Bank of Albania

# FINANCIAL STABILITY REPORT 2012 H1

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# C O N T E N T S

## B O X E S



## T B L E S

# C H A R T S

# PREFACE

This is the eighth 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 facing the financial system and its infrastructure, in order to provide the public authorities with the opportunity to identify relevant measures for necessary adjustments. The Financial Stability Statement, whose half-yearly release is a legal requirement, prefaces the Report.

In producing this Report, we have used data available at the Bank of Albania and information 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 presented data and analyses cover mainly the developments over 2012 H1. Expectations for the economic and financial outlook, unless otherwise stated, extend until end-2012.

The financial system stability assessment has been based on the performance and risks arising from financial system's interaction with the overall internal and external economic environment, as well as from its activity. To assess risks arising from its interaction with the surrounding environment, we have analysed 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 banking sector. As far as domestic indicators are concerned, the Report assesses the overall developments and expectations for economic growth, balance of trade, exchange rate and fiscal indicators. By analysing employment and income, it also provides an assessment of businesses and households' financial situation and the impact on the banking sector borrowers' solvency.

# NOTES

As at end-June 2012, the banks operating in Albania were divided into the following groups by their share:

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

b) Banks Peer Group 2 (each sharing 2-7% of total banking sector assets): Procredit Bank, Emporiki Bank, Branch of National Bank of Greece, Société Générale Bank-Albania, Alpha Bank-Albania, Union Bank;

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

As at end-June 2012, by capital origin, the banks operating in Albania were divided as follows:

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

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

f) Greek-owned banks: Alpha Banka - Albania, Tirana Bank, Branch of the National Bank of Greece;

g) French-owned banks: Société Générale Bank - Albania (former-Banka Popullore), Emporiki Bank (Credit Agricole).

h) Albanian-owned banks: Credins Bank, Union Bank;

As at end-June 2012, the National Commercial Bank and Intesa Sanpaolo Bank – Albania, expanded their branch network, respectively in Prizren, Kosovo and Athens of Greece.

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

# FINANCIAL STABILITY STATEMENT FOR 2012 H1

Pursuant to provisions 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", as amended, 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 jeopardise its stability, the Bank of Albania releases this Regular Statement, which is an integral part of the Financial Stability Report for the same stated period.

The financial system and banking sector's situation and performance remained stable throughout the period. The banking sector and the financial system operated within a more challenging environment, characterised by slow domestic and foreign economic growth, reduced public financial stimulus, slower investments and public consumption, decreased bank lending rates and quality, as well as imposed structural changes in the interbank liquidity market. However, the banking sector generated income and presented good capitalisation and liquidity indicators over the period. The direct impact of market risks on the banking sector was moderate, but the indirect impact arising from exposure of households and businesses was significant, suggesting the need for a prudential monitoring by the banking system. The deteriorated credit quality represents the main concern about the stability of the banking sector's financial indicators. As Albanian and foreign economic developments do not reveal any stable improvement of operators' expectations, the credit quality improvement may not occur duly and timely only through the smooth operation of banks. To effectively address this issue, the banking sector and Albanian public authorities should cooperate and be committed to taking parallel measures in several directions, as follows:

First, the banks should continue improving credit monitoring to: strengthen respective structures for assessing a borrower's creditworthiness and for collecting loans; accelerate operations which provide loan restructuring for potential borrowers; proactively create provisions to hedge against credit risk; perform operations to detect the financial effect of loan losses, write them off from the balance-sheet and execute collateral for the maximum recovery of credit value. If these operations are performed correctly and professionally, they will provide the banking sector with financial resources to better support lending in the periods ahead;

Second, the public authorities, including the Ministry of Justice and the Ministry of Finance, should be committed to promoting and accelerating these processes in the banking sector, by establishing the needed legal and financial stimuli. The Bank of Albania lays emphasis on the importance of rapid improvements in the legal framework to strengthen the collateral execution infrastructure on bank loan. It also assesses positively the important reform of establishing private bailiff entities. However, other legal and operational improvements are needed to: improve the financial education of lawyers and increase court's efficiency in dealing correctly and in due time with lending practices; provide consistency of decisions across same-level courts related to similar lending practices; improve the collateral auction result securing a loan; better connect the financial compensation of private bailiff entities to their performance in executing the collateral execution order; encourage the out-of-court resolution of disputes between a lender and a borrower; enable establishment and entry into the market of non-bank financial institutions, which through negotiations with banks, undertake to assess and manage or purchase part of non-performing loan portfolio. The Bank of Albania assesses that these proposals, identified through the cooperation among public authorities, international financial institutions and Albanian Banks Association, provide solutions already tested in countries that share similar characteristics, hence creating premises for a comprehensive addressing of and stable solutions to non-performing loans.

Third, the banking sector should continue to be well-capitalised and liquid throughout this process. To this end, the Bank of Albania shall ensure that banks conduct correct estimations of their needs for additional capital and liquid assets, by prudentially analysing their operational risk profile and acting proactively to guarantee them.

In more concrete terms, the following outlines the financial system's interaction with the economic environment and exposure to various risks in 2012 H1:

*Global economy grew at unstable rates during 2012 H1*. They reflected the sluggish economic performance of the euro area and the structural vulnerabilities, mainly in the labour and real estate markets. Advanced economies provided a considerably lower contribution to global economic growth, compared to emerging and developing economies. The lower expectations about global economic growth and tensions in financial markets, particularly in the euro area, urged the European authorities to take certain measures to reduce the refinancing cost of public debt for the peripheral member countries, stabilise the banking system and strengthen the European mechanisms for its capitalisation. The euro-area countries and other countries surrounding the European Union, which are negatively affected by the euro-area situation through the trading channels, human and financial capital movement, and financial system integration, are all interested in the success of these measures.

*The downward foreign demand appears to have impacted the weak performance of domestic economy*. In 2012 Q1, GDP contracted by 0.2% y-o-y and 1.2% q-o-q. Industry, construction, post-telecommunication and transport contributed to this fall. Services, trade and agriculture performed positively. Indirect data suggest that developments in consumption and private investments are slow, thus providing lower contribution to economic growth. Fiscal consolidation is accompanied by a contracted public financial stimulus for the economy. The weak foreign demand is followed by considerably slowed Albanian exports, compared to the same period of the previous year.

*Household and business financial situation maintained the same trend in 2012 H2 as in the previous period.* Households deepened their creditor position further, owing to faster growth of deposits compared to loans at the financial system. Businesses continued to deepen their debtor position, mostly in foreign currency. Lending to businesses increased at lower paces in 2012 H1, while lending to households decreased. Business and household loan quality decreased. Households and businesses are exposed to indirect credit risk arising from adverse exchange-rate or interest-rate movements.

*Operators have expanded their activity in the financial markets. The interbank market is characterised by higher transaction volumes and stable interest rates, thus demonstrating the ability to meet the banks' needs for liquidity*. Debt securities market recorded higher demand and supply in the primary market as well as their trading in the secondary market. During the period under review, the debt securities' secondary market recorded higher trading volumes, hence reflecting interbank operations to adapt to structural changes in liquidity and the entry of new non-bank operators into the market. One of the main developments in the financial markets was the unexpected decision of a large bank in Albania - part of an important European banking group - to withdraw from the Albanian Government debt auctions. This decision was driven by the request from the regulatory authority of its country of origin for improving the capital adequacy of the largest European banking groups, pursuant to recommendations by the European Banking Authority. The liquidity supply by other banks of the sector and the strongly supporting actions taken by the Bank of Albania helped fill the created vacuum and maintain a low volatility of interest rate on Government debt securities. This event, which tested the Bank of Albania's framework on market operations, showed the need to raise competition in the banking market, expand investors' base in Government debt securities, and improve the secondary-market function, in order to lower the concentration in debt allocation and reduce the refinancing risk. In the exchange market, the trading volumes increased, and the national currency appeared stable against the major foreign-currency basket.

The financial system expanded its activity further, albeit at slower rates. Measured as the ratio of financial system assets to Gross Domestic Product (GDP), the level of financial intermediation in Albania, was estimated at 92.8% as at end-June 2012, from 89.5% as at end-2011 and 86.9% in the same period of 2011. The banking sector remains the dominant segment of financial intermediation in Albania. Its assets account for about 93.9% of total financial system assets and about 87.2% of GDP. Over the period, the banking sector assets grew by about 3.4% compared to end-2011, and by about 11% compared to the same period in the previous year. Insurance companies represent the second most important segment of the financial system. Over the period, a financial institution was established to provide collective investment schemes, by expanding investment opportunities for different entities.

*In the banking system, lending is the main contributor to asset performance, despite its downtrend due to decelerated economic growth and bank's reluctance to lend*. Deposits have financed banking activity almost totally. This development is assessed as positive, affecting the stability of the banking system's liquidity position. On the other hand, this development highlights the need for retaining public confidence in the banking sector. As at the end of the period, capital adequacy ratio resulted 15.7%. The banking system generated a positive profit, although it remained concentrated in the largest banks. Loan quality deteriorated in almost all its categories. The ratio of non-performing loans to total loans stood at 21.1% at the end of the period.

*Risks to the financial system arise from its interaction with the surrounding economic environment and its own activity.*

*Concerning the impact of macroeconomic developments, fiscal stimulus and the contribution of foreign demand to economic growth remain low.* The Bank of Albania deems that the priority of fiscal policy should be operations that aim at: lowering the budget deficit and public debt; reducing the refinancing risk through the extension of average debt maturity duration and expansion of institutional investors and individuals' base; and providing the sources needed for financing or settling foreign-currency liabilities. Some of these objectives are more difficult due to economic performance in 2012 Q1, the sluggish foreign demand and the downward expectations of economic growth for 2012. In the foreseeable future, inflationary pressures may remain weak, hence providing more opportunities for the monetary authority to maintain accommodative monetary conditions. Nevertheless, the benefit that economic operators gain from more favourable monetary conditions would also depend on their financial position, the quantity of bank lending and respective interest rate.

*Direct and indirect credit risks represent the major risk to the banking sector. Though at different rates, credit quality has deteriorated for lek and foreign currency loans to businesses and households. The credit quality deteriorated in all the main sectors of the economy.* Addressing non-performing loan concerns in the banking sector is important to the lending pace and future contribution of the banking sector and financial system to Albania's economic development. Therefore, the Bank of Albania encourages public authorities and the banking sector to cooperate and take measures for providing a lasting and comprehensive solution to this issue. Some of these measures are outlined in the Financial Stability Statement of this Report.

The banking sector appears relatively hedged against direct risk arising from adverse exchange rate and interest rate movements, but sensitivity has increased. The open foreign exchange position of the banking sector appears within the historical levels, while the values of assets and liabilities sensitive to interest rate are comparable to each-other. It, however, appears sensitive to the impact of exchange rate and interest rate movements on bank clients. A significant level of exchange rate depreciation or a similar increase in the interest rate may impair bank clients' solvency, particularly businesses' solvency. This risk arises mainly from foreign currency-denominated loans, when the main source of their settlement is in the national currency, and also from variable interest rate loans.

*Liquidity risk to the banking sector is also at moderate levels.* Deposits continue to be the key financing source for the banking sector and grew at good rates. Borrowing from non-residents remains contained. Banking sector's liquid assets in lek and in the major foreign currencies remained above the minimum rates required by the regulatory framework.

*Capitalisation indicators are at good levels, but banks should assess carefully their needs for additional capital in the future.* During the period under review, the sluggish growth of risk-weighted assets and the moderate increase of capital provided the main contribution to this performance. Despite the positive financial result, banking sector's capacity to generate sufficient income for supporting the increase in capital and carrying out its activity through domestic resources remains unstable. On the other hand, the covering of net non-performing loans with capital decreased. Therefore, banks should assess carefully and proactively their needs for additional capital in line with their activity risk profile.

*Stress testing may serve banks as an instrument to assess possible needs for additional capital.* The Bank of Albania conducts regular stress tests to assess the sensitivity of key banking sector capitalisation indicators to movements in macroeconomic indicators. The baseline and adverse scenarios include assumptions related to movements in GDP growth rate, exchange rate and interest rate, and the credit level. They run over a two-year time period until end-2013. Stress-test results show that, overall, the banking sector appears resilient in the event the assumptions about respective indicators take place. Capitalisation level for the entire sector remains above the required minimum for the baseline scenario. In the event of the most severe scenarios, which assume fall in GDP growth rate and in lending, as well as depreciation of the exchange rate, individual banks may need additional capital.

*The technical infrastructure supporting banking sector activity is assessed to have operated in line with the expected parameters.* Payment systems constitute an important part of the financial system structure, enabling the transfer of funds between banks, other financial institutions and customers. As a consequence, their stable and efficient operation contributes significantly to safeguarding financial stability. In this context, AIPS and AECH systems, the basic infrastructure of lek payments, have operated in compliance with the requirements under their regulatory and operational framework. The Bank of Albania remains committed to carrying out improvements in the regulatory framework and supportive technological infrastructure, so that the performance of these systems anticipates the operators' needs for a safe and efficient activity.

# 1. INTERNATIONAL DEVELOPMENTS

Global economy grew at unstable rates during 2012 H1. They reflected the sluggish economic performance of the euro area and the structural vulnerabilities, mainly in the labour and real estate markets. Advanced economies' contribution to global economic growth was considerably lower than that of emerging and developing economies. The lower expectations about the global economic growth and the tensions in financial markets, particularly in the euro area, urged the European authorities to take some measures to reduce the refinancing cost of public debt for the peripheral member countries, stabilise the banking system and strengthen the European mechanisms for its capitalisation. The euro area countries and other countries surrounding the European Union, which are negatively affected by its situation through the trading channels, the human and financial capital movement and the financial system integration, are all interested in the success of these measures.

After an unfavourable period in 2011 H2, the global economy showed signs of stability at the beginning of 2012, marking an annual growth of 3.6%[2] in the first quarter. Global trade and industrial production rebounded, which, in turn, benefited trade-oriented economies, like Germany and those in Asia. These developments owed mainly to reduced tensions in financial markets following a series of economical and political operations in the euro area such as, ECB's longer-term refinancing operations for the European banks and compilation of medium-term fiscal programmes from the euro area governments, particularly in Italy and Spain. These programmes focus on fiscal consolidation and ambitious reforms that liberalise the labour market and improve the economy's competitiveness. However, they were short-lived developments, as in May-June 2012, the euro area periphery was at the epicentre of financial market stress. Concerns related to the lack of political and financial stability in Greece after the political elections in May, the banking sector's problems in Spain, and the increased doubts about the euro area governments' ability to deliver on fiscal adjustment and reform following the presidential elections in France, stirred a new wave of uncertainty in financial markets. The perception of higher various risks appeared with capital flows to safer and more liquid products in more sustainable economies, increased government debt interest rates in peripheral European countries and tighter refinancing operations in the euro-area banking sector.

Therefore, the stabilising effect of the above-stated measures subsided quickly and the indicators on economy's real sector in Q2 reflected the hampering effect of the euro area tensions. The weaker economic growth

[2] *IMF World Economic Outlook – July, 2012*

in 2012 Q2, affected also the global economic growth prospect for 2012. According to the International Monetary Fund (IMF), global economic growth is projected to moderate to 3.5% in 2012 and 3.9% in 2013, lower than the April 2012 forecast. Advanced economies are expected to have a more considerable slowing of economic growth by 1.4% in 2012 (1.6% in 2011) and 1.95% in 2013. This expectation reflects the contraction of the euro area economy and structural vulnerabilities mainly in the labour and real estate markets. Growth in emerging and developing economies continued to expand at high rates during 2012, providing the main contribution to the global economic growth. However, the growth rate is expected to moderate to 5.6% in 2012 (from 6.2% in 2011) due to implementation of consolidated fiscal policies and weaker demand from advanced economies, before picking up to 5.9% in 2013. Meanwhile, inflationary pressures dropped due to a weak global demand and steady oil and primary commodity prices. Global inflation is expected to fall to 3-3.5% at end-2012, compared to 4.5% at end-2011.

The optimism characterising the US economic activity at end-2011 with an annual growth of 4.1% in 2011 Q4, decreased in 2012 Q1 and Q2, mainly due to the fall in consumption by private and public sectors and negative contribution of net trade. Business confidence dropped in 2012 Q2 due to deterioration of global macroeconomic environment, particularly in the euro area. Nevertheless, the negative euro-area effects were partially offset by capital flows from the European markets to safer and more liquid US markets. The labour market conditions improved, particularly in 2012 Q1. Unemployment rate stands at around 8.2%. Activity in real estate market, albeit showing some positive signals, remains a structural vulnerability that impedes the economic growth. Inflationary pressures remain weak (Table 1.1). Against this setting, the Federal Reserve has maintained the interest rate on funds lending unchanged, at 0-0.25%, and has publicly announced the intention to keep this interest rate unchanged until end-2014.

The economic activity in the euro area slowed down considerably during 2012 Q1, albeit at uneven rates across member countries. Following a relatively stable economic situation at the beginning of 2012, expectations on the region's economic growth were hit by elevated tensions concerning the financial stability of some countries. The euro area entered into economic recession again in 2012 Q2.[3] The economic downturn was further pronounced in countries significantly affected by the debt crisis, most notably in Greece, Italy, Spain and Portugal. On the other hand, advanced economies, such as, Germany, Finland, France and Austria maintained a modest positive growth during the first two quarters of 2012 (Table 1.1). The weak economic growth mainly owes to the sluggish domestic demand driven by the negative effect of debt crisis on consumer and business confidence and the unfavourable lending terms in some member countries. The IMF estimates an economic recession, at 0.3% in 2012 for the euro area, and a slight economic growth of 0.7% in 2013.[4] Against a background of weak

[3] *Latest estimations by Eurostat.*
[4] *IMF World Economic Outlook-July 2012.*

economic growth and decreased volatility in primary commodities and food prices, inflation was downward in 2012 H1 and is expected to fluctuate below 2% in 2013. The euro area performed a considerable fiscal consolidation in 2011 that continued intensively in 2012 H1. Nevertheless, budget deficit in most countries remained above the reference rate of 3%. The labour market continued to deteriorate and unemployment rate peaked at 11.2% in June 2012. European experts expect unemployment rate to peak at 11.4% in 2013 and fall to 10.8% in 2014.

*Table 1.1 Selected macroeconomic indicators for USA and euro area*

| | GDP change (in annual %) | | | | Inflation (in annual %) | | | Unemployment (in annual rate %) | | | Sovereign debt (% of GDP) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2011 | 2012* | Q1'12 | Q2'12 | 2011 | May'12 | Jul'12 | 2011 | May'12 | Jul'12 | 2011 | Q1'12 |
| USA | 1.8 | 2.0 | 2.4 | 2.3 | 3.2 | 1.7 | 1.4 | 9 | 8.2 | 8.3 | 102.9* | : |
| Euro area | 1.4 | -0.3 | 0.0 | -0.5 | 2.7 | 2.4 | 2.4 | 10.2 | 11.2 | 11.3 | 87.3 | 89.3 |
| Germany | 3.0 | 1.0 | 1.2 | 1.0 | 2.5 | 2.2 | 1.9 | 6 | 5.5 | 5.5 | 81.2 | 80.9 |
| France | 1.7 | 0.3 | 0.3 | 0.3 | 2.3 | 2.3 | 2.2 | 9.6 | 10.1 | 10.3 | 85.8 | 89.2 |
| Italy | 0.4 | -1.9 | -1.4 | -2.5 | 2.9 | 3.5 | 3.6 | 8.4 | 10.5 | 10.7 | 120.1 | 123.3 |
| Greece | -6.9 | : | -6.5 | -6.2 | 3.1 | 0.9 | 0.9 | 17.7 | 23.1 | : | 165.3 | 132.3 |
| Spain | 0.7 | -1.5 | -0.6 | -1.3 | 3.1 | 1.9 | 2.2 | 21.7 | 24.8 | 25.1 | 68.5 | 72.1 |

*Source: Bureau of Economic Analysis-USA, Eurostat database, ECB: Monthly Bulletins.*
**Outlook by IMF*
*: Data not aviable*

In response to these negative developments, the European authorities have undertaken some actions, which aim to stabilise financial market conditions and revive the economic growth. Euro area summit, 28-29 June 2012, is a culminating moment for identifying these mechanisms. The decisions consist in establishing a single banking supervisory mechanism; and authorising the ESM to inject funds directly to banks (Box 1).

*Box 1 Political decisions of the euro area summit, 28-29 June 2012*

*At the euro area summit on 28 - 29 June 2012, heads of states or governments of euro area countries met to address financial market tensions, restore confidence and revive growth. As a follow up of these decisions, two other meetings of Eurogroup took place in 9 and 20 July to discuss the details of their implementation. The main decisions in these meetings were:*

- *Establishment of a single banking supervisory mechanism run by the European Central Bank; and once this mechanism has been created, the providing of European Stability Mechanism (ESM) with possibility to recapitalize banks directly. It aims to break the vicious cycle between European banks exposure in Sovereign debt and its sustainability. It has played a considerable negative role on debt crisis prolongation. Direct recapitalisation of banks through the ESM will not increase public debt burden, decreasing, therefore, tensions on these markets.*

- *Approval of the financial assistance for the recapitalisation of banks for Spain (at Eurogroup meeting on 20 July 2012). The loan will cover financing needs up to EUR 100 billion. The financial assistance will be provided by the EFSF in compliance with the existing rules, until the ESM becomes available (after July 2012). Then, funds will be transferred to the ESM, without gaining seniority status.*

- *Increased flexibility in the usage of the existing EFSF/ESM instruments to stabilise debt markets of euro area sovereigns that strictly comply with EU fiscal rule.*

*The implementation of these measures might not be easy, for some issues need the unanimity of all Eurogroup members, whereas many technical details remain unclear. June Summit's endorsement for a common oversight of banks is the first step towards a banking union in the euro area and implies an important initiative to restore market confidence.*

*The implementation of these measures might not be easy, for some issues need the unanimity of all Eurogroup members, whereas many technical details remain unclear. June Summit's endorsement for a common oversight of banks is the first step towards a banking union in the euro area and implies an important initiative to restore market confidence*

The ECB cut the key interest rate to 0.75% in July 2012 and continued to provide ample liquidity to banks to address their needs to refinance liabilities and continue lending.

The deepening of problems in the euro area has emerged as a considerable problem to the economic activity in European emerging and developing economies. The economic growth in many Central and Eastern European countries weakened, in particular during 2012 Q2. Economic recession in Czech Republic and Hungary was deepened owing to the fall in foreign demand and the measures on fiscal tightening. Poland and Baltic countries were at the top of economic growth list in the region, albeit showing notable decelerating signs during 2012. Available data on South-Eastern European countries (Balkan region) show a fall of economic activity in 2012 Q1, particularly in Croatia, Macedonia and Serbia, thus deepening the trend which had begun since 2011 Q4. Economic data on Bosnia and Herzegovina and on Montenegro signal a weak economic growth during this year. Economic deterioration in these countries owes mainly to the fall in exports, which were negatively impacted by the worsening of foreign market conditions. In contrast, Turkey continues to record high economic growth rates, thus spearheading the European emerging and developing countries in terms of economic growth rates.

*Table 1.2 Selected macroeconomic indicators for Central and South-Eastern Europe*

| Central and South-Eastern Europe | GDP growth (y-o-y in %) | | | Inflation (y-o-y in %) | | | Unemployment (y-o-y in %) | | | Sovereign debt (% of GDP) | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2011 | Q1' 12 | Q2'12 | Dec.'11 | May '12 | Jul'12 | 2011 | May'12 | Jul '12 | 2011 | Q1'12 |
| Hungary | 1.6 | -1.2 | -1 | 4.1 | 5.4 | 5.7 | 11.0 | 11.0 | 10.8 | 80.6 | 79.0 |
| Poland | 4.3 | 3.5 | 2.5 | 4.5 | 3.6 | 4.0 | 9.7 | 10.0 | 10.0 | 56.3 | 56.1 |
| Romania | 2.5 | 1.2 | 1.7 | 3.2 | 2.0 | 3.1 | 7.4 | 7.1 | 7.0 | 33.3 | 34.3 |
| Serbia | 1.6 | -1.3 | -0.6 | 7* | 2.7 | 5.5 | 23.0 | 25.5** | : | 47.7 | 50.7 |
| Kosovo | 4.9*** | : | : | 4.1* | 1.1 | : | : | : | : | : | : |
| Bosnia & Herzegovina | 1.6 | : | : | 4.0 | 2.3 | : | 43.8 | 43.8** | 44.1** | 25.7 | 26.1 |
| Macedonia | 3.1 | -1.4 | : | 2.8 | 1.4 | 2.1 | 31.4 | 31.5** | : | 28.2 | : |
| Monte negro | 2.5 | : | : | 1.0 | -1.5 | 1.8 | 13.2 | : | : | 45.3 | 45.1 |
| Turkey | 8.5 | 3.2 | : | 9.2* | 8.28 | 9.07 | 9.8 | 10.4** | : | 38.4f | : |

*Source: Eurostat database, European Commission, respective central banks.*
** - Available data for 2011 Q4.*
*** Unemployment data are available for 2012 Q1 and Q2.*
**** Outlook by ECFIN and IMF.*
*: Data not aviable*

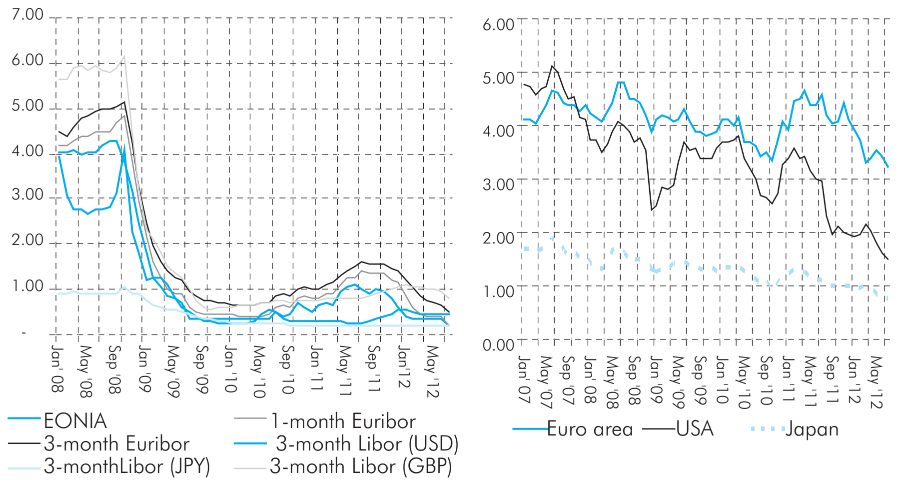
The negative developments in the euro area and in the region are expected to negatively affect our country. The sluggish economic activity in Europe will provide an adverse contribution to the demand for Albanian exports, whereas the receding inflationary pressures may bring import prices down. On the other hand, the still high unemployment rates in the euro area, particularly in Italy and Greece, combined with the additional fiscal tightening measures, will continue to aggravate the financial situation of Albanian emigrants in these countries, and impact negatively on their remittances to Albania over time.

## 1.1 FINANCIAL MARKETS HIGHLIGHTS

Financial markets experienced a calm momentum at the beginning of year 2012, but election results in Greece and heightened concerns about the Spain's banking system soundness have shaken the market confidence, thus capital flows to safer and more liquid markets have intensified.

In European money markets, interest rates appeared stable and downward throughout the first half of the year, as a result of ample liquidity provided by ECB through refinancing operations and further easing of monetary policy by cutting the key interest rate to 0.75% in July 2012. In the sovereign debt market, yield spreads were highly volatile, thus reflecting capital flows to countries with a better economic and financial performance. Sovereign debt rates fell considerably in USA, Switzerland and Germany (for the latter, the yield on 2-year debt fell below 0). On the other hand, the volatility increased, and yields on the sovereign debt of Italy and Spain displayed an uprising trend. The temporary yield on 10-year debt of Italy and Spain increased to 7%, broadly considered as the maximum rate that set forth its sustainability.

Chart 1.1 Interest rates in money markets and public bonds markets




Source: European Central Bank, Eurostat.

Activity in equity markets increased during 2012 Q1. Equity prices rose in both US and European markets, and trading conditions also improved in corporate bonds markets. The heightened insecurity concerning European crisis during March-June gave rise to new tightening of operations in equity markets, particularly in the financial sector. Currently, the implemented political initiatives to strengthen the financial stability in the euro area and the extension of accommodative monetary policy in the USA have impacted positively on the financial stability of these markets. In the foreign exchange markets, the euro has depreciated against the major foreign currencies since the end-February 2012, hence reflecting investor uncertainty about fiscal and economical developments in the euro area. On the other hand, the flow of funds to safe markets, partially within the euro area (as government bonds of Germany and Austria) contributed to maintaining the euro value.

In primary commodity markets, oil price rose swiftly at the beginning of 2012, thus reflecting the intensification of geopolitical tensions in Middle East and the optimism on global economic growth after the publication of positive data on the US and Chinese economies. This increase peaked in March, when oil price stood at USD 122.7 per barrel. Prices on other primary commodities displayed the same increasing trend during this period. The sluggish economic activity of advanced economies and China in 2012 Q2, as well as the maintaining of oil production levels, restored the downward oil price trend. Thus, the oil price dropped at USD 90 per barrel on 26 June 2012, about 28% lower than the end-2012 Q1's figure.

Global Large and Complex Banking Groups (GLCBG) operated in a challenging environment, particularly banks with high exposure to real estate. Euro-area developments impacted negatively the American Banking Groups, while the UK Banking Groups' profits were hit by the decline in real estate prices. Trade activity income improved, after the sharp fall at end-2011. Overall, interest income appears stable. Capital indicators on GLCBG remained stable at end-2011 and during 2012 Q1. Authorities assessed capital adequacy positively for American banks, while UK banks were requested to add capital. Equity prices of these banking groups, in particular American banks, increased at the beginning of 2012, but this growth resulted temporal due to market uncertainty in 2012 Q2.

The financial performance of euro-area Large and Complex Banking Groups (ELCBG) weakened after March 2012, thus reflecting the heightened credit risk and deteriorated conditions in the real estate market of several euro area countries. On the other hand, the major euro area banking groups improved their capital rates during 2012 Q1, as part of implementing the European Banking Authority recommendations to raise their capital following the stress testing conducted in November 2011. Further on, many euro area large banking groups have informed on their restructuring plans, which consist in decreasing the activity during the medium-term period and relying on stable financial sources. The Eurosystem has provided sufficient liquidity to sustain the necessary structural changes in the banking sector.

*Box 1.2 Developments in banking groups operating in Albania*

*The table below summarises financial statements of the banking groups operating in Albania. Compared to the end of the previous year or the same period of the previous year, these data show a downward trend of earnings, mainly due to lower income of these banking groups, despite spending cuts. Capital adequacy ratio is at satisfactory levels, thereby requiring no additional capital, according to legal obligations. The ratio of total assets of each individual bank in Albania to total assets of the group showed quite slight changes for all banking groups under review, compared to previous periods.*

*Table 1.3 Financial data on foreign banking groups operating in Albania (in EUR billion)*

| | Raiffesen Bank International[I] | Intesa San Paolo[II] | Alpha Bank*[III] | Piraeus Bank*[IV] | National Bank of Greece*[V] | Societe Generale[VI] | Credit Agricole[VII] |
|---|---|---|---|---|---|---|---|
| Total assets | 152.7 | 666.4 | 57.6 | 46.4 | 104.1 | 1,246.7 | 1,956.7 |
| 6-month change | 3.9% | 4.3% | | | -12% | 6% | 4.1% |
| Volume of loans to customers | 84.9 | 374.9 | 43.7 | 34.1 | 70.7 | 360.5 | 805.6 |
| 6-month change | 4.1% | -0.5% | | | -5% | -2% | 0.8% |
| Volume of customer deposits | 72 | 365.6 | 27.9 | 20.7 | 57.4 | 348.5 | 678.1 |
| 6-month change | 7.9% | 2.3% | | | -15% | 2% | 1.7% |
| NPL ratio | 9.8% | 7% | 14.9% | | | | |
| Provisioning | 0.4 | 2.1 | 3.1 | 0.3 | 0.8 | | |
| Net profit | 0.73 | 1.3 | -0.1 | 0.3 | -0.5 | -1.2 | 1.7 |
| Annual change | 8.3% | -9.1% | | | | -29.9% | -33.2% |
| Operating income | 2.6 | 8.9 | 0.5 | 0.4 | 0.8 | 2.5 | 3.4 |
| Annual change | -4.9% | 2.6% | -15.5% | | | 4% | -28% |
| Net interest income, annual change | -3.6% | 3.6% | -5% | | | | |
| Net commission income, annual change | -2.2% | -5.9% | -7.7% | | | | |
| Operating expenses annual change | 0.2% | -1.9% | -3.3% | | -7% | -3.5% | 0% |
| Personnel cost, annual change | 1.5% | -1.4% | -1.9% | | | | |
| Net operating profit, annual change | -11.2% | 7.4% | | | | | -8.2% |
| Net interest margin | 2.3% | | 2.8% | | 4% | | |
| Capital adequacy ratio | 10.6% | 11.7% | 9.6% | 9% | 8.1% | 11.6% | 12.7% |
| Total assets of the bank in Albania to total group assets | 1.52% | 0.14% | 0.82% | 1.38% | 0.26% | 0.03% | 0.01% |

**The data refer to 2012 Q1.*

*I Financial Report, June 2012, URL: http://investor.rbinternational.com/fileadmin/ir/2012_Q2/2012-08-29_Q2_Report_RBI.pdf*

*II Financial Report H1, June 2012, URL: http://www.group.intesasanpaolo.com/scriptIsir0/si09/contentData/view/20120824_Relazione_Semestrale_06_12_uk.pdf?id=CNT-04-00000000BCF2B&ct=application/pdf*

*III Financial results for 2012 Q1, press release, UR: http://www.alpha.gr/files/deltia_typou/Deltio_Typou_20120531EN.pdf*

*IV Financial Statements 2012 Q1, URL: http://www.piraeusbank.gr/Documents/internet/ConsolidatedCo2012/3M_1st_ENG.pdf*

*V Financial Results 2012 Q1, URL: http://www.nbg.gr/wps/wcm/connect/2c09bb804b6f4efca8e6ae277c464667/20120530+NBG+%26+Group+Q1+2012+Results+EN.pdf?MOD=AJPERES&CACHEID=2c09bb804b6f4efca8e6ae277c464667*

*VI Financial information 2012 H1, press release, URL: http://www.societegenerale.com/sites/default/files/documents/CP_Q212-.pdf*

*VI Financial results 2012 H1, URL: http://www.credit-agricole.com/en/Finance-and-Shareholders/Financial-reporting/Credit-Agricole-S.A.-financial-results*

# 2. ALBANIA'S MACROECONOMIC DEVELOPMENTS IN 2012 H1

## 2.1 REAL ECONOMY

The Albanian economy contracted by 0.2% year-on-year and 1.2% quarter-on-quarter in 2012 Q1. Industry and construction deepened significantly their annual contraction in 2012 Q1, 19.3% and 17.6%, respectively. Post and telecommunications and transport declined as well. Other services and trade continued to contribute positively to economic growth by 11.1% and 5.3% y-o-y, respectively. Also, agriculture grew 4.5% from start-2011 and 1.6% from end-2011.

Indirect data suggest that private consumption and investments are sluggish. Higher propensity to save, coupled with consumers' prudent behaviour, is reflected in a limited contribution of consumption to economic growth. Despite lending for private investments, the presence of spare production capacities, lower aggregate demand and slow developments in the labour market are reflected in lower levels of private investments. During this period, the fiscal policy was consolidated, therefore, reducing the fiscal stimulus to economy. The weak developments on the foreign demand side, also followed by lower production of electric energy, are reflected in significant slowdown of Albanian exports compared to the beginning of the previous year.

According to a more detailed analysis of the above-mentioned developments, the significant deterioration in consumers' confidence[5] in 2012 H1 reflects the downward expectations about consumers' economic situation and higher propensity to save. In 2012 Q1, the average wage in the economy dropped significantly by 12.4% in real terms. As remittances declined 2.08% in annual terms during H1, available income also slowed down.

Consumption was limited also due to developments in the labour market. In 2012 Q1, the unemployment rate was 13.32%, compared to 13.29% at end-2011. However, the unemployment rate was down 0.11 percentage points from a year earlier. Employment in the private non-agriculture sector remained positive, expanding 8.3% from a year earlier, but slower than at end-2011 when it had posted 9.9%. On the other hand, employment in the public sector at year start continued falling by 0.5% in annual terms. In 2012 Q2, expectations[6] for the labour market are assessed as downward for the industry and construction sectors, and positive but at a lower growth rate, for services.

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[5] *In 2012 Q2, the Consumers Confidence Index (CCI) fell 1.1 percentage points in line with the downtrend having started at end-2011.*

[6] *According to the Businesses Confidence Index, in 2012 Q1, the Employment Expectation Index was -2.8 for the industry, -7.6 for construction and 2.1 for services.*

In 2012 H1, reduction of fiscal stimulus to the economy was reflected in an increase in income by 4.1% y-o-y, amounting to ALL 161.6 billion, and a reduction in budget expenditures by 0.3% y-o-y, amounting to ALL 182.7 billion. The higher income reflected the performance of tax and non-tax revenues, whereas lower expenditures were mainly impacted by capital ones. As a result of these developments, at the end of the period, the budget deficit was ALL 21.1 billion or 3.1% of GDP.[7] The deficit was financed to 60.6% by internal resources and 39.4% by external resources. At the end of the period, the public debt stock reached ALL 800.9 billion. At the end of 2012 Q1, the domestic debt accounted for 56.6% of total debt. The average term of debt was volatile during H1, upward as of May reaching 386 days until maturity at the end of the period.

During 2012 H1, foreign trade developments reflected a narrowing of the current account deficit to EUR 446 million, shrinking 17.8% y-o-y. During the same period, the trade balance was EUR 904 million, down by 10.8%, year-on-year. This development reflected the low expansion of exports by 0.5%, year-on-year, during 2012 H1, while imports declined 4.2% year-on-year. During the same period, the capital and financial account stood at EUR 425.7 million, down by 3.8%. Foreign Direct Investments were up 28.5% from a year earlier, whereas portfolio and other investments contracted.

As regards prices, during 2012 H1, inflation was below the Bank of Albania's target, although it was upward mainly owing to higher unprocessed food prices. In 2012 Q2, the average annual inflation was 1.9%, about 0.8 percentage points higher from year start.

Negative developments in the euro area and in our region continue to impact negatively on Albania's economy. The weakening of economic activity in Europe will continue to provide an adverse impact on the Albanian exports, while lower inflationary pressures may contribute to lower import prices. Furthermore, combined with the continued implementation of fiscal tightening, ongoing high unemployment rates in the euro area, especially in Italy and Greece, will continue to aggravate the financial situation of Albanian emigrants in these countries and exercise pressure on them to reduce their remittances towards Albania.

7 *The Report is based on GDP estimates for 2012 H1.*

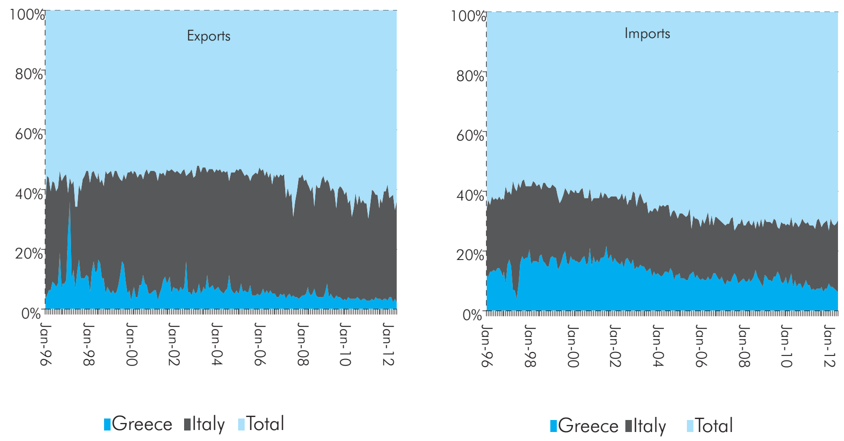
Box 2 Exposure of the Albanian economy to Greece and Italy

*Exposure of the Albanian economy to Greece and Italy in terms of foreign economy is considered as important. Demand for exports, remittances* and foreign direct investments from Italy and Greece are the main channels that transmit the developments in these countries onto our economy.*

*Chart 2 presents the performance of exports and imports from Italy compared to total foreign trade. The share of Albanian exports to Greece has been dropping, reaching 3.9% to total exports and in June 2012. Given the low exposure to Greece, Albania is able to buffer any possible effects from a deeper crisis in Greece. Over the same period, exports to Italy accounted for 52.1% to total exports, rendering as important the impact on our economy from the slowdown or the contraction of the Italian economy. Regarding the structure of exports, In June 2012, 39.2% of exports towards Greece consisted in construction materials and metals, 23.8% textile and shoes and 19.4% food, beverages and tobacco. Exports towards Italy consisted in 50.7% textile and shoes, 25% minerals, fuels and electric energy and 10.2% construction materials and metals. These developments show that reduction of exports towards Greece affects mainly the construction sector, whereas reduction of exports towards Italy affects the textiles sector and minerals, fuels and electric energy sector. The Albanian businesses have, however, responded through enhanced efforts to diversify trade partner countries, hence mitigating somewhat the negative effects of the financial crisis.*

*On the import side, dependency on Greek imports is higher, with 8.9% to the total; this share has also been downward. Overall, diversification of imports is easier than that of exports. Therefore, resolution of potential problems that may arise from importing from Greece is easier.*

Chart 2 Structure of exports and imports by country




Source: Bank of Albania.

*Economic developments in Greece and Italy will have negative effects on remittances received from Albanian emigrants in these countries, subsequently affecting the available income and consumption of households at home. The effects on remittances are expected to be more evident in the medium run.*

*In relation to Foreign Direct Investment developments, the share of the Greek capital in total stock remains significant, despite the downward trend. Most recent official data refer to 2010, when the share of Foreign Direct Investments from Greece* *decreased to 27. 42% of the total, from 42.48% in 2007. The share of Foreign Direct Investments from Italy increased to 15.18% in 2010, from 11.72% in 2007. These developments reflect the significant impact of the financial crisis, which has hit Greece and Italy, on their foreign investments in other countries. However, the expansion of the total Foreign Direct Investments (Table 2.1), while the share of Greece has been dropping, shows that Albania has capacities to attract capital from other non-neighbouring countries.*

*Table 2.1 Foreign Direct Investments by country*

| | Foreign Direct Investments in EUR million | | |
|---|---|---|---|
| Period | Greece | Italy | Total FDIs |
| 2007 | 771.05 | 212.7 | 1,815.08 |
| 2008 | 694.22 | 317.57 | 2,039.85 |
| 2009 | 670.69 | 349.99 | 2,233.38 |
| 2010 | 723.97 | 400.62 | 2,639.85 |

*Source: Bank of Albania.*

*Notwithstanding the above, a good share of Foreign Direct Investments in the form of capital from Greece has played a significant role in supporting the activity of Greek-capital banks operating in Albania.*

* *Updated data on remittances from Greece are absent. However, according to "Information on household survey results" by A.Frasheri, published in the Economic Bulletin of the Bank of Albania, September 2007, 37.7% of remittances are sent from Grece and 45.8%, are sent from Italy.*

## 2.2 HOUSING MARKET

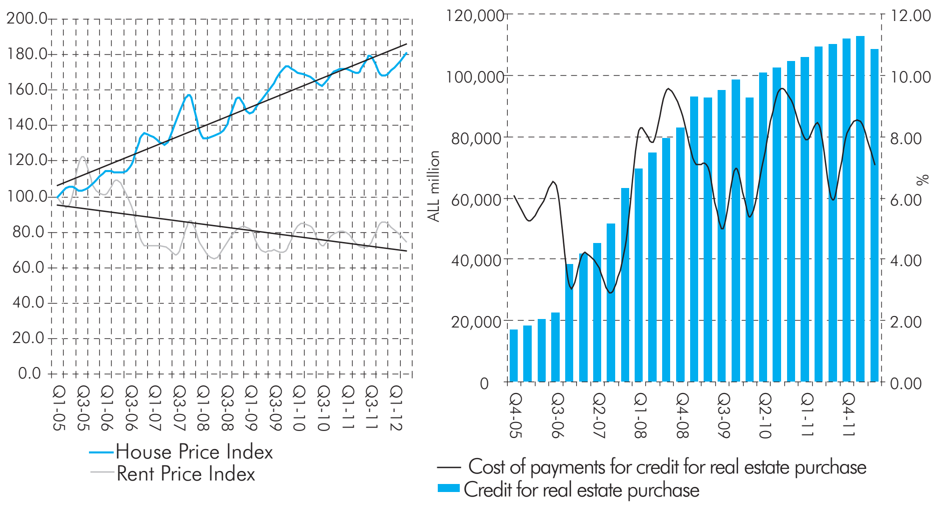
During the period under review, developments in the housing market do not show significant changes compared to previous periods, when the main indices ranged around the long-term trend. In 2012 H1, the increase in the house price index exceeded that of the rental price index. Real estate purchase loan shrank as the demand by households was low and the credit quality continued to deteriorate. The fact that the house indices have increased, while the real estate purchase loan has shrank is an indicator of the complexity of factors affecting the demand for real estate and the size of their impact during a certain period. It also signals the need to improve the index construction methodology.

### 2.2.1 HOUSING MARKET DEVELOPMENTS

During 2012 H1, the average growth of the House Price Index[8] was 3.3%, year-on-year, against the 2.3% of the Rental Price Index. Quarter on quarter, the Rental Price Index fell by 6.3%, being less than at end-2011, whereas the House Price Index increased by 3.6%, which is higher than at end-2011. At the end of the period, the House Price Index to Rental Price Index ratio stood at 2.14, from 1.96 at end-2011.

[8] *House price indices are constructed only for Tirana city.*

Chart 2.1 Housing market developments




Source: Bank of Albania.

In 2012 Q2, outstanding loans for real estate purchase shrank 0.6%, year-on-year, having expanded 6.3% in Q1. Along the same line, the relative repayment cost of real estate purchase loan fell by 1.27 percentage points in 2012 Q2 compared to a year earlier, while at year start, it had increased by 0.63 percentage points. This development[9] reflects mainly higher growth rates of house prices, which in relative terms, lowers the repayment cost of this loan. During 2012 Q2, the weighted interest rate on investment in real estate, slipped slightly, only 0.3 percentage points, year-on-year.

The real estate loan contracted also due to households' lower demand for houses, though it improved over the second quarter, compared with previous quarters.[10] Meanwhile, banks reported that overall bank lending standards for households did not change in Q2 and are expected to improve in Q3.

The portfolio quality for real estate loans continued to deteriorate. In June 2012, non-performing real estate loans stood at 13.9% from 12.55% in December 2011. Against the total credit portfolio, the portfolio quality for real estate loans is better due to a stronger connection between the borrower, the object of the loan and its collateral.

## 2.3 FINANCIAL POSITION AND RISK EXPOSURE OF HOUSEHOLDS AND BUSINESSES

Financial position of households and businesses remained unchanged from the previous period. Households' inclination to save persisted, expanding

[9] *The relative repayment cost of real estate purchase loan is calculated as a difference between the interest rate on real estate purchase loan and the average house price rise rate for the four preceding quarters. When the interest rate increases faster than the house price, the relative cost is assessed as upward and vice-versa.*

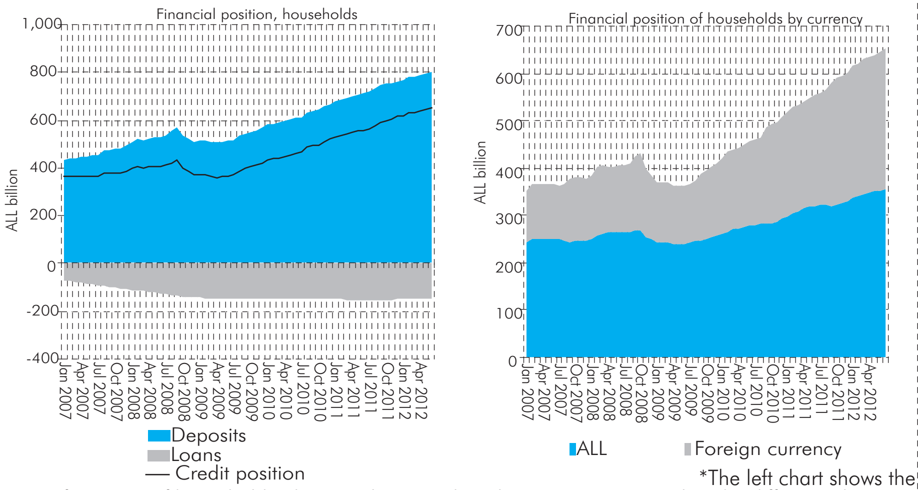
[10] *According to the Bank Lending Survey for 2012 Q2, households' demand for house purchase recorded negative values, -30.0 and -6.1 in 2012 Q1 and Q2.*

their creditor position to the financial system as deposits grew faster than loans. Businesses continued to deepen their debtor position, mostly in foreign currency. During 2012 H1, lending to businesses increased at lower pace, while lending to households shrank. Credit quality for households and businesses deteriorated. Though differently, households and businesses remained exposed to indirect credit risk arising from unfavourable exchange-rate or interest-rate movements.

### HOUSEHOLDS

At the end of 2012 H1, households' creditor position[11] amounted to ALL 653.3 billion, about ALL 93.98 billion more than in June 2011 and ALL 37.87 billion more than in December 2011. Year-on-year, household deposits at the financial system increased by ALL 87.7 billion, whereas credit narrowed by ALL 6.3 billion. By currency, households are creditors of ALL 355.3 billion in the national currency and ALL 298 billion in foreign currency. The lek credit position grew by ALL 35.1 billion from a year earlier, mainly due to ALL loans expanding faster than ALL deposits. Over the same period, credit position in foreign currency expanded ALL 64 billion, mainly owing to foreign-currency deposits.

Chart 2.2 Households' financial position in the financial system*




*The left chart shows the performance of households' deposits, loans and credit position, measured as the difference between deposits and loans. The right chart shows households' financial position in lek and foreign currency.
Source: Bank of Albania.

### 2.3.1 CREDIT RISK

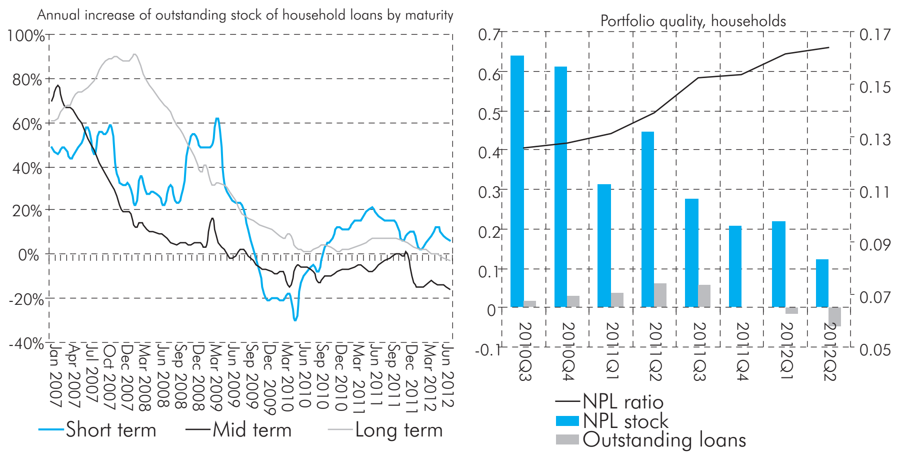
During 2012 H1, outstanding loans to households[12] shrank continuously, falling by 3.72%, y-o-y. A year earlier, outstanding loans had expanded by 5.57%. Signs of slowing down appeared in December 2011, when it expanded only 0.5% in annual terms. During this period, the medium-term credit recorded the highest contraction of 16%, whereas the long-term

[11] *Households' financial position is estimated as the difference between households' deposits and households' loans in the system. When the difference is positive, households are creditors to the system.*

[12] *Calculations do not include non-residents.*

one shrank 3%, in annual terms. Only the short-term loan to households continued to grow with positive annual rates of 6%. The loan maturity structure remained unchanged; short-term credit accounted for 6.8%, medium-term credit accounted for 13.7% and the long-term credit accounted for 79.3% to the total. The foreign-currency loans contracted most, down by 6.9% y-o-y, whereas ALL loans expanded slightly, by 1%. Therefore, as at June 2012, foreign-currency loans accounted for 55.6% of total loans to households, from 57.1% a year earlier and 56.6% in December 2011.

Chart 2.3 Household loans*




*The right chart presents the annual increase in the NPL stock; the left-hand axis shows the outstanding stock of household loans (in per cent) and the right-hand axis shows the NPL ratio (in per cent).
Source: Bank of Albania.

Credit quality deterioration reflected in the continuously increased stock of non-performing loans (NPL) has led to a higher NPL ratio for households. In June 2012, this ratio stood at 16.41%, from 15.4% at end-2011 and 13.9% in June 2011. The increase in the stock of NPLs during 2012 H1 was slower, however it is concerning, since banks have reduced lending to households. Given the sluggish economic growth and lower tendency of banks to lend, end-year expectations for higher exposure of households to credit risk are now materialised. Lending to households[13] for 2012 H2, mainly on the demand side, is expected to be similar to 2012 H1.

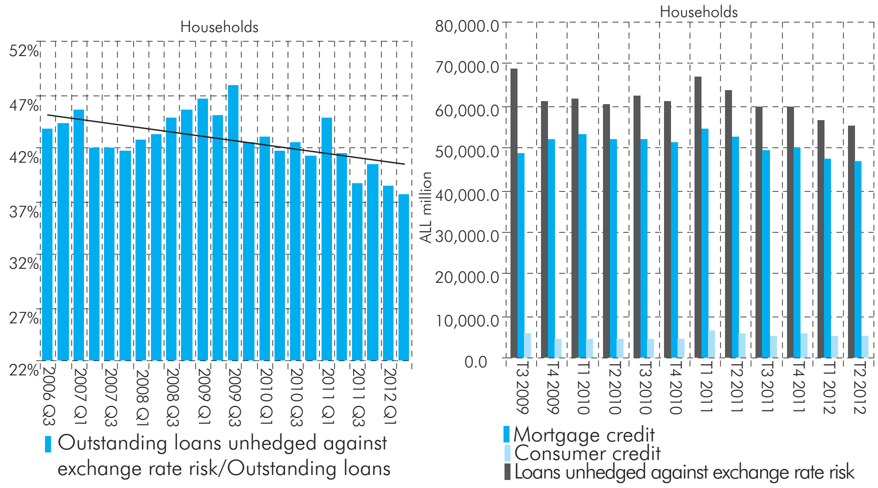
### 2.3.2 INDIRECT CREDIT RISK ARISING FROM THE EXCHANGE RATE

In June 2012, the ratio of household loans unhedged against exchange rate risk to total household loans stood at 37.7%, from 41.4% a year earlier, and 40.4% in December 2011.

House purchase loans account for about 84.5% of loans unhedged against exchange rate risk. This ratio is higher compared to 82.4% on a year earlier.

[13] *According to the Bank Lending Survey 2012 Q2, credit demand by households is downward, although banks report positive expectations for easing bank lending standards.*

Chart 2.4. Households' exposure to indrect risk from exchange rate

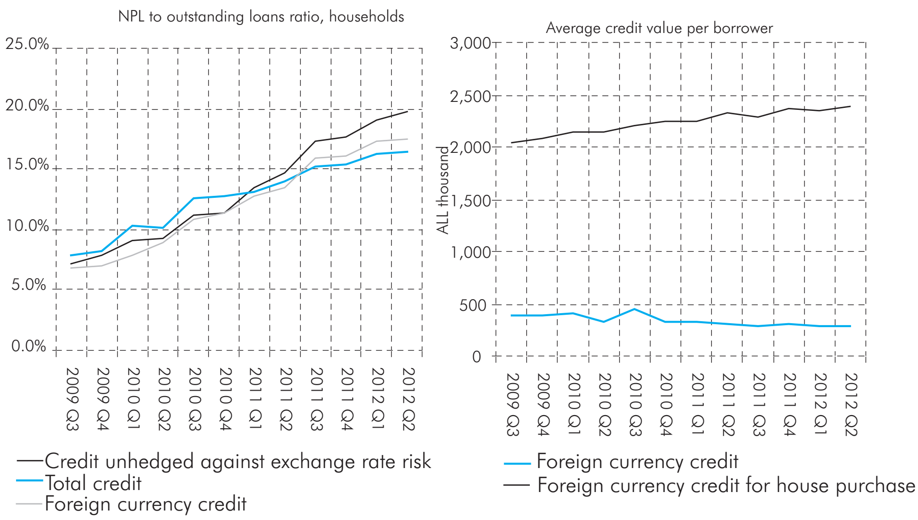



*Right chart shows credit unhedged against exchange rate for households with its two components: mortgage credit and consumer credit.

Source: Bank of Albania.

The portfolio quality for loans unhedged against the exchange rate risk deteriorated faster than the foreign-currency loan portfolio and the total loan portfolio. In June 2012, the share of non-performing household loans unhedged against the indirect exchange-rate risk rose to 19.7%, from 17.7% in December 2011 and 14.7% a year earlier.

Chart 2.5 Household loan quality




Source: Bank of Albania.

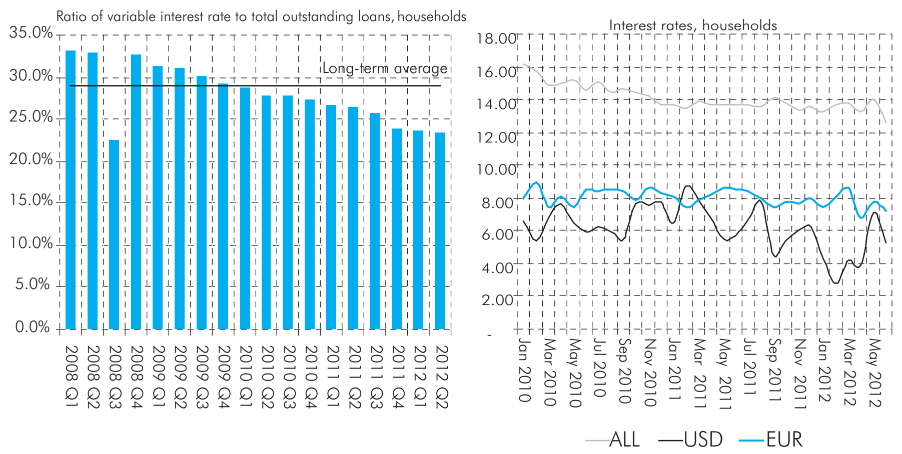
The quality indicator for foreign-currency household loans is 17.53%, whereas for total household loans is 16.41%. The quality indicator for house purchase loans is 19.9%, deteriorating by 2.4 percentage points from end-2011 and 5.8 percentage points from June 2011.

In 2012 H1, the 'house purchase loan/households' remained almost unchanged at ALL 2.38 million, from ALL 2.36 million in December 2011. Although the major part of loans unhedged against exchange rate risk is covered by collateral, its persistently deteriorating quality should be cautiously monitored. The average appreciation by 1.2% of the ALL/EUR exchange rate over this period had a positive impact on borrowers' solvency. However, other factors affecting available income could have provided a significantly adverse impact.

### 2.3.3 INDIRECT CREDIT RISK ARISING FROM THE INTEREST RATE

In 2012 H1, households' exposure to indirect credit risk arising from the interest rate continued to trend down. The ratio of variable-interest rate loans to total outstanding household loans reached 23.4%, from 23.8% in December 2011 and 26.5% a year earlier. Moreover, interest rates on household loans in both national currency and foreign currency declined.

Chart 2.6 Households' exposure to indirect credit risk arising from the interest rate




Source: Bank of Albania.

In 2012 H2, developments are expected to be determined by the balancing of interest rate determinants. On the one hand, the accommodating monetary policy at home exercises downward pressures on interest rates in the foreseeable future, whereas a tightening in bank lending standards[14] in terms of the average margin[15] will somewhat offset this effect. In global markets, interest rates on major currencies will remain low against a backdrop of economic activity slowdown.

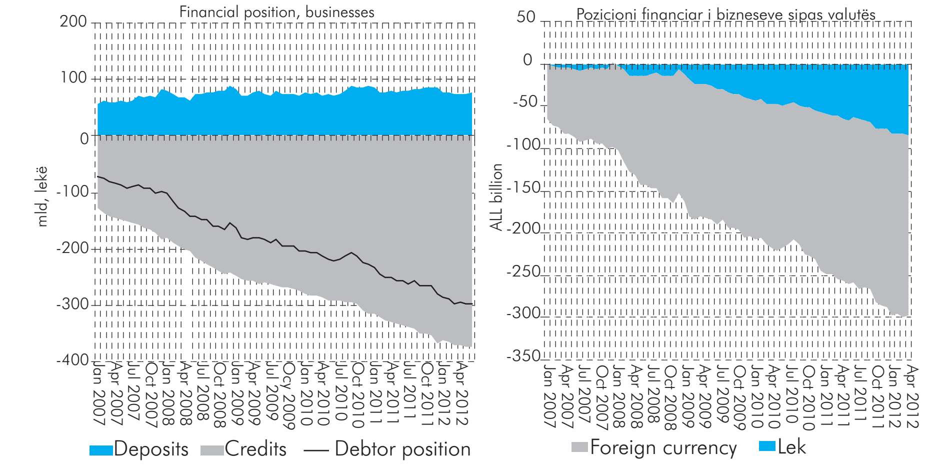
[14] *Bank Lending Survey reported that bank lending standards for businesses had slightly tightened in 2012 Q2. This policy of banks was implemented through expanding the average margin, increasing collateral requirements and commissions, and decreasing maximum credit maturity.*

[15] *The average margin is calculated as the difference between the credit interest rate and the bank reference rate (e.g. treasury bill rates, Euribor, Libor)*

*BUSINESSES*

In June 2012, businesses' debtor position [16] stood at ALL 296.5 billion, expanding ALL 40.87 billion from a year earlier and ALL 15.44 billion from December 2011. This development reflected the credit growth by ALL 38.79 billion from a year earlier, while deposits contracted by ALL 2.08 billion. By currency, businesses are debtors of ALL 84.7 billion in the national currency and ALL 211.78 billion in foreign currency. Debt position in the national currency expanded ALL 20.48 billion and in foreign currency ALL 20.39 billion, mainly owing to foreign currency credit growing faster than deposits.

Chart 2.7 Businesses' financial position*




*The left chart shows the performance of businesses' deposits, loans and debtor position measured as a difference between deposits and loans. The right chart shows the financial position of businesses in lek and foreign currency.
Source: Bank of Albania.

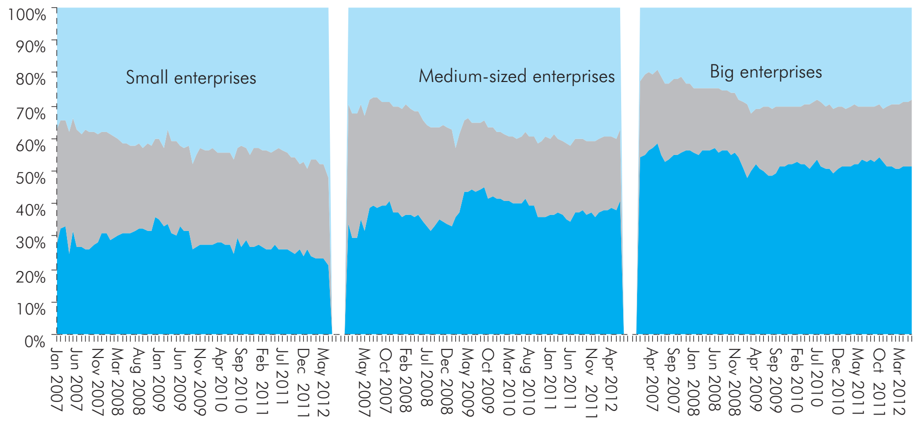
## 2.3.4 CREDIT RISK

In 2012 H1, business credit growth rates slowed down persistently. In June 2012, lending to businesses expanded by 11.9%, year-on-year, against 16.6% in December 2011 and 14.3% a year earlier. By business category, small enterprises' loans surged, whereas medium-sized enterprises' loans decelerated. Big enterprises' loans slowed down slightly, thus reducing significantly the share of long-term[17] and short-term loans, concentrating more in medium-term loans. Small enterprises reduced the share of long and medium-term loans, increasing the share of long-term loans. Medium-sized enterprises focused mainly on short-term loans.

[16] *Businesses' financial position is calculated as the difference between businesses' deposits and their loans in the system. When the difference is negative, businesses are debtors to the system.*

[17] *In June 2012, long-term credit accounted for 28.3% to the total, from 30.4% a year earlier.*

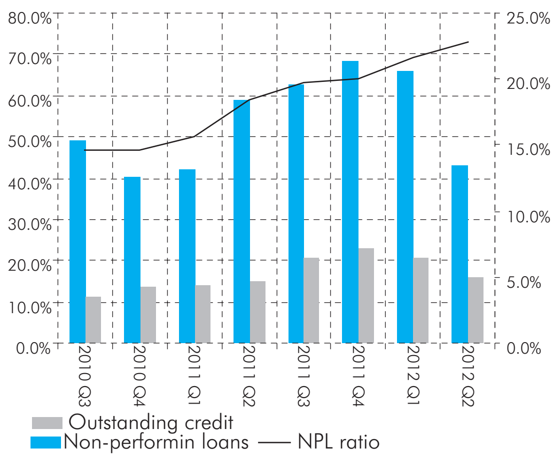
Chart 2.8 Structure of business loans by maturity




Source: Bank of Albania.

During the period under review, the NPLs deterioration pace descended to 42.9%, from 68.2% in December 2011. All the same, the increase in the NPLs level to 22.8% remains concerning.

Chart 2.9 Business portfolio quality*




*The chart presents the annual growth of the NPL stock, the outstanding credit for businesses (in per cent) on the left-hand axis and the NPL ratio (in per cent) on the right-hand axis.
Source: Bank of Albania.

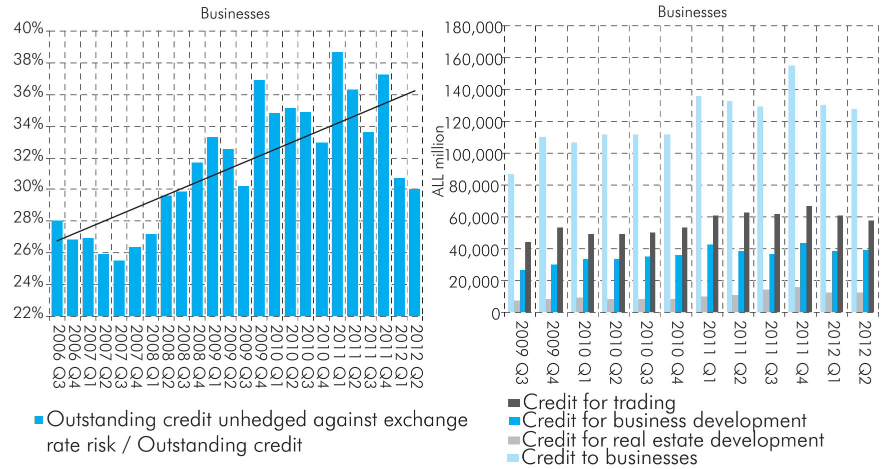
The ratio of NPLs to businesses stands about 6.4 percentage points above the NPLs to households, whose crediting contracted. Although at decelerated rates, businesses continue to be supported by loans, up 15.9% year-on-year as at end-2012 H1.

For the second half of the year, when economic activity and bank lending are expected to be similar to the first half, the credit risk for businesses will remain present.

## 2.3.5 INDIRECT CREDIT RISK ARISING FROM EXCHANGE RATE

In 2012 H1, businesses' exposure to exchange rate fluctuations was significantly down. The ratio of loans unhedged against exchange rate risk to total outstanding loans was 30%, from 37.2% at end-2011. Foreign currency loans to outstanding business loans fell to 70.4%, from 71.4% in December 2011 and 72.8% a year earlier.

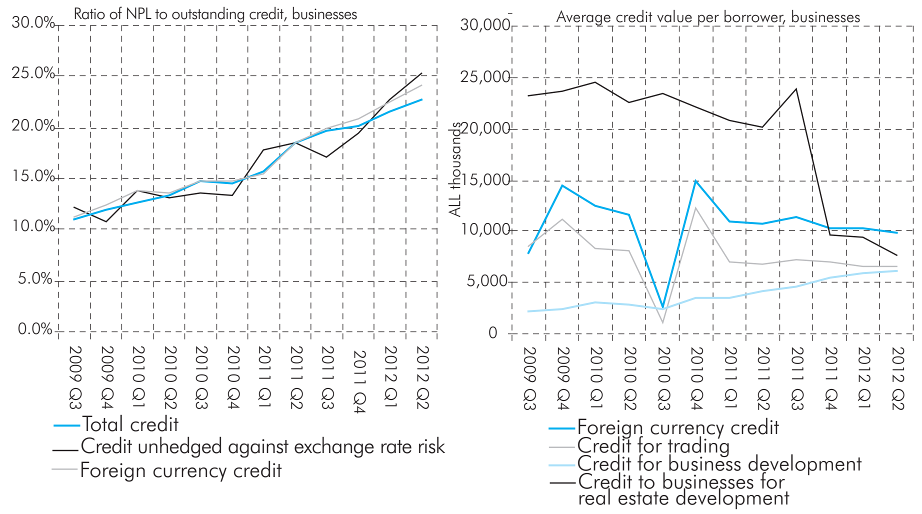
Chart 2.10 Businesses' exposure to indirect credit risk arising from the exchange rate




Source: Bank of Albania.

In 2012, business loans unhedged against exchange rate risk shrank for the first time, by 4.3%, whereas for households, the same loans had started to contract since end-2009.[18] During 2012 H1, 45.4% of business loans unhedged against indirect credit risk arising from exchange rate consists of 'trading' loans, up 2.4 percentage points from end-2011, but down 1.5 percentage points from a year earlier. The second important component of this credit is for business development, accounting for 30.5% to the total, continuously up from 2011. Real estate development loans decreased to 9.6%, from 10.4% in December 2011.

Chart 2.11 Business loan portfolio quality




Source: Bank of Albania.

[18] *Average contraction for foreign-currency loans unhedged against the risk arising from the exchange rate for households was 14.4% in 2012 H1.*

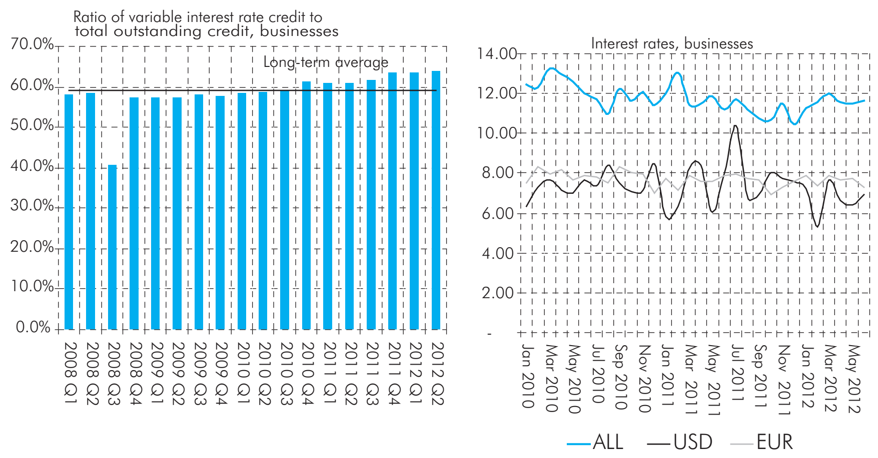
The portfolio quality for business loans unhedged against exchange rate movements deteriorated faster than the total loan portfolio and foreign-currency loan portfolio. In June 2012, the foreign-currency NPL ratio for loans unhedged against indirect credit risk arising from the exchange rate reached record highs by 25.2%. This ratio stands at 24.1% for foreign-currency business loans and 22.77% for total business loans. The quality deteriorated for all categories of foreign-currency business loans.

About 19.1% of trading loans unhedged against exchange rate risk was non-performing, from 14.1% in December 2011. Business development loans unhedged against exchange rate risk hiked to 35.8%, from 27.2% in December 2011. Business loans for real-estate development deteriorated even more sharply, reaching 37.6% from 33% at end-2011. These developments reflected the increase in the NPL stock and contraction of loans unhedged against the exchange rate risk, during 2012 H1.

### 2.3.6 INDIRECT CREDIT RISK ARISING FROM THE INTEREST RATE

In June 2012, businesses' exposure to indirect credit risk arising from interest rate increased. The ratio of variable interest rate loans to total outstanding loans for businesses reached 63.8%, from 63.5% in December 2011 and 60.8% a year earlier. It remained above the long-term average.

Chart 2.12 Businesses' exposure to indirect credit risk arising from the interest rate




Source: Bank of Albania.

In June 2012, although the interest rates on new business loans were slightly up for ALL and USD loans, they remained at lower levels than a year earlier. Hence, interest rates on business loans was down 0.46 percentage points, 1.1 percentage points and 0.55 percentage points for loans denominated in lek, US dollar and euro, respectively, against 1.07 percentage points, 0.41 percentage points and 1.22 percentage points, respectively, for households. These developments reflect the banks' tendency to support businesses with loans, however, slightly mitigating their cost.

Box 3 Survey on the financial position of households and businesses

*To support our assessment on the financial position of households and businesses, the Bank of Albania conducts a special semi-annual survey. The latest survey was conducted during June-July 2012 focusing on 2012 H1 highlights.*

## A. SURVEY ON HOUSEHOLDS' FINANCIAL POSITION AND BORROWING

- FINANCIAL POSITION

*According to survey results, during the period under review, the main source of income for households are self-employment, retirement and work in the private sector, respectively accounting for 25%, 28%, and 24% of the total number of employed persons of surveyed households. The share of 'remittances' as a source of income for 2012 H1 remained unchanged from 2011 H2, whereas the share of self-employed to the total employed has risen.*

- BORROWING

*Of total interviewed households, about 31% of the sample (373 households) responded that they had a loan to repay. The figure is up by about 4 percentage points from the previous quarter. In 43% of cases, borrowing households declared that they had borrowed from banks (39%) and other non-bank financial institutions (4%); in 54% of the cases, borrowing households responded that they had resorted to informal sources of funding from natural persons (40%) and shops (15%). In 13% of the cases, households responded that they had actually more than one loan from different sources.*

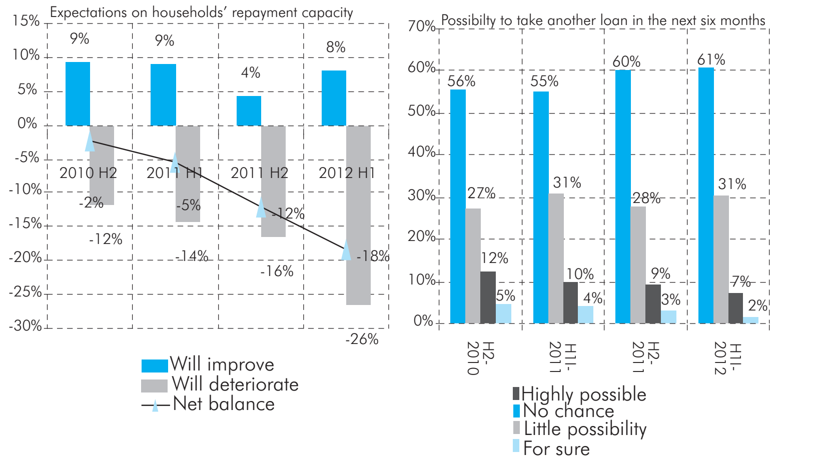
*By purpose of loan, households responded to have taken loans for 'purchase/ renovation of an immovable property' in 36% of the cases, 'consumption' in 27% of the cases and 'business development' in 16% of the cases. From six months earlier, the share of households declaring to have obtained a loan for real estate purchase/ renovation dropped by 4 percentage points, whereas the other two categories remained at similar levels. The euorisation of credit continued to be low (91% of cases in lek), mainly due to high borrowing from natural persons. The outstanding period for repaying the credit stock at the time of interview was 1-3 years in 39% of the cases and up to 12 months in 34% of the cases.*

- HOUSEHOLD DEBT BURDEN

*According to the survey, 32% of the borrowing households stated their repayment capacities had deteriorated mainly due to lower income, higher necessary expenditures or a combination of both. To cope with financial difficulties related to loan repayment, the answers reveal that in 45% of the cases households reduced their expenditures and only in 8% they sought renegotiation of credit terms.*

*In 2012 H1, about 65% of borrowing households did not expect a change in their repayment capacity, whereas about 26% expected it to deteriorate, compared to 16% in the previous survey. As regards the possibility to obtain a new loan in the next half of the year, about 61% of the respondents* answered that the possibility was inexistent.*

Chart 2.13 Net balance of answers on households' repayment capacity and respective expectations




Source: Calculations of the Financial Stability Department, Bank of Albania.

## B. SURVEY ON BUSINESSES FINANCIAL POSITION AND BORROWING

- *FINANCIAL POSITION*

*Given the lack of official data, in order to analyse businesses financial position and borrowing at home, we take into account the survey results for the first half of the year, with a sample of 712 businesses interviewed across the entire country. During this period, only 15.7% of the interviewed businesses have stated an expansion of their activity or higher investment over the last six months, whereas the majority (56.7%) had undergone no changes to their activity.*

- *BORROWING*

*Of total enterprises that responded, 56.4% (or 47.9% of the total sample) actually have a loan to pay, up by 6.5 percentage points from six months earlier. Some 29.3% of interviewed businesses (209 businesses) have funded their business activities with loans as a separate or combined source, up 3.6 percentage points from six months earlier. Sales have funded only 15.3% of enterprises in the total sample or 31.3% of respondent businesses, confirming reduction of sales during these six months, affirmed by 41.7% of interviewed enterprises. While most businesses affirm that over 80% of their products are sold in the country, economic slowdown at home leads to business sales slowdown. In this aspect, the financial result subdued during these six months, as reported by 43.5% of enterprises. In the meantime, 26.4% of them say the financial result has not changed over the same period.*

*Business activity was conducted mainly in lek for 75.3% of respondent businesses and only in lek for 17.5% of them. According to responses from businesses that had taken a loan, the outstanding loan for 52.9% of businesses is in the national currency and for 36.4% of them is in euro.*

*About 49% of the interviewed businesses had taken the loan during the last five years, whereas 29.3% of them had taken the loan during the last year. All the same, 48.4% of the loans of these enterprises will be repaid within a medium term, 29% over the long term, leaving only a few for the short term. The credit is used for short-*

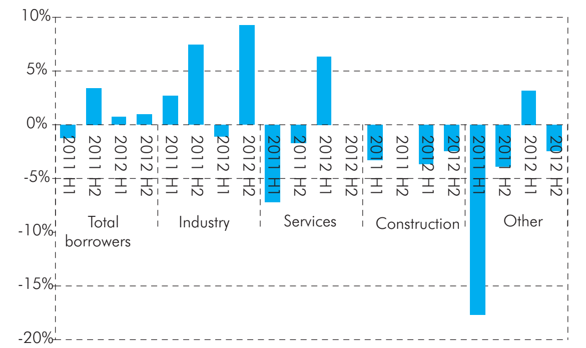
*term expenditures for 35.6% of respondent businesses, and long-term investments for 34.1% of them. 73.3% of businesses have placed an immovable property as collateral, whereas credit without collateral has continued to contract, accounting only for 2.3% of interviewed enterprises.*

- *BUSINESSES DEBT BURDEN*

*The overall credit value compared to the capital is about half for 70.4% of respondent enterprises, about 3.1% from the previous six months. About 74% of the respondent businesses affirm that, in the last six months, credit expenditures amounted to 20% of their income, whereas 19.5% of them have spent 20-50% of their income on credit repayment. Of total respondent businesses, 79% admit that their credit repayment expenditure has not changed. However, 17.2% say that this expenditure has been upward during the period under review.*

*Taking into account the expectations for the upcoming six months, of the total respondent borrowers, a slight increase of credit repayment is expected, although results differ across the sectors. Nonetheless, 67.3% of businesses do not foresee to take a loan in the second half of the year.*

Chart 2.14 Index of distribution of credit repayment expectations*




*This index is constructed by quantifying qualitative answers on businesses expectations on total loan repayment in the next six months. It is calculated as a weighted average of answers frequency and value for each alternative. The values are as follows: 0 = will not change, 1 = will increase, -1 = will not increase.

Source: Calculations of the FS Department, Bank of Albania.

* *This question was addressed to the entire sample of households (1209), but 85% of them answered it (1027 households).*

# 3. FINANCIAL MARKETS

In the first half of 2012, the activity in financial markets increased. The interbank market was characterised by higher transaction volumes, hence proving adequate liquidity and a more stable perception about interest rates by market operators. A key development in the financial markets was the unexpected decision by a major bank operating in Albania, a member of an important European banking group, to withdraw from the Albanian Government debt auctions. The reason was the requirement of the regulatory authority at the bank's home country, in the light of European Banking Authority recommendations to improve capital indicators of larger European banking groups. The liquidity supply from other banks of the sector and the strong support by the Bank of Albania succeeded to fill in the resultant vacuum and maintain low volatility of interest rates on government debt securities. This event, however, while testing the framework of the Bank of Albania for operations in the market, evidenced the need for boosted competition in the banking market, expansion of the base of investors in government debt securities and improvement of the secondary market functioning to decrease the concentration of debt distribution and hedge the re-financing risk. During the period under review, 12-month maturity bonds were dominant, to better respond to the preference of market participants. During this period, the secondary market of securities experienced higher trading volume, reflecting thus the transactions between banks to adapt to structural changes of liquidity in the market and entrance of new non-bank operators. The trading volume of foreign exchange market increased, as well. In this market, the national currency has been stable against the major currencies basket. Following is a detailed analysis of the performance of each market.

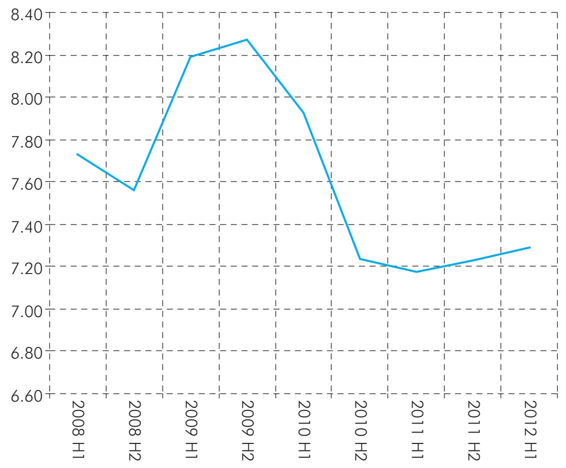
## 3.1 PRIMARY MARKET OF DEBT SECURITIES

The volume of government debt securities issued during 2012 H1 increased to ALL 231.4 billion from ALL 185.6 billion six months earlier. By component, T-bills account for 82.2% and notes/bonds account for 17.8% of the total value. During 2012 H1, the share of debt with longer than one-year maturity in the total existing debt increased 3.2 percentage points.

The average interest rate of the debt issued during the period under review was up 0.06 percentage points, reaching 7.29%. Compared to six months earlier, the average interest rate of treasury bills was down, while that of the debt with longer than one-year maturity was up, hence contributing to higher average interest rate on total debt.

At the end of 2012 H1, the treasury bills reached ALL 190.2 billion from ALL 158.4 billion at end-2011. The volume of issued instruments surged 20.1% from end-2011, and 4% year-on-year. Compared to end-2011, the higher volume of issued treasury bills is attributed to the increase in 12-month maturity bills by ALL 41 billion or 47.6%, whereas 6-month maturity bills decreased by ALL 1.3 billion or 2.9% and 3-month maturity bills were down by ALL 7.9 billion or 28.5%. At the end of the period under review, in the existing treasury bills debt, 12-month maturity bills accounted for 66.9%; 6-month maturity bills accounted for 22.6%; and 3-month maturity bills accounted for 10.5%. Regarding the debt issued in treasury bills, the issue has shifted towards the 12-month maturity, in response to the preference of investing entities.

Chart 3.1.1 Average interest rate on debt issued in securities (in %)

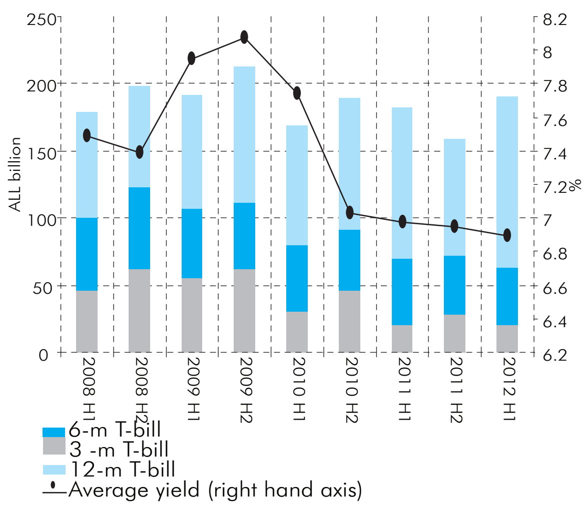



Source: Bank of Albania.

The average interest rate continues its slight fall. At the end of the period under review, it stood at 6.9% or 0.05 percentage points lower than at end-2011 and 0.08 percentage points lower, year-on-year. This level is 0.5 percentage points lower than its four-year average.

During the period under review, the issue of debt in the form of notes/bonds surged, reaching ALL 41.2 billion or 51.7% higher from end-2011 and 18.8%, year-on-year. Among these issues, the 2-year maturity bonds account for 52.5% of the value, followed by 5-year maturity bonds with variable interest rate accounting for 23.5%, 3-year maturity bonds accounting for 12.8%, 5-year maturity bonds with fixed interest rate accounting for 5.1%, and 7-year maturity bonds with variable and fixed interest rate, together accounting for 6% of the value. Compared with end-2011, the 2-year maturity debt hiked ALL 4.4 billion or 25.6%. The 3-year maturity debt almost doubled reaching ALL 3.5 billion.

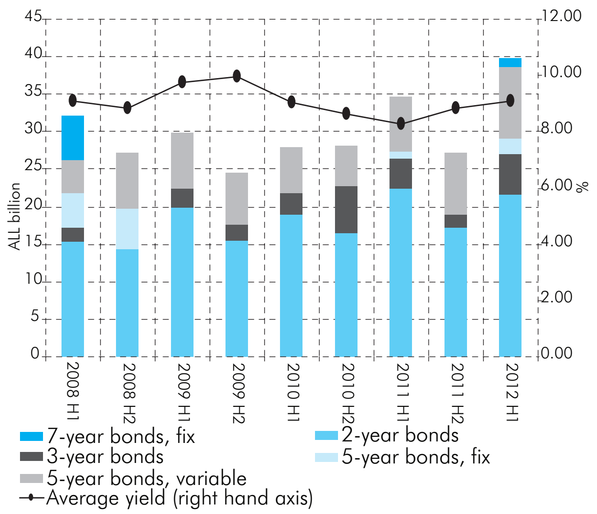
Chart 3.1.2 Volume and yields in the primary market




Source: Bank of Albania.

The interest rate on these instruments continued the uptrend observed since the past year. However, it stands only 0.04 percentage points higher than the 4-year average.

Chart 3.1.3 Bond auctions volume and average yield




Source: Bank of Albania.

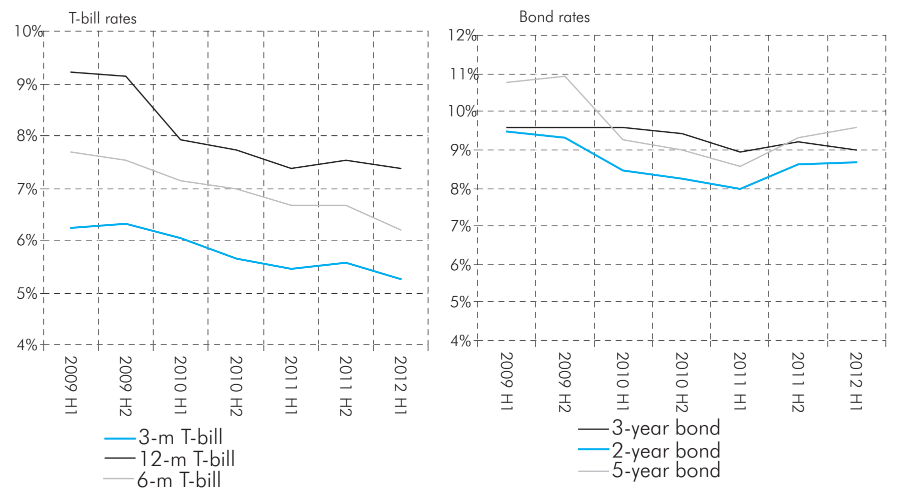
Following are yields by maturity of government debt securities.

## 3.2 SECONDARY MARKET OF DEBT SECURITIES

In 2012 H1, the trading of securities in the secondary market was considerably active and treasury bills continued to dominate this trading.

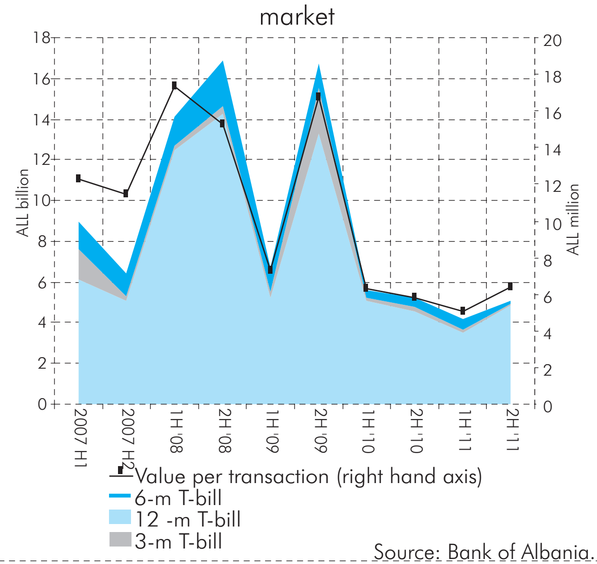
The volume of treasury bills transactions, in nominal value, recorded ALL 18.4 billion, almost twice higher than the trading value during 2011 (ALL 9.3 billion). 12-month maturity bills continued to register the highest values of trading, although during the period under review, the traded volume of 3-month maturity bills saw rapid growth.

Chart 3.1.4 Average interest rate on debt in the primary market




Source: Bank of Albania.

Chart 3.2.1 Trading volume of bills in the secondary market




Source: Bank of Albania.

## 3.3 INTERBANK MARKET

The volume of transactions in the interbank market surged 42.9% during 2012 H1. Year-on-year, the volume of the interbank market almost doubled. A series of factors mentioned earlier have contributed to this development, such as banks' response to adapt to structural changes of liquidity in the market, lower growth rates of lending, and higher deposits. These factors have contributed in general to the increase in available funds for interbank market transactions and have exerted downward pressure on interest rates in this market.

Among transactions in the interbank market, overnight transactions continue to prevail, although the number of transactions with 1-week and 1-month maturity has also been up. During the period under review, higher volumes of transactions for each maturity took place in March, when the first liquidity structural changes were materialised by market operators.

Easing monetary policy during the first six months of the year was also reflected in interest rates in the interbank market. The weighted average fell to 4.17% from 5.12% six months earlier. The same trend is transmitted also to new loans and deposits interest rates in the national currency (more detailed in the respective paragraphs on loans and deposits).

As regards the interest rate by maturity of transaction, the rates for overnight and 1-week transactions were higher in the first quarter and lower in the second quarter, compared to the key interest rate. This deviation minimised at end-June 2012.

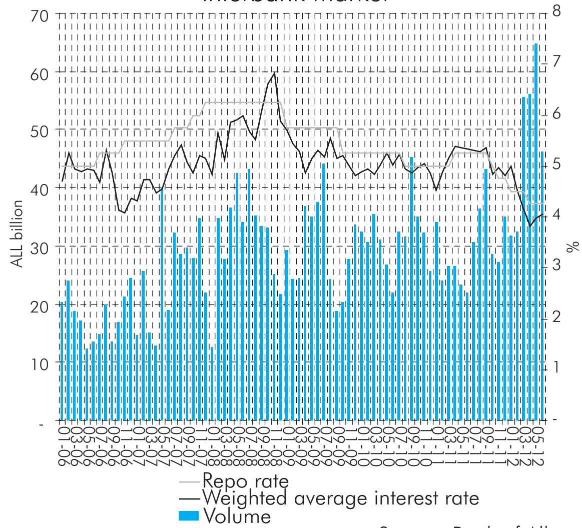
## 3.4 FOREIGN EXCHANGE MARKET

The exchange rate of the euro against major currencies was stable, reflecting their performance in international forex markets.

Year-on-year, the national currency appreciated against the euro about 2.4%, and depreciated against the U.S. dollar about 12.0%. Since end-2011, the Albanian lek has been steady against the euro, and depreciated about 5.1% against the U.S. dollar.

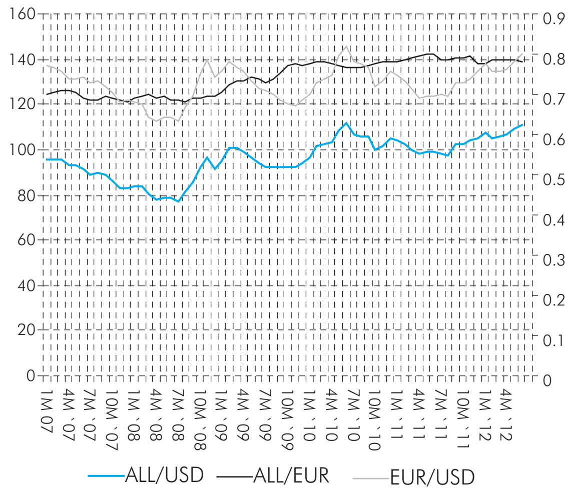
In real terms, during the period under review, the nominal effective exchange rate (NEER) and the real effective exchange rate (REER) reinforced their annual trend, weakening 1.3% and 1.8%, respectively. This performance supports Albanian products competitiveness in foreign markets, in terms of their price. This effect, however, is moderate while other factors related to product quality and their tradeability are very important and our imports and exports have low sensitivity to price change.

Chart 3.3.1 Volume and interest rates in the interbank market



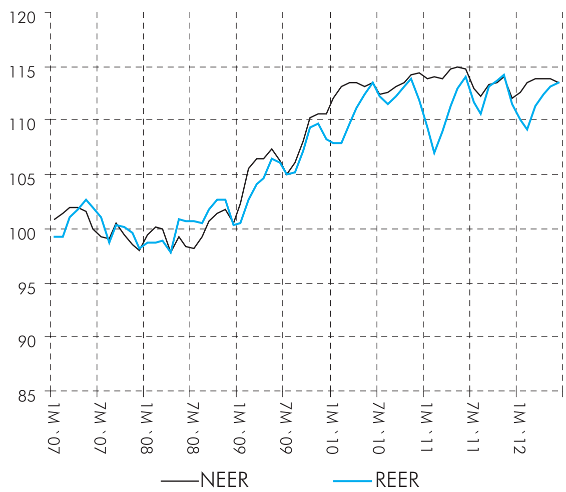
Source: Bank of Albania.

Chart 3.4.1 Exchange rate for the three major currencies



Source: Bank of Albania.

Chart 3.4.2 Nominal effective exchange rate (NEER) and real effective exchange rate (REER)



Source: Bank of Albania.

# 4. PAYMENT SYSTEMS DEVELOPMENTS IN 2012 H1

## 4.1 PAYMENT SYSTEMS PERFORMANCE

Payment systems constitute an important part of the structure of a financial system as channels through which the transfer of funds between banks, other financial institutions and customers takes place. As a consequence, their stable and efficient operation contributes significantly to safeguarding financial stability. In this context, AIPS and AECH systems, the basic infrastructure of lek payments, have operated in compliance with the requirements under their regulatory and operational framework.

Statistical information on the values and volumes of transactions processed by both systems during January-June 2012 shows a considerable increase in the value of transactions and a stable increase in their number. The considerable increase in the value of transactions processed in the AIPS attributed mainly to 'Bank of Albania's transactions/financial instruments' and 'Interbank transactions', reflecting banks' operations in the interbank market to adjust to the liquidity structural changes.

*Table 4.1 AIPS operations by type of transactions in 2012 H1*

| AIPS | January-June 2011 | January-June 2012 |
|---|---|---|
| Number of transactions | 37,045.00 | 37,250.00 |
| Value of transactions (in ALL billion) | 1,873.23 | 2,670.66 |
| Average value per transaction (in ALL millions) | 50.57 | 71.70 |

*Source: Bank of Albania.*

*Table 4.2 AECH operations by type of transactions during January-June 2012*

| AECH system | January-June 2011 | January-June 2012 |
|---|---|---|
| Number of transactions | 183,342 | 183,621 |
| Value of transactions (in ALL millions) | 28,624 | 32,257 |
| Average value per transaction (in ALL millions) | 0.16 | 0.18 |

*Source: Bank of Albania.*

The data show that the four most active banks in the system account for 26.2% of the number of transactions and 45.1% of their value.

Concerning payment instruments, total payments are dominated by credit transfers. Their share, however, has been downward in favour of electronic payments, card-based payments, direct debit and home banking.

*Table 4.3 Distribution of payments per customer by type of instrument during January-June 2012*

| | Number | | | | | Value | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2008 | 2009 | 2010 | 2011 | 2012 | 2008 | 2009 | 2010 | 2011 | 2012 |
| Credit transfers initiated by customers | 88.30% | 82.16% | 81.08% | 79.15% | 75.58% | 97.96% | 96.08% | 94.25% | 95.23% | 94.53% |
| 1- paper-based credit transfer | 98.42% | 97.59% | 97.29% | 97.05% | 96.61% | 98.27% | 97.93% | 97.15% | 97.25% | 96.71% |
| 2- non-paper-based credit transfer | 1.58% | 2.41% | 2.71% | 2.95% | 3.39% | 1.73% | 2.07% | 2.85% | 2.75% | 3.29% |
| Card-based payments initiated by customers | 4.60% | 5.85% | 7.15% | 9.33% | 11.90% | 0.11% | 0.14% | 0.22% | 0.28% | 0.35% |
| Direct debit | 5.53% | 10.94% | 10.84% | 10.75% | 11.81% | 0.48% | 1.79% | 3.55% | 2.29% | 2.81% |
| Cheques | 1.56% | 1.06% | 0.93% | 0.77% | 0.71% | 1.44% | 1.99% | 1.99% | 2.20% | 2.31% |

*Source: Bank of Albania.*

# 5. FINANCIAL SYSTEM DEVELOPMENTS

Financial developments appear stable. The banking sector is well-capitalized and liquid. Profitability figures have increased; however, assets have grown at a lower rate compared to the previous year. The annual growth rate of loans is lower, while deposits continue to grow at stable rates. Non-bank financial institutions and savings and loan associations have expanded their activity, while that of insurance companies has slowed down. The private supplementary pension market shows a positive, albeit limited, performance, reflected in the asset increase of pension fund managing companies. One investment fund entered the market and expanded its activity rapidly during the period under review. In addition to the positive developments in the financial system, credit risk remains the major risk to lending institutions operating in Albania.

The level of financial intermediation in Albania, as measured by the ratio of financial system assets[19] to GDP, was estimated at 92.8% at end-June 2012, compared to 89.5% at end-2011 and 86.9% in the same period of 2011. The volume of financial institutions' assets grew by about 4.2% compared to 2011 H2 and by about 11.6% compared to 2011 H1. The banking sector remains the dominant segment of financial intermediation in Albania. Its assets account for about 93.9% of total financial system assets and about 87.2% of GDP.

*Table 5.1 Financial system segments as a percentage of GDP across the years*

| Licensing and Supervisory Authority | Financial System | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 H1 |
|---|---|---|---|---|---|---|---|
| Bank of Albania | Banking system | 75.9 | 76.7 | 77.5 | 80.9 | 84.7 | 87.2 |
| | Non-bank institutions | 1.5 | 1.7 | 2.2 | 2.7 | 2.5 | 2.5 |
| | SLAs and their Unions | 0.6 | 0.7 | 0.8 | 0.8 | 0.7 | 0.7 |
| Albanian Financial Supervisory Authority | Insurance companies | 1.4 | 1.4 | 1.5 | 1.4 | 1.5 | 1.5 |
| | Pension funds | - | - | 0.01 | 0.01 | 0.01 | 0.01 |
| | Investment funds | | | | | | 0.86 |

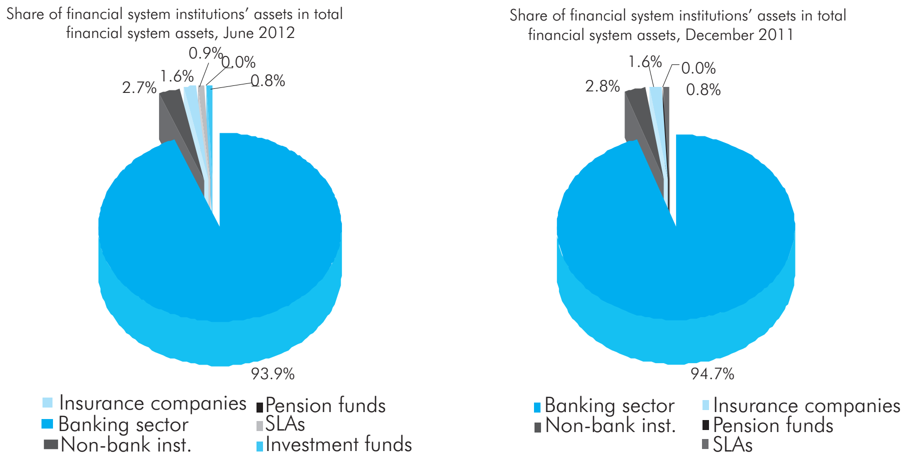
*Source: Bank of Albania, Albanian Financial Supervisory Authority.*

Non-bank financial sector continues to share a small weight in total financial system. Total non-bank financial sector assets[20] account for about 6.1% of the financial system, hence higher compared to 5.3% at end-2011. This increase attributes to the entry of 'Raiffeisen Prestigj' investment fund into the market during the period under review. At the end of the period, non-bank financial sector's activity as a percentage of GDP was 5.6%.

[19] *The financial system consists of banks, non-bank financial institutions, savings and loan associations (SLAs), insurance companies, private supplementary pension funds and investment funds. While reading the analysis of this chapter, please consider that the activity of non-bank financial institutions is based on data as reported by them and on Financial Stability Department assessments.*

[20] *The information on total pension fund assets has been obtained from the latest AFSA's publication of 19 June 2012.*

Chart 5.1 Financial system institutions as a percentage of total financial system assets



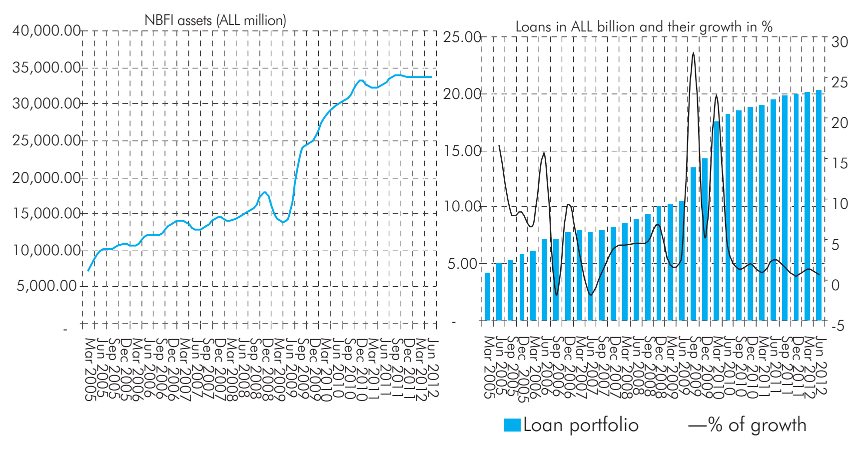

Source: Bank of Albania, Albanian Financial Supervisory Authority.

Box 5.1 Non-Bank Financial Sector

## ACTIVITY OF NON-BANK FINANCIAL INSTITUTIONS

*Non-bank financial institutions are licensed and supervised by the Bank of Albania. As at the end of 2012 H1, non-bank financial institutions' assets totalled ALL 33.8 billion, about ALL 115.5 million (or 0.3%) more than at end-2011 and ALL 1.1 billion (or 3.4%) more than in the same period of 2011. Lending activity has the main share in non-bank financial institutions' activity, accounting for 60% of total assets. Despite recording positive growth rates, the loan portfolio has maintained a downward trend since 2010 H2.*

Chart 5.2 Non-bank financial institutions' assets and loan portfolio

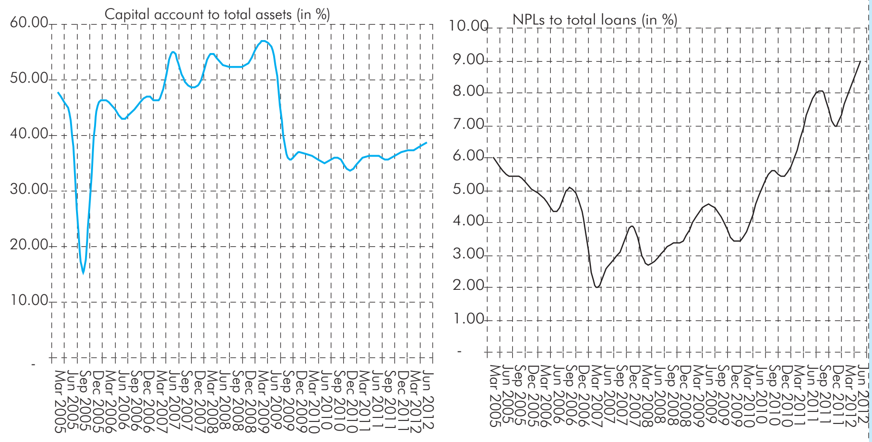



Source: Bank of Albania.

*Capitalisation, as measured by the ratio of capital account to total assets, rose to 38.5% in 2012 H2, compared to 36.8% at end-2011 and 36.4% in the corresponding period in 2011.*

*The loan portfolio quality for non-bank financial institutions deteriorated further compared to end-2011 and the same period of 2011. More specifically, the ratio of non-performing loans to total loans rose to 8.9%, from 6.9% at end-2011 H2 and 7.6% in 2011 H1. The deterioration in the loan quality reflects the overall economic growth slowdown and a generally more challenging environment for borrowers.*

Chart 5.3 Capital adequacy and non-performing loan ratio (in %)




Source: Bank of Albania.

*Profit of non-bank financial institutions increased in 2012 H1. Net profit was estimated at ALL 788 million, compared to ALL 742 million in the corresponding period in 2011. For the same stated period, income amounted to ALL 3.9 billion, from ALL 3.7 billion in the previous year. 'Income from commissions' provided the major contribution to the increase in income. They rose by ALL 256 million, hence offsetting the negative effect of the decline in interest income, which fell by ALL 26 million.*

## ACTIVITY OF SAVINGS AND LOAN ASSOCIATIONS (SLAS)

*During 2012 H1, SLAs registered positive developments in asset and loan portfolio growth compared to end-2011. They, however, deepened the financial loss versus the previous year, mainly due to the deteriorated loan portfolio quality.*

*Table 5.2 Selected indicators of SLAs and their unions*

| | 2010 H1 | 2010 H2 | 2011 H1 | 2011 H2 | 2012 H1 |
|---|---|---|---|---|---|
| Total assets (in ALL millions) | 9,378.00 | 9,705.00 | 9,649.57 | 9,808.68 | 9,901.69 |
| Outstanding loans (in ALL millions) | 7,125.00 | 7,072.00 | 6,946.58 | 7,118.68 | 7,261.55 |
| Outstanding loans/total assets (%) | 75.90 | 72.80 | 71.99 | 72.58 | 73.34 |
| Non-performing loans (in ALL millions) | 237.10 | 357.90 | 315.11 | 315.65 | 389.20 |
| Non-performing loans/ outstanding loans (%) | 3.30 | 5.06 | 4.54 | 4.40 | 5.36 |

*Source: Bank of Albania.*

*SLAs and their unions deepened their financial loss to ALL 35.9 million, compared to the positive profit of ALL 9.6 million in the previous year. This financial loss owes mainly to the higher provisions of one financial union and the increase in administrative expenses and other.*

## ACTIVITY OF INSURANCE COMPANIES AND PRIVATE SUPPLEMENTARY PENSION FUNDS

*During January-June 2012*, the insurance market registered a deceleration in its activity. Premium income fell and the number of new contracts declined. This deceleration was also reflected in the level of capitalisation and RoE and RoA. The insurance market remains oriented towards non-life insurance.*

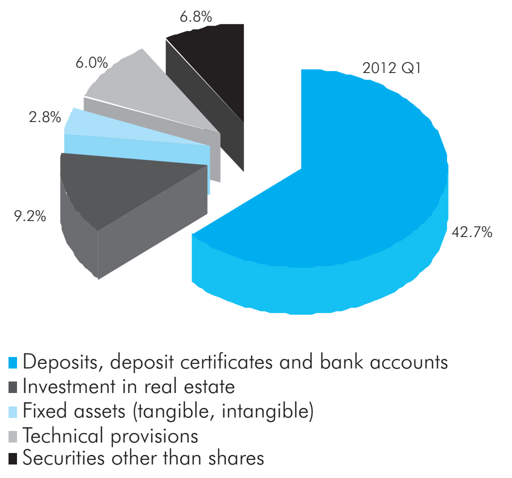
*During January-June 2012, insurance premium income amounted to about ALL 4,072 million or 5.56% less than in the corresponding period in 2011. Over the same stated period, paid claims totalled ALL 1,501 million or 35.9% more than in the previous year. Consequently, claim-to-premium ratio, which also measures the penetration of the insurance market into the financial system, recorded substantial increase to 36.8%, from 26% at end-2011. The number of insurance contracts decreased by about 25.4% from the same period of 2011.*

*The insurance market remained oriented towards non-life insurance, which accounted for about 88.63% of total premium volume. Broken down by type of insurance, gross written premiums of voluntary insurance accounted for 54.48% and those of compulsory insurance accounted for the rest, 45.52%, of the total insurance market.*

*Insurance sector's assets** amounted to about ALL 19.6 billion in 2012 Q1, slightly up by ALL 234 million (or 1.21%) from end-2011 and by ALL 1.3 billion (or 7.3%) from the same period of 2011. 'Deposits, certificates of deposits and bank accounts' have the major share in total insurance companies' assets by about 42.7%.*

*'Capital to technical provisions' ratio, which measures the insurance companies' capacity to cover losses, fell to 132% in 2012 Q1, compared to 133.8% at end-2011 and 172% in the corresponding period in 2011. The lower ratio owes to the higher increase in technical provisions, thereby signalling greater expectations for risk exposure in the activity of insurance in Albania.*

Chart 5.4 Share of insurance companies' asset items in total assets (in %)




Source: Albanian Financial Supervisory Authority.

*Insurance companies registered lower profit. In 2012 Q1, it was estimated at ALL 46.7 million, compared to ALL 331.8 million in the previous year. The significantly lower profit was also reflected in both return indicators, RoA and RoE, which fell to 0.25% and 0.44%, respectively, compared to 1.9% and 3.4% in 2011.*

*Private supplementary pension market registered a positive performance in 2012 Q1. Its assets increased to ALL 194.8 million, compared to about ALL 154.7 million in the same period of 2011. There remain 3 private pension fund managing companies in Albania.*

*'Raiffeisen Prestigj' investment fund, which was licensed at end-2011, commenced its activity in 2012 H1. At the end of the period, this investment fund's assets totalled ALL 11.4 billion, accounting for 0.92% of total financial system assets.*

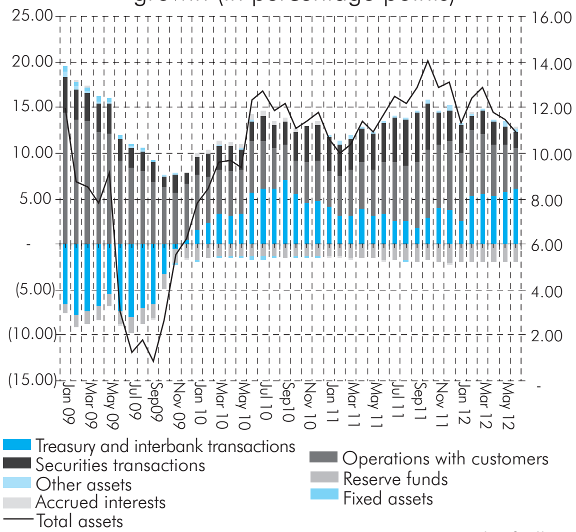
* According to AFSA's statistical release "Insurance Market, January-June 2012".
** According to the last reporting of insurance companies' balance sheets to the Bank of Albania.

# 6. BANKING SECTOR

## 6.1 ASSET AND LIABILITY PERFORMANCE AND COMPOSITION

Total banking sector assets account for about 82% of Albania's GDP. In 2012 H1, they increased by about 3.4% from end-2011 and by about 11% from the same period of 2011. The historical performance of banking sector assets has been volatile due to changes in the contribution of key asset items (see Chart 6.1.1).

Chart 6.1.1 Contribution of asset items to asset growth (in percentage points)




Source: Bank of Albania.

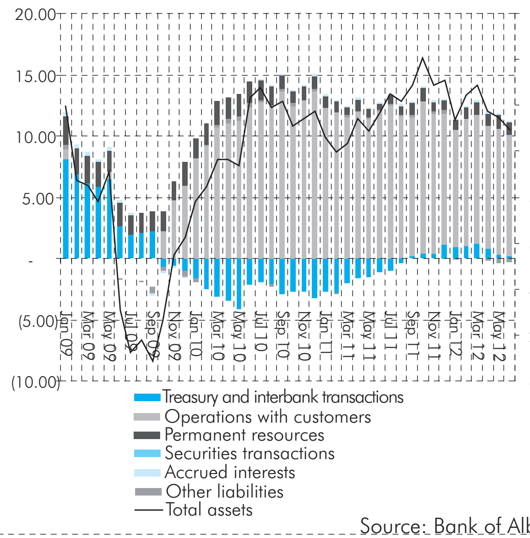
The contribution of lending activity (represented by 'operations with customers') dominates the asset performance. However, its contribution has been declining due to decelerated economic growth and a more cautious bank lending approach. In addition, the post-global financial crisis developments brought about a deteriorated loan portfolio quality, yielding in turn, increased provisions, which have contracted the normal performance of assets and have adversely affected the banking sector's profitability. The high demand for sovereign debt financing has kept the contribution of 'Treasury and interbank transactions' to the banking sector's assets at high levels.

Banking activity has been recently entirely financed (on the liability-side) through deposits (represented by 'Operations with customers'). This is considered a positive development as it contributes to maintaining a stable banking sector liquidity situation. On the other hand, this development points out the need to preserve public confidence in the banking sector.

Banks have stabilized the ratio of capital use ('Permanent resources') to finance their activity, adjusting at the same time to the supervisory authority's requirements for capital boost in view of observing the regulatory requirements. Capital use has been an important source of banking activity financing when the global financial crisis burst (2008-09), followed by the Bank of Albania's operations to inject liquidity and safeguard Albania's financial system stability.

Five banks continue to dominate the Albanian banking sector. Altogether, they account for about 68% of lending and 75% of public deposits. This implies that they play an important role in lending to the economy and in the Albanian financial system's performance and stability.

Chart 6.1.2 Annual financing of banking sector assets (in percentage points)



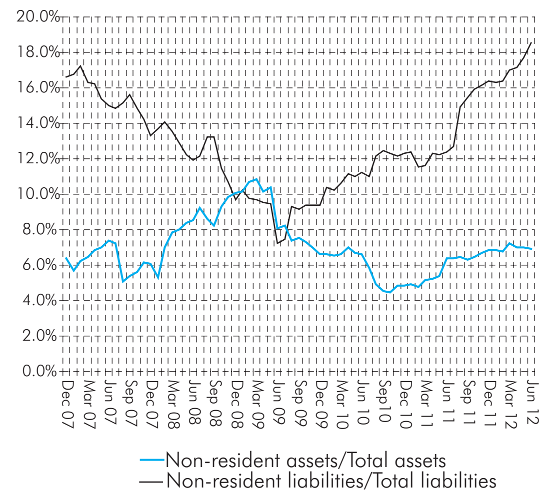

Source: Bank of Albania.

## 6.2 BANKING SECTOR'S POSITION TO NON-RESIDENTS

There are higher banking sector investments in non-resident institutions' assets. Placements in the form of current accounts and deposits have increased. In addition, there has been a lower use of credit lines from the parent banks. These developments provide evidence for an improved liquidity situation in the banking sector during the period under review.

Banking sector investments in non-resident institutions' assets amounted to ALL 214.5 billion, up by about 17% from end-2011 and about 66% y-o-y. Banking sector placements with non-resident institutions increased by 25% on a semi-annual basis, and 77% y-o-y, mainly due to the increase in current accounts and deposits. Assets held with non-resident institutions account for 18.5% of total assets, up from end-2011 and the corresponding period in 2011.

Chart 6.2.1 Banking sector's position to non-residents (in %)




Source: Bank of Albania.

Banking sector liabilities to non-residents totalled ALL 79.8 billion, accounting for 6.8% of total liabilities. Out of these liabilities, those to the parent banks have the major share.

Credit lines from parent banks decreased over the period under review. The same tendency has been noted in the performance of the used and unused portion of the credit lines.

*Table 6.1 Commitments received from parent banks and other group banks*

| In ALL million | Total credit line | Used credit line | Unused credit line |
|---|---|---|---|
| June 2012 | 55,510.84 | 13,750.17 | 41,760.67 |
| December 2011 | 63,422.40 | 16,903.90 | 46,518.50 |
| June 2011 | 65,582.53 | 19,504.29 | 46,078.24 |

*Source: Bank of Albania.*

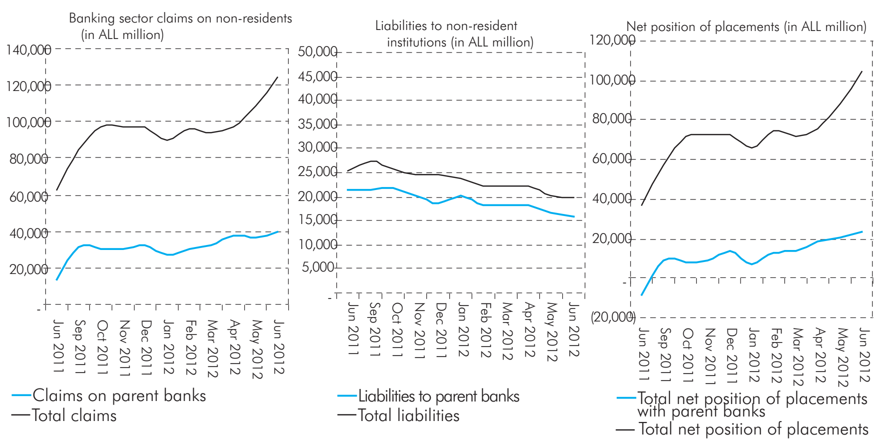
The above analysis, which evidences that banking sector assets to non-residents are almost three times higher than liabilities to non-residents, shows that there is low dependence of the Albanian banking sector on parent banks. However, individual banks display a more significant dependence on their parent banks, which requires cautious monitoring. On the other hand, European banks, which hold some of the banks operating in Albania, have been affected considerably by the global financial crisis. The diffusion of their concerns to banks operating in Albania represents a potential risk channel. Banks should, therefore, estimate the level of this type of risk and assess their stability by building scenarios that respond to the reality of the global financial developments.

*Box 6.2 Banking Sector Exposure to Non-Residents*

*Share in total assets: At the end of June 2012*, total claims on non-residents accounted for 10.8% of total assets and those on parent banks accounted for 3.4%. Liabilities to non-residents accounted for 1.7% of liabilities and those to parent banks accounted for 1.4%.*

*Performance: Total claims on non-resident institutions increased in 2012 H1 compared to the same period of 2011 and end-2011. Total claims almost doubled from a year earlier and increased by 27.9% compared to end-2011. Claims on parent banks operating in Albania maintained a similar tendency. In absolute terms, they nearly tripled, while increasing by 21.1% from end-2011. At the end of June 2012, claims on parent banks accounted for 31.8% of total banking sector's claims on non-residents. On the liability side, the Albanian banking sector's total liabilities to non-resident institutions declined by 22.6% from June 2011 and 19.8% from end-2011.*

Chart 6.2.2 Banking sector exposure to non-residents




Source: Banks' operational data and Financial Stability Department's processed data.

*Net position of exposure to non-residents: The banking sector shows a positive net position to non-residents. This position is considerably higher than a year earlier* *and, in the case of operations with parent banks, it has shifted from negative to positive values.*

*Maturity structure of exposures: The major part of claims on non-residents is of short maturity term. At the end of June 2012, up to 1-month claims accounted for 81.6% of time claims, while up to 1-month liabilities accounted for 11.4% of time liabilities. Liabilities maturing in more than 6 months have the major share in liabilities, accounting for 88.6% of the total.*

*Composition by currency: In June 2012, claims on non-residents were mainly denominated in euro, at 78.6%, while the share of euro-denominated claims on parent banks was higher, at 87.7%. Liabilities to non-residents show a similar setting, with the euro being the currency for 98.5% of total liabilities and for 98.25% of liabilities to parent banks.*

*Composition of exposure by bank capital origin: Out of total claims on non-residents, Greek group claims share 18% of the total, Italian group claims share 14.4%, French group claims share 8.2% and the Albanian group claims share 4.5%. Relative to end-2011, total claims on non-residents were higher for the Greek, Italian and French groups, and lower for the Albanian group. Claims on parent banks were volatile. Compared to end-2011, they increased for the Italian and French groups but declined sharply for the Greek group. At the end of June 2012, the French group had the largest share in total liabilities to non-residents, 57.6%, followed by the Greek group, 26%, and the Italian group, 10.5%. Liabilities to parent banks show a similar performance since a considerable portion of total liabilities to non-residents are liabilities to parent banks. There is a negative net position of exposure for the French group, although its size has reduced significantly. The Italian and Greek groups show a positive and increasing position, though the Greek one has displayed higher volatility.*

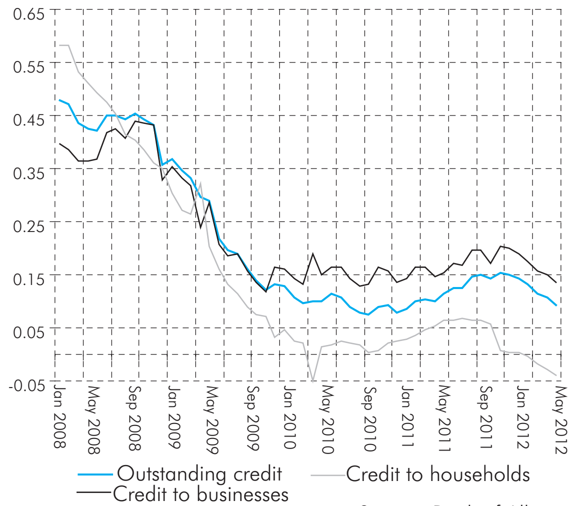
* *The box outlines operational data reported by the Albanian banking sector on operations with non-residents.*

## 6.3 OUTSTANDING LOANS

At the end of the period, the loan portfolio as a percentage of GDP was 43.5%. Outstanding loans maintained sluggish growth rates due to the weak demand for loans and tight lending standards.

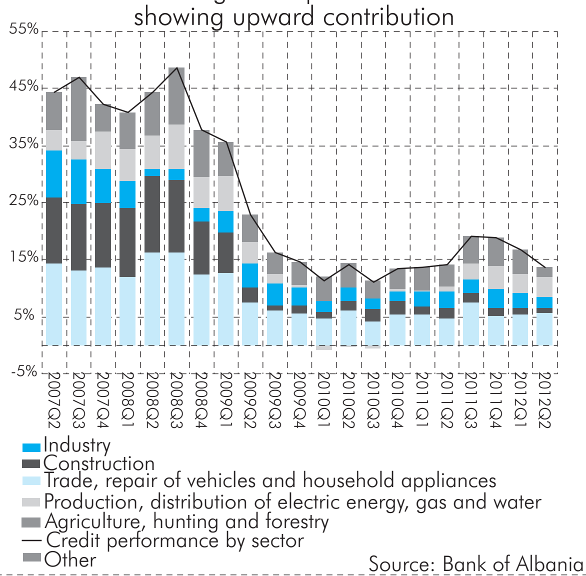
At the end of 2012 H1, outstanding loans grew to ALL 571.9 billion, up by only ALL 5.7 billion or 1%. In 2011 H2, outstanding loans grew by ALL 42.7 billion or 8.2%. At the end of June 2012, credit grew 9.3% year-over-year.

Chart 6.3.1 Annual performance of bank lending to businesses and households (in %)




Source: Bank of Albania.

Chart 6.3.2 Lending to the private sector and sectors showing upward contribution



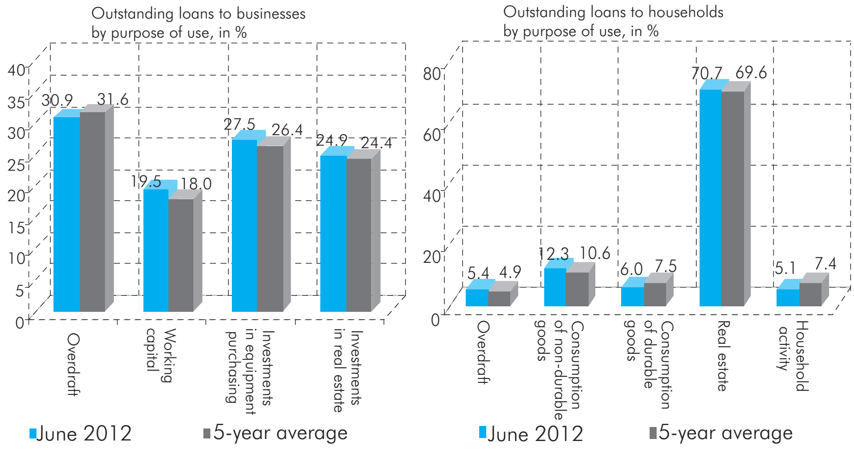

Source: Bank of Albania.

Broken down by borrowers, lending to public enterprises increased faster than lending to the private sector, while lending to households declined. More specifically, lending to the public sector grew by ALL 1.5 billion or 7.4%, hence maintaining the rising trend of the previous semester when credit grew by ALL 4.8 billion or 30.8%. Lending to the private sector grew by ALL 5.2 billion or 1.3%, considerably lower than the previous semester when credit grew by ALL 43.3 billion or 12.2%. Lending to households fell by about ALL 1 billion or 0.7%, hence maintaining the tendency of 2011 H2 when it fell by ALL 5.3 billion or 3.4%. This deceleration in credit reflects a weaker demand for loans due to business and household uncertainty about the performance of the economy and the tight bank lending standards following the deterioration in the loan portfolio quality.

By currency, foreign currency-denominated loans declined during the period under review, while lek-denominated loans grew at stable rates. More specifically, lek loans grew by ALL 6.4 billion or 3.5%, while foreign currency loans declined by ALL 0.7 billion or 0.2%. In 2011 H2, lek loans grew by ALL 18.3 billion or 11.2%, while foreign currency loans grew by ALL 24.5 billion, or 6.8%.

By maturity term, during the period under review, short-term loans contributed positively by about ALL 4.0 billion (up 2.0%) to the growth of loans, while long-term ones contributed by about ALL 6.8 billion (up 2.7%). On the other hand, medium-term loans fell by ALL 5.0 billion, or 4.4%.

Chart 6.3.3 Distribution of outstanding business and household loans by purpose of use




Source: Bank of Albania.

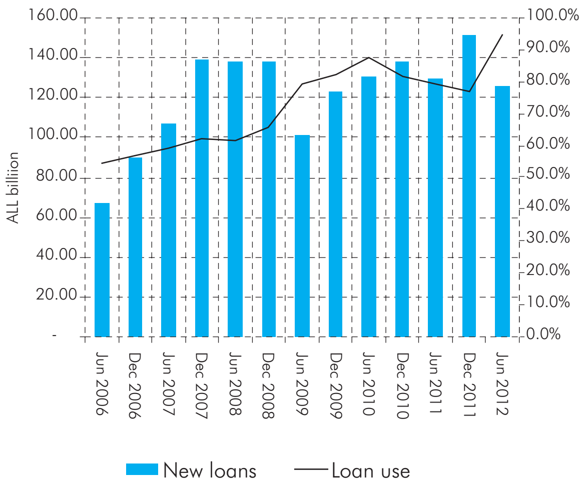
By sectors of economy, loans were mainly extended to trade, construction, industry and production of electrical energy, while lending to other sectors recorded modest growth. In relative terms, during the period under review, lending to the education sector, extractive industry and hotels increased by about 22%, 22% and 12.3%, respectively, due to the seasonal effect. Lending to the agricultural sector contracted by ALL 0.7 billion, or 11.8%.

By purpose of use, lending to businesses was mainly oriented towards purchase of equipment. Overdrafts continue to dominate and their size remains above the 5-year average, despite showing a slight downward tendency. No structural changes are noted in lending to households, with real estate investment loans having the major share.

*Box 6.3.1 New Loans*

*In 2012 H1, the banking sector's new loans amounted to ALL 126.3 billion, considerably down by ALL 25.2 billion or 16.7% from end-2011 and by only ALL 3.5 billion or 2.7% from the corresponding period in 2011. Over the same stated period, the banking sector's collected loans amounted to ALL 119.5 billion, compared to about ALL 116.6 billion at end-December 2011 and ALL 103.2 billion in 2011 H1. The ratio of collected loans to extended loans represents the loan use ratio. In 2012 H1, it was estimated at 94.6%, compared to 77% at end-2011 H2 and 79.5% at end-2011 H1, due to a lower growth rate of new loans compared to collected loans.*

Chart 6.3.4 New loans (left) and loan use (right)



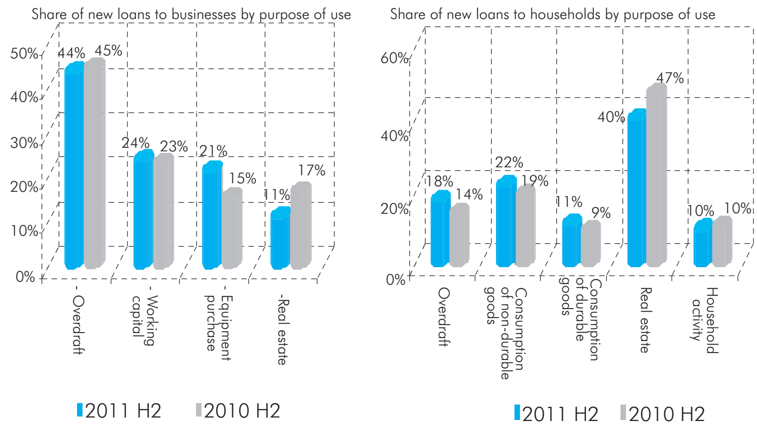

Source: Bank of Albania.

*Broken down by users, during 2012 H1, businesses were extended about ALL 109.9 billion or about 87.04% of new loans, while households were extended about ALL 16.4 billion or about 13% of total new loans. Chart 6.3.4 shows the performance of new loans and the loan use ratio on a semi-annual basis.*

*The distribution of new loans to businesses by purpose of use shows that new loans shifted towards working capital loans in 2012 H1. Concerning households, new loans for the consumption of durable goods show a higher growth rate, while new loans for operating activity grew at slower rates.*

*By currency, new loans in lek and US dollar grew by 0.6% and 44%, amounting to ALL 51.2 billion and ALL 18.5 billion. New loans denominated in euro fell considerably by 14.3% to ALL 56.6 billion. This tendency may be a consequence of the international developments, with the euro being unstable against the other currencies. A longer time period is needed to assess the consistency of this trend and its reasons and consequences.*

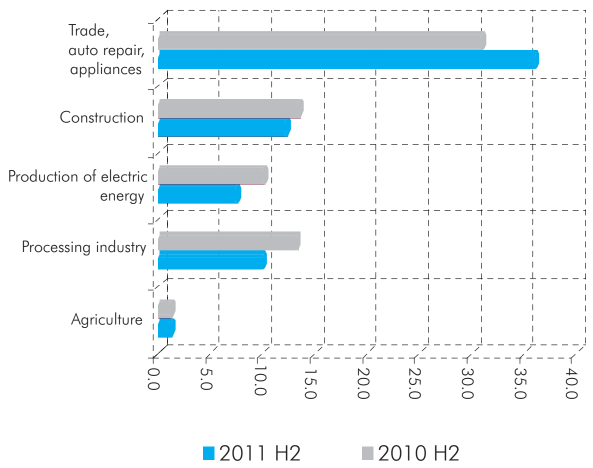
Chart 6.3.5 Distribution of new loans to businesses and households by purpose of use, in percent




Source: Bank of Albania.

*Chart 6.3.6 shows the distribution of new loans by main sectors of the economy. Two main developments are noted. First, the share of new loans for 'Trade, repair of vehicles and household appliances' increased to about 38.8%, from 32.5% at the end of June in 2011. Second, the share of new loans to 'Processing industry' fell to 9.1%, from 12.3% in the previous year.*

Chart 6.3.6 New loans by sectors of economy (in %)



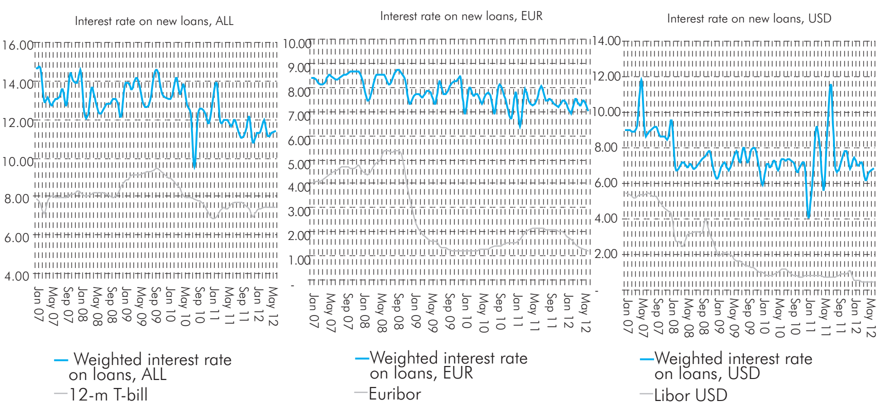

Source: Bank of Albania.

## *INTEREST RATES ON NEW LOANS*

*During 2012 H1, interest rates on new loans denominated in the three major currencies dropped slightly. Interest rates on new lek loans showed negligible fluctuation. Interest rate on lek loans averaged 11.41% or 0.06 percentage points lower than in 2011 H2. Less favourable lending standards on new business loans were applied to overdrafts. Average interest rate on new overdrafts increased by about 0.45 percentage points to 10.89%. Lending standards on new lek loans to households were more favourable during this period. Average interest rate on new lek loans for operating activity dropped by 0.7 percentage points to 16.38%.*

*Over the same stated period, average interest rate on new usd loans dropped to 6.88%, about 1.01 percentage points lower than in 2011 H2. This fact favoured new overdrafts, with the average interest rate dropping by about 2.11 percentage points to 6.31%. The downward trend of the interest rate on new usd loans may have contributed to a higher demand for this type of loan. During the same period, average interest rate on euro loans dropped by about 0.25 percentage points to 7.25%. This drop may have been driven by the performance of average Euribor rates in the international markets, which dropped by about 0.6 percentage points over the period under review.*

Chart 6.3.7 Interest rate on new lek and foreign currency loans



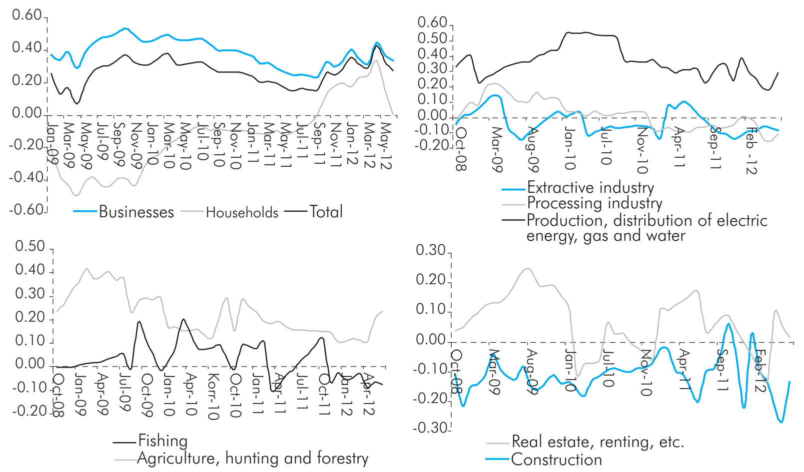

Source: Bank of Albania.

*Box 6.3.2 Correlation between New Loans and Loan Portfolio Quality and Interest Rates*

## CORRELATION BETWEEN NEW LOANS AND LOAN PORTFOLIO QUALITY

*As at the end of 2012 Q2, the performance of new loans reflected banks' tendency to support businesses with lending at a time when lending to households shrank. Out of total new business loans, 37.3% was extended to 'Trade, repair of vehicles and household appliances', 16.3% to the construction sector and 6.7% to processing industry. On the other hand, the business loan portfolio quality deteriorated more than households'. Broken down by sectors, NPLs in 'Trade, repair of vehicles and household appliances' stand at 25.5%, while those of the construction sector and processing industry stand at 29.6% and 23.1%, respectively. Households' NPLs (excluding non-residents) stand at 16.9%. In order to determine whether banks have responded to the deterioration of the loan portfolio quality by reducing lending to both sectors, businesses and households, we build the time variable correlation between new loans and NPLs. The following charts show the correlation for each sector.*

Chart 6.3.8 Correlation index between new loans and NPLs, by sector




Source: Financial Stability Department.

*Total correlation index shows that after reaching a high level in early 2009, it gradually reduced, reflecting banks' tendency to contract new lending against a background of deteriorated loan portfolio quality. Following September 2011, the correlation increased owing mainly to the developments in the correlation coefficient for businesses, whose increase reflected the growth in new reconstructed loans. In May and June 2012, the correlation decreased as a reflection of banks' tendency to decelerate lending to businesses. In individual sectors, the correlation coefficient is positive and high for the sector of production and distribution of electrical energy, gas and water, and agriculture. It results that the construction sector has a negative correlation index between new loans and the loan portfolio quality over the entire post-crisis period.*

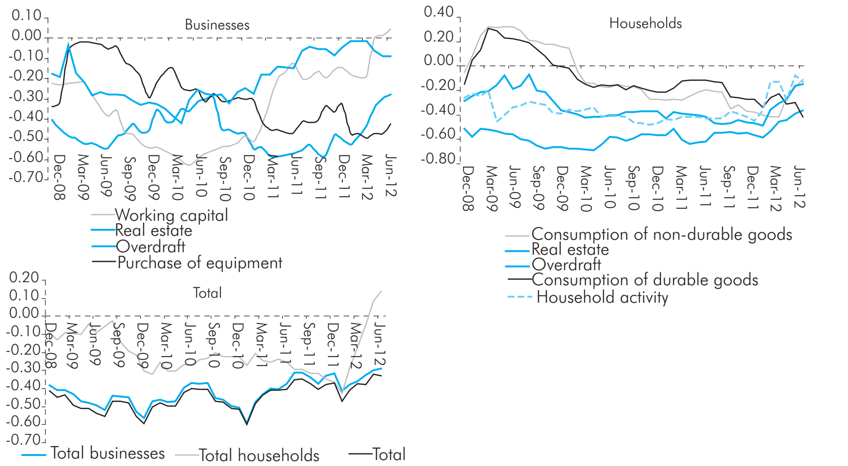
*On the other hand, there is a negative correlation between new loans and households' loan portfolio quality in the post-crisis period. This development reflects banks' swift response to reducing new lending to households against a background of a deteriorated loan quality, and the shift of lending to the restructuring of business loans. The strong downward tendency of the correlation coefficients shows that as a result of the strong* *banks' response during 2012 H1, new lending to households has decelerated considerably.*

## CORRELATION BETWEEN NEW LOANS AND INTEREST RATE

*The correlation between new loans by sectors of economy and the respective interest rate is assessed through the analysis of the respective correlation. Concerning the business sector, there is a negative correlation coefficient during the entire period reflecting the indirect correlation between new loans and the interest rate. However, the rising trend of this correlation as from June 2011 for new working capital and real estate investment loans is a reflection of banks' tendency to reduce lending for these purposes and the increase in the respective interest rates. The downward trend in the correlation coefficient for overdrafts is a result of banks' tendency to reduce lending for overdraft purposes and its cost. Lending for equipment purchase has also declined; however, its interest rate continues to maintain a rising trend.*

*Concerning households, the positive correlation between new loans and the interest rate for the consumption of durable and non-durable goods prior to 2010 shows the rising tendency of loans for this purpose of use, which were followed by higher interest rates. In the meantime, there is a negative correlation for all other loan items.*

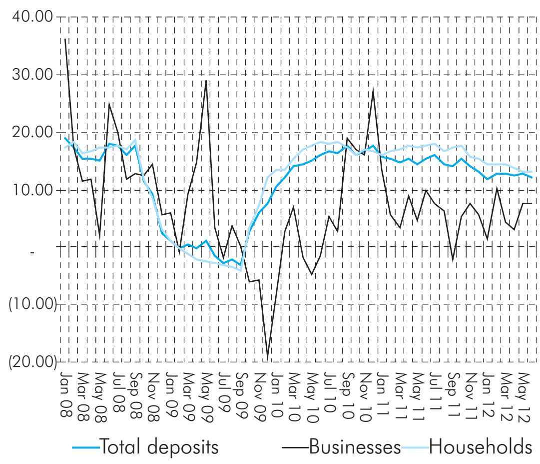
Chart 6.3.9 Correlation index between new loans and the interest rate, by purpose of use




Source: Financial Stability Department.

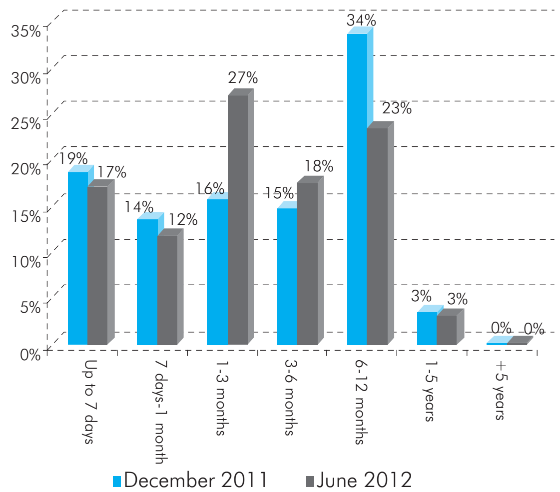
*In the beginning of 2012, the correlation coefficient increased for all items, excluding that for durable goods, due to the fall in new loans for this purpose and the decrease in the respective interest rates. There is an exception for new household loans for real estate investment, which in May and June 2012 increased slightly but at a higher cost. This strong tendency of the deceleration in new household loans reflected in a rapid increase in their total correlation compared to a more moderate tendency of business loans and total loans.*

Chart 6.4.1 Annual deposits growth rate (in %)




Source: Bank of Albania.

Chart 6.4.2 Banking sector deposits by maturity




Source: Bank of Albania.

## 6.4 DEPOSITS

Banking sector deposits continued to grow over the period under review, though at lower rates than in the previous period.

Deposits continue to remain concentrated in the largest banks in the banking sector and the degree of their concentration has increased year-over-year. In 2012 H1, total deposits increased by 4% from December 2011 and by 12.2% from June H1.

The deposit structure shows a 28% decline in the value of deposits of 6-12 month maturity and a shift towards shorter-maturity deposits. This performance may reflect a higher public need for liquidity (withdrawal of savings in a short period of time) due to expectations for slower economic growth at home. For banks, in turn, this performance calls for cautious monitoring of the size and performance of liquid assets.

By currency, as at June 2012, lek and foreign currency deposits had almost a similar share in total deposits, each by about ALL 480 billion. A year earlier, lek deposits shared 48% of total deposits.

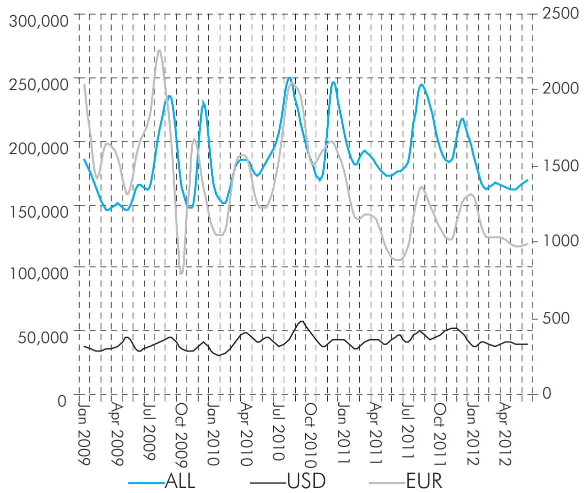
*Box 6.4.1 New Time Deposits*

*New lek time deposits fell during 2012 H1. During this period, new lek time deposits accepted by the banking sector totalled ALL 250 billion, or about 23.3% less than in 2011 H1. This decline occurred at a time when the average interest rate on lek deposits fell to 4.5% from 4.8%. Concerning the maturity structure of new lek deposits, the share of new 3-month deposits declined by about 3.8 percentage points to 19.3%. During the same period, the share of new 12-month deposits increased by about 10.1 percentage points to 36.2%.*

*In 2012 H1, new US dollar time deposits amounted to USD 363.6 million, about 23.6% less than in the previous year. The deposit structure shows a higher share of 12-month deposits by 6.8 percentage points and a lower share of 1-month deposits by 9 percentage points. Interest rate on new US dollar deposits averaged 1.6%, compared to 1.2% in the corresponding period in 2011.*

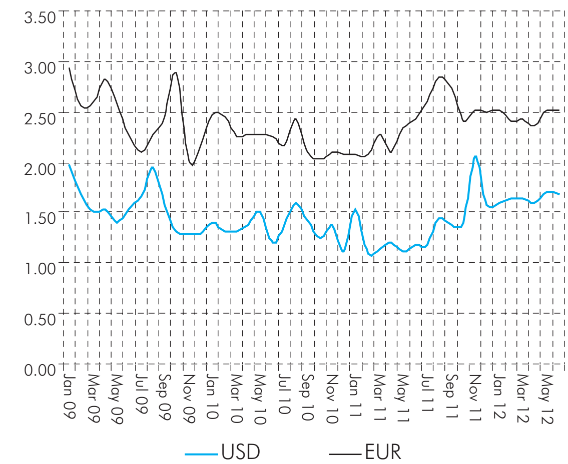
*New euro time deposits amounted to EUR 1.68 billion, down by 31.6% from 2011 H1, despite the increase in the average interest rate by about 0.3 percentage points to 2.5%. Concerning the maturity structure of new euro deposits, the share of 12-month time deposits increased by 13.3 percentage points to 26.6%, while the share of 1-month time deposits declined by 21.3 percentage points to 34.9%.*

Chart 6.4.3 New deposits




Source: Bank of Albania.

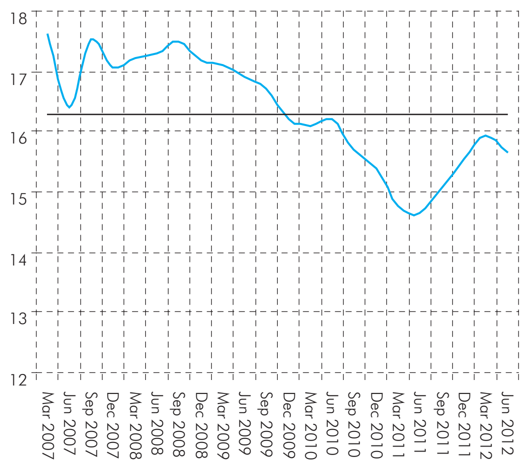
Chart 6.4.4 Interest rates on new time deposits (in %)




Source: Bank of Albania.

## 6.5 BANKING BUSINESS CAPITALISATION

Chart 6.5.1 Capital adequacy ratio (in %)




Source: Bank of Albania.

As at end-2012 H1, capital adequacy ratio stood at 15.66%, compared to 15.56% at end-2011 and 14.6% in the corresponding period in 2011. Chart 6.5.1 shows the performance of the capital adequacy ratio.

As at end-2012 H1, banking sector's regulatory capital totalled ALL 100.2 billion or 1.7% higher than at end-2011. Risk-weighted assets and off-balance sheet items increased by about ALL 6.9 billion (or 1.1%) compared to end-2011, to ALL 639.6 billion.

Table 6.5.1 summarizes the capital adequacy ratio for the banking sector and banking groups by size and capital origin.

*Table 6.5.1 Capital adequacy ratio*

| | Sector | Group 1 | Group 2 | Group 3 | Italian | French | Greek | Albanian |
|---|---|---|---|---|---|---|---|---|
| June 2012 | 15.66 | 28.5 | 13.4 | 15.8 | 20.2 | 13.3 | 15.2 | 14.6 |
| December 2011 | 15.56 | 27.9 | 14.1 | 15.5 | 20.2 | 12.5 | 16.6 | 13.9 |
| June 2011 | 14.64 | 30 | 13.5 | 14.3 | 18.7 | 13.3 | 13.3 | 12.7 |

*Source: Bank of Albania.*

The level of capitalisation for the entire banking sector exceeds the required minimum, while banks falling under Group 2 show the lowest ratio, standing at 13.4%. By origin of capital, Italian and Greek banks have the highest level of the capital adequacy ratio.

As at the end of June 2012, shareholders' equity totalled ALL 99.4 billion, up by about ALL 2 billion (or 2.1%) from end-2011. Paid-in capital is the main item in the banking sector's shareholders' equity, accounting for 90%. At the end of 2012 H1, paid-in capital totalled ALL 89.6 billion, about ALL 6.8 billion or 8.3% higher than at end-2011, as a result of capital boost in some banks.

## 6.6 PROFITABILITY AND EFFICIENCY IN USING RESOURCES

In 2012 H1, average earning assets rose to ALL 977.5 billion, accounting for about 90.7% of total banking sector's average assets. Average earning assets increased by ALL 38.5 billion (or 4.1%) from December 2011, and by ALL 58.3 billion (or 6.3%) from the same period of 2011. 'Average paying liabilities to average earning assets' stood at 99.7%, about 5.4 percentage points higher than at end-December 2011 and 6.3 percentage points higher than in 2011 H1.

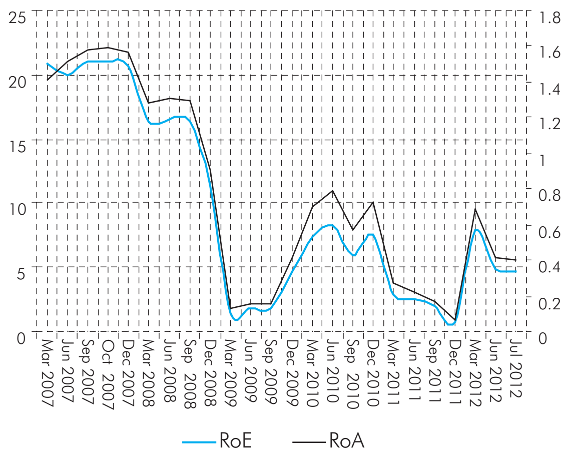
Banking sector's net operating income[21] amounted to ALL 17.3 billion or 21.6% lower than in the corresponding period a year earlier, being totally represented by net interest income (other net operating income is negative). Operating expenses[22] amounted to ALL 12.3 billion, or 5.2% higher than a year earlier. Consequently, the ratio of operating expenses to net income stood at 71%, compared to 52.9% in the same period of 2011.

The ratio of general operating expenses[23] to income stood at 82.7%, compared to 93% in June 2011, due to the decline in provisions by about ALL 6.8 billion.

In 2012 H1, the net profit was positive at ALL 2.36 billion, doubling from the same period a year earlier. It is worth noting that the net interest income has almost remained unchanged, while other operating income has decreased. The increase in net income owes mainly to the considerable decline in provisions. In addition, banking sector's profit continues to remain concentrated in the largest banks.

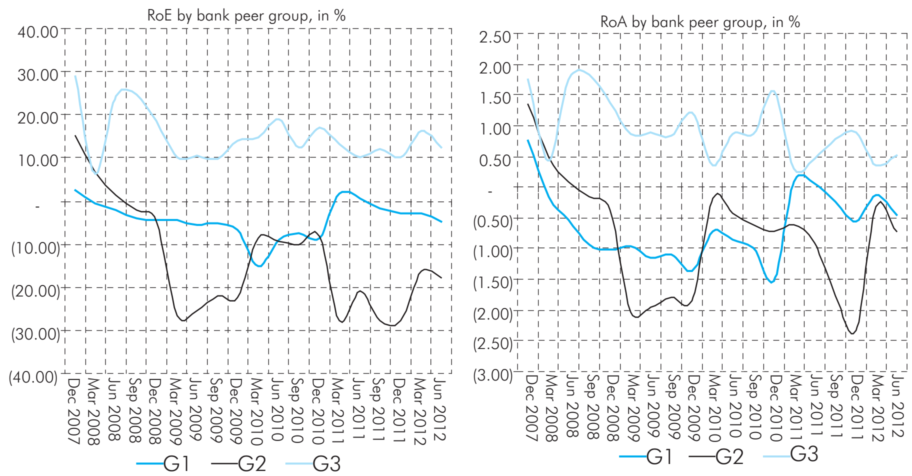
Annualized Return on Assets (RoA) stood at 0.42%, compared to 0.22% in the same period of 2011. Annualized Return on Equity (RoE) was 4.8%. At end-June 2011, it stood at 2.4%.

Chart 6.6.1 RoE (right) and RoA (left), in %




Source: Bank of Albania.

Chart 6.6.2 RoE and RoA for the banking groups by size of activity




Source: Bank of Albania.

21 *Net interest income plus other net income.*
22 *Excluding provisioning expenses.*
23 *Operational costs plus provisioning expenses and other reserves.*

*Box 6.6 Factors Affecting RoE*

*RoE, as measured by the net profit to shareholder's equity, is a widely used measure of bank's profitability. A higher RoE is generally a positive development; however, it should be interpreted carefully as it may reflect changes in factors other than profit, such as leverage. If this is the case, a rise in RoE does not necessarily imply an improvement of a system's financial strength.*

*One way to decompose RoE is decomposing it into four factors: profit margin, risk-adjusted income, risk level and financial leverage (see Table 6.6.1)*.*

$$ROE = \frac{\text{Net profit}}{\text{Operating income}} \times \frac{\text{Operating income}}{\text{Risk-weighted assets}} \times \frac{\text{Risk-weighted assets}}{\text{Total assets}} \times \frac{\text{Total assets}}{\text{Capital}}$$

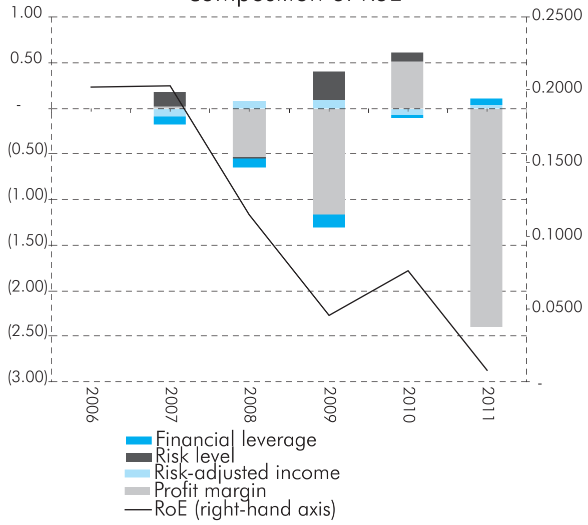
*Table 6.6.1 Decomposition of RoE***

| Factor | Description and financial stability implications |
|---|---|
| Profit margin | Measures the difference between income and expenses. Effect of rise: positive |
| Risk-adjusted income | Measures the level of income discounting for risk. Effect of rise: positive |
| Risk level | Measures risk appetite (it refers to a bank's credit risk level). Effect of rise: negative |
| Financial leverage | Measures the impact of debt. Effect of rise: negative |

*According to this ranking, a rise in RoE driven by a higher profit margin (profit/ main operating income) reduces a bank's financial fragility as it reflects a higher difference between income and expenses. Likewise, a rise in risk-adjusted income (main operating income/risk-weighted assets) may be viewed as positive to a bank's stability as it reflects higher risk-weighted assets.*

*On the other hand, a rise in RoE because of increased financial leverage (total assets/equity) may indicate a weakening of the bank's financial strength as it implies higher debt and/or reduction of equity and, consequently, higher risks to the bank. Using the same logic, a rise in exposure to risk (right-weighted assets/total assets) may have a negative effect on the financial position, as it for instance may imply that the bank has engaged in riskier projects.*

Chart 6.6.3 Performance and (linearized) composition of RoE




Source: Financial Stability Department, BoA.

*Therefore, in order to assess whether a higher RoE implies that a bank is more resilient to shocks, we need to determine whether this situation is mainly a result of a good margin and higher efficiency, or of a high level of risk and high financial leverage.*

*In the case of banks in the Albanian banking system, the changes in RoE in the recent years have mainly been a result of the fluctuations in the profit margin and level of risk (see Chart 6.6.3). In 2008 and 2009, RoE fell by 9 and 7 percentage points, respectively. In addition to the lower profit margin, there has also been a lower effect of the financial leverage. On the other hand, the downward trend of the ROE (2009) was offset by the higher level of risk. This implies that the fall in RoE is not only a reflection of the loss in financial strength but also of the higher exposure to risks. In the meantime, the banking system's efficiency has been increasing (risk-adjusted income).*

*The fall in RoE in 2011 was totally due to the deteriorated profit margin, which may be considered as an indication of the fall in the banking sector's financial strength.*

* This analysis was initially used by the Bank of England in its Financial Stability Review (December 2003).

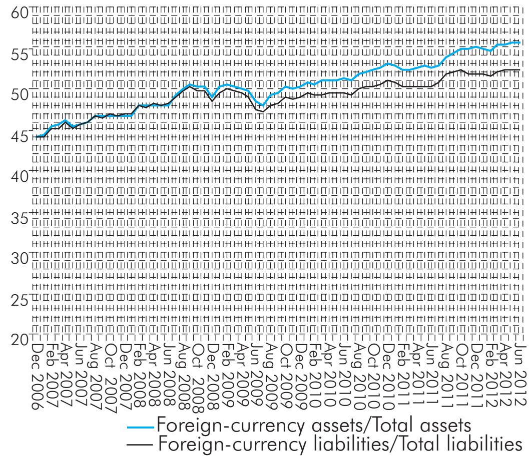
** This approach does not consider the type of exposure outside the bank's balance sheet and how they affect the bank's risk profile.

# 7. MONITORING BANKING SECTOR RISKS

## 7.1 MARKET RISKS

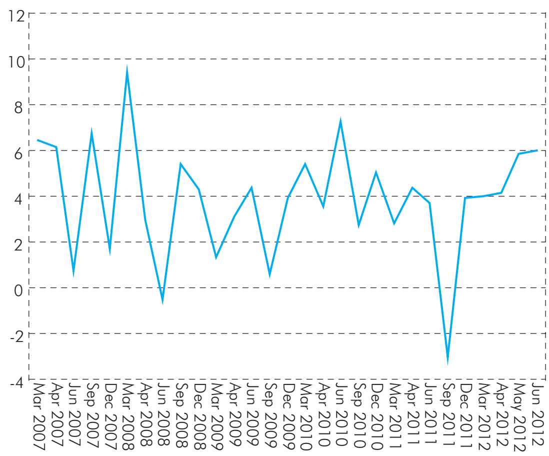
### 7.1.1 EXCHANGE RATE RISK

Chart 7.1.1 Share of foreign-currency assets and liabilities in total banking sector assets, in % (December 2006 – June 2012)




Source: Bank of Albania.

Chart 7.1.2 Net FX position to regulatory capital, in percentage




Source: Bank of Albania.

The performance of the gap between foreign-currency assets and foreign-currency liabilities, and the increased share of open foreign-exchange position to regulatory capital, show the banking sector's increased sensitivity to exchange-rate movements. However, in the event of any adverse exchange-rate movements, we assess that they will not make any significant impact on the banking sector capital indicators.

As at the end of 2012 H1, the banking sector's foreign-currency assets totalled ALL 645.8 billion, up by 4.8% from 2011 H2 and 17.9% from 2011 H1. As at end-June 2012, the share of foreign-currency assets and liabilities in total assets is 55.8% and 52.3%, respectively. It has increased by 6.23 and 3.9 percentage points, respectively, compared with a year earlier. Though the gap between foreign-currency assets and liabilities has peaked over the latest years, it still remains within the 0-10% historical band.

The banking sector has posed a higher but restricted exposure to direct exchange rate risk. As at the end of 2012 H1, net foreign-exchange position to regulatory capital is 6.02%, at its highest level since July 2010.

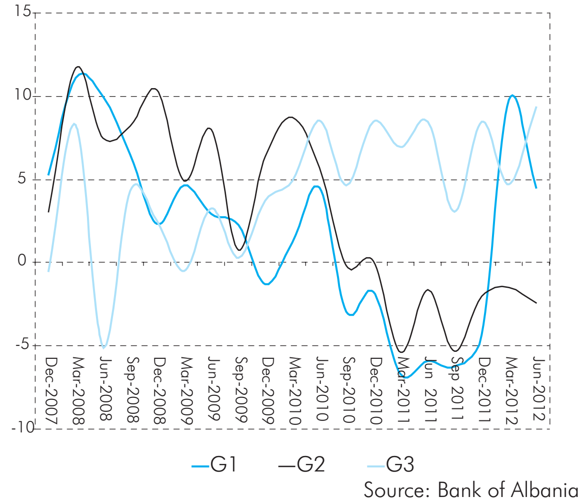
By banks peer group, G2 banks deepened their short position, while G1 and G3 banks recorded a long position in 2012 H1.

### 7.1.2 INTEREST RATE RISK

According to reprising periods, the gap between rate-sensitive assets and rate-sensitive liabilities was negative over the period. For a period of up to one month, this gap was negative by ALL 0.7 billion; for up to three months, it was negative by ALL 71 billion; for up to 12 months, it was negative by ALL 82 billion.

The negative gap between rate-sensitive assets and rate-sensitive liabilities, particularly for a reprising period of over three months, expose the banking sector to risk from interest rate rise. However, the impact of probable increase in interest rate on the banks' capital is assessed as limited, since the share of these gaps in banking sector assets is relatively low, 0.06%, 6.1% and 7.1%, respectively.

Chart 7.1.3 Net FX positions to regulatory capital per banks peer group, by activity size, in percentage

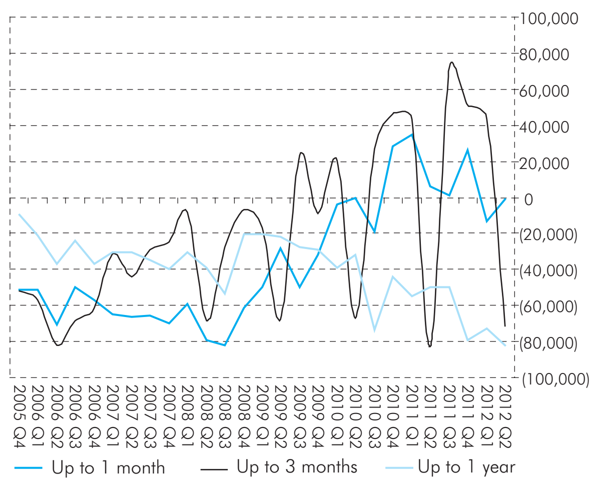



Source: Bank of Albania.

*INTEREST RATE SPREAD BETWEEN NEW LOANS AND DEPOSITS*

During 2012 H1, the average interest rate spread between loans and deposits narrowed for the three major currencies, by 0.5 percentage points for operations in ALL, 0.6 percentage points for those in US dollar, and 0.8 percentage points for those in euro. In foreign currency, this spread was mainly driven by the decreased average interest rate on loans and increased average interest rate on deposits denominated in euro and US dollar, whereas in the national currency, it was driven by the higher decrease in average interest rate on loans than in average interest rate on deposits. It is worth of note that the spread for the national currency expanded significantly in June due to the sharp decline in lek-denominated deposit rates[24], however, it did not manage to impact on average spread reduction over the six-month period.

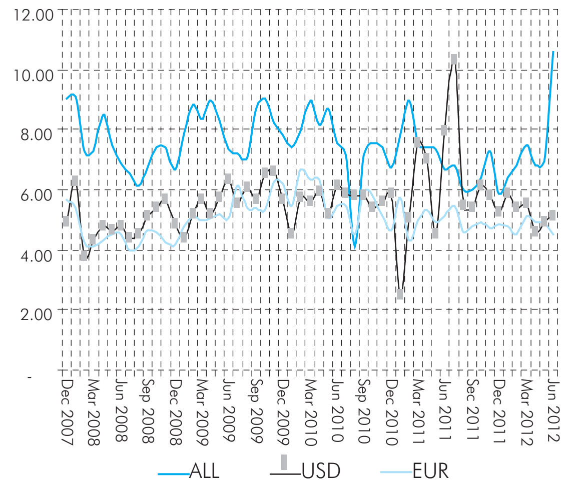
Chart 7.1.4 Asset - liability gap, by reprising periods, in ALL millions




Source: Bank of Albania.

24 *Interest rates on lek time deposits dropped to 0.8% in June 2012, from 4.4% in May 2012, bringing about a significantly expanded spread in this currency.*

Chart 7.1.5 Interest rate spread between loans and time deposits, in %



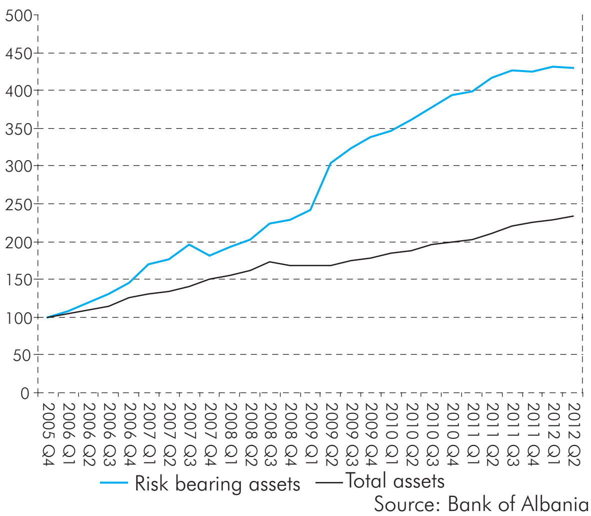

Source: Bank of Albania.

## 7.2 CREDIT RISK

Credit quality continued deteriorating over the period. Credit risk is the main risk to banks' activity.

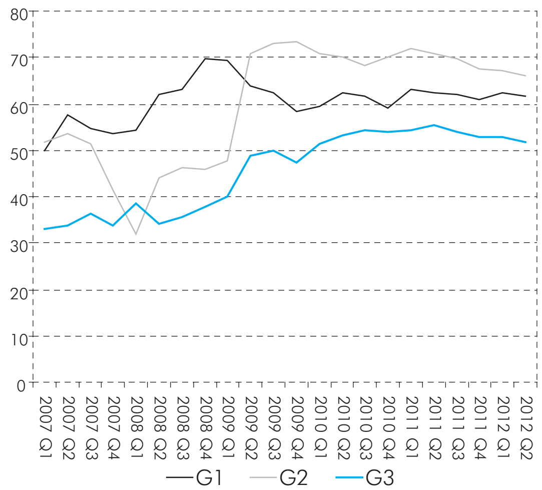
As at the end of 2012 H1, the banking sector's risk-weighted assets[25] totalled ALL 639.7 billion, about ALL 6.9 billion or 1.1% more than in 2011 H2, and about ALL 20.9 billion or 3.4% more than in 2011 H1. Currently, they account for about 55.2% of total banking sector assets. Risk-free assets (0% risk) were ALL 457.9 billion, up by ALL 18.6 billion or 4.2%, y-o-y.

Chart 7.2.1 Risk-bearing assets and total assets index: December 2005=100




Source: Bank of Albania.

Chart 7.2.2 Risk-bearing assets to toal assets by bank peer groups, in %




Source: Bank of Albania.

In 2012 H1, assets risk-weighted at 150% increased by about ALL 1.6 billion or 1.1% compared to 2011 H2, amounting to ALL 153.9 billion. Assets risk-weighted at 50% and 100% fell by about 2.9% and 0.6%, respectively, relative to 2011 H2. Low-risk assets (weighted at 20%) increased by about ALL 32.3 billion, or 24%, compared to 2011 H2. During this period, the banks continued investing in low-risk assets, reflecting their preference for placements in the form of deposits and current accounts, as well as for operations under the regulatory requirements on liquidity indicators.

By banks' size, the analysis indicates a lower ratio of risk-weighted assets to total assets for all banks peer groups due to a higher asset growth rate. G2 banks continue to have the largest share of risk-weighted assets in total assets, accounting for about 65.9%.

[25] *To estimate the capital adequacy ratio, assets are risk-weighted at a coefficient of 20%, 50%, 100% or 150%. Overall, risk-weighted assets are dominated by the loan portfolio and include also debt security investments and placements with financial institutions.*

In 2012 H1, non-performing loans in the banking sector continued trending up, amounting to ALL 120.6 billion, from ALL 106 billion in 2011 H2 and ALL 89 billion in 2011 H1. The ratio of non-performing loans to total gross loans amounted to 21.1%, from 18.8% in 2011 H2 and 17% in 2011 H1.

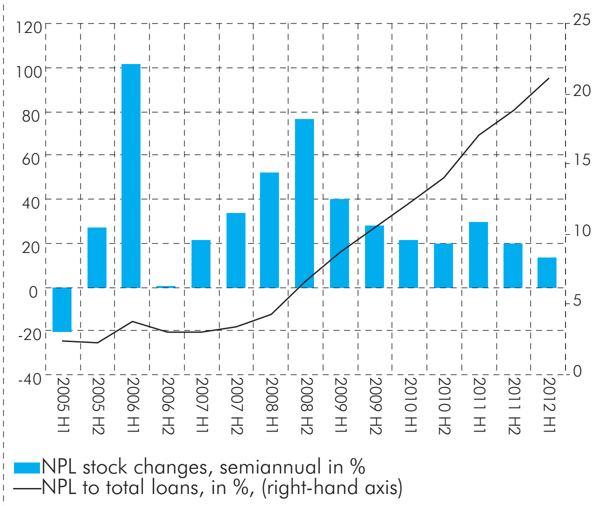
Total provisions pursued the same upward trend as non-performing loans, accounting for about 11.3% of total gross loans as at June 2012. Compared to a year earlier, provisions increased at a higher rate (about 40.6%) than non-performing loans (35.6%), being reflected in an increased NPL coverage ratio, ('loan loss provisions/non-performing loans'), to 53.64% (about 2 percentage points higher than in June 2011).

The banks' capacity to cover losses from non-performing loans with capital diminished, since the ratio of 'non-performing loans net of provisions to regulatory capital' amounted to 55.8% at the end of the period, from 52% at end-2011 and 47.4% at end-June 2011. This increased indicator depicts that banks should find ways to strengthen their regulatory capital to withstand the loan quality impairment and increased loan-loss provisions.

Loan classification structure by loan quality presented slight changes in its composition, though lower-quality loans trended up. During 2012 H1, standard loans decreased slightly by about ALL 11 billion, or about 2.6%, shifting to lower-quality loans. Special-mention loans increased by ALL 2.4 billion, or 5.8%; sub-standard loans increased by ALL 2 billion, or 3.7%; doubtful loans increased by ALL 6.1 billion, or 27.5%; and, loss loans registered the highest absolute value, increasing by ALL 6.3 billion, or 19.9%. The share of standard loans in total classified loans fell by about 2.7 percentage points, down to 71.2% over the period.

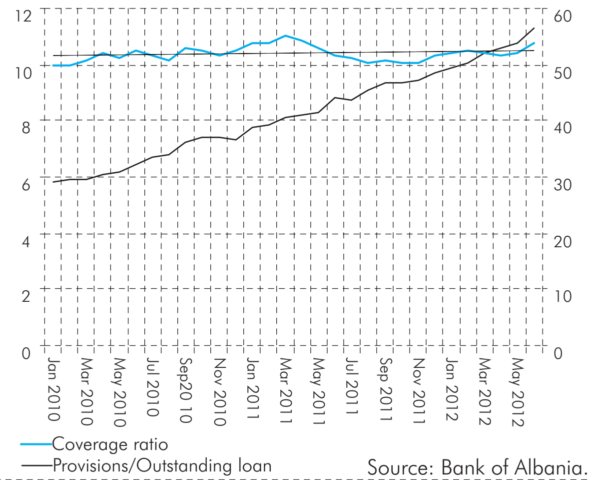
The banks remained more exposed to the credit risk of foreign currency loan portfolio and business loan portfolio. Non-performing loans to total gross loans for both categories increased to 22.6% and 23.8%, respectively, from 19.6% and 20.8% in 2011 H2, being above the average non-performing loan ratio.

Chart 7.2.3 Non-performing loans, in %



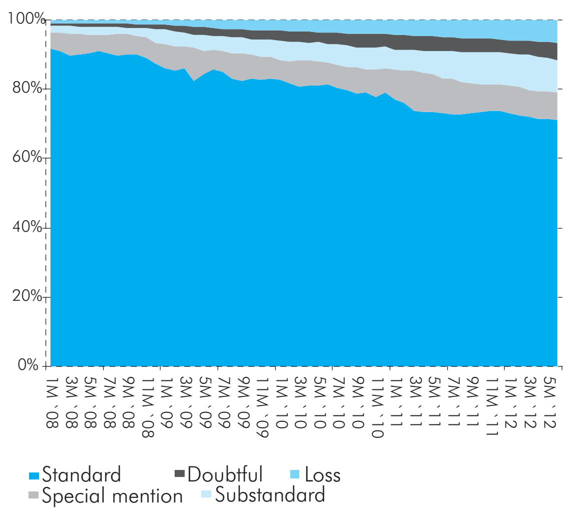

Source: Bank of Albania.

Chart 7.2.4 Loan-loss provisions (left) and NPL coverage ratio (right), in %



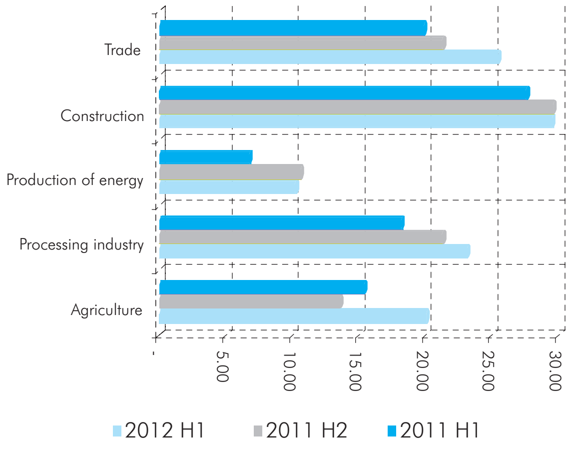

Source: Bank of Albania.

Chart 7.2.5 Loan portfolio classification, in %




Source: Bank of Albania.

Chart 7.2.6 Loan portfolio quality by sector, in %




Source: Bank of Albania.

During 2012 H1, a number of sectors that had a small share in total gross loans presented an impaired credit quality. This category was headed by businesses operating in: medical and social activities, in which the NPL ratio increased by 18.7 percentage points; education sector, in which the NPL ratio increased by 8.2 percentage points; agriculture, in which the NPL ratio increased by 6.5 percentage points. The loan portfolio quality deteriorated even in the public sector, with an increased NPL ratio by 20.3 percentage points, and in hotels and restaurants, with an increased NPL ratio by 4.3 percentage points. Over the period, both sectors benefited a considerable share of new loans as well. Chart 7.2.6 shows the loan portfolio quality by the most representative sectors.

Foreign-currency outstanding credit (when borrower's income is in lek), dropped by about 15% in 2012 H1 to ALL 182.3 billion, down to 31.9% of total outstanding credit and 47.6% of foreign-currency outstanding credit. By currency, about 85% of outstanding credit is denominated in euro and about 16.8% in US dollar. As at the end of 2012 H1, the ratio of 'non-performing foreign-currency loans (when borrower is unhedged against exchange rate risk) to foreign-currency outstanding loans (when borrower is unhedged against exchange rate risk)' amounted to 23.6%, up by 4.7 percentage points from 2011 H2 and 6.5 percentage points from 2011 H1. By currency, the USD-denominated credit[26] has made the main contribution to increasing this indicator. This performance is likely a consequence of the lek's depreciation against the US dollar over the past year.

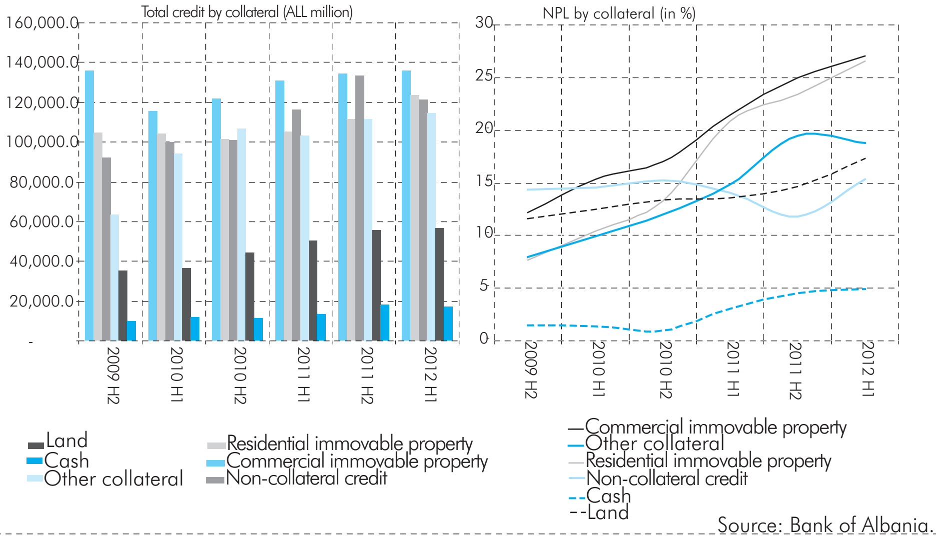
The loan portfolio collateral coverage ratio[27] increased to 78.7%, from 76.4% as at end-2011. The NPL portfolio coverage ratio fell to 84.6%, slightly down from 85.2% as at end-2011.

The following charts show the credit composition by type of collateral and the related credit quality performance. The loan collateralised by 'other collateral' increased during the latest years and its quality improved over the period. Uncollateralised loan also performed positively, but its impaired quality over the period was associated with a contracted supply by banks. The quality of loans collateralised by real-estate (commercial and residential) deteriorated during the period.

[26] *More specifically, by currency, the same indicator in euro reached 22.8% in June 2012, from 20.3% in December 2011 and 17.6% in June 2011. Over the same period, the same indicator in US dollar resulted 24.7%, from 10% in December 2011 and 13% in June 2011.*

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

Chart 7.2.7 Credit by type of collateral



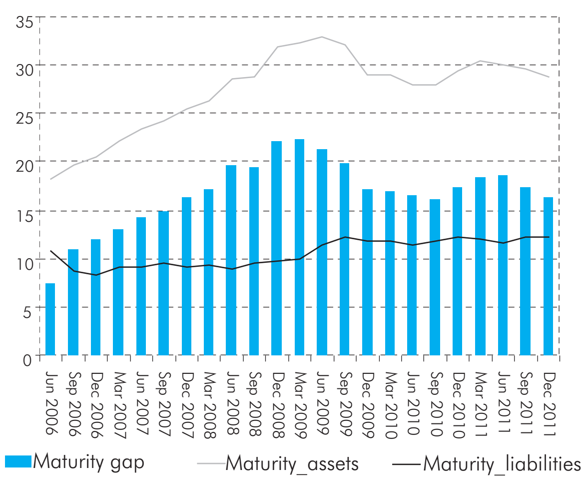

Source: Bank of Albania.

## 7.3 LIQUIDITY RISK

As at the end of 2012 H1, the maturity gap between assets and liabilities narrowed relative to end-2011 and relative to the same period a year earlier. This performance coincided with the increased value of banking sector's liquid assets, improving the banking sector resilience to liquidity risk.

As at period-end, the average remaining maturity of banking sector assets is 27.6 months, from 28.7 months as at end-2011 and 30.1 months as at the end of 2011 H1. The same indicator for banking sector liabilities is 11.7 months, from 12.3 months as at end-2011 and 11.5 months as at 2011 H1.

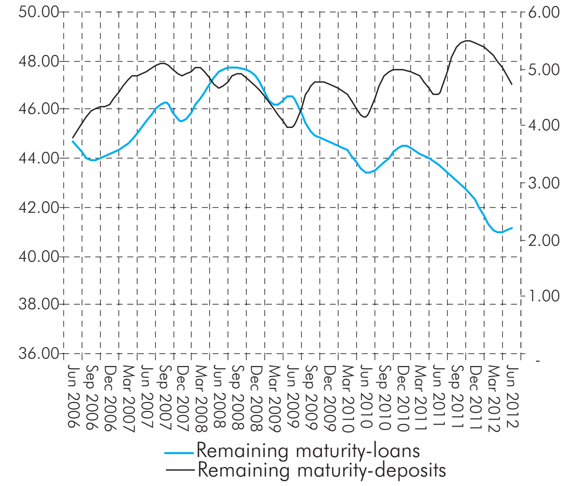
Chart 7.3.1 Average remaining maturity of assets and liabilities, in months




Source: Bank of Albania.

The maturity gap between assets and liabilities narrowed to 15.9 months, from 16.4 months as at end-2011 and 18.5 months as at the end of 2011 H1. This narrowing was due to decline in the remaining maturity of loans - the main asset item - by about 1.2 months from end-2011, to about 41.1 months. In terms of deposits - the main liability item - their remaining maturity fell by 0.72 months to 4.75 months, from 5.5 months a year earlier. This decline attests to households' inclination to place their savings at short-term deposits (whose level has increased for a maturity of one to three months and three to six months, and has decreased for longer time spans). This performance, which is likely to reflect depositors' preference against lower deposit interest rate, should be cautiously monitored in the months ahead, since its continuation would make the banking sector more vulnerable

Chart 7.3.2 Average remaining maturity of deposits and loans, in months



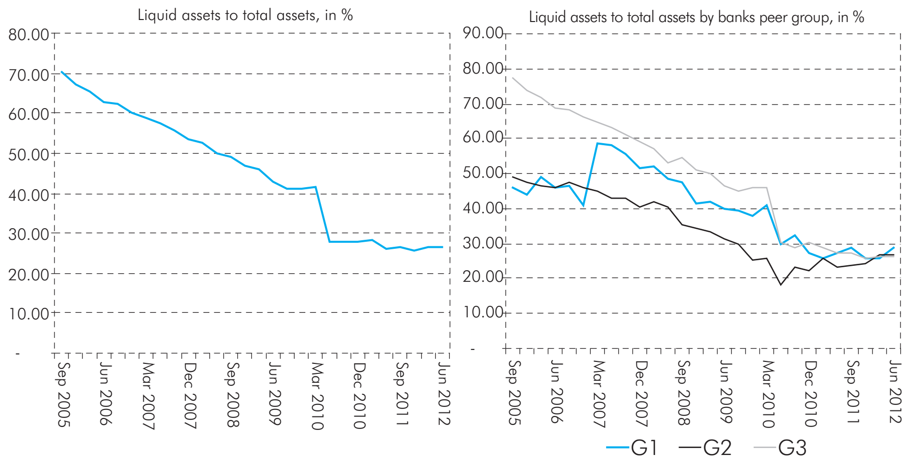

Source: Bank of Albania.

to depositors' changed preference and to various shocks from liquidity position.

'Liquid assets/short-term liabilities' and 'liquid assets/total assets' improved relative to end-2011 and to the same period a year earlier, indicating banks' adequate liquidity condition.

As at the end of 2012 H1, the ratio of liquid assets to short-term liabilities (with a maturity of up to 12 months) was 36%, from 33.2% as at end-December 2011 and 30.2% in the same period a year earlier. By currency, this ratio is higher for the lek and the euro and lower for the dollar. Specifically, it is 45.4% for the lek, 27.3% for the euro and 19.9% for the dollar. During the period, the ratio of liquid assets to total assets increased by 3.4 percentage points,

Chart 7.3.3 Liquid assets to total assets for the banking sector and for bank peer groups, by size of activity (in%)

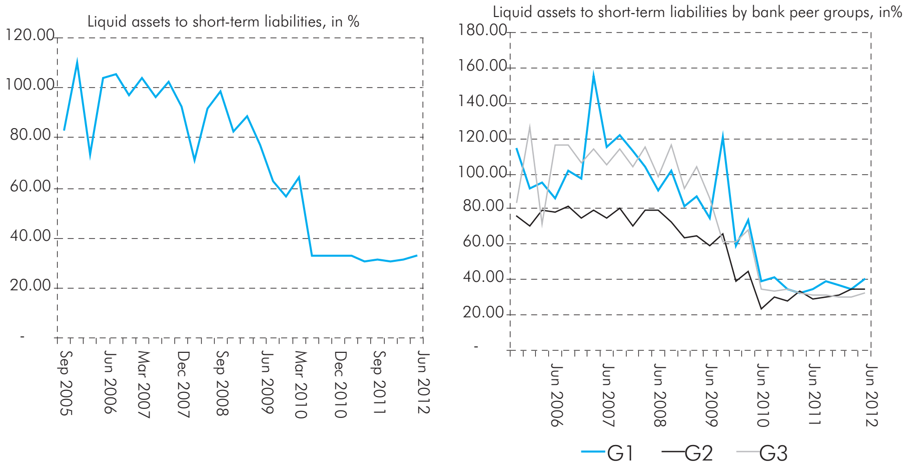



Source: Bank of Albania.

to 29%. By size of activity, the three banks peer groups presented increase in both indicators on a year earlier. Overall, the same performance holds true also for banks divided by capital origin, in which only the French group displayed a slightly decreased ratio of liquid assets to short-term liabilities. Overall, both ratios improved, being above the minimum required by the Bank of Albania[28].

[28] *Pursuant to amendments to Regulation "On liquidity risk management", approved by Decision No. 71 of 14/10/2009, banks shall, at all times, observe the minimum level of liquid assets to short-term liabilities at 20% in national currency, 20% in foreign currency and 25% in total.*

Chart 7.3.4 Performance of liquid assets to short-term liabilities, in %




Source: Bank of Albania.

## 7.4 STRESS-TESTING[29]

A forward-looking stress-testing analysis is conducted to assess the financial system's resilience and the banking sector's capital adequacy over a period of up to end-2013. The stress-testing exercise assesses the impact of macroeconomic situation on the banking sector's financial condition, excluding the possibility of increase in paid-in capital during the period under review. In practice, the situation deteriorates gradually and the banks have time to take appropriate measures by injecting capital. This analysis includes three scenarios: the baseline scenario and two adverse scenarios.

The baseline scenario is built on economic and financial indicators forecast, generally based on their historical performance. The adverse scenarios assume a 'stressed' situation of low probability of occurrence[30], based on three probable shocks to the Albanian economy: a) Further slowdown in lending; b) Increase in market interest rates, and c) National currency depreciation.

[29] *We emphasize that stress-testing does not represent a way of forecasting. Intentionally, scenarios assume adverse and extreme events of a low probability of occurrence, to test the banking sector resilience to them. Though banks are promoted to assess their financial position capacity to withstand the impact of those scenarios, they should not regard them as events expected by the Bank of Albania. Scenarios are various along the time span, depending on economic and financial developments. On the other hand, scenarios do not take into consideration operations that banks may carry out to constantly strengthen their financial position and their resilience to risks.*

[30] *Research Department, Bank of Albania*

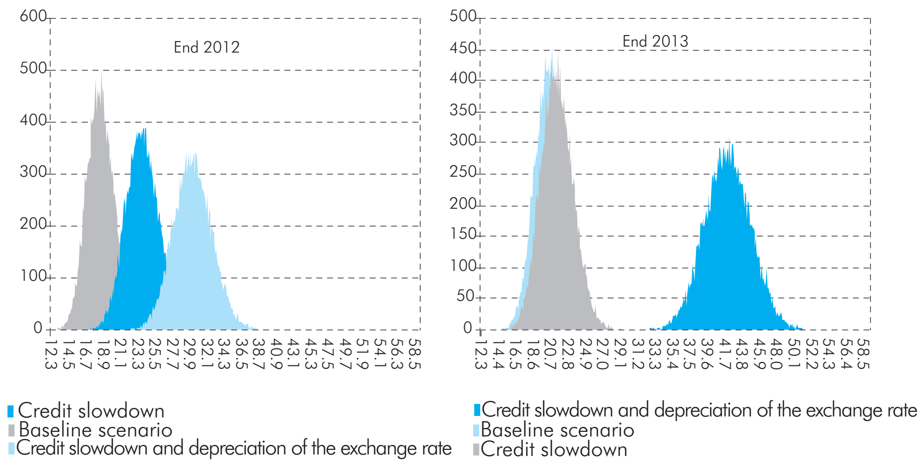
*Table 7.4.1 Stress-test assumptions*

| | Baseline scenario | | Adverse scenarios | | | |
|---|---|---|---|---|---|---|
| | | | Shock to lending | | Shock to lending and exchange rate depreciation | |
| Value in average terms | 2012 | 2013 | 2012 | 2013 | 2012 | 2013 |
| Annual GDP growth, in % | 1.7 | 2.08 | 1.1 | 1.8 | 0.6 | 1.13 |
| Annual growth of market interest rates | 0.0 | 0.5 pp | 0.5 pp | 1 pp | 0.5 pp | 1 pp |
| The lek's appreciation against both major currencies (EUR and USD), in % | 0.9 | 0.05 | 0.9 | 0.05 | -10% | -10% |
| Annual envisaged growth of outstanding credit, in % | 8.5 | 8.8 | 4.25 | 4.4 | 4.25 | 4.4 |

*Source: Assumptions of the Financial Stability Department and projections of the Research Department, Bank of Albania.*

Estimates on the loan portfolio quality indicator as at the end of 2013 (Chart 7.4.2) show that the probability of facing extreme values of the NPL ratio (far from the average) is higher in the adverse scenario than in the baseline scenario.

Chart 7.4.1 Distribution of the density of NPL values for 2012 Q4 and 2013 using Monte Carlo simulations, according to baseline and adverse scenarios, in %




Source: Financial Stability Department.

The following table shows the impact of above loan portfolio quality (besides other elements) on the banking sector's capital indicator. The results are presented in terms of capital adequacy for the banking sector as a whole and for individual banks, respectively as at end-2012 and 2013.

*Table 7.4.2 a): Results for the end of 2012*

| | Stress-testing results as at end-2012 | | | | | |
|---|---|---|---|---|---|---|
| | Baseline scenario | | Credit scenario | | Exchange rate scenario | |
| | Bank | Sector | Bank | Sector | Bank | Sector |
| Regulatory capital | | Capitalized | | Capitalized | | Capitalized |
| Modest undercapitalisation 1/ | Yes | | Yes | | Yes | |
| Severe undercapitalisation 2/ | No | | No | | Yes | |
| Tier 1 capital/Total risk-weighted assets | | Capitalized | | Capitalized | | Capitalized |
| Modest undercapitalisation 3/ | Yes | | Yes | | Yes | |
| Severe undercapitalisation 4/ | No | | Yes | | Yes | |

*Table 7.4.2 b): Results for the end of 2013*

| | Stress-testing results as at end-2013 | | | | | |
|---|---|---|---|---|---|---|
| | Baseline scenario | | Credit scenario | | Exchange rate scenario | |
| | Bank | Sector | Bank | Sector | Bank | Sector |
| Regulatory capital | | Capitalized | | Capitalized | | Capitalized |
| Modest undercapitalisation 1/ | Yes | | Yes | | Yes | |
| Severe undercapitalisation 2/ | No | | No | | Yes | |
| Tier 1 capital/Total risk-weighted assets | | Capitalized | | Capitalized | | Undercapitalized |
| Modest undercapitalisation 3/ | Yes | | Yes | | Yes | |
| Severe undercapitalisation 4/ | No | | Yes | | Yes | |

*/1= Below the 12% ratio*
*/2= Below the 8% ratio*
*/3= Below the 6% ratio*
*/4= Below the 3% ratio*
*Source: Financial Stability Department.*

The stress-testing results reveal that the overall banking sector is resilient to assumed shocks. The banking sector capitalisation remains above the minimum required ratio in the event of the baseline scenario. In the event of the adverse scenarios, which include the respective assumptions of decline in GDP growth rate, credit slowdown and exchange rate depreciation, individual banks and the banking sector may need additional capital. In the face of pressures from international developments and domestic economic activity, banks should cautiously monitor their activity to maintain an appropriate capital level in any case.

*Box 7.4 "Bottom-up" approach to stress testing*

*Actually, to conduct stress testing, the Bank of Albania builds macroeconomic scenarios and uses official data reported by individual banks to assess the impact of those scenarios on banks' capitalisation. In this case, the whole process takes place at the Bank of Albania without involving banks. It is otherwise conceived as the "top-down" approach.*

*In 2012, the Bank of Albania took an initiative to build a stress-testing exercise through a "bottom-up" approach, which will take place yearly. This approach aims at assessing the resilience of banks and of the banking sector to macroeconomic shocks, by incorporating the results assessed by the banks themselves according to severe scenarios offered by the Bank of Albania. Banks should assess the impact of shocks on their activity indicators in terms of balance sheet items, table of income and expenditure, credit risk, market risk, etc. After processing the results, individual banks send them to the Bank of Albania, which processes and compares them with the internal "top-down" assessments. Any discrepancy between assessments by the Bank of Albania and by individual banks is subject to discussion at joint meetings. The final version of the exercise summarizes the stress-testing results according to individual banks' results, which will be revised, if necessary.*

*Employing the "bottom-up" approach provides access to a broader and more detailed database of banks, comparing them with the database available at the Bank of Albania, potentially leading to higher-quality results. Also, committing individual banks to the exercise, this approach increases their vigilance to macroeconomic risks and promotes their capacity building to regularly conduct stress-testing themselves.*

*The formal exercise of 2012 was preceded by a pilot version conducted in October-November 2011, addressed to all the banks of the sector but mandatory for 5 largest banks. The formal exercise included 5 largest banks in Albania, whose assets accounted for 73.4% of total banking sector assets as at end-2011. Once a broader database of results is created and its quality is consolidated, the database will be disclosed to participant banks and will be duly published.*

# ANNEX 1 FINANCIAL STRENGTH INDEX[28]

*FINANCIAL STRENGTH INDEX OF THE BANKING SECTOR*
*JUNE 2012*

It is assessed that as at end-June 2012, the value of the Financial Strength Index fell to 83.3, down by 2.4% relative to end-2011, and slightly up by 0.13% relative to the same period a year earlier. The financial strength index value was below the 94.7 period average[32] and also below the level of the base period (December 2005=100). The index decline was driven by the combined effect of its sub-index components, as follows:

- *Asset quality deteriorated further, due to the sub-index decline to 66.5, from 68.6 as at the end of 2011. It is a consequence of increase in gross and net non-performing loans of the banking sector.*

- *Liquidity Sub-index declined by about 4.2% to 85.4 due to decline in 'assets of up to three-month maturity/liabilities of up to three-month maturity' from 77.2% to 73.1% in 2012 H1.*

- *Exchange Rate Risk Sub-Index declined, indicating a larger exposure to exchange rate risk due to reverse calculation of this sub-index. This larger exposure was due to increased ratio of 'balance sheet items[33]/regulatory capital' to 8.7%, from 3.7% as at the end of 2011.*

- *Capital Adequacy Sub-Index fell by about 3.5% to 65.5 in 2012 H1. Even though the capital adequacy ratio improved in June 2012, the other component of this sub-index, 'free capital[34]/total assets' fell to 24%, from 29% as at end-2011, as a consequence of increased non-performing loans.*

In the meantime, the sub-indices that have positively contributed to financial strength index and consequently to banking sector performance are analysed as follows:

- *Profitability Sub-Index improved obviously to 79.1 in 2012 H1 from 71.1 at end-2011 due to simultaneous increase in both ratios composing this sub-index.*

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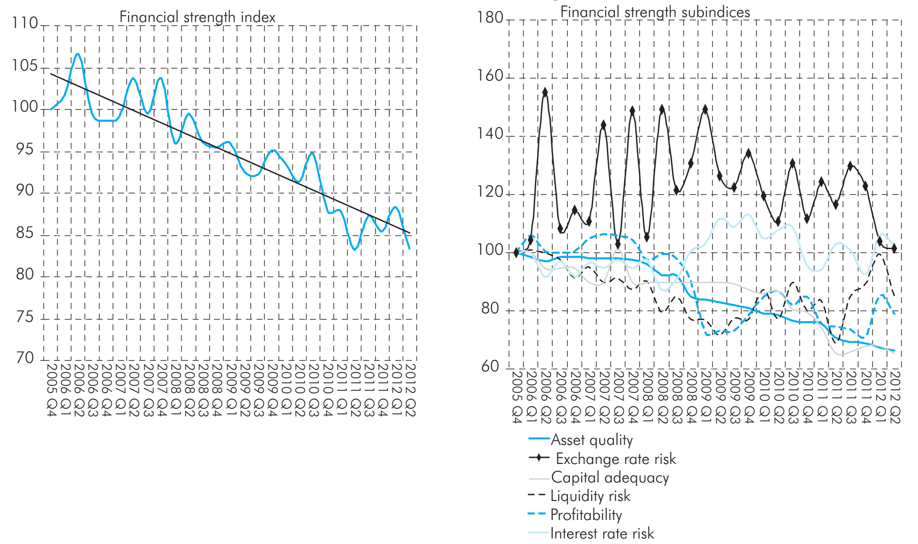
[31] *The methodology of building the Financial Strength Index is presented in the Financial Stability Report on 2010 H1.*
[32] *The average refers to December 2005-June 2012.*
[33] *The balance sheet items refer to the difference between foreign-currency assets and foreign-currency liabilities, excluding off-balance sheet items.*
[34] *Free capital = Shareholder's equity - fixed assets (fixed assets + net non-performing loans)*

- *Interest Rate Risk Sub-Index increased, signalling a lower exposure to risk due to reverse calculation of this sub-index. In 2012 H1, this sub-index value resulted 102.3, from 92.7 as at the end of 2011.*

The following charts and table show the performance of the financial strength index and its sub-indices for the banking sector.

Chart 8.1 Financial Strength Index




Source: Bank of Albania, Financial Stability Department calculations.

*Table 8.1 Performance of sub-indices and financial strength index for the banking sector*

| Sub-indices | Asset quality | Liquidity risk | Exchange rate risk | Profitability | Capital adequacy | Interest rate risk | Financial strength index |
|---|---|---|---|---|---|---|---|
| December 05 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |
| March 06 | 98.46 | 100.76 | 104.50 | 106.09 | 100.00 | 100.18 | 101.67 |
| June 06 | 96.97 | 100.02 | 155.33 | 100.70 | 94.77 | 91.54 | 106.56 |
| September 06 | 98.46 | 97.40 | 108.51 | 100.15 | 94.77 | 97.15 | 99.41 |
| December 06 | 98.46 | 91.40 | 114.78 | 100.50 | 94.77 | 91.92 | 98.64 |
| March 07 | 98.15 | 95.17 | 110.97 | 104.88 | 89.54 | 96.55 | 99.21 |
| June 07 | 98.15 | 89.93 | 144.07 | 106.39 | 89.54 | 94.55 | 103.77 |
| September 07 | 97.83 | 91.45 | 102.89 | 105.88 | 101.41 | 97.67 | 99.52 |
| December 07 | 97.52 | 87.33 | 148.84 | 104.34 | 89.54 | 94.63 | 103.70 |
| March 08 | 96.06 | 90.34 | 105.30 | 97.46 | 89.54 | 97.32 | 96.00 |
| June 08 | 92.09 | 79.46 | 149.27 | 99.57 | 89.54 | 87.29 | 99.54 |
| September 08 | 92.37 | 84.73 | 121.53 | 98.11 | 89.54 | 90.62 | 96.15 |
| December 08 | 84.92 | 76.86 | 130.95 | 90.01 | 89.54 | 100.27 | 95.43 |
| March 09 | 83.81 | 77.25 | 149.27 | 72.69 | 89.54 | 102.82 | 95.90 |
| June 09 | 82.95 | 71.62 | 126.12 | 73.22 | 89.54 | 111.53 | 92.50 |
| September 09 | 81.83 | 77.80 | 122.23 | 73.16 | 89.29 | 108.74 | 92.18 |
| December 09 | 80.75 | 77.04 | 134.14 | 78.51 | 87.37 | 113.02 | 95.14 |
| March 10 | 79.00 | 87.23 | 119.59 | 84.89 | 85.89 | 105.09 | 93.62 |
| June 10 | 78.70 | 77.14 | 110.50 | 86.68 | 86.72 | 108.03 | 91.29 |
| September 10 | 76.59 | 89.82 | 130.91 | 81.87 | 80.32 | 109.01 | 94.75 |
| December 10 | 76.26 | 80.19 | 111.71 | 84.75 | 79.33 | 95.84 | 88.01 |
| March 11 | 75.60 | 83.61 | 124.25 | 75.65 | 74.20 | 93.93 | 87.87 |
| June 11 | 70.95 | 68.58 | 116.78 | 74.64 | 65.46 | 102.99 | 83.23 |
| September 11 | 69.16 | 84.72 | 129.52 | 73.53 | 65.86 | 100.84 | 87.27 |
| December 11 | 68.63 | 89.11 | 122.96 | 71.14 | 67.93 | 92.71 | 85.41 |
| March 12 | 67.11 | 99.52 | 104.14 | 85.42 | 67.98 | 105.95 | 88.36 |
| June 12 | 66.54 | 85.36 | 101.26 | 79.11 | 65.52 | 102.27 | 83.34 |

*Source: Bank of Albania, Financial Stability Department calculations.*

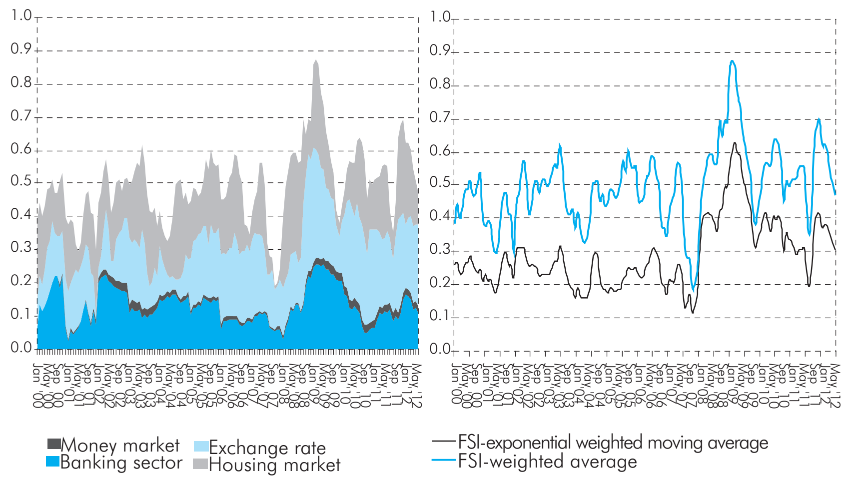
# ANNEX 2 SYSTEMIC RISK INDEX AND SURVEY RESULTS ON BANKS' PERCEPTION OF SUCH RISK

*Box 8.1 Financial Stress Index for Albania (FSI)*

*Quantifying and tracking the systemic risk* remain important in macro-prudential decision-making, helping to identify and assess threats to financial stability.*

*Therefore, the following presents the financial stress index** that measures the level of financial stress in Albania through data on different components of the financial system, aggregated into a single Financial Stress Index. The employed indicators, grouped into 4 sub-indices, represent the principal components of the financial system: banking sector, money market, foreign exchange market (exchange rate) and housing market. These sub-indices are weighted to present their contribution to the financial system and economic activity in Albania. They also aim to provide different and complementary data on the level of financial stress in different market components.*

Chart 8.1.1 Financial Stress Index

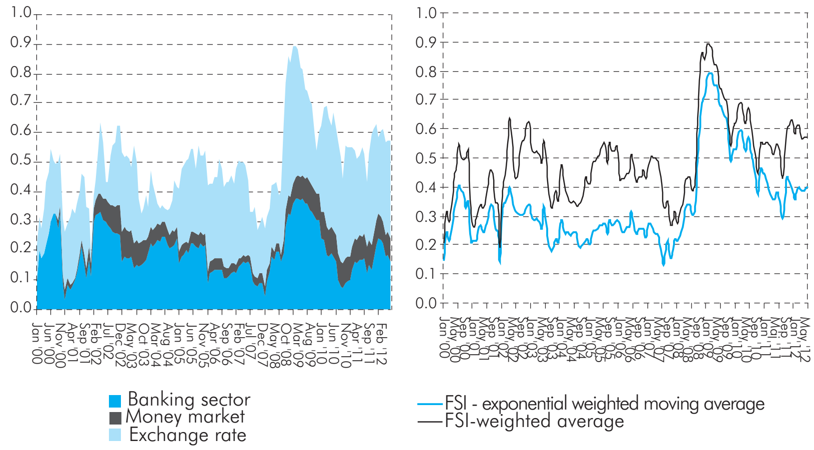



Source:Bank of Albania, Financial Stability Department.

*Chart 8.1.1 shows the Financial Stress Index (FSI) by contributions of each sub-index (left) to overall systemic stress (right), and by estimates of correlations (right), using relevant variance-covariance of each sub-index. This index highlights the main periods of a higher stress level. Besides the onset of an underlying stress situation in late 2008 due to the financial crisis, late 2011 highlighted an obvious stress level in the financial sector, which, albeit downward, remained present in 2012 Q1 as well. The contracted credit demand***, tighter credit supply and impaired credit quality, changes in exchange rate and housing market, reflected also in collateral value, have contributed to increasing the level of the systemic stress index, mainly due to interaction of various components of the financial system with one another.*

*Including the housing market in this index aims at assessing the direct exposure of this market to other markets of the system. Chart 8.1.2 shows the financial stress index in the event of excluding it.*

Chart 8.1.2 Financial Stress Index excluding housing market




Source: Bank of Albania, Financial Stability Department.

*According to both approaches, exposure to risk has gradually declined following the end of 2012 Q1.*

* *Systemic risk is the materialization of shocks, when financial instability becomes so widespread that it impairs the functioning of a financial system to the point where economic growth and welfare suffer materially. (Hollo et al, 2011).*

** *A detailed presentation of the methodology used for constructing the Systemic Risk Index is presented in the material "A Financial Stress Index for Albania", by Vasilika Kota and Arisa Saqe, Financial Stability Department, Bank of Albania, presented at the 5th Workshop on Research in South-East Europe, Tirana, 10–11 November 2011.*

*** *According to Lending Activity Survey for 2012 Q1.*

*Box 8.2 Survey results on "Banks' perception of systemic risk"*

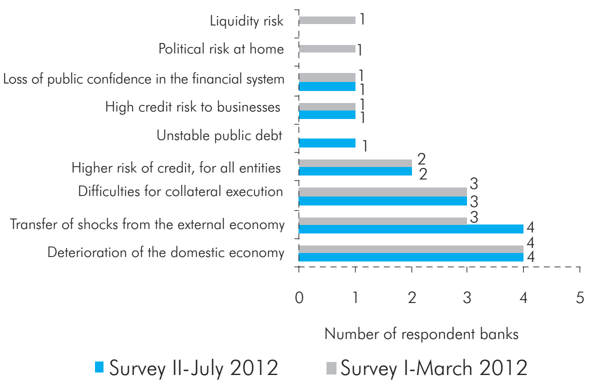
*The systemic risk survey is conducted on a quarterly basis, having started since March 2012, aiming to quantify perceptions of banks operating in the country, on systemic risks that may threaten the banking sector. This survey encompasses all the banks. The results of the second survey (conducted in July 2012), highlight:*

- *The top five risks most frequently cited by banks, listed by their size of impact on the financial system if they were to materialise are: 1) Exacerbation of domestic economy; 2) Transfer of shocks from external economy; 3) Difficulties in collateral execution; 4) Increased corporate credit risk; 5) Increased credit risk to all entities simultaneously.*

- *The top three systemic risks cited to be less concerning to the banking sector are: 1) Domestic inflation risk; 2) Concerns in the interbank market functioning; 3) Concerns in the payment system functioning.*

- *Risks most challenging to manage as an institution are: Exacerbation of domestic economy, and transfer of shocks from external economy. This is because of their complex and comprehensive nature. Regarding the risk of difficulty in collateral*

Chart 8.2.1 Risks most challenging to manage as an institution




Source: Bank of Albania, Financial Stability Department.

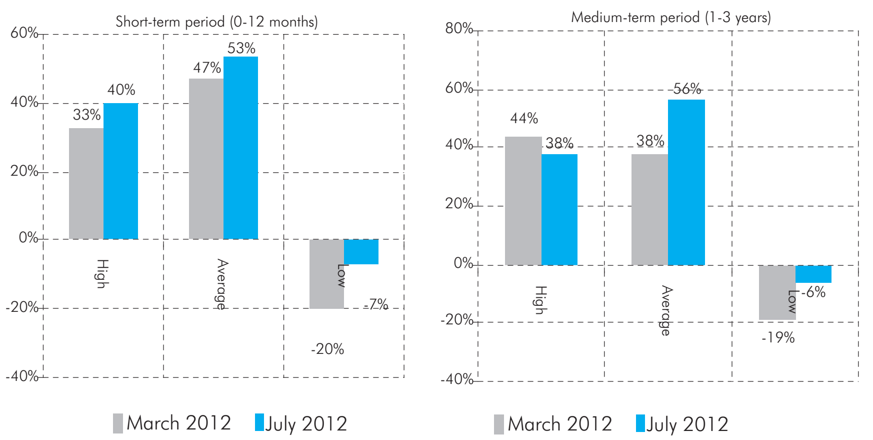
*execution, the banks found more concerning the legal and regulatory deficiencies, which cause delays in this process.*

*About 53% of respondent banks perceive an average probability of occurrence of a key systemic risk in the short term (up to 12 months), while this frequency increases to 56% in the medium term (one-three years).*

*About 67% of respondent banks think that the probability of occurrence of a systemic risk has increased in the short term up to one year and to 75% over a medium-term horizon (one to three years).*

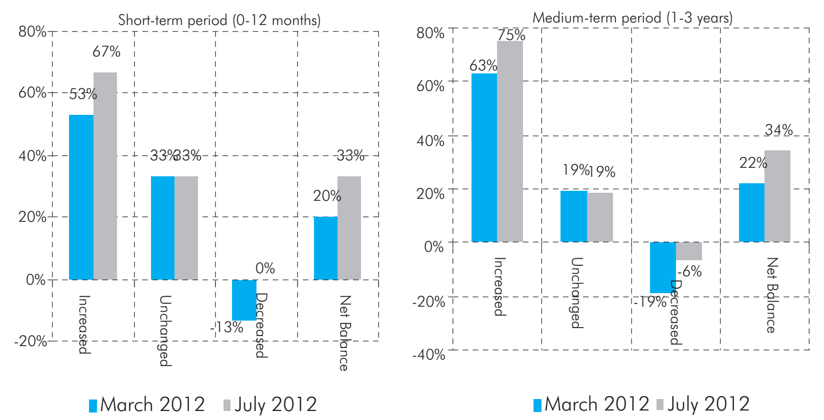
*Among the main strategies cited by banks to mitigate*

Chart 8.2.2 Probability of occurrence of a key systemic risk




Source: Bank of Albania, Financial Stability Department.

Chart 8.2.3 Change in the probability of occurrence of a systemic risk

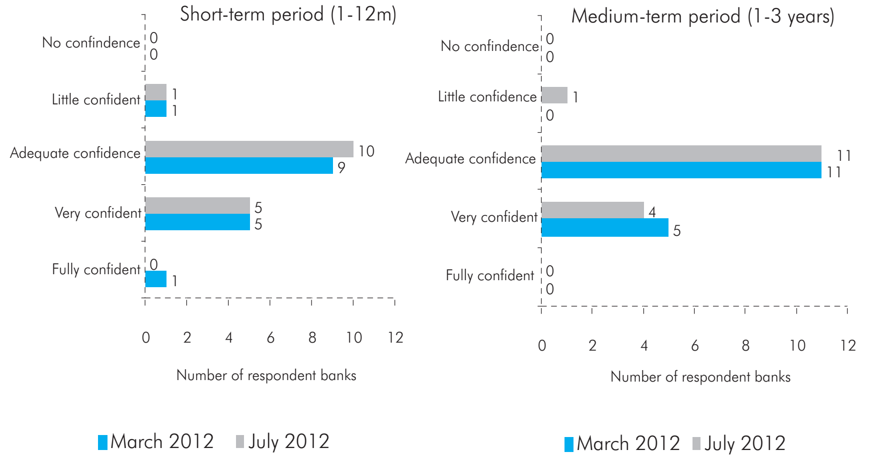



Source: Bank of Albania, Financial Stability Department.

*the systemic risk in the short term are: strengthening the internal audit systems and tightening the credit conditions. Over the medium-term horizon, banks lay more emphasis on activity diversification strategies, capital addition, undertaking of policies to increase deposits, and orientation towards strategic sectors of the economy.*

- *In spite of increase in the perceived risks, most banks reported sufficient confidence in the Albanian financial system in the short and medium term. In the survey conducted in July 2012, 10 out of 16 banks (owning 76% of assets of the system), report sufficient confidence in the financial system in the short term and this number increases to 11 banks (owning 77% of assets of the system) in the medium term.*

Chart 8.2.4 Banks' confidence in the Albanian financial system




Source: Bank of Albania, Financial Stability Department.

- *When respondent banks were asked how the level of confidence in the financial system had changed over the past six months (having July 2012 as a reference), 14 out of 16 respondent banks reported that their confidence level had not changed because the system was well-capitalised and liquid.*