daily value of ALL 225 million.

Table 10 Volume of transactions processed in AECH

AECH	2007	2008	2009	2010	2011 H1
Number of transactions	71,857	113,682	102,304	332,777	183,342
Value of transactions (in billions of ALL)	12.01	17.61	15.46	43.98	28.62
Average value per transaction (in millions of ALL)	0.17	0.15	0.15	0.13	0.16

Source: Bank of Albania.

[36] *This section has been based on processed data and materials prepared by the Payment Systems Department, Bank of Albania.*

PAYMENT INSTRUMENTS

At the end of June 2011, the number of banks licensed as card issuers, providing the service of cash withdrawal from ATM machines, was 14. Out of these card-issuing banks, only 8 banks (from 7 at end-2010) are also licensed to accept cards, by offering the service of card payment acceptance at point-of-sale terminals (POS) systems located in shops, restaurants, hotels or trade centres. At end-2011 H1, the number of ATMs and POS terminals increased by 2.9% and 1.1%, respectively, compared to end-2010.

Table 11 Number of ATMs and POS terminals as at end of respective periods

Number of ATMs/POS terminals	2006	2007	2008	2009	2010	2011 H1
Number of ATMs	309	433	642	741	761	783
Number of POS terminals	1234	1832	2953	4,370	4,680	4.729

Source: Bank of Albania.

During January to June 2011, a total of around 5.6 million transactions amounting to ALL 56 billion were processed via cards (ATMs and POS terminals). Out of total transactions, around 96% are cash withdrawals from ATMs and only 4% are customer payments made via cards at POS terminals, thus providing evidence for the high use of cash in the economy.

Table 12 Number and type of cards

Number of cards	2008	2009	2010	2011 H1
Type of cards:	512,232	596,985	694,848	709,100
1- Debit cards	482,072	543,141	667,548	680,465
2- Credit cards	15,931	23,844	27,300	28,635
Total number of cards in circulation	498,003	566,985	694,848	712,575

Source: Bank of Albania.
Banks' reporting according to the methodology "On reporting the payment instruments".

Based on banks' reports, debit cards represent 96% of the total number of cards in circulation, while by brand or type of card-processing operators, VISA cards share the largest percentage (about 83%) to the total, followed by MasterCard. Maestro and American Express account for a relatively small share. Only two banks issue local cards, which account for only 1.6% of total cards in circulation.

Home Banking is another banking service being ever-increasingly used, allowing customers to access their bank accounts in distance, through an internet line, telephone line or software that the banks make available to their customers. This service was first provided in Albania in 2005. In 2011 H1, home banking was provided by 11 banks. As at 2011 H1, around 86 thousand home banking electronic transactions were reported for the entire banking system, with a total value of ALL 46.16 billion. In 2011 H1, home banking electronic transactions increased by 11% in number and 13% in value.

5. FINANCIAL SYSTEM DEVELOPMENTS

The level of financial intermediation in Albania, measured as a ratio of financial sector assets to GDP, was 86.9% in 2011 H1, from 85.9% at end-2010 and 84.4% in the same period a year earlier. The volume of financial institutions' assets increased by 5.1% compared to end-2010. The banking sector remains the dominant segment of financial intermediation in Albania. Its assets account for about 94.5% of total financial system assets and about 82.2% of GDP.

Table 13 Financial system assets as a share of GDP through the years (in %)

Licensing and Supervisory Authority	Financial system	Years					
		2006	2007	2008	2009	2010	2011/Q2
Bank of Albania	Banking system	69.6	75.9	76.7	77.5	80.9	82.2
	Non-bank institutions	1.52	1.48	1.66	2.2	2.7	2.58
	SLAs and their Unions	0.52	0.63	0.7	0.77	0.78	0.76
Albanian Financial Supervisory Authority	Insurance companies	1.29	1.36	1.45	1.5	1.4	1.44
	Pension funds	-	-	-	0.01	0.01	0.01

Source: Bank of Albania, Albanian Financial Supervisory 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 Albanian Financial Supervisory Authority (AFSA). The institutions supervised by the Bank of Albania are a) non-bank financial institutions (credit and leasing associations), b) savings and loan associations and their unions, and c) other institutions providing payment and foreign exchange services. The institutions supervised by the AFSA are a) insurance companies, and b) private supplementary pension funds. Securities trading associations are also supervised by the AFSA but their share is negligible.

The non-bank financial sector continues to reflect a relatively small share in the entire financial system. Thus, the total non-bank financial sector assets account for about 5.5% of the financial system, downward from end-2010 (5.7%). The non-bank financial sector's activity represents about 4.78% of Albania's GDP, from 4.9% estimated at end-2010.

Based on the latest data, non-bank financial institutions' assets account for 2.97% of total financial system assets (from 3.1% at end-2010), accounting for about 2.58% of GDP, from 2.7% at end-2010. Assets of insurance companies account for 1.65% of the financial system, from 1.72% compared to end-2010. In the meantime, their share remains around 1.44% of GDP. Assets of savings and loan associations account for 0.87% of total financial system and 0.76% of GDP, without any significant changes compared with end-2010. Private pension funds continue to have a limited share in the total financial system assets and GDP (about 0.01%).

Chart 36 shows the structure of the financial system for each segment operating in Albania.

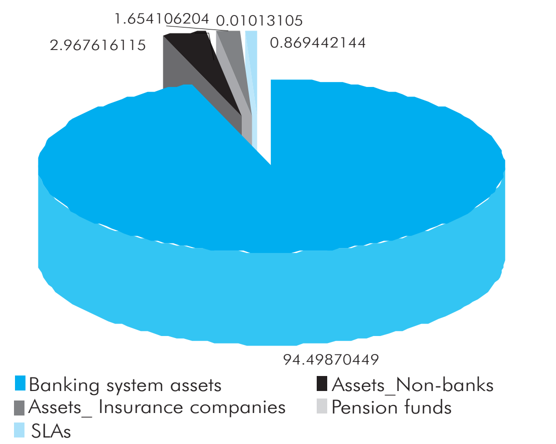
FINANCIAL ANALYSIS OF THE ACTIVITY OF NON-BANK FINANCIAL INSTITUTIONS

The activity of non-bank financial institutions was relatively positive in 2011 Q2, registering loan portfolio growth, improved capitalization level and increased financial profit. However, the asset level slowed down and the loan portfolio quality fell constantly.

In 2011 Q2, assets of non-bank financial institutions amounted to around ALL 32.8 billion, about ALL 653 million less (or -1.95%) than at end-2010.

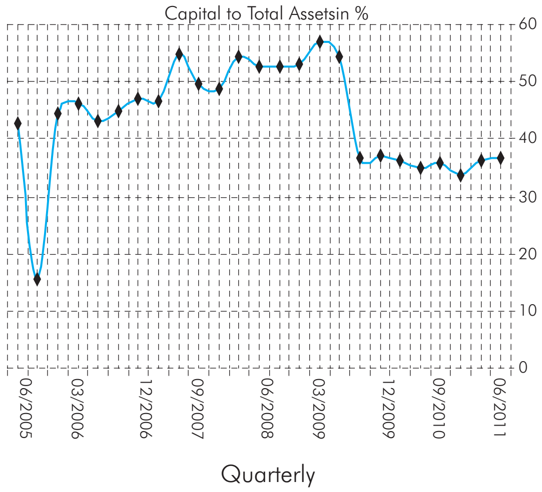
Cash, deposits and accounts made the largest contribution to the decline in the asset level by approximately 163.6%,

Chart 36 Share of financial system entities' assets in total financial system assets, in %



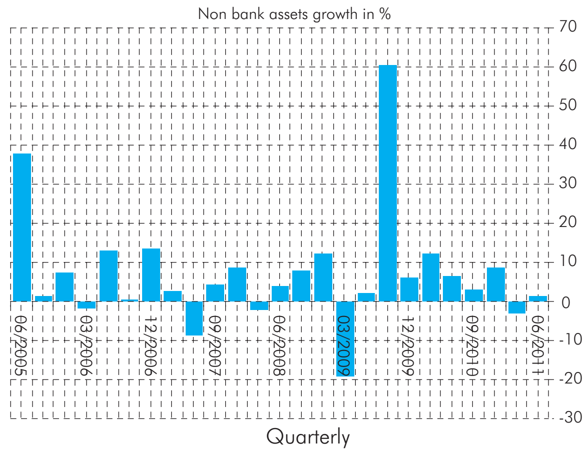
Source: Bank of Albania.

Chart 38 Capitalization of non-bank financial institutions



Source: Bank of Albania.

Chart 37 Growth of non-bank financial institutions' assets, quarterly



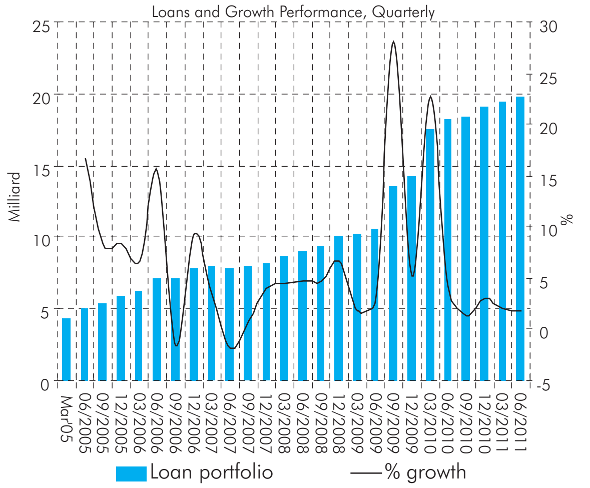
Source: Bank of Albania.

followed by variable-income securities by about 18.1%. "Operations with customers" is the only item that made a positive contribution to asset performance, by about 87.1%.

On the liability side, Other Payables and Loans Received are the items that have contributed negatively, by 73.8% and 131.8%, respectively. In the meantime, the Capital account item made a positive contribution by about 106.2%.

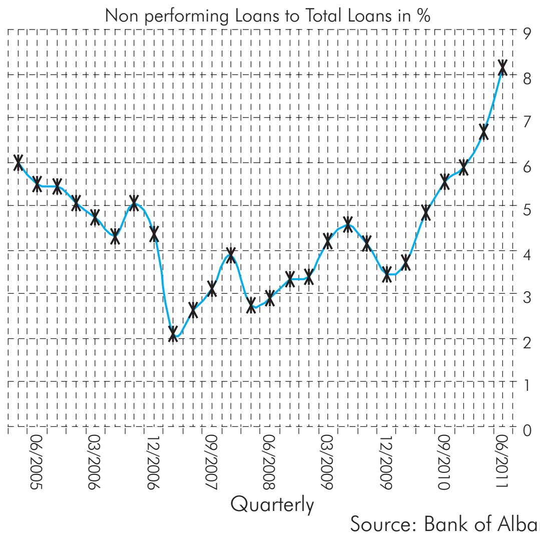
In 2011 Q2, capitalization level, measured as the ratio of capital account to total assets, rose to 36.6%, from 33.7% at end-2010, thus observing the regulatory requirement of over 10%.

Chart 39 Loan portfolio for non-bank financial institutions



Source: Bank of Albania.

Chart 40 Non-performing loans to total loans



Source: Bank of Albania.

The loan portfolio has the main share in total non-bank financial institutions' assets, estimated at about 60.4% for 2011 Q2. Total loans (gross) grew to ALL 19.8 billion, up ALL 3.9% from end-2010.

The loan portfolio quality for non-bank financial institutions worsened further in 2011 Q2. Quality indicator rose to 8.1%, from 5.9% at end-2010. Outstanding loans increased by 3.9%, while non-performing loans increased by about 43.5% for non-bank financial institutions.

Profitability of financial institutions increased in 2011 Q1, with a net profit estimated at ALL 663.9 million, from ALL 628.6 million in the same period a year earlier.

Income for the same period totalled ALL 3.6 billion, about ALL 257.8 million more than in the same period in 2010. Interest income and Commissions income continue to have the largest share in income, 46.4% and 13.9%, respectively. Concerning expenditure, Operating expenses have the largest share. In 2011 Q2, they accounted for 35.2% of total expenditure, less than the figure registered a year earlier (38.7%).

Savings and Loan Associations (SLAs)

Total assets of SLAs and their unions for 2011 Q2 decreased slightly by 0.6% compared with year-end 2010, to ALL 9.64 billion. Lending continues to have the main share in the financial activities of SLAs. In 2011 Q2, they reported that about 71.9% of total assets were invested in lending. Loan portfolio quality has improved for SLAs and their unions. Non-performing loans fell to 4.5%, from about 5.1% at end-2010. The net profit of SLAs and their unions was about ALL 9.6 million in 2011 Q2, from ALL 62 million a year earlier.

Table 14 shows the performance of several indicators on the activity of SLAs and their unions.

Table 14 Indicators of SLAs activity

	QI-09	QIV-09	QI-10	QII-10	QIII-10	QIV-10	QI-11
Total assets (in ALL million)	7,866	8,765	8,825	9,378	9,581	9,705	9,649
Outstanding loans (in ALL million)	6,419	6,893	7,003	7,125	7,124	7,072	6,946
Outstanding loans /total assets (in %)	81.6	78.6	79.4	75.9	74.4	72.8	71.9
Non-performing loans (in ALL million)	104	135.2	198.8	237.1	262.6	357.9	315.1
Non-performing loans / outstanding loans (in %)	1.62	1.96	2.84	3.3	3.69	5.06	4.5

Source: Bank of Albania.

The above analysis highlights that as at end-2011 Q2, the SLAs and their unions had an improved loan portfolio quality, a positive net profit and a slower expansion of activity.

INSURANCE COMPANIES AND PRIVATE SUPPLEMENTARY PENSION FUNDS

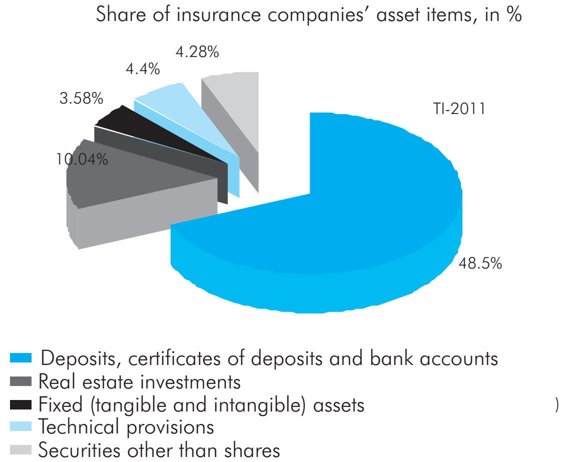
Concerning insurance companies, income from insurance premiums from January to June 2011 totalled about ALL 4.3 billion, or 8.5% higher than in the same period last year. During January to June 2011, the number of insurance contracts reached 629.225, doubling the number of contracts compared with a year ago. The insurance market remains oriented towards non-life insurance, which accounts for 87.8% of total premiums. The rest is shared by life insurance (about 11.9%) and reinsurance (0.2%).

During 2011 H1, paid claims increased by 9.5% compared with the same period a year earlier. Subsequently, claim/premium ratio, which measures the insurance market penetration in the financial system, is 25.6% at national level.

In terms of the market share by type of insurance, gross written premiums from voluntary insurance account for 55.8% and gross written premiums from compulsory insurance account for 44.2% of the market.

In 2011 Q1, the insurance sector's assets amounted to ALL 18.3 billion, slightly up by ALL 234.6 million (or 1.3%) relative to end-2010. Deposits, certificates of deposit and bank accounts have the largest share in total insurance companies' assets, by about 48.5%, followed by Real estate investments (10%) and Technical provisions (4.4%).

Chart 41 Share of insurance companies' asset items



Source: AFSA, Bank of Albania.

Capital to total assets ratio, which measures the insurance companies' capitalization, rose to 58.8% in 2011 Q1, from 57.7% a quarter earlier. Capital to technical provisions ratio is an indicator that measures the capacity to cover losses incurred from exposure to potential risks. As at 2011 Q1, it stood at 172%, from 168.7% at end-2010. The upward trend of the indicator signals higher absorption of losses arising from the insurance activity.

Insurance companies' profit for 2011 Q1 amounted to ALL 331.8 million, from ALL 362.4 million over the same period a year earlier. The slower profit was also reflected in both return indicators, RoA and RoE, which in 2011 Q1 stood at 1.9% and 3.4%, respectively, from 2.19% and 3.9% in the same period a year earlier.

Private supplementary pension market expanded in January to December 2010, compared with the same period a year earlier, with an increase in the number of contributors. At end-2010, the number of contributors reached 4,992 compared with 4.429 in the same period a year earlier. In terms of value, these contributions rose to ALL 111.9 million, up 53.4% from 2009

5.1 GENERAL DEVELOPMENTS IN THE BANKING SECTOR

5.1.1 ASSETS, LIABILITIES, AND THEIR COMPOSITION

In 2011 H1, the banking sector assets accounted for 82.2% of GDP, from 80.9% at end-2010 and 79.7% at end-2010 H1. The banking sector assets amounted to ALL 1043.9 billion, increasing by 5.4% from end-2010 and 11.7% from 2010 H1.

The composition of banking sector assets, according to their shares, has changed through the years, as follows:

Table 15 Share of assets (December 2004-June 2011)

Share in total assets (in %)	December 2005	December 2006	December 2007	December 2008	December 2009	December 2010	June 2011	In billions of ALL (June 2011)
1. Treasury and interbank transactions, of which:	58.8	50.6	39.5	30.1	28.7	29.9	29.3	306.0
Transactions with the Central Bank	9.3	8.9	9	8.3	7.8	8.3	7.95	82.9
Treasury	35.3	26.3	17.1	12.8	12	10.4	11.1	116.1
Transactions with other banks	12.2	13.2	11.2	6.6	6.5	9.28	8.49	88.6
2. Operations with customers (gross)	25.7	31.7	39.4	47.6	50.8	49.11	49.7	518.7
Provisions[9]	(0.36)	(5.45)	(6.24)	(1.51)	(2.83)	(3.77)	(4.58)	(47.8)
3.Securities transactions	12.2	14.7	18	20	20.1	21.27	22.0	230.2
4. Other assets	0.7	0.9	1.3	1	0.9	0.92	1.1	11.0
5. Fixed assets	1.5	1.5	1.5	1.8	1.7	1.4	1.3	13.5
Accrued interests (total)	1.60	1.27	1.32	1.30	1.18	1.19	1.17	12.3
Total assets	100	100	100	100	100	100	100	1043.9

Source: Bank of Albania.

In terms of the banking sector asset composition, we note:

- Loan portfolio (excluding accrued interests[37]) amounted to ALL 518.7 billion, up 6.6% from end-2010 and 11.5% from 2010 H1. The 2011 H1 has registered a higher growth rate of outstanding loans than in the same period a year earlier by 4.3%. Foreign-currency loans account for 68.7% of total loans, down 1.1 percentage points from end-2010;

- Treasury and interbank transactions (excluding accrued interests) amounted to ALL 306 billion, up 3.3% from December 2010 and 11.1% from the previous year. This item's growth rate was 8.3% in December 2009-June 2010, due to higher growth of Albanian Government investments in T-bills compared with 2011 H1;

- Banking sector investments in public and private debt securities, both

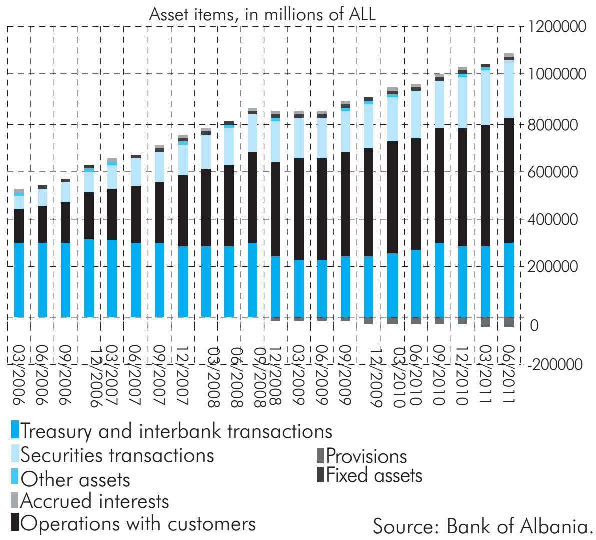
[37] Estimated at about ALL 4.7 billion.

domestic and foreign, reached ALL 230.2 billion, 9.3% higher than at year-end and 20.9% higher than a year earlier. Investments in debt securities of the Government of the Republic of Albania with an initial maturity of over 1 year account for 71.4% of the total value of these investments, down about 15 percentage points compared to end-2010.

Chart 42 shows the composition and performance of asset items.

The composition of banking sector liabilities, according to their shares, has changed through the years, as follows:

Chart 42 Asset items, in millions of ALL



Source: Bank of Albania.

Table 16 Share of liabilities (December 2004-June 2011)

Share in total liabilities (in %)	December 2005	December 2006	December 2007	December 2008	December 2009	December 2010	June 2011	In billions of ALL (June 2011)
1. Treasury and interbank transactions, of which :	4.1	7.6	5.7	11.8	4.5	6.18	6.75	70.4
Transactions with the Central Bank	0.2	0.2	0	0.1	0.2	0.05	0.06	0.6
- Treasury	0	1.4	0.2	2.4	3.6	1.31	2.28	23.8
Transactions with other banks	4	4	5.3	9	4.3	4.7	4.3	44.7
2. Operations with customers (gross)	88.1	84.2	84.9	77.3	88.1	81.27	80.7	842.5
3. Other liabilities	0.6	0.8	1	1.1	1	0.76	1.0	10.9
4. Accrued interests	0.93	0.86	1.14	1.40	1.22	1.21	1.4	14.8
5. Permanent resources, of which:	7.2	7.4	8.4	9.6	10.8	10.58	10.1	105.3
- Shareholders' equity	6.6	6.8	7.5	8.6	9.6	9.4	8.6	90.2
Total liabilities	100	100	100	100	100	100	100	1043.9

Source: Bank of Albania.

In terms of banking sector liability composition, we note:

- Deposits (excluding accrued interests[38]) amounted to ALL 842.5 billion, up 4.6% from December 2010 and 15.4% from 2010 H1. Banks peer group 3 accounts for about 74.7% of the total deposit value;

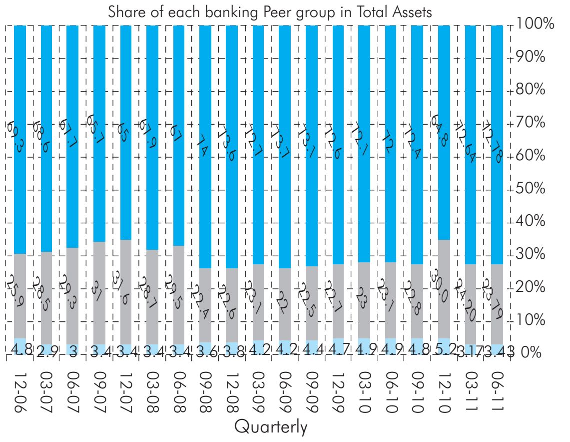
- Treasury and interbank transactions[39] amounted to ALL 70.4 billion. As at end of the period, their volume increased by ALL 9.2 billion or 15% from December 2010, however, it decreased by about 12.5% from a year earlier.

As at end-2011 H1, the share of banks peer groups (by size of activity)

[38] *Estimated at ALL 14.4 billion.*

[39] *Treasury and interbank transactions include: transactions with the central bank, T-bills sold by repurchase agreements, and transactions (borrowings from) with foreign banks (mainly of the banking group they belong to).*

Chart 43 Share of each banking peer group in total assets



Source: Bank of Albania.

in total banking sector assets was 72.8%, 23.8% and 3.4%, respectively, for G3, G2 and G1 banks (See Chart 43). The lower share of the small-sized banks peer group owes to the expansion of some of them, being included in big or medium-sized groups. Chart 43 shows the share of each banking peer group's assets.

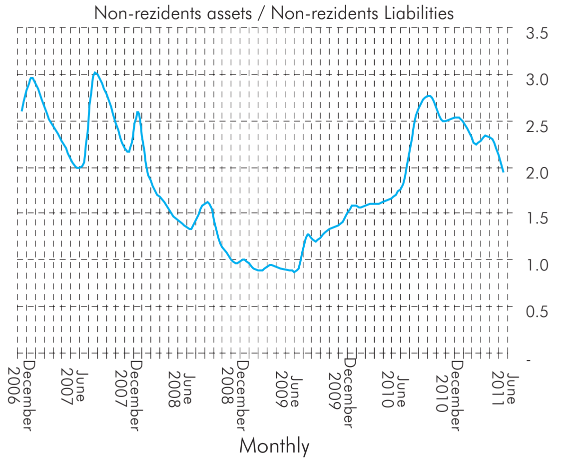
5.1.2 BANKING SECTOR'S POSITION TO NON-RESIDENTS

In order to assess the banking sector's position to non-residents, we need to analyze the performance of the banking sector assets and liabilities to non-residents.

The banking sector assets to non-residents, or banking sector investments in non-resident assets rose to ALL 129 billion, up 6% from end-2010 and 23.5% from a year earlier. G3 banks represent 81.7% of total investments in non-resident assets. In the meantime, banking sector placements with non-resident institutions amounted to ALL 69.4 billion, of which ALL 59 billion were in the form of deposit + current accounts and ALL 10.4 billion were in the form of loans. Compared with end-2010, placements with non-resident institutions have decreased by 1.8%.

The banking sector liabilities to non-residents are estimated at ALL 66.2 billion, increasing by 37% compared with December 2010 and 7.7% compared with a year earlier. Credit lines extended from bank-holding companies and the used proportion are estimated at around ALL 19.5 billion. The committed and unused proportion[40] of credit lines is estimated at around ALL 46.1 billion.

Chart 44 Non-resident assets to non-resident liabilities



Source: Bank of Albania

In 2011 H1, the ratio of liabilities to non-residents to total liabilities was 6.3%, from 4.9% at end-2010. In 2011 H1, the pronounced increase in liabilities to non-residents reflected the upward support by bank holding companies.

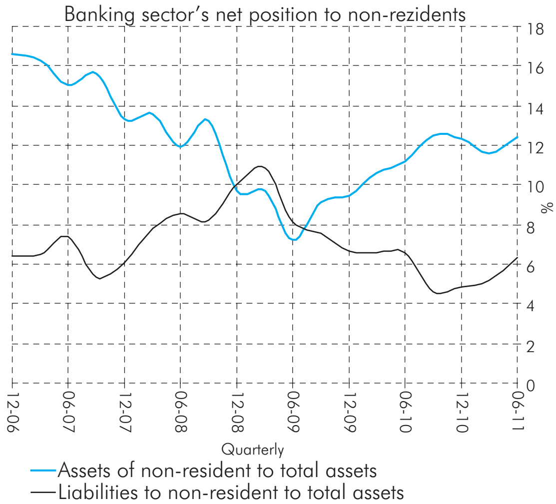
As at end-2011 H1, the ratio of non-resident assets to total assets fell marginally to 12.4%, from 12.3% at end-2010. Compared with the same period a year earlier, this ratio has risen by 1.2 percentage points.

[40] Registered as off-balance sheet item.

Peer group 2 banks, which appear more exposed to non-resident institutions, have provided the main impact on liabilities to non-residents to total liabilities. Though the ratio increased in 2011 H1, the situation appears normalized, reflecting the stable financial position.

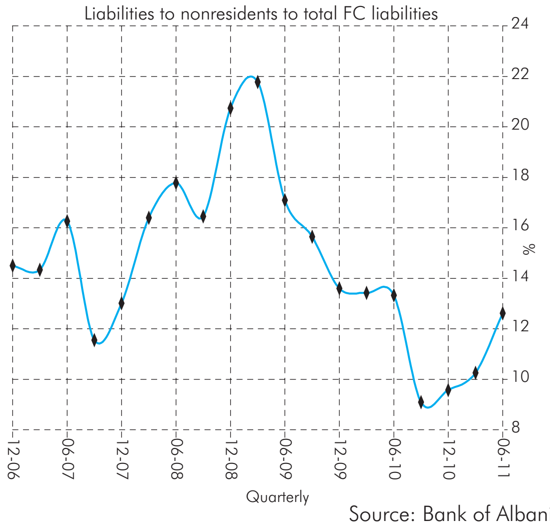
Borrowing from bank holding companies is currently almost always in foreign currency. These funds compete with other banks' financing sources in foreign currency, mainly customer deposits in foreign currency. It is, therefore, of interest to know the share of liabilities to non-residents in total foreign-currency liabilities. As at end-2011 H1, this indicator stood at 12.6%, compared with 9.6% at end-2010 and 13.3% at the end of 2010 H1. This increase has reflected the need of individual banks to obtain foreign-currency funds from non-residents, when lacking the possibility to obtain them from residents, particularly through customer deposits in foreign currency.

Chart 45 Banking sector's net position to non-residents



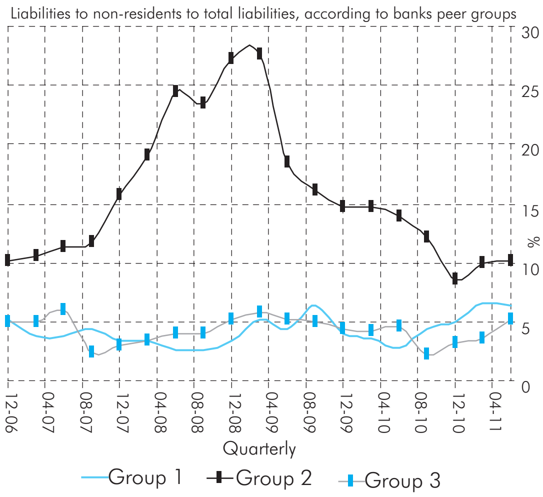
Source: Bank of Albania.

Chart 47 Total liabilities to non-residents to total foreign-currency liabilities



Source: Bank of Albania.

Chart 46 Liabilities to non-residents to total liabilities, according to banks peer groups

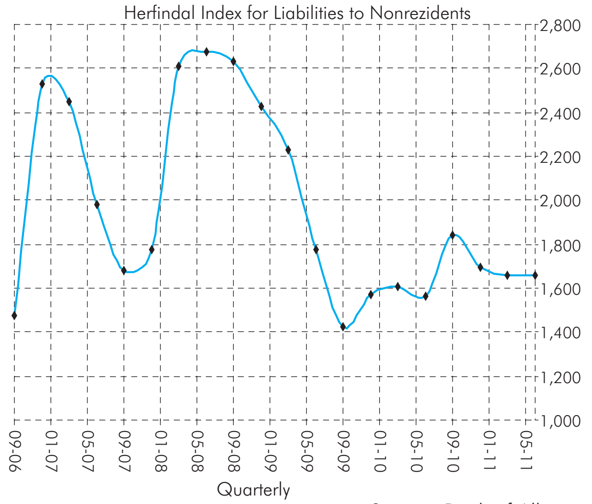


Source: Bank of Albania.

Herfindahl Index in Chart 48 shows the concentration of exposure to non-residents[41]. The banking sector's concentration in 2011 H1 is assessed as moderate, at 1,661. The Herfindahl Index shows a slightly decreased concentration relative to end-2010 H2.

[41] *A HHI index is interpreted as follows: 0.01 (or 100) indicates a highly competitive index; 0.1 (or 1,000) = an unconcentrated index; 0.1 – 0.18 (or 1,000 to 1,800) = moderate concentration; above 0.18 (or 1,800) = high concentration.*

Chart 48 Herfindahl Index for liabilities to non-residents



Source: Bank of Albania.

5.1.3 OUTSTANDING LOANS

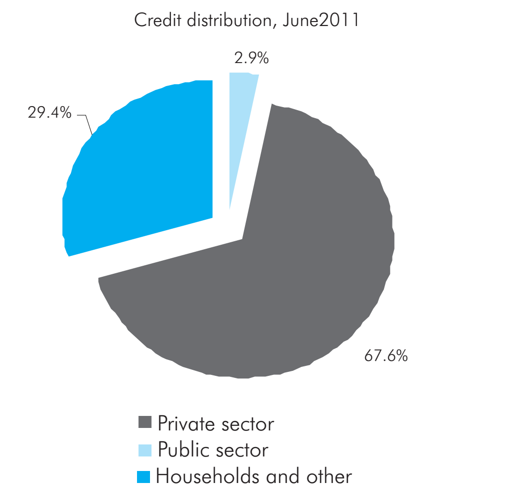
As at end-2011 H1, banking sector's outstanding loans amounted to ALL 518.7 billion[42], about ALL 32.5 billion or 6.6% higher than at end-2010. The lending growth rate over this six-month period is estimated as higher than in the same period a year earlier, up 2.2 percentage points. It is estimated that outstanding loans account for about 41.2% of Albania's GDP.

The growth of outstanding loans was mainly due to the increase in Lek-denominated loans by about ALL 14 billion or 9.4%, and in euro-denominated loans by about EUR 72 million or 3.5%. USD-denominated loans have declined by about USD 12.2 million or 3.8%. Loans denominated in other foreign currencies have also declined by about ALL 47 million or 5.6% relative to end-2010.

As at end-2011 H1, outstanding loans in foreign currency and in Lek had a respective share of 68.7% and 31.3%, undergoing slight changes compared with end-2010.

In terms of outstanding loans composition at end-2011 H1, the short-term loans amounted to about ALL 171.9 billion or 32.8%; medium-term loans amounted to about ALL 106.8 billion or 20.4%; and, long-term loans amounted to about ALL 244.1 billion or 46.6%. This loan distribution by maturity shows levels close to those seen at end-2010.

Chart 49 Credit distribution, June 2011



Source: Bank of Albania.

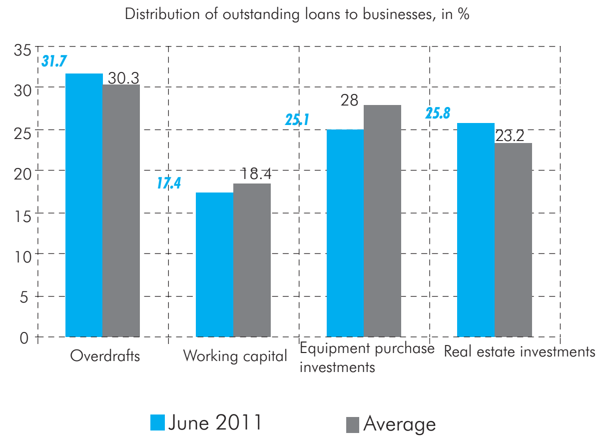
Chart 49 shows the outstanding loans distribution by public sector, private sector and households.

As at end-2011 H1, outstanding loans to the private sector reached ALL 353.8 billion, up ALL 23.6 billion or 7.2% from end-2010. Outstanding loans to households reached ALL 154.1 billion, up ALL 6.4 billion or 4.3% from December 2010. Despite the greater financial support by the banking sector to the private sector than to households, the figures for the same period a year earlier show an improved growth rate of outstanding loans to households, while outstanding loans to the private sector have been characterized by a constant growth rate[43].

[42] *Including accrued interests, the loan portfolio amounted to ALL 523.4 billion.*

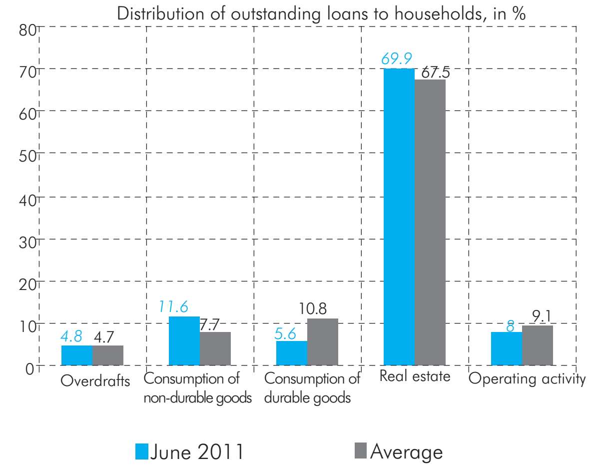
[43] *As at June 2011, outstanding loans to households increased by about 4 percentage points versus the current growth rate of 4.3% (December 2010-June2011).Outstanding loans to the private sector have maintained the same growth rate as in the previous year (0 pp spread).*

Chart 50 Distribution of outstanding loans to businesses, in %



Source: Bank of Albania.

Chart 51 Distribution of outstanding loans to households, in %



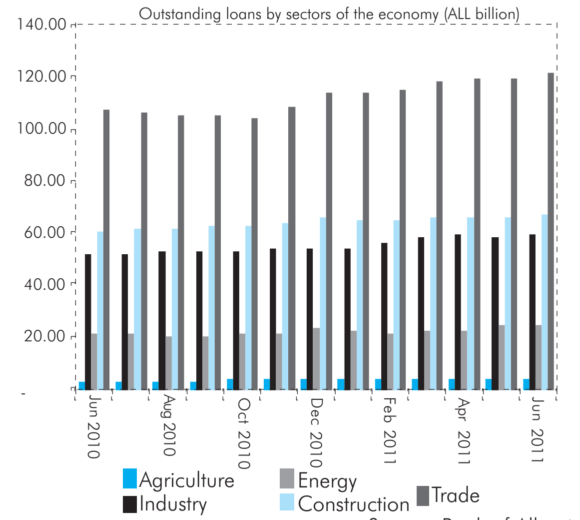
Source: Bank of Albania.

Charts 50, 51 and 52 show the distribution of lending to businesses and households by form and purpose of use and a comparison with the average for 2007-2011.

With respect to the distribution of loans to the two major sectors, businesses and households, over the course of the last 4 years, outstanding loans to businesses in the form of overdrafts have had the largest share. Loans for purchase of equipment have decreased, shifting to loans for investments in real estate. Outstanding loans to households present a shift to loans for the consumption of non-durable goods and real estate purchases.

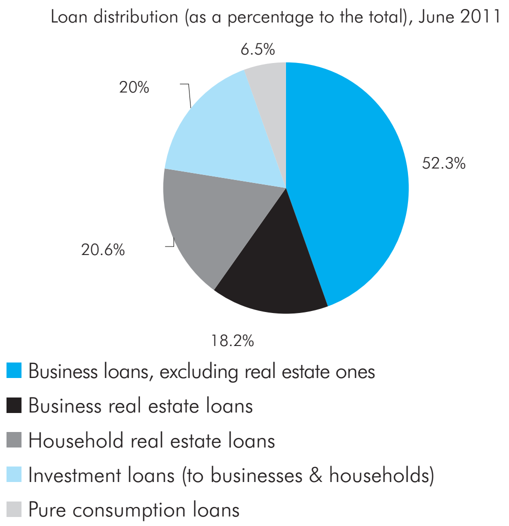
As at end-2011 H1, pure consumption loans, identified as household loans in the form of overdrafts for the consumption of durable and non-durable goods, are estimated at ALL 32.5 billion or 6.5% of the total loan portfolio, 22% of the household loan portfolio and 2.6% of Albania's GDP. Loans for investment purposes, in the form of purchase of equipment and operating activity, are estimated at ALL 99.9 billion or 20% of total loan portfolio and 7.8% of GDP. Loans for investment in real estate to businesses and households are estimated at ALL 193.8 billion or 15.3% of Albania's GDP.

Chart 52 Distribution of outstanding loans by sectors of the



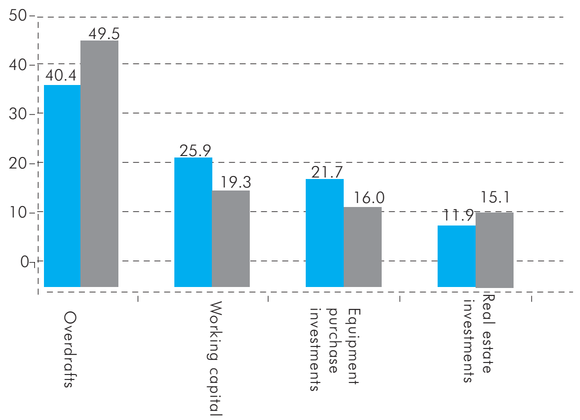
Source: Bank of Albania

Chart 53 Distribution of total outstanding loans



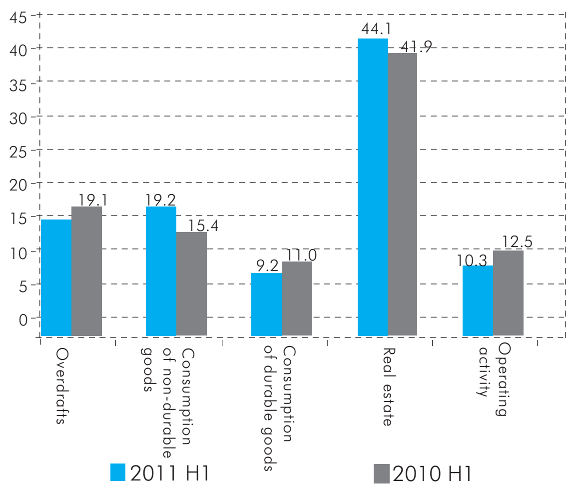
Source: Bank of Albania.

Chart 54 Distribution of new business loans by purpose of use (in %)



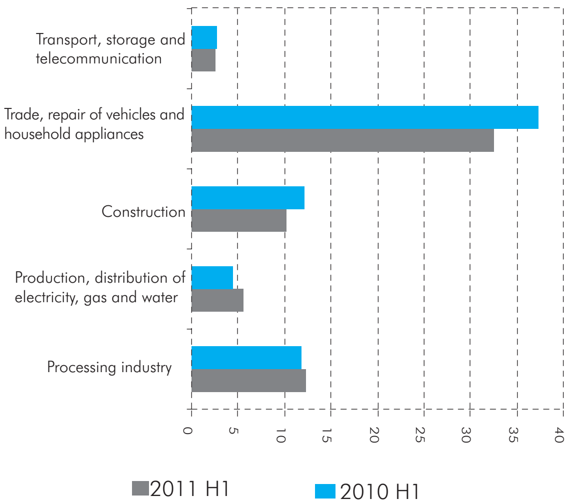
Source: Bank of Albania.

Chart 55 Distribution of new household loans by purpose of use (in %)



Source: Bank of Albania

Chart 56 Distribution of new loans by economy sectors (in %)



Source: Bank of Albania.

Box 4 New loans

In 2011 H1, the banking sector's new loans amounted to ALL 129.8 billion, down slightly by 0.4% from the same period a year earlier. Over the same period, the banking sector collected around ALL 103 billion, from ALL 113.7 billion in the same period in 2010. The ratio of collected loans to extended loans represents the loan use indicator. As at 2011 H1, this ratio stood at 79.5%, from 87.3% in the same period a year earlier .

In terms of users, in 2011 H1, businesses were extended about ALL 106.9 billion, or about 82% of total new loans, while households were extended about ALL 22.8 billion or about 18% of total new loans.

In 2011 H1, new business loans by purpose of use were distributed as follows: overdrafts account for about 40.4% (from 49.5% a year earlier); working capital loans account for about 25.9% (from 19.3% a year earlier); equipment purchase investment loans account for about 21.7% (from 16% a year earlier); and real estate investment loans account for about 11.9% (from 15.1% a year earlier). In 2011 H1, new business loans for overdraft and real estate investments seem to have shifted to new loans for working capital and equipment purchases.

In terms of the households sector, new loan distribution by purpose of use presents the following highlights: an increased share of new loans for non-durable consumer goods and for real estate purchases; decreased share of new loans for the three other items by purpose of use, concretely for overdraft, durable consumer goods and operating activity.

In terms of composition by currency, 2011 H1 highlighted the increase in new ALL-denominated loans by about 11.7% to ALL 51 billion, and decline in new foreign currency-denominated loans, by 23% for new loans in USD and 3% for those in euro, to ALL 12.8 billion and ALL 66 billion, respectively.

In terms of new loan distribution by maturity, 2011 H1 highlighted a shift towards longer maturities, whose share rose to 21.6%, from 17% in the same period last year.

As regards loan distribution by economy sectors, 2011 H1 highlighted a downward share of new loans to the sector of trade, repair of vehicles and household appliances, as well as to construction, to 32.5% and 10.2%, from 37.2% and 12.1% for the same period last year.

5.1.4 DEPOSITS

In 2011 H1, the level and performance of banking sector deposits registered growth. They remained concentrated in the largest banks of the banking sector[44] and the degree of their concentration increased as compared to end-2010.

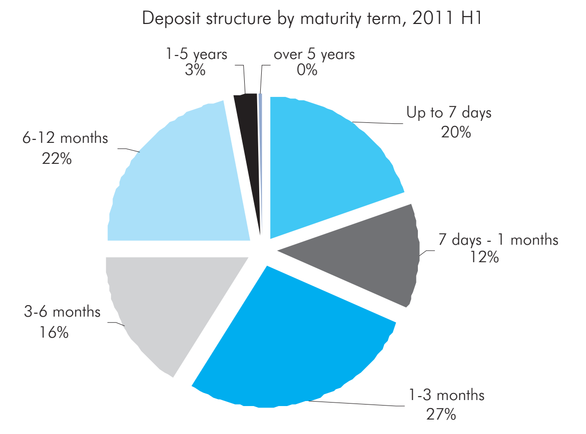
In 2011 H1, total deposits increased by 4.9%45 compared with December 2010 and 15.3% compared with the previous year.

Table 17 Annual growth of total deposits of the banking sector through 2004-2011

Period	2004	2005	2006	2007	2008	2009	2010 H1	2010	2011 H1
Total deposit growth, (in %)	13.4	16.4	20.1	19.9	2.4	7.6	7.04	17.7	4.9

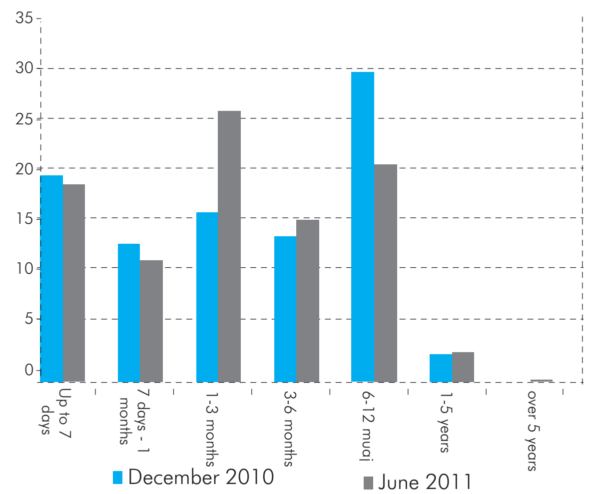
Source: Bank of Albania.

Chart 57 Banking sector deposits by maturity, as at end of 2011 H1



Source: Bank of Albania.

Chart 58 Banking sector deposits by maturity (compared with the previous period)



Source: Bank of Albania

Charts 57 and 58 show the composition of deposits by remaining maturity and the change between 2011 H1 and end-2010. There is noted a change in the deposit structure, which is an outcome of increase in the share of 1-3 month deposits by 10 percentage points and decline in the share of 6-12 month deposits by 8 percentage points. The share of deposits of 1-5 years, albeit small, has increased about 82% over the period.

Deposit structure by currency highlights that in June 2011, ALL-denominated deposits accounted for 52% of total deposits, amounting to ALL 445 billion, whereas those in foreign currency accounted for ALL 411,6 billion. The share of ALL-denominated deposits increased by 0.8 percentage points relative to end-2010, however, they have declined by 1.6 percentage points relative to June 2010.

[44] *The concentration of deposits in the banking system is measured by using the Herfindahl Index. As at June 2011, it was 1524, from 1502 at the end of 2010. In general, the regulatory agencies in America use this index to take preliminary measures for preventing the concentrated markets, at the moment of approving mergers or acquisitions of companies. The index value above 1800 indicates a high concentration.*

[45] *Including accrued interests.*

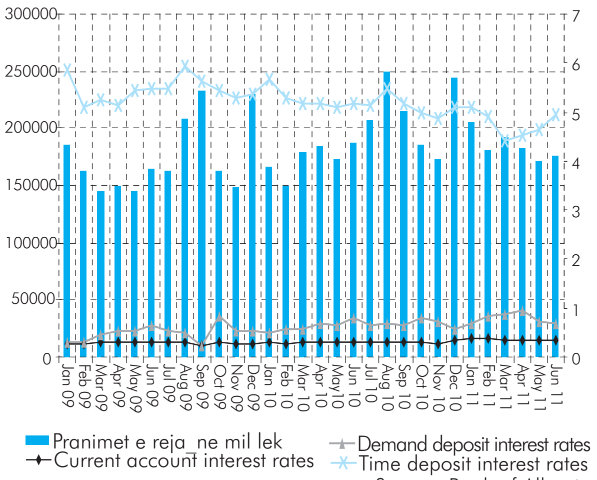
Box 5 New deposits

New ALL-denominated deposits increased during 2011 H1. Hence, as at June 2011, new ALL-denominated time deposits accepted amounted to ALL 326 billion or about 7% higher than in 2010 H1. Worth noting is that this increase has occurred at a time when interest rates on new ALL-denominated deposits have declined. Hence, the average interest rate on new ALL-denominated deposits was 4.8% in 2011 H1, compared to 5.3% in the same period last year.

Regarding the maturb structure of new ALL-denominated deposits, the first half of 2011 highlights that the share of new ALL-denominated deposits of 3-month maturity dropped about 2.5 percentage points, to 15.5% compared with the same period in 2010, whereas the share of new ALL-denominated deposits of 1-year maturity increased by about 2 percentage points, to 26%.

New USD-denominated time deposits accepted by the banking sector over 2011 H1 were USD 476.1 million, down 9.6% from 2010 H1. Time-deposit structure has changed, mainly in those with a maturity of 1 year being increased by 4.1 percentage points, and in those with a maturity of 1 month being decreased by 5.8 percentage points.

Chart 59 Total volume of new ALL-denominated deposits against average interest rates on current accounts and ALL-denominated time and demand deposits



Source: Bank of Albania.

New EUR-denominated time deposits accepted by the banking sector over 2011 H1 amounted to EUR 2.45 billion, falling by 21% compared with 2010 H1. Their maturity structure highlights that the share of 1-month EUR-denominated deposits fell by 14.2 percentage points, to 56.2%, whereas the share of 3- and 12-month EUR-denominated deposits increased by 6.2 and 4.6 percentage points, to 18.8% and 13%, respectively, compared with the same period last year.

Average interest rate on new EUR-denominated deposits was 2.2% in 2011 H1, compared with 2.3% in the same period last year.

Average monthly interest rate on new USD-denominated deposits was 1.2% in 2011 H1, compared with 1.35% in the same period last year.

Table 18 Share of maturities of new deposits, by currency

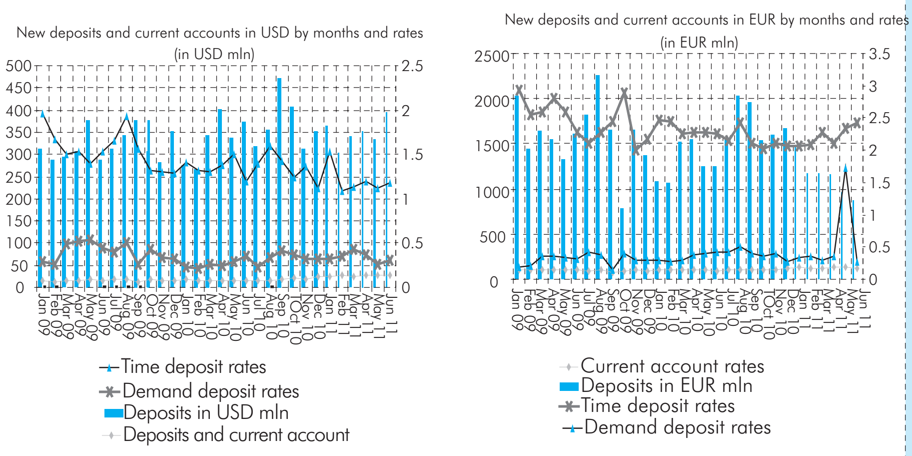
	ALL		USD		EUR	
Share of maturities (%)	2010 H1	2011 H1	2010 H1	2011 H1	2010 H1	2011 H1
2-year	0.98	1.51	0.58	0.48	0.33	0.80
1-year	24.02	26.03	13.77	17.86	8.71	13.36
6-month	12.72	13.51	15.23	15.64	7.79	10.54
3-month	18.00	15.52	25.54	25.79	12.60	18.83
1-month	44.06	43.44	44.83	38.98	70.44	56.24

Source: Bank of Albania.

New ALL-denominated deposits and current accounts in 2011 H1 generally reflected the performance of interest rates. The largest value of new deposits corresponds to the highest interest rate for the period. However, the fluctuations have not been substantial over the course of months and have reflected stability and an ongoing improvement.

New EUR-denominated deposits and current accounts showed volatility and decline in 2011 H1. However, due to seasonal effect, they are expected to increase over the second half, similarly as over the same period in 2009 and 2010. The same *developments are observed even with regard to new USD-denominated inflows.*

Chart 60 Total volume of new foreign-currency deposits against average interest rates on current accounts, EUR and USD demand and time deposits



Source: Bank of Albania

The performance of new deposits over 2011 H2 has generally confirmed the stable growth of public deposits in the banking sector. This element helps improve the structure of financial resources in the banking system and enhances the efficiency of financial intermediation.

5.1.5 CAPITAL

As at year-end 2010, Permanent Resources[46] totalled ALL 105.3 billion, thus maintaining their upward trend. Their main item, Shareholders' Equity amounted to ALL 90.2 billion at end-period, down by ALL 2.9 billion or 3.1% from end-2010 and up by only 0.5% on a year earlier. Shareholders' equity accounted for 8.6% of total assets, compared with 9.4% at end-December 2010 and 9.6% on a year earlier. Banks peer group 3 accounted for 69.6% of total banking sector's shareholders' equity, from 64.4% at end-2010.

Paid-in capital totalled ALL 73.1 billion, up ALL 2.4 billion or 3.4% from end-2010, due to injection of capital in several banks of the system. It accounted for 7% of total assets, almost at the same level as at December 2010, but upward on a year earlier.

5.1.6 PROFITABILITY AND EFFICIENCY IN USING RESOURCES

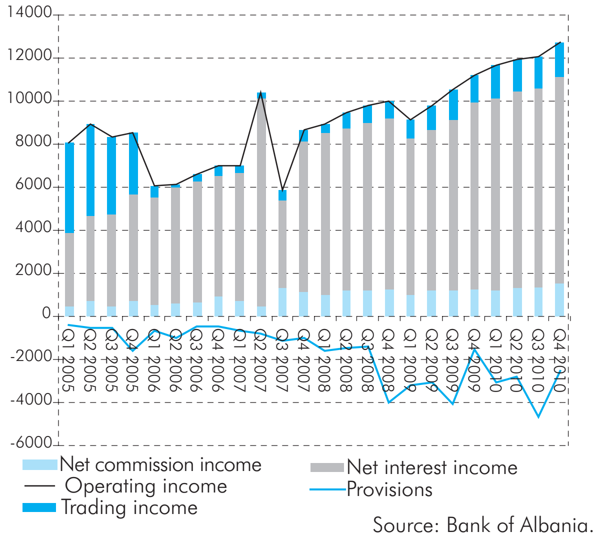
As at 2010 H1, average earning assets rose to ALL 919.1 billion, accounting for about 90.7% of banking sector's total average assets. This indicator pointed to increase by ALL 63.8 billion or 7.5% compared to end-2010, almost at the same growth rate as in the same period last year (by 7.3%). Average paying

[46] *It includes the capital account (shareholders' equity, retained earnings/loss, the year's profit/loss), reserves (general, specific), revaluation, etc.*

liabilities to average earning assets stood at 93.3%, about 0.4 percentage points higher than at end- 2010, but almost unchanged on a year earlier.

Banking sector's operating income[47] amounted to ALL 22 billion or 2.7% higher than in the same period last year. Operating costs[48] were ALL 11.7 billion or 1.7% higher than a year earlier. As a result, the ratio of operating costs to income was 52.9%, from 53.4% in the same period a year earlier. General operating expenses[49] to income accounted for 93%, compared to 80.9% in June 2010, a consequence of increase in provisioning expenses relative to the same period a year earlier.

Chart 61 Selected operating income components

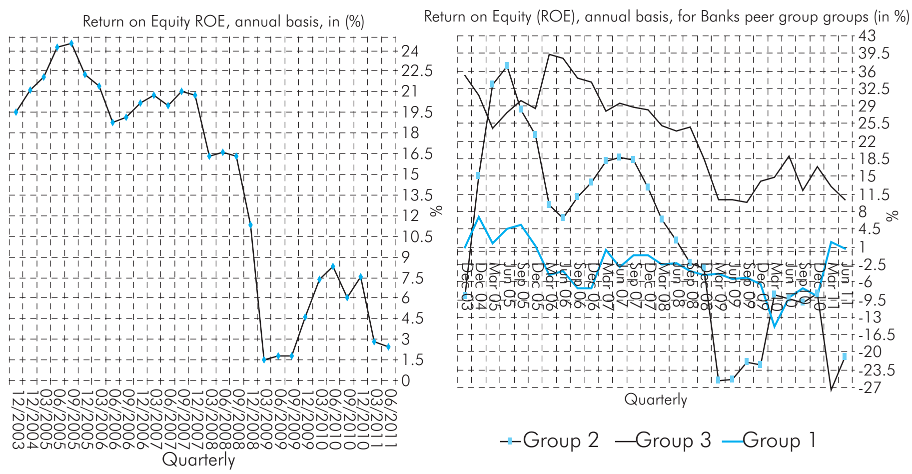


Source: Bank of Albania.

Chart 61 shows the composition of the banking sector's operating income, which is expressed as the sum of net interest income, net commission income and net trading income.

As at 2011 H1, the net profit was positive, at ALL 1.1 billion, being 69% lower than in the same period a year earlier. Despite the increase in the net interest income by ALL 1.3 billion compared with the same period a year earlier, the decline in net profit from other activities (by ALL 672 million or 20%) and mainly the increase in provisions by about ALL 3 billion or 50% compared with 2010 H1, explains the significant decline in the net profit.

Chart 62 Return on Equity (RoE)



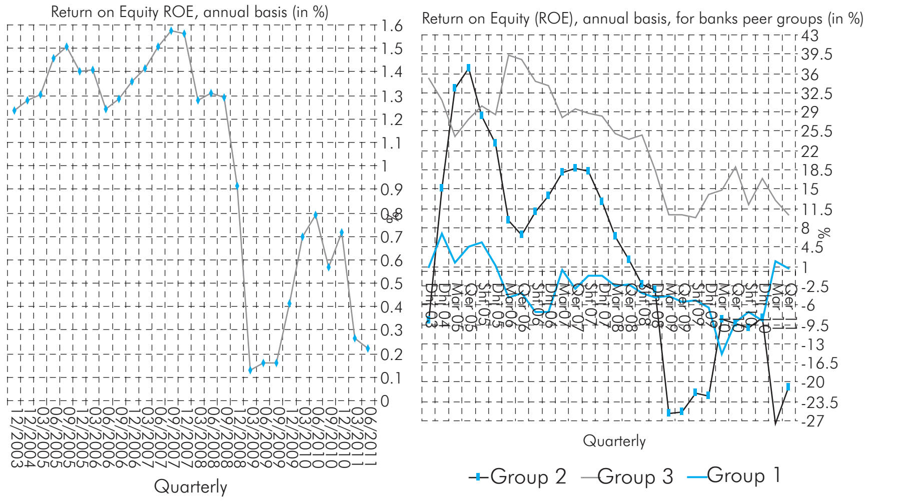
Source: Bank of Albania.

47 Net interest income plus other net income.
48 Excluding provisioning expenses.
49 Operational costs plus provisioning expenses and other reserves.

Also, the banking sector's profit remains concentrated in the largest banks. Annualized Return on Assets (RoA) is estimated at 0.22%, from 0.79% in the same period a year earlier. Annualized Return on Equity (ROE) is estimated at 2.4%,. from 8.31% as at 2010 H1.

Chart 63 Return on Assets (RoA)

a. RoA for the banking sector   b. RoA for banks peer groups



Source: Bank of Albania.

6. MONITORING RISKS THE ALBANIAN BANKING SECTOR IS EXPOSED TO

6.1 MARKET RISKS

6.1.1 EXCHANGE RATE RISK

Balance Sheet Composition by Currency and Net Open Position in Foreign Currency

As at 2010 H1, banking sector assets denominated in foreign currency amounted to ALL 548 billion, up 4.3% from end-2010 and 7.8% in 2010 H1. Banks peer group 3 accounted for 65.1% of total assets in foreign currency. Foreign currency liabilities amounted to ALL 525.4 billion, up 4% from end-2010, compared with 6.5% in 2010 H1. Banks peer group 3 accounted for 65.3% of total liabilities denominated in foreign currency.

Banking sector assets denominated in foreign currency accounted for about 52.5% of total assets, down 0.6 percentage points from end-2010. Banking sector liabilities in foreign currency accounted for about 50.3% of total balance sheet, down 0.7 percentage points from December 2010. The gap between assets and liabilities denominated in foreign currency reached the peak of the last years, by 2.2 percentage points, albeit still at restricted levels.

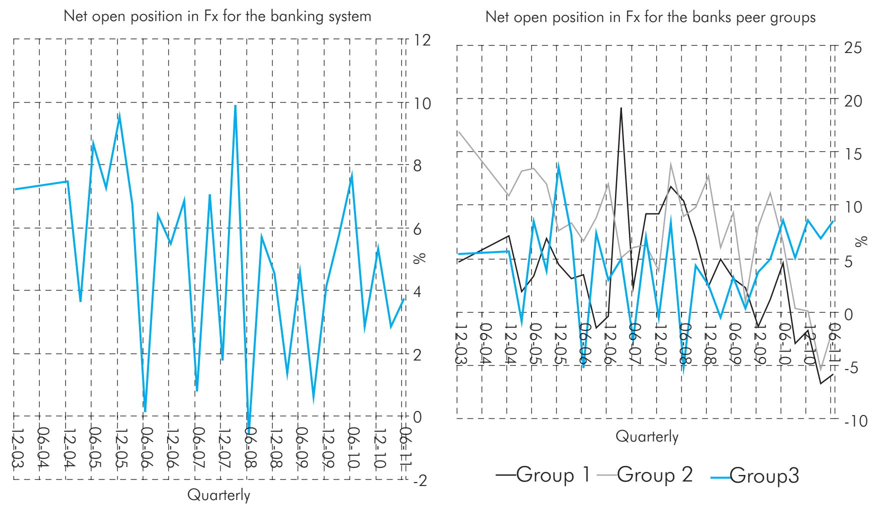
Table 19 Share of assets and liabilities in foreign currency in total banking sector assets, in % (December 2005 - June 2011)

	Share in total banking sector assets, in %		
Period	Foreign currency assets	Foreign currency liabilities	Gap (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
September 2010	52	50.2	1.8
December 2010	53.05	51	2.05
March 2011	52.3	50.2	2.1
June 2011	52.5	50.3	2.2

Source: Bank of Albania.

As at June 2010, the net open position in foreign currency accounted for about 3.7% of the banking sector's regulatory capital. This indicator remains in the long position and within the 0-10% range of the last years.

Chart 64 Exposure to exchange rate risk for the banking sector and banks peer groups



Source: Bank of Albania.

The size of the open position is regarded as limited; therefore, the exchange rate risk for banks is assessed as moderate. In terms of banks peer groups, G1 and G2 banks have generally shifted to a short position over the course of first months of the year, while G3 banks have deepened their long position.

Box 6 Modified Currency Mismatch Index

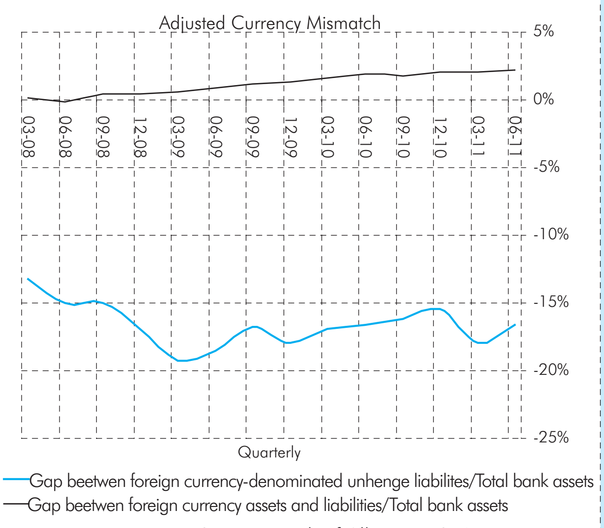
This index is a new indicator based on the methodology provided by the IMF experts, Romain Ranciere, Aaron Tornell and Athanasios Vamvakidis in their working paper entitled "A New Index of Currency Mismatch and Systemic Risk". It enables a more complete measurement of bank exposure to exchange rate risk. Unlike previous indices, the index provided by Ranciere, Tornell and Vamvakidis takes into account the indirect credit risk through the exchange rate, which increased considerably during the financial crisis.

The authors use the following formula to measure this index:

Foreign currency denominated net unhedged liabilities/total bank assets = {[foreign currency foreign liabilities + foreign currency domestic liabilities] – [foreign currency foreign assets + foreign currency domestic assets] + [foreign currency lending to unhedged households + foreign currency lending to unhedged nonfinancial firms]} / [total bank assets]

This formula is the difference between foreign currency assets and liabilities, plus foreign currency lending to unhedged borrowers, which is later calculated as a percentage to total assets. In the Financial Stability Reports, this difference has been derived by subtracting liabilities from assets. We have therefore tried to use the same logic by making some changes to the formula. The absolute values of currency mismatches remain the same but the sign changes to "negative". In this way, it comes out more clearly that foreign currency liabilities are higher than foreign

Chart 65 Currency Mismatch Index



Source: Bank of Albania, FSD's estimations.

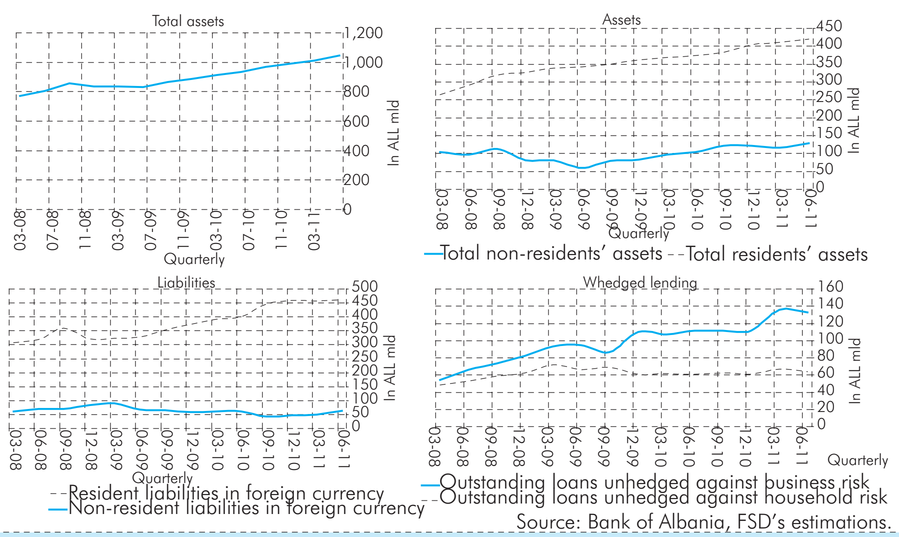
currency assets (since the latter are adjusted/reduced for the amount of unhedged borrowing). In this case, the exchange rate depreciation would have a negative impact on bank's balance sheet, which would then add to the indirect credit risk effects, and later on, might affect the liquidity situation.

The new formula has been transformed into the following:
Transformed foreign currency denominated net unhedged liabilities/total bank assets = {[foreign currency foreign assets + foreign currency domestic assets] – [foreign currency foreign liabilities + foreign currency domestic liabilities] – [foreign currency lending to unhedged households + foreign currency lending to unhedged nonfinancial firms]} / [total bank assets]

Chart 65 shows the quarterly performance of this index for the banking system. In 2011 H1, the index declined from -15.4% at end-2010 to -16.7% at end-June 2011. Compared with the same period last year, the index has declined by 0.01 percentage points.

Chart 66 presents the performance of components of Currency Mismatch Index as at January 2008-June 2011

Chart 66 Components of Currency Mismatch Index



Source: Bank of Albania, FSD's estimations.

6.1.2 INTEREST RATE RISK

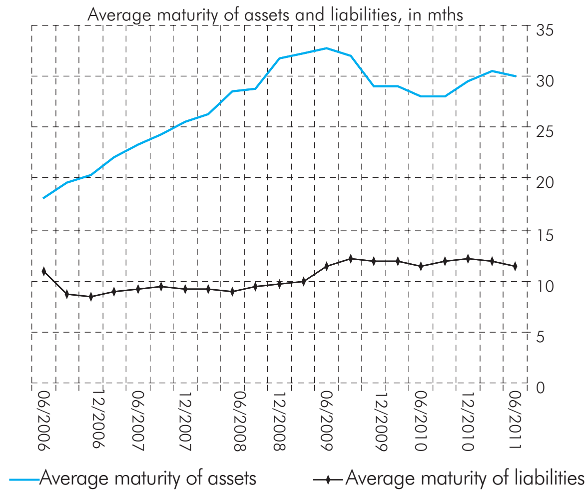
COMPOSITION BY MATURITY TERM

As at end of 2011 H1, banking sector assets had an average remaining maturity[50] of 30.1 months, from 29.5 at end-2010. Over the same period, banking sector liabilities had an average remaining maturity[51] of about 11.5 months, from 12.1 at end-2010. Chart 63 shows the average remaining maturity of assets and liabilities:

As also shown by the chart, the deepening of maturity gap between average remaining maturity of assets and liabilities was 18.5 months in 2011 H1, from 17.3 months at end-2010. Within a 5-year time span, the maturity gap between assets and liabilities has deepened by about 1.8 months compared with the historical average.

As at end 2011 H1, the average remaining maturity[52] of loans was 43.7 months compared with 44.5 months at end-2010. Over the same period, the average remaining maturity[53] of deposits was 4.5 months, compared with 4.9 months at end-2010.

Chart 67 Average remaining maturity of assets and liabilities, in months



Source: Bank of Albania.

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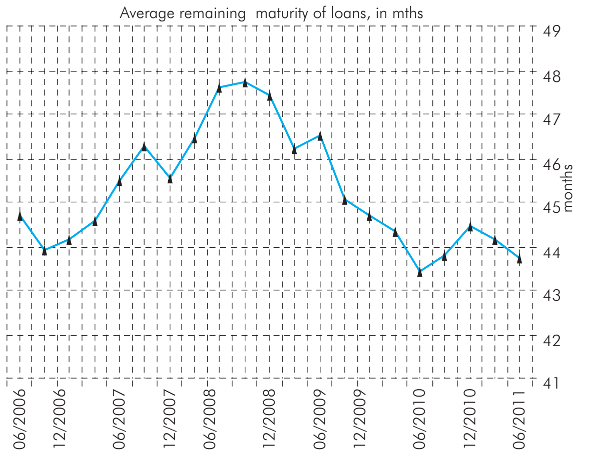
50 *The weighted average of the assets' distribution is calculated based on the reported maturity terms. For each interval, the mid-value is taken "a priori". Specifically, the interval which includes assets of a 0-7 day remaining maturity, the average duration considered is 3.5 days; for the one of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

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

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

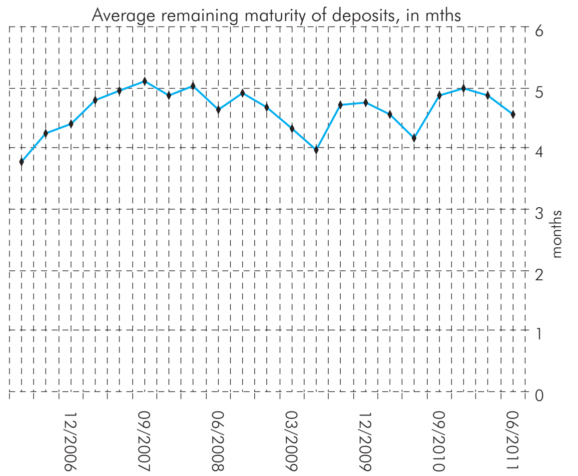
53 *The weighted average of the deposits' distribution is calculated based on the reported maturity terms. For each interval, the mid-value is taken "a priori". Specifically, the interval which includes the up to 7 day- deposits, the average duration considered is 3.5 days; for the 7 days-1 month interval,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

Chart 68 Average remaining maturity of loans, in months



Source: Bank of Albania.

Chart 69 Average remaining maturity of deposits

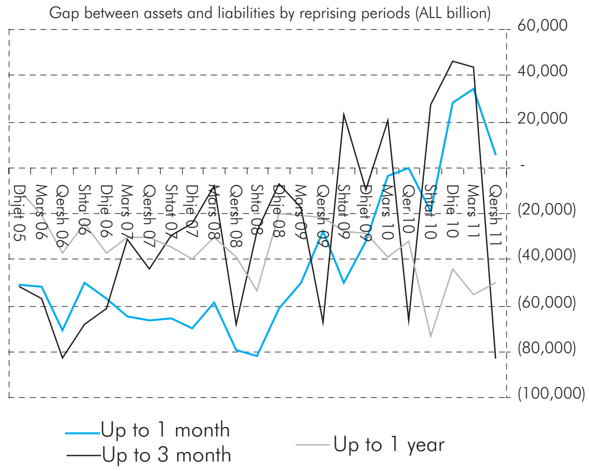


Source: Bank of Albania

MISMATCH BETWEEN INTEREST RATE-SENSITIVE ASSETS AND LIABILITIES

As at end 2011 H1, interest rate-sensitive assets and liabilities remained at similar levels. Their gap for a maturity of up to 1 month is positive, at ALL 6.2 billion. The asset and liability gap for a maturity of up to 3 months and up to 12 months is negative, at ALL -82.7 billion and -50.1 billion, respectively. The negative gap in the above maturities signals the creation of additional net costs to the banking sector in the event of interest rate rise, which would impact negatively on the financial profit and in consequence on the capital indicator. However, the magnitude of exposure to interest rate risk is assessed from the percentage shares of the above gaps in total assets, which is estimated at non-material values.

Chart 70 Gap between assets and liabilities by reprising periods



Source: Bank of Albania.

6.2.3 CREDIT RISK

In order to assess the level of credit risk posed to banking activity, we first make an analysis of the performance of risk-weighted assets and off-balance sheet items as a share of total assets[54]. As at end-2011 H1, the banking sector's risk-weighted assets[55] amounted to ALL 618.7 billion or 59.3% of total assets, whereas risk-free assets (0% risk) amounted to ALL 439.3 billion or 42.1% of total

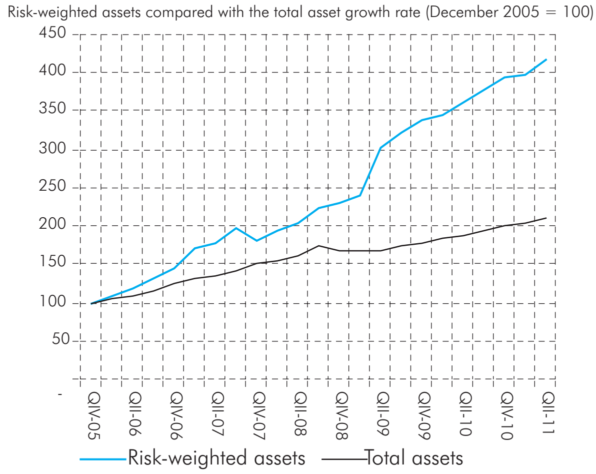
[54] *Total assets and total risk-weighted assets have been presented in the form of a ratio to a base period (in our case, December 2005=100).*

[55] *For the purpose of calculating the CAR, they are weighted by a specific risk coefficient (20%, 50%, 100%, or 150%). In general, risk-weighted assets are dominated by the loan portfolio and they also include investments in debt securities and placements with financial institutions.*

assets of the system. Out of risk-weighted assets, high risk assets[56] amounted to ALL 460.5 billion.

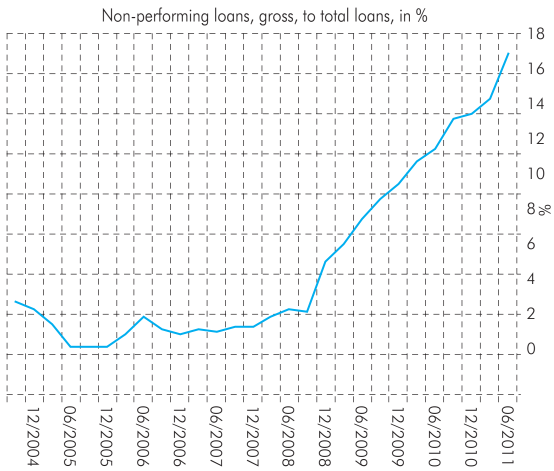
Risk-weighted assets were 5.61% higher than at end-2010 and 15.2% higher than in the same period a year earlier. Risk-weighted assets and off-balance sheet items accounting for 59.3% of total assets of the banking sector remained almost similar to end-2010's figure; however, they are 1.8 percentage points higher than in 2010 H1. Chart 70 shows (in the form of an index) the performance of risk-weighted assets relative to the performance of total assets. It is pointed out that the growth rate of risk-weighted assets has been twice higher than that of total assets, due to a significant share of assets risk-weighted at 150% in their total share (by 31.9%). Relative to base period (December 2005 = 100), risk-weighted assets have been 4-folded.

Chart 71 Risk-weighted assets compared with the total asset growth rate



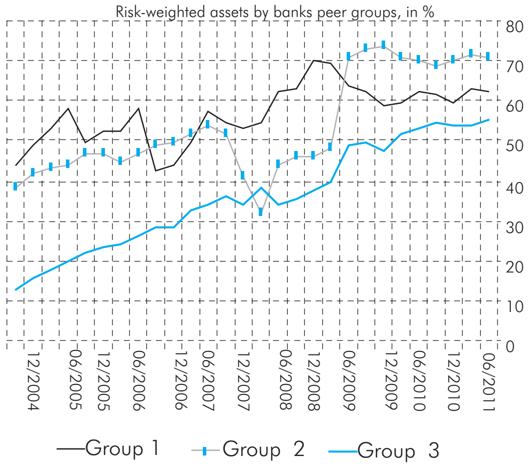
Source: Bank of Albania

Chart 73 Non-performing loans to total loans



Source: Bank of Albania.

Chart 72 Risk-weighted assets by banks peer groups



Source: Bank of Albania.

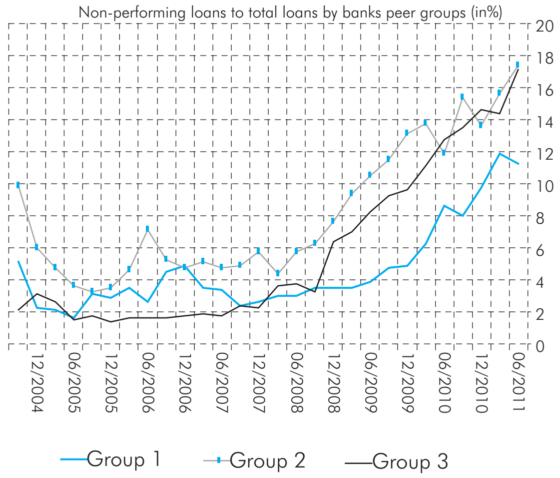
In terms of banks peer groups, as at end-2011 H1, the ratio of risk-weighted assets to total assets increased to 62.4% for G1 banks, from 59.2% at end-2010, whereas compared with the same period last year, G3 banks hit record highs of this ratio, by about 2.2 percentage points, to 55.3%.

As at the end of 2011 H1, the ratio of non-performing loans to total loan portfolio, on a gross basis, amounted to 17%, from 13.9% at end-2010 and 12.2% in the same period a year earlier.

56 *For the purpose of calculating the CAR, they are weighted by the risk coefficients of 100% and 150%. They are generally represented by loans, including foreign currency lending to borrowers whose income is in Lek.*

Non-performing loans of the banking sector amounted to ALL 88.9 billion, significantly increasing by about ALL 20.4 billion or 29.8% compared with end-2010. The analysis about the performance of non-performing and outstanding loans relative to the base period (December 2005 = 100), highlights increase in non-performing loans by about 30 times more than the base period and increase in outstanding loans by 4 times more than the base period. Relative to outstanding loans, non-performing loans have increased by about 7.3 times. The decelerated growth rate of outstanding loans indicates the decreased loan portfolio quality.

Chart 74 Non-performing loans to total loans by banks peer groups

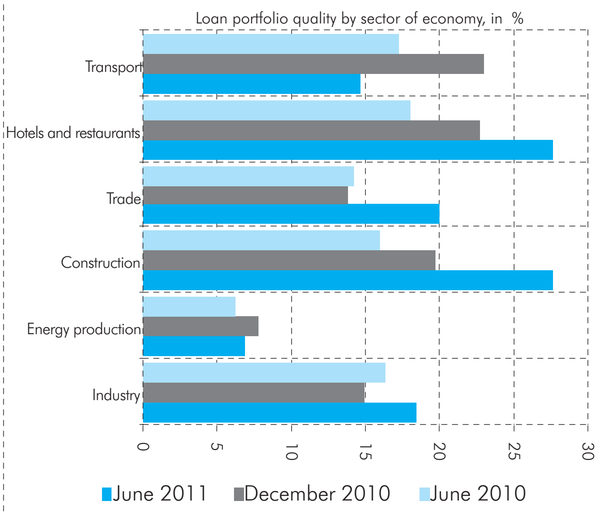


Source: Bank of Albania

In terms of banks peer groups by size of their activity, G2 and G3 banks recorded the highest increase in the ratio of non-performing loans to total loans relative to end-2010, by 3.8 and 2.5 percentage points, to 17.4% and 17.1%, respectively.

Loan portfolio quality has declined for both businesses and households. The ratio of non-performing loans to outstanding business and household loans is estimated at 19.1% and 13.9%, respectively, compared with 15.5% and 11.7% at end-2010. Also, the loan portfolio quality by currency is downward for both lek and foreign currency portfolios. In terms of currency, the loan portfolio quality worsened for both lek and foreign currency loans. The ratios of "non-performing loans in lek to outstanding loans in lek" and "non-performing loans in foreign currency to outstanding loans in foreign currency" are estimated at 16.7% and 17.1%, compared with 14.4% and 13.8% as at end-2010.

Chart 75 Loan portfolio quality by sector of economy



Source: Bank of Albania.

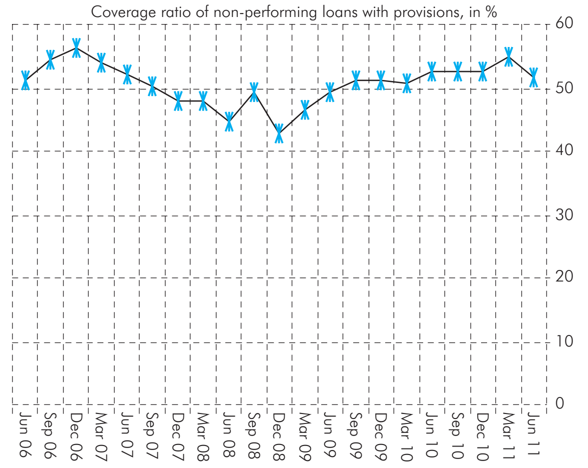
The loan portfolio quality has deteriorated for the main sectors of the economy relative to end-2010 and end-2010 H1. Based on estimates, the sector with the lowest quality as at 2011 H1, is construction, whose quality indicator edged up to 27.6%, from 19.7% at end-2010 and 15.9% in the same period a year earlier. In the meantime, improved loan portfolio quality has been registered in the transport sector, whose quality indicator fell to 14.6%, from 23% at end-2010 and 17.2% in the same period a year earlier.

Outstanding loans in foreign currency, when the borrower's income is in lek, amounted to about ALL 198.6 billion, representing 37.9% of total outstanding loans and about 55.2% of outstanding loans in foreign currency. In terms of currency, around 89.7% of this type of loan is in euro and about 9.9% is in U.S. dollar. As a percentage of total outstanding loans in foreign currency, the share of this loan in euro accounts for 49.5% and in U.S. dollar 5.5%. As at end-2011 H1, the ratio of "non-performing loans in foreign currency, when the borrower is unhedged against the exchange rate risk, to outstanding loans in foreign currency, when the borrower is unhedged against the exchange rate risk" is estimated at 17.1%, from 12.5% at end-2010[57], which is also explained by the contraction of this portfolio by the banks of the system. Specifically, in 2011 Q2, outstanding loans in foreign currency, unhedged against exchange rate risk, fell to around ALL 5.9 billion or 2.9%.

Loan loss provisions rose to ALL 46 billion, up by 27.3% from December 2010. The ratio of provisions to non-performing loans (gross) fell to 51.7%, from 52.7% at the end of 2010 H2, close to the 5-year historical average of around 51%. The ratio of provisions to total outstanding loans (gross) rose to 8.8%, compared with 7.4% at end-December 2010 and 6.4% on a year earlier.

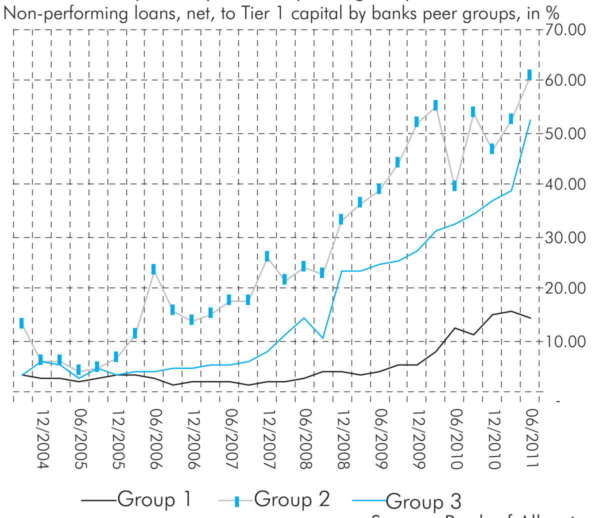
As at end-2011 H1, the loan portfolio quality declined in terms of capital as well, resulting in a weaker capacity of the banking sector to cover non-performing loans with capital. Specifically, "non-performing loans, net, to capital" rose by an average of 12.5 percentage points, to 48.8%, compared to end-2011. Non-performing loans, net, to Tier 1 capital" is the indicator with the largest increase, up by around 13.2 percentage points, to 51.3%, from 38.1% at end-2010.

Chart 76 Coverage ratio of non-performing loans with provisions, in %



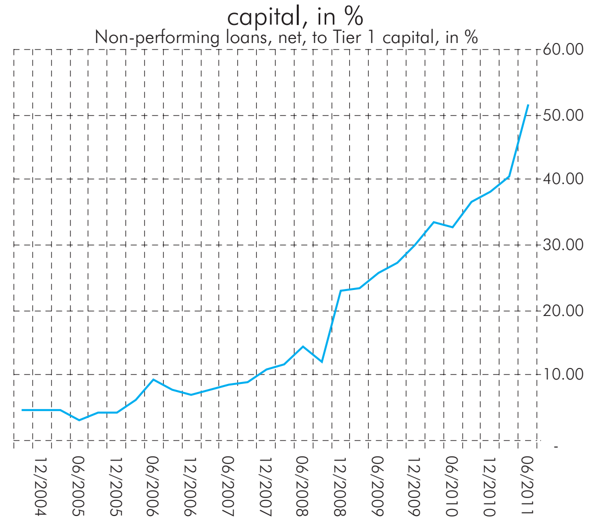
Source: Bank of Albania.

Chart 78 Non-performing loans, net, to Tier 1 capital by banks peer groups, in %



Source: Bank of Albania.

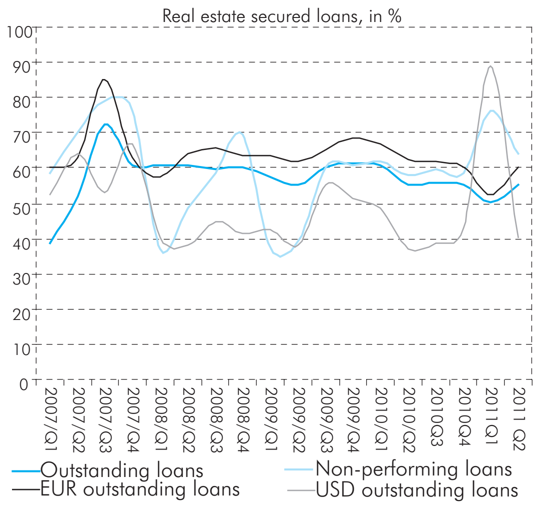
Chart 77 Non-performing loans, net, to Tier 1 capital, in %



Source: Bank of Albania.

57 *More specifically, in terms of currency, this ratio in Euro was 17.6% in June 2011, from 13.3% in December 2010. Over the same period, this ratio in US dollar was 13%, from 6.5% in December 2010.*

Chart 79 Real estate secured loans, in %

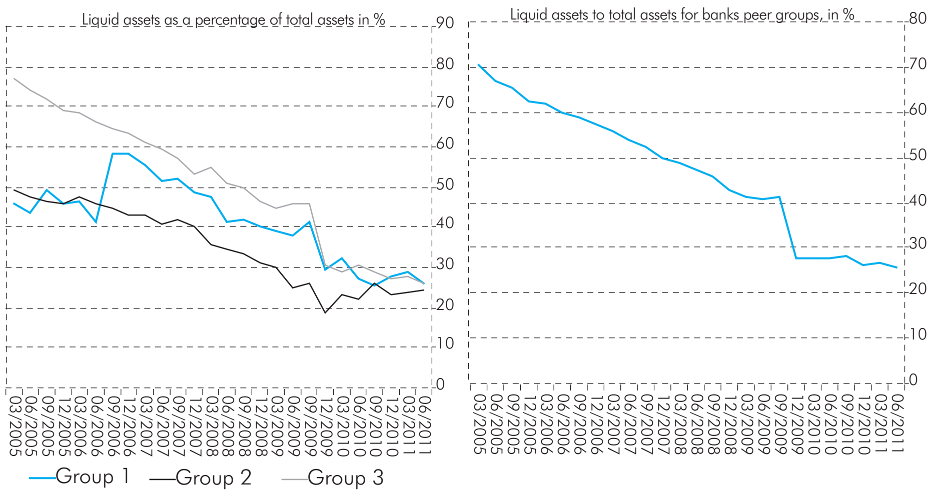


Source: Bank of Albania.

In terms of banks peer groups, G2 and G3 banks posted the highest average increase in non-performing loans, net, to Tier 1 capital. More specifically, for G2 banks, this indicator increased by an average of 14.2 percentage points, compared with December 2010, amounting to 61.1%. The same indicator for G3 banks has increased by around 15.2 percentage points, to 52.3 %.

As at end-2010 H1, the collateral coverage[58] of non-performing loans is estimated at 81.7% of the loan portfolio, from 79.3% at end-2010.

Chart 80 Liquid assets as a percentage of total assets for the banking sector and for banks peer groups



Source: Bank of Albania.

6.2.4 LIQUIDITY RISK

As at end-2011 H1, the ratio of liquid assets to short-term liabilities (with a maturity of up to 1 year) was 30.2%, from 30.6% at end-2010 and 32.8% in the same period a year earlier. In terms of currency, the ratio is higher for the Lek (41.2%), and the U.S. dollar (28.5%) and lower for the euro (14.9%). Liquid assets to total assets ratio dropped to 25.5%, from 27.8% a year earlier. In terms of banks peer groups, G1 banks showed the largest increase in the ratio of liquid assets to short-term liabilities by around 2.2 percentage points compared to end-2010, to 36.5%. G3 banks showed a decrease in both above indicators, compared with end-2010.

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

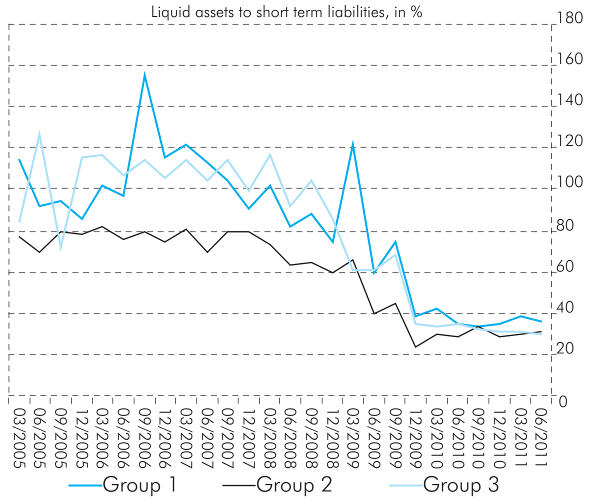
The maturity gap between assets and liabilities by maturity[59] structure – for balance sheet and off-balance sheet items – is negative.

These gaps are, however, covered several times by the value of liquid assets, thus providing evidence for the full capacity to pay liabilities when they fall due. Nonetheless, the liquidity position in foreign currency, particularly the one in euro, needs cautious monitoring.

Loan to deposit ratio reached 61%, very close to end-2010's figure, down 2.2 percentage points from the same period a year ago. Within a one-year time span, deposits have increased by around 3.9 percentage points higher than loans. The loan to deposit ratio for foreign-currency transactions registered 87.4%, up 1.5 percentage points from end-2010 and down 7.8 percentage points from the same period a year earlier. The loan to deposit ratio for lek transactions resulted 36.7%, from 35.4% at end-2010. The increase in this indicator was due to a larger recovery in ALL-denominated loans (10.4%), compared with the performance of ALL-denominated deposits (6.5%) relative to end-2010.

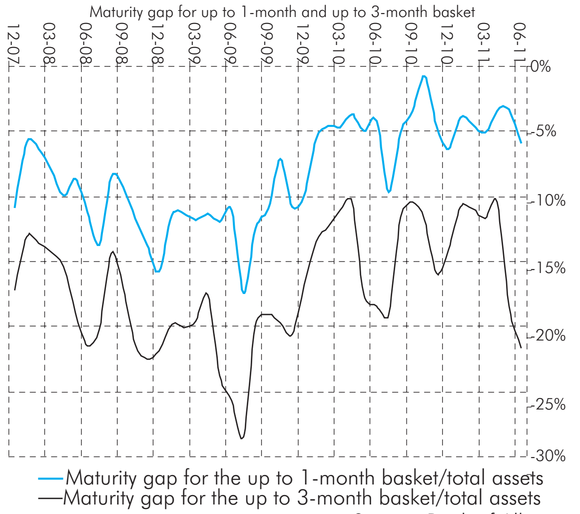
Borrowing in the interbank market or from the Bank of Albania is another form of managing the short-term needs for liquidity. This is generally a collateralized borrowing; the type and adequacy of assets that may serve as collateral is another element that needs cautious monitoring in order to assess the banks' capacity to meet their short-term needs for liquidity.

Chart 81 Liquid assets as a percentage of total short-term liabilities for the banking sector and banks peer groups



Source: Bank of Albania.

Chart 82 Maturity gap for up to 1-month and up to 3-month basket



Source: Bank of Albania.

6.2.5 BUSINESS CAPITALIZATION

Business capitalization represents the long-term stability of the banking sector. In order to assess the banking business capitalization, the regulatory capital and capital adequacy are monitored.

As at end-June 2011, the regulatory capital[60] rose to ALL 90.6 billion, up only 0.5% and 4%, respectively, relative to end-2010 and end-June 2010.

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

[60] *It is a supervisory concept that is composed of Tier 1 capital and supplementary capital. It consists of paid-in capital, reserves, net retained profit, net profit for the financial period, subordinated liabilities, etc.*

Tier 1 capital level dropped to ALL 84 billion, down by 1.2 billion or 1.4% from end-2010, and only ALL 1 billion or 1.3% more than in the same period a year earlier. Tier 1 capital accounts for 92.7% of the regulatory capital, providing evidence for the stability of the banking sector capital and its very good quality.

At end-2011 H1, capital adequacy ratio (CAR), which measures the coverage ratio of risky banking sector activities with capital, is estimated at 14.6%, down 0.7 percentage points from end-2010 and down 1.6 percentage points from a year earlier. The regulatory framework envisages a minimum CAR of 12%. The deterioration of this indicator is explained by the low increase in the regulatory capital size and the higher increase in risk-weighted asset growth (by 5.6%). In terms of banks peer groups, G2 banks have the lowest CAR of 13.5%. Although banking business capitalization is considered to be good, capital requirements for individual banks call for ongoing monitoring.

6.2 ASSESSING BANKING SECTOR RESILIENCE THROUGH STRESS TESTING EXERCISE[61]

Through a forward-looking stress-testing analysis we assess the financial system stability and the banking system's capital adequacy over a period of up to end-2012. The stress-testing exercise assesses the impact of macroeconomic situation on the financial condition of the banking sector, excluding the possibility of increase in paid-in capital during the period under review. In practice, the situation usually gets worse gradually and banks have time to take necessary measures by injecting capital.

This exercise includes two scenarios: The baseline scenario is built on the forecast of economic and financial indicators based generally on their historical performance. The second adverse scenario assumes a "stressed" situation of low probability of occurrence, based on three probable shocks to economy: a) further slowdown in lending, b) increase in market interest rates and c) national currency depreciation.

Table 20 Stress-testing assumptions

	Baseline scenario		Adverse scenario	
Value in average terms	2011	2012	2011	2012
Annual GDP growth, in %	2.96	3.67	2.5	2.4
Annual growth of market interest rates	0.1 pp	0.25 pp	2 pp	2 pp
The lek's depreciation against both major currencies (EUR and USD), in %	2.05	1.55	20	20
Forecasted growth of outstanding loans, in %	10.2	18	5	9

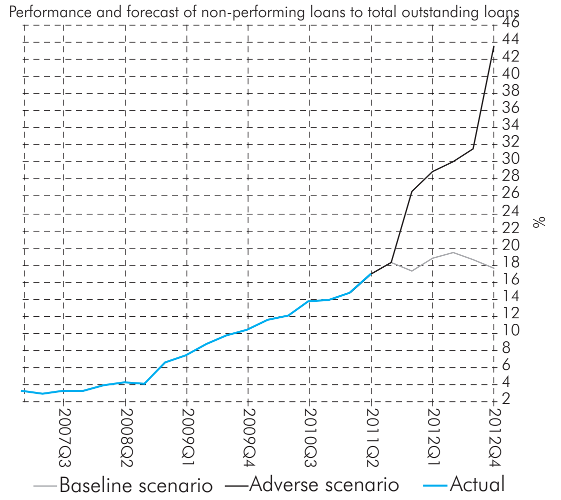
[61] *We emphasize that stress-testing is not a way of forecasting. The scenarios intentionally assume adverse events in order to test the banking sector resilience to them. The scenarios assume extreme events of low probability of occurrence. Although banks are encouraged to assess their financial capacity to cope with the impact of these scenarios, they should not consider them as events expected by the Bank of Albania to occur in the future. The scenarios change over time in light of the economic and financial developments. On the other hand, these scenarios do not consider the actions banks may take to strengthen their financial position and resilience to risks.*

Chart 83 indicates the estimates on loan portfolio quality as at end-2011, according to both scenarios (actual values have been used as at 2011 Q2). The probability of facing extreme values (far from the average) of non-performing loans to total outstanding loans is higher in the adverse scenario than in the baseline one.

Chart 85 shows the estimates on the impact of non-performing loan growth on bank-specific or the banking sector's risk-weighted assets and size of capital.

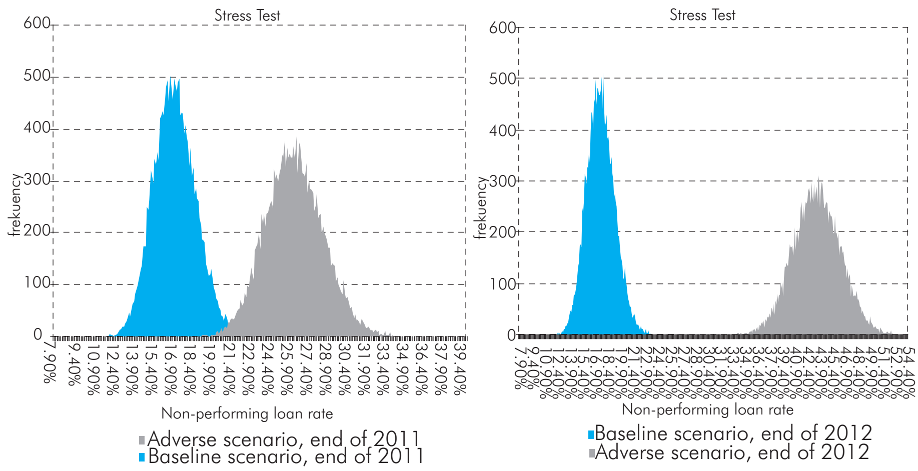
The following tables show the sensitivity of individual banks and of the banking sector to loan quality shocks, estimated in terms of CAR for end-2011 and 2012.

Chart 83 Performance and forecast of non-performing loans to total outstanding loans until end-2012, according to baseline and adverse scenarios



Source: Financial Stability Department.

Chart 84 Distribution of frequency of values of non-performing loans for 2011 Q4 and 2012 using Monte Carlo simulations, according to baseline and adverse scenarios



Source: Financial Stability Report

Grafik 85. Ecuria dhe parashikimi i normës së mjaftueshmërisë së kapitalit, sipas skenarit bazë dhe të rënduar

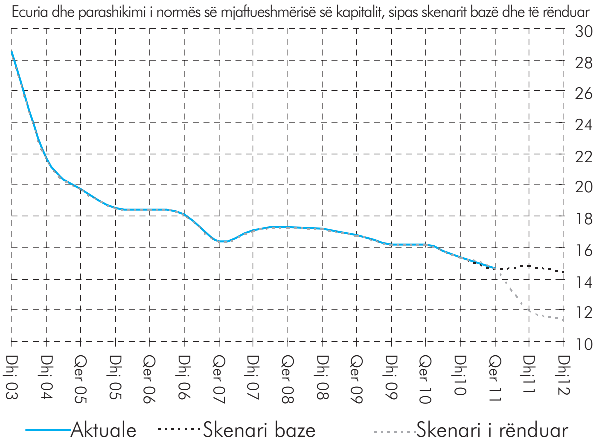


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Table 21 Stress-testing results in terms of banking sector capitalization

Results for end-2011				
	Scenario 1		Scenario 2	
	Individual banks	Banking sector	Individual banks	Banking sector
Regulatory capital/Total risk-weighted assets		Capitalized		Capitalized
Modest undercapitalization /1	Yes		Yes	
Severe undercapitalization /2	Yes		Yes	
Tier 1 capital/Total risk-weighted assets		Capitalized		Capitalized
Modest undercapitalization /3	Yes		Yes	
Severe undercapitalization /4	Yes		Yes	

/1 = Below the 12% ratio;
/2 = Below the 6% ratio;
/3 = Below the 6% ratio;
/4 = Below the 3% ratio.
Source: Financial Stability Department.

Table 22 Stress-testing results in terms of banking sector capitalization

Results for 2012				
	Scenario 1		Scenario 2	
	Individual banks	Banking sector	Individual banks	Banking sector
Regulatory capital/Total risk-weighted assets		Capitalized		Capitalized
Modest undercapitalization /1	Yes		Yes	
Severe undercapitalization /2	Yes		Yes	
Tier 1 capital/Total risk-weighted assets		Capitalized		Capitalized
Modest undercapitalization /3	Yes		Yes	
Severe undercapitalization /4	Yes		Yes	

/1 = Below the 12% ratio;
/2 = Below the 6% ratio;
/3 = Below the 6% ratio;
/4 = Below the 3% ratio.
Source: Financial Stability Department.

In conclusion, the stress-testing exercise shows that the overall banking sector appears resilient to severe macroeconomic shocks, which impact on the banks' loan portfolio impairment and in consequence on increase in provisioning expenses, decrease in financial profit and reduction in capitalization position of activity. The individual banks' sensitivity to assumed shocks has increased; therefore, the banks should assess the appropriateness of their capitalization indicators and strengthen their capital positions.

ANNEX

ANNEX 1 FINANCIAL STRENGTH INDEX

Financial Strength Index (FSI) is constructed and calculated based on the latest banking sector developments.

Table 23 shows the financial indicators that help calculate the index. They assess the banking sector's financial strength, and the developments and magnitude of the main risks it is exposed to. The table also shows the sign of the impact of indicators and their weights in the formula used to calculate each sub-index. The positive sign shows the positive effect that the increase of each specific indicator has on the sub-index, while the negative sign shows the negative effect of this increase[61] on the sub-index.

Table 23 FSI components

	Financial Strength Indicators	Direction of the impact	Weight
Asset quality	NPLs gross/Total	negative	0.33
	NPLs net/Shareholders' equity	negative	0.33
	Fixed assets/Total assets	negative	0.33
Liquidity	Liquid assets/Total assets	pozitive	0.40
	Assets of up to 3-month maturity/Liabilities of up to 3-month maturity	pozitive	0.60
Exchange rate risk	Short and long FX position/Regulatory capital	negative	0.50
	FX net general position /Regulatory capital	negative	0.50
Profitability	Net profit/Total assets	pozitive	0.50
	Net profit/Shareholders' equity	pozitive	0.50
Capital adequacy	Free capital/Total assets**	pozitive	0.50
	Capital adequacy ratio	pozitive	0.50
Interest rate risk	(ALL Gap sensitive to interest rate up to 1 month)/Shareholders' equity***	negative	0.50
	(FX Gap sensitive to interest rate up to 1 month)/Shareholders' equity	negative	0.50

* *Fixed assets are calculated as the sum of fixed assets and net NPLs.*

** *Free capital is calculated as the difference between shareholders' equity and fixed assets.*

*** *The difference between assets and liabilities of up to 1 month, both in domestic and foreign currency, shows the mismatching between interest rate-sensitive short-term assets and liabilities, which may trigger losses in case of adverse movements in this rate.*

The time series of indicators (ratios) used to construct the sub-indices are standardized. The standardization process is carried out by measuring the distance between the real value of the indicator (ratios) in a given moment

[61] *According to this methodology, a negative sign does not mean a negative value. The sign shows only the direction of the effect of each specific indicator (ratio) on the index. The positive sign means that the index increases due to an increase in the ratio, while the negative sign means that the index falls because of this increase.*

and the average of values over the period, in terms of standard deviation.[62]

A new series Z is derived using the formula:

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

where X is the value of the ratio in each given moment, μ is the average value of the ratio over the selected period, and σ is the standard deviation. To construct the sub-indices referred to above, the standardized values of the ratios according to the formula (1) are multiplied by the weights assigned to the ratios in the table above and ultimately, they are summed. An adjustment has been made in order to turn all the standardized values of the Z series positive. According to the methodology, a base period is selected, which is assigned the value of 100[63], and the indices are calculated using direct proportions if the increase in the ratios making up the sub-indices is favourable; otherwise, indirect proportions[64] are used. Finally, the FSI is calculated as the arithmetic average of the sub-indices.

You will find below the assessment of the sub-indices forming the FSI for the banking system and banks peers groups as at the end of 2011 H1.

Asset Quality Sub-Index[65]: Its downward performance signals the negative impact on the banking sector's position and vice versa. Asset quality sub-index continued to show a declining tendency according to its historical values. As at the end of 2011 H1, it fell to 65.3, from 71.2 as at end-2010 and 74 in the same period a year earlier. The values of this sub-index have fluctuated markedly from the average of the period of 85.9. The base ratios forming this sub-index increased in June 2011 compared with the base period. The continuous increase in these indicators shows the downward quality of the banking sector assets.

Liquidity Risk Sub-Index: Its downward performance signals the negative impact on the banking sector's position and vice versa. As at the end of 2011 H1, the liquidity sub-index dropped to 66.7 compared with 79.5 as at end-2011 and 76 in the same period a year earlier. The value of this sub-index remains below the average of the period. Its decline has been triggered by one of its constituent radios, i.e., assets of up to 3-month maturity to liabilities of up to 3-month maturity, which has dropped by 10 percentage points relative to end-2010.

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[62] *In this way, we derive the difference between the ratio in each period and the average for the entire stated period (In our case December 2005-December 2010). This difference is later divided by the standard deviation of the selected period.*

[63] *in our case, December 2005.*

[64] *A typical case in the use of indirect proportions relates to the Asset Quality Sub-Index where the increase in the ratios forming this sub-index (such as NPLs to total loans or net NPLs to shareholders' equity) in fact causes the fall in the asset quality sub-index, as their increase is unfavourable to the banking system. The signs or the direction of the effects shown in Table 23 help decide whether direct or indirect proportions should be used*

[65] *Indirect proportion is used to construct this sub-index.*

Exchange Rate Risk Sub-Index[66]: Its upward performance signals the positive impact on the banking sector's position and vice-versa. As at the end of 2011 H1, the exchange rate sub-index increased to 115.5, from 110.7 at end-2010 and 111.1 in the same period a year earlier. The improvement in this sub-index has been mainly triggered by the decreased radio of FX open general position to regulatory capital[67]. The increase in this sub-index signals restriction in the magnitude of the banking system's exposure to exchange rate movements.

Profitability Sub-Index: Its downward performance signals the negative impact on the banking sector's position and vice versa. As at end 2011 H1, the value of this sub-index fell to 73.6, from 84.2 at end-2010 and 86.2 in the same period a year earlier. The decline in the value of this sub-index has been mainly triggered by the decreased radio of net profit to total assets[68]. The downward performance of indicators composing this sub-index signals the negative impact on the banking sector's position.

Capital Adequacy Sub-Index: Its downward performance signals the negative impact on the banking sector's position and vice versa. This sub-index is equally composed of the free capital/total assets ratio and the CAR. In June 2011, it fell to 52.3, from 76.6 at end-2010 and 87.4 in the same period a year earlier. The value of this sub-index is much below the historical average, which is estimated at 87.8. This decline has been triggered by the radio of free capital[69] to total assets, which was 3.2% in June 2011, from 4.7% at end-2010.

Interest Rate Risk Sub-Index[70]: Its upward performance signals the positive impact on the banking sector's position and vice-versa. As at the end of 2011 H1, the performance of interest rate risk sub-index highlights decreased exposure of the banking system to interest rate risk relative to end-2010; however, this risk appears higher than in the same period a year earlier. Concretely, in June 2011, the value of this sub-index amounted to 102.9, from 95.3 in December 2010 and 108.3 in June 2010.

Financial Strength Index (FSI) is calculated as the arithmetic average of all the sub-indices referred to above. Their combined effect made the banking system's FSI fall to 79.4 at the end of 2011 H1, from about 86.3 at end-2010, which is below the average of the period of 95.5.

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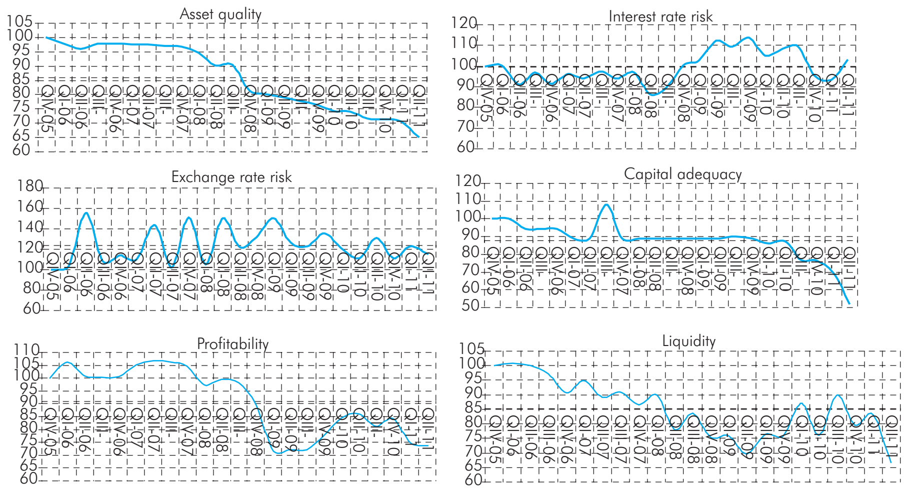
66 *Indirect proportions have been used to construct this sub-index due to the negative sign (direction of the impact) in the table.*
67 *The ratio was 3.73% in June 2011, from 5.03 in December 2010.*
68 *The ratio was 0.22% in June 2011, from about 0.77% in June 2010.*
69 *Given that the free capital is calculated as a difference between shareholders' equity and fixed assets, where the latter ones are calculated as a sum of fixed assets and net non-performing loans, it is precisely the substantial increase in the net non-performing loans that has triggered the decline in the free capital. Net NPLs increased about 32.6% in June 2011 relative to December 2010.*
70 *Interest rate risk is measured through the time inconsistency of assets and liabilities that exposes the banking system to interest rate movements. Indirect proportion has been used to measure this sub-index.*

It is estimated that at end-2011 H1, the FSI value fell to 79.4 from about 86.3 in H1. The fall in the FSI by about 7.9% owes to the decline in loan portfolio quality, CAR, liquidity and banking system profitability. In the meantime, the positive performance owes to lower exposure to exchange rate and interest rate movements.

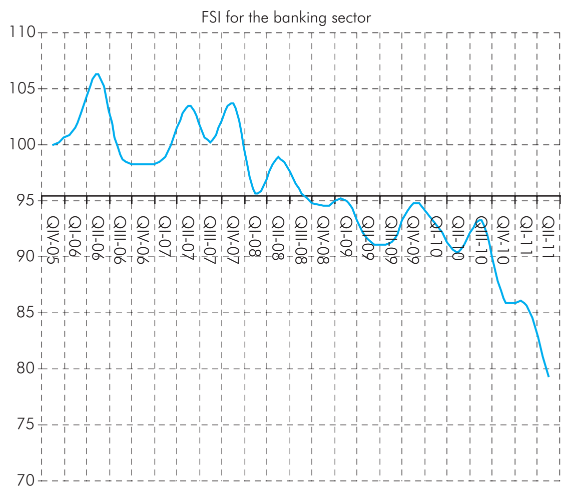
Chart 86 presents graphically the performance of the sub-indices and the FSI for the banking system.

Chart 86 Financial Strength Sub-Indices for the Banking Sector (December 2005=100)



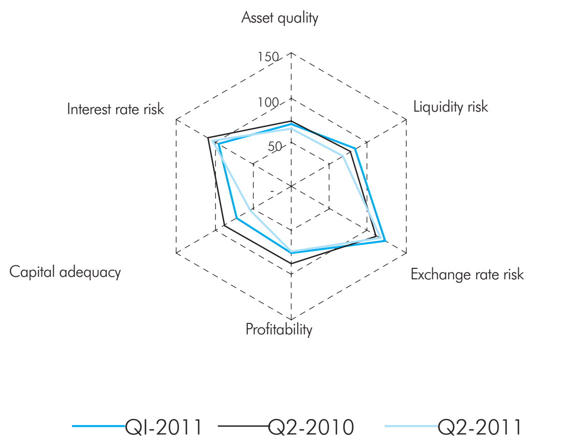
Source: Bank of Albania.

Chart 87 FSI for the banking sector



Source: Bank of Albania, FSD's estimates

Chart 88. FSI for the banking system



Source: Bank of Albania, FSD's estimates.

Table 24 Figures on the sub-indices and the FSI

Sub-indices	Asset Quality	Liquidity Risk	Liquidity Risk	Profitability	Capital Adequacy	Interest rate Risk	Financial Strength Index
Dec 05	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Mar 06	97.96	100.87	103.92	106.37	100.00	100.19	101.55
Jun 06	96.01	100.13	155.77	100.76	94.52	91.03	106.37
Sep 06	97.96	97.28	107.84	100.19	94.52	96.94	99.12
Dec 06	97.96	90.71	114.27	100.56	94.52	91.42	98.24
Mar 07	97.54	94.93	110.67	105.13	89.04	96.29	98.93
Jun 07	97.54	89.23	144.05	106.69	89.04	94.14	103.45
Sep 07	97.11	90.97	102.09	106.18	107.95	97.45	100.29
Dec 07	96.70	86.51	150.96	104.57	89.04	94.20	103.66
Mar 08	94.79	89.85	105.51	97.40	89.04	97.03	95.61
Jun 08	90.05	77.96	150.11	99.61	89.04	86.44	98.87
Sep 08	90.42	83.79	122.09	98.09	89.04	89.95	95.56
Dec 08	81.42	75.24	132.17	89.66	89.04	100.17	94.62
Mar 09	80.06	75.74	150.11	71.61	89.04	102.86	94.90
Jun 09	79.03	69.55	126.52	72.17	89.04	112.22	91.42
Sep 09	77.70	76.33	122.77	72.11	90.21	109.25	91.39
Dec 09	76.45	75.94	135.83	77.68	88.86	113.66	94.74
Mar 10	74.41	87.13	120.21	84.34	86.20	105.16	92.91
Jun 10	74.05	76.05	111.06	86.20	87.36	108.34	90.51
Sep 10	71.62	89.97	130.81	81.18	76.94	109.35	93.31
Dec 10	71.25	79.46	110.78	84.18	76.62	95.35	86.27
Mar 11	70.49	83.19	123.27	74.69	69.45	93.32	85.74
Jun 11	65.30	66.72	115.54	73.65	52.35	102.93	79.41

Source: Bank of Albania, FSD's estimates.

ANNEX 2: FINANCIAL SOUNDNESS INDICATORS OF THE BANKING SECTOR

Table 25 Banking sector

(%)	December `08	December `09	June `10	December `10	June `11
CAPITAL BASED INDICATORS					
Regulatory capital to risk-weighted assets	17.2	16.2	16.2	15.4	14.6
Core capital to risk-weighted assets	16.3	15.3	15.4	14.5	13.5
Core capital to total assets	7.8	8.7	8.9	8.6	8.0
Regulatory capital to total assets	8.3	9.2	9.3	9.1	8.7
Shareholders' equity to total assets	8.6	9.6	9.6	9.4	8.6
NET NON-PERFORMING LOANS TO CAPITAL					
Net non-performing loans to core capital	23.0	29.9	32.8	38.1	51.3
Net non-performing loans to regulatory capital	21.7	28.2	31.2	35.9	47.4
Net non-performing loans to shareholders' equity	21.1	27.1	30.3	34.8	47.6
GROSS NON-PERFORMING LOANS TO TOTAL LOANS	6.64	10.48	12.21	13.96	17.00
RETURN ON EQUITY, ROE (annual basis)	11.4	4.6	8.3	7.6	2.4
RETURN ON ASSETS, ROA (annual basis)	0.9	0.4	0.8	0.7	0.2
INDICATORS OF INCOME AND EXPENDITURE					
Interest margin to gross income	106.5	119.6	116.2	118.9	146.6
Non-interest expenditure to gross income	81.4	231.4	213.1	227.5	289.7
LIQUIDITY					
Liquid assets to total assets	42.8	27.6	27.9	25.9	25.5
Liquid assets to short-term liabilities (up to 1 year)	64.9	32.6	32.8	30.6	30.2
Deposit/Loan Ratio	162.6	154.3	158.2	166.4	163.7
NET OPEN FOREIGN CURRENCY POSITION TO CAPITAL					
Net open foreign currency position to core capital	4.5	4.1	7.6	5.3	4.0
Net open foreign currency position to regulatory capital	4.3	3.9	7.3	5.0	3.7
Net open foreign currency position to shareholders' equity	4.0	4.3	8.1	5.4	4.1

Table 26 Banks peer groups

	December '08			December '09			June'10			December '10			June '11		
(%)	G1	G2	G3	G1	G2	G3	G1	G2	G3	G1	G2	G3	G1	G2	G3
CAPITAL BASED INDICATORS															
Regulatory capital to risk-weighted assets	30.8	15.3	16.6	32.7	13.6	16.1	27.0	14.0	16.3	23.4	13.8	15.6	30.0	13.5	14.3
Core capital to risk-weighted assets	29.1	12.5	16.5	32.7	10.9	15.9	27.0	11.6	16.1	23.4	11.6	15.5	30.0	10.7	13.8
Core capital to total assets	20.3	8.1	7.0	19.1	8.0	8.2	16.9	8.8	8.3	13.9	8.1	8.4	18.7	7.6	7.7
Regulatory capital to total assets	21.5	10.0	7.1	9.1	10.0	8.3	16.9	10.1	8.4	13.9	9.6	8.5	18.7	9.6	7.9
Shareholders' equity to total assets	21.3	7.7	8.2	20.0	8.4	9.3	17.6	9.1	9.2	14.8	8.6	9.3	19.8	8.2	8.3
NET NON-PERFORMING LOANS TO CAPITAL															
Net non-performing loans to core capital	3.62	33.07	23.42	4.9	51.9	27.0	12.1	39.9	32.5	15.1	46.9	37.2	14.4	61.1	52.4
Net non-performing loans to regulatory capital	3.42	26.91	23.24	4.9	41.5	26.7	12.1	34.7	32.2	15.1	39.5	36.8	14.4	48.7	50.6
Net non-performing loans to shareholders' equity	3.45	32.07	20.31	4.7	49.3	23.8	11.6	38.5	29.3	14.2	44.5	33.3	13.6	56.8	48.5
GROSS NON-PERFORMING LOANS TO TOTAL LOANS	3.50	7.67	6.37	4.9	13.1	9.6	8.6	11.9	12.8	9.7	13.6	14.6	11.2	17.4	17.1
RETURN ON EQUITY, ROE (annual basis)	(4.48)	(4.83)	18.52	(6.54)	(22.48)	14.07	(9.09)	(9.40)	19.05	(8.78)	(8.29)	17.00	0.59	(21.03)	10.24
RETURN ON ASSETS, ROA (annual basis)	(1.02)	(0.37)	1.39	(1.36)	(1.85)	1.22	(0.86)	(0.42)	0.86	(1.53)	(0.73)	1.55	0.05	(0.90)	0.45
INDICATORS OF INCOME AND EXPENDITURE															
Interest margin to gross income	79	121	105	90	210	108	99	148	108	103	152	111	74	300	132
Non-interest expenditure to gross income	145	122	67	168	256	232	182	771	59	178	831	62	121	1,997	85
LIQUIDITY															
Liquid assets to total assets	40.1	31.1	46.6	29.7	18.4	30.4	27.3	22.3	30.4	27.5	23.2	27.1	25.9	24.1	26.0
Liquid assets to short-term liabilities (up to 1 year)	63.6	49.5	69.3	38.6	23.2	34.9	34.7	28.5	34.5	34.3	29.1	31.0	36.5	30.9	29.8
Deposit/Loan Ratio	149.5	100.77	190.32	147	103.72	178.63	147.4	112.9	192.11	157.3	120	200.71	136.08	116.63	187.96
NET OPEN FOREIGN CURRENCY POSITION TO CAPITAL															
Net open foreign currency position to core capital	2.4	12.8	2.6	(1.32)	7.97	3.77	4.5	6.6	8.6	(1.78)	0.07	8.54	(5.91)	(2.02)	8.74
Net open foreign currency position to regulatory capital	2.3	10.4	2.6	(1.32)	6.38	3.73	4.5	5.7	8.6	(1.78)	0.06	8.45	(5.91)	(1.61)	8.45
Net open foreign currency position to shareholders' equity	2.3	11.8	2.2	(1.26)	9.89	3.80	4.3	11.5	7.8	(1.67)	0.11	7.65	(5.57)	(2.91)	8.10

Table 27 Banks Peer Groups by Origin of Capital

	December '08				December'09				June'10				December'10				June'11			
(%)	Ital.	Fr.	Gr.	Al.	Ital.	Fr.	Gr.	Al	Ital.	Fr.	Gr.	Al	Ital.	Fr.	Gr.	Al	Ital.	Fr.	Gr.	Al
CAPITAL BASED INDICATORS																				
Regulatory capital to risk-weighted assets	16.9	15.5	16.5	14.7	18.8	14.2	14.1	14.2	19.4	15.4	14.6	13.3	17.6	13.2	14.8	13.6	18.7	13.3	13.3	12.7
Core capital to risk-weighted assets	16.3	13.2	16.5	10.4	17.9	11.3	14.1	11.2	18.6	12.5	14.4	10.6	16.9	12.8	12.0	11.1	18.0	11.3	11.5	10.4
Core capital to total assets	7.9	8.3	10.8	7.5	8.5	8.6	11.2	7.8	9.5	8.7	11.4	7.1	9.4	8.4	10.2	6.8	10.2	8.3	9.0	6.7
Regulatory capital to total assets	8.2	9.7	10.8	10.6	9.0	10.8	11.2	9.9	10.0	10.7	11.6	8.9	9.8	10.3	10.5	8.4	10.6	9.8	10.4	8.2
Shareholders' equity to total assets	9.3	9.1	9.1	8.3	10.5	9.5	11.6	8.1	10.2	9.4	11.9	7.2	10.3	9.3	10.9	7.3	11.1	9.6	8.8	7.1
NET NON-PERFORMING LOANS TO CAPITAL																				
Net non-performing loans to core capital	12.5	47.6	10.5	16.4	25.0	70.0	22.8	42.4	29.9	62.5	23.1	50.8	47.1	50.7	35.5	41.0	53.6	44.0	96.8	32.1
Net non-performing loans to regulatory capital	12.1	40.7	10.5	11.6	23.8	55.4	22.8	33.4	28.6	50.9	22.7	40.3	45.1	41.2	34.3	33.5	51.6	37.1	84.1	26.5
Net non-performing loans to shareholders' equity	10.7	43.3	17.3	14.8	20.3	63.4	21.9	40.6	27.9	57.9	22.2	49.4	42.6	45.9	33.0	38.2	49.3	38.0	98.7	30.4
GROSS NON-PERFORMING LOANS TO TOTAL LOANS	4.3	12.7	4.5	3.1	8.8	18.6	8.1	8.1	12.0	19.6	8.7	10.5	17.8	18.2	12.1	9.1	21.1	17.3	23.5	8.1
RETURN ON EQUITY, ROE (annual basis)	11.8	(18.9)	8.2	19.1	15.7	(30.8)	(5.7)	4.5	5.1	(20.1)	5.0	(10.8)	5.1	(3.2)	(3.8)	5.2	11.9	(7.6)	(38.2)	15.9
RETURN ON ASSETS, ROA (annual basis)	1.0	(1.7)	0.7	1.4	1.5	(2.8)	(0.6)	0.4	0.3	(0.9)	0.3	(0.4)	0.5	(0.3)	(0.4)	0.4	0.6	(0.4)	(1.9)	0.6
INDICATORS OF INCOME AND EXPENDITURE																				
Interest margin to gross income	83.9	206.3	116.7	0.9	73.3	381.8	171.7	10.8	01.5	25.9	112.0	180.6	100.9	127.5	161.2	116.0	87.2	202.9	(197.8)	107.5
Non-interest expenditure to gross income	95.7	205.9	94.1	0.7	74.8	537.3	1,125	91.0	03.6	40.8	636.4	144.1	97.1	321.3	988.2	89.6	77.2	569.2	(1,423.0)	68.7
LIQUIDITY																				
Liquid assets to total assets	47.6	34.0	24.9	29.9	34.0	26.7	18.6	21.7	32.7	30.7	20.3	24.1	29.8	30.5	22.2	23.0	31.2	26.8	24.6	20.2
Liquid assets to short-term liabilities (up to 1 year)	72.3	68.4	33.0	48.6	40.1	37.6	22.4	25.7	38.4	45.6	24.4	28.2	35.7	44.3	26.1	26.8	38.1	39.4	29.4	23.7
Deposit/Loan Ratio	197	107	91	140	190	94	91	134	192	104	95	138	202	114	107	149	189	105	114	136
NET OPEN FOREIGN CURRENCY POSITION TO CAPITAL																				
Net open foreign currency position to core capital	-2.1	21.1	-2.9	1.5	0.6	15.6	-1.7	6.8	2.7	12.8	-0.8	16.4	-3.2	-1.1	-0.5	14.9	-3.3	-1.5	-2.4	7.2
Net open foreign currency position to regulatory capital	-2.1	18.0	-2.9	1.1	0.6	12.4	-1.7	5.3	2.5	10.4	-0.8	13.0	-3.1	-0.9	-0.4	12.1	-3.2	-1.3	-2.1	5.9

(Footnotes)

1 Semi-annual financial report on H1 2011, URL: http://investor.rbinternational.com/index.php?id=498&L=1
2 Consolidated results as at 30 June 2011, URL: http://www.group.intesasanpaolo.com/scriptIsir0/si09/eng_index.jsp
3 Financial statements for H1 2011, URL: http://www.alpha.gr/page/default.asp?la=2&id=78&pl=291&pk=1107
4 Financial statements for H1 2011, URL: http://www.piraeusbank.gr/ecPage.asp?id=300892&lang=2&nt=96&sid=&fid=294541
5 Financial statements for H1 2011, URL: http://www.nbg.gr/wps/portal/!ut/p/c1/04_