Bank of Albania

FINANCIAL STABILITY REPORT 2012 H2

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PREFACE

This is the ninth 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 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 exchanged information with other authorities supervising the financial market activity. We have also used information and analyses of public and private, national and international financial institution. The presented data and analyses cover mainly the developments over 2012 H2. Expectations on the economic and financial outlook, unless otherwise stated, generally extend until end-2013.

The financial system stability has been assessed based on the performance and risks arising from its 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, general price level, exchange rate and fiscal indicators. In addition, by making an analysis of employment and income, it provides an assessment of businesses and households' financial situation, and impact on the banking sector borrower's solvency.

NOTES

As at end-December 2012, 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's 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's assets): Procredit Bank, Credit Agricole Bank, National Bank of Greece, Société Générale Albania, Alpha Bank – Albania, Union Bank;

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

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

a) Foreign-owned banks[1]: Raiffeisen Bank (Austria); Intesa Sanpaolo Bank – Albania, Veneto Bank (Italy); Alpha Bank-Albania, Tirana Bank, National Bank of Greece (Greece); National Commercial Bank (Turkey); Société Générale Bank, Credit Agricole Bank (France); Procredit Bank (Germany); First Investment Bank (Bulgaria); International Commercial Bank (Malaysia); United Bank of Albania (Saudi Arabia); Credit Bank of Albania (Kuwait);

b) Albanian-owned banks: Credins Bank, Union Bank.

As at end-2012, the National Commercial Bank expanded its branches network to Prizren, Kosovo.

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

FINANCIAL STABILITY STATEMENT FOR 2012 H2

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 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. This Statement 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 improved further its profit, capitalisation and liquidity indicators. The volume of activity expanded at lower paces due to the slower increase in deposits and the considerable decrease in lending rates. Macroeconomic framework appeared stable despite the further slowdown of economic growth. It is characterised by a low fluctuating exchange rate, weak inflationary pressures and decreased government borrowing cost despite the increase in budget deficit and public debt. Financial markets operated in line with their last years’ trend, characterised by upward activity volume and transactions. Credit risk represents the most important challenge to the banking sector. Banking sector’s exposure to market and liquidity risks remains contained.

The following provides an overview of developments in the surrounding economic environment, both internal and external ones, and within the financial system.

Notwithstanding the improved functioning of global financial markets, economic developments remain unstable. Economic growth in advanced economies contracted, whereas developing economies continue to provide positive contribution to economic growth. The United States and Europe recorded a more pronounced slowdown of economic growth in 2012 Q4. Also, countries in South-Eastern Europe recorded a further decrease in economic growth in the last part of 2012, or a contraction across different countries. Inflationary pressures remained weak due to the sustainable output gap, increased unemployment and decrease in oil and food prices. Monetary policies remain deeply eased, while governments’ actions, particularly in Europe, are aiming at fiscal consolidation, business climate improvement and labour market liberalisation, mainly with a medium-term effect. Situation in financial markets remains more stabilised, particularly after the European

Central Bank actions. However, the demand for loans, particularly in euro area and Central and South-Eastern Europe, continues to remain weak due to the perceived credit risk and the need for further restructuring of banks and other credit institutions' balance-sheets. Capital markets, particularly in the United States, increased driven by the improved investors' confidence following the more optimistic indicators on the economic growth.

Economic developments at home remain similar to the previous period, characterised by a slower pace of economic growth. Albania's economic growth averaged 1.6% in 2012 Q4. Consumption and private investments continue to be weak, whilst unemployment rate remains stable. Industry, agriculture and services provided positive contribution to economic growth, whereas transport and construction provided a negative contribution. Over the period under review, external demand provided positive contribution to economic growth leading to a decrease in both current and trade account deficit, in absolute value and as a percentage of GDP. Economic developments were reflected in an annual decrease in fiscal revenues, mainly driven by the fall in tax revenues. Fiscal deficit was estimated at 3.4% of GDP as at end-2012. The Parliament approved the Government request to increase public debt to GDP ratio to above 60%, motivated by the need to increase the contribution of fiscal incentive to economic growth. The average term of debt continued to increase due to the sharper increase in the value of debt issues with maturity term longer than 12 months. During the period under review, due to the low inflationary pressures, Bank of Albania implemented an easing monetary policy by cutting the interest rate on one-week repurchase agreements several times. This monetary policy stance aims at providing better conditions to support consumption and private investments through lowering the financing costs in the domestic currency.

Businesses and households' financial position and sensitivity against risks did not show any substantial change throughout the period. Households' creditor position deepened, mainly driven by the considerable increase in foreign currency deposits. Loan quality for households has been worsening in almost all its components. Households' exposure against unfavourable exchange rate and interest rate changes does not show substantial changes from the previous period. Businesses' debtor position has been reducing during the period due to the lower increase in loans than in deposits. Businesses' debtor position is mainly impacted by the activity in foreign currency. Business non-performing loan ratio increased due to the considerable slowdown in lending, despite the lower growth rate of non-performing loans. Businesses' exposure to unfavourable exchange rate and interest rate changes, albeit still high, reduced slightly during the period.

Overall, financial markets at home pursued the recent years' tendency. Related to non-financial assets, worth noting is the simultaneous fall and at similar paces of house and rental price index. This was due to the lower increase in the relative cost of real estate loan payment in the last quarter of 2012. Combined, this information suggests a more stable continuation of the downward trend in house prices. In the government debt securities market, there was an increasing preference for debt issues of longer than 12 months maturity. Interest rates have been decreasing, reflecting the cut of the key interest rate by the Bank of Albania, and the ample liquidity due to the considerable slowdown in lending to the private sector. In the secondary market for debt securities, trading volumes remain low and concentrated only in T-bills. Volume in the interbank market grew considerably. Overnight transactions had the main share in the number of transactions, although one-week transactions grew considerably. Interest rate in interbank transactions has reflected the performance of the key interest rate. In the foreign exchange market, lek was relatively stable against both, euro and US dollar.

Technical infrastructure supporting banking sector activity has operated in line with the expected parameters. Payment systems constitute an important part of financial system structure being the channels to transfer funds between banks, other financial institutions and customers. As a consequence, their stable and efficient operation contributes significantly to safeguarding financial stability. During this period, AIPS and AECH systems have operated in compliance with the technical requirements to meet the banking sector needs relating to settling payment transactions in the domestic currency. The volume and value of transactions processed in AIPS increased in 2012, followed by an almost doubled value per transaction. The number and value of transactions processed in AECH have been falling. In both systems, transactions processed on behalf of banks' customers have the main share in the value and number of transactions. According to banks, the four most active banks in both systems account for 2/3 of the number and value of processed transactions. Due to the importance of these systems, the Bank of Albania shall engage in carrying out all the required improvements to the regulatory framework and supportive technological infrastructure, in order to ensure that their performance precedes the operators' needs for a safe and effective payment activity.

Banking sector improved its profit, capitalisation and liquidity indicators further in 2012 H2. Activity volume increased at lower paces, due to the sluggish increase in deposits and considerable decrease in lending pace. The level of financial intermediation in Albania, as measured by the ratio of financial system[2] assets to GDP, was 93.9% at end-2012, from 92.8% in 2012 H1 and 89.5% in the same period a year earlier. The volume of financial institutions' assets grew by about 2.9% from 2012 H1 and by about 7.3% from a year earlier. The banking sector remains the dominant segment of financial intermediation in Albania. Its assets account for about 93.6% of total financial system assets and about 87.9% of GDP.

Total banking sector's assets grew to ALL 1,187.98 billion, up by 6.1% from the previous year, but down by 0.1% in 2012 Q4. The annual growth rate of lending slowed down considerably to 2%. Due to the contraction in foreign currency lending, the growth of lending in lek by 12.8% provided

[2] *The financial system consists of banks, non-bank financial institutions, savings and loan associations (SLAs), insurance companies, private supplementary pension funds and investment funds. The data on non-bank financial institutions, insurance companies and pension funds refer to 2012 Q3, as the latest reported to the Bank of Albania.*

the sole contribution to the growth of lending. The slowdown in banking sector indicators was more evident during 2012 Q4, as the economic growth decelerated compared to the previous period. Loan-to-deposit ratio was 58.6% as at end-2012. Loan stock increased ALL 11.8 billion during the year, from ALL 75.2 billion in 2011. Despite the low growth in loans, new banking sector loans during 2012 were comparable to the previous year. Hence, the increase in loan repayments at higher levels over 2012 impacted the credit stock performance. Non-performing loans to total loans ratio stood at 22.5%, down by 0.24 percentage points in 2012 Q4, but up 3.72 percentage points from end-2011. Lek loan ratio stood at 18.5%, up by 1.6 percentage points from December 2011 and improving by 0.9 percentage points from September 2012. Foreign currency loan ratio stood at 24.7%, up by 5.0 percentage points from end-2011 and increasing by 0.3 percentage points in 2012 Q4. Deposits amounted to ALL 991.6 billion, increasing by 7.3% during the year. The growth of foreign currency deposits was higher than that of lek deposits.

The banking sector registered a positive financial result, with an accumulated net profit of ALL 3.8 billion. 'Net interest income' totalled ALL 39.8 billion, or 0.3% higher than in the previous year. Loan loss provisions increased by about ALL 19 billion, or about 12% lower than a year earlier. Paid in capital increased by about ALL 9.5 billion (about 2/3 of the increase took place during 2012 H1). Regulatory capital climbed to ALL 104.1 billion, up by 5.7%. Risk-weighted assets rose to ALL 643.7 billion, up 1.7%, y-o-y. Consequently, capital adequacy ratio rose to 16.2%.

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

Concerning the impact of macroeconomic developments, fiscal stimulus contribution to economic growth would be more significant if accompanied by improved confidence of economic agents in the sustainability of medium-term fiscal indicators. The increase in budget deficit and public debt is expected to be accompanied by a higher fiscal stimulus in the economic activity at home. The orientation of expenses to capital ones, including those in the form of settlement of existing liabilities to private sector entities, would be important to improve the financial situation of these entities and related ones in business relationships. This behaviour would improve their solvency and the quality of debt they have against the banking sector. On the other hand, economic agents' perception about the economic situation determines the difficulties the Albanian and global economy are encountering. A prolonged negative perception becomes a lack of confidence for an optimistic outlook and impels economic agents to undertake actions that aim to restrict the damage in their financial performance. In a more generalised framework, these actions undertaken individually reinforce the decelerating cycle of economic developments bringing about negative consequences in a broader context. Therefore, the Bank of Albania deems that fiscal policy objective to encourage economic growth should be followed with the objective of improving the economic agents' confidence in the stability of fiscal indicators. This would require the establishment of a stable fiscal rule in the short-term, which will set the maximum public debt limits in the medium-term and will provide the return of this indicator to a downward stable trend. Bank of Albania has formulated the proposals in this regard and is willing to contribute to this process on the way this rule will be established and function. The Bank of Albania assesses positively the Ministry of Finance's policy to increase the issue of debt securities with a maturity longer than 12 months. The extension of the average maturity of debt reduces the re-investment risk in debt securities and its cost volatility. For this reason, this policy should continue to carefully consider the liquidity situation in the interbank market and other investors' demand. The cautious monitoring of foreign currency liabilities is another important element in fiscal policy. Actions to provide, in due time and at an acceptable cost, the foreign currency sources to meet these obligations, contributes to avoiding instabilities in the market and fostering financial stability.

In the activity of financial system, direct and indirect credit risk represent major risks, particularly to the banking sector. Credit quality deterioration during 2012 was accompanied by a considerable slowdown in lending pace. As both tendencies have a strengthennig effect on each other, the Bank of Albania undertook some measures to encourage banks to lend and engage in earlier loan restructuring. More specifically, in order to boost lending, the regulatory amendments provide for:

a. removal of capital requirements for the annual growth of lending to the economy if it ranges between 4-10%.

b. the increase in capital requirements for the additional banking sector investments with non-resident financial institutions.

c. overall decrease by 5 percentage points of the regulatory requirement for the minimum liquidity ratio in total, in lek and foreign currency, compared to the existing level, by banks' risk profile.

To address the phenomenon of non-performing loans increase, the regulatory amendments provide for:

a. loan restructuring since the stage it is categorised as standard but the borrower begins to manifest the first problems in paying the credit. The new terms and conditions following the loan modification process seek to preserve borrower's solvency and loan quality. This loan will continue to be classified as standard (in the first two categorisation classes) but will require higher provisioning of 10%.

b. decreasing from nine months (or until the borrower has paid 3 loan instalments) to six months of the restructured loan classified in the same category, to encourage banks' interest toward the restructuring process.

The change in capital requirements for the annual growth of credit and banking sector investments with non-resident financial institutions is countercyclical and transitory, and will be effective for 2013-14. Unless otherwise decided by the Bank of Albania, these amendments will be repealed upon the termination of the effect period, and banks will ensure compliance with the current regulatory framework requirements by June 2015. This mechanism is considered important to preserve banks' cautious lending and well-capitalised activity.

These measures follow-up on the legal proposals for amendments to the Civil Code and Code of Civil Procedure, which aim at improving the collateral execution process. The Bank of Albania considers that the timely approval of these amendments by the Albanian Parliament will be conducive to tackling and easing banking sector's non-performing loan situation, contributing in turn to recovering lending.

The primary objective of the Bank of Albania is to maintain a stable banking sector. Under the impact of these amendments, banks' behaviour will therefore be monitored closely and continuously, in order to assess the impact of these measures on banking activity indicators and identify the need for further action.

The presence of high non-performing loans stock in banks' balance sheet, give rise to the banks' activity cost and imposes an increased and inefficient use of their capacities. As a result, bank services tend to be more expensive for the consumer. Typically, the above measures aim to slowdown the further increase of non-performing loans ratio to total loans. In this framework, it is important to assess the needed additional actions as well address the existing stock of non-performing loans.

The Albanian 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 customers. A significant level of exchange rate depreciation or a similar increase in the interest rate may impair bank customers' solvency, particularly in the business sector. This risk arises mainly from foreign currency-denominated loans, when the main source of their settlement is in the domestic currency, and also from the variable interest rate loans.

Liquidity risk to the banking sector is assessed at moderate levels. As in the previous periods, deposits constitute the key financing source for the banking sector. They grew at satisfactory rates, albeit slower, during 2012. Borrowing from non-residents pursued a falling tendency and remains controlled. Banking sector's liquid assets in lek and in major foreign currencies remained notably above the minimum rates required by the regulatory framework. Loan to deposit ratio stands at optimal levels due to the sluggish lending.

Currently, capitalisation indicators are at good levels, although banks should assess carefully their needs for additional capital in the future. During the period under review, the sluggish growth of risk-weighted assets provided the main contribution to this increase. Despite the positive financial result, banking sector's ability to generate sufficient income to support the increase in capital and carry out its activity through domestic resources remains unstable. On the other hand, net non-performing loan coverage with capital was lower. Banks should, therefore, assess carefully and proactively their needs for additional capital in line with their activity risk profile. Whenever needed, based on this assessment, banks should act to enhance their capital position, initially by restricting the allocation of profit and then by injecting additional capital.

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-2014. Stress-test results show that, overall, the banking sector appears resilient in the event the assumptions about respective indicators take place. Capitalisation for the entire sector remains above the required minimum for the baseline scenario. In the event of the most severe scenarios, which assume the fall in GDP growth rate, credit slowdown and exchange rate depreciation, individual banks may need additional capital.

1. INTERNATIONAL DEVELOPMENTS

Global economic activity continued to recover gradually during 2012 H2, but at slower paces than in 2012 H1, reflecting primarily euro area's economic weakness and its effects on the rest of the world. Political actions in response to the deteriorated macroeconomic outlook, and in particular the measures taken by the European Central Bank (ECB), impacted positively the financial markets. Investor confidence increased and trading conditions improved across almost all market segments.

Global economic growth was positive during 2012 H2, but at slower paces than in 2012 H1. Economic downturn was more evident in advanced economies, particularly in the euro area driven by the weak domestic consumption and investments, due to the high unemployment rate, decline in lending and the implementation of strong fiscal reforms. Emerging and developing economies headed the economic growth for the period under review, but their pace was conditioned by the fall in external demand and implementation of tight policies pursued since last year. Global trade activity deteriorated mainly due to the downward demand for exports from advanced economies. Globally, inflationary pressures eased in the last months of 2012, after an increase in the third quarter, attributable mainly to developments in the energy sector.

Notwithstanding the developments in the real sector, overall, global financial markets performed positively in the last two quarters of 2012, reflecting the political initiatives implemented mainly in the euro area and United States. The operations taken by the European Central Bank, such as: further easing of monetary policy[3], the commitment to purchase an unlimited amount of bonds in secondary markets[4], the restructuring of the banking sector in Spain and renovation of financial loan to Greece, affected positively investors' confidence in financial markets. Yields on government bonds in euro area dropped and trading conditions improved in almost all financial market segments.

The recent developments of macroeconomic indicators show that global activity is expected to recover gradually at end-2013 and to reinforce this trend in the following year[5], driven by the improvement of financial conditions

[3] *In July 2012, the ECB announced the cut of the interest rate on the main refinancing operation to 0.75%.*

[4] *In September 2012, the ECB announced the initiative to purchase government securities affected by the crisis in the secondary market, via a new program, OMT (Outright Monetary Transactions). This initiative aims at maintaining monetary policy transmission and avoiding uncertainties about the future of the common currency.*

[5] *The IMF projects the economic growth to average 3.5% in 2013 and 4.1% in 2014.*

and accommodative monetary policies in most advanced and emerging economies. However, a number of risks, such as: slowed implementation of structural reforms in the euro area, further weakening of global trade, the geopolitical conflicts and macroeconomic instability in advanced economies continue to be present. These factors might impact negatively the sensitivity in financial and prime commodities markets, postponing the recovery of global economy.

The U.S. economic activity slowed down in 2012 Q4 compared to the optimistic performance in Q3, driven by the fall in government spending, declined inventories and sluggish exports due to the weak global trade. On the other hand, the increase in consumer spending and private investments drove the economic growth up. The U.S. economy slowdown is expected to continue during 2013 as well. The labour market conditions have shown signs of improvement, whereas activity in the house market continued to recover gradually. Inflationary pressures were low throughout 2012 H2, due to the drop in oil price in the last months of the year. Despite the positive signs, a number of weaknesses continue to be present, including: structural labour market weakness, pressures to decrease the financial leverage, and in particular the ambiguities related to fiscal policies for the year 2013. In this regard, the Federal Reserve's monetary policy supported the economic growth, by keeping the funds rate unchanged, at 0%-0.25%.

In the euro area, the economic downturn deepened further during 2012 H2, driven by the fall in consumption and domestic demand, combined with the weak external demand. The weak economic activity and fall in energy sector prices, kept inflation low. Labour market conditions in the region continued to deteriorate, although at uneven rates across member countries. Fiscal consolidation process marked remarkable progress throughout 2012, leading to deficit dropping to 3.5% of GDP (from 4.2% in 2011) and debt reduction to 90% of GDP. Lending to the private sector continued to fall, as a reflection of the high credit risk and financial and non-financial sector balance sheet adjustment. Last quarter indicators attest to the further weakening of credit demand and credit risk effect on tightening the lending standards. At the same time, there has been a positive effect of measures taken by the Eurosystem in the overall liquidity situation and banking sector financing, and a significant improvement of economic sentiment in the European financial markets.

With regard to the coming year, the euro area economic activity is expected to weaken in 2013 H1, and start to recover gradually during the end of year. Labour market conditions will continue to be tight and projections for the unemployment are upward, but at a slower pace. Inflationary pressures are expected to remain weak, with inflation marking rates below 2%. Meanwhile, the main risks threatening euro area's economic perspective remain: the fall in domestic demand and exports below the expected levels, and the risk of debt crisis return in case of delays or failures to timely implement structural reforms in the fiscal and financial sector.

Table 1.1 Selected macroeconomic indicators for the United States and euro area

	GDP change (annual %)			Inflation (annual %)			Unemployment* (annual %)			Sovereign debt (% of GDP)		
	2012*	2012 Q3	2012 Q4	Av. 2012	Sept'12/ Sept'11	Dec'12/ Dec'11	2012	Sept.'12	Dec.'12	2011	2012Q2	2012 Q3
USA	2.2	2.6	1.7	2.1	2.0	1.7	8.1	7.8	7.8	86.0	88.2	88.7
Euro area	-0.6	-0.6	-0.9	2.5	2.6	2.2	11.4	11.6	11.7	87.3	89.9	90.0
Germany	0.7	0.9	0.4	2.1	2.1	2.0	5.5	5.4	5.3	80.5	82.4	81.7
France	:	-2.4	-2.7	3.3	3.4	2.6	10.6	10.9	11.3	120.7	126.0	127.3
Italy	-6.4	-6.7	-6.0	1.0	0.3	0.3	:	26.2	27.0*	170.6	149.2	152.6
Greece	-1.4	-1.6	-1.8	2.4	3.5	3.0	25.0	25.7	26.1	69.3	76.0	77.4
Spain	2.2	2.6	1.7	2.1	2.0	1.7	8.1	7.8	7.8	86.0	88.2	88.7

Source: ECB, Eurostat database, IMF.
***IMF's projection, October 2012.*

Economic activity in Eastern European countries slowed down in 2012 H2, with pronounced differences across the countries. The large countries, such as Romania, the Czech Republic and Poland, continued to be affected negatively by the fall in external demand and the moderate domestic demand, while the growth of lending remained constrained and labour market conditions difficult.

In South-Eastern European countries, despite the distinctions, overall, the economic activity slowed down during 2012 Q3. Turkey's 1.6% economic growth was lower than expected. Economic activity slowed down in Kosovo, Montenegro and Bosnia and Herzegovina as well. Economy continued to contract in Croatia and Serbia. In the labour market, conditions improved slightly in Turkey, Montenegro and Macedonia. Unemployment rates declined compared to the previous year. They remain a particular concern in most countries of the region. Inflationary pressures increased in some countries during 2012, driven mainly by domestic factors, such are customs tax policies. In the banking sector, growth of lending slowed down further in the last two quarters of 2012, and in some cases (for example in Croatia and Montenegro) it declined. Loan portfolio quality deteriorated in almost all countries of this region.

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

Central and Eastern Europe	GDP growth (annual %)			Inflation (annual %)			Unemployment* (annual %)			Sovereign debt (% of GDP)		
	2012*	2012 Q3	2012 Q4	Av. 2012	Sept'12/ Sept'11	Dec'12/ Dec'11	2012	Sept'12	Dec.'12	2011	2012 Q2	2012 Q3
Hungary	-1.0	-1.7	-2.8	5.7	6.4	5.1	10.9*	10.8	10.9	81.4	78.9	78.6
Poland	2.0	1.8	:	3.7	3.8	2.2	10.2	10.3	10.6	56.4	57.0	55.9
Romania	0.9	-0.3	0.1	3.4	5.4	4.6	7.0	7.0	6.5	33.4	35.6	35.2
South-Eastern Europe (Balkan)				2012	2012 Q3	2012 Q4	2012	2012 Q3	2012 Q4	2011*	2012 Q3	2012 Q4
Serbia	-1.9p	-2.5	-1.5	7.3p	10.3	12.2	26.4p	22.4	22.4	48.7	55.1	59.2
Kosovo	3.7p	:	:	0.6*	3.2	2.5	:	:	:	:	:	:
FYROM	0.8p	0.2	:	3.3p	3.8	4.9	30.8p	30.6	:	27.7	:	:
Montenegro	0.2p	0.0	:	3.9p	4.4	:	13.5p	12.2	13.5	46.8	:	;
Turkey	3.0p	1.6	:	8.9p	9.0	6.8	7.5p	8.8	:	39.2	:	:

Source: ECB, Eurostat, IMF; Ecofin.
***IMF's projection, October 2012.*
p- ECOFIN projection, November 2012.

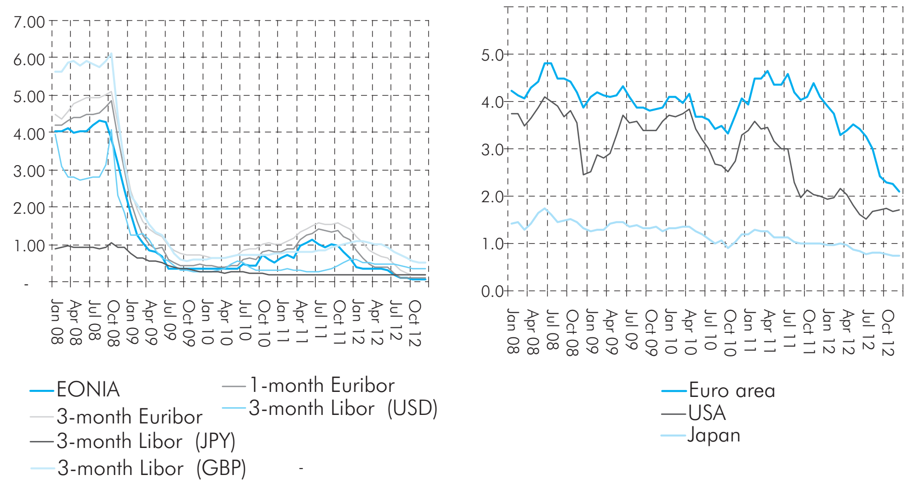
1.1 FINANCIAL AND PRIMARY COMMODITY MARKETS HIGHLIGHTS

Developments in international financial markets continued to reflect investors' perceptions related to debt crisis performance in the euro area during 2012 H2. Nevertheless, the political measures implemented by authorities in Europe and the United States reduced considerably tensions in markets, in particular during 2012 Q4, leading to an increase of investors' confidence and improvement of trading conditions almost in all market segments.

The European money markets were characterised by declining interest rates and low volatility, due to the accommodative policy and the ongoing ECB support with liquidity. The interbank market activity increased considerably and fragmentations lessened slightly after September 2012, reflecting the lower credit risk. In U.S. money markets, liquidity was ample and interest rates low, in particular after the Federal Reserve announcement to keep the funding rate at 0%-0.25% till the middle of 2015, and the initiative to purchase mortgage backed securities amounting USD 40 billion per month.

In euro area sovereign debt markets, tensions eased after the agreement on the Greek debt, the progress related to the banking sector restructuring in Spain, and in particular after ECB's announcement in September 2012 of the commitment to purchase debt securities of problematic countries in the secondary markets, as they request officially the European Union assistance. These events eased the risk perception of the euro area, leading to a general fall in yields on the member countries' sovereign debt. In the United States, yield rates on government long-term securities were overall stabilised, but with an upward trend at end-2012 due to the increased investors' confidence in economic performance and the flow of funds to more profitable markets.

Chart 1.1.1 Interest rates in main money markets and 10-year public bonds



Source: ECB, Eurostat.

Activity in capital markets continued to improve in 2012 H2, despite the uncertainties concerning the global economic outlook. Overall, prices in equity markets increased, particularly in U.S. markets, due to the more optimistic expectations. Trading conditions improved in credit markets as well, where the increased investors' confidence led to demand growth for more profitable financial securities, particularly for corporate bonds, both in the European and U.S. markets.

In the currency markets, since end-July 2012, the euro has appreciated against the U.S. Dollar and the Japanese Yen, mainly reflecting market perceptions related to the aggressive monetary stimulus implemented in these markets.

In primary commodity markets, crude oil price was upward pointing to USD 116 per barrel[6] in September 2012. The same increasing tendency characterised the non-energy primary commodity markets, where the increase in agricultural products prevailed. In 2012 Q4, pressures from the sluggish global economic activity brought the oil price down, ranging USD 107-112 per barrel.[7] Agricultural products' prices also decreased, due to the excess supply driven by the weak demand. For 2013, global demand for oil is expected to remain low, whilst the production levels continued to remain high, which is expected to generate a slight fall in prices in the medium run.

Global Large and Complex Banking Groups (GLCBGs) operated in a difficult economic environment, characterised by the fall in income due to the high unemployment, low interest rates and sustainability of non-performing loans, and weakening real estate market, particularly in the United States and United Kingdom. Their financial performance weakened during 2012 Q2 and Q3[8], due to the deterioration in all major income sources. Overall, commissions remained the main income source, whereas interest income continued to decline. Capital indicators improved at the beginning of 2012, mainly due to the increase in non-allocated profit and in general remained at the same levels for the rest of year. Nevertheless, large global banking groups performed better financially than their euro area peers during this period, which were negatively affected by the increased provisions and non-performing assets loss. Notwithstanding the unfavourable environment, characterised by downward lending and interest rates, overall, interest and commission income remained stable. Their profit are expected to be low in 2012 Q4, due to the combination of new economic and regulatory developments, and the effort to adapt the business models to the new economic reality. Capital position improved considerably for most European banks in response to the recapitalisation exercise of the European Banking Authority (EBA) and in light of continued progress for implementing Basel III requirements. Notwithstanding the improvement of economic sentiment of financial markets against European banks, after the new ECB measures, the situation remains fragile. Banks in the euro area continue to encounter a

6 *On 5 September 2012 (ECB Monthly Bulletin, January 2013).*
7 *December 2012- January 2013.*
8 *Financial Stability Review, ECB, December 2012.*

number of challenges in the short and medium run that will impact their financial result in the short run. These challenges relate to the need to adapt their business models, improve the sustainability of financing sources and improve assets quality. Facing them becomes more difficult due to the weak economic growth.

Euro area banking groups operating in Albania have shown varying trend of activity. Greek banking groups recorded fall in lending and deposits, and a decline in the net financial result, although they cut considerably the operating costs. Banking groups from other euro area countries, despite recording a moderate expansion of their activity, also encountered downward profits.

Box 1 Developments in banking groups operating in Albania

The table below summarises financial statements of the banking groups operating in Albania. Compared to end-2011 or the same period in 2011, the data show changes in the volume of customer deposits and loans, and earnings, despite the spending cuts. Capital adequacy ratio is at satisfactory levels, thereby requiring no additional capital under the legal requirements. The ratio of total assets of each individual bank in Albania to total assets of the group showed slight changes compared to previous periods.

Table 1.3 Financial data on foreign banking groups operating in Albania

	Raiffeisen Bank International[I]	Intesa San Paolo[II]	Alpha Bank[III]	Piraeus Bank*[IV]	National Bank of Greece[V]	Société Générale[VI]	Credit Agricole[VII]
Total assets	136.1	673.5	58.4	75.3	104.8	1250.7	2008.2
Annual change[VIII]	-7.4%	5.3%	-1.3%	-	-2%	6%	6.8%
Volume of customer loans	83.3	376.6	45.1	42	70.5	350.2	734.9
Annual change	2.2%	-0.1%	-9.3%	-	-3%	-5%	-8%
Volume of customer deposits	66.3	377.4	28.4	33.3	58.7	337.2	639
Annual change	-0.7%	5.6%	-3.2%	-	-1%	-1%	-4.2%
NPL ratio	9.8%	-	22.8%	18%	18.3%	-	8.1%
Provisioning	1	4.7	4.6	4.6	2.5	2.8	-
Net profit	0.73	1.6	-1.1	-0.6	-2.1	0.8	-0.5
Annual change	-25%	-	-	-	-	-67.5%	-
Operating income	5.1	17.9	1.5	1.1	3.4	2.7	6
Annual change	-6.1%	6.5%	-34.2%	-	-23%	-35.9%	-25.4%
Net interest income Annual change	-5.3%	-3.6%	-21.7%		-12%	-	-
Net commission income Annual change	1.8%	-0.3%	-7.3%	-	0%	-	-
Operating expenses Annual change	4.6%	-2.5%	7.5%	-	-8%	-3.5%	0.1%
Personnel cost Annual change	4.3%	-1.5%	2%	-	-14%	-	-
Net operating profit Annual change	-20.3%	17.3%		-	-	-	-
Net interest margin	2.4%	-	2.4%	-	3.7%	-	-
Capital adequacy ratio	10.7%	11.2%	9.5%	12.5%	8.8%	12.5%	11.8%

Data in EUR billion.
**Data for 2012 Q3.*

[I] Annual Report 2012, URL: http://investor.rbinternational.com/fileadmin/ir/2012_FY/2013- 04-10_2012_Annual_Report_RBI.pdf

[II] Financial results for 2012, press release, URL: http://www.group.intesasanpaolo.com/scriptIsir0/si09/contentData/view/20130312_RisultatiFY12_uk.pdf?id=CNT-04-00000000FF11B&ct=application/pdf

[III] Financial results for 2012, press release, URL: http://www.alpha.gr/files/deltia_typou/Deltio_Typou_20130327En.pdf

[IV] Financial Statements for 2012 Q3, URL: http://www.piraeusbank.gr/Documents/internet/Group_Presentations/2012/9m_Results_Presentation_en.pdf

[V] Financial results for 2012, URL: http://www.nbg.gr/wps/wcm/connect/ebe1c4aa-84d8-43f8-82cd-a4bf73026f65/Combined+Q42012+Presentation_FINAL.pdf?MOD=AJPERES&CONVERT_TO=url&CACHEID=ebe1c4aa-84d8-43f8-82cd-a4bf73026f65

[VI] Financial Information for 2012, URL: http://www.investor.socgen.com/phoenix.zhtml?c=69575&p=irol-results

[VII] Financial results for 2012, press release, URL: www.credit-agricole.com/en/content/download/30520/924604/version/43/file/Press_release_VA_Q4-12.pdf

[VIII] 9-month change in balance-sheet indicators for 2012 Q3.

2. ALBANIA'S MACROECONOMIC DEVELOPMENTS IN 2012 H2

2.1 REAL ECONOMY

The Albanian economy grew at an annualised rate of 1.7% in 2012 Q4. Industry, agriculture and services provided positive contribution to economic growth by 7.8%, 6.1% and 4%, respectively. Post and telecommunications recorded the highest increase in services by 24%, followed by other services, 7.8%. Transport and construction continued to shrink during this period, by an annualised rate of 8.4% and 15.4%, respectively. Trade also contracted at an annualised rate of 1.7%.

Indirect data show that consumption and private investments at home remained at low levels during 2012 H2. Lending and fiscal stimulus deceleration weakened the domestic and aggregate demand, despite the improved net exports. External demand remains unstable due to the weak economic performance in Albania's trading partners. During the period under review, the Bank of Albania implemented an easing monetary policy, aiming at encouraging consumption and investments in Albania.

At end-2012 Q4, the average wage in economy shrank 6.5% in real terms. Thus, the pressure for the decline in disposable income was higher. This situation was also reflected in the deterioration of the consumer confidence index[9] in 2012 Q4.

Developments in consumption have also reflected the movements in the labour market. Unemployment rate stood at 13.26% at end-2012, narrowing only by 0.03 percentage points in annual terms. Employment in the private non-agricultural sector rose by 6.7% in annual terms. Meanwhile, employment in the public and private agricultural sector fell 0.6% and 4.2%, respectively. Concerning the period ahead, expectations[10] for the labour market are not assessed positively for industry and construction sectors, but appear more optimistic for services.

Fiscal data for end-2012 reveal that total revenues decreased by 0.03% in annual terms, amounting to ALL 330.4 billion. Expenditures dropped at a similar level, amounting to ALL 376.2 billion. General revenue performance was driven by the poorer performance of tax revenues, due to their higher share in the budget, although non-tax revenues increased in annual terms. Total expenditure reflected the considerable decrease in capital expenditure,

[9] *Consumer Confidence Index fell by 3.1 percentage points in 2012 Q4.*

[10] *According to the Business Confidence Index, in 2012 Q4, expectations for employment point to -2.3 for industry, -6.5 for construction and 4.6 for services.*

despite the increase in current expenditure for this period. Budget deficit was ALL 45.9 billion at end-2012 or 3.4% of GDP[11]. 57.8% of this deficit was financed through domestic resources and 42.2% through external ones. At end-2012, the public debt stock reached ALL 828 billion. The average term of debt increased compared to end-2011, reaching 386 days to maturity at the end of the period. The domestic debt accounted for about 56.8% of total debt.

Inflation rate reflected the low inflationary pressures resulting within the tolerance band and below the Bank of Albania's target during 2012 H2. The average inflation rate for this period was 2.5% or 0.6 percentage points higher than 2012 H1.

The current account deficit was down by 13.8% in annual terms, amounting to EUR 1.02 billion as at end-2012 Q4. Remittances improved slightly in 2012 Q4, recording an annual growth of 1.6%. Trade deficit stood at EUR 1.99 billion as at end-period, narrowing by 10.8% from a year earlier. Its fall reflects an annual growth in exports by 8.5% and a decline in imports by 3.4%. For the same period, financial and capital account amounted to EUR 867.3 million, down by 11.3% y-o-y. Foreign Direct Investments remained at almost the same levels to the previous year, amounting to EUR 744.9 million. Portfolio investments and other investments narrowed in this period. The weakening activity in euro area and the region will keep the external demand for home products at low levels, and will preserve the pressure on remittances. On the other hand, inflationary pressures arising from imported commodities will continue to be low.

2.2 HOUSING MARKET

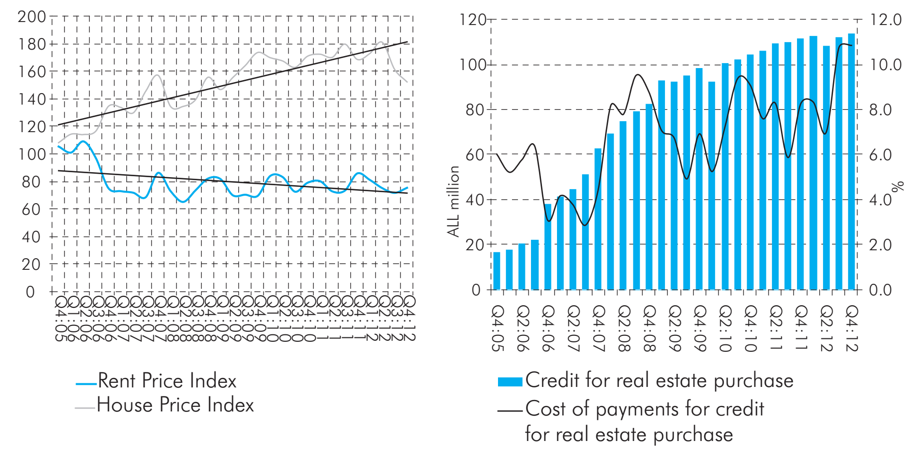
During 2012 H2, developments in the real estate market show moderate changes compared to the previous period. In this period, the fall in the house price index was more pronounced than in the rental price index. The real estate purchase loan increased slightly. Loan portfolio quality for real estate purchase improved at end-2012 H2, and the relative cost of real estate purchase increased in this period.

2.2.1 HOUSING MARKET DEVELOPMENTS

House Price Index[12] decreased averagely by 10% in annual terms in 2012 H2, whereas the Rental Price Index fell by 7.3%. At end-2012, the House Price Index to Rental Price Index ratio stood at 2.03, changing slightly by 1.96 units from end-2011.

[11] *This Report is based on GDP estimates for 2012.*
[12] *House and rental price indices are constructed only for Tirana.*

Chart 2.2.1.1 Housing market developments



Source: Bank of Albania.

In 2012 Q4, outstanding loans for real estate purchase increased by 1.61% from a year earlier, after expanding by 1.96% in 2012 Q3. In 2012 Q4, the weighted interest rate on loans for real estate purchase increased by an annualised rate of 0.52 percentage points. Relative repayment cost[13] on this loan increased in 2012 Q4 by 2.58 percentage points, although lower than the increase by 4.86 percentage points in 2012 Q3. Due to the increase in the average interest rate on real estate loans by only 0.52 percentage points, the fall in the relative cost mainly shows the higher decrease in the housing price rise rate during the previous year, with the last quarter providing the main contribution. If this performance repeats in 2013, this will indicate the entry of the housing market into a more stable correction process of housing price.

Notwithstanding the tight lending standards[14] by lenders, the real estate purchase loans improved in Q3 and Q4 in annual and quarterly terms. The collateral coverage in relation to its size increased for businesses and households. Also, banks report that lending standards for house purchase remained unchanged for households and suggest their easing in 2013 Q1.

Real estate loan portfolio quality improved in 2012 H2. Non-performing real estate loans to loan outstanding ratio for this purpose stood at 12.88%, from 13.9% at end-June 2012. This indicator is higher but close to end-2011, at 12.55%. Nevertheless, the quality of these loans remains better than total loan portfolio quality, where the loan object and collateral type show a more cautious behaviour by both banks and borrowers.

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

[14] *According to the Bank of Albania's Bank Lending Survey for 2012 Q4.*

2.3 FINANCIAL POSITION AND RISK EXPOSURE OF HOUSEHOLDS AND BUSINESSES

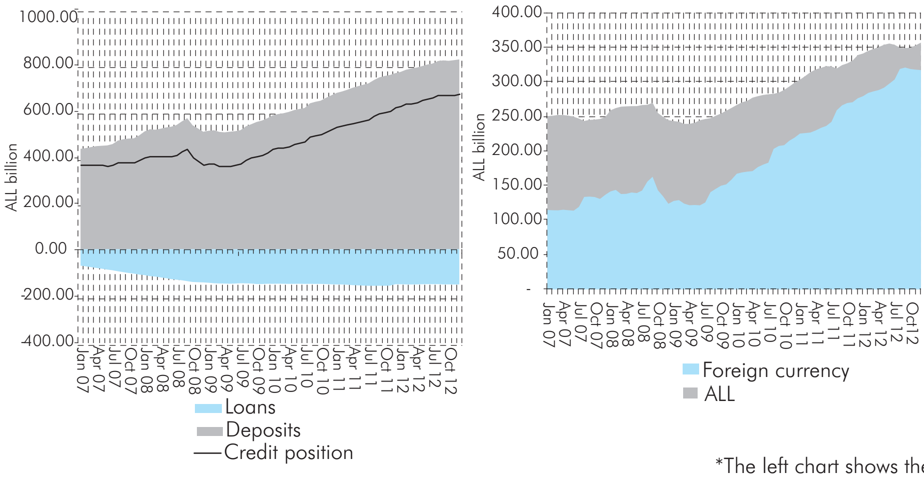
The financial position of households maintained similar characteristics and trend to the previous period. Households' inclination to save persisted during 2012 H2, but at a slower pace compared to 2012 H1. As lending to households increased at a rather low value, their creditor position expanded further during the period. Businesses increased their debtor position, mostly in foreign currency, but at a slower pace due to the considerable deceleration in banking sector lending. Loan quality for both households and businesses continued to decline during 2012 H2. Though differently, households and businesses remain exposed to indirect credit risk arising from unfavourable exchange-rate or interest-rate movements.

HOUSEHOLDS

At the end of 2012, households' creditor position[15] amounted to ALL 674.23 billion, about 20.94 billion more than at end-June 2012, and about ALL 58.82 billion more than in December 2011.

Household deposits in the system were up by ALL 59.69 billion from a year earlier, and lending recorded a slight increase by ALL 0.8 billion. During the period under review, household deposits rose by ALL 22.2 billion, lower than their increase of ALL 37.5 billion in 2012 H1. Lending to households rose by ALL 1.27 billion, after a contraction of ALL 0.41 billion in the preceding period. By currency, households are creditors of ALL 356.62 billion in the national currency and ALL 317.62 billion in foreign currency. The lek creditor position increased by about ALL 18.3 billion from a year earlier (December 2011), mainly due to ALL deposits growing faster than loans. Over the same period, creditor position in foreign currency expanded ALL 40.8 billion, due to the increase in foreign-currency deposits, while foreign currency loans contracted.

Chart 2.3.1 Households' financial position in the financial system*

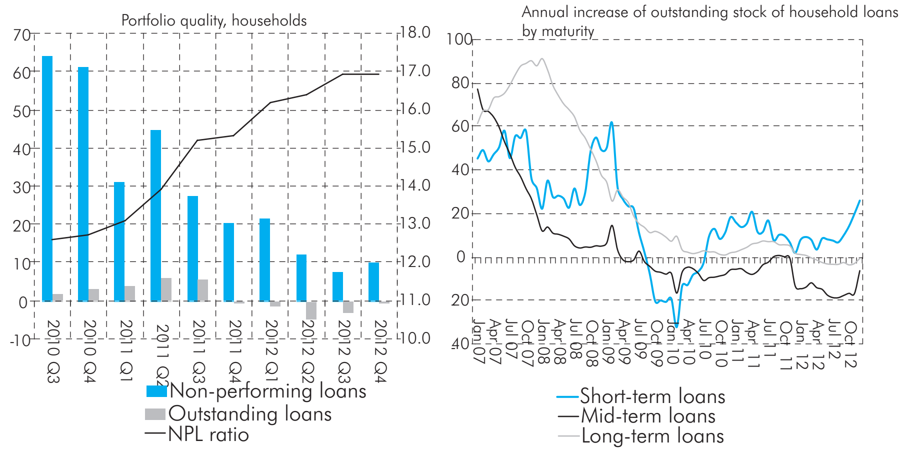


*The left chart shows the performance of households' deposits, loans and credit position, measured as the difference between deposits and loans. The right chart shows households' financial position in lek and foreign currency.
Source: Bank of Albania.

2.3.1 CREDIT RISK

As at end-2012, outstanding loans[16] to households in the banking sector increased slightly by 0.46% in annual terms, and 1.01% from end-June 2012. By maturity, during 2012 H2, short-term loans to households increased at a high pace, recording an annual growth of 26%. Medium-term loans shrank 5.96% in annual terms. Long-terms loans also contracted, albeit at a moderate pace. The loan maturity structure for households remained similar to the preceding period: short-term loans accounted for 7.7%, medium-term loans accounted for 13.3% and long-term loans accounted for 79% of total outstanding loans to households. Loan structure by currency remained almost unchanged. Foreign-currency loans accounted for 55.3%, whereas ALL loans accounted for 44.7%. ALL loans to households increased by 3.3%, whereas foreign-currency loans shrank by 1.72%.

Chart 2.3.1.1 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.

Outstanding loan quality deteriorated for the households' portfolio. At end-2012 H2, the 'Household non-performing loans to total household loans' ratio stood at 16.9%, up by 0.5 percentage points from end-2012 H1, and 1.6 percentage points from end-2011.

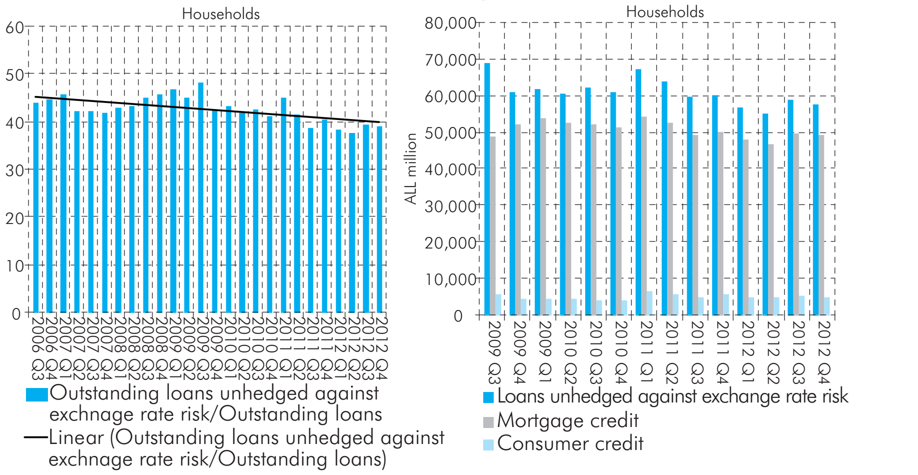
2.3.2 INDIRECT CREDIT RISK ARISING FROM THE EXCHANGE RATE

In December 2012, the ratio of household loans unhedged against exchange rate risk to total household loans rose to 39.0%, from 37.7% at end-2012 H1, but lower than 40.4% in the same period a year earlier.

House purchase loans account for about 85.1% of loans unhedged against exchange rate risk. This ratio is higher than 83.7% a year earlier.

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

Chart 2.3.2.1 Households' exposure to indirect credit risk arising from exchange rate*



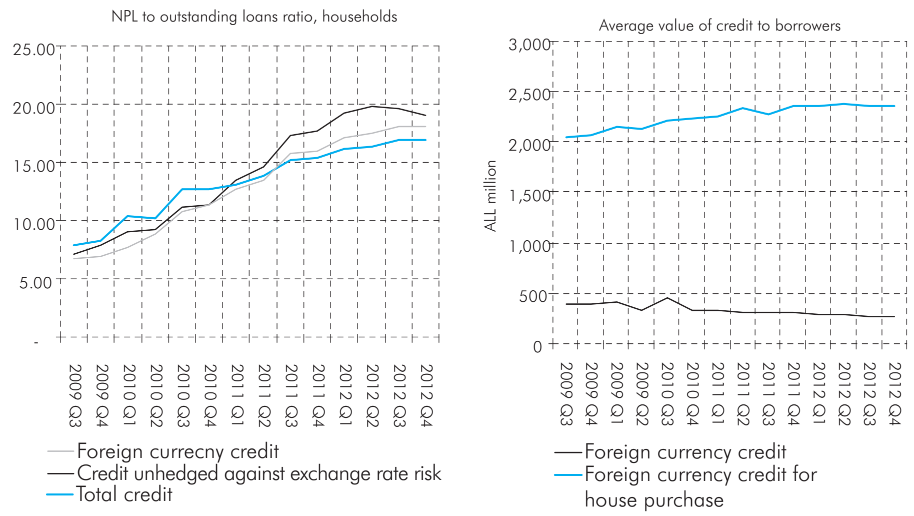
*Right chart shows credit unhedged against exchange rate for households with its two components: mortgage credit and consumer credit.

Source: Bank of Albania.

The portfolio quality for household loans unhedged against the exchange rate risk deteriorated faster than the foreign-currency and total loan portfolio at end-2012, but at a slower pace in 2012 H2. In December 2012, the share of non-performing household loans unhedged against indirect exchange-rate risk rose to 19.0%, from 17.7% in December 2011, but lowered somewhat compared to 19.7% in June 2012. The quality for foreign-currency household loans stands at 18.08%, whereas that for total household loans stands at 16.94% (see Chart 2.3.2.2, left-hand).

As at end-2012, the 'house purchase loan/per household' dropped to ALL 2.36 million, from ALL 2.38 million in June 2012, standing almost at the same level to a year earlier (see Chart 2.3.2.2, right-hand).

Chart 2.3.2.2 Household loan quality



Source: Bank of Albania.

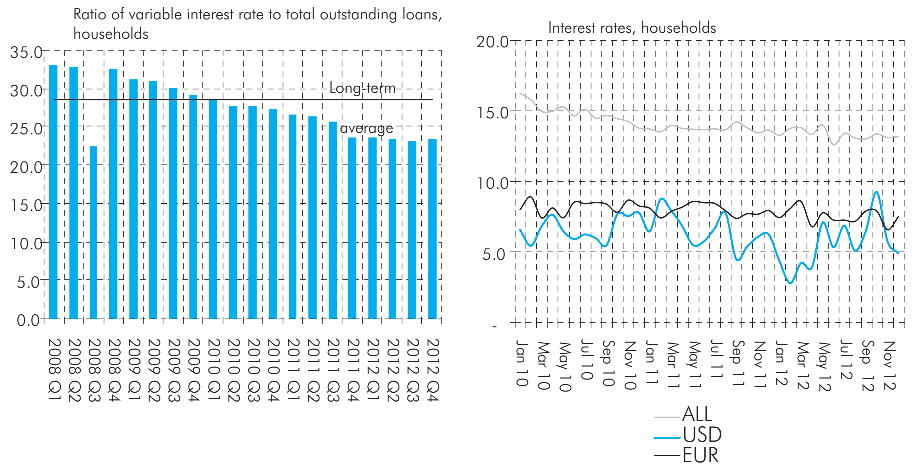
The ratio of non-performing loans in household loans for home purchase unhedged against exchange rate risk stood at 18.6%, improving by 1.3 percentage points from June 2012, but deteriorating by 1.1 percentage points from a year earlier.

Although the major part of loans unhedged against exchange rate risk is covered by collateral, its persistently deteriorating quality should be cautiously monitored, to find the reasons and assess expectations for the future performance.

2.3.3 INDIRECT CREDIT RISK ARISING FROM THE INTEREST RATE

At end-2012 H2, households' exposure to indirect credit risk arising from unfavourable interest rate movements maintained the same levels as in end-2012 H1. The ratio of variable-interest rate loans to total outstanding household loans was 23.4%, down by 0.4 percentage points from end-2011. For the period under review, interest rates on household loans in both national currency and foreign currency declined compared to the end of 2011. For new loans to households, interest rates fell by 0.47 percentage points for ALL loans, 1.34 percentage points for USD loans and 0.44 percentage points for EUR loans.

Chart 2.3.3.1 Households' exposure to indirect credit risk arising from the interest rate



Source: Bank of Albania.

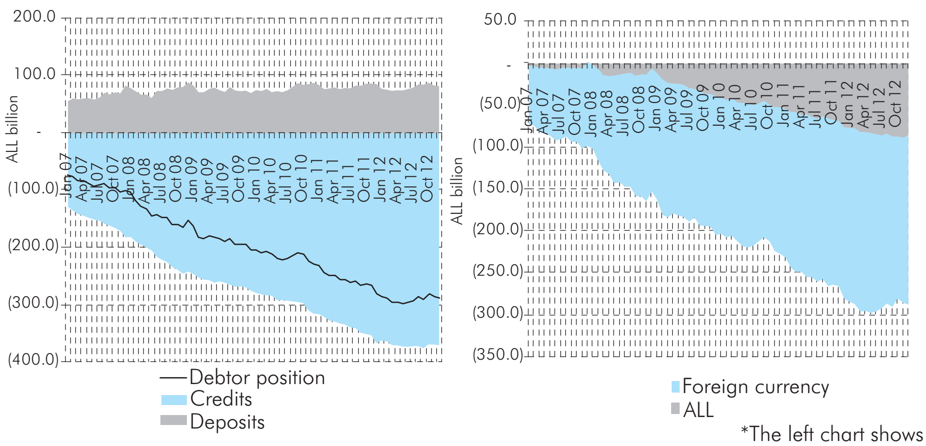
Concerning the period ahead, the eased monetary policy is expected to lower the interest rates of ALL loans, while the accommodative policies in the euro area and the interest rate performance in the international markets will keep the interest rates on major foreign currency loans at the current levels in the foreseeable future.

BUSINESSES

In December 2012, businesses' debtor position[17] to the financial system at home amounted to ALL 288.4 billion, narrowing by ALL 8.5 billion from end-June 2012, but expanding by ALL 7.4 billion from a year earlier. This was a result of the fall in business loans by ALL 2.74 billion, while deposits increased ALL 5.31 billion.

By currency, businesses are debtors of ALL 86.14 billion in the national currency and ALL 202.32 billion in foreign currency. Debtor position in the national currency expanded ALL 1.42 billion from June 2012, and ALL 9.79 billion from a year earlier. Debtor position in foreign currency showed an opposite tendency, narrowing by ALL 9.47 billion from June 2012, and ALL 2.39 billion from a year earlier.

Chart 2.3.3.2 Businesses' financial position*



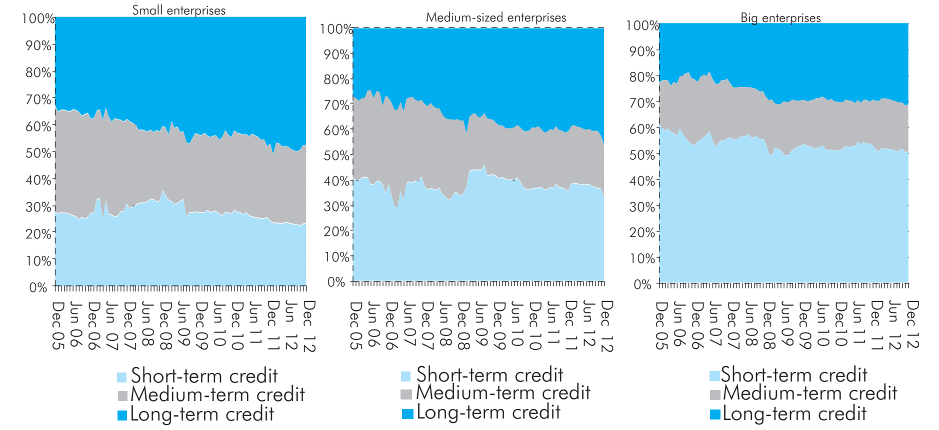
*The left chart shows the performance of businesses' deposits, loans and debtor position measured as a difference between deposits and loans. The right chart shows the financial position of businesses in lek and foreign currency.
Source: Bank of Albania.

2.3.4 CREDIT RISK

Lending to businesses slowed down considerably during 2012 H2. In December 2012, lending to businesses expanded by an annualised rate of only 1.8%, against 11.9% at end-2012 H1 and 15.6% at end-2011. Broken down by lending structure by business size, the share of lending to small and medium-sized enterprises fell, while that of lending to large enterprises increased, sharing 63.7% of the business loan portfolio or 1.7 percentage points higher than in 2012 H1. Large enterprises reduced the share of short and medium-term loans, increasing somewhat the share of long-term loans compared to 2012 H1 and end-2011. Medium-sized enterprises displayed the same trend, whereas small enterprises, unlike medium-sized and large enterprises, focused mainly on increasing the share of medium-term loans.

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

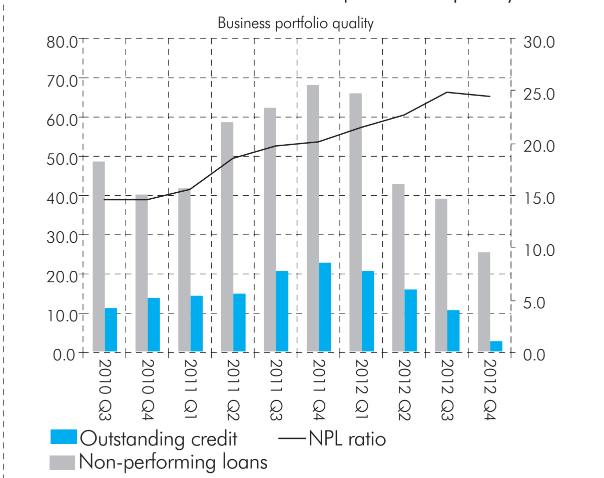
Chart 2.3.4.1 Structure of business loans by maturity



Source: Bank of Albania.

During the period under review, the NPLs to businesses continued to shrink, pursuing this trend since 2011 Q4. Nevertheless, the NPLs ratio rose to 24.5% in December 2012, from 22.8% in June 2012 and 20.0% in the same period in 2011, due to the considerable deceleration in lending.

Chart 2.3.4.2 Business portfolio quality*

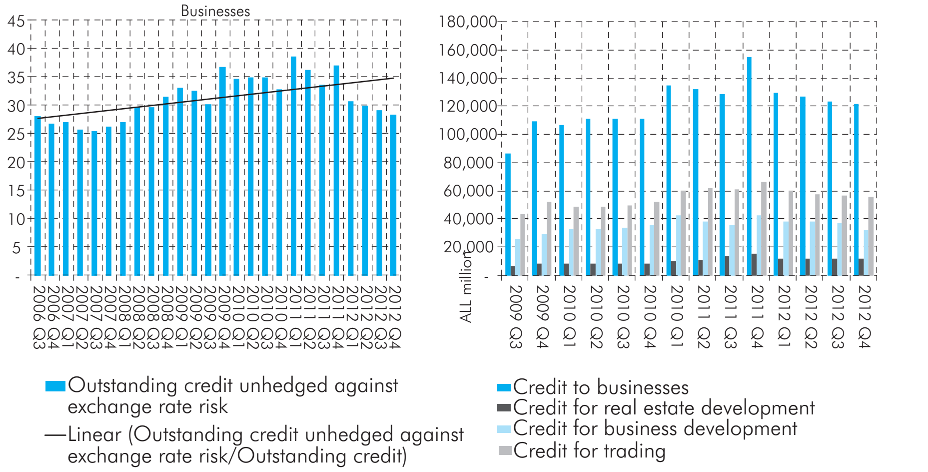


*The chart presents the annual growth of the NPL stock, the outstanding credit for businesses (in per cent) on the left-hand axis and the NPL ratio (in per cent) on the right-hand axis.
Source: Bank of Albania.

2.3.5 INDIRECT CREDIT RISK ARISING FROM THE EXCHANGE RATE

Foreign currency loans to outstanding business loans continued to fall standing at 67.0% at end-2012, from 70.4% in June 2012 and 71.4% at end-2011. Businesses' exposure to exchange rate fluctuations continued to decline during 2012 H2, maintaining the fall started in 2012 H1. The ratio of 'Loans unhedged against exchange rate risk to total outstanding loans' fell to 28.4% in December 2012, from 30.0% in June 2012 and 37.2% in December 2011 (See Chart 2.3.5.1- left).

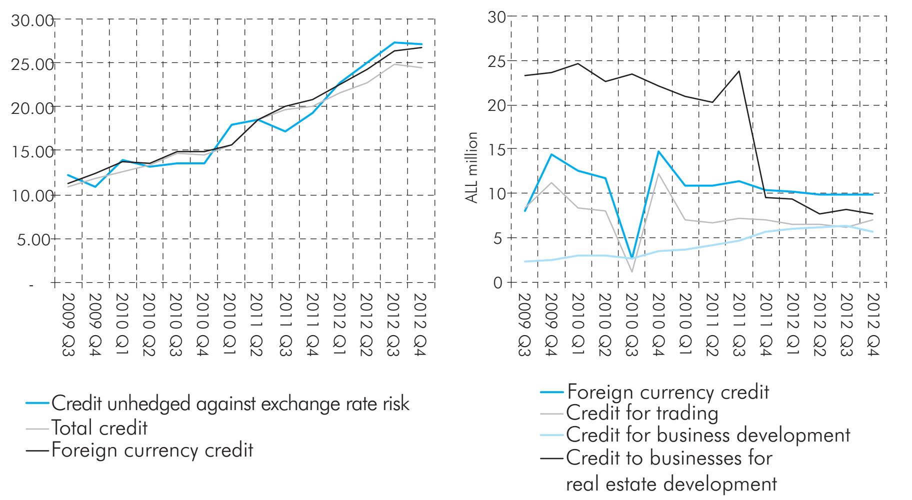
Chart 2.3.5.1 Businesses' exposure to indirect credit risk arising from the exchange rate



Source: Bank of Albania.

Business loans outstanding unhedged against exchange rate risk shrank throughout 2012[18] by 21.4% (see Chart 2.3.5.1- left). At end-2012, 46.3% of business loans unhedged against indirect credit risk arising from the exchange rate consist of 'Commercial loans', 26.6% for 'Business development loans' and 10.4% for 'Real estate development loans' (see Chart 2.3.5.1- right).

Chart 2.3.5.2 Business loan portfolio quality



Source: Bank of Albania.

The portfolio quality for 'Business loans unhedged against exchange rate movements' continued to deteriorate throughout 2012. The NPL ratio reached 27.2% in December 2012, from 25.2% in June 2012 and 19.4% in December 2011. The deterioration of business loans' portfolio quality at

[18] *In December 2011, outstanding loans unhedged against exchange rate risk to businesses were ALL 155.03 million. In December 2012, they fell to ALL 121.85 million.*

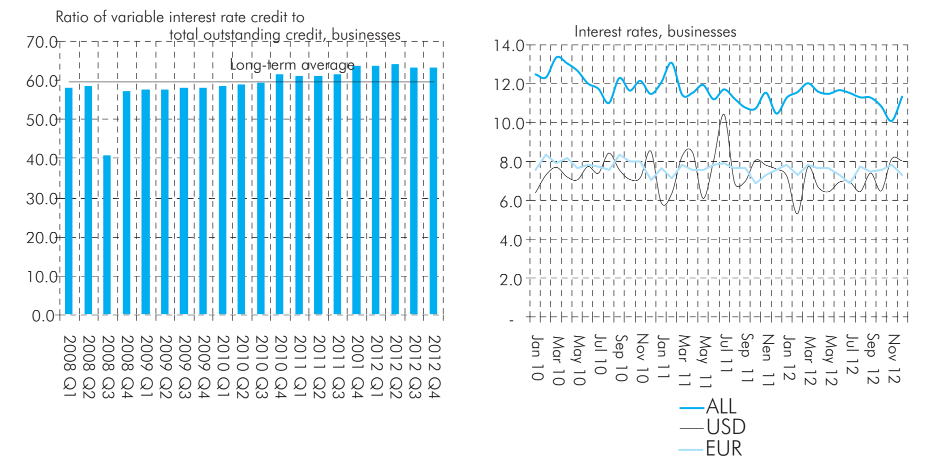
end-2012 was higher than that of total business loans, whose NPL ratio was 24.5%, and of foreign currency business loans, whose NPL ratio stood at 26.7% (see Chart 2.3.5.2 - left).

About 20.4% of commercial loans was non-performing, from 19.1% in June 2012 and 14.1% in December 2011. NPL ratio for business development loans rose to 37.9% from 35.8% in June and 27.2% at end-2011. The deterioration in business loans for real-estate development was more pronounced. Their NPL ratio rose to 47.1%, from 37.6% in June 2012 and 33.0% a year earlier. In addition to the increase in NPL stock, the contraction in loans unhedged against exchange risk compared to a year earlier impacted the performance of these developments.

2.3.6 INDIRECT CREDIT RISK ARISING FROM THE INTEREST RATE

In 2012 H2, businesses' exposure to indirect credit risk arising from the interest rate was downward. The ratio of variable interest rate loans to total outstanding loans for businesses reached 63%, from 63.8% at end-2012 H1. This rate, albeit downward, remains above the long-term average.

Chart 2.3.6.1 Businesses' exposure to indirect credit risk arising from the interest rate



Source: Bank of Albania.

The interest rates on new business loans were higher for ALL and USD loans, while they were slightly down for EUR loans. Interest rates on new business loans were up 0.85 percentage points and 0.42 percentage points for loans denominated in lek and U.S. dollar, respectively, and down 0.22 percentage points for loans denominated in EUR. The volatility of these rates reflects the performance of key interest rates by currency and banks' decisions on determining their margins.

Box 2 Survey on Households and Businesses' Financial Position

In order to support the assessment for the financial position of households and businesses, the Bank of Albania conducts a special semi-annual survey. The latest survey was conducted during November-December 2012 focusing on 2012 H2 highlights.

II.1 SURVEY ON HOUSEHOLDS' FINANCIAL POSITION AND BORROWING[I]

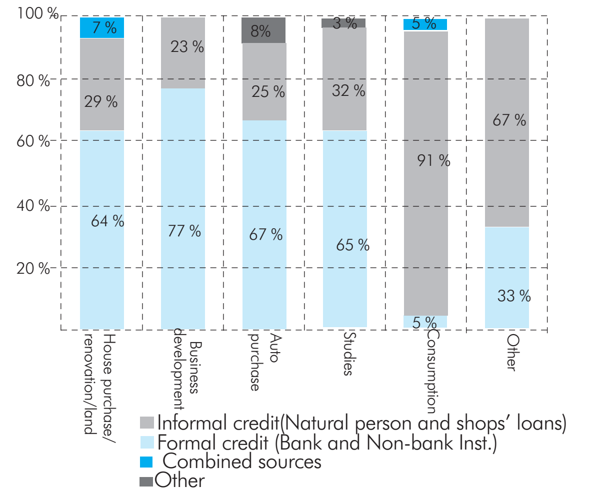
- *FINANCIAL SITUATION*

According to survey results, the main source of income for households continue to be self-employment, retirement and work in the private sector, respectively accounting for 26%, 28% and 25% of the total number of persons providing income. The share of 'remittances' as a source of income for 2012 H2 remained unchanged from 2012 H1. Focusing only on 'total employed', it results that 41% are self-employed, 39% employed in the private sector and 18% employed in the public sector. The share of self-employed in total employed has risen from 2012 H1, whereas the share of public-sector employed has declined.

- *BORROWING*

Of total interviewed households, about 33% of the sample (401 households) responded that they had (at the interview moment) a loan to repay. The figure is up by about 2 percentage points from 2012 H1. In 45% of the cases, borrowing households declared that they had borrowed from formal sources, such as 'banks' (39%) and 'other non-bank financial institutions' (6%), increasing 2 percentage points from 2012 H1. In 54% of the cases, borrowing households responded that they had resorted to informal sources of funding, such as natural persons (41%) and shops (13%). Out of 401 borrowing households, about 7% responded that they had actually more than one loan from different sources, mainly banks and natural persons.

Chart 2.1.1 Borrowing households by purpose and source of borrowing (2012 H2)



Source: Bank of Albania, Financial Stability Department.

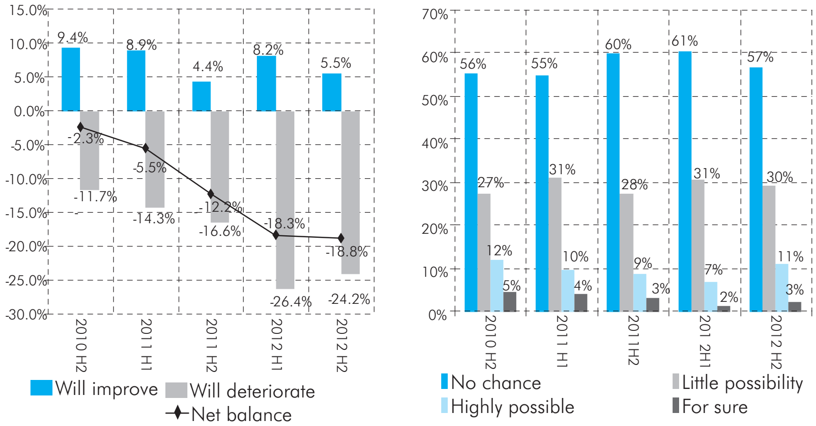
By purpose of loan, households responded to have taken loans for 'purchase/renovation of an immovable property' in 33% of the cases, 'consumption' in 32% of the cases and 'business development' in 15% of the cases. From 2012 H1, the share of households declaring to have obtained a loan for real estate purchase/renovation dropped by 3 percentage points, a trend started since the previous period. The number of cases declaring that the loan had been received for 'consumption' rose by 4 percentage points compared to 2012 H1. The eurorisation of credit continued to be low (92% of cases in lek), mainly due to the high borrowing from natural persons. The outstanding period for repaying the credit stock at the time of interview was mainly up to 12 months in 41% of the cases and 1-3 years in 34% of the cases.

- *HOUSEHOLD DEBT BURDEN*

About 26% of the surveyed 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 51% of the cases households reduced their expenditures, in 24% they sought for a second job, and only in 12%, they sought renegotiation of credit terms.

In this survey, about 70% of the surveyed borrowing households did not expect a change in their repayment capacity in the next six months, whereas about 24% expected it to deteriorate, and 5% to improve. The share of households that do not expect a change in their repayment capacity increased by 5 percentage points, whereas households' share expecting it to decrease fell by 2 percentage points. As regards the possibility to obtain a new loan in the next half of the year, about 57% of the respondents[ll] answered that the possibility was inexistent.

Chart 2.1.2 Households' answers on: expectations on households' repayment capacity (left hand) and possibility to take another loan (right hand) in the next six months



Source: Bank of Albania, Financial Stability Department.

II.2 SURVEY ON BUSINESSES' FINANCIAL POSITION AND BORROWING

- *FINANCIAL SITUATION*

In order to analyse businesses' financial position and borrowing at home, a sample of 727 businesses was interviewed across the entire country. During 2012 H2, the weak tendency to expand the activity or increase investment continued. The net balance of 1.7% enterprises declaring expansion/increase attests that, manifesting also a fall of 2.4 percentage points from the previous period. Of total respondent enterprises, 53.6% (or 43.6% of total sample, 317 enterprises) actually have a loan to repay, down by 2.8 percentage points from six months earlier.

- BORROWING

Some 65.9% of respondent enterprises (211 businesses) have funded their business activities through loans as a separate or combined source, up 5.9 percentage points from six months earlier. Sales have funded only 27.2% of enterprises' activity. About 71% of businesses state that over 80% of their products are sold in the country.

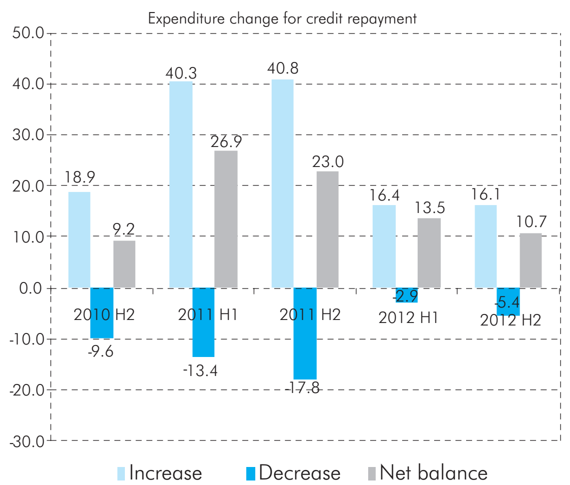
About 25% of businesses declare a negative financial result from their activity. Business activity was held mainly in lek for 80.3% of respondent enterprises and only in lek for 15.4% of them.

According to responses from enterprises that had taken a loan, for 49.3% of businesses the loan is in ALL, for 36.1% is in EUR and for 2.1% in U.S. dollar. About 29% of respondent businesses had taken the loan during the last year, while 48.2% of them had taken the loan during the last five years. All the same, 60.1% of the enterprises will repay the loan within 1-5 years, 16.9% of enterprises up to 12 months and 23.1% of them in over 5 years. The loans were mainly used to afford current expenses for 37.3% of enterprises, and the conduct of a long-term investment for 30.2% of enterprises, although the number of enterprises taking a loan for this purpose has continued the previous declining trend. 63.7% of businesses have placed an immovable property as collateral, down from 2012 H1. However, this form of collateral is also used by enterprises that have combined some collateralisation form, whose percentage increased during 2012 H2.

- *BUSINESS DEBT BURDEN*

More than half of enterprises repay the loan by instalments of equal amounts, monthly and at a fixed interest rate up to the end of maturity. The overall credit value as a percentage of the capital is about half for 74.7% of respondent enterprises, 4.2 percentage points higher than in 2012 H1. As a percentage of income, 68.6% of the respondent businesses affirm that, in the last six months, credit expenditures amounted to 20% of their income, whereas 27.1% of them have spent 20-50% of their income on credit repayment. Credit repayment cost slowed down compared to the previous periods, stated at a positive net balance of 10.7% at end-2012 H2.

Chart 2.2.1 Expenditure change for credit repayment



Source: Bank of Albania, Financial Stability Department.

Total credit instalment is expected to remain unchanged during the first half of 2013, as expressed by the net balance of 0.65% of enterprises expecting a higher credit repayment for the upcoming six months, although results differ across the sectors Nonetheless, 83.8% of businesses do not expect to take a loan in the upcoming six months. The relationship with banks is considered "indispensable" for 47.8% of enterprises, up by 2.8 percentage points from the previous six months and "important" for 48.5% of them. 52% of enterprises considered the process of taking a loan from banks as "normal", 37% of them as "difficult" and 6.6% of them as "very difficult".

[I] *The sample includes 1210 households in 16 different districts of Albania. In the last survey (2012 H2), 98% of the interviewed households answered the survey questions (1184 households).*

[II] *This question was addressed to the entire sample of households (1210), but 91% of them answered it (1102 households).*

3. FINANCIAL MARKETS

During 2012 H2, in the primary market of government securities, participants showed greater preference for long-term instruments, thus contributing to the decrease in the average interest rate on debt issued in securities.

In the secondary market trading government debt securities, the activity volume maintained its long-term trend. The trading of T-bills continued to dominate this market at 52.1% of transactions.

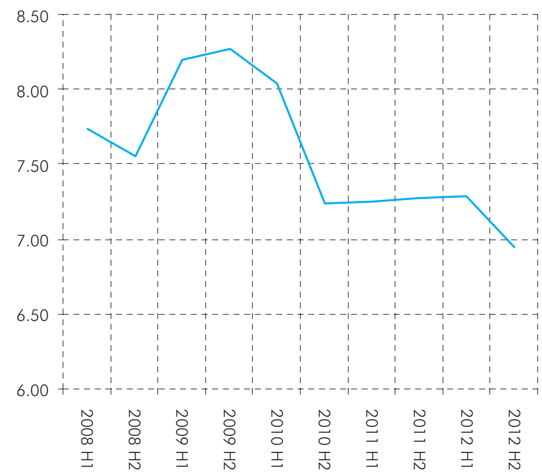
The activity volume in the interbank market increased, serving better to banks' needs for short-term liquidity. In the foreign exchange market, the national currency was stable against the main currencies. In fact, lek exchange rate performance was more stable than that of the other currencies of Eastern European countries implementing a free floating exchange rate regime.

The following provides a detailed analysis of the performance of each market.

3.1 PRIMARY MARKET OF DEBT SECURITIES

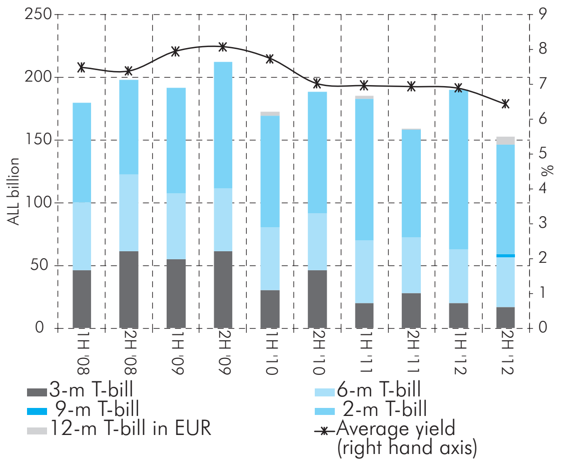
The volume of government debt securities issued during 2012 H2 decreased to ALL 196.6 billion, from ALL 231.4 billion in H1. Government financing was enabled through long-term instruments. The issue of bonds increased by 4.6 percentage points, accounting for 22.4% of total debt. Ask interest rates in debt securities dropped, reflecting the key interest rate cut and the ample liquidity due to the deceleration in lending to the private sector. The average interest rate on debt issued during the period under review was down 0.34 percentage points, reaching 6.95%.

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



Source Bank of Albania.

Chart 3.1.2 Volume and yields in the primary market



Source Bank of Albania.

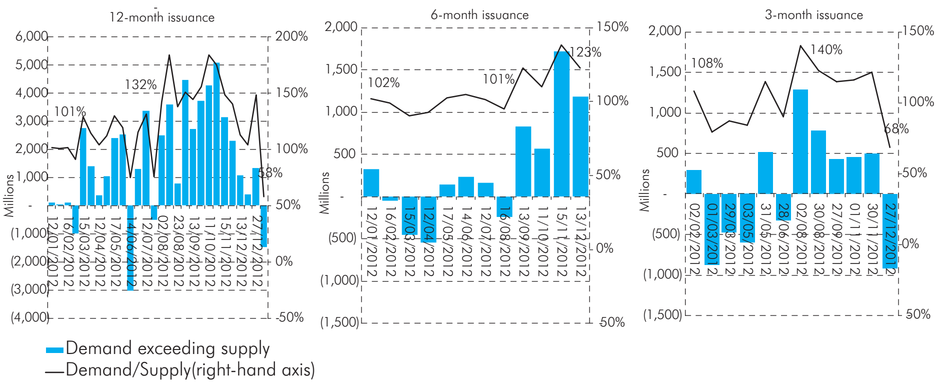
Note: 12-month T-bills includes also the issue in EUR. (EUR 20 million, converted with the auction date exchange rate)

Over the period under review, ALL 152.6 billion were issued in T-bill auctions, from ALL 190.2 billion at end-2012 H1 and ALL 158.4 billion at end-2011.

Participants showed greater preference for 12-month T-bills in auctions. Extraordinary auctions were held during the period, including the first-time issue of 9-month T-bills. Also, an auction was held for the issue of a 12-month T-bill in EUR, where participants' demand exceeded considerably the issued value.

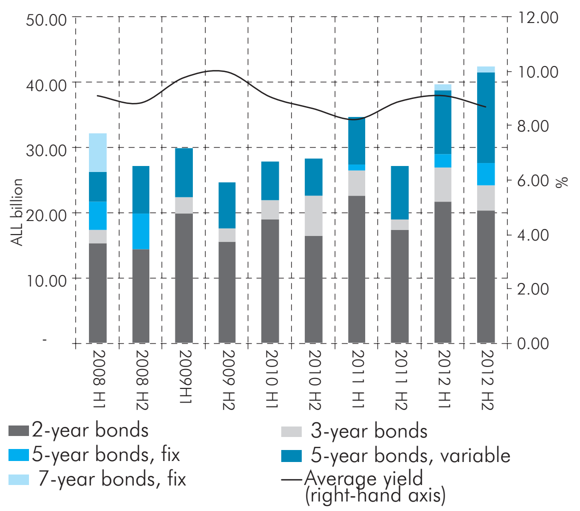
As at end-period, T-bills interest rate averaged 6.4% or 0.5 percentage points lower than at end-2012 H1, 0.6 percentage points lower than a year earlier and 0.3 percentage points lower than the 4-year average.

Chart 3.1.3 T-bills auctions during 2012



Source Bank of Albania.

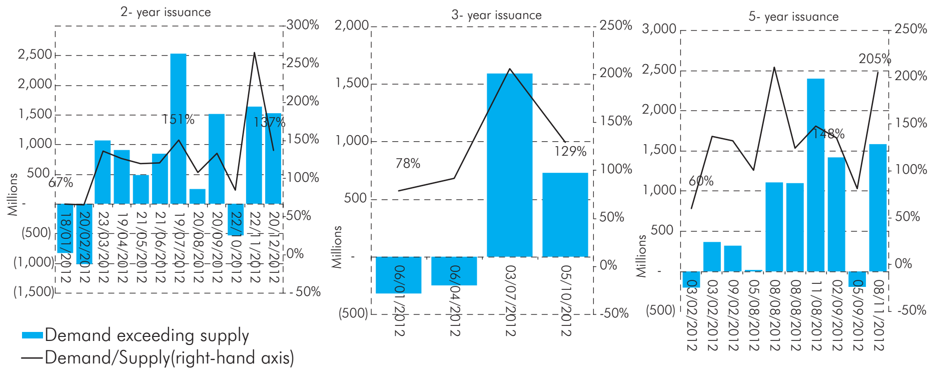
Chart 3.1.4 Bond auctions volume and average yield



Source Bank of Albania.

The issue of debt in the form of bonds increased slightly compared to the previous period, surging at ALL 44 billion at end-2012 from ALL 41.2 billion. This increase is considerable compared to the previous year when the value of these issues amounted ALL 27.2 billion. Over the period, the growth was driven by the issue of 5-year securities (for both interest rate categories, fixed and variable) by ALL 5.5 billion or 31.6%. Despite the fall in 2 and 3-year bonds, for all issues categories the yield dropped averaging 8.7%, from 9.1% in H1. Interest rate on these instruments in relation to the 4-year average was 0.9 percentage points lower.

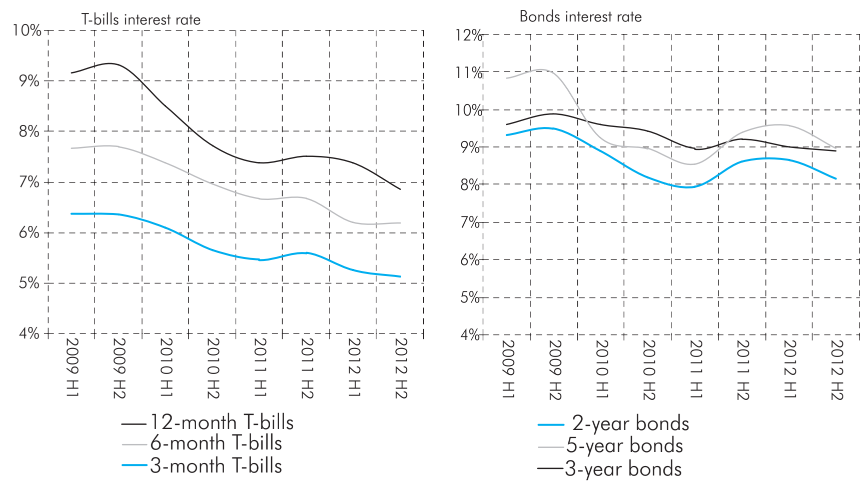
Chart 3.1.5 Bonds auctions during 2012



Source: Bank of Albania.

The following shows the yields by maturity of government debt securities.

Chart 3.1.6 Average interest rate on debt in the primary market

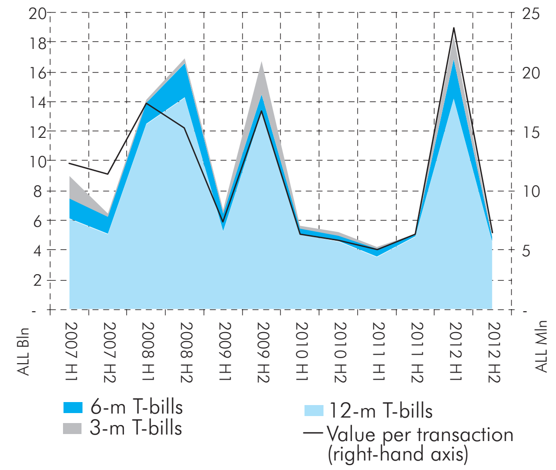


Source Bank of Albania.

3.2 SECONDARY MARKET OF DEBT SECURITIES

The volume of T-bill transactions, in nominal value, amounted to ALL 4.9 billion, down by about ALL 13.5 billion or 73.2% from H1. Following a considerable activity of securities trading in the secondary market during 2012 H1, due to structural movements of liquidity and the entry of new non-bank operators in the market, the latter restored the average trading value of the two last years. The trading of 12-month T-bills continued to dominate the market.

Chart 3.2.1 Trading volume of bills in the secondary market



Source: Bank of Albania.

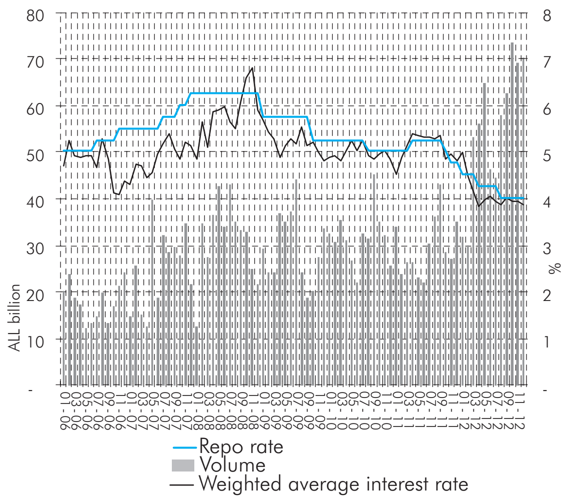
3.3 INTERBANK MARKET

The volume of transactions in the interbank market rose during 2012 H2.

Overnight transactions prevailed, although the number of transactions of 1-week and 1-month maturity increased considerably (by ALL 81.1 billion or 95.4% and ALL 5 billion or 63.7%, respectively).

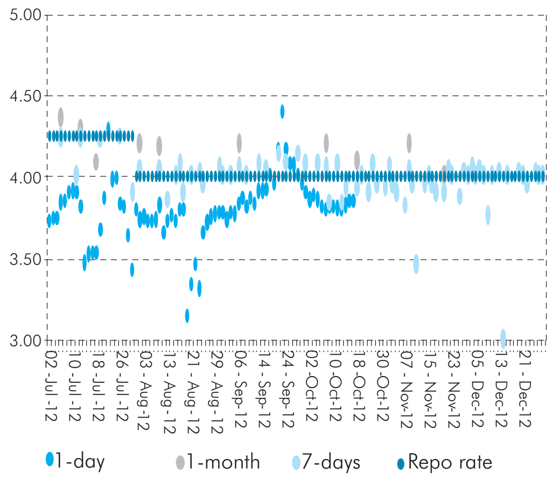
The weighted average interest rate in the interbank market continued to be below the key interest rate[19], at a lower deviation from H1, closing the year with a downward trajectory. At end-2012, it pointed to 3.93%, from 4.16% a year earlier. The same tendency is transmitted to new loan and deposit interest rates denominated in lek (more broadly addressed in the respective paragraphs of loans and deposits). Regarding the interest rate by transaction maturity term, the fall in rates was notable for 1-week transactions, whereas overnight interest rate shows higher volatility from the key rate.

Chart 3.3.1 Volume and interest rates in the interbank market



Source: Bank of Albania.

Chart 3.3.2 Interest rates as per maturities versus repo rate in interbank market



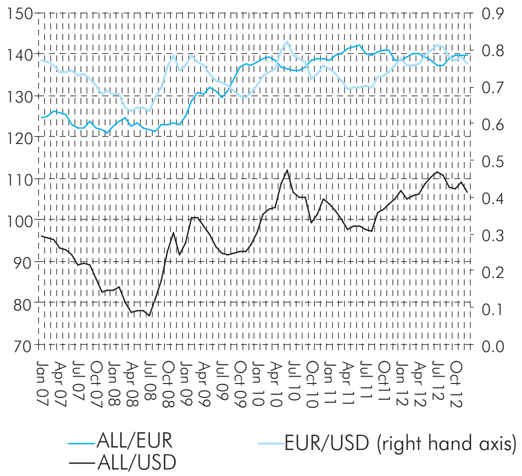
Source: Bank of Albania.

3.4 FOREIGN EXCHANGE MARKET

In the foreign exchange market, the lek was stable against major currencies. The Albanian lek depreciated against the euro and the U.S. dollar by 1.03% and 1.42%, respectively, from 2011 H2. Meanwhile, average lek/euro exchange rate was 138.81, from 139.27 in H1, whereas lek/usd exchange rate was 109.00, from 107.36 in the same period.

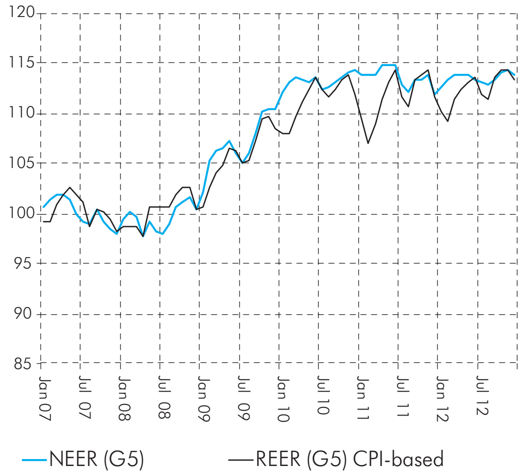
[19] *The eased monetary policy actions continued during 2012 H2, cutting the repo rate by 0.25 percentage points to 4% in July 2012, and keeping it unchanged for the next 5 months.*

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.

The nominal effective exchange rate (NEER) was more stable due to lower risks in the international markets, whereas the CPI-based real effective exchange rate (REER) improved by only 0.3% during the six-month period, thereby not impacting considerably the competitiveness of the purchasing power in foreign markets.

4. PAYMENT SYSTEM DEVELOPMENTS

AIPS and AECH systems, the basic infrastructure for lek payments, operated smoothly and in compliance with the technical parameters, hence reflecting a stable basic infrastructure of national payments in lek.

Payment systems are an integral part of the financial system structure, representing the channels enabling the transfer of funds between banks, other financial institutions and customers. Their stable and efficient operation is therefore conducive to safeguarding financial stability.

The following elaborates on the volume of transactions in AIPS and AECH systems.

AIPS

Table 4.1 AIPS transactions

AIPS	July - December 2011	July - December 2012
Number of transactions	38,224	39,840
Value of transactions (in ALL billion)	2,211.83	4,072.76
Average value per transaction (in ALL million)	57.87	102.23

Source: Bank of Albania.

As the number of transactions in the AIPS increased, their total value and average value per transaction almost doubled from the same period in 2011.

The increase in the volume of processed transactions was mainly attributable to 'Interbank transactions' and 'Bank of Albania's financial instruments'. Concerning their value, all types of transactions increased from a year earlier.

'Customer payments' continued to have the main share in the number of transactions, accounting for about 63.6% of the total.

Despite accounting for only 5% of the number of transactions processed in the AIPS, 'Bank of Albania's financial instruments' are estimated at 56% of total transaction volume.

AECH SYSTEM

The AECH system processes and clears customer payments below ALL 1.5 million. In 2012 H2, the AECH system processed about 178 000 payment orders, with an average value per settled transaction of ALL 200 000.

Table 4.2 AECH transactions

AECH system	July - December 2011	July - December 2012
Number of transactions	204,866	177,931
Value of transactions (in ALL million)	35,474.50	34,733.46
Average value per transaction (in ALL million)	0.17	0.20

Source: Bank of Albania.

The reduced number of transactions in the AECH system was attributable to the lower number of payments processed by the Ministry of Finance, given that the latter has major share in processing payments through this system. Nonetheless, the Ministry of Finance remains the main contributor to processing small-value payments, respectively by 66% in terms of number and 58% in value.

The data show that the four most active banks in the system account for about 60% of the number of transactions and 66.4% of their value.

Table 4.3 Concentration indicators for AECH

AECH system	Number of transactions	Value of transactions (in ALL billion)
4 Banks*	68,061	17.13
Share in total (%)	59.75	66.35
Total	361,552	66.99

** Excluding Bank of Albania and Ministry of Finance.*
Source: Bank of Albania.

Concerning payment instruments, credit transfers dominate total payments. Their share, however, has been pursuing a downward tendency in favour of electronic payments, card-based payments, direct debit and home banking.

Table 4.4 Share of customer payments by payment instrument

	2011 H2		2012 H2	
	Number	Value	Number	Value
Credit transfers initiated by customers	78.10%	95.36%	75.42%	95.38%
1- paper-based credit transfer	75.73%	92.69%	72.59%	92.19%
2- non-paper-based credit transfer	2.37%	2.67%	2.83%	3.19%
Card-based payments initiated by customers	10.05%	0.29%	13.35%	0.37%
Direct debit	11.10%	2.15%	10.50%	2.06%
Cheques	0.75%	2.20%	0.73%	2.19%

Source: Bank of Albania (banks' reporting according to the 'Methodology for reporting payment instruments').

5. FINANCIAL SYSTEM DEVELOPMENTS

Financial system performance appeared stable in 2012. The banking sector was well-capitalised and liquid. Profitability figures rose; however, assets grew at a lower rate than in 2011. The annual growth rate of deposits was lower, while that of loans hit record lows. Non-bank financial institutions, savings and loan associations, insurance companies, private supplementary pension companies and investment funds expanded their activity further. In addition to the positive developments in the financial system, loan quality remains a major risk to lending institutions operating in Albania.

Financial intermediation in Albania, as measured by the ratio of financial system assets[20] to GDP, was estimated at 93.9% at end-2012, from 92.8% at end-2012 H1 and 89.5% at end-2011. In terms of volume, financial institutions' assets grew 2.9% from 2012 H1 and 7.3% from end-2011. The banking sector remained the dominant segment of financial intermediation in Albania. Its assets account for about 93.6% of total financial system assets and about 87.9% of GDP.

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

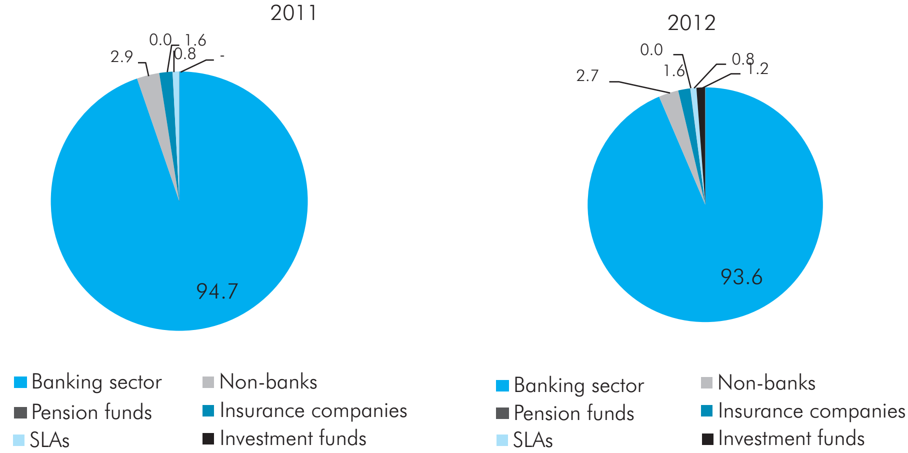
Licensing and Supervisory Authority	Financial System	2007	2008	2009	2010	2011	2012
Bank of Albania	Banking system	75.9	76.7	77.5	80.9	84.7	87.9
	Non-bank institutions	1.5	1.7	2.2	2.7	2.5	2.6
	SLAs and their unions	0.6	0.7	0.8	0.8	0.7	0.78
Albanian Financial Supervisory Authority	Insurance companies	1.4	1.4	1.5	1.4	1.5	1.5
	Pension funds	-	-	0.01	0.01	0.01	0.02
	Investment funds						1.1

Source: Bank of Albania, Albanian Financial Supervisory Authority.

Non-bank financial sector continued to have a small share in total financial system. Total non-bank financial sector assets accounted for about 6.4% of the financial system, being higher than at end-2011 when they accounted for 5.3%. The higher share was attributable to the increase in the number of non-bank financial institutions. At end-2012, non-bank financial sector's activity as a percentage of GDP was about 6%.

[20] *The financial system consists of banks, non-bank financial institutions, savings and loan associations (SLAs), insurance companies, private supplementary pension funds and investment funds. In this chapter, the activity of non-bank financial institutions, insurance companies and pension funds is based on Q3 data, the latest reported to the Bank of Albania.*

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



Source: Bank of Albania, Albanian Financial Supervisory Authority.

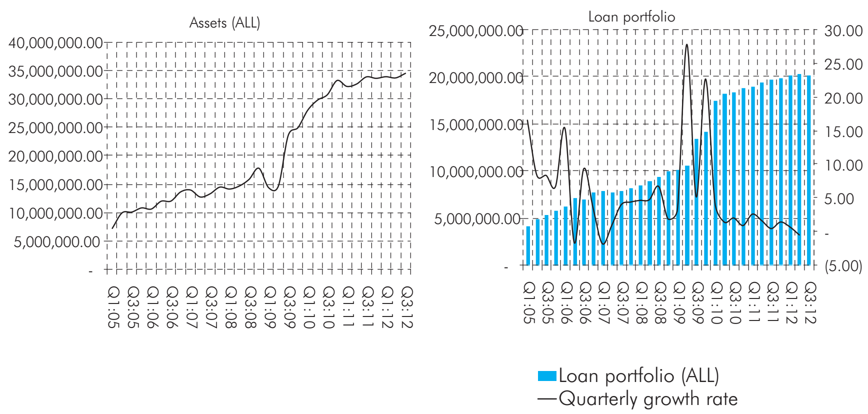
Box 3 Non-Bank Financial Sector

- *ACTIVITY OF NON-BANK FINANCIAL INSTITUTIONS*[I]

Non-bank financial institutions are licensed and supervised by the Bank of Albania. There were positive developments in the activity of non-bank financial institutions in 2012 Q3, with the number of institutions increasing to 21[II]*, leading in turn to rising assets compared to a year earlier. Non-bank financial institutions' assets totalled ALL 34.6 billion, up ALL 631 million (or 2%) y-o-y.*

Lending institutions have the main share in total assets of non-bank financial institutions, accounting for about 66.9%. Financial leasing institutions account for about 31.5%, followed by microcredit and factoring institutions, accounting for about 1.2% and 0.4%, respectively. Despite the positive growth rates, lending has shown a downward trend since 2010 H2.

Chart 3.1 Assets and loan portfolio of non-bank financial institutions

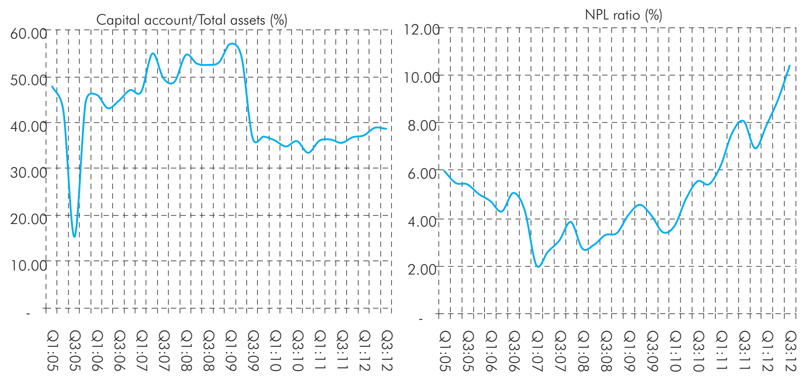


Source: Bank of Albania.

Capitalisation, as measured by the ratio of capital account to total assets, rose to 38.7% in 2012 Q3, from 35.7% in 2011.

The loan portfolio quality worsened further in 2012. The ratio of non-performing loans to total loans rose to 10.4% from 8.1% in 2011 Q3. The worsening loan quality reflects the overall economic growth slowdown, affecting in turn borrowers' solvency.

Chart 3.2 Capital adequacy and non-performing loan ratio, in percent



Source: Bank of Albania.

Profit of non-bank financial institutions increased in 2012 Q3. It was estimated at ALL 719.7 million, from ALL 181.8 million in the corresponding period in 2011. For the same period, income totalled ALL 5.8 billion, up about 4.5% annually (or ALL 250 million). 'Income from commissions' provided major contribution by 63.9% to the increase in income, hence offsetting the negative effect of the decline in interest income, by ALL 9.4 million.

- *ACTIVITY OF SAVINGS AND LOAN ASSOCIATIONS*

Savings and loan associations (SLAs) expanded their activity in 2012 Q4, driven primarily by the loan portfolio. They, however, deepened the financial loss while their loan portfolio quality worsened.

Table 3.1 Selected indicators of SLAs and their unions

	2010 H1	2010 H2	2011 H1	2011 H2	2012 H1	2012 H2
Total assets (ALL million)	9,378.00	9,705.00	9,649.57	9,808.68	9,901.69	10,559.99
Outstanding loans (ALL million)	7,125.00	7,072.00	6,946.58	7,118.68	7,261.55	7,122.11
Outstanding loans/total assets (%)	75.90	72.80	71.99	72.58	73.34	67.44
Non-performing loans (ALL million	237.10	357.90	315.11	315.65	389.20	450.96
Non-performing loans/Outstanding loans	3.30	5.06	4.54	4.40	5.36	6.33

Source: Bank of Albania.

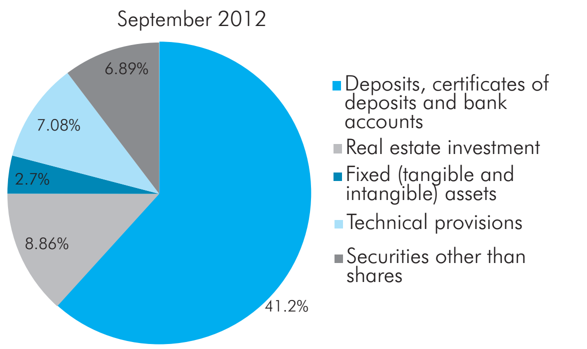
SLAs and their unions deepened their financial loss to ALL 40 million in 2012 compared to the positive profit of ALL 7.1 million in 2011. This financial loss was primarily due to higher loan loss provisions of one financial union and increasing administrative expenses.

- *ACTIVITY OF INSURANCE COMPANIES AND PRIVATE SUPPLEMENTARY PENSION FUNDS*

The insurance market improved in 2012.[III] Gross written premium income rose and RoE and RoA improved. However, capitalisation and coverage against possible losses decelerated. The insurance market remains oriented toward non-life insurance.

Insurance gross written premium income amounted to about ALL 8,951 million in 2012 or 7.4% higher than in 2011. The number of insurance contracts fell 19% from 2011. The insurance market remains oriented toward non-life insurance, accounting for about 89.8% of total premium volume. Broken down by type of insurance, gross written premiums of voluntary insurance accounted for 48.8% and those of compulsory insurance accounted for 51.1% of the total insurance market. Total claims paid out in 2012 were ALL 2,823 million or 27.7% more than in 2011. Consequently, claim-to-premium ratio, which also measures the penetration of the insurance market into the financial system, recorded substantial rise to 31.5% from 26.5% in 2011.

Chart 3.3 Share of insurance companies' asset items, in percent



Source: Albanian Financial Supervisory Authority.

Insurance sector assets[IV] totalled ALL 20.8 billion in 2012 Q3, up ALL 2.6 billion (or 14.1%) from 2011. 'Deposits, certificates of deposits and bank accounts' have the main share in total insurance companies' assets by about 41.2%.

'Capital to technical provisions' ratio, which measures the insurance companies' ability to cover losses fell to 138.2% in 2012 Q3, from 158.4% in 2011 Q3. The lower ratio was attributable to the higher increase in technical provisions, thereby signalling higher risk perception in the activity of insurance in Albania. Insurance companies registered higher profit. In 2012 Q3, it was estimated at ALL 647 million from ALL 540.4 million in 2011. The higher profit was also reflected in the two return indicators, RoA and RoE, which rose to 3.3% and 6.1%, respectively, compared to 3.1% and 5.6% in 2011.

The private supplementary pension market registered positive performance in 2012 Q3. Its assets rose to ALL 248.6 million from ALL 154.9 million in the same period in 2011.

'Raiffeisen Prestigj' investment fund, which was licensed at end-2011, commenced its activity in 2012 H1. At end-2012, this investment fund's assets totalled ALL 15.2 billion, accounting for 1.2% of total financial system assets.

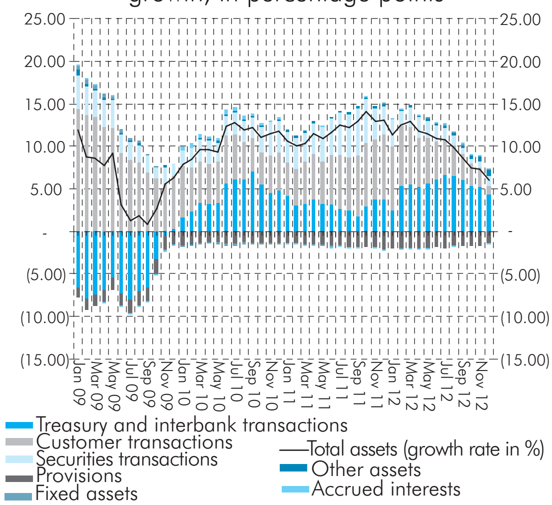
[I] *The latest data reported to the Bank of Albania are as at 2012 Q3.*
[II] *The Bank of Albania licensed two new institutions to conduct their business as non-bank financial institutions. Only one of them reported to the Bank of Albania for the first time in 2012 Q3.*
[III] *According to AFSA's statistical publication of 24 January 2013 'Insurance Market for 2012'.*
[IV] *According to the last reporting of insurance companies to the Bank of Albania.*

6. BANKING SECTOR

6.1 ASSETS AND LIABILITIES AND THEIR COMPOSITION

Banking sector assets rose at end-2012, albeit at a slower pace than in 2011. On the asset-side of banks' balance sheet, the contribution of 'Treasury and interbank transactions' dominated, while that of lending (represented by 'Customer transactions') fell continuously due to the decelerated economic growth, lower demand for loans and banks' more cautious approach to lending. Banks increased their investment in securities, particularly in 2012 Q4, despite the low annual growth rate. On the liability-side of banks' balance sheet, the contribution was entirely attributable to deposit activity (represented by 'Customer transactions'), despite the lower annual growth rates as in the rest of banking sector activities.

Chart 6.1.1 Contribution of asset items to asset growth, in percentage points



Source: Bank of Albania.

Total banking sector assets accounted for about 87.9% of Albania's GDP. In 2012 H2, their growth rates slowed to about 6.1% from 13.1% a year earlier. 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).

On the asset-side, the contribution of 'Treasury and interbank transactions' dominated, registering an annual growth of 14.7%, from 12.5% in 2011.[21] The unfavourable combination of credit demand and supply-side factors translated into a downward contribution of lending (represented by 'Customer transactions'[22]), which hit the lowest level on record at end-2012. The deceleration in loan portfolio growth was followed by lower growth rates of loan loss provisions to about 25.5%, from 57.3% in 2011. The banking sector increased its security investments - mainly in fixed-income securities -, hence being conducive to total asset performance.

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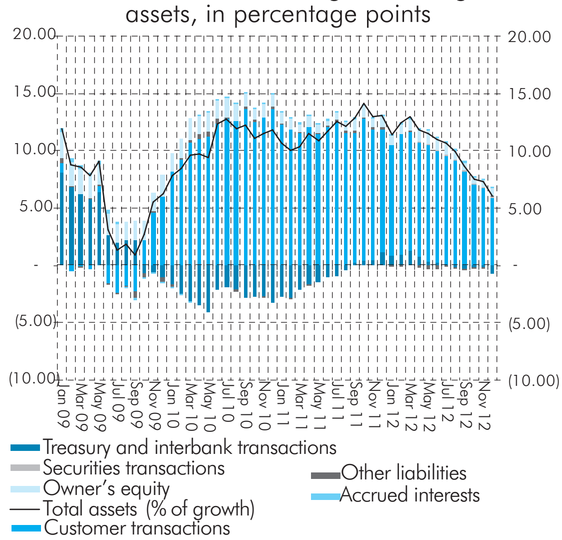
[21] *This item was particularly positively affected by 'Transactions with banks, lending and other financial institutions', which amounted to ALL 163.7 billion, from ALL 117.6 billion in 2011. 'Deposits with banks, lending and other financial institutions' and 'Loans' were the main driver of interbank transactions in 2012.*

[22] *On the asset-side, 'Customer transactions' represent banking sector lending to residents and non-residents, excluding accrued interests.*

On the liability side, the contribution of deposits (represented by 'Customer transactions')[23] dominated, accounting for about 82.3% of total liabilities. This is considered as positive as it is conducive to maintaining stable liquidity levels in the banking sector. This important financial source has, however, displayed a downward tendency following the general development trend of the Albanian economy. Banks maintained the ratio of capital use ('Owner's equity') to finance their activity, adjusting at the same time to the supervisory authority's requirements for capital boost with a view to observe the regulatory requirements.

Chart 6.1.2 Annual financing of banking sector assets, in percentage points



Source: Bank of Albania.

Five major banks continue to dominate the Albanian banking sector, with a combined share of 67.8% in the loan portfolio and 74.4% in deposits. This implies that these banks play an important role in lending to the economy and in the Albanian financial system's performance and stability.

6.2 BANKING SECTOR'S POSITION TO NON-RESIDENTS

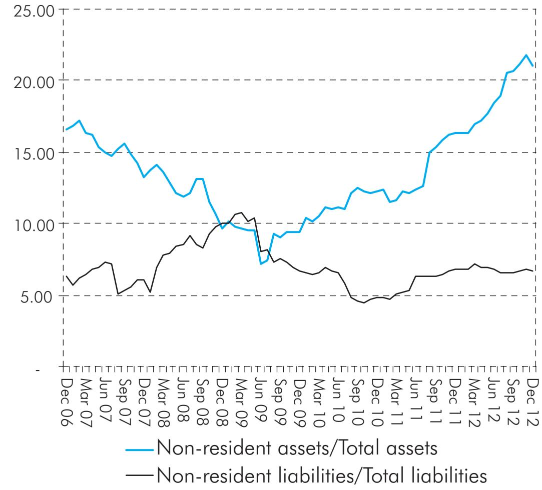
Banking sector investments, mainly as placements with non-resident institutions in the form of current accounts and deposits, increased in 2012. On the other hand, the Albanian banking sector lowered the use of credit lines from banking groups further. These developments provide evidence for an improved liquidity situation in the banking sector.

Banking sector investments in non-resident institutions' assets amounted to ALL 250 billion in 2012 H2, up 16.5% from H1 and 36.3% y-o-y. Investments in the form of placements with non-resident institutions rose considerably to ALL 140.6 billion from ALL 98.2 billion in 2011, mainly due to the increase in current accounts and deposits. Investments with banking groups account for 1/3 of total investments with non-residents. Assets held with non-resident institutions account for 21% of total assets, up 4.7 percentage points y-o-y.

Banking sector liabilities to non-residents amounted to ALL 80.2 billion, sharing 6.7% in total liabilities. Their share did not undergo significant changes in 2012. Liabilities to banking groups have major share in liabilities to non-residents.

[23] *On the liability-side, 'Customer transactions' represent resident and non-resident deposits, excluding accrued interests.*

Chart 6.2.1 Banking sector position to non-residents, in percent



Source: Bank of Albania.

Lines of credit received from banking groups reduced in 2012. The same tendency was noted in the used and unused part of lines of credit.

Table 6.2.1 Commitments received from banking groups and other group banks

In ALL million	Total credit line	Used credit line	Unused credit line
December 2011	63,422.40	16,903.90	46,518.50
June 2012	55,510.84	13,750.17	41,760.67
December 2012	49,045.40	10,116.90	38,928.50

Source: Bank of Albania.

The above analysis, which evidences that banking sector assets held with non-residents are almost three times higher than liabilities to non-residents, shows that there is low reliance of the Albanian banking sector on banking groups. However, individual banks display higher reliance on their banking groups, which requires cautious monitoring.

Box 4 Banking Sector Exposure to Non-Residents[1]

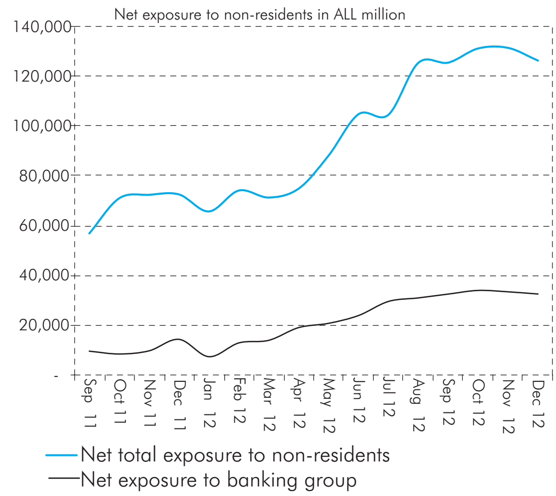
Note: This Box seeks to elaborate on the characteristics of banking sector exposure to non-resident institutions. As these data are available as operational, we should take into account a difference from the data as presented in the certified balance sheets.

Net exposure to non-residents. The banking sector showed a positive net position. The latter rose sharply from end-2011, particularly for operations with banking groups.

Maturity structure of time exposures. Claims on non-residents are generally of short-term maturity term. At end-2012, up to one-month claims on non-residents accounted for 76.3% of claims, while up to one-month liabilities accounted for 8.7% of time liabilities. On the liability-side, liabilities with a maturity of more than six months accounted for the main share in total liabilities, at 86.1%.

Composition by currency. At end-2012, claims on non-residents were mainly denominated in euro at 76.6%, and in U.S. dollar at 17.7%. A similar setting is also shown for liabilities to non-residents, mostly banking groups, with the euro accounting for 99.1% of total liabilities.

Chart 4.1 Banking sector exposure to non-residents



Source: Bank of Albania, Financial Stability Department.

Composition of exposure by bank capital origin. By bank capital origin, claims on non-resident institutions have the following share in total claims: Greek banks at 21%, Italian banks at 13.9%, French banks at 6.1%, and Albanian banks at 5.8%. In 2012, these claims were higher than in 2011 for all bank peer groups. The same trend is true versus 2012 H1, excluding French-owned banks. Claims on banking groups were also higher in 2012.

The falling rates of liabilities to non-residents were attributable to the lower liabilities for Italian and French banks from 2012 H1 and end-2011. At end-December 2012, French banks' liabilities accounted for 56.3% of total non-resident liabilities, Greek banks for 23% and Italian banks for 13.4%. Net exposure remains negative for French-owned banks, albeit improved from the previous stated periods. The other banking groups show increasing positive net position versus the previous periods.

[1] *The information in this Box is based on operational data as reported by the banking sector on operations with non-resident institutions.*

6.3 OUTSTANDING LOANS

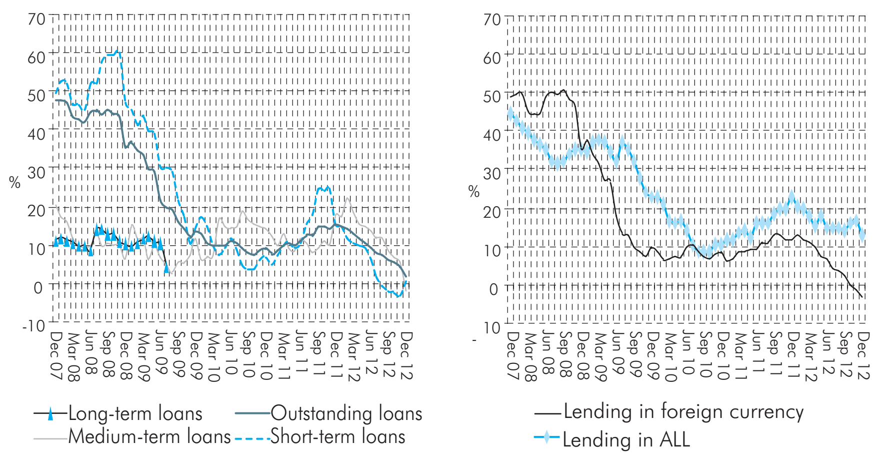
The growth of lending to the economy decelerated markedly in 2012, hitting record lows. The deceleration was mostly driven by the weak demand for loans due to economic agents' uncertainties about the economic outlook. Banks also pursued a more cautious approach to selecting their customers and implementing lending and loan monitoring procedures.

At end-2012, lending was estimated at 42.8% of GDP, amounting to ALL 577.8 billion.[24] Credit grew 2% y-o-y versus 15.3% in 2011.

Lending toward long-term maturity in 2012. In 2012 H2, long-term loans grew ALL 8 billion or 3.1%, whereas short-term loans grew negligibly and medium-term ones fell ALL 2.2 billion or 1.9%. At end-2012, long-term loans accounted for about 47% of total loan portfolio.

By currency, foreign currency-denominated loans continued to maintain a falling trend, while lek-denominated loans grew at higher rates. More specifically, foreign currency loans fell ALL 11 billion or 2.9%, whereas lek loans grew ALL 16.9 billion or 9%. In 2012 H1, foreign currency loans fell ALL 0.7 billion or 0.2%, whereas lek loans grew ALL 6.4 billion or 3.5%. At end-2012, foreign currency loans accounted for about 65% of total loan portfolio, from 68% in 2011.

Chart 6.3.1 Annual growth rate of lending by maturity and currency

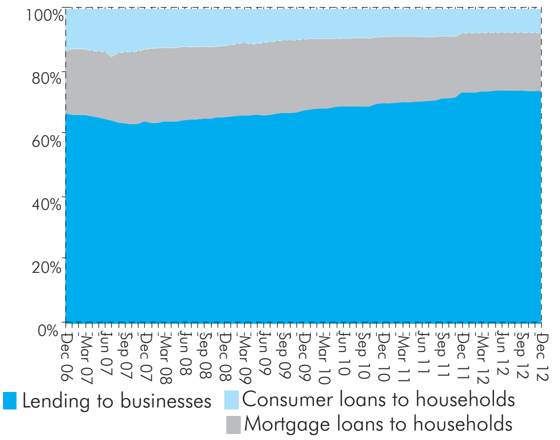


Source: Bank of Albania.

By borrower, lending to households grew at a faster pace, albeit moderately, by ALL 1.7 billion or 1.1%. Lending to businesses grew only ALL 0.6 billion or 0.1%. In 2012 H1, lending to households grew at lower rates, by about ALL 1 billion or 0.7%, whereas lending to businesses grew ALL 5.2 billion or 1.3%. Lending to the public sector continued to grow at stable rates. In 2012 H2, it grew ALL 3.7 billion or 16.8%, from ALL 1.5 billion or 7.4% in H1.

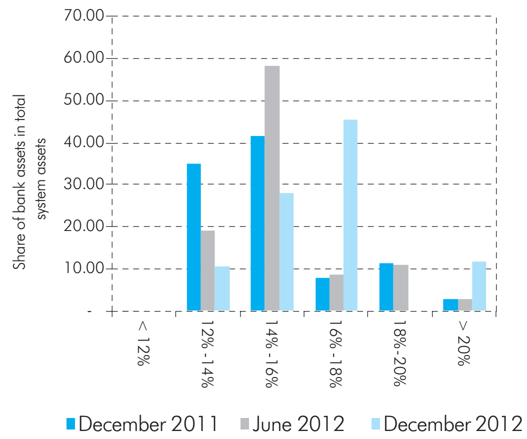
24 *Including accrued interests.*

Chart 6.3.2 Lending to the economy



Note: The data in Chart 6.3.2 refer to lending to residents, which at end-2012 accounted for 99.7% of total lending to businesses (including state-owned enterprises) and 95.2% of total lending to households.
Source: Bank of Albania.

Chart 6.6.3 Banks' assets based on capital adequacy ratio

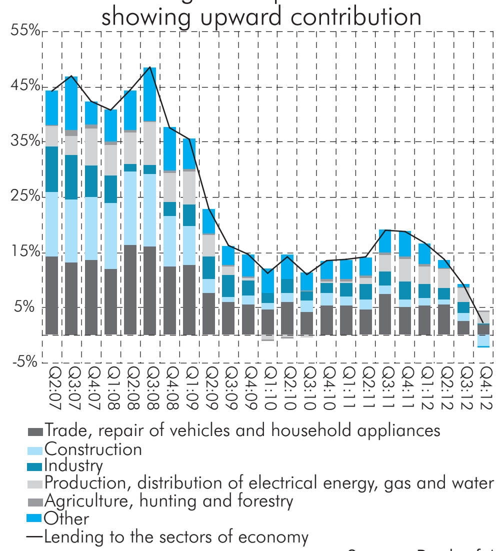


Source: Bank of Albania.

By sectors of economy, ALL 8.6 billion of loans were released to the production of electrical energy, and ALL 3 billion to immovable property purchase and development. Lending to construction, trade and industry shrank in 2012 H2, receiving ALL 7.7 billion, ALL 3 billion and ALL 1 billion, respectively. Chart 6.3.4 shows the contribution of main sectors to lending.

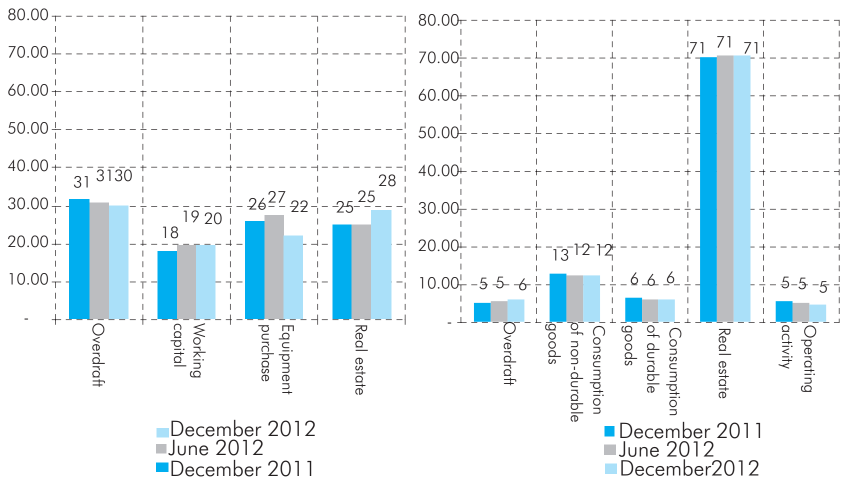
By purpose of use, lending to businesses oriented toward immovable property investment, whereas lending for equipment purchase fell. Overdrafts continued to show a slight falling tendency, both in businesses and households. The other items in the distribution of lending to households show no structural changes.

Chart 6.3.4 Lending to the private sector and sectors showing upward contribution



Source: Bank of Albania.

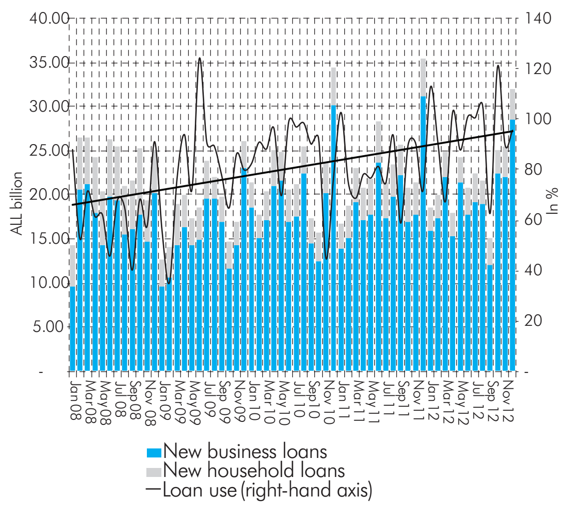
Chart 6.3.5 Distribution of outstanding business and household loans by purpose of use



Source: Bank of Albania.

Box 5 New Loans

Chart 5.1 New loans and loan use



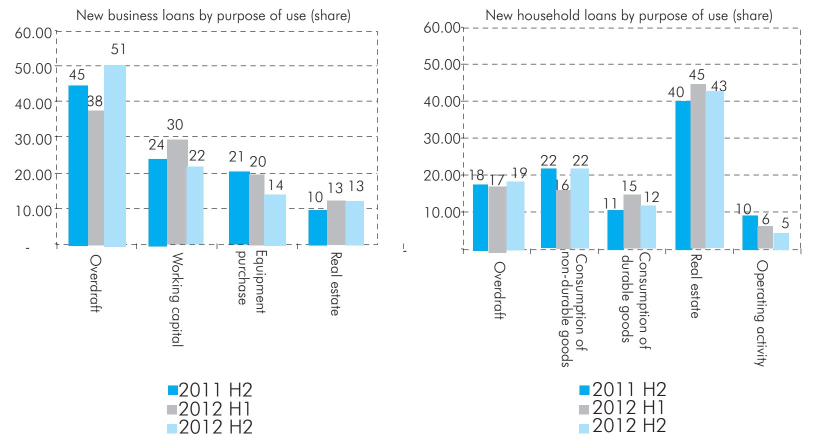
Source: Bank of Albania.

In 2012 H2, new loans extended by the banking sector amounted to ALL 142 billion, up ALL 15.7 billion or 12.4% from H1, or down ALL 6.5 billion or 4.4% from 2011 H2. Over the same period, the banking sector's collected loans amounted to ALL 139 billion, up ALL 22.5 billion (19.3%) from end-June 2012 and ALL 22.3 billion (19.1%) y-o-y. The ratio of collected loans to extended loans represents the loan use ratio. In 2012 H2, it was estimated at 97.8%, from 92.2% in H1 and 78.6% at end-2011.

Broken down by users, during 2012 H2, businesses were extended about ALL 123 billion or about 86.6% of new loans, whereas households were extended about ALL 19 billion or about 13.4% of total new loans. Chart 5.1 shows the performance of new loans and loan use ratio.

The distribution of new loans by purpose of use shows the increase in short-term loans for unspecified purposes - overdrafts -, whereas working capital loans fell. Concerning households, new loans for operating activity continued to shrink, whereas those for the consumption of non-durable goods showed higher growth rate.

Chart 5.2 Distribution of new business and household loans by purpose of use



Source: Bank of Albania.

Chart 5.3 shows the distribution of new loans by main sectors of the economy. New loans to 'Production and distribution of electrical energy, gas and water' grew ALL 14.3 billion or 190%, whereas new loans to 'Trade' fell ALL 5.9 billion or 12%.

The distribution of new loans by currency shows the recovery of loans denominated in euro, while new loans in lek continue to record the highest growth. In 2012 H2, new euro loans grew ALL 5.4 billion or 9.6% from H1, whereas new lek loans grew ALL 19 billion or 37.1%. New loans denominated in U.S. dollar shrank ALL 8.8 billion or 47.3% in H2.

- *INTEREST RATES ON NEW LOANS*

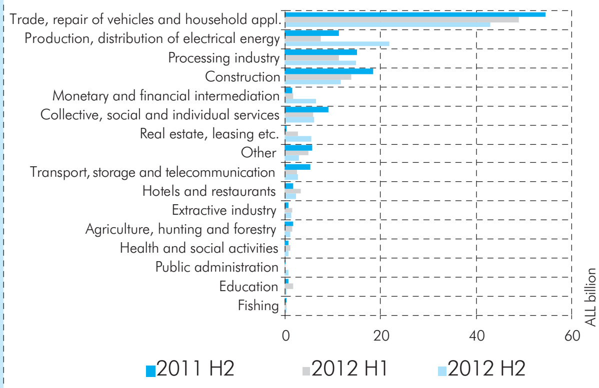
During 2012 H2, interest rates on new loans denominated in the three major currencies dropped slightly. Interest rate on new lek loans averaged 10.62% or 0.8 percentage points lower than in 2012 H1.

Interest rates on business overdrafts registered major drop by about 1.2 percentage points, to 9.66%. Interest rates on new lek loans applied to households for immovable property investment were more favourable in 2012 H2. They dropped 0.9 percentage points to 8.43%.

Despite the downward average Euribor rates, the domestic market did not maintain similar intensity. Average interest rate on new euro loans dropped 0.2 percentage points from H1, to 7.06%. New business overdrafts were more favourable, dropping by 0.6 percentage points. Interest rates on household loans for operating activity increased, while dropping for all other purposes.

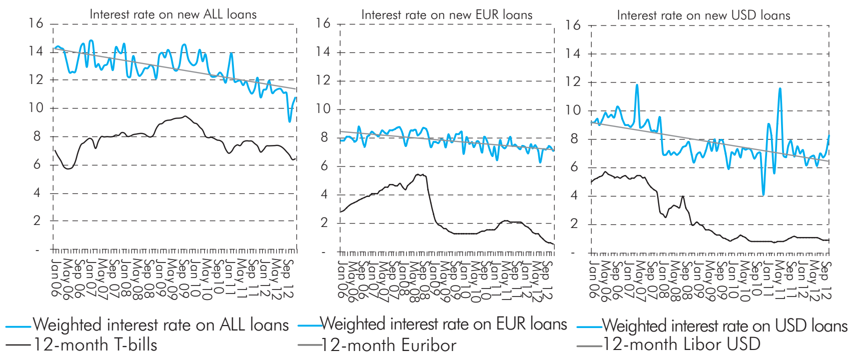
Average interest rate on new U.S. dollar loans rose slightly by 0.1 percentage points to 7.01%. Interest rates on new U.S. dollar business loans for immovable property investment increased 2.1 percentage points. Along the same line, interest rates on new household overdrafts increased 2.5 percentage points.

Chart 5.3 New loans by sectors of economy



Source: Bank of Albania.

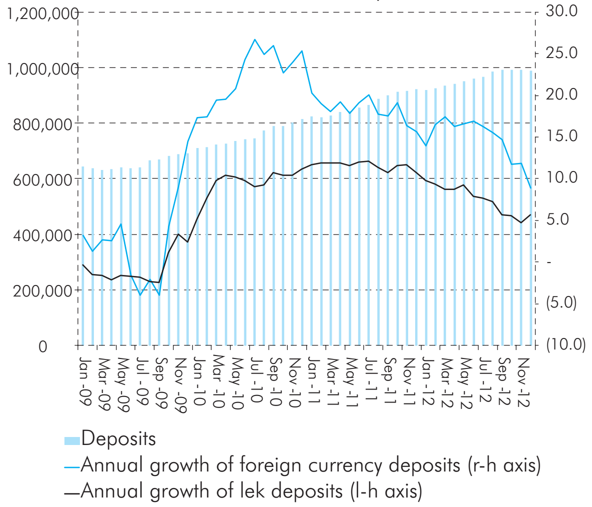
Chart 5.4 Interest rate on new lek and foreign currency loans



Source: Bank of Albania.

6.4 DEPOSITS

Chart 6.4.1 Total deposits and deposits by currency, in ALL million and in percent



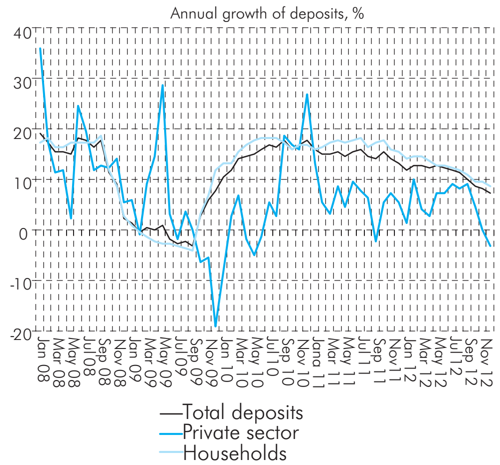
Source: Bank of Albania.

Banking sector deposits continued to grow in 2012 H2, albeit at a slower pace than in the previous two years.

Deposits continued to remain concentrated in the largest banks in the banking sector; however, the degree of their concentration fell y-o-y.[25] Total deposits amounted to ALL 992 billion[26] in 2012 H2, up 3.1% from June 2012 and 7.3% from December 2011.

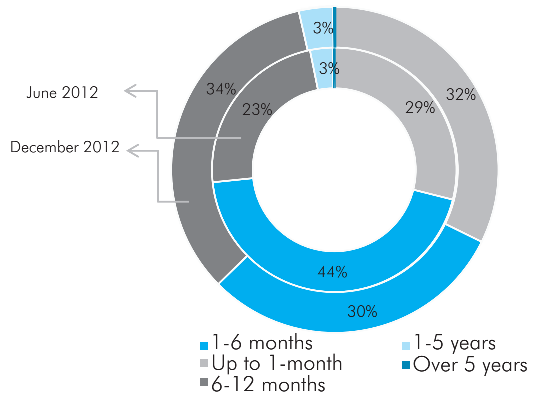
Household deposits, which account for about 88% of total deposits, grew at a lower annualised rate of 8.9%, from the 13.1% growth in 2011. After falling in 2012 H1, business deposits rebounded into positive territory, albeit 3% lower, y-o-y.

Chart 6.4.2 Annual growth rate of deposits, in percent



Source: Bank of Albania.

Chart 6.4.3 Banking sector deposits by maturity



Source: Bank of Albania.

The deposit structure shows significant shift to longer maturities. This may reflect Albanians' tendency to save and need for higher return rates. This trend is also conducive to making deposits a more stable financial source for banks.

By currency, as at end-2012, lek and foreign currency deposits had almost the same share in total deposits, each by about ALL 500 billion. The share of foreign currency deposits in total deposits is slightly higher y-o-y.

25 *Deposit concentration ratio, as measured by Herfindahl Index, fell to 1542, from 1581 in 2011. Despite the lower index, the banking sector showed levels of concentration in the collection of deposits.*

26 *Including accrued interests.*

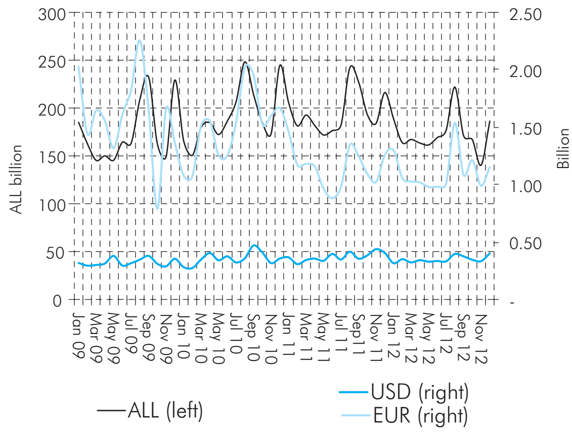
Box 6 New Time Deposits[1]

New lek time deposits fell in 2012 H2 to ALL 273 billion or 18% less y-o-y. This fall occurred as the average interest rate on lek deposits dropped to 4.6%, from 5.1% in 2011 H2. Concerning the maturity structure of new lek deposits, the share of new 1-month deposits fell by about 12.5 percentage points to 19%. During the same period, the share of new 12-month deposits increased by about 9.8 percentage points to 47%.

In 2012 H2, new U.S. dollar time deposits amounted to USD 422 million, or 13.4% less y-o-y. The deposit structure shows a higher share of 12-month deposits by 6.2 percentage points and a lower share of 1-month deposits by 8.9 percentage points. Average interest rate on new U.S. dollar deposits was 1.8%, from 1.5% in 2011 H2.

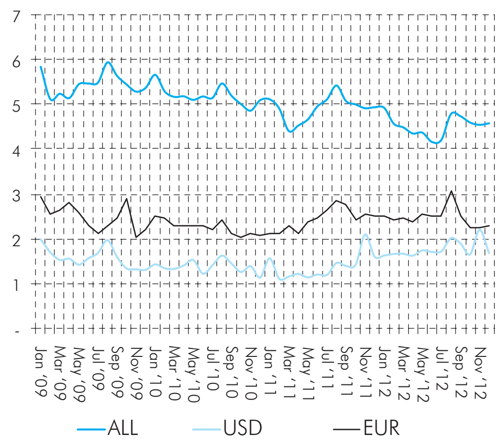
New euro time deposits totalled EUR 1.92 billion, down 8%, y-o-y. Average interest rate remained almost unchanged at 2.6%. Concerning the maturity structure of new euro deposits, the share of 12-month time deposits increased by 8.8 percentage points to 43.5%, whereas the share of 1-month time deposits fell by 6.8 percentage points to 20%.

Chart 6.1 New time deposits by currency, in million monetary units



Source: Bank of Albania.

Chart 6.2 Interest rates on new time deposits, in percent

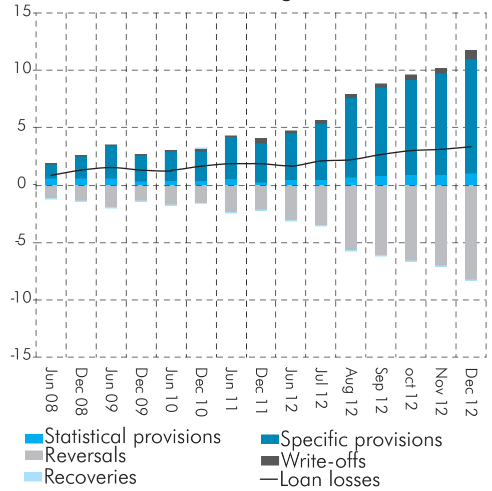


Source: Bank of Albania.

[1] *The analysis of new deposit figures should take into account the fact that a considerable portion of new deposit flows is attributable to the renegotiation of existing deposit agreements.*

6.5 PROFIT AND EFFICIENCY OF FUNDS

Chart 6.5.1 Loan loss components, as a percentage of outstanding loans



Source: Bank of Albania.

As at end-2012, banking sector's net profit was positive at ALL 3.8 billion, 5.3 times higher y-o-y. Profit from main banking operations – interest and other operating income – remained unchanged from 2011. Almost the entire change in the Albanian banking system's net profit was attributable to the considerably lower provisioning. This was primarily driven by the improved security prices in banks' portfolios, which has in turn lowered provisioning on these investments. The higher settlements provided further positive effect on net profit, mitigating the eroding effect of profit induced by the worsened loan portfolio. Non-recurring income[27] also had a positive impact, albeit to a lesser extent.

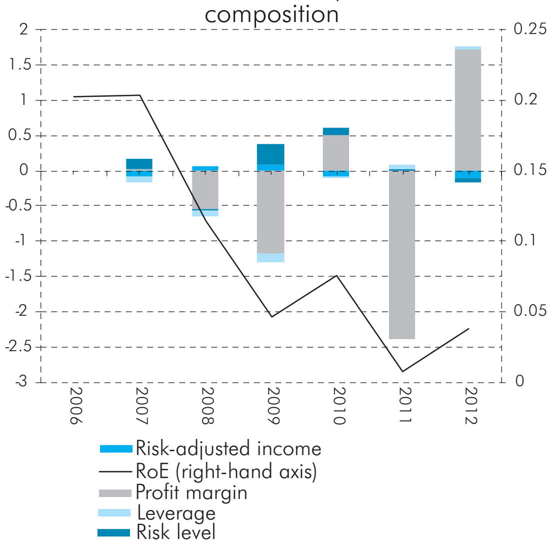
Net interest margin declined in 2012, reflecting the higher financing costs of interest-earning assets versus the decline in income generated from interest-earning assets.

Table 6.5.1 Profitability ratios, in percent (cumulative)

Indicators	December 2008	December 2009	December 2010	December 2011	December 2012
Interest income/interest-earning assets (1)	8.06	8.10	8.11	7.78	7.73
Interest expenses/interest-earning assets	3.94	4.06	3.78	3.57	3.72
Net Interest Margin (NIM)	4.13	4.04	4.32	4.20	4.01

Source: Bank of Albania.

Chart 6.5.2 RoE's linearised performance and composition



Source: Bank of Albania.

At end-2012, average interest-earning assets rose to ALL 977.5 billion, accounting for about 85.7% of total banking sector's average assets. They increased by ALL 14.8 billion or 1.5% from June 2012 and ALL 53.2 billion or 5.7% from end-2011. 'Average interest-paying liabilities to average interest-earning assets' stood at 99.7%, almost unchanged from June 2012 and 6 percentage points higher y-o-y.

Banking sector's net operating income amounted to ALL 39.3 billion, remaining unchanged y-o-y, whereas net interest income and other operating income showed negligible increase. Operating expenses amounted to ALL 25.9 billion or 6% higher y-o-y. Consequently, the ratio of operating expenses to net income stood at 52.8%, from 50.1% at end-2011.

[27] *The increase in non-recurring income was mainly affected by the execution of collateral pledged at banks to guarantee credit repayment.*

The ratio of general operating expenses to income fell to 88.4%, from 94.1% in December 2011, due to the decline in provisions by about ALL 4 billion.

Banking system's profitability improved y-o-y. Return on Equity (RoE) was 3.8%, from 0.8% a year earlier. However, a higher RoE does not necessarily imply a stronger financial system as its increase may derive from higher risky assets. The decomposition of RoE components[28] provides a more elaborate analysis of factors affecting its improvement:

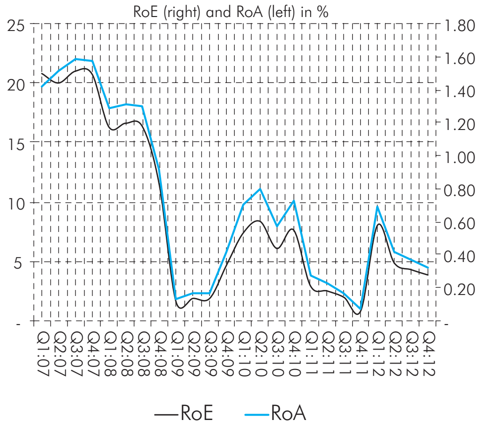
$$RoE = \frac{Net\ profit}{Operating\ income} x \frac{Operating\ income}{Risk-weighted\ assets} x \frac{Risk-weighted\ assets}{Total\ assets} x \frac{Total\ assets}{Equity}$$

RoE's change in 2012 was almost entirely a result of the profit margin (ratio I in the decomposition) and the higher financial leverage (ratio IV) which, from the stability viewpoint, exposes the banking system more. Risk-adjusted income (ratio II) and risk level (ratio III) fell in 2012.

Return on Assets (RoA) was 0.33%, about five times higher, y-o-y.

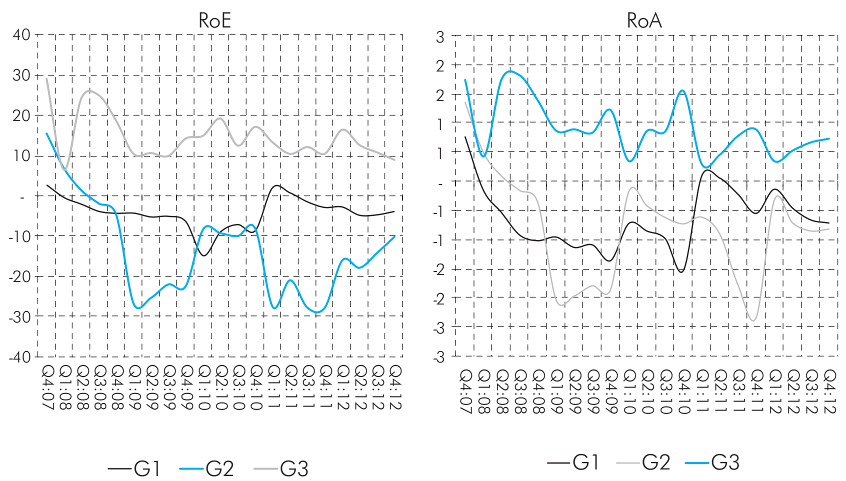
Chart 6.5.4 shows the performance of RoE and RoA by banking groups.

Chart 6.5.3 RoE and RoA, in per cent



Source: Bank of Albania.

Chart 6.5.4 RoE and RoA by banking groups, in percent



Source: Bank of Albania.

[28] *For a more elaborate description of RoE components, refer to Financial Stability Report 2012 H1.*

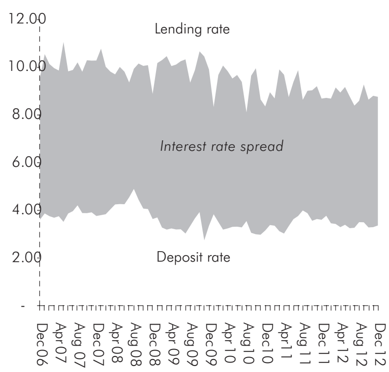
Box 7 Decomposition of ex-post financial intermediation cost in the Albanian banking sector

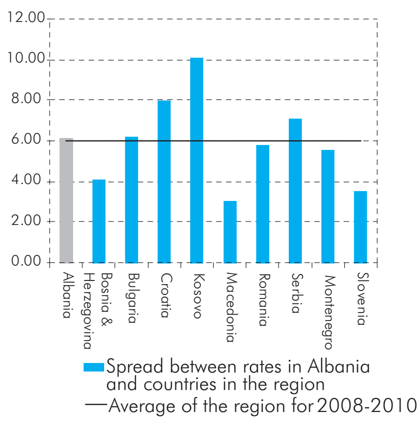
This Box seeks to analyse the factors driving the change in the net interest margin in the Albanian banking sector. The net interest margin, measured as a difference between lending and deposit rates, is a commonly accepted proxy measure of how costly bank intermediation services are for a given economy. Empirical analyses suggest that the interest margin is broadly connected to banking sector's efficiency. Determinants of interest margin are classified into three categories of indicators related to: bank's business model, banking sector's business model and economy-driven business model.

Academic studies show that high financial intermediation costs may constitute an important impediment for financial deepening in an economy. On the other hand, the high margins might be symptomatic of a number of (potentially systemic) structural concerns, such as: lack of competition, high market and credit risks, scale diseconomies that cause high operating costs, unfavourable institutional environment, and existence of various regulatory constraints distorting financial market activity (Poghosyan, 2012).[I]

The spread between lending and deposit rates in the Albanian banking sector has narrowed by an average of 0.5 percentage points in the last three years. In 2012, it averaged 5.4% or 0.2 percentage points lower y-o-y (see Chart 7.1).

Chart 7.1 Lending and deposit rates and spread, in percent





Source: Bank of Albania.
**Note: The right-hand chart shows the spread average during 2008-10, www.dataworldbank.org*

The following presents the ex-post estimation of financial intermediation rate and the decomposition of ex-post intermediation cost into four components in order to analyse their contribution to determining the lending rate during 2006-12. The results are shown in Table 7.1. We decompose the financial intermediation cost based on methodologies proposed by Randall (1998)[II] and Hansen & Rocha (1986)[III], and study by Kalluci (2010)[IV]. The application of these approaches enables the estimation of financial intermediation rate relating it only to bank lending operations. The estimation is based on accounting concepts where income from bank lending operations equal lending costs and bank's profit for the given period. Interest margin components have been decomposed based on the financial statements of income and expenditure, and banks' balance sheets.[V]

By applying formula (1), the margin is decomposed as the difference between bank lending cost and profit. Table 7.1 shows the obtained ratios. The intermediation rate that is borne by the borrower consists of the lending rate (interest rates from lending) and payment of tariffs and commissions, which reflect bank's profit from lending (see Table 7.1). Profit should cover bank's costs, decomposed into: funding, operational costs, risk and regulatory costs, and satisfy banking activity with a certain profit margin. The residual reflects errors that result from combining data from income statement (flow data) and stock data from the consolidated balance sheet, as well as making the simplifying assumptions about the estimated ratios.

Table 7.1 Intermediation cost decomposition for the Albanian banking sector

Description	2006	2007	2008	2009	2010	2011	2012	Average
Ex-post intermediation rate	10.0%	10.3%	10.0%	9.3%	9.4%	9.0%	8.8%	9.6%
-Lending rate	9.4%	9.6%	9.4%	8.7%	8.7%	8.3%	8.2%	8.9%
-Tariffs and commissions	0.6%	0.6%	0.7%	0.6%	0.7%	0.7%	0.6%	0.6%
Ex-post costs	8.2%	8.5%	9.7%	10.6%	10.2%	10.7%	10.2%	9.7%
Funding cost	2.8%	3.3%	3.9%	4.1%	3.8%	3.5%	3.5%	3.6%
Operational cost	2.4%	2.4%	2.5%	2.6%	2.5%	2.3%	2.2%	2.4%
Risk costs	1.7%	1.4%	2.4%	3.0%	2.9%	3.9%	3.5%	2.7%
Regulatory costs	1.3%	1.3%	0.9%	0.9%	1.0%	1.0%	0.9%	1.0%
-Taxes	0.4%	0.4%	0.2%	0.1%	0.2%	0.2%	0.1%	0.2%
-Required reserve	0.9%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%
Additional indicators								
Residual	1.8%	1.8%	0.3%	-1.3%	-0.8%	-1.8%	-1.4%	-0.2%
Profitability	1.4%	1.5%	0.9%	0.4%	0.7%	0.1%	0.3%	0.7%

Source: Bank of Albania.

COST COMPONENTS

Funding costs: IE/D. Deposits are the main funding source of lending. Banks' expenses in the form of interest paid on customer deposits will affect the margin. Operational costs: OC/L. This component measures the impact of bank efficiency on the margin. More efficient banks are able to maintain lower operational costs relative to their less efficient counterparts.

Loan loss provision costs: Prov/L. This component proxies the impact of credit risk on the interest rate margin. Banks with riskier lending portfolio are required to transfer a larger amount of funds to maintain adequate loan loss provisions. These funds are amortised over time, hence increasing costs for a relatively long time and weighing on the margin.

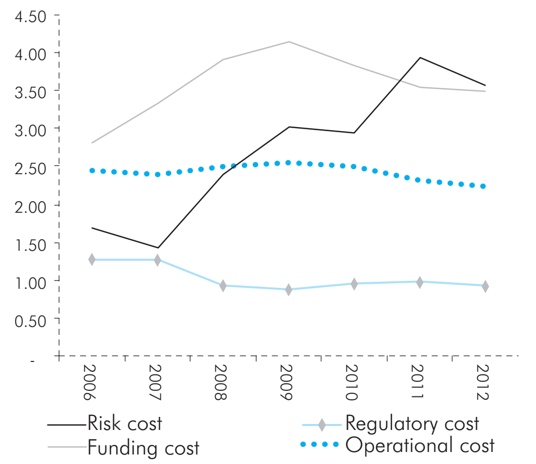
Regulatory costs (taxes and required reserve): High reserve requirements impose additional costs on banks. They have to pay a market interest rate to depositors but have to hold a fraction of these deposits in the central bank at a rate lower than the market rate (remunerated reserves). Banks normally prefer to pass these additional costs on to their customers by widening the margin.

Profitability: P/L. Banks aim to maintain an adequate level of profitability. Profitability is ,therefore, considered a factor that banks add up to their costs. In banking industries featuring low degree of competition, banks have the power to demand profitability rates that exceed the normal level by widening the margin.

RESULTS

Intermediation rates during 2006-12 maintained a falling tendency as shown in Table 7.1. In 2012, the lending rate was 8.2%, whereas tariff and commission rate was 0.6%, hence generating a total intermediation rate of 8.8%, down 0.2 percentage points from 2011 and lower than the average for the stated period (9.6%).

Chart 7.2 Financial intermediation costs expressed as expression (1) ratios, in percent



Source: Bank of Albania.

On the other hand, developments in the intermediation cost structure show that funding and risk costs have the dominant effect on the margin. Funding and risk costs have increased their share in margin formation over the last years due to the higher loan loss provisions, which have increased at a rate faster than the lending volume. Banks have lowered their operational costs, whereas regulatory costs remain low (see Chart 7.2). Funding costs have a similar performance to deposit volume (lower growth rate in the last years); on the other hand, they also reflect banks' need to maintain their market share.

The improved market competition following the privatisation of state-owned banks may have lowered profitability, while the higher risk costs in the last two years has potentially contracted profitability. Bank of Albania's accommodative monetary policy during 2011-12 was slightly reflected in the rates of lending to the economy. However, the increasing contribution of costs to the financial intermediation rate suggests that banks have passed them on to their customers, unable to maintain their profitability (as shown in Table 7.1). The constant monitoring of cost components remains one of the objectives of the regulatory authority with a view to implementing market discipline rules.

I *Poghosyan, T. (2012) Financial Intermediation Costs in Low-Income Countries: The Role of Regulatory, Institutional, and Macroeconomic Factors, IMF, WP/12/140.*

II *Randall, R. (1998), Interest Rate Spreads in the Eastern Caribbean, IMF/ WP/ 98/59*

III *Hanson, J. A. and R. Rocha (1986), High interest rates, spreads, and the cost of intermediation, Industry and Finance Series 18, WB.*

IV *Kalluci, I. (2010), Determinants of net interest margin in the Albanian banking system, Bank of Albania.*

V *The consolidated income and expenditure statement of banks defines profit (P) as interest income (II), plus non-interest income (NII), minus interest expense (IE), minus operating costs (OC), minus provision for loan losses (Prov), and minus paid tax: PII+NII-IE-OC-Prov-Tax. This identity is further transformed by dividing it to average lending (L) and average deposits (D) and multiplying by intermediation growth (A), as measured by the share of loans in total average assets, as a scale factor, as in expression (1):*

$$\frac{II}{L}+\frac{NII}{L}\cdot A=\frac{IE}{D}+\frac{OC}{L}\cdot A+\frac{Prov}{L}+\frac{Taxes}{L}\cdot A+\frac{IE}{L}\cdot A\cdot 0.1+\frac{P}{L}\cdot A+\varepsilon$$

6.6 BANKING BUSINESS CAPITALIZATION

Banking sector's improved financial performance, higher capital and lower increase in risk-weighted assets strengthened its solvency further in 2012 H2.

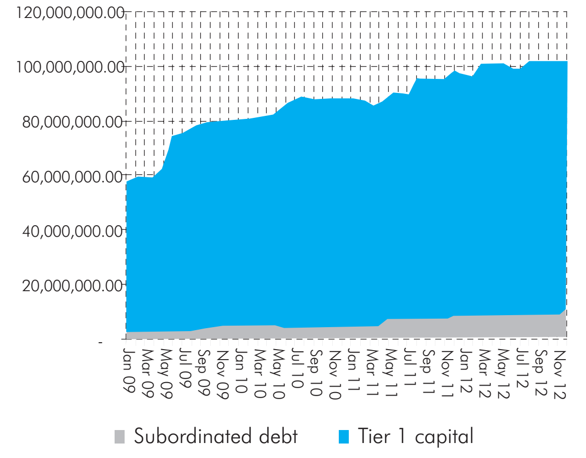
Banking sector's improved financial performance in 2012 raised the regulatory capital by about 5.7% to ALL 104.1 billion. The regulatory capital structure appears favourable in terms of covering any potential losses, with core capital accounting for 90%.

During 2012, the banking sector responded to the fall of demand for loans and further worsening of their quality by expanding their investment in low risk assets (weighted at 20%).

At end-2012, the annual growth rates of investments in risk-weighted assets slowed to 1.7%, from 7.9% at end-2011, amounting to ALL 643.7 billion. The higher growth rates of regulatory capital relative to risk-weighted assets improved the capital adequacy ratio at end-2012 to 16.2% from 15.7% in June 2012 and 15.6% in 2011.

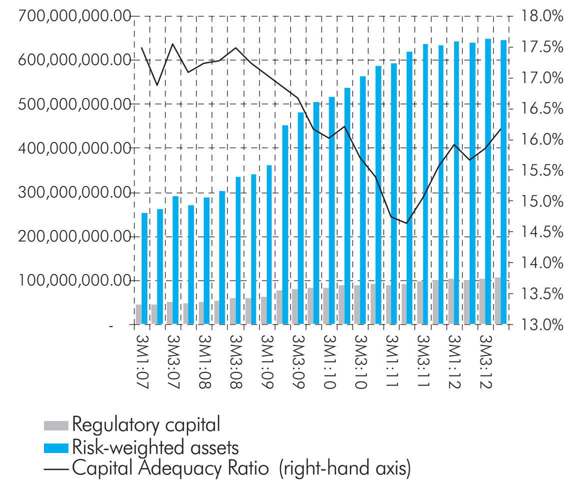
At end-2012, capitalisation for all banks exceeded the minimum requirement of 12%. The improved banking sector capitalisation is evidenced by the higher share of banks having this ratio ranging between 16-18% (see Chart 6.6.3).

Chart 6.6.1 Banking sector's Tier 1 capital and subordinated debt, in ALL billion



Source: Bank of Albania.

Chart 6.6.2 Components of capital adequacy ratio



Source: Bank of Albania.

Chart 6.6.3 Banks' assets based on capital adequacy ratio

Source: Bank of Albania.

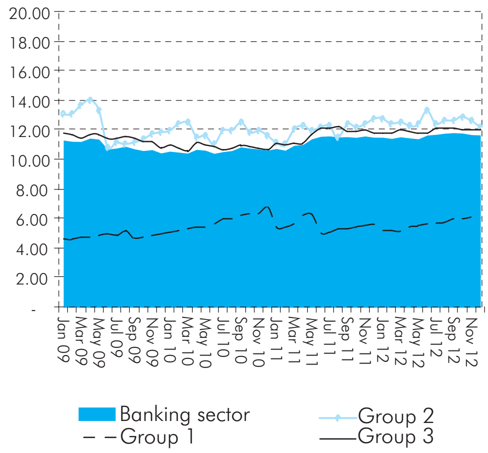
Table 6.6.1 summarizes the capital adequacy ratio for the banking sector and banking groups by size and capital origin.

Table 6.6.1 Capital adequacy ratio, in per cent

	Sector	Group 1	Group 2	Group 3	Italian	French	Greek	Albanian
December 2011	15.6	27.9	14.1	15.5	20.2	12.5	16.6	13.9
June 2012	15.7	28.5	13.4	15.8	20.2	13.2	15.1	14.5
December 2012	16.2	25.1	15.1	16.0	19.6	14.7	16.7	13.9

Source: Bank of Albania.

Chart 6.6.4 Financial leverage ratio for the banking sector and groups by size



Source: Bank of Albania.

At end of December 2012, shareholders' equity totalled ALL 101.8 billion, up ALL 4.5 billion (or 4.7%) y-o-y. Paid-in capital is the main item in the banking sector's shareholders' equity, accounting for 90.7%. At end-2012, it amounted to ALL 92.3 billion, from ALL 89.6 billion at end-June 2012 and ALL 82.8 billion in the corresponding period in 2011. During 2012, eight banks, which account for 54.3% of total banking sector, augmented their paid-in capital by a total of ALL 9.5 billion.

The financial leverage ratio (total assets to shareholders' equity) was 11.7, fluctuating negligibly in annual and bi-annual terms. Chart 6.6.4 shows the financial leverage ratio for the banking sector and banks by size. Although Group 2 banks' leverage ratio (12.2) is higher than the other two groups', it showed a downward tendency at end-2012 due to the higher growth rate of this group's shareholders' equity to total assets.

7. MONITORING BANKING SECTOR RISKS

7.1 MARKET RISKS

The Albanian banking sector is relatively hedged against direct risk of unfavourable exchange rate and interest rate movements but the sensitivity is higher. Banking sector's open foreign exchange positions resulted within the historical levels and the values of assets and liabilities sensitive to the interest rate are comparable to one another.

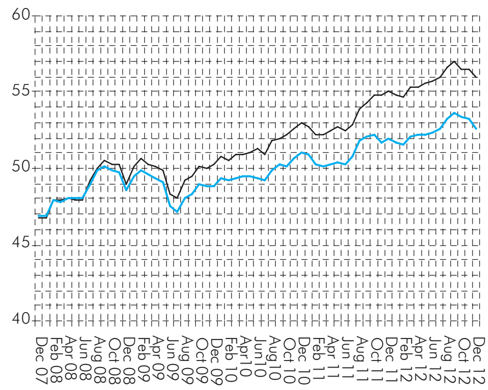
7.1.A EXCHANGE RATE RISK

The gap between foreign currency assets and liabilities during the period, and the share of open foreign exchange position in regulatory capital, suggest that the unfavourable exchange rate movements should be considerable to have a material impact on banking sector's capital ratios.

At end-2012 H2, the banking sector's foreign currency assets totalled ALL 665.7 billion, up 3.07% from H1 and 8% from 2011 H2. The share of foreign currency assets and liabilities in total assets was 56.03% and 52.60%, respectively, slightly higher from June 2012 and December 2011. The gap between foreign currency assets and liabilities remains within the historical range of 0-10%.

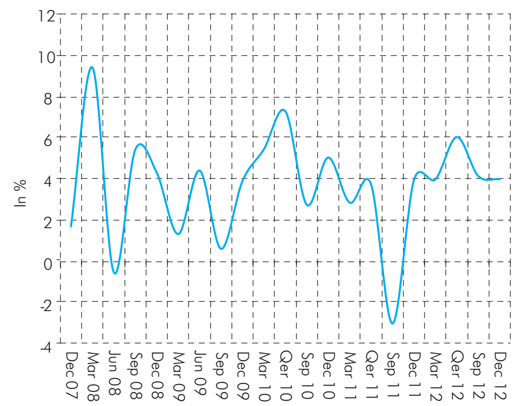
The banking sector showed low exposure to direct exchange rate risk. At end-2012, the banking sector's open foreign exchange position accounted for 3.98% of its regulatory capital, which is markedly lower than the maximum threshold of 30%.

Chart 7.1.a.1 Share of foreign currency assets and liabilities in total banking sector assets, in percent



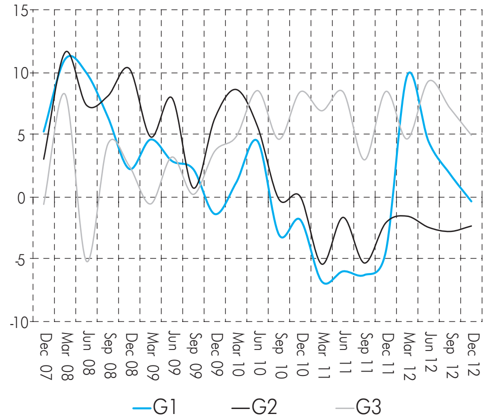
Source: Bank of Albania.

Chart 7.1.a.2 Net foreign exchange position to regulatory capital, in percent



Source: Bank of Albania.

Chart 7.1.a.3 Net foreign exchange positions to regulatory capital per banking group, by activity size, in percent



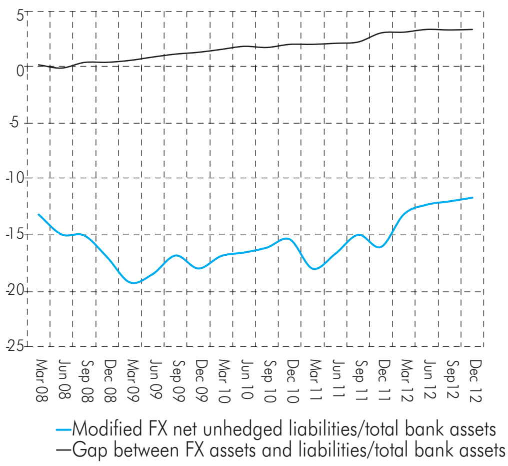
Source: Bank of Albania.

By banking groups, G3 banks continued to have a long foreign exchange position in 2012 H2, whereas G1 and G2 banks had a short foreign exchange position. Relative to June 2012, G1 banks shifted their foreign exchange positioning from long to short, whereas G2 banks maintained a similar position to the previous period.

The Modified Currency Mismatch Index[29] shows lower banking sector exposure to indirect exchange rate risk.

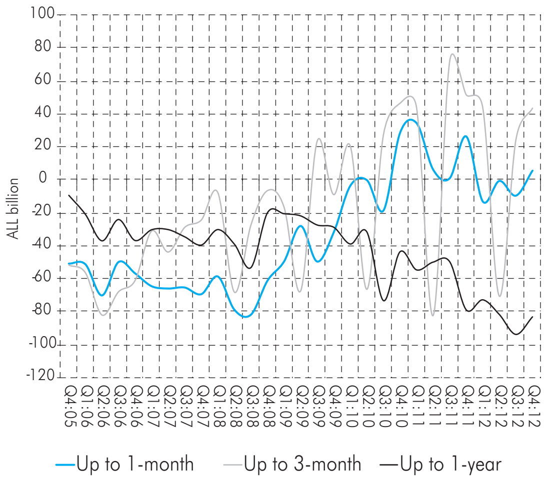
In December 2012, the Currency Mismatch Index improved by 0.6 percentage points from June, to 11.7%. In December 2011, it was estimated at 16.1%. Banks showed a contracted position of loans unhedged[30] against exchange rate risk to total loan portfolio and foreign currency loan portfolio. The decline in outstanding foreign currency loans unhedged against exchange rate risk mitigated banking sector exposure to indirect risk; however, its considerable share in total loan portfolio (about 31.3%) makes the banking sector sensitive to unfavourable exchange rate movements.

Chart 7.1.a.4 Modified Currency Mismatch Index, in percent



Source: Bank of Albania.

Chart 7.1.b.1 Asset-liability gap, by repricing periods, in ALL billion



Source: Bank of Albania.

29 This is a new index based on the methodology provided by Romain Ranciere, Aaron Tornell and Athanasios Vamvakidis in "A New Index of Currency Mismatch and Systemic Risk". It enables a more complete measure of banks' exposure to exchange rate. The index is calculated as follows: Foreign currency denominated net unhedged liabilities / total bank assets = {[foreign currency foreign liabilities + foreign currency domestic liabilities] - [foreign currency foreign assets + foreign currency domestic assets] + [foreign currency lending to unhedged households + foreign currency lending to unhedged non-financial firms]} / [total bank assets]

30 Loan in a currency other than that of the borrower's income serving to repay the loan.

7.1.B INTEREST RATE RISK

The banking sector exposure to interest rate movements has been limited. The size of exposure, as measured by the gap between interest rate-sensitive assets and liabilities to total assets, is not considerable.

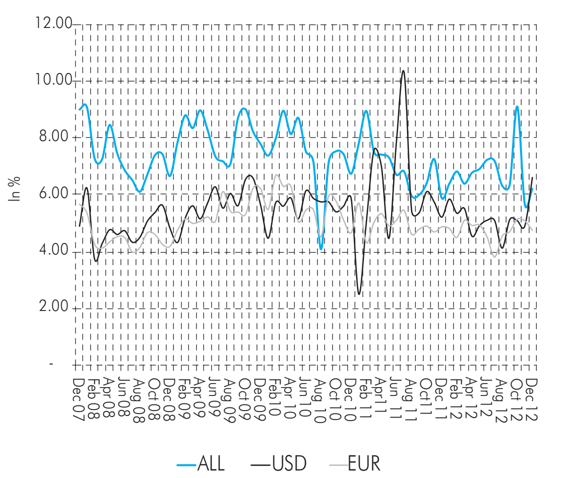
As at end-2012, the gap between interest rate-sensitive assets and liabilities for up to 12-month maturity was negative and upward on a year earlier, to ALL 83.4 billion, or 7% of total assets. The gaps are positive and lower for 1- and 3-month maturities – ALL 5.5 billion and ALL 43.2 billion, respectively. Though these levels are regarded as handleable, further deepening of the negative gap would expose the banking sector to additional costs in the case of a rise in the interest rate.

Box 8 Spread between lending and deposit rates

Interest rates on loans and deposits by major currencies were not uniform in 2012 H2. The banking sector appeared less exposed to indirect interest rate risk mainly for the lek-denominated portfolio, with the spread narrowing due to the higher decrease in lek loan rates. The spread widened slightly for the other two currencies due to the lower deposit rate.

Exposure to indirect interest rate risk in 2012 was lower, with the spread narrowing for the three major currencies. The spread between weighted average interest rates on loans and deposits narrowed for the three major currencies in 2012. The U.S. dollar and euro interest rate spread narrowed 0.95 percentage points and 0.6 percentage points, respectively, to 4.4% and 4%. Lek interest rate spread narrowed slightly by about 0.3 percentage points, to 5.4% in 2012. The narrower spread was mainly driven by the lower loan rates for the three currencies, whereas the average deposit rates did not show significant changes from a year earlier.

Chart 8.1 Spread between interest rates on loans and deposits, in percent



Source: Bank of Albania.

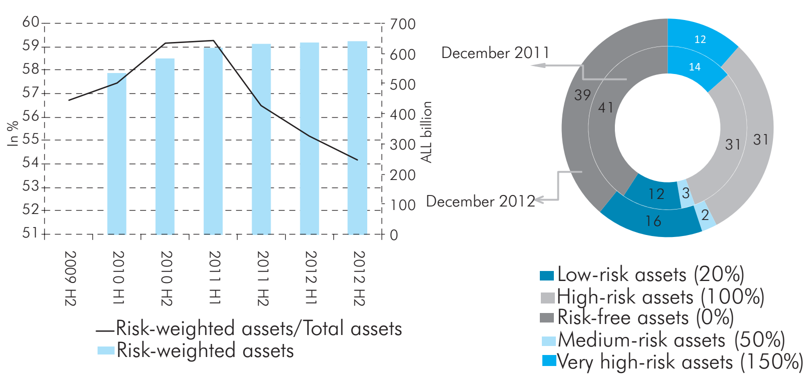
7.2 CREDIT RISK

Even under normal conditions of economic development, any bank investment of financial sources bears a certain risk level. This risk is complete in lending, particularly due to the uncertainties surrounding the economic outlook. In the domestic banking sector, lending to the public and financial institutions accounts for about 50% of the sector's assets and dominates the indicator of risk-weighted assets.

The further tightening of lending conditions may be harmful. Outstanding credit grew only 1% (or ALL 5.9 billion) in 2012 H2, registering a record low annualised growth of 2%. In addition to the low private sector demand, the lending standards seem to have tightened as shown by the lower risk-weighted assets to total assets (see Chart 7.2.1). Any further tightening of lending standards would transmit negative signals to the macroeconomic environment, which would in turn hamper financial system's stability. A policy is therefore required to balance public financing and lending.

In absolute terms, risk-weighted assets grew 0.6% or ALL 4 billion from H1. At end-2012, they amounted to ALL 644 billion, registering an annualised growth of 1.7%. Assets risk-weighted at a coefficient of 20% increased their share in 2012 H2 and expanded by 4 percentage points or ALL 56.8 billion. Assets risk-weighted at 150% shrank 2 percentage points or ALL 15 billion. Risk-free assets amounted to ALL 457.7 billion, registering an annualised growth of ALL 7.4 billion or 1.7%. The lower growth rate of risk-weighted assets to total asset growth lowered the share of risk-weighted assets to 54.2% at end-2012.

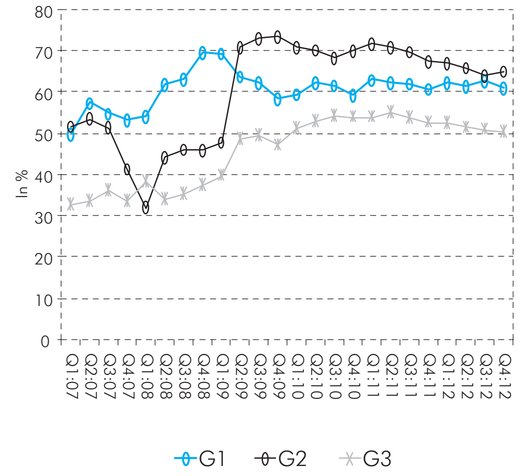
Chart 7.2.1 Risk-weighted assets



Note: Right-hand chart shows the distribution of risk-weighted assets by weighting coefficients.
Source: Bank of Albania.

G2 banks continued to have the largest share of risk-weighted assets in total assets, accounting for about 65.03%.

Chart 7.2.2 Risk-weighted assets by banking groups, in percent



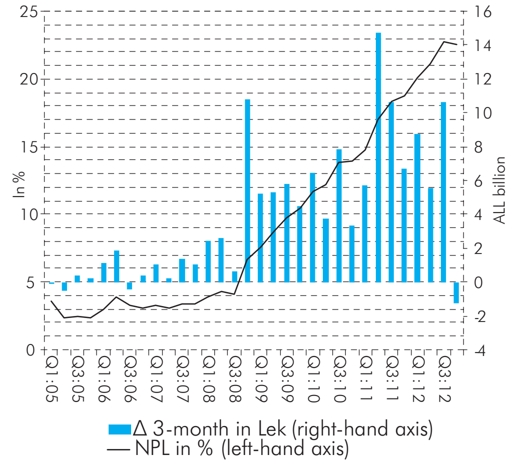
Source: Bank of Albania.

Despite banks' cautious lending, credit risk dominates the risk profile.

Credit risk originating from bank lending portfolio remained major risk with direct impact on banking sector's financial stability. Despite the contraction in lending and banks' recent tendency to place a considerable fraction of their funds in safe assets, credit risk continued to remain the dominant banking sector risk, increasing further in 2012 H2.

Several-year below-potential growth and the structural concerns facing individual sectors of the economy continued to condition borrower's solvency, hence leading to an increase in non-performing loans.

Chart 7.2.3 Absolute quarterly change in non-performing loan volume and non-performing loans to total loans ratio (right-hand axis)



Source: Bank of Albania.

In 2012 H2, banking sector's non-performing loans rose to ALL 130 billion, from ALL 121 billion in H1 and ALL 106 billion in 2011 H2. Their growth rate, however, slowed over the quarters. In 2012 Q4, non-performing loans improved slightly by 0.95%, reflecting banks' increasing efforts to encourage borrowers to repay their loans.

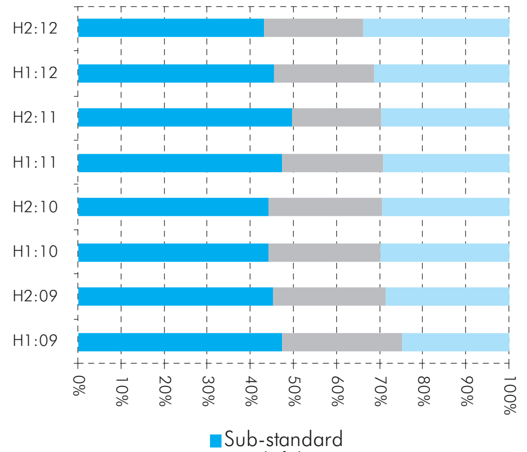
At end-period, the ratio of non-performing loans to total loans rose to 22.5%, from 21.1% in 2012 H1 and 18.8% at end-2011.

The increase in non-performing loans led to a rise in loss loans.

Lower-quality loans trended up in 2012 (see Chart 7.2.4). During 2012 H2, standard loans fell ALL 7.1 billion or 1.8%, shifting toward lower-quality loans. Special-mention loans grew ALL 3.7 billion or 8.4%; sub-standard loans grew ALL 1.5 billion or 2.7%; and doubtful loans grew ALL 1.7 billion or 5.9%. Loss loans registered the highest growth in absolute value, by ALL 6.2 billion or 16.4%. The share of standard loans in total classified loans reduced by about 2.8 percentage points from 2012 H1, to 69.2%.

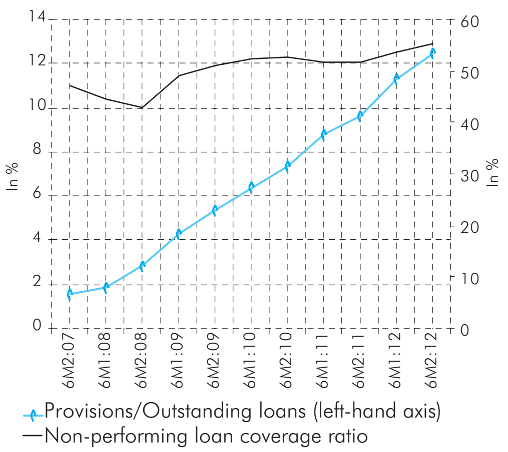
The higher share of loss loans increases banks' reliance on the well-functioning of collateral execution process, hence drawing attention to the significance of approving the legal amendments incorporated recently in the Civil Code and Code of Civil Procedure. The increase in loss loans lowers expectations for the recovery of non-performing loans, enhances

Chart 7.2.4 Loan portfolio categories, in percent



Source: Bank of Albania.

Chart 7.2.5 Provisions and non-performing loan coverage ratio (right-hand axis), in percent



Source: Bank of Albania.

their persistence and negative impact on banks' balance sheets and call for structural actions. The latter should aim at setting requirements and implementing incentives that write them off banks' balance sheets steadily and in due time.

Credit risk provisions increased ALL 7.4 billion or 11.4% from H1. In December 2012, non-performing loan coverage ratio rose to 55.4%, from 53.6% in June 2012 and 51.8% in December 2011. The improved ratio was attributable to the increase in provisions (11.4%) at a higher pace than that in non-performing loans (7.8%).

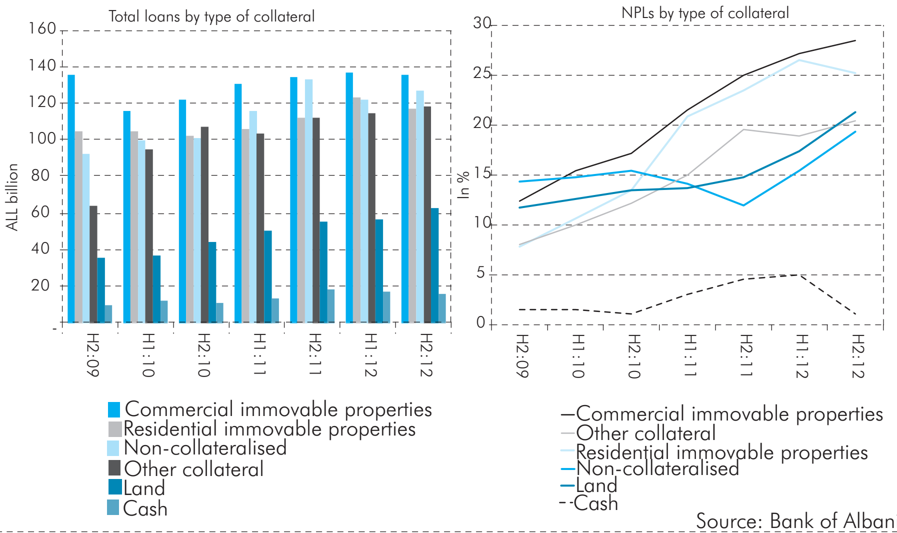
On the other hand, the ratio of provisions to outstanding loans showed an upward tendency, reaching 12.5% in December 2012, from 11.3% in June 2012 and 9.6% in December 2011.

The loan portfolio collateral coverage ratio[31] dropped slightly to 78%, from 78.7% in 2012 H1. Similarly, the non-performing loan collateral coverage ratio dropped to 81.1%, from 84.6% in June.

Chart 7.2.6 shows the composition of loans by type of collateral and related loan quality performance. Loans secured by 'other collateral' increased in 2012, while their quality worsened by about 1.6 percentage points to 20.4%. Cash-secured loans showed improved performance, growing by 9.5% from the previous period. Similarly, their quality improved. The quality of loans secured by commercial immovable property worsened slightly during the period, whereas that of loans secured by residential immovable property improved modestly.

[31] Collateral in the form of immovable property (residential, commercial or land), cash etc.

Chart 7.2.6 Loans by type of collateral



Source: Bank of Albania.

It, however, remains questionable whether provisions and collateral coverage will be sufficient in a decelerated economy. Collateral coverage, albeit slightly lower, was at satisfactory levels. However, the assessment of immovable properties and other types of collateral (other than cash) may be problematic in a situation characterised by an incomplete legal framework, which hampers the collateral execution infrastructure for bank loans.

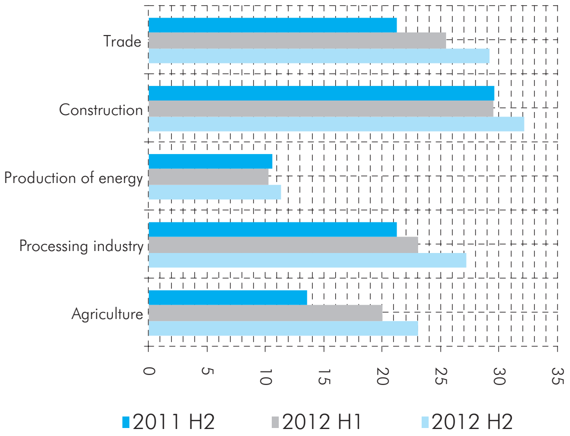
Other signals from developments in the non-performing loan structure, as described above, may be indicative of some risks. Loss loans increased in 2012. A vague economic perspective may increase loss loans further and, consequently, call for additional provisioning or loan write-offs, hence contributing adversely to the banking system's profitability.

Banking sector's ability to cover non-performing loans with capital weakened, as the ratio of non-performing loans net of provisions to regulatory capital rose to 55.6% at end-December 2012, from 52% at end-2011. The increased indicator shows that banks should find ways to strengthen their regulatory capital to withstand the loan quality impairment and increased loan loss provisions. These ways may initially include limitations regarding profit distribution and injection of additional capital.

Banks remained more exposed to credit risk in the three following items: long-term loan portfolio, foreign currency loan portfolio and business loan portfolio. Gross non-performing loans to total loans for the three items increased to 31.6%, 24.7% and 25.9%, respectively, from 28.8%, 22.6% and 23.8% in 2012 H1, being above the average non-performing loan ratio.

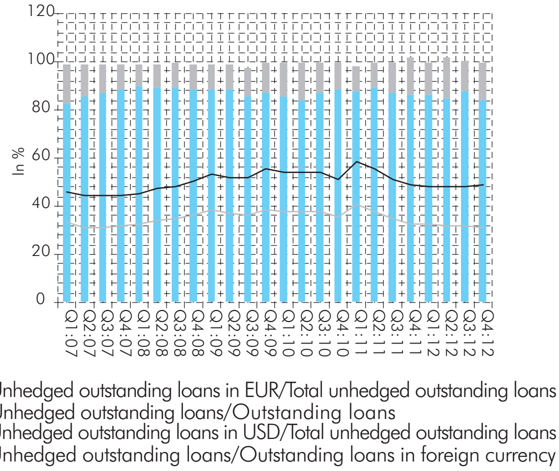
By sectors of economy, the loan quality worsened for almost all sectors. As shown by the Chart, construction, trade and processing industry are the most exposed sectors to credit risk. At end-2012, the ratio of non-performing loans to outstanding loans for these three items was estimated at: 32.2%, 29.2%

Chart 7.2.7 Loan portfolio quality by sectors of economy, in percent



Source: Bank of Albania.

Chart 7.2.8 Share of unhedged outstanding loans in foreign currency, in percent



Source: Bank of Albania.

and 27.2%. Relative to 2012 H1, non-performing loan ratio for processing industry rose about 4.1 percentage points, for trade 3.7 percentage points and for construction 2.7 percentage points.

Outstanding foreign currency loans (when borrower's income is in lek) fell slightly by 0.8% to ALL 180.9 billion in 2012 H2, down to 31.3% of total outstanding loans and 48.5% of outstanding foreign currency loans.

By currency, about 84% of unhedged outstanding loans are denominated in euro and about 15.9% in U.S. dollar. At end-2012, the ratio of 'non-performing foreign currency loans (when the borrower is unhedged against exchange rate risk) to outstanding foreign currency loans (when the borrower is unhedged against exchange rate risk)' rose to 24.4%, up 0.8 percentage points from H1 and 5.3 percentage points from end-2011. By currency, U.S. dollar-denominated loans accounted for major share in the ratio of 'non-performing (euro, U.S. dollar) loans, when the borrower is unhedged against exchange rate risk, to (euro, U.S. dollar) outstanding loans, when the borrower is unhedged against exchange rate risk.[32]

[32] *More specifically, by currency, the same indicator in euro reached 24.1% in December 2012, from 22.8% in June 2012 and 20.4% in December 2011. Over the same period, the same indicator in U.S. dollar resulted 26.2%, from 24.7% in June 2012 and 11.1% in December 2011.*

Box 9 Distribution of banks by coverage ratios of non-performing loans by provisions

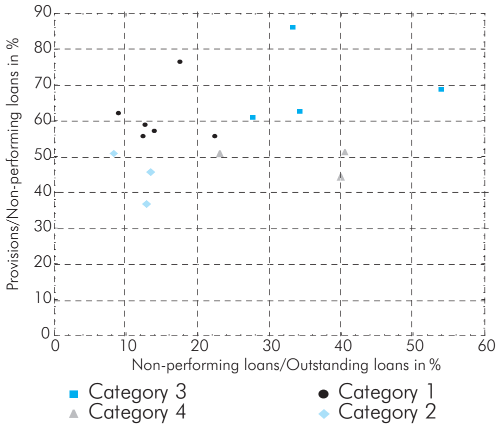
Banks' distribution map relating to the coverage of non-performing loans by provisions (see Chart 9.1) shows that most banks have coverage ratios above 50%. There are, however, a few banks with below 50% coverage ratio, hence standing below the system's average of 55%. The increasing provisions and the considerable collateral presence strengthen banking sector resilience to credit risk.

The combination of a high non-performing loan to outstanding loan ratio and low provision coverage may pose higher risk. This risk is shown graphically through banks under category 4, which includes three banks.

Chart 9.2 shows the point combination of 'non-performing loans/outstanding loans' and 'late loan payments[1]/outstanding loans' ratios for Albanian banks. As shown in the chart, banks are almost positioned on 45 degrees, indicating that most late payment loans are classified as non-performing loans, that is, they are more than 90 days past due. The third category includes banks most exposed to credit risk, that is, banks with a high non-performing loan ratio and higher share of late loan payments in outstanding loans.

On the other hand, the second category includes banks showing better results in terms of loan portfolio quality.

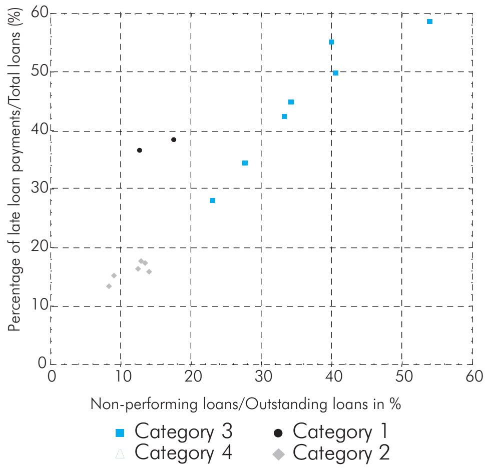
Chart 9.1 Non-performing loan provision coverage ratio for each bank in the system



Source: Financial Stability Department.

Note: The categorisation of point combinations for each bank takes into account the banking system's non-performing loan provision coverage ratio (55%) and non-performing loan ratio (22.5%).

Chart 9.2 Credit risk for each bank in the system



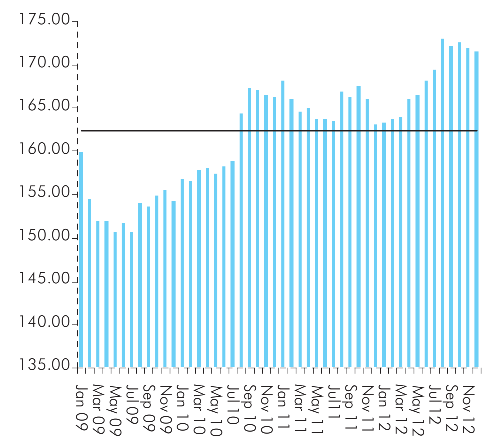
Source: Bank of Albania.

Note: The categorisation of point combinations for each bank takes into account the banking system's non-performing loan ratio (22.5%).

[1] *Late loan payments are loans not repaid on the loan instalment due date. The repayment of the loan a day later than the due date is also considered a late loan payment. Non-performing loans do not include late loan payments that are 1-90 days past due.*

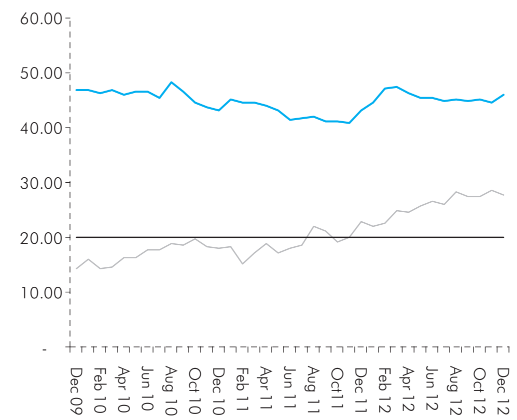
7.3 LIQUIDITY RISK

Chart 7.3.1 Loan-to-deposit ratio, in percent



Source: Bank of Albania.

Chart 7.3.2 Liquid assets to current liabilities by currency, in percent



Source: Bank of Albania.

Banking sector liquidity risk was moderate and the liquidity figures were stable. Deposits remained the main funding source and their growth rate was adequate. Banking sector liquid assets in lek and foreign currency stand above the minimum regulatory ratios. Asset-liability maturity mismatch narrowed further relative to the previous periods, being conducive to improved liquidity risk management.

The Albanian banking sector's activity is considerably funded through customer deposits, which cover the loan value by 1.7 times.

At end-2012, banks were liquid and observed the regulatory liquid assets to current liabilities ratio, in the three major currencies: lek, euro and U.S. dollar.[33] By currency, liquid assets to current liabilities ratio for the lek was estimated at 45.8%, from 43% at end-2011. The same ratio for foreign currency was estimated at 27.5%, from 22.8% at end-2011.

At end-2012, liquid assets accounted for 36.7% of total current liabilities and 29.4% of total assets, from 33.1% and 26.5% in 2011. The improved liquidity ratio was also evidenced in the banking groups by size and origin. G1 and G3 banks, and Italian banks, showed the highest liquidity ratio, while the Albanian group banks registered lower ratio. Table 7.3.1 shows the liquid assets to total assets ratio by banking groups.

Table 7.3.1 Liquidity ratio for banking groups, in percent

	Group 1	Group 2	Group 3	Italian group	French group	Greek group	Albanian group
December 2011	28.7	26.6	26.4	31.1	25.5	26.6	20.9
June 2012	29.5	27.2	29.5	35.2	26.4	29.6	21.3
December 2012	30.9	27.5	29.9	36.9	26.0	27.2	20.8

Source: Bank of Albania.

Though parent bank financing remains an important source for several banks, in December 2012, the lines of credit fell substantially on a year earlier. More specifically, at end-2012, these funds amounted to ALL 49

[33] Some amendments to Regulation 'On liquidity management' redefined some liquid asset items, raised the minimum liquid assets to current liabilities ratio to 25%, and separated the two ratios for the lek and foreign currency, whose minimum is set at 20%.

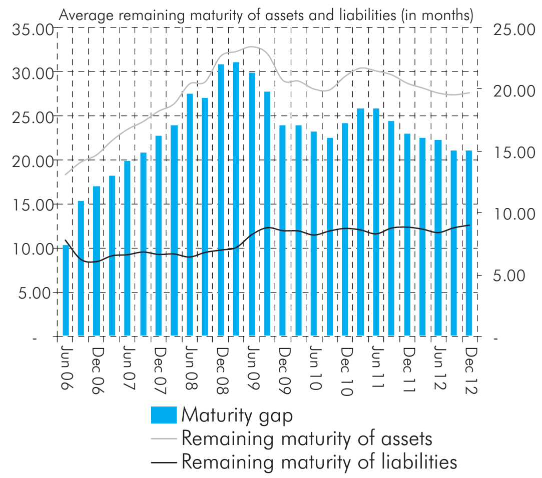
billion, from ALL 63.4 billion in December 2011. Overall, banking sector's liquidity remains at adequate levels.

The maturity gap between assets and liabilities narrowed further from 2012 H1 and end-2011, hence exposing less the banking sector to liquidity risk. This positive performance was attributable to the extension of deposits' remaining maturity following public's investment of savings in longer maturities.

At end-2012, banking sector assets had an average remaining maturity of 27.6 months, quite close to the previous half of the year and lower than at end-2011, estimated at 28.7 months. Banking sector liabilities had an average remaining maturity of 12.5 months, from 11.7 months in June 2012 and 12.3 months at end-December 2011.

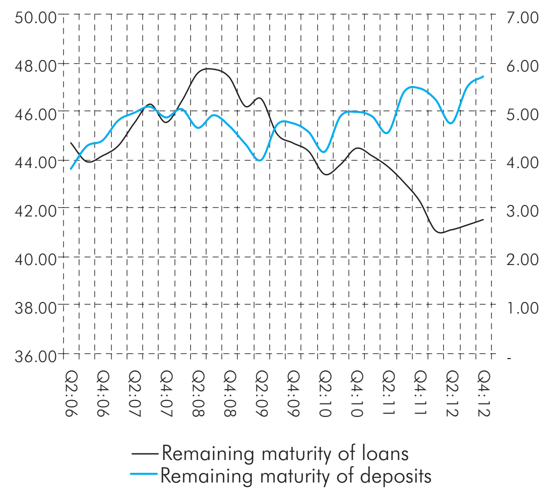
The maturity gap between assets and liabilities narrowed further to 15.1 months, from 15.9 months in June 2012 and 16.4 months at end-2011. This narrowing was mainly attributable to the extension of deposits' remaining maturity by about 0.97 months from 2012 H1 and 0.25 months from end-2011. On the other hand, loans' average remaining maturity was slightly extended from H1 to 41.5 months; however, it narrowed 0.76 months on a year earlier. In annual terms, the shorter loan remaining maturity implies banks' reluctance to grant longer maturity loans. Banks' reluctance, however, seems to have materialised in their decisions to extend fewer loans rather than extend shorter maturity loans.

Chart 7.3.3 Average remaining maturity of assets and liabilities, in months



Source: Bank of Albania.

Chart 7.3.4 Average remaining maturity of deposits and loans, in months



Source: Bank of Albania.

7.4 ASSESSMENT OF BANKING SECTOR'S RESILIENCE THROUGH STRESS-TESTING[34]

A forward-looking stress-testing analysis is conducted to assess the financial system stability and the banking sector's capital adequacy over a period of up to end-2014. Stress-testing exercise assesses the impact of macroeconomic situations on the banking sector's financial condition, excluding the possibility

[34] *Stress-testing does not represent a way of forecasting. Intentionally, the scenarios include adverse and extreme events, with a low probability of occurrence, to test banking sector resilience. Though banks are encouraged to assess their financial position capacity to withstand the impact of these scenarios, they should not regard them as events expected by the Bank of Albania. The 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 condition and resilience to risks.*

of an increase in paid-in capital during the period under review. In practice, the situation deteriorates gradually and banks have time to take appropriate measures by injecting capital. This analysis includes three scenarios: the baseline scenario and two adverse scenarios.[35]

The baseline scenario is built on the forecast of economic and financial indicators, generally based on their historical performance. The adverse scenarios assume a 'stressed' situation with a low probability of occurrence[36], based on two possible shocks on the Albanian economy:

a) halving of annual credit growth (which also implies an increase in market rates) from the previous period (A1 scenario);

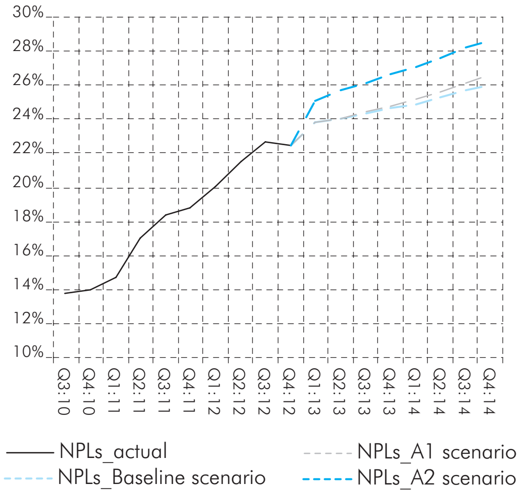
b) halving of annual credit growth and 10% depreciation of the Albanian lek (A2 scenario).

Table 7.4.1 Stress-test assumptions

	Baseline scenario		Adverse scenarios			
		A1 scenario		A2 scenario		
	2013	2014	2013	2014	2013	2014
	Value in average terms					
Annual GDP growth, in %	1.43	1.26	1.13	0.99	1.29	-0.1
Annual increase in market rates, in pp	0	0.5 pp	0.5 pp	1 pp	0.5 pp	1 pp
Lek's appreciation against both major currencies (Euro and U.S. dollar), in %	1.7	0	1.7	0	-10%	-10%
Projected annual growth of outstanding loans, in %	4	4	2	2	2	2

Source: Financial Stability Department assumptions and Research Department projections, Bank of Albania.

Chart 7.4.1 Actual and projected non-performing loan ratio



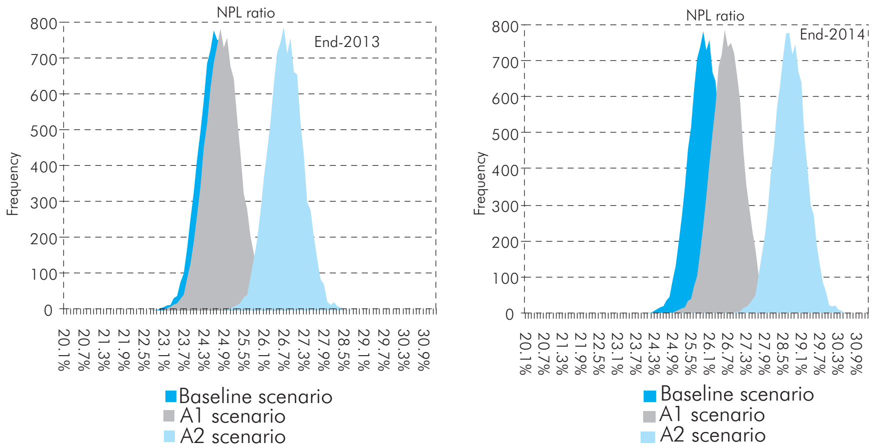
Source: Financial Stability Department.

Chart 7.4.1 shows projections for the loan portfolio quality at end-2013 and end-2014, under baseline and adverse scenarios.

[35] *These scenarios do not take into account the possible effect of central bank measures to boost lending, approved by the Supervisory Council on 27 March 2013.*

[36] *Research Department, Bank of Albania.*

Chart 7.4.2 Density distribution of non-performing loan ratio values for 2013 Q4 and 2014 Q4 using Monte Carlo simulations, under baseline and adverse scenarios



Source: Bank of Albania, Financial Stability Department.

Table 7.4.2 shows the impact of loan portfolio quality (besides other elements) on banking sector's capital ratios. The results are presented in terms of capital adequacy ratio for the banking sector as a whole and for individual banks, respectively at end-2013 and 2014.

Table 7.4.2 a) Stress-test results for end-2013

	Baseline scenario		A1 scenario		A2 scenario	
	Bank	Sector	Bank	Sector	Bank	Sector
Regulatory capital		Capitalised		Capitalised		Capitalised
Modest under-capitalisation 1/	Yes		Yes		Yes	
Severe under-capitalisation 2/	No		No		No	
Core capital (Core capital/Total risk-weighted assets)						
Modest under-capitalisation 3/	Yes	Capitalised	Yes	Capitalised	Yes	Capitalised
Severe under-capitalisation 4/	No		No		Yes	

1/ = Below 12%;
2/ = Below 6%;
3/ = Below 6%;
4/ = Below 3%;
Source: Financial Stability Department, Bank of Albania.

Table 7.4.2 b) Stress-test results for end-2014

	Baseline scenario		A1 scenario		A2 scenario	
	Bank	Sector	Bank	Sector	Bank	Sector
Regulatory capital		Capitalised		Capitalised		Capitalised
Modest under-capitalisation 1/	Yes		Yes		Yes	
Severe under-capitalisation 2/	No		No		Yes	
Core capital (Core capital/Total risk-weighted assets)						
Modest under-capitalisation 3/	Yes	Capitalised	Yes	Capitalised	Yes	Capitalised
Severe under-capitalisation 4/	Yes		Yes		Yes	

1/ = Below 12%;
2/ = Below 6%;
3/ = Below 6%;
4/ = Below 3%;
Source: Financial Stability Department, Bank of Albania.

Stress-test results show that, overall, the banking sector is resilient to assumed shocks. In all cases, for the assumed scenarios, the banking sector's capitalisation remains above the minimum requirement. However, for all scenarios, baseline and adverse, individual banks and the banking sector may need additional capital. In the face of pressures from international developments and unfavourable domestic economy, banks should cautiously monitor their activity to maintain adequate capitalisation levels.

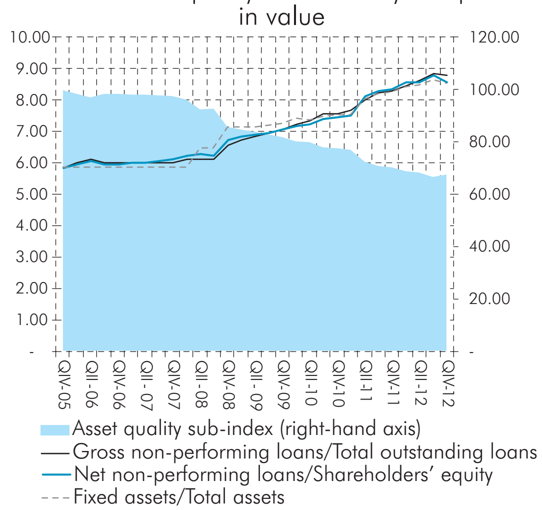
ANNEX 1. FINANCIAL STRENGTH INDEX[37]

FINANCIAL STRENGTH INDEX OF THE BANKING SECTOR

The banking sector showed positive results in terms of indicators measuring its financial soundness. This reflected in increased Financial Strength Index to 87.1 at end-2012, from 85.8 at end-2011. The positive index performance was affected by the combined effect of its sub-indices, more specifically: profitability, liquidity, capital adequacy, and lower exposure to interest rate risk. The other two sub-indices: loan portfolio quality and exposure to exchange rate risk contributed adversely to the aggregate Financial Strength Index.

The quality of banking sector assets continued to deteriorate in 2012, being reflected in the related sub-index performance, which fell to 67.6 from 70.4 in 2011. The three sub-index components increased in 2012, particularly the ratio of gross non-performing loans to outstanding loans, which rose to 22.5%, from 18.8% in 2011. Chart 1.1 shows the performance of standardised components and asset quality sub-index.

Chart 1.1 Asset quality sub-index by components, in value

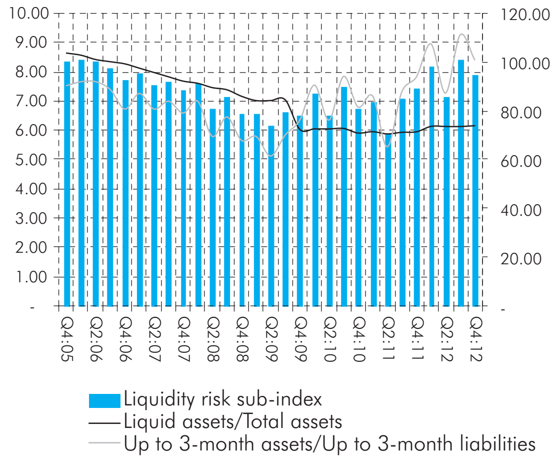


Source: Bank of Albania, Financial Stability Department estimates.

Liquidity sub-index, albeit downward at end-2012, registered a higher score from a year earlier, 94 from 88.6 in December 2011. The increase in the sub-index score was mostly driven by the ratio of assets with a maturity of up to 3 months to liabilities with a maturity of up to 3 months, which rose to 82%, from 77.2% in 2011.

[37] *The Bank of Albania calculates the Financial Strength Index as the weighted average of component indicators of banks' financial soundness. The index combines six areas of financial soundness indicators: asset quality, liquidity, profitability, exchange rate risk, capital adequacy and interest rate risk. The methodology for building the Financial Strength Index is presented in the Financial Stability Report 2010 H1.*

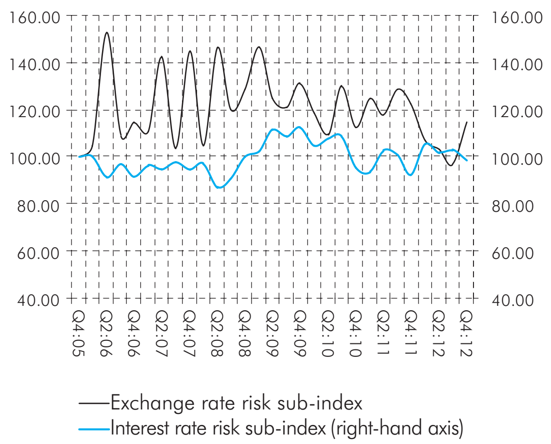
Chart 1.2 Liquidity sub-index by components, in value



Source: Bank of Albania, Financial Stability Department estimates.

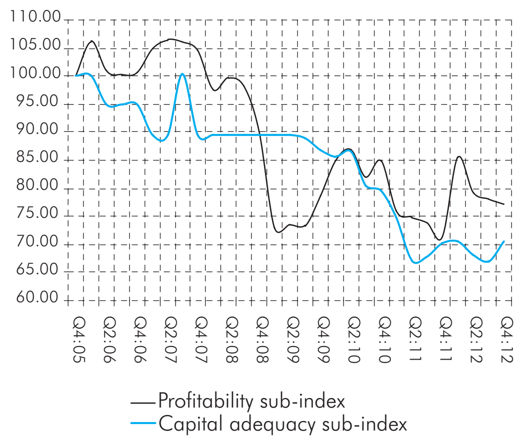
The sub-indices representing market risks[38] - exposure to interest rate risk and exchange rate movements - made opposite contributions to the aggregate financial strength index performance. More specifically, interest rate risk sub-index rose to 98.7 from 92.5 in 2011, due to the lower ratio of 'gap between up to 1-month assets and liabilities sensitive to the interest rate (in foreign currency) to shareholders' equity', thereby lowering banking sector exposure to interest rate risk. By contrast, exchange rate risk sub-index fell to 114.7, from 122.4 in 2011, due to the increased ratio of 'balance sheet items (excluding off-balance sheet items) to regulatory capital, which was estimated at 6.5% at end-2012, from 3.7% in 2011. However, overall, banking sector exposure to market risks remained at moderate levels.

Chart 1.3 Market risk sub-indices



Source: Bank of Albania, Financial Stability Department estimates.

Chart 1.4 Profitability and capital adequacy sub-indices



Source: Bank of Albania, Financial Stability Department estimates.

Profitability sub-index improved markedly during December 2011-December 2012 and registered a higher score. At end-2012, it rose to 77.1, from 71.2 in 2011. It, however, remains below the historical average[39] of 88.5. Profitability sub-index performance was determined by two major profit ratios 'net profit to total assets' and 'net profit to shareholders' equity', which rose to 0.32% and 3.7%, respectively, from 0.1% and 0.73% in 2011.

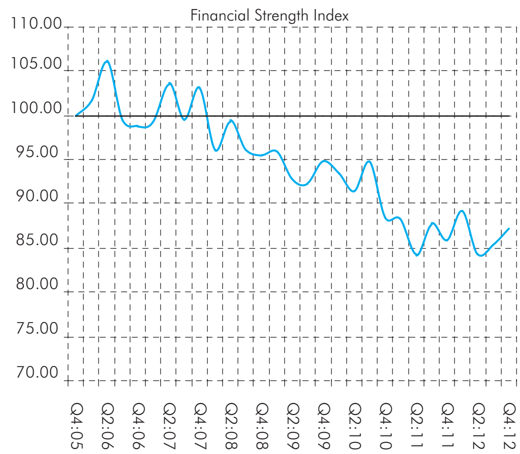
[38] *Both these sub-indices are calculated in inverse proportion. The methodology is elaborated in the Financial Stability Report 2010 H1.*

[39] *December 2005 - December 2012.*

Capital adequacy sub-index improved mainly due to the increase in banking sector's capitalisation to 16.2% at end-2012, from 15.5% in 2011. This sub-index rose slightly to 70.3, from 69.9 in 2011, remaining, however, below the historical average of 84.5.

The aggregate effect of the above sub-indices increased the Financial Strength Index to 87.1 in December 2012, from 85.8 in December 2011, hence providing evidence for an improved banking sector situation.

Chart 1.5 Financial Strength Index



Source: Bank of Albania, Financial Stability Department estimates.

Table 1.1 Financial strength sub-indices

Subindices	Asset quality	Liquidity risk	Exchange rate risk	Profitability	Captial adequacy	Interest rate risk	Financial strength index
Dec '05	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Mar '06	98.60	100.63	104.98	106.07	100.00	100.18	101.75
Jun '06	97.24	99.88	152.64	100.70	94.70	91.53	106.12
Sep '06	98.60	97.49	108.98	100.15	94.70	97.12	99.51
Dec '06	98.60	92.07	114.86	100.50	94.70	91.90	98.77
Mar '07	98.31	95.36	110.98	104.87	89.40	96.50	99.24
Jun '07	98.31	90.57	142.42	106.37	89.40	94.48	103.59
Sep '07	98.02	91.84	103.67	105.87	100.27	97.60	99.54
Dec '07	97.73	88.06	144.81	104.33	89.40	94.53	103.15
Mar '08	96.39	90.71	104.93	97.47	89.40	97.20	96.02
Jun '08	92.64	80.89	146.50	99.57	89.40	87.16	99.36
Sep '08	92.90	85.55	120.26	98.12	89.40	90.50	96.12
Dec '08	85.91	78.38	128.64	90.05	89.40	100.15	95.42
Mar '09	84.88	78.64	146.50	72.78	89.40	102.68	95.81
Jun '09	84.08	73.60	124.85	73.31	89.40	111.38	92.77
Sep '09	83.02	79.14	120.95	73.25	88.89	108.63	92.31
Dec '09	82.00	77.82	131.23	78.58	86.82	112.70	94.86
Mar '10	80.34	86.94	118.33	84.95	85.53	104.82	93.48
Jun '10	80.06	77.92	109.61	86.73	86.32	107.77	91.40
Sep '10	78.05	89.27	129.95	81.93	80.50	108.71	94.74
Dec '10	77.74	80.56	112.34	84.80	79.37	95.60	88.40
Mar '11	77.11	83.65	124.50	75.73	74.49	93.69	88.19
Jun '11	72.64	70.16	117.58	74.73	67.06	102.73	84.15
Sep '11	70.92	84.63	128.53	73.62	67.77	100.57	87.67
Dec '11	70.40	88.56	122.40	71.24	69.96	92.46	85.84
Mar '12	68.93	97.99	106.85	85.47	70.33	105.67	89.21
Jun '12	68.38	85.32	102.99	79.18	68.03	102.00	84.32
Sep '12	66.70	100.30	96.96	77.96	66.88	102.92	85.28
Dec '12	67.65	94.04	114.70	77.10	70.32	98.69	87.09

Source: Bank of Albania, Financial Stability Department estimates.

Table 1.2 Financial soundness ratios

In %	2007	2008	2009	2010	2011	2012
Capital-based ratios						
(i) Regulatory capital to risk-weighted assets	17.1	17.2	16.2	15.4	15.6	16.2
(ii) Core capital to risk-weighted assets	16.0	16.3	15.3	14.5	14.3	14.6
(iii) Shareholders' equity to total assets	7.6	8.6	9.6	9.4	8.7	8.6
Loan quality						
(iv) Non-performing loans net of provisions to regulatory capital	11.2	25.7	28.2	35.9	52.2	55.6
(v) Non-performing loans, gross, to outstanding loans	3.4	6.6	10.5	14.0	18.8	22.5
Profitability						
(vi) Annualised Return on Equity (RoE)	20.7	11.4	4.6	7.6	0.8	3.8
(vii) Annualised Return on Assets (RoA)	1.6	0.9	0.4	0.7	0.1	0.3
Market (exchange rate) risk						
(viii) Net open foreign exchange position to regulatory capital	1.7	4.3	3.9	5.0	3.9	4.0
(ix) Net open foreign exchange position to core capital	1.8	4.5	4.1	5.3	4.3	4.4
Banking sector liquidity						
(x) Liquid assets to total assets	49.8	42.8	27.6	25.9	26.5	29.4
(xi) Liquid assets to total current liabilities	55.6	104.7	32.6	30.6	33.1	36.7
(xii) Customer deposits to total loans	215.5	162.6	154.3	166.4	163.2	171.6

Source: Bank of Albania.

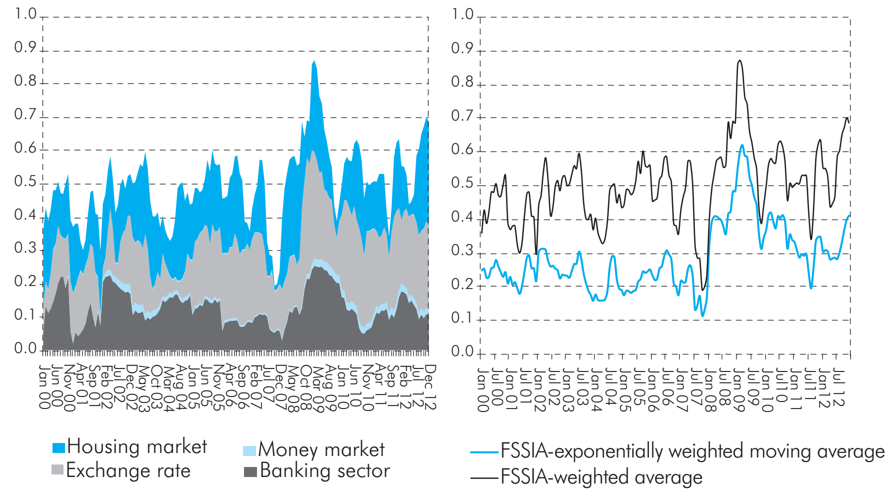
ANNEX 2. SYSTEMIC RISK IN ALBANIA

2.1 FINANCIAL SYSTEMIC STRESS INDEX FOR ALBANIA

The quantification and analysis of systemic risk[40] are important to macro-prudential decision-making, contributing to the identification and assessment of threats to financial stability.

The following presents the Financial Systemic Stress Index for Albania[41] (FSSIA), which measures the level of financial stress in Albania through information on different financial system segments, aggregated into a single index. The employed indicators, grouped into four sub-indices, represent the major financial system segments: banking sector, money market, foreign exchange market (exchange rate) and housing market. They also aim to provide different and complementary information on the level of financial stress in different market segments. These sub-indices are weighted to reflect their contribution to the financial system and economic activity in Albania.

Chart 2.1 Financial Systemic Stress Index for Albania



Source: Financial Stability Department.

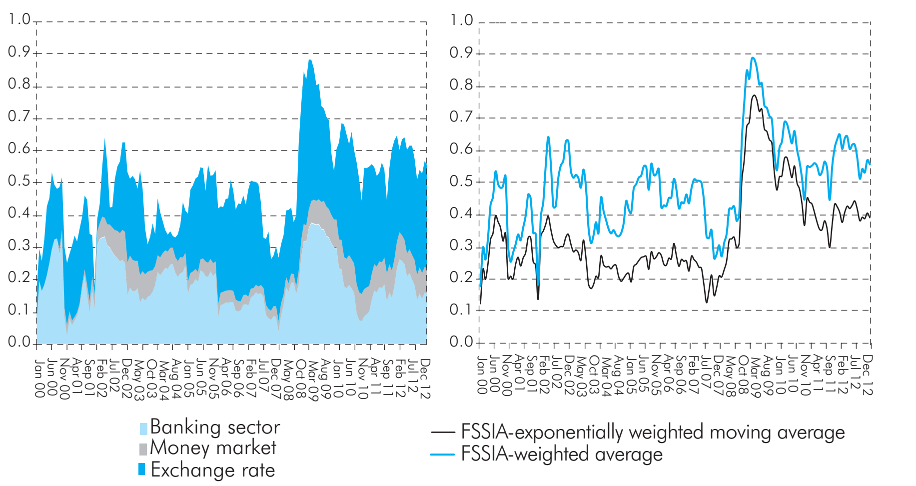
[40] *Systemic risk is the materialisation of shocks when financial instability becomes so widespread that it impairs the functioning of a financial system to the point where economic growth and welfare suffer materially (Hollo et al., 2011).*

[41] *For an elaborate description of the methodology used to construct the FSSIA, see 'A Financial Systemic 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.*

Chart 2.1 shows the FSSIA by contributions of each sub-index (left) to overall index, and by estimates of correlations (right), using relevant variance-covariance of each sub-index. This index distinguishes the main periods with a higher stress level. Besides the unprecedented spike in financial stress from late 2008 due to the financial crisis, end-2012 saw distinct levels of stress in the financial sector. The decelerated lending, (relative) exchange rate depreciation and lower house prices are considered factors augmenting financial stress in the economy, hence contributing to increasing the index score, particularly due to the interaction of these different financial system segments with one-another.

Though not part of the financial system, the inclusion of the house market in this index aims at assessing this market's direct exposure and vulnerability it poses to other financial system markets in Albania. Chart 2.2 shows the FSSIA if we exclude the house market.

Chart 2.2 Financial Systemic Stress Index excluding the House Market Sub-index



Source: Financial Stability Department.

If we include the house market, risk exposure appeared lower in 2012 H2 than in H1. The house market, therefore, adds pressure to financial stress due to its interaction with financial system segments. However, the banking sector and exchange rate remain major contributors to systemic risk, sharing a considerable weight in Albania's financial stress.

2.2 SYSTEMIC RISK SURVEY RESULTS

The quantification of banks' perceptions of risks that may potentially threaten banking sector operations is used by the Bank of Albania as an additional tool to assess the financial system stability. It also serves as a source of information to undertake macro prudential policies. Starting from March 2012, the Bank of Albania collects, on a quarterly basis, banks' perception of risks with potentially high impact on the financial system stability in the event of their materialisation.

The last survey was conducted in January 2013 and collects opinions on 2012 Q4 from all banks operating in the Albanian territory. After processing the information, it resulted that:

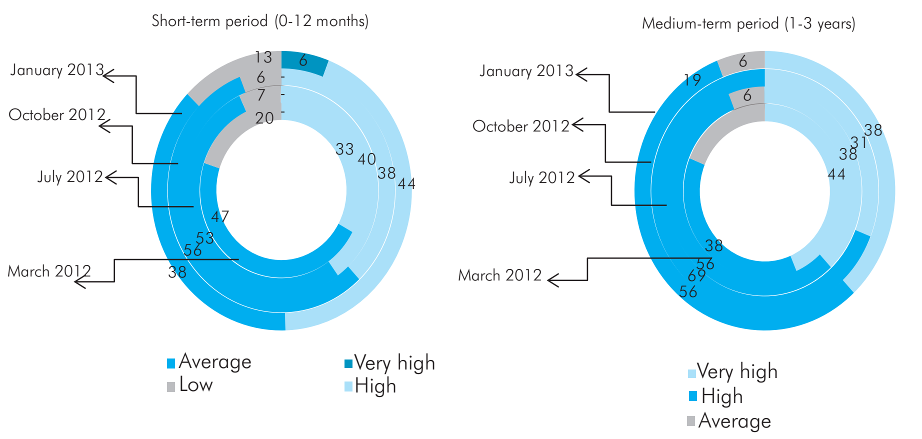
The top five systemic risks to the financial system in the event of their materialisation were: 1) Domestic economy deterioration; 2) Increase in business credit risk; 3) Transfer of shocks from the external economy; 4) Public debt unsustainability; and 5) Difficulties in collateral execution. Compared to the previous survey results, there are increasing concerns about 'business sector credit risk' and 'public debt unsustainability'.

The three least concerning systemic risks to the banking system, ranked by the frequency of their selection by banks, were: 1) Risk of domestic inflation; 2) Concerns relating to payment system operation; and 3) Concerns relating to interbank market operation.

The two most challenging systemic risks to manage at a bank-level are: 'Domestic economy deterioration' due to its vast and complex nature, and 'Difficulties in collateral execution', which, according to banks, relates to legal and regulatory deficiencies delaying the collateral execution process.

About 48% of banks perceive a high probability of occurrence of an important systemic risk in the short-term period (up to 12 months), a higher frequency than in the previous surveys. Concerning the medium-term period (1-3 years), banks' perception of the probability of a systemic risk occurrence is slightly mitigated, with 56% of banks considering it average.

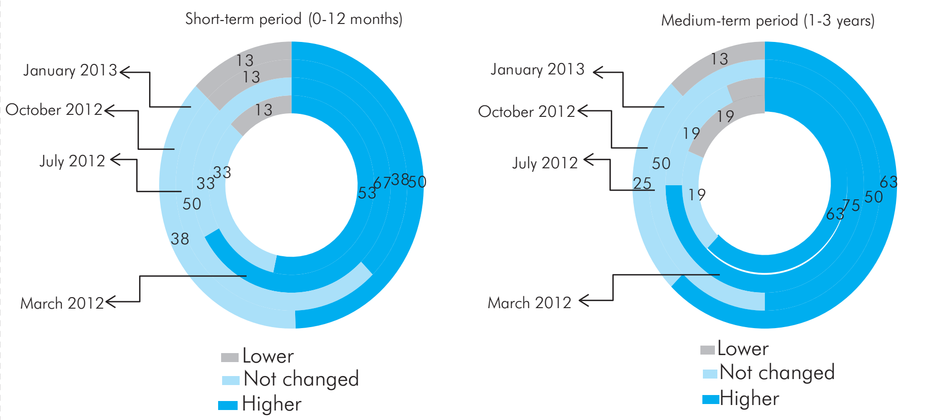
Chart 2.2.1 Probability of occurrence of an important systemic risk, in percent



Source: Bank of Albania, Financial Stability Department.

About 50% of banks think that the probability of occurrence of a systemic risk has increased in the short-term period of up to one year. It increases to 63% over a medium-term period of 1 to 3 years.

Chart 2.2.2 Change in the probability of occurrence of a systemic risk, in percent

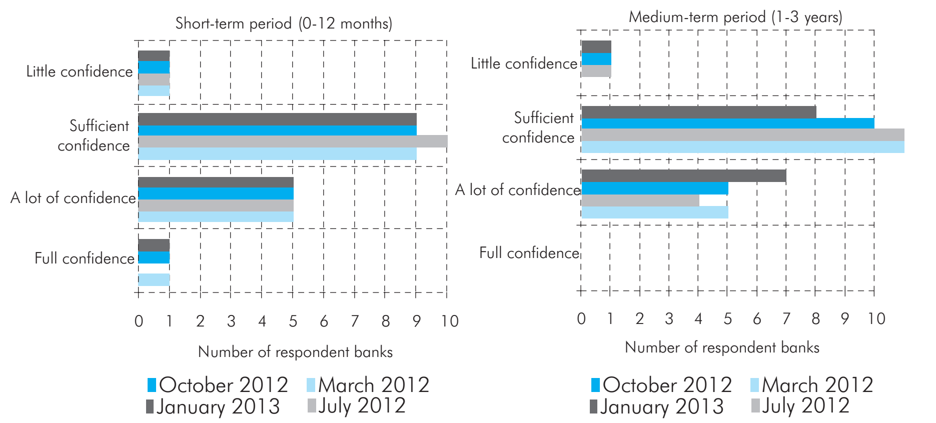


Source: Bank of Albania, Financial Stability Department.

Banks cite the following top strategies that help mitigate the systemic risk in the short-term period: 'strengthening of internal audit systems', 'tightening of lending standards' and 'reduction of exposure, particularly of foreign currency'. In the medium-term period, banks accentuate the need for longer-term strategies, such as 'diversification of activity; and 'orientation toward strategic sectors'.

Despite the increased perceived risks, most banks reported sufficient confidence in the Albanian financial system in the short- and medium-term period. In January 2013 survey, 15 (holding 94% of total banking sector assets) out of 16 respondent banks reported confidence levels ranging from 'full confidence' to 'sufficient confidence' in the short-term period.

Chart 2.2.3 Banks' confidence in the Albanian financial system



Source: Bank of Albania, Financial Stability Department.

The perception is similar for the medium-term period, with 15 (holding 89.3% of banking sector assets) out of 16 respondent banks reporting 'full confidence' and 'sufficient confidence'.

When respondent banks were asked to determine the change in the level of confidence in the domestic financial system over the past six months (having December 2012 as the reference month), 15 out of 16 respondent banks reported that their confidence level had not changed as the system remained well capitalised and liquid. Only one bank reported lower confidence in the financial system.

GLOSSARY

Adverse scenario – A stress-testing scenario, which assumes a 'stressed' situation with a low probability of occurrence, based on possible shocks on domestic economy (such as further deceleration in lending, increase in market rates and depreciation of domestic currency).

Aggregate demand – The total amount of goods and services demanded in the economy at a given overall price level and in a given time period.

AIPS and AECH systems – Two interbank payment systems under the ownership of and operated by the Bank of Albania: the real-time gross settlement system (AIPS) and the Albanian electronic clearing house system (AECH). The AIPS processes all lek interbank payments exceeding ALL 1.5 million. The AECH is a clearing system for payments lower than ALL 1.5 million.

Assets of non-resident institutions – Liabilities in a bank's balance sheet owned by non-resident institutions.

Average wage – The ratio of gross wages to the number of employed people.

Balance of Payments – An accounting record of all monetary transactions between a country and the rest of the world. It consists of the current account, capital account and financial account.

Bank loan classification – A methodology used by banks to classify loans into five categories based on the borrower's solvency, in order to provide for their provisioning.

Banking group – An international banking group operating in Albania.

Basel III – An international regulatory framework for a financial institution's capital adequacy, which replaces Basel II in this area. Compared to Basel II, Basel III strengthens capital requirements and also provides for a bank's liquidity management. This framework will be implemented on a gradual basis until 2019.

Bond – A long-term financial instrument (over one year) guaranteed by the issuing government/institution.

Businesses' debtor position – The difference between business deposits and loans in the system. If the difference is negative, businesses are debtors to the system.

Capital Adequacy Ratio – The ratio of regulatory capital and risk-weighted assets, expressed as a percentage. This ratio should not fall below 12%.

Capital markets – Markets where individuals and institutions trade financial instruments to raise funds. Consequently, these markets consist of the primary and secondary market.

Consumer Confidence Index – An indicator designed to measure through surveys consumers' willingness to spend.

Consumer loan – An amount of money lent to an individual for consumption purposes.

Core capital – An indicator consisting of some bank's balance sheet items, such as subscribed capital, reserves and retained earnings. From the regulator's point of view, it is considered the key indicator for a bank's financial strength.

Credit risk – The risk of borrower's failure to repay a loan, which impacts a bank's capital negatively.

Current expenditure – A category of public balance expenditure on goods and services consumed within the current year. Current expenditure includes personnel expenditure, interests, operating and maintenance expenditure, subsidies, other social expenditure, etc.

Easing monetary policy action – A central bank's policy to keep the interest rates low and control money supply. The lower the market rates, the less is the public encouraged to save, hence contributing to an increase in consumption. Conversely, a more attractive borrowing increases investments. An increase in consumption and investments contributes to a country's economic growth.

Financial intermediation – The process of channelling funds between surplus and deficit agents.

Fiscal stimulus – A government measure consisting of an increase in public spending and reduction in the level of taxation in order to encourage and support economic growth.

GDP (Gross Domestic Product) – The value of all goods and services produced in a country to be used for consumption, exports and investments during a period, usually a year or a quarter.

Gross written premium for voluntary/compulsory insurance – The total premium written and assumed by an insurer before deductions for reinsurance and ceding commissions.

Herfindahl Index (HHI) – A commonly accepted measure of market concentration. The index values range from 0 to 1, with 0 indicating lower concentration and 1 maximum concentration of operators in the activity being measured. A HHI index below 0.01 indicates a highly competitive environment; below 0.15 indicates an unconcentrated index; between 0.15-0.25 indicates moderate concentration; and above 0.25 indicates high concentration.

Households' creditor position – The difference between household deposits and loans in the system. If the difference is positive, households are creditors to the financial system.

Indemnity – The sum paid for a financial or non-financial loss, under an insurance contract, upon the occurrence of an insured event.

Indirect credit risk – The risk a bank is exposed to due to lending in a currency other than the borrower's source of income to repay the loan.

Insurance – The transfer of an eventual risk, financial loss or material damage from the insured to the insurer in accordance with an insurance contract.

Insurance company – A legal person with its seat in the territory of the Republic of Albania, licensed to carry out insurance activity.

Insurance premium – The amount paid immediately or periodically by the insured to the insurer or a person acting on his behalf, in order to insure him from a risk determined in the insurance or reinsurance contract.

Interbank market – A market in which banks and financial institutions trade financial instruments or currencies.

Investment fund – An institution financed through the capital of many investors, which uses these funds for collective purchases of securities, with each investor holding the share of his individual investment.

Leverage – The amount of debt used to finance an institution's assets.

Line of Credit – An arrangement between a financial institution, usually a bank, and a customer that establishes a maximum loan balance that the bank will permit the borrower to maintain. The borrower can draw down on the line of credit at any time, as long as he or she does not exceed the maximum set in the agreement.

Liquidity – A measure of the extent to which an institution meets its short–term obligations. It can also describe the speed with which an asset can be turned into cash.

Liquidity risk – The risk of failure to meet obligations due to lack of liquidity.

Loan unhedged against exchange rate risk – Loan extended in a currency other than the borrower's source of income that will serve to repay the loan.

Loan use ratio – The ratio of collected loans to extended loans.

Macro prudential policy – A package of measures to identify, monitor and prevent risks threatening financial system stability.

Market risk – The risk that an unfavourable move in financial markets, such as change in interest rates, exchange rates and prices of financial instruments, will generate losses.

Mortgage loan – An amount of money lent to an individual to finance the purchase of real estate.

Net exports – The value of a country's total exports minus the value of its total imports. It is used to calculate a country's GDP.

Nominal Effective Exchange Rate (NEER) – The weighted average value of a country's currency relative to all major currencies being traded within an index or pool of currencies. The weights are determined by the importance a home country places on all other currencies traded within the pool, as measured by the balance of trade.

Non-bank financial institution – An institution licensed by the Bank of Albania to conduct some lending operations, but not allowed to take deposits from the public.

Non-performing loan (loan quality/credit risk) – A loan with a high probability of default.

Operating expenses – A category of expenditure in a bank's financial statements incurring as a result of bank's normal business operations. Operating expenses include personnel expenditure, amortisation of equipment, other operating expenses, etc.

Operating income – A category of income in a bank's financial statements that result from the bank's normal business operations. Operating income includes net interest income, net income from commissions and banking services, other operating income, etc.

Owner's equity – The residual interest in the assets of a bank that remains after deducting its liabilities.

Pension fund member – A natural person, on behalf and on account of whom has been opened a pension account in the pension fund, and is entitled to benefit from this pension fund in the future, under the pension fund contract with the managing company.

Placements with non-resident institutions – A bank's balance sheet assets held with institutions that are not residents in the territory of the Republic of Albania.

Primary market (issuing government debt securities) – A market where investors purchase newly-issued financial instruments.

Private supplementary pension – A group of assets in the ownership of pension fund members.

Profitability/Net Interest Margin – Interest income generated from lending minus interest payments, such as deposits.

Real Effective Exchange Rate (REER) –The weighted average of a country's currency relative to an index or basket of other major currencies adjusted for the effects of inflation. The weights are determined by the importance a home country places on all other currencies traded within the pool, as measured by the balance of trade.

Regulatory capital – It consists of core capital, supplementary capital and a number of other balance sheet items' calculations. It is used to measure a bank's capital adequacy ratio.

Repo rate – The rate at which a central bank repurchases government securities from the commercial banks, depending on the level of money supply it decides to maintain in the country's monetary system.

Risk premium – Marginal return on the risk-free rate of a financial instrument.

Risk-weighted assets – A bank's assets bearing market, operational or credit risks according to regulations on capital adequacy.

Risky asset – Any financial instrument being assigned other than zero risk.

RoA – Return on Assets measures a company's profit in relation to the value of its asset.

RoE – Return on Equity measures the return generated on stockholders'/shareholders' equity.

Savings and loan association – A legal person consisting of voluntary unions of individuals, legal or natural persons, who deposit their money in the association for the latter to make loans to the association members.

Secondary market – A market where investors purchase financial instruments from other investors, rather than from issuing companies themselves.

Solvency – A borrower's ability to meet its financial obligations.

Spread – The difference between two interest rates in a financial market.

Stress-testing – An analysis of scenarios to assess a bank's resilience to adverse and unexpected events.

Systemic importance – The situation of a market player, part of financial infrastructure, whose failure may trigger severe consequences for the entire financial system, with high costs for the society.

Systemic risk – The materialisation 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).

Technical reserves for insurance companies – The amounts insurance companies set aside from profits to cover possible claims.

Term to maturity – The remaining life of a financial instrument.

Trade deficit – An economic measure of a negative balance of trade in which a country's imports exceed its exports. A trade deficit represents an outflow of domestic currency to foreign markets.

Treasury bills – A short-term financial instrument guaranteed by the issuing government.

Under capitalisation – A situation when a company does not have sufficient capital to conduct normal business operations.

Yield – The rate of return on an investment, expressed as a percentage.